BREAKING THE MOLD

BEYOND THE STANDARD VENTURE CAPITAL AND PRIVATE EQUITY MODELS

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CONTENTS

Definitions

AUM Assets under management
BDSP Business development service providers
Development Investors Donors, DFIs, and other development-motivated investors
DFI Development finance institution
Identified Fund Managers Private market fund managers focused on Target SMEs
IFC International Finance Corporation
MFI Microfinance institution
NBFI Non-bank financial institution
PCV Permanent capital vehicle
PD Private debt
PE Private equity
SME Small and medium-sized enterprise
SOE State-owned enterprise
TA Technical assistance
Target SMEs SMEs operating in frontier and/or emerging markets
VC Venture capital

EXECUTIVE SUMMARY

POINT OF DEPARTURE

A few years ago, in East Africa, the authors met a group of local business people. Having worked in Europe erecting mobile masts for telecommunications operators, these entrepreneurs had returned to Africa to make their sought-after skills available at a time when frontier market mobile communications were leapfrogging fixed-line technology. The business they set up succeeded in winning a large contract to install base stations and masts for a multinational mobile network operator. They required approximately $3 million to finance the working capital cycle of the project, but despite many attempts they were unable to raise the capital from any source. Ultimately, they lost the contract to a foreign competitor that utilized foreign staff and extracted the profits from the local economy.

This anecdote illustrates the challenges faced by so many small and medium-sized enterprises (SMEs) in frontier and emerging markets—a group we refer to in this paper as Target SMEs. In many emerging countries, the capital markets are nascent and borrowing by government and state-owned enterprises crowds out private entities and disincentivizes banks from lending to the real economy. The funding gap is enormous. The IFC estimates that nearly 30 million SMEs face an aggregate funding gap of more than $4 trillion.[1] In their research on private credit solutions in emerging markets, EMPEA identified only $57 billion in capital raised since 2006—less than 2 percent of that gap.[2]

At the same time, commercial investors from developed markets show an increasing appetite for private investment vehicles in frontier and emerging markets. In addition, impact-oriented investors, such as donors and development finance institutions (DFIs), seek to support Target SMEs because they promote inclusive and sustainable growth, provide employment, foster innovation, reduce income inequalities, and generally contribute to achieving the Sustainable Development Goals (SDGs).[3]

Clearly, there is some kind of bottleneck between these willing investors and the Target SMEs thirsty for their capital. Private market fund managers focused on Target SMEs are often seen as the primary conduit for this capital. Yet few such managers have been able to meet investor expectations and make the model profitable. In interviews, they diagnose the problem as a complex one involving fund manager economics, cashflow timing, fund mandates, investor expectations, and investment instruments. Given the existing fund management models, the question is: can we "break the mold"?

Accordingly, our research aims to:

- Identify alternative models that could break the mold of traditional fund management and unlock appropriate levels of finance for Target SMEs;
- Analyze what alternative models have worked and why; and
- Determine the remaining challenges.

Methodology
There is surprisingly little research specific to the challenge of investing in Target SMEs.[4] Much of the existing research addresses only isolated elements of our research objective. Some papers restrict themselves to looking at private markets in a particular geography or niche area. Others highlight certain changes in the model, instrument, mandate, or fund structure as potential solutions to deploying smaller "cheque sizes."

We therefore supplemented our secondary source review with interviews of 20 fund managers, investors, and advisors active in the SME investment ecosystem. Their insights proved particularly valuable, and we cluster them in three categories: **What IS NOT Working, What IS Working, and What MIGHT Work,** the latter being the interviewees' recommendations on changes that would enhance their ability to execute smaller deals.

WHAT IS NOT WORKING?

Spend/Earn Mismatch. One hundred percent of the interview respondents feel that resourcing is the main impediment to deploying smaller cheque sizes. More than 80 percent of the interviewees questioned the economic viability of investing in SMEs, based on prevailing fee levels in the market. Questioned further, interviewees highlighted the interplay between resourcing, costs, the timing of investments, and the consequent mismatch in fund management economics. Smaller and first-time fund managers especially struggle with the disconnect between the upfront period—with the highest resource requirements and costs—and the later stages when capital is raised, assets deployed, and fees earned. While certain Development Investors have introduced technical assistance to ameliorate this situation, this assistance has been largely focused on transaction facilitation and has not sufficiently addressed the timing mismatch of fund managers' cashflows.

Inflexible Mandates. The interviewees mentioned rigid, single-asset-class mandates as an obstacle to deploying smaller investments, with 25 percent of them prioritizing it as the major factor. While most existing funds emphasize equity, many industry players believe debt is better suited to meet Target SME needs.[5]

Fund Structure. The third-ranked impediment, cited by 50 percent of respondents and prioritized by just under 20 percent, was the inappropriateness of traditional fund structures—that is the closed-ended, limited liability partnership with a life of 10 years—when it comes to Target SME investing. Funds with fixed term fund lives can lead to forced exits at a time when the SME lacks liquidity and the investor must accept a lower, undervalued, sale price. This ultimately damages investor returns.

Risk-Reward. The fourth-ranked impediment, for 9 percent of respondents, was fund managers' and Development Investors' perception that the risks inherent in Target SME investing are high while the returns are low, a combination that deters fund managers from focusing on Target SMEs.

WHAT IS WORKING?

Flexible Investment Mandates. All interviewees agreed that flexible mandates, which allow fund managers to invest in a range of private market instruments, contribute to the successful deployment of smaller investments. Thirty percent of them deem such flexibility the most important success factor. Fund managers that can invest beyond private equity and venture capital to include mezzanine finance and private debt instruments in the same fund had more success closing smaller deals in Target SMEs.

Non-bank financial institutions (NBFIs). Twenty-six percent of interviewee comments related to fund managers investing into NBFIs, or fund managers who changed their business model from third party fund management to direct lenders and financiers, effectively becoming NBFIs themselves. Successful fund managers are effectively partnering with, or outsourcing to, specialist lenders who each operate in a particular frontier market or financial niche.

Other. The interviewees also mentioned other concepts that they perceived to facilitate smaller investments into the SME ecosystem: a) operational leverage from being a part of a large asset management group or a service provider (e.g. outsourced CFO or accounting platforms); b) the use of linked life policies (the practice in many of the Commonwealth countries of using an insurance license to link the performance of an investment to an underlying asset or pool of assets); and c) the use of blended finance in the capital structure of the funds that are investing in SMEs.

WHAT MIGHT WORK?

Data. Relatively few of the deals considered are actually concluded, thanks largely to the poor quality of information available to fund managers, in particular financial information. This paucity of data elevates costs, lengthens due diligence periods, and increases the resources required to originate a large number of small deals. However, in the course of their business, NBFIs and other business development service providers to Target SMEs gather extensive data on these businesses, which makes them ideal origination and monitoring partners for fund managers.

Flexible Mandates and Structures. Deals should be "sculpted" around SMEs' cashflows. This favorable structuring can be achieved by investing in combinations of private equity, private debt, and mezzanine finance instruments such as convertible notes, revenue-sharing instruments, or phantom equity. These investment instruments often require longer-term investment horizons requiring evergreen or permanent capital vehicle structures. Longer-term investment horizons solve several issues, including the perverse incentives to deploy capital too quickly, forcibly exiting deals at the wrong time, and the inability to scale deals over time.

Bridging the Spend-Earn Mismatch. Fund manager interviewees see technical assistance that bridges the timing mismatch between income and expenses in the early years as a significant deal enabler, particularly for first-time managers. Among the solutions they suggest:

- Mirror the model of many NBFIs in the SME space by charging for other services they provide to SMEs—such as investment readiness, financial data collation, and/or outsourced CFO functions—thereby compensating for search and due diligence costs. Fee structures and fee levels for fund managers need to be reconsidered given the high costs inherent in responsibly originating and managing a portfolio of Target SMEs.

- Bridge the cashflows of the fund managers by carving out a small portion of investable funds to invest in the fund manager. The Development Investor's returns would then be a mezzanine-style hybrid of the returns from its investment in the fund (managed by the fund manager) and from its equity (or other instrument) in the fund manager.

Coordinate Investors. Most interviewees proposed a concerted effort to educate Development Investors, seeing a need to better align the expectations of Development Investors with fund managers and Target SMES. The Development Investor interface with fund managers, and with the broader SME ecosystem, is widely seen as requiring better coordination and communication.

Other. Innovations and interventions recommended by interviewees also included: a) the standardization of investment processes and templates, including the application of fintech solutions; b) blended finance capital structures with first-loss or other catalytic capital tiers; c) the use of life policy structures to create hybrid liquidity; d) open-ended, or evergreen, fund characteristics for private markets portfolios; e) revenue-sharing instruments; and f) the use of a platform based approach rather than the traditional fund model for developing a pipeline of SME private market investments.

CONCLUSION

It would have been ideal to identify a single solution to break the mold of traditional private equity and venture capital models that have not had great success in channeling capital from Development Investors to Target SMEs. But this silver bullet does not exist.

Nonetheless, in aggregate, our research suggests a model of an asset management business that could provide Development Investors with a sustainable solution to invest in Target SMEs. Specifically, fund managers should adopt a three-pronged approach:

1. Use a portion of their portfolio to partner with domestic and regional NBFIs, which are close to the data and afford access to the missing middle. This approach allows a reasonably quick deployment of capital, thus creating a base level of assets under management on which to charge management fees.

2. Partner with business development service providers, possibly assisting them to create data-driven solutions. Successful partnerships will shorten the origination cycle, increase deal flow, and ultimately improve the probability of success.

3. Use the sculpted cashflow model to engage with larger SMEs ($3-5 million transactions), likely found in domestic industrial and technology sectors. Many of these firms are likely to be family-owned businesses.

This approach could be enhanced and enabled by working with Development Investors on the following initiatives:

- A flexible mandate that includes private equity, venture capital, private debt, mezzanine finance, convertibles, and phantom equity.

- An evergreen fund structure that allows the fund to scale up its investment as the Target SME grows, rather than a one-off investment over a short investment period.

- A willingness on behalf of the seed Development Investors to consider investing in the fund manager to bridge a portion of the funding required for its working capital requirements in the early years of its business cycle.

- A blended finance liability stack for the fund managers that allows the crowding in of commercial investors at an early stage.

To make a composite solution like this implementable, the mold that requires breaking most urgently is the fixed mindset of the participants in the Target SME financing ecosystem. Absent an ability to embrace innovative fund terms and structures—and partner with fund managers to de-risk their businesses—we will continue to grapple with the challenge of driving capital at scale to promising opportunities.

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[1] IFC, MSME Finance Gap Database.
[2] Private Credit Solutions: A Closer Look at the Opportunity in Emerging Markets, EMPEA, 2019
[3] "Enhancing the Contributions of SMEs in a Global and Digitalised Economy" - OECD, June 2017
[4] Please refer to Annex 2 for the list of articles considered.
[5] Private Credit Solutions: A Closer Look at the Opportunity in Emerging Markets, EMPEA, 2019

CONTEXT

TARGET SME FINANCING

There is broad consensus amongst academics and practitioners regarding the impact and importance of small and medium-sized enterprises, particularly SMEs in frontier and emerging markets—a group we refer to in this paper as Target SMEs.

This paper will not attempt to enter the wider debate around the definition of SMEs. The metrics vary widely by region and country, and each participant in the Target SME financing ecosystem has its own metric. Some definitions rely on number of employees; others look at assets or turnover. For the purposes of this paper, we assume that a deal size between $1 million and $5 million is a suitable proxy for smaller investment transactions into Target SMEs by venture capital and private equity firms. (An investment size of approximately 30 percent of the value of the SME, defined by the IFC[6] as businesses with assets and revenues of $100,000 to $15 million, with 10 to 300 staff, is in line with this deal range.)

Development Investors have identified Target SME investment as offering attractive risk/return dynamics. According to the 2019 EMPEA Global Limited Partners Survey, 81 percent of emerging market private equity investors "reported they currently invest or plan to invest in middle-market opportunities."[7] And it is not just private equity investors. EMPEA reported that private debt investors are "increasingly interested in [emerging market] private credit [acknowledging that] emerging economies represent a vast and scalable market with attractive growth rates."[8]

Development Investors emphasize the importance of achieving the Sustainable Development Goals and recognize the prospect of achieving some SDGs through investment in Target SMEs.[9] Certain Development Investors acknowledge that without the growth, employment, industrialization, and innovation engendered by Target SMEs, frontier and emerging market ecosystems will continue to deteriorate and—among other consequences—the immigration crisis facing developed market economies will intensify. "SME development can contribute to economic diversification and resilience," reports the OECD. "This is especially relevant for resource-rich countries that are particularly vulnerable to commodity price fluctuations."[10]

In this research, we assume the need and demand from Target SMEs for investments in the $1 million to $5 million range. There is more than sufficient evidence—anecdotal and academic, and further substantiated through our interview process—to suggest that this is the case. The *Financial Times* recently reported[11] that, according to the World Bank, "there is an unmet demand for $1.2 trillion from formal SMEs in developing countries, and another $1 trillion from informal enterprises. SMEs requiring between $100,000 and $2m in capital fall into the 'missing middle:' too big for microfinance initiatives but too small for commercial banks."

Target SMEs often cite access to capital as the greatest impediment to growth, sometimes even survival. In many frontier and emerging markets, the capital markets are nascent and borrowing by government and state-owned enterprises crowds out private entities and disincentivizes banks from lending to the real economy. In 2013, the IFC highlighted these persistent challenges,[12] stating that "the ability of SMEs to spur growth and foster job creation is limited by their ability to find adequate finance," as evidenced in the IFC graph below (Figure 1). This view was corroborated by the interviewees for this research. The bottom line: in most frontier and emerging markets, a well-functioning SME lending market does not exist, and SME growth is prejudiced.

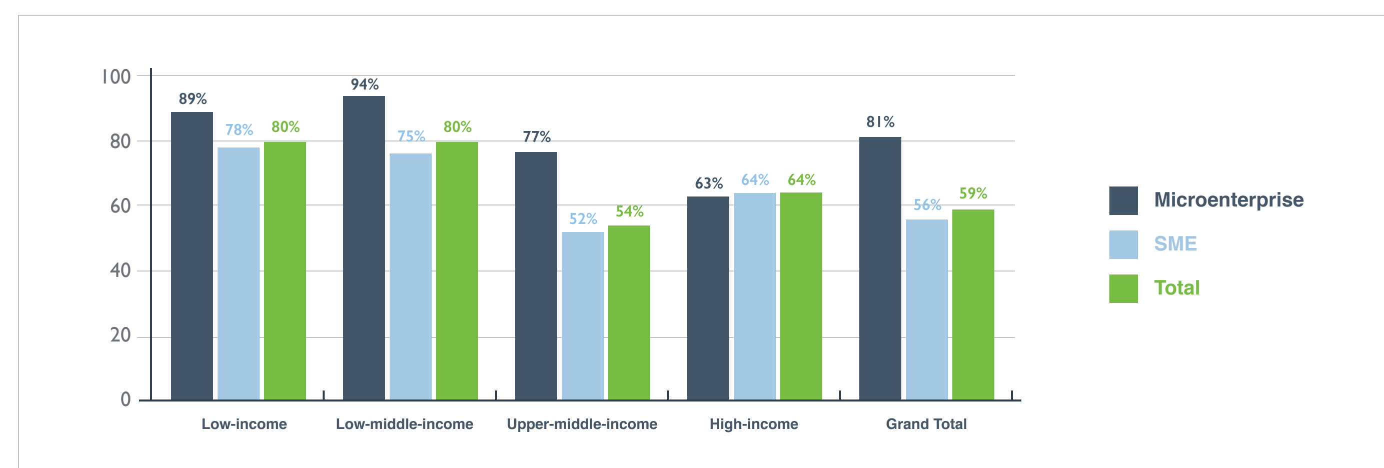

FIGURE 1: Finance Gap as Percentage of Potential Demand

RESEARCH OBJECTIVE

Despite the increased appetite from Development Investors for venture capital and private equity funds focusing on Target SMEs, these investors have not been able to identify many fund managers who have been able to sustainably deploy capital in smaller transaction sizes (using an average of $3 million as a proxy).

This research set out to:

- Identify alternative models that are breaking the mold of traditional fund management and thereby unlocking appropriate levels of finance for Target SMEs;
- Analyze what alternative models have worked, and why; and
- Identify remaining challenges.

The research specifically sought to better understand why Development Investor capital is not being invested in Target SME transactions.

Cost structures and traditional fund management models tend to incentivize investment in larger deals through bigger funds. More than 25 percent of interviewees corroborated this observation. Using similar financial benchmarks for asset manager costs and profitability, fund managers illustrated the pitfalls of launching and managing private markets funds or investment businesses that are focused on smaller cheque sizes.

The economic analysis to the right applies composite cost and profitability benchmarks provided by fund managers interviewed. A typical 10-year fund manager financial model is used to demonstrate how the additional upfront costs of managing an SME fund may discourage fund managers despite the possibility of a higher internal rate of return. The point of departure is $100 million in assets under management (AUM), commonly used as the minimum AUM needed for a fund management business to be viable. The setup cost is estimated at $500,000 and salary costs are approximated to allow each analyst to review 30 deals, within the first three years. The average deal size is $3 million with 20 deals screened for every deal closed. Profitability assumptions are based on a standard 2 percent management fee, 20 percent performance fee and an 8 percent hurdle rate.

The model projects that a fund manager can earn a reasonable premium of 18 percent, roughly 3.4 percent per annum over the fund's internal rate of return to its direct investors. Assuming the fund exceeds its hurdle rate, the limited partners compensate the general partner (fund manager) with carried interest for taking higher risks and actively managing the fund. The longer-term premium earned by the fund manager may seem to incentivize high risk, high return, SME investments but it hides the fact that smaller deal sizes, and the larger number of deals required, necessitates significantly more staff and incur higher costs. A first-time fund manager may incur losses for a longer period of time compared to a fund where the general partner can deploy capital quicker through larger deals requiring fewer analysts. In the model, this is illustrated by negative average profits in years one through nine and a later breakeven in year seven.

TABLE 1: Fund Manager Economic Analysis

Fund Manager Economics	
Average Revenue (Years 1-9)	1 911 225,25
Average Cost (Years 1-9)	(2 394 166,67)
Average Profit (Years 1-9)	(482 941,42)
Initial Staff Req.	2
Max Staff Compliment	19
Total Financing Req.	(2 475 000,00)
Breakeven	Year 7
Final Fund Manager IRR	18,07%
Investor Net Return	14,63%
Assumptions	
Capital Committed	100,000,000.00
Time to raise capital (Years)	2
Fund Term (Years)	10
Time to deploy capital (Years)	3
Capital Redeployment Period (Years)	4
Wind down period	3
Setup Cost	500,000.00
Management Fee	2%
Performance Fee	20%
Hurdle Rate	8%
Average Deal Size	3,000,000.00
Deal Churn in redeployment	30%
Deal Sceened / Invested Ratio	20
Deals reviewed per staff member	30
Ratio Inv Analysts: Inv Prof	4 : 1
Investment prof salary (USD)	120,000.00
Investment analyst salary (USD)	60,000.00
Cost Multiplier / Cariable Costs: Salaries	1.50

In more developed markets, fund managers targeting SMEs can rely more heavily on reliable and easily accessible financial data. This means a shorter deal pipeline and quicker decision making, resulting in faster deployment of capital. In the model above, this is illustrated by the high number of deals reviewed in frontier markets compared to the number of eventual investments: a 20 to 1 ratio. The conversion ratio in developed markets is likely to be lower, between 8 and 15 to 1, depending on the fund strategy and deal size. In addition, SME capacity in frontier markets is generally lower and the complexity of the contexts in which they operate require more analysts to review and support due diligence on more deals.

High upfront cost and delayed return may discourage aspirant fund managers, particularly first-time fund managers. If the aim is to create a population of successful fund managers in this space, then—like their Target SME investments—they require a financing that matches their cashflows.

Methodology

While there are many papers which look at private markets in a particular geography or niche area, there is surprisingly little research specific to investing in, and financing, Target SMEs.[1] There are gaps in the knowledge about the Target SME financing ecosystem. Much of the research only addresses specific elements of our research objective. Some papers highlight certain changes in the model, instruments, mandate, or fund structure as potential solutions to deploying smaller cheque sizes. Noticeably, most suggestions or observations seem to cluster around similar themes: 1) resourcing and fund manager economics, 2) fund structures, 3) mandates and instruments, and 4) risk/return expectations.

We therefore supplemented our secondary source review with interviews of 20 fund managers, investors, and advisors active in the SME investment ecosystem. Their insights proved particularly valuable, and we cluster them in three categories: **What IS NOT Working, What IS Working,** and **What MIGHT Work,** the latter being the interviewees' recommendations on changes that would enhance their ability to execute smaller deals.

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[6] https://www.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/financial+institutions/priorities/ifcs+definitions+of+targeted+sectors

[7] EMPEA 2019 Global Limited Partners Survey

[8] Private Credit Solutions: A Closer Look at the Opportunity in Emerging Markets, EMPEA, 2019

[9] "Enhancing the Contributions of SMEs in a Global and Digitalised Economy" - OECD, June 2017

[10] "Enhancing the Contributions of SMEs in a Global and Digitalised Economy" - OECD, June 2017

[11] "Unlocking the potential of SMEs in emerging markets : Small companies grapple with finance, expertise and cross-border trade challenges" – Financial Times, April 2019

[12] "Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises" – IFC, 2013

TARGET SME FINANCING ECOSYSTEM

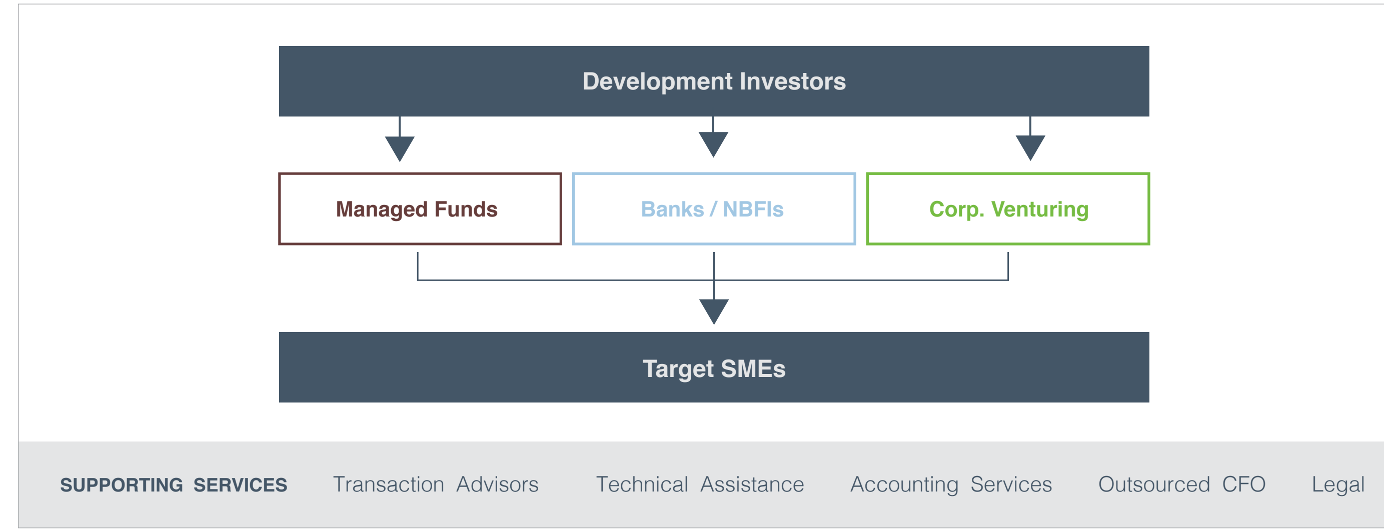

FIGURE 2: Various participants in the Target SME financing ecosystem

DEVELOPMENT INVESTORS

The universe of prospective investors into the Target SME ecosystem is not limited to donors and development finance institutions (DFIs). Largely driven by similar imperatives as the DFIs and donors, certain family offices and other impact-led investors have also prioritized an allocation to Target SMEs.

A host of commercial and corporate investors are looking for strategic acquisitions for their businesses in frontier and emerging markets or pursuing socially responsible investment agendas. The advent of corporate venturing has seen developed market, and large regional frontier and emerging market, corporates establishing investment capabilities to explore new geographies, technologies, and business models, and forge new relationships with local Target SMEs.

In South Africa, the Black Economic Empowerment codes encourage South African corporates to invest in the development of SMEs or in supplier development within their value chains. They see both a tax benefit and improvement in their empowerment score, which improves the corporate's ability to secure business. McKinsey & Company's research[13] indicates a similar experience in India, where "large pools of domestic funding [are] being [made] available through the corporate social responsibility budgets of Indian businesses." In both cases, this dynamic has driven a new corporate focus on Target SMEs in order to improve the ecosystem in which those investing corporates participate. Similar initiatives are being replicated across Africa in various forms of ownership indigenization and local content incentives.

The Development Investor universe also includes influencers such as portfolio consultants, asset allocators, and multi-managers. These investors often promote the inclusion of impact-driven and private market mandates for their clients, and they assist in seeking fund managers through which to express those themes.

In developed markets, banks would be a large part of the solution. However, in frontier and emerging markets the monetary policy and government financing requirements largely "crowds out" lending to domestic individuals and businesses. In those jurisdictions, private markets funding offers more immediate solutions. Typically, frontier and emerging market domestic banks focus on expanding branch networks to create more deposits, at an effective interest rate close to zero, while buying their sovereign and large corporate debt at attractive yields. In addition to being very profitable, this activity requires far lower capital adequacy and effort compared to any form of lending into the real economy. In other frontier and emerging market jurisdictions, the domestic banks compete for institutional savings by hiking up savings interest rates. This increases the cost of capital—a cost which is then transferred to retail and corporate lending. The net result is that—save for lending to a few creditworthy individuals, regional SMEs, or state-owned enterprises—the savings pool gets largely recycled to fund domestic and regional fiscal policy.

TARGET SMEs

The Target SMEs most in need of the finance provided by Development Investors are those falling into what is often described as the "missing middle." The World Bank sets the parameters of the missing middle in its description of "SMEs requiring between $100,000 and $2m in capital,"[14] and the following diagram provides a high-level understanding of the concept.

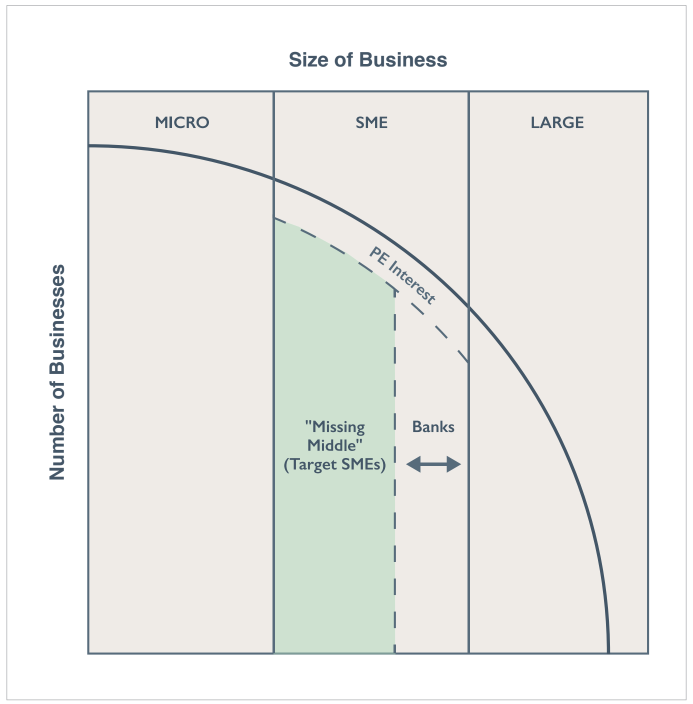

FIGURE 3: Illustration of SME Financing Gap

As indicated in the diagram, more sophisticated SMEs may receive secured finance from banks in certain positive economic conditions. Small and growing businesses—commercially viable firms that have significant potential and ambition for growth—do receive some attention from the private equity and venture capital fund managers when seeking capital (typically growth capital from $20,000 to $2 million). But the remaining SMEs, constituting the "missing middle", is a significant part of the Target SME universe. And this universe is vast, spanning smaller start-ups looking for early-stage venture funding to medium-sized, mature, family-owned businesses looking for growth capital.

For various reasons, family-owned businesses form a disproportionate share of the Target SME universe.[15] These businesses have often been built over generations, perhaps enduring combinations of political turmoil, hyperinflation, spikes in interest rates, and lack of access to foreign exchange. While the allure of growth or even access to working capital may be appealing, the families are loath to enter contractual arrangements and covenants that could threaten their asset base if circumstances beyond their control change again, suddenly. Owners are also reluctant to sell equity beyond their circle of trust. The corollary is that business owners tend to attach a higher premium to control than might be typical in developed markets. Family-owned SMEs are typically frustrated with the current providers of capital in their ecosystem and often unwilling to take on leverage and its associated risk. The ability to utilize a range of investment instruments that can be sculpted to investee cashflows, in addition to mechanisms that allow a slow take-up of equity as trust builds and value is created, is the key to unlocking this sector.

That said, any successful approach to investing in Target SMEs must be nuanced and tailored to take into account the distinctions between different geographies, sectors, and ownership structures. Considerations include indigenization legislation and local content requirements, local legal and investment restrictions (such as Shariah law, to take just one example), and differing tax practices. Trusted relationships and networks in target investment jurisdictions are critical.

CONDUITS OF CAPITAL

The original focus of our research was on private equity and venture capital fund managers. However, the fund management model limited to allocating private equity and venture capital may not necessarily be the most appropriate for the Target SME ecosystem. So we extended the universe beyond private equity and venture capital to include those fund managers adopting other private market strategies—including private debt, mezzanine finance, and multiple-asset-class mandates. Some of the fund managers have more narrow, local jurisdiction mandates while others have regional, or even global, mandates to seek investments in frontier and emerging markets.

Certain established NBFIs are efficient allocators of Development Investors' capital to Target SMEs. These are specialist lending or investment businesses that have a high degree of experience in a particular area and can achieve scale via some level of standardization in their processes. They typically raise debt, mezzanine finance, and equity (including from commercial investors, Development Investors, and frontier and emerging market private market managers) to invest in, or lend to, Target SMEs via combinations of private equity, private debt, and hybrid instruments. The more established NBFIs—such as Business Partners International (BPI), Sofala Capital, and Retail Capital—have grown to become regionally focused. There are also a host of smaller domestic frontier and emerging market lenders that have businesses focused on factoring, securitization, leasing, and other trade finance. Several of these NBFIs took part in our interview process.

Microfinance institutions (MFIs) are a specific type of NBFI. Many MFIs have attempted to scale up their businesses to include lending to Target SMEs, but with mixed results. A notable success story is Aavishkaar, in India, which leveraged its MFI experience to create a successful SME lending platform. However, the complexity of lending larger amounts to larger businesses has been a difficult transition for most MFIs and they have more often retreated to their specialty—smaller standardized transactions.[16]

While MFIs have previously been seen as attractive conduits of capital, the dramatic growth in certain frontier and emerging markets has unfortunately caught the attention of less savory participants, whose lending is clearly predatory. Development Investors shied away from the reputational risk surrounding such bad actors. There is still a significant unregulated "black market" of lenders providing finance at exorbitant rates, and SMEs sometimes resort to this market in search of capital they are unable to obtain elsewhere. In summary, Development Investors and fund managers should only consider those MFIs that are Smart Campaign certified.[17]

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[13] "Indian Private Equity: Coming of Age" – McKinsey & Company, November 2018
[14] Unlocking the potential of SMEs in emerging markets: Small companies grapple with finance, expertise and cross-border trade challenges" – Financial Times, April 2019
[15] "Indian Private Equity: Coming of Age" – McKinsey & Company, November 2018. McKinsey & Company note that *"as in much of Asia, most companies in India are owned by families. Family businesses have become more purposeful and sophisticated in their interactions with private equity over the past 15 years."*
[16] This picture is mirrored in much of Southern Africa and South America. "Four Challenges for Shifting from MFI to SME Finance: Lessons learned on effective tools for moving into this customer segment in Africa" – Elodie Gouillat, Portail de la Microfinance, November 2017
[17] http://www.smartcampaign.org/

ANALYSIS OF CAPITAL FLOWS WITHIN THE TARGET SME ECOSYSTEM

WHAT IS NOT WORKING?

The graph below summarizes the interviewee perspectives on why Development Investor capital is not being channelled to Target SMEs as efficiently as is required.

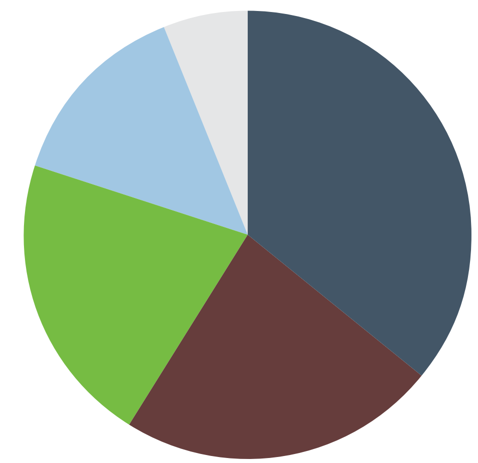


FIGURE 4: Impediments to private market small deal implementation

Fund Manager Economics

Almost 40 percent of the interviewee comments highlighted the relationship between resourcing, costs, timing of investments, and the consequent mismatch in fund management economics. Smaller and first-time fund managers struggle with the disconnect between the upfront period, with the highest resource requirements and costs, and the later stages when capital has been raised, assets deployed, and fees are earned. Several interviewees used similar benchmarks and projections to those depicted in Table 1 and Figure 5 to illustrate the difficulty of raising and deploying a standalone, small cap, private markets mandate.

In implementing a successful private market fund management business, the high cost of searching for "investment-ready" opportunities during the initial investment period is a critical factor to consider. A low number of deals converted—compared to the number of opportunities considered—indicates that only higher-quality deals are being converted. However, Target SMEs are generally less investment-ready. Their processes, accounts, governance, and reporting often require significant improvement before a fund manager can justify presenting the deal to its investment approval process. This means that a lot more work needs to be done on each deal to make it investment-ready. Therefore, more human resources are required upfront to implement the strategy successfully. Furthermore, the likelihood of success is higher with fund management teams who have hands-on experience in business and financial transaction work, deal analysis, and deal structuring.[18] Development Investors premise their investment with a fund manager based on the quality of the team.

All interviewees highlighted the critical importance of having local human resources with deep networks and trusted relationships in the places where the fund manager is investing. But the duplication of operations across jurisdictions can have a significant cost. Cultural nuances also make it more difficult to standardize processes and documents, while further requiring more skilled and experienced executive teams with the wherewithal and bandwidth to address local idiosyncrasies. In this context, our fund manager interviewees highlighted the shortage of skills and the additional costs of training and support.[19]

Finally, the fund manager's and the fund's boards of directors and investment committees should be sufficiently experienced, skilled, and independent of the fund manager. Attracting these skills is a further material cost often borne by the fund manager.

Although the costs of active management of a portfolio of Target SMEs clearly justify higher fees, there is significant downward pressure on management fees. Some fund managers have been able to negotiate higher management fees with Development Investors that understand the risks of short-changing their fund manager. However, most frontier and emerging market fund managers must accept the suppressed market levels for management fees, despite being asked to focus on SMEs. They therefore require alternative sources of income or business models to make their operations more efficient and reduce their costs.

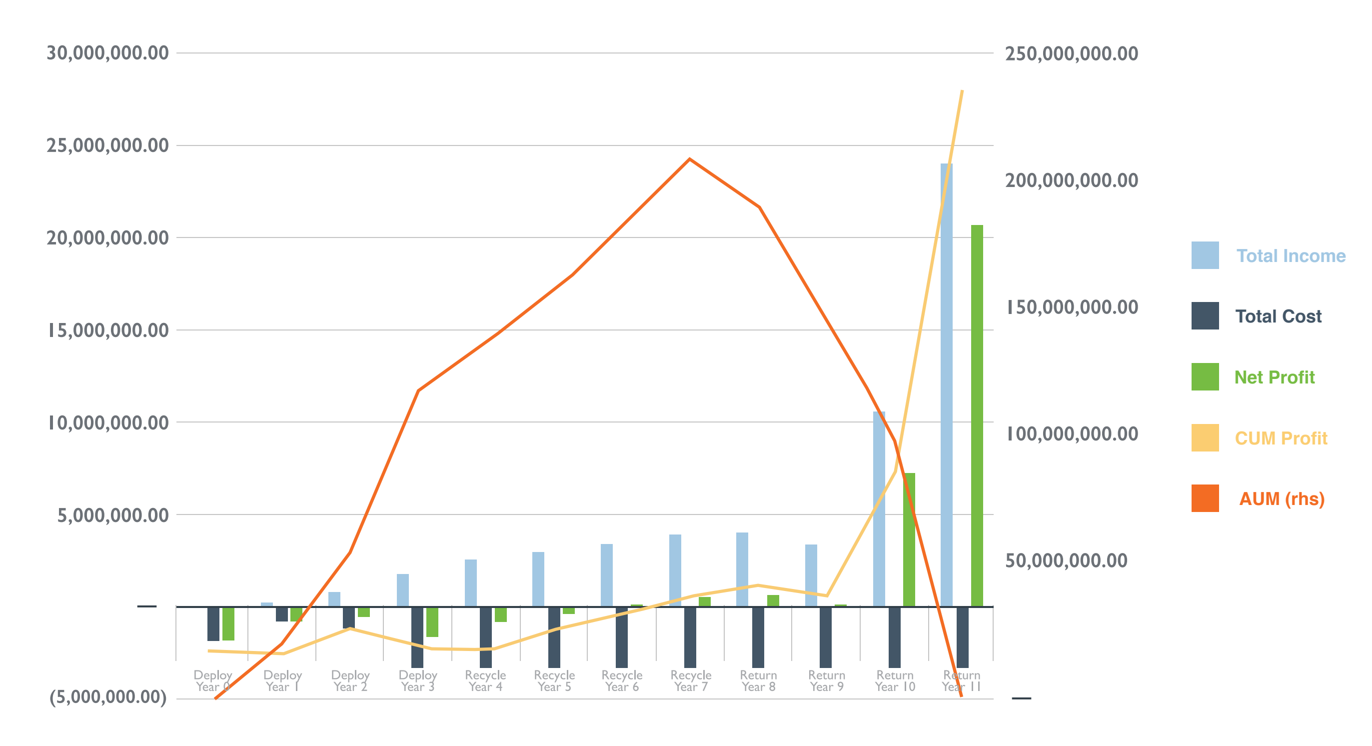


FIGURE 5: Private Market Fund Manager Economics

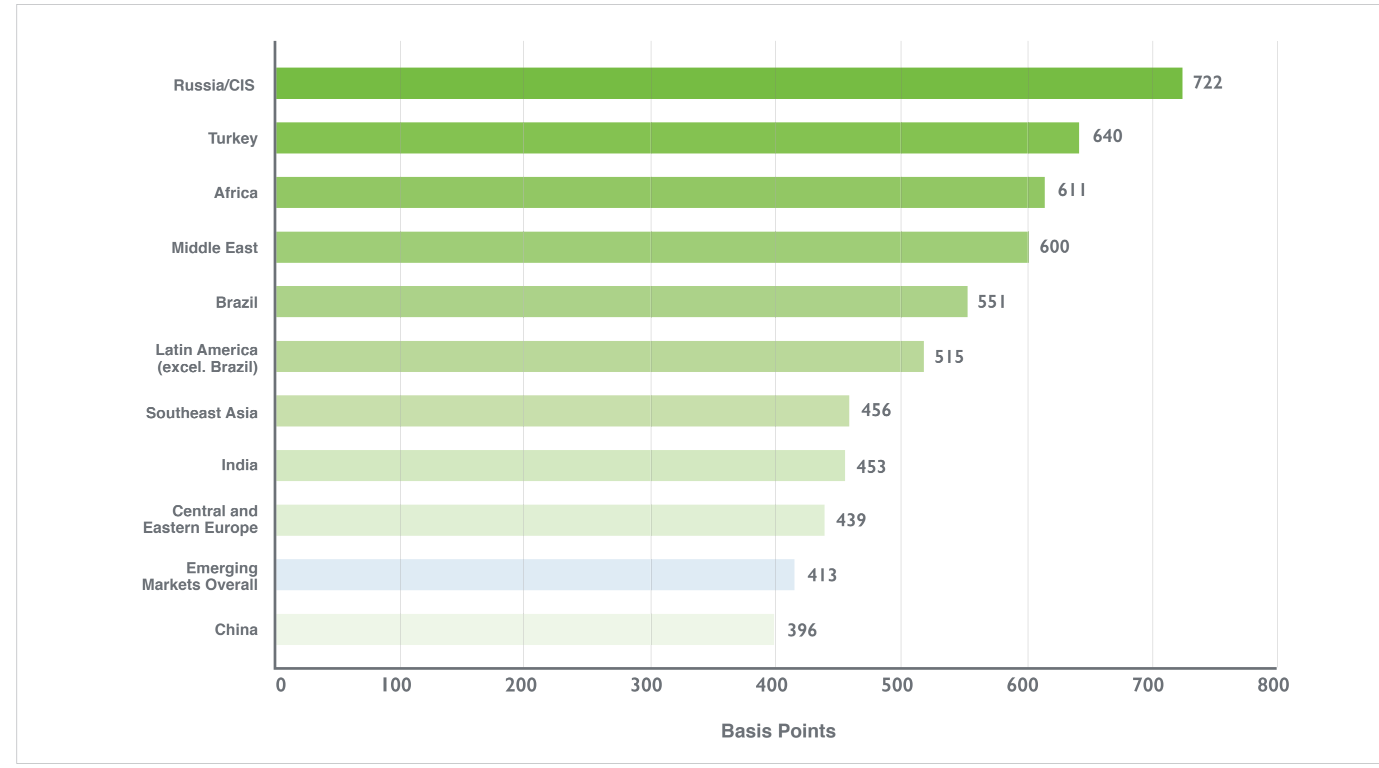


FIGURE 6: Return premium over developed markets that would justify decision to commit to EM PE funds

Inflexible Mandates

All of the interviewees mentioned rigid, single-asset-class mandates as a major obstacle to deploying smaller investments, with 25 percent of them prioritizing it as the major factor. The limitations of pure private equity mandates, particularly in the context of Target SMEs, were highlighted. Fund managers bound by mandates that only permit investment in a single type of investment instrument are less likely to meet the needs of Target SMEs, as discussed above, and therefore less likely to conclude successful Target SME deals.

Structures

The third-ranked impediment, mentioned by 50 percent of respondents and prioritized by just under 20 percent, was the traditional fund structure to which the Development Investors have become accustomed. These are typically closed-end funds with a 10-year life. The appropriateness of this investment horizon was questioned with respect to Target SME investments because those investments often take longer to mature. Thus, the inflexible fund investment horizon means that fund managers are often forced to exit deals before the investment has reached its potential and offer to a limited secondary market at unattractive multiples.

Perception of Risk Deterrent

The assumption is that Development Investors have an appetite for investing in Target SMEs. However, 9 percent of the interviewee comments questioned the Development Investors' perception of the risks and returns inherent in Target SME investing.

Many interviewees challenged the assumption that there is appetite among Development Investors for investment into Target SMEs. They said developed market investors still exhibit a home bias, where similar returns can be earned "at home," albeit from investing into riskier assets. The risk premium that Target SME investment returns are required to exhibit in order to entice developed market capital out of its home jurisdiction was viewed by interviewees as a deterrent. Development Investors have an aversion to the currency risk and political risk of investing in frontier and emerging markets, which can be exaggerated in the media, social media, and even in some academic research.

Figure 6 illustrates the return premium over developed markets that would justify a decision to commit capital to emerging market private equity funds.[20]

Some investors do indeed remain skeptical about the returns offered by portfolios of smaller deals, regardless of the jurisdiction. And there is certainly some merit to the notion that smaller deals may take more work and have more inherent risk. However, there is research to indicate that a well-executed portfolio of smaller deals should deliver a premium over time.

Investor Requirements

Possibly taking advantage of the license afforded by their anonymity, fund managers interviewed for our research expressed some frustration at their dealings with Development Investors.

With respect to DFIs providing debt directly, they said that certain DFI mandates crowd out commercial capital. Particular frustrations include: requirements that the transaction be subject to a legal jurisdiction unrelated to the jurisdiction of either the borrower or the lender; the insistence on bilateral deals that have specific covenants and requirements for seniority in the capital structure; and the preference for term debt facilities with onerous drawdown conditions and inflexible bullet repayments, with no cognizance of the timing of the underlying SME borrowing needs (the latter creates cash drag and is punitive for smaller borrowers).

The concerns with DFIs, generally, centered on onerous—arguably unnecessary, in some instances—reporting requirements, and DFIs' inflexibility around innovative new fund terms and structures. DFIs are perceived to have strict requirements on how a fund manager and a fund must be established and how private debt and private equity transactions must be implemented, which are often incompatible with the requirements of the Target SMEs in question.

A common refrain from the interviewees was that the point of departure for this paper—the notion that Development Investors are looking for fund managers specializing in Target SMEs—is not well known to said fund managers. DFIs, it is implied, may well be unaware of fund managers whose models are already working in this space. In fact, the perception is that DFIs shy away from smaller, first-time fund managers in favor of larger fund management businesses and larger deals.

The processes used by Development Investors to make investment decisions are worthy of a separate research project. Investing in Target SMEs is more of an art than a science, requiring a flexible approach. But given their own structures, many Development Investors are uncomfortable with or unable to facilitate such flexibility. The DFI capital allocation, decision-making, and deployment cycle is part of the reason DFIs can appear unpredictable and mercurial in their priorities and appetite. Many interviewees opined that it might be worth reviewing the manner in which DFI investment professionals are incentivized, since this incentive structure is perceived to produce investment priorities (returns) at odds with publicly stated DFI priorities (SDGs, ESG, impact). Finally, many fund managers bemoaned the requirement from DFIs (due to their investment process) to immediately take payment of the full capital allocated by the DFI, as this creates a cash drag which makes the targeted returns more difficult to attain.

WHAT IS WORKING?

The pie chart below reflects the opinions of the interviewees as to what interventions or innovations are enabling fund managers to deploy smaller cheque sizes to Target SMEs.

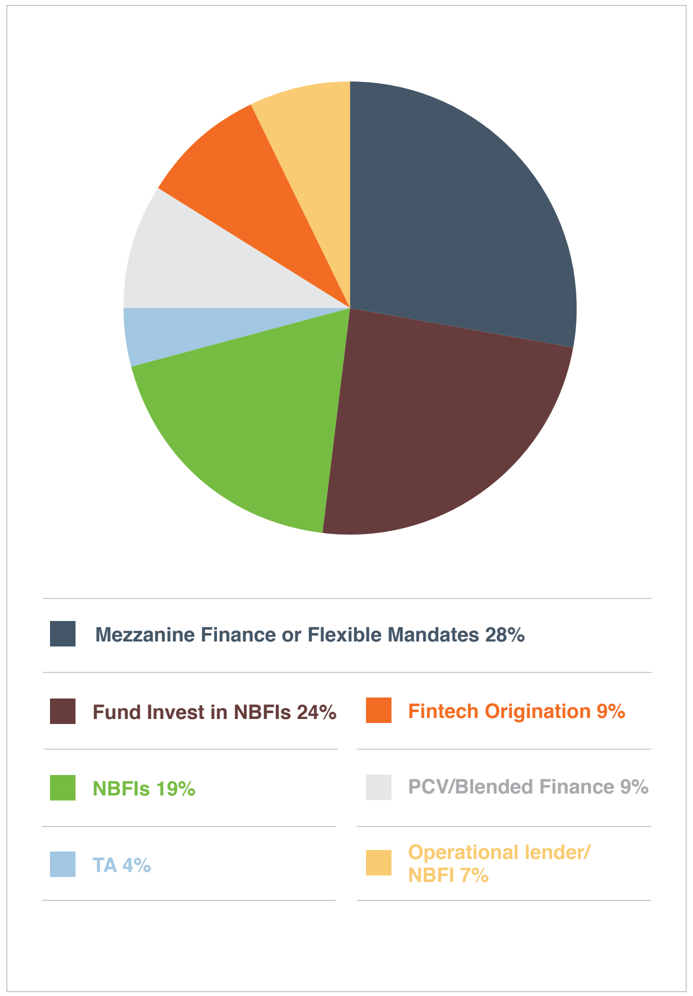


FIGURE 7: Areas influencing success in deploying smaller deal sizes

Flexible Mandates

All of the interviewees mentioned flexible mandates that allow fund managers to invest in a range of private market instruments—from private equity through to mezzanine finance and private debt—in the same fund, as a contributor to successfully deploying smaller investments. Thirty percent of them prioritized it as the major factor. Subsequent capital raises by certain of these fund managers may be more efficient as the funds that they manage are open-ended. They have therefore been able to scale up with their portfolio companies as the relationships have developed.

This recommendation is at odds with the way many Development Investors typically structure their investment teams and decision-making processes. Private equity and private debt are often handled by different teams within these organizations and have different allocations and incentives within the overall investor portfolio. Nevertheless, several European DFIs have recently begun to expand their debt focus and have recognized the benefits of flexible mezzanine finance mandates within this asset class.

Case Study: Sanlam Private Credit[21]

Sanlam is a leading pan-African, broad-based financial services group. In 2012, in response to client demand, it created an alternative credit and mezzanine finance asset management division to focus on private markets and direct lending. The division initially managed two private market funds, one entirely commercial and one focused on socially responsible investments particularly within the context of South Africa's Black Economic Empowerment and Supplier Development frameworks.

Both these funds are structured as open-ended limited liability partnerships with an initial lock-up period (typically one year) and a one-year redemption notice period. The investors range from life insurance companies to multi-managers and pension funds.

The funds have provided capital to businesses at varying stages in the business cycle and across a range of industries. Their track records reflect that typical borrowers/investees have tended to be businesses that have moved beyond "friends and family" and VC funding and have reached profitability and proof of concept. They have enterprise values between $5 million and $25 million, making them too small for traditional avenues of private debt and private equity finance.

Aside from an asset-backed portfolio component unlocking value for Target SMEs, the funds' next biggest component has been NBFIs (including MFIs), invoice discounting and reverse factoring businesses, equipment financers, and merchant cash advance businesses (such as Retail Capital, presented in another case study below).

To quote the fund manager Erica Nel (a participant in the survey), "I know many investors prefer closed-end funds with specific mandates. Our ability to be flexible when negotiating with a borrower and our ability to scale with successful investments has been key to our success."

As a testament to its model, Sanlam Private Credit now manages in excess of $100 million. It has deployed a total of $150 million with an average deal size of $1.5 million.

Fund managers with successful records in deploying capital in $1 million to $5 million cheques tend to have had flexible investment mandates. Those mandates allow for participation in the different parts of the Target SME capital structure.

In their paper on frontier and emerging market mezzanine finance for the Dutch Good Growth Fund, the RebelGroup noted that, "In search for new models to provide risk capital, several small cap SME mezzanine providers have been able to scale up, and claim that their model can improve the risk-return balance of small cap SME finance." The scope of instruments available to the mezzanine finance providers makes their investment mandates and strategies more appropriate to providing capital to Target SMEs. The level of due diligence for mezzanine finance is generally less onerous than private equity and venture capital, making it more viable to enter into a larger number of smaller transactions. Unfortunately, however, even mezzanine finance fund managers have drifted to providing mezzanine finance to larger businesses due to the disconnect in the fund manager economics highlighted in the pages above.

The focus of mezzanine finance and private debt fund managers on cashflows and interest payments also provides them with a natural barometer of the health of the underlying business. In addition, profit or equity participation can achieve upside returns, which are further attractive aspects of a mezzanine finance portfolio. The fact that Target SME mezzanine finance transactions are rarely sponsored (by a private equity fund manager who is raising all parts of the capital structure) means that a mezzanine finance fund manager is able to participate in more of the equity (and other upside instruments).

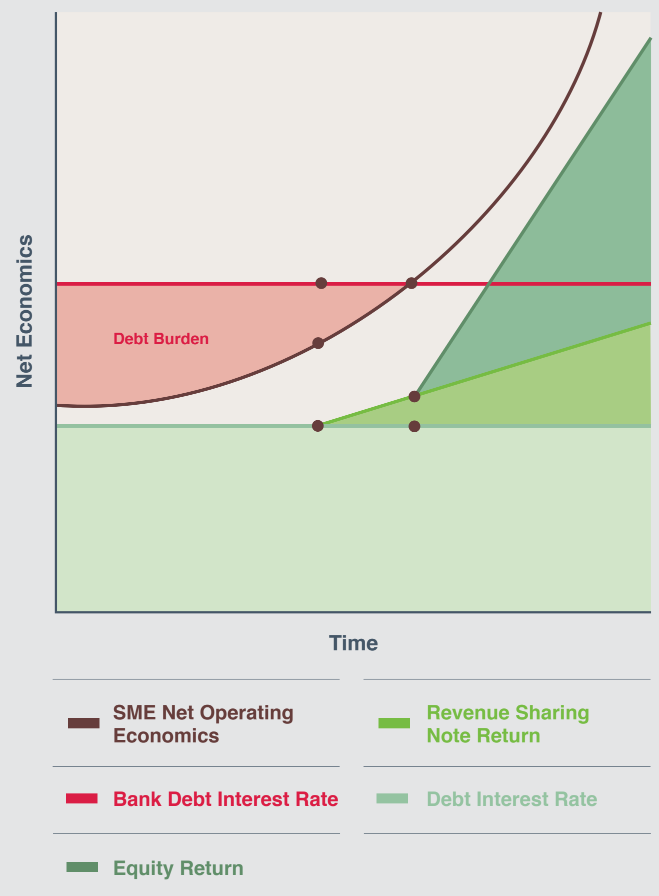
In the diagram below, The RebelGroup[22] depicted the full universe of mezzanine finance instruments in order to highlight the wide range of instruments that can be included in a mezzanine finance mandate.

Participating in revenue is a feature of many investment instruments. Banks and mezzanine finance managers often embed a share of revenue as part of the financing provided to their clients. More recently, the term "revenue sharing" has come to mean a particular subset of instruments that recover a predetermined amount of capital and return from a borrower (typically referenced to a multiple of amount advanced), based on a fixed ratio of participation in a borrower's revenue for a defined period of time. This mechanism has the advantages of helping to "sculpt" repayments in line with the borrower's cashflow, while providing the lender with a preferential claim on any revenue earned.[1] Such an instrument is seldom used alone and may be part of a broader package of equity and debt financing.

FIGURE 8: Landscape of common small cap SME (mezzanine) transaction structures, RebelGroup

Case Study: Sculpted Cash Flows

- Assume that a bank will lend to a Target SME at a flat annual interest rate of 18 percent. Although that price of capital may be affordable to the SME at a later stage in its development, it is often not affordable in the short term. Many Target SMEs can't afford to sustain such a debt burden early in their lifecycle, and the debt cripples the business.
- A sculpted cashflow program brings together a number of instruments to shape the cashflow requirements of the finance according to what the Target SME can afford.
- In this mezzanine finance example, three instruments are issued:
    1. Lower-cost debt that has a fixed-cost cashflow requirement below the J-curve for the Target SME.
    2. A revenue participation note (RPN) that begins to share in the cashflow of the Target SME once the net cashflows (after the RPN cashflow requirements) can sustain the Target SME business.
    3. An equity instrument that only participates in the Target SME cashflows once the business is making a net profit.
- In this way, the Target SME can prioritize its available cashflow on its operations and the investor is appropriately rewarded for the risk taken in the combined long-term value of the three instruments.



NBFIs

Collaboration between Smaller Niche NBFIs and Fund Managers

A number of fund managers have achieved success in the Target SME space by investing substantially in niche or early-stage NBFIs.

The life stage of these financial businesses, coupled with the cheque size required, usually makes them unattractive to Development Investors and commercial capital. However, they have typically developed a high degree of specialization, standardization, and experience in a particular niche, such as mortgage, specialist MFI, factoring, securitization, leasing, and other trade finance. They have often achieved success on the founder's capital.

Niche NBFIs can be ideal partners for fund managers. As discussed in the section on fund manager economics, fund managers are unlikely to be able to afford the resources needed to achieve specialization in a particular niche. By partnering with an NBFI, however, the fund manager is able to vet processes and monitor the Target SMEs' health and success. In this scenario, fund managers are effectively outsourcing to specialist lenders who each operate in a particular frontier and emerging market or financial niche. This allows Development Investor investments of $10 million to $20 million into a fund that will translate into $50,000 to $2 million investments into Target SMEs.

Development Investors Assisting Established NBFIs to Crowd in Commercial Capital

In many cases, established NBFIs initially raised capital from fund managers and then progressed to raising capital directly from DFIs, impact investors, and commercial capital when their models had matured and they were perceived to present a lower risk.

These NBFIs typically have good data on the Target SMEs within their investment apertures—data related to the SMEs' capital structure, cashflows, earnings integrity, balance sheets, growth trajectory, and borrowing behavior. They can use that data to help SMEs improve their operations and achieve scale, and build the capacity of their own staff, raising the quality of their human capital in a cost-efficient manner. Some NBFIs are able to hire capable but inexperienced junior investment professionals, who are supported by fewer senior executives. They are also able to standardize documentation and curate it on a region- or sector-specific basis, or even according to the specific business of the Target SME. Such standardization facilitates quicker, less costly, and more efficient decision making. In addition, some established NBFIs maintain databases of mentors, with a wealth of experience on specific industries and types of business, who are available to the investment professionals and assist in assessing the investment readiness of the borrower.

These NBFIs also have dedicated local teams of skilled resources with experience in restructuring transactions. They can assist Target SMEs with restructuring their capital structures and balance sheets. This skill set is invaluable in its blend of empathy and emotional intelligence with technical financial skills. In a portfolio of Target SME investments there will be issues and restructurings which can consume an inordinate amount of executive time at the expense of focus across the entire portfolio, which is a risk.

Although usually entering these investments after the early stage, many Development Investors have achieved attractive returns from their investments into NBFIs. Often, they have subordinated debt, subscribed for convertible instruments, or taken equity in the NBFI in order to assist it with raising further debt and crowding in commercial capital.

Linked Life Policies

Life insurance (or assurance) creates a contract between an insurance policy holder and an insurer, where the insurer promises to pay a designated beneficiary a sum of money (the benefit) in exchange for a premium. In much of the world this business is only associated with risk events, such as death, but in countries such as Australia, India, the United Kingdom, and English-speaking Asia and Africa, the benefit may also be linked to the performance of an underlying asset or pool of assets. Effectively, the life license is used as a pooling or unitizing mechanism.

Case Study: Retail Capital

Retail Capital was established in 2011 by Karl Westvig, a South African entrepreneur and co-founder of the leading consumer finance business, RCS Group. Retail Capital's business model follows that of similar merchant cash advance businesses in the United States and United Kingdom.

Retail Capital's target market consists of businesses that receive a significant percentage of their turnover through credit card transactions. Retail Capital purchases a defined value of future card transactions from its clients, in return for an upfront advance to the client. Retail Capital is effectively an NBFI with a highly specialized revenue sharing model.

Much of Retail Capital's success is attributable to strong management and its innovative business model. However, standardization and the ability to use data for both credit assessment and client acquisition have been key in its evolution.

Retail Capital's business focuses on a key driver for South Africa's developing economy; namely, access to finance for SMEs. Finance is typically used to provide working capital and fund business opportunities and, because repayments are linked to a business' daily card sales transactions, repayments are matched to the cashflow cycles of a business. Retail Capital was initially equity funded by its founders. Once it was beyond its pilot phase, the business entered into a mezzanine-style transaction with a commercial partner. This resulted in the sale of a significant minority stake, in exchange for a funding line on favorable economic terms. As the business reached profitability and three years of operating history, it was able to approach socially responsible investment, private debt, and mezzanine finance funds for further funding. Initially, these were bilateral deals negotiated with each funder. Karl Westvig notes that "At that stage it was crucial that funders were flexible and able to negotiate facilities that were suited to our specific business needs."

As the company has reached a more mature phase, it has been able to standardize funding and has moved to common terms and inter-creditor agreements. The business is now raising capital from both domestic and international investors via its own note program.

One interviewee had significant success in the use of linked-life policies as a mechanism for attracting and pooling capital for portfolios of illiquid assets. The advantage is that such policies can accommodate individual investor preferences for exposure to particular portfolios, subsets of portfolios, or individual assets. Investors can gain access to a specific cross-section of an existing portfolio of assets (for example, smaller private equity deals, loans in a particular jurisdiction, or real estate properties with certain tenant profiles) already originated by the insurer and/or its manager.

Furthermore, the linked-life policy creates the perception of liquidity and the result is more akin to an open-ended fund structure than the typical closed-end vehicles used for private markets, which has been successful in attracting investors. It is important to note that the key difference when using linked policy structures is that it is essentially a "promise" from an insurance balance sheet to link your returns to a given asset pool. The investor's comfort that this promise would be honored— which is usually provided by a fund's governance structures, valuation agents, administrators, and boards—is centered on the creditworthiness of the insurer itself.

Part of Large Asset Manager

There are examples of fund managers that are part of a large asset management business. Using its other sources of income, the larger business is able to subsidize the disconnect in the timing of the costs of the fund manager. The ability of the asset manager to further benefit from the operational leverage and utilization of the residual capacity of its back office, governance, finance, brand and marketing, HR, and other sunk costs makes it attractive to add a fund manager capability.

Part of Service Provider

Certain providers of services to Target SMEs—such as outsourced CFOs, accountants, and other business development service providers—have significant data on their clients. This data puts them in a position to better understand the investable universe and to select the more investable candidates. They are also able to determine the most appropriate form of capital for those candidates. This model, whereby the conduit for capital is a service provider earning income (for providing a service, at a rate more affordable to the Target SMEs) and simultaneously building a relationship with the Target SMEs, is a potentially attractive one.

Blended Finance

Blended finance, or "catalytic capital," is one of the most innovative developments in the impact community. The strategic tiering of different development finance and philanthropic capital on the liability side of a fund's balance sheet to mobilize private capital into frontier and emerging markets has been utilized to great effect. Recently, for example, Climate Fund Managers[23] working with the Dutch DFI, FMO, have utilized this approach to attract $800 million in blended capital. Convergence[24] has built its business on offering a global network for blended finance, generating blended finance data, intelligence, and deal flow to increase private sector investment in frontier and emerging markets.

Certain fund managers have premised their business on subsidizing the returns, and mitigating the risk, of the commercial investors in their funds—with a significant part of their fund capital being grant money which has no expectation of return. However, that grant money required the fund manager to catalyze private investment and certain development objectives.

The complexity entailed in structuring a blended finance solution can often result in a longer time to raise capital. The requirements of certain Development Investors prepared to absorb losses often result in more constrained investment mandates. We therefore need to weigh the benefit of subsidizing the cost of capital against the working capital implications for the fund manager (with longer periods until launch) and the ability to deploy smaller cheque sizes with a more restrictive list of available instruments.

It is important to realize that blended finance is not an investment solution in and of itself. Rather, it is a mechanism to subsidize the cost of capital or underwrite risk and thereby make investments in funds attractive to commercial capital that might otherwise not have considered investment in the fund in question. The basic premise and investment thesis of the fund vehicle must still be compelling and able to deliver returns. Blended finance cannot change the nature of returns (as the other initiatives listed above might do) but it apportions them differently between the different types of suppliers of capital (see Figure 8).

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[18] "Managing SME Investment Funds in Latin America and the Caribbean (LAC): Lessons Learned and Recommended Best Practices" – Solana Incorporated, November 2003

[19] Business Partners has established and funded dedicated training centers and LeapFrog finances the resources required to run their Innovation Hub.

[20] EMPEA 2019 Global Limited Partners Survey

[21] Authors were employed by Sanlam Investments. StJohn Bungey is currently the chairman of the Sanlam Private Credit investment committee.

[22] "New Perspectives on Financing Small Cap SME's in Emerging Markets: The Case for Mezzanine Finance" – Rebel Group, May 2016

[23] www.climatefundmanagers.com

[24] www.convergence.finance

WHAT MIGHT WORK

The innovations that have real prospects for breaking the traditional private equity and venture capital molds center on four themes, and possible combinations thereof.

GET CLOSE TO THE DATA

Getting close to the data on Target SMEs is a critical aspect of investing in these businesses. A significant factor in the high number of deals considered versus those actually concluded is the low quality of information available, in particular financial information. This paucity of data elevates costs, lengthens due diligence periods, and increases the resources required to originate a large number of small deals. In the course of business, NBFIs and business development service providers gather extensive data on these SMEs. This insight makes them ideal origination partners for fund managers, who also gain deeper networks and trusted relationships from such partnerships.

A dedicated fund of NBFIs by region
As noted above, certain fund managers have had great success in funding and partnering with early-and mid-stage NBFIs. A few have made this approach a cornerstone of their strategy. Establishing a dedicated fund of early- and mid-stage NBFIs in frontier and emerging markets might be an effective way to deploy small cheque sizes. This strategy would be best suited to an open-ended, or longer-term, mandate. The ability to scale up investments in the successful partnerships—and cut those that don't work—would be key.

Unlike an industrial business, money is inventory for an NBFI. This means that successful NBFIs will always be looking for more capital. This provides the ideal opportunity for the use of mezzanine finance and convertible instruments so that the fund manager can assist each NBFI in its portfolio to attract further debt, while benefiting from participating in revenue or phantom equity. As each NBFI reaches scale, there is also a natural exit to a direct investment from a Development Investor or commercial investor.

Many but not all respondents expressed the view that fund managers should use data science to create fintech solutions which can facilitate a shorter—but equally rigorous—origination and search process, and enable better monitoring of (a larger portfolio of) Target SMEs. However, fintech solutions have not yet succeeded at scale despite a number of attempts.

SCULPTED CASH FLOWS

As noted above, allowing the fund manager to provide different types of capital to the Target SME in a manner that best suits the firm's cashflow cycle will best serve the agenda of sustainably supporting Target SME growth. A broad mandate that spans many types of capital and instruments—broader even than a typical mezzanine finance mandate—would be most appropriate.

Part of this solution would include new investment horizons, preferably evergreen fund mandates expressed through permanent capital vehicles (PCVs). There was general consensus among interviewees that a longer-term investment horizon solves several issues, including removing the perverse incentives to deploy capital too quickly (particularly if the assets under management raised is large), structuring deals (at entry) for exit, forcibly having to exit deals at the wrong time, and the inability to scale deals over time.

Longer-term deals allow the fund manager to focus on appropriate distributions and yield from the underlying investment. The need to establish a second fund, and further funds, in order to get the aggregate fund management business to scale, and the significant costs inherent in that project, appears inefficient in contrast to simply raising further capital for a PCV, or other open-ended structure. Any mechanism to provide liquidity to investors in the PCV makes the structure more attractive and there are a number of options (distributions, periodic liquidity events, facilitated secondary market) which can be considered in the context of the underlying assets in the PCV.

SUBSIDIZED FUND MANAGER ECONOMICS

In private market fund management businesses, it is standard practice that the founders provide the working capital required to start the business, attract investors, and get their fund to a first close. The founders further align themselves with investors by providing the first capital to their fund. As capital is deployed, assets under management reaches a level where management fees cover the day-to-day expenses and may even permit the founders to start recouping some of the upfront establishment costs they financed. The real profitability lies in the performance fees at the end of the fund's life.

This typical model of fund progression is why private markets fund managers tend to favor large transactions, so that they can get to breakeven as quickly as possible. A fund focused on Target SMEs and dedicated to smaller cheque sizes takes longer to deploy, increasing the working capital requirements and thus discouraging fund managers from pursuing this strategy.

The concept of subsidized fund manager economics should not remove any of the founders' commitment or alignment. The idea is to provide sufficient incentive for the founders to pursue a development mandate (focused on Target SMEs and smaller cheques) versus defaulting back to larger deals.

There is also a perceived cap on the assets under management which these fund managers can raise because Development Investors are anxious about providing capital to a fund that is too large. This discomfort is due to their concern about the temptation to deploy capital recklessly within narrow (often inappropriately narrow) investment periods. A number of initiatives should be explored in this regard:

- **Amended Fee Structures:** Despite innovation to improve the efficiency and reduce the costs involved in responsibly managing a fund structure that supports Target SMEs, those costs remain high. There is therefore an urgent need to revisit the fee levels for fund managers, which should be higher than other private market fund managers to sustain the higher costs necessary to responsibly manage a Target SME strategy.

- **Sculpted Manager Fees:** The *manner* in which the fund management fee is charged and paid should also be revisited. We recommend exploring a fee income model sculpted to the anticipated cashflows of the fund manager. Many fund managers do not make it through the initial set-up phase. The timing of how the fees are paid over the life of an investment vehicle could be adjusted to assist in financing the high costs and therefore the survival of a fund manager.

- **All-In Fee Model:** Some interviewees argued that performance fees might create a perverse incentive to strip economics out of SME borrowers and that perhaps larger management fees, in lieu of performance fees -possibly completely- should be considered by the market.

- **Disaggregation of Services:** The fund manager's broader business charges the fund, and therefore investors, discrete fees for each of the services provides to the fund, e.g. vetting, origination, administration. Each of those services is individually priced and charged to the fund separately instead of a pooled management fee intended to capture the cost of all the services provided by the fund manager's business. In this manner the investors can compare the price of each of the services with the market prices, at a more granular level. This provides more comfort to the investors, while the aggregate fees charged to them are higher than the standard management fee.

Fund Manager-Focused Technical Assistance
Most fund manager interviewees see structured technical assistance focused on bridging the timing mismatch between income and expenses in the early years as a significant enabler, particularly for first-time managers.

Because fund managers need to be aware of the assistance available to them, Development Investors should sponsor a free platform providing details on the technical assistance and grant facilities they provide, including terms and conditions. Financial assistance and assistance with the search process were particularly attractive prospects for fund managers investing into Target SMEs. In this regard, a more coordinated approach[25] from the Development Investors makes sense.

Target SMEs tend to require more due diligence and active management than their larger counterparts. Most interviewees felt that any initiatives or technology innovations funded by the Development Investors that would allow fund managers to better rely on the financial data provided by Target SMEs would make the SMEs more investable. Those initiatives would also shorten the origination process and ultimately enable more deals to be concluded. Such assistance might entail establishing or subsidizing centralized origination portals of Target SME deals, though the appetite of fund managers to use a public resource of this nature would need to be tested before it is established. A central, sponsored platform that provides training for fund manager staff and others interested in the Target SME ecosystem also has merit as it would help fund managers reduce their training costs.

Investment in Fund Managers
Investing a small part of the exposure that a Development Investor is prepared to take in the fund as working capital directly into the fund manager may improve the fund manager's cashflow profile through the investment cycle.

Combinations of debt and options or equity, convertible debt, and revenue sharing could all achieve the desired effect, depending on the cashflows, target assets under management, profile, and life stage of the fund manager in question.

Returns to the instrument utilized to invest in the fund manager would be enhanced by the operational leverage of the underlying asset management business. The fund manager receives a management fee on the total assets under management plus, in the later years, if successful, the carried interest/performance fee on the whole portfolio. For bridging some of the cashflow mismatch, the Development Investor not only earns the 15 percent IRR on its investment in the fund but also benefits from the operational leverage to the performance fee within the fund manager in which it has an equity interest or participation, thereby enhancing its total blended return.

At the same time, the fund manager is willing to dilute its return in exchange for the certainty and increased chances of success created by the Development Investor's working capital facility. Arguably, both parties derisk their investments and the fund manager's team can focus on origination and deal vetting rather than business risk.

Fund Manager Revenue Supplement
Certain participants in the Target SME space have innovative business structures which remunerate them for services they provide to Target SMEs (for example, outsourced CFO). Fund managers supplement their insufficient management fee by providing services which support the function of fund management. However, this approach requires a disciplined fund manager that does not become distracted by services that pay in the short term but might prejudice the establishment of the Target SME-focused fund.

Deal-by-Deal Pledge Fund Model
Although not raised by any interviewees, when the research was presented at the Emerging Markets Private Equity Association (EMPEA) Sustainable Investing in Emerging Markets Summit in October 2019 in London, several private market investors and managers mentioned the use of a deal-by-deal pledge fund approach . Under this alternative model, members of the platform commit capital for investment into Target SMEs on a deal-by-deal basis. Similar to a fund model, the fund manager attracts investors with an investment thesis which may be based on a singular geography or theme, or multiple sleeves each focused on different sectors or countries.

Investors pay the fund manager a monthly commitment fee, for a defined period. The aggregate fee covers the costs of the resources required for origination and vetting of deal flow. Investors have first option on a predetermined share of each asset sourced for the platform, or specific thematic sleeve. The platform manager presents assets that align with a particular strategy to an investment committee. At that point, each investor can opt to participate in the specific deal up to their participation rate. If one or more investors choose not to take up their allocation, it is offered to the other investors, pro-rata.

Once assets are added on to the platform, the manager earns a management fee, on deployed capital, in addition to the participation and commitment fee. The express fee percentage is typically lower than traditional fund models but seen in conjunction with the commitment or participation fee, ends up at similar, or even slightly better, economics for the fund manager. Performance related fees are often similar to tradition private equity and credit funds, at between 10% and 20% above a hurdle rate of return, paid upon realization.

This model effectively bridges the earn-spend mismatch described earlier by paying the resourcing, operational and due diligence costs from day one. The early fees are then equalized by way of lower management and performance fees when assets are added to the platform.

The nuance that makes the model attractive is the element of choice for investors, who can opt-in on a deal-by-deal, or thematic, basis, depending on appetite and preference. This option is a powerful drawcard. The corollary is that investors who pay for a larger option on deals, but rarely opt in to deals, end up paying extremely high fees, when compared to the equivalent management fee of a traditional structure.

It was difficult to find businesses where this model had been implemented. Several managers present at the EMPEA summit were looking to raise impact funds based on variants of this idea. A platform focusing on Target SMEs is possible, although the practicalities of its implementation need to be tested.

COORDINATE AND EDUCATE INVESTORS

Development Investors fulfil a crucial role in the development of the frontier and emerging markets financial ecosystem, but it is clear that fund managers perceive a need for more flexibility on the part of these investors. They consider investor expectations to be a significant frustration in the investment lifecycle and suggest that significant investor education is required to better align expectations and objectives, particularly with respect to investment horizons.

Some interviewees observe that Development Investors might benefit from issuing specific requests for proposals (RFP) related to the investment objectives. In that scenario, fund managers that have previously been deterred from setting up Target SME investment vehicles may have more confidence that winning the formal RFP process is connected to a commitment of capital from the Development Investor.

[26] https://www.empea.org/research/deal-by-deal-and-pledge-fund-models/
[25] "More Mobilizing, Less Lending: A Pragmatic Proposal for MDBs" – Centre for Global Development (CDG), April 2018

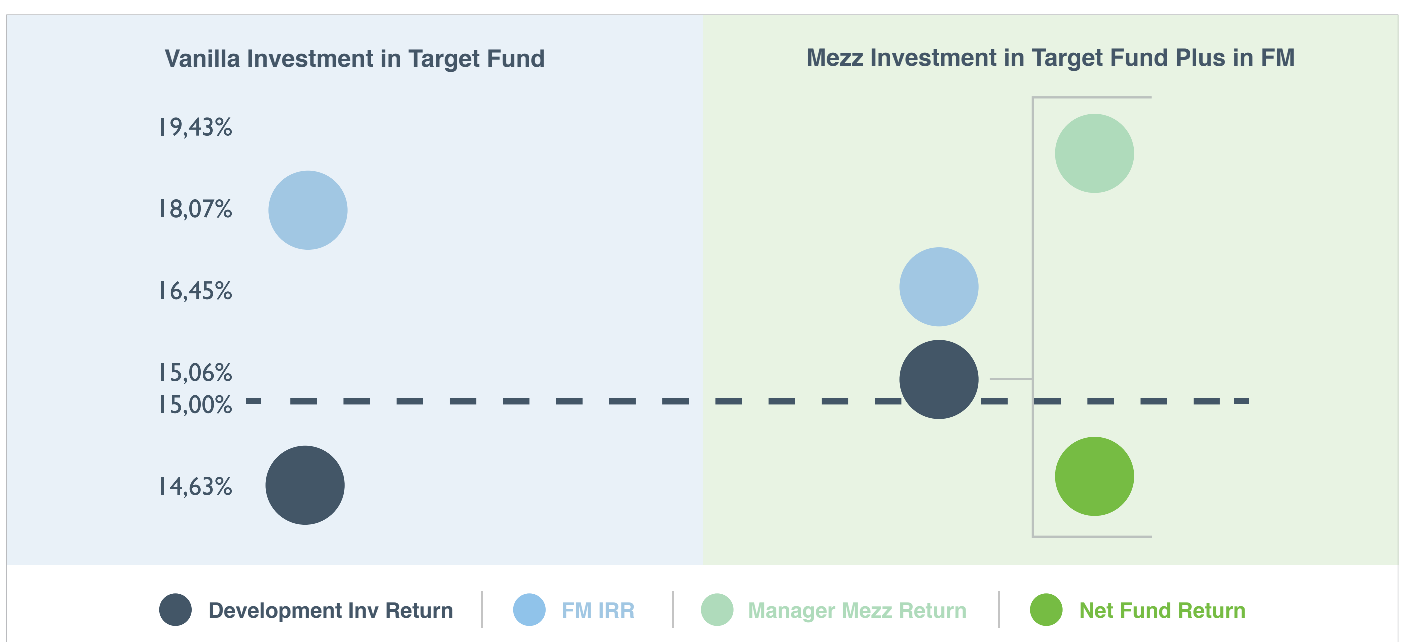

FIGURE 9: Comparison of a Mezzanine Investment Structure

Case Study: Lelapa Fund

Lelapa are African entrepreneurs with a mission to scale investments in Target SMEs. They do this by rethinking investment-readiness and using technology to reduce deal overheads. They also advocate and provide technical support to change African capital markets regulations to include SMEs that are too big for microfinance yet too small for institutional investors. Lelapa promotes a gender lens approach to supporting woman-owned-and-managed SMEs and women fund managers.

Lelapa has two tools: a platform-based collaborative tool to support investment-readiness and a low-cost investment platform that selects aligned investors and technical assistance donors to customise an investment-readiness plan for the SME.

> "The Lelapa team have created an innovative and cost-effective solution to give institutional investors access to smaller investment deal sizes in Africa."
>
> — Zee de Gersigny, CFA, Managing Partner, Victus Global Capital Ltd.

CONCLUSIONS

It would have been ideal to identify a single solution to break the mold of traditional private equity and venture capital models that have not had great success in channeling capital from Development Investors to Target SMEs. But this silver bullet does not exist.

Nonetheless, in aggregate, our research suggests a model of an asset management business that could provide Development Investors with a sustainable solution to invest in Target SMEs. Specifically, fund managers should adopt a three-pronged approach:

1. Use a portion of their portfolio to partner with domestic and regional NBFIs, which are close to the data and afford access to the missing middle. This approach allows a reasonably quick deployment of capital, thus creating a base level of assets under management on which to charge management fees.

2. Partner with business development service providers, possibly assisting them to create data-driven solutions. Successful partnerships will shorten the origination cycle, increase deal flow, and ultimately improve the probability of success.

3. Use the sculpted cashflow model to engage with larger SMEs ($3-5 million transactions), likely found in domestic industrial and technology sectors. Many of these firms are likely to be family-owned businesses.

This approach could be enhanced and enabled by working with Development Investors on the following initiatives:

- A flexible mandate that includes private equity, venture capital, private debt, mezzanine finance, convertibles, and phantom equity.

- An evergreen fund structure that allows the fund to scale up its investment as the Target SME grows, rather than a one-off investment over a short investment period.

- A willingness on behalf of the seed Development Investors to consider investing in the fund manager to bridge a portion of the funding required for its working capital requirements in the early years of its business cycle.

- A blended finance liability stack for the fund managers that allows the crowding in of commercial investors at an early stage.

- The exploration of a platform-based approach, encompassing both private equity and private debt. The key would be to provide Development Investors with access to Target SME deal-flow whilst financing the fund managers costs of origination and management.

To make a composite solution like this implementable, the mold that requires breaking most urgently is the fixed mindset of the participants in the Target SME financing ecosystem. Absent an ability to embrace innovative fund terms and structures—and partner with fund managers to derisk their businesses—we will continue to grapple with the challenge of driving capital at scale to promising opportunities.

This paper was conceived under DAI's Flagship Investment Initiative, which seeks to contribute to thought leadership that advances frontier market investment. The flagship is managed by Kirsten Pfeiffer, DAI Senior Global Practice Specialist, DAI Technical Services. The report was co-authored by Brett Mallen and StJohn Bungey. Brett Mallen is an independent frontier market investor in private markets and StJohn Bungey is Director at Broadreach Capital and Advisory. Terry Wyer, DAI Investment Specialist, provided technical contributions to the paper.

ANNEX 1: INTERVIEWEES

Interviewee	Institution	Type of Participant
Anurag Agruwal	**Aavishkaar**	MFI / Private Debt fund manager
Rob le Blanc	**Awethu Project**	Impact PE fund manager
Mark Paper	**Business Partners International**	NBFI
Carl Combrinck	**Chrysalis Capital**	Private Debt fund manager
Richard Rose	**Edge Growth**	Development fund manager
Andrew Canter	**Futuregrowth**	Debt + Development fund manager
Ashraf Esmael	**GroFin**	Impact Debt fund manager
Kiara Suttner-Tromp	**Havaic**	VC fund manager
André Rheeder	**Independent**	Private Real Estate fund manager
Raimund Snyder	**Leap Frog**	Impact PE fund manager
Marc Immerman	**Metier Capital**	PE fund manager
Philip Walker	**Obviam**	DFI
Karl Westvig	**Retail Capital**	NBFI
Samantha Pokroy	**Sanari Capital**	PE fund manager
Patrick Kilkenny	**Sanlam Alternative Investments**	Alternative Investments
Erica Nell	**Sanlam Private Credit**	Private Debt fund manager
Lourenço Tigre	**SAVV Partners**	Illiquid Assets fund manager
Michael Waller	**Sofala Capital**	NBFI
Warren van der Merwe	**Vantage Capital**	Mezzanine finance fund manager
Barthout van Slingelandt	**XSML**	Mezz/quasi-equity fund manager

ANNEX 2: LIST OF REFERENCES

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