BERTHA CENTRE FOR SOCIAL INNOVATION & ENTREPRENEURSHIP

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Smart Capital for Small Businesses

DRIVING SMALL BUSINESS SUSTAINABILITY AND JOB GROWTH THROUGH THE ALLOCATION OF SMART CAPITAL TO DEBT AND ALTERNATIVE CAPITAL FUNDS

BERTHA FOUNDATION | GSB Graduate School of BUSINESS UNIVERSITY OF CAPE TOWN

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To build capacity and pioneer practices in Africa
– with partners, practitioners and students
– to advance the discourse and systemic impact of social innovation.

AUTHORED BY

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East Africa Venture Capital Association and Open Capital Advisors who provided Kenyan context

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1 EXECUTIVE SUMMARY

1.1 DONORS SHOULD PUT THEIR MONEY BEHIND MARKET-BASED MECHANISMS

The UCT GSB Bertha Centre was asked to investigate a job-linked payment to incentivise job creation in small and growing businesses (SGBs), something that our team has designed and launched in the past year through the Green Outcomes Fund. We concluded that while it is valuable to test variants of outcomes-based contracts, in order to grow the quantum of finance for SGBs in emerging markets it is preferable to distribute concessionary capital or grant funding based on the growth and sustainability of an SGB or portfolio of SGB investments. Job growth is a by-product of such businesses, with evidence to indicate a correlation between these data points. Concessionary capital is debt, equity, guarantees, and other investments that accept disproportionate risk and/or lower returns relative to a conventional investment in order to generate positive impact and leverage commercial capital that otherwise would not be possible.

This may not be a popular opinion, given that governments, development agencies and donors have shown particular interest in impact expressed as job creation, often reporting programmatic success based on jobs created per $1 million invested. However, the variability context and job type, not to mention measurement methodology, means that impact pricing is too variable to create a meaningful market at scale. In other words, if you cannot adequately compare prices then they cannot be used to drive the prices down towards market efficiency; and there is a greater chance that they will distort the market with enhanced returns or cross-subsidisation.

Instead we propose that fund managers be supported and incentivised based on certain predictors of success in their operational models, or based on the financial performance of their underlying investments. This conclusion has been reached through engagement with multiple fund managers across Africa, as well as through an assessment of the government-driven Jobs Fund in South Africa. It reflects the preference to create a market-based approach for the distribution of concessionary capital in order to enable the SGB finance market to reach sustainability more quickly. The incentive mechanism is more likely to succeed in this regard if it reflects the priorities of more commercial capital.

Thus governments, development agencies and donors can achieve sustained job growth by adequately supporting the SGBs that are creating those jobs. The argument can be taken further in that resilient SGBs are better indicators of sustained job growth than the job numbers themselves, as without a sustainable and growing business model, jobs are likely to be under threat in the medium and long term.

1.2 SMART CAPITAL ALLOCATION IS SUPPORTED BY DEEP UNDERSTANDING OF PERFORMANCE DRIVERS

The subset of alternative debt funds chosen as the basis of the sampled cohort arose predominantly as a result of the Black Economic Empowerment legislation, where concessionary capital is provided by corporates. Through the research we were able to affirm the growing market sentiment in the ability of alternative debt funds to successfully finance underserved SGBs, but needed to take it a step further. Because we needed to find a market-based solution to the practice of supporting SGB finance in emerging markets, it was necessary to figure out exactly what makes alternative debt funds work. As a by-product of the research, we thus developed a segmentation approach to better assess the levers for growth so we could develop a theoretical model for the placement of smarter subsidies and incentives. We've called the theoretical model a Smart Capital Mechanism. Investors who wish to optimise job creation through enhancing SGB resilience and growth can use this mechanism as a basis on which to design a smart subsidy or incentive.

The Smart Capital Mechanism was built according to the following set of logic:

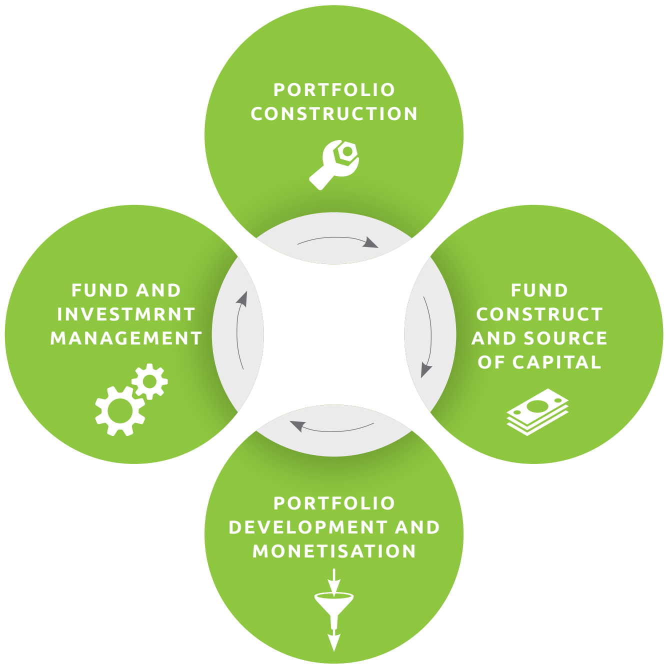
SGBs create jobs but lack access to finance, so cannot survive and grow.

- Small and Medium Size Enterprises (SME) contribute to >50% of employment in emerging economies, with 80% new jobs created in SMEs.
- A ±$1 trillion funding gap exists for formal SMEs in emerging markets, with a $331 billion SME funding gap in Africa.
- Banks and Venture Capital (VC) do not adequately meet the needs of SMEs in emerging markets; even more so in the case of SGBs, which represent the least established and smallest of these business types. In fact, traditional financiers have been so slow to adapt their models to serve SGBs that a cohort of alternative debt funds have emerged up to meet this need.

Alternative debt funds that coherently manage the interplay among the key performance determinants to their operational model are meeting the capital needs of underserved SGBs. This means that there are scalable models of SGB finance that are successfully doing what traditional finance providers have been unable to do. Furthermore, there is a way of breaking down the operational components of these funds to the point where one could predict and enhance their success.

- This interplay can be determined through a framework of 4 Key Performance Determinants and associated growth levers.
- The most effective fund managers have a built both an instinctive and calculated awareness of how they can maximise growth levers for success, which are shared in this paper.

Four Key Performance Determinants



Funds can be segmented according to these key performance determinants with a cohort of 4 archetypes emerging based on the variants.

> "Four alternative debt fund archetypes emerged based on key performance determinants"

Archetypes

Table 1: Fund Archetypes with growth levers associated with Source of Capital

	INCLUSIVE VALUE CHAIN: Working Capital	VALUE CHAIN: Growth	SMALL TICKET ASSET-BASED	VENTURE DEBT
DESCRIPTION	• Affordable working capital to SGBs in local communities and supply chain continuums	• Growth capital to SGBs in supply chains looking to expand	• Capital to SGBs, with principal needs related to the acquisition of tangible assets able to grow means of production	• Growth capital to SGBs that require patient, risk-tolerant terms to fund intangible needs to grow entire business
PERFORMANCE DETERMINANT: Source of capital	• Principally short-term/ revolving capital needs • Working capital funders • Lower risk profile investors	• Longer-term capital sourcing of 3-5 years • More risk-tolerant capital	• Medium-term capital • Low risk profile-seeking asset collateral coverage	• Longer-term funding sources • Higher risk tolerance • "Patient" capital • IRR highly sensitive to duration
GROWTH LEVER	• Increase and diversify local capital sources • Increase supply chain partnerships • Tap local ESG/ foundation stakeholders	• Tap existing funding relationships • Layer capital along risk, yield and duration profiles • Develop data on underlying supply chain	• Tranche capital to provide asset coverage to low-risk investors • Target lower-yield-oriented investors • Develop lease/ securitised receivable vehicle structures	• Target yield-orientated investors • Capital tranching to align investors with different yield/ duration/security levels • Offer equity-like return tranche

Targeted support/investments based on the growth levers of specific fund archetypes offer high-impact opportunity to build and sustain their underlying portfolio.

- Concessionary capital is currently required to support the market, but is in limited supply.
- The application of subsidies and incentives can be better targeted to optimise SGB sustainability growth, and thus job retention and creation.
- The archetypes form the basis for the flexible application of subsidy or incentive and choice of indictors.
- The valuation of impact can be tied to existing estimates or determined through a bidding process.

Defining Small and Growing Business

For the purpose of this research and the related proposals, SGBs are considered to be commercially viable businesses with 5-250 employees that have significant potential, and ambition, for growth seeking capital from \$20,000 to \$2 million. (ANDE)

Table 2: Design Flow in Smart Capital Mechanism

ARCHETYPE	SUBSIDY OR INCENTIVE	INDICTORS	VALUATION OF IMPACT
• Determination of Key Performance Determinants and growth levers	• Choice based on level of data available. Start with subsidy and transition to incentive	• Selection of portfolio- or SGB-level financial indicators. Transition to non-financial indicators if data available	• Based on difference between commercial expectation and current market realities

Table 3: Application of Smart Capital Mechanism

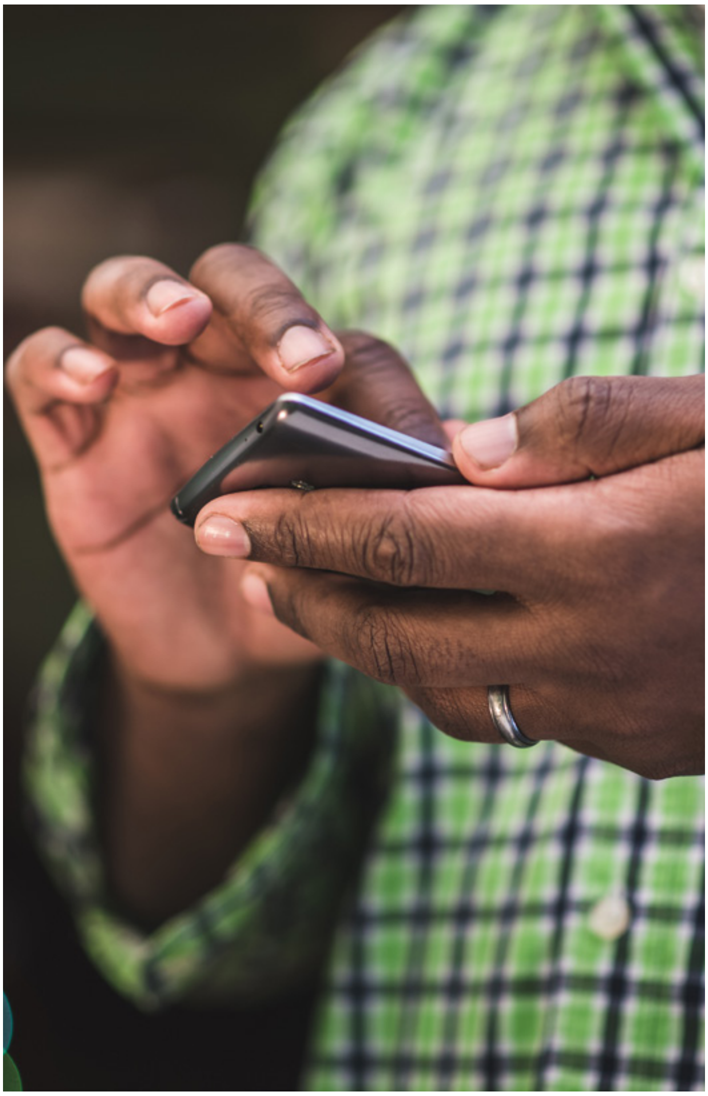
	INCLUSIVE VALUE CHAIN: Working Capital	VALUE CHAIN: Growth	SMALL TICKET ASSET-BASED	VENTURE DEBT
ILLUSTRATIVE GROWTH LEVERS	**Fund Capacity & Performance** • Pipeline: Increase value chain impact by expanding fund's geographic/sector coverage	**SGB Portfolio Performance** • Pipeline: Increase financing advance rate and/or leverage level	**Fund Capacity & Performance** • Investment thesis: Tranche capital to provide asset-coverage to low risk investors	**SGB Portfolio Performance** • Portfolio development: Post-investment TA/BDS services to strengthen strategic and operational capacity of high-growth companies
IMPACT CATEGORIES	• AUM Growth Rate • Lower operating Cost per Financing Transaction	• Accelerate ROA of business • Allow entrepreneur to invest in non-working capital assets/ infrastructure	• AUM	• Enterprise-level growth rate • Level of EBITDA across portfolio • Accelerate enterprise level revenues by 33%
INDICATIVE PERFORMANCE MULTIPLIERS	• AUM increase of 30%	• Increase ROA by ±30% p/a	• 3x leverage	• Accelerate EBITDA by 25%
IMPACT CONSIDERATIONS	• Support expansion of local staff hires and/or local office infrastructure. • If corporates open supply chain to local SGBs then business model is easily transported into new communities or supply chains, and capital follows. • Subsidy supports new hubs during community entry phase. **Impact**: Decrease in operating costs as % of AUM improves viability of fund's operational model.	• Supply chain provides competitive advantage so specialist funders have grown to support corporate needs. • Fund growth of businesses through long-term and intangible assets. • Growth keeps pace with corporate growth or additional corporate supply chains secured **Impact**: Increase access to capital permits enterprise to accelerate growth trajectory.	• Structural limitations to bank funding this segment. • Specialised fund manager is better able to assess perceived risk than bank. • Additional capital supports fund economics. **Impact**: Increase in fund size enables more businesses to benefit.	• SGBs receiving high-quality, high-touch TA similar to VC support. • TA orientated to maximise use of investment capital for growth. **Impact**: By accelerating the growth trajectory, achieve increased enterprise level sustainability and job retention resilience.

1.3. THE SMART CAPITAL MECHANISM REQUIRES RIGOROUS QUANTITATIVE TESTING

Three recommendations emerge from this work, including (i) a Smart Capital Fund, (ii) an independently-held repository of financial and non-financial fund performance data, and (iii) partnership development with guarantee schemes and/or banks.

A fund of funds initiative could create sufficient scale to accelerate learnings and catalyse concessionary and commercial funding in the market.

- A R3 billion injection of debt, equity, mezzanine and asset-backed finance, channelled through banks and other vehicles, has the potential to significantly influence eco-system in particular country or market segment (ANDE/Enclude/Shell Foundation, 2017)
- The proposed Smart Capital Fund (SCF) is a $50 million fund of funds that will provide smart capital to 10-20 SGB-oriented fund vehicles, leveraging ±$500 million of fund-level AUM. This represents ±10% of the target.
- The benefit of a large injection of capital is that it provides the ability to test the smart capital mechanism with a view to a much more explicit monetisation of socio-economic impact, and to demonstrate job creation driven from a market-based perspective.
- The timing is such that such a vehicle could leverage the work being undertaken in many contexts by multiple alternative debt providers.
- The ultimate aim would be to clearly calculate and drive the market- and impact-related value proposition for commercial and concessionary funders respectively, with the view of driving more capital in the market.



A repository of data could be set up in a credible neutral institution, in order to, amongst other things, track the effectiveness of concessionary capital allocation.

- Analysis of fund performance and subsidy effectiveness tends to be done in retrospect, which does not enable real-time allocation or re-direction of capital.
- Performance data is often presented in such a way that it cannot be compared across investments. This can be remedied through partial standardisation of reporting, which will enable benchmarking.
- We have used predominantly qualitative data to support the theoretical model described in this paper. One of the benefits of collecting additional data would be to support, nullify or sharpen the Smart Capital Mechanism through the analysis of a critical mass qualitative and quantitative data.
- Data should be anonymised, analysed, aggregated and disseminated by a credible neutral body such as the Collaborative for Frontier Finance.

The operational model used by alternative debt funds could inform the lending practices of banks and multi-lateral guarantee funds

- Banks are the most scaled institutional lenders across emerging markets and are the most likely to commoditise lending in the quantum required.
- Guarantee schemes have failed to drive sustainedbehaviourchangewithinbankswith regards to lending practice.
- Data, track record and effective operational models are required to drive this behaviour change, not just risk mitigation.
- A learning module can be created to support this change based on the theoretical thinking contained in this and other complementary research.

2

METHODOLOGY: UNCOVERING MARKET BASED MECHANISMS TO ACCELERATE JOB GROWTH

2.1. FOUNDATIONAL QUESTIONS

This research was launched to better understand the role that impact capital might play in creating and sustaining jobs across geographies and sectors in emerging markets, and to recommend alternative approaches to distribution of that capital. Going into the research, the authors recognised several factors:

- Ineffective application of philanthropic and government "supply side" methods in driving sustainable jobs, questioning the potential that the capital markets might play in providing alternative approaches, yet…
- A lack of understanding of the key drivers of different capital vehicles that target SGBs in emerging markets, and therefore…
- the inability to define and apply effective market and quasi-market-based mechanisms to stimulate job creation.

The authors explicitly recognise that the issues are complex and nuanced based on local dynamics, behaviours and populations, often requiring resources beyond what is available to the private sector. Hence, while the goal is to look at "market-based" mechanism, we recognised that at times philanthropic and government funds may be required. Therefore, we looked at "smart capital" mechanism; incentives structured instruments where the path and outcomes are well known, allowing private actors to take measured risk in applying their monies. In other situations, the path, timeframes and outcomes are not as well understood – thereby requiring the application of "smart subsidies", funds that drive towards financial sustainability, and therefore are highly aligned with the commercial marketplace.

2.2. RESEARCH METHODOLOGY

2.2.1. HYPOTHESIS

The hypothesis being framed is whether: (i) there is a value in the socio-economic impact of job creation, (ii) the value can be monetised, and (iii) such monetised value can be used as an incentive mechanism to drive further job creation by the investment activities of fund managers.

2.2.2. DESIRED OUTCOME

This research is intended as a first step to creating an "impact kicker" incentive mechanism for job creation by SGB-oriented funds across Africa.

2.2.3. RESEARCH METHODOLOGY & ANALYTICS

This research focused principally upon the potential of debt and alternative capital vehicles/funds that finance the business activities of small and growing businesses in emerging economies. The authors sought to assess whether such fund vehicles offered the capacity to affect job creation with their portfolio enterprises – and what mechanisms could be applied at the fund level to accelerate job growth.

Defining Smart Capital: While there is no universal definition to Smart Capital, in the context of impact investing, the authors have used the framing of "smart capital" as capital contributed by sophisticated investors who bring not only money, but also knowledge of the potential application of such monies in order to align the capital to specific outcomes.

This research builds upon recent studies and mapping initiatives. In 2018, "The Missing Middle – Segmenting Enterprises to Better Understand Their Financial Needs" report developed by Omidyar Networks and Dalberg mapped out and defined 4 SGB business segments:

1. **High-Growth Ventures.** Disruptive business models, with high growth potential as they target large addressable markets.
2. **Niche Ventures.** Creative businesses that target niche and defined market and customer segments.
3. **Dynamic Enterprises.** Businesses that operate in established "bread & butter" industries (e.g. trading, manufacturing, retail, services, etc.). Building on existing products and proven business models, they seek to grow through market extension and incremental innovations.
4. **Livelihood-sustaining Enterprises.** Opportunity-driven, family-owned businesses that may have incremental growth – though often with limits. They are highly local in nature, meeting established community needs or accepted products/services.

Focusing on predominantly equity but also debt financing models, the Dutch Good Growth Fund supported research released in November 2019 "Scaling Access to Finance for Early Stage Enterprise in Emerging Markets – Lessons from the Field", laid analysed the requirements – and constraints – of equity funds to meet the needs of growing SGBs. • Whereas equity is considered to provide the bulk of non-bank working and growth capital, debt was considered supplemental due to the significant de-risking required and limited supply available for growth.

Building on these foundational works, this research was developed from 3 major analytical components:

2.2.3.1. REVIEW AND ASSESSMENT OF EXISTING JOB-ORIENTED FUND MECHANISMS

Analysis of a cohort of funds representing ±50% of the on-lenders supported by the South African Jobs Fund. Some 32% of the Jobs Fund portfolio is made up of investments into intermediary vehicles such as debt and equity funds. Analysis was undertaken to assess the use of the creation and retention of a "job" as a non-financial metric for incentive-based payments. Assessment included suitability, adequacy, cost vs value of job, data collection and verification, fund manager behaviour and unintended consequences.

The South African Jobs Fund

The Jobs Fund is a R9 billion South African government challenge fund established in 2011 to co-fund public and private sector initiatives with significant job creation potential. The Fund awards once-off grants to support projects that place unemployed citizens, especially youth and women, into sustainable. The fund targets the supply and demand sides of the market as well as addressing institutional barriers. On the demand side this includes the support for thematically focused enterprise and infrastructure development with high potential for growth. On the supply side the fund supports work seekers to link to formal sector work opportunities through training and placement programmes. As of mid-2018, the Jobs Fund had deployed R6.7 billion across 127 individual projects, leveraging R9.5 billion in matched funding from partners and completed funding agreements encompassing an estimated 225,981 permanent jobs. Theoretically this works out to R71,000 per job created. The fund has also served as a key support in accessing and supporting small businesses and, as of 2016, had already supported 12,000 small businesses.

2.2.3.2. ASSESSMENT OF THE APPLICATION OF SUBSIDY AND INCENTIVE STRUCTURES

Review and assessment of subsidies and incentive mechanisms in emerging markets. These mechanisms are constructed to be applied at investor, fund manager and enterprise level. Different constructs have been applied in the commercial capital markets and philanthropic sectors. These range from first loss guarantees, concessionary debt or equity and technical assistance grants on the subsidy side; in addition to tax incentives, results-based finance mechanisms, and impact hurdle rates on the incentive side. However, there is a lack of meaningful literature on comparative financial and non-financial performance of different structures. This is primarily due to lack of uniformity and fidelity in data collection. Therefore, it is currently of low value to assess the effectiveness of job creation mechanisms unless within similar sectors in similar geographies.

2.2.3.3. ANALYSIS OF DEBT/ ALTERNATIVE CAPITAL FUNDS AND VEHICLES OPERATING IN SUB-SAHARAN AFRICA

Qualitative and quantitative assessment of fund archetype; fund performance; potential role of "impact kickers" for job creation; alternative metrics as proxies to sustainable job growth; alternative mechanisms for implementing performance-based payments in order to drive incremental capital into the SGB finance. A particular focus of the review was on funds vehicles regulated via the South African Enterprise and Supplier Development Funds legislation.

SGB-Oriented Fund Vehicles

This research largely focused on fund vehicles that provide debt and alternative debt financing for SGBs. On average, the financing amounts range between an average of $50,000 to $500,000.

The review and discussions with fund managers provide insights as to the context, constraints and alternatives that warranted consideration in the design of mechanisms to drive job growth in these markets.

Yet, even here, it became obvious that fund models themselves are a heterogeneous group. Recognising this, the authors developed an analytical approach to assess the factors that drive success and sustainability for funds that target SBGs in emerging economies. This framing – The 4 Key Performance Determinants – looks at the coherency and integrated alignment of factors that fund managers need to consider as they strive to provide returns to their investors. Such returns can vary along the financial and societal impact return spectrum. With this common framing, we were able to better inform the metrics and mechanisms that could be applied to incentivise job growth.

Broad-Based Black Economic Empowerment (B-BBEE)

The BBBEE act was introduced in 2007 to address the large degree of inequality resulting from the racially exclusive policies of the previous apartheid regime. The voluntary regulation aims to accelerate the participation of previously disadvantaged groups in the economy by rewarding business ownership, management and control, skills development, procurement and enterprise and supplier development (ESD), and socio-economic development. Businesses that transform in this manner are treated preferentially in government tender processes. The ESD Funds are capitalised by low cost debt seeking returns ranging from 0-8%. Corporates are required to maintain a level of investment equivalent to 3% Net Profit After Tax in order to receive maximum recognition.

2.2.4. RESEARCH LEARNINGS

Informed by the research – and most particularly by the input and learnings from fund managers – the authors propose a Funds of Funds framework with the express purpose of applying a more targeted and disciplined approach to subsidy or incentive allocation. Through the review process of the government vehicles – such as the South African Jobs Fund – it became evident that such supply-side mechanism lacked evidence of being an efficient mechanism to effectively drive sustainable job growth. Equally, the application of the traditional of philanthropic results-based constructs. Meanwhile, the application of traditional developed economy capital market vehicles such as the 2/20 closed-end fund model has limitations in emerging markets, particularly for SGB investing.

The conclusion from the research is that an alternative approach was needed. This research has identified potential in the market to test new and propagate existing sustainable SGB debt fund models in emerging markets, as well as to create additional efficiencies in these models.

The metrics and mechanism most appropriate for each fund archetype will allow each to be supported in a more targeted and thus more effective manner. This will accelerate the growth in capital allocation to SGB funds and growth in SGB size – a proxy for job creation.

This so-called Smart Capital Fund will focus on Green Energy Enterprises in emerging markets, but the concept can be applied generically to support SGB growth.

3 THE OPPORTUNITY

The Smart Capital Fund described in this chapter is a $50 million fund of funds that will provide smart capital to 10-20 SGB oriented fund vehicles, leveraging ±$500 million of fund level AUM.

3.1. WHY NOW?

"More than half of global population growth between now and 2050 is expected to occur in Africa," according to the United Nations. There are ±30 million or ±7% unemployed and ±250 million in vulnerable employment in Sub Saharan Africa with >12 million youth entering the job market annually. With slowing growth in South Asia, unemployment is starting to rise to a similar level of ±7%. These statistics more than double when it comes to youth employment. The socio-economic cost of not addressing the lack of jobs as populations are expanding is substantial. One of the missing ingredients to job growth is appropriate capital, as evidence by IFC's estimate that there is a $5.2 trillion deficit in SME finance in emerging markets. One of the underlying factors is the misalignment of commercial capital with the market needs. For fund managers that target financing SGBs, the traditional developed market investment model of 2/20 is not achieving the requisite flow of capital. In the emerging market context, such investment mechanisms have struggled, particularly in the arena of SGB finance.

The dominant concessionary investors in these emerging market funds, DFIs and MDBs, account for over half of SGB finance, with donors/foundations and impact investors/corporations making up ±25% each. Yet, such their monies are relatively ad hoc and in short supply compared to the scale of the needs in emerging markets. Further, the application of low level of concessionary capital into the sector has led to slow growth and lack of innovation. Meanwhile, as evidenced by this research, the South African ESD fund market has demonstrated that a consistent supply of low-cost wholesale capital can lead to the mushrooming of local alternative debt funds, with >20 currently operating. Further, the consensus from fund managers interviewed is that were B-BBEE funding to be directed in a "smart" manner then that market would be growing even faster.

There is potential to reach a tipping point similar to that experienced in these other subsidised markets. Market-builders have created a stretch target of raising an additional $3 billion over 3-5 years to be absorbed by a number of financing models including banks (40-50%), mezzanine funds (20-30%), asset backed finance solutions (10-15%) and flexible equity and debt funds (5-10%) . Despite the obvious potential for local banks to play a bigger role in their home markets, numerous factors have constrained their capacity. However, the authors believe that mechanisms that begin to break down the information asymmetry with regards to the perceived risk/reward imbalance in SGB financing, new paths could be available to such players. This Smart Capital Fund represents about 10% of this stretch target and could be a model for similar funds in different geographies or sectors.

> "Smart capital refers to the use of concessionary/ catalytic capital or grants in the form of market subsidies and incentives that are utilised at their maximum potential to create socio-economic impact avoiding market distortion and unintended consequences."

3.2. VALUE PROPOSITION

The proposed Smart Capital Fund offers a unique opportunity to align wholesale capital with positive socio-economic outcomes that can be generated through a growing and resilient SGB business sector in emerging markets.
As a fund of funds, the Smart Capital Fund…

- provides a framework to assess the unique attributes of specific SGB oriented fund archetypes, as well as the key determinants of success for such funds,
- allows for a more explicit alignment of capital to the fund archetypes and their SGB portfolios,
- proposes the application of metrics and mechanisms that explicitly align such capital with the growth drivers available to such fund archetypes,
- continuously assesses the performance data related to the smart capital being applied, and
- thereby increases the transparency (and diminished information asymmetry), allowing for ever greater capacity to value and monetise impact of the smart capital – driving scale and leveraged impact on creating quality and sustainable jobs.
- Based on this there is the opportunity to implement a fund vehicle that provides the "smart capital".

Graphic 1: Smart Capital Fund – A vehicle to more efficiently allocate the requisite SGB growth capital

Smart Capital fund

A fund of funds vehicle that applies a disciplined framework to structure market & quasi-market based investment mechanisims to accellerate the growth and impact of SGBs.

1 APPLY

Smart Subsidies & Incentives

Apply:

An understanding of:
- A fund's investment & operational model
- The financing needs of its SGB portfolio

In order to structure:
- Incentives and/ or subsidies that best align with the fund and SGB requirements

2 LEVERAGE

SGB Oriented Fund Archetypes

Leverage:
- Mechanisms that are tailored to adress the opperational needs of specific fund archetypes, as well as the requisite growth needs of their SGB portfolios
- While attracting additional commercial capital into the fund vehicles

3 ACCELERATE

SGB Funds' Sustainability & Perfolio Reformance

Accelerate:
- The investment impact and growth trajectory through the application of incentives and support mechanisms
- Data analytics will allow the SCF to monitor and qualify the impact of the underlying mechanisms

4

KEY LEARNINGS & IMPLICATIONS

Throughout the inquiry process several key learnings guided the development and refinement of the proposed Smart Capital Fund. These learnings and the related implications included:

4.1. JOB GROWTH IS A BY-PRODUCT OF RESILIENT AND GROWING BUSINESSES

- Consistently the comment from fund managers is that, "We are in the business in investing and growing businesses". They do not see it as their role – or value proposition – to explicitly focus on or influence the job creation at their portfolio companies.
- However, there was universal consensus that growing and resilient business are creating jobs. Further, as the enterprises evolved the quality of jobs appears to be strengthening as the entrepreneurs themselves demand more skills in order to compete.
- Data from government-sponsored jobs programmes further indicate that despite financial resources and explicitly designed programs, that "push" job creation have not substantiated steady, living wage quality employment.

Implication: If job creation is a desired goal, the means to such may best be achieved in supporting the growth and accelerating the resiliency of small businesses.

Decent job creation tends to have a positive impact at an individual and societal level whereas unemployment tends to have the reverse effect. *Unemployment is one of the biggest indicators of poverty in developing economies and currently there are in excess of ±30 million or ±7% unemployed and ±250 million in vulnerable employment in Sub-Saharan Africa, with >12 million youth entering the job market annually. More than half of global population growth between now and 2050 is expected to occur in Africa.*

4.2. FUNDS THAT COHERENTLY MANAGE THE INTERPLAY

AMONG THE KEY PERFORMANCE DETERMINANTS TO THEIR OPERATIONAL MODEL, ARE INDEED MEETING THE CAPITAL NEEDS OF UNDERSERVED SGBS

- In reviewing the design and operations of the funds, the understanding of a fund's "Key Determinants Alignment Framework" evolved. The four factors/determinants are segmented into the alignment of their: (i) Investment Objectives & Source of Capital, (ii) Portfolio Construction, (iii) Fund and Investment Management, and (iv) Portfolio Development & Monetisation.
- By ensuring consistent and coherent alignment among each of these factors, these fund managers were able to serve a segment of the SGB market that is materially underserved by mainstream capital providers. Those funds that lack such alignment have struggled to operate in a sustainable manner, requiring substantial grant/patient capital to support their operations.
- It is interesting to note that the managers may not have always been able to self-define the operational alignment of these factors, as it was either inherent in their business approach or the result of learned iteration.

Implication: While the broad sector for financing SGBs **(<$1 MILLION CAPITAL NEEDS)** is underserved, there are fund models that are achieving success in providing the appropriate capital. Shell Foundation and the ecosystem field-builder community can target their support and investments into such players, accelerating their impact on growing sustainable businesses, and ultimately job growth.

4.3. DATA ANALYTICS CAN BE LEVERAGED FOR MARKET-BASED MECHANISMS

- Fund managers actively track a number of key data inputs regarding their portfolio. At the individual enterprise level, these include jobs created, gender, financial and operational performance metrics.
- The influence of their investors/LPs has material impact on the decision and commitment to tracking such metrics as jobs and gender.
- Traditional "Know Your Customer" marketing is a requirement for a business in order to grow its revenues and client base – hence, gathering of such market level data at the enterprise level is simply "good business", and inherently strengthens their underlying portfolio companies' finances.
- That said, the data gathering, and analytics methodologies/tools are frequently primitive.

Implication: By applying data analytics, fund managers are able to track – and assess – the financial and social value creation of their investments. These metrics can therefore be the basis for structuring incentive systems that target such business and economic outcomes.

4.4. TARGETED SUPPORT/ INVESTMENTS

BASED ON THE GROWTH LEVERS OF SPECIFIC FUND ARCHETYPES OFFER HIGH-IMPACT OPPORTUNITY TO BUILD AND SUSTAIN THEIR UNDERLYING PORTFOLIO.

- Several clearly defined capital vehicle archetypes emerged from the case study research. Among each of these archetypes (a.k.a. fund business models) there was a well-articulated balance between the investment thesis of the fund manager and the financing needs of the entrepreneur. The fund managers were very purposeful in managing the risk/reward alignment, while operating within the constraints of their own sources of capital and fund operational resources/ approach.
- The archetype which we have explored from the research fell into the following 4 buckets: (i) inclusive value chain, working capital – short-term loans to cover the daily operational needs of lifestyle businesses; (ii) value chain, growth capital – financing for growth oriented business that were facilitated by their role within the local supply chain and economy; (iii) small ticket asset-based financing - monies to fund productive investments that have relatively fast payback; and (iv) venture debt – capital to meet the "soft infrastructure" and long-term investments requirements of a growth-oriented company.
- Developing an understanding of these archetypes allows for greater clarity as to the factors that best support and accelerate the investment activities of these capital providers.
- In turn, targeting the fund level "growth levers" can be the targeted intersection of the, creating "smart subsidies and incentives", highly targeted mechanism that drive exponential influence in accelerating the growth of the underlying enterprise portfolio.

Implication: With a clear understanding of the archetype of an investment model, field builders can target their "smart capital" to accelerate the growth and impact of their underlying enterprise portfolio. Applying data analytics, such growth levers can be monitored as to their direct impact on the strengthening of the underlying portfolio. Fund archetypes and their underlying portfolios have specific growth levers that should be targeted/supported by field building institutions and "informed" LP investors.

5

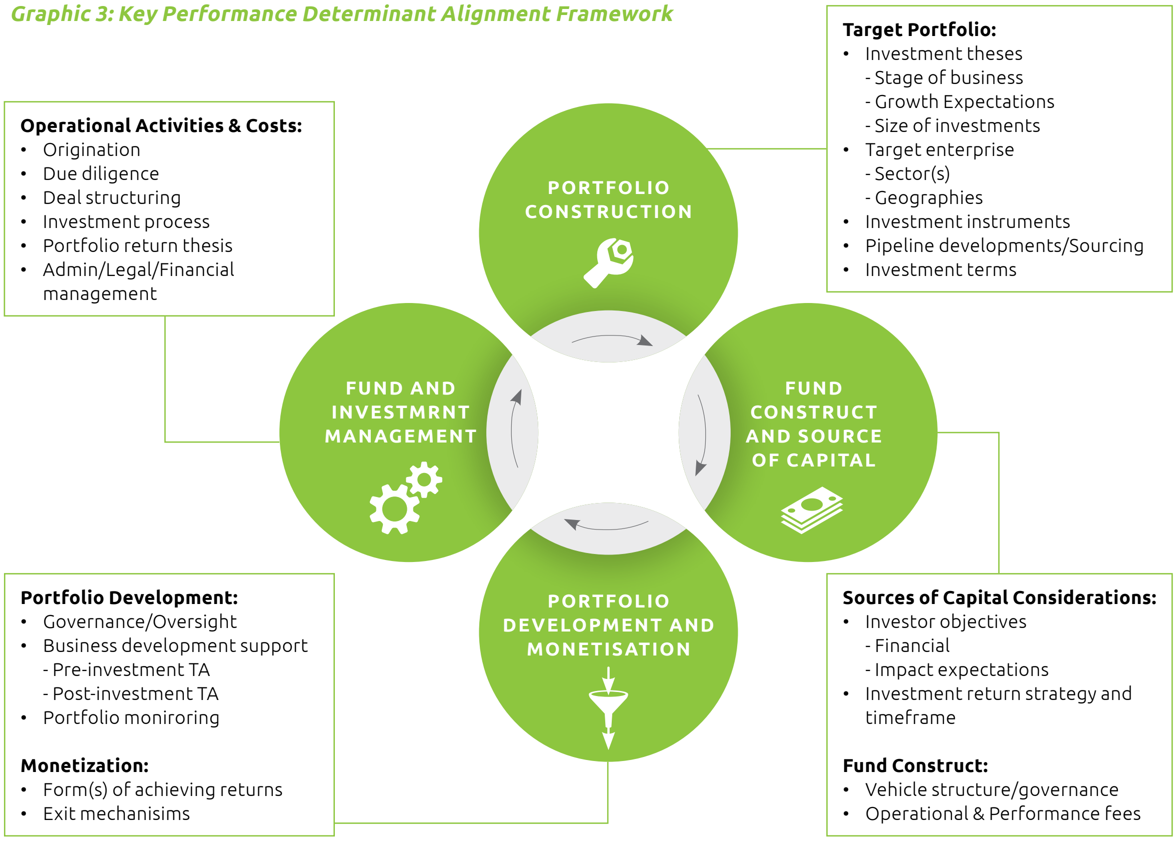
BUILDING A FRAMEWORK

5.1. ASSESSING KEY PERFORMANCE DETERMINANTS

Based on the analysis of the funds reviewed during the research, it became clear that a coherent alignment among several key factors / "determinants" were critical for success. The design and operating construct of capital vehicles is informed by 4 Key Performance Determinants These factors are highly interrelated, each interconnected and aligned with the other. It is the coherent alignment of these determinants that defines the fund's value proposition and its operational archetype.

The Key Performance Determinant Framework forms the basis of a due diligence analytic tool that can be used by wholesale capital providers as to the potential of a fund's operational model – and therefore not only its investment performance opportunity – but also for field building funders, they are more able to precisely identify mechanisms/investment strategies that support the viability of a given fund.

Graphic 3: Key Performance Determinant Alignment Framework



5.2. DEFINING FUND VEHICLE ARCHETYPES

In assessing the opportunity to develop market-based mechanisms that could be applied at the fund vehicle level, it became clear that such funds themselves are a heterogeneous group – and therefore may require different approaches. The research developed four fund archetypes (a.k.a. business models) described in Table 1.

These archetypes, developed from our research and engagement with fund managers, are not exhaustive. Follow-on research and deeper, ongoing assessment of these models should allow for further understanding of the fund ecosystem and vehicle constructs. By recognising that each of these fund models seek to address different financing challenges, and the type and stage of SGBs they target, we are then able to better assess how the fund should be structured and managed.

The table below illustrates how a fund manager can align their Key Performance Determinants to meet the specific needs of its underlying portfolio enterprises. By coherently aligning the design and operations of its fund, managers can achieve a combined out-sized socio-economic impact for its investors.

Table 1: Description of 4 archetypes articulating the various business models alternative debt funds

ARCHETYPE	INCLUSIVE VALUE CHAIN: Working Capital	VALUE CHAIN: Growth	SMALL TICKET ASSET-BASED	VENTURE DEBT
SUMMARY DESCRIPTION	• In emerging markets, SGBs often are the result of opportunism not entrepreneurialism. With limited access to employment in the formal economy, many small businesses are established out of economic necessity. They are focused on generating an acceptable level of livelihood income, not growing business. Nevertheless, local economies benefit from more resilient livelihood oriented SBGs as they address specific needs within the community or a local supply chain continuum. From a financing perspective, as growth is not their main objective, their key need is affordable and consistent working capital.	• Value chain implies the interconnectivity and interdependence of the enterprise to meet market opportunities with regards to supply chain within sector or specific needs within a given geographic market region. SGB entrepreneurs that are growth oriented seek to expand their market share, product/service offering, geographic reach, or lower their operational cost structure. Risk and reward commensurate with growth trajectory. Capital needs principally are working and growth capital.	• SGBs in growth stage with principal needs related to the acquisition of tangible assets. Tangible security can be fixed or moveable assets. Asset financing used to grow means of production and thereby growth. Most closely resemble Non-Bank Finance Institutions, the characteristics of which mean they can meet the credit demand unmet by traditional banks.	• Growth-oriented enterprises that require capital to grow the entire business. This can include investing in the human capital, marketing & sales capabilities, productive/services development, back office support and systems – and other more "intangible" investments. Without these investments, an enterprise cannot sustain its growth. Often the "payback" and cash flow impact of such investments have longer time horizon. Traditional debt instruments in emerging markets do not align well with this risk profile, requiring more "alternative debt" and quasi-equity constructs.

" Fund archetypes focus on clusters of SGBs and have been designed to meet their particular financing requirements "

Table 2: Debt Fund Archetypes – Addressing the Capital Needs of Target SGBs

PERFORMANCE DETERMINANTS	INCLUSIVE VALUE CHAIN: Working Capital	VALUE CHAIN: Growth	SMALL TICKET ASSET-BASED	VENTURE DEBT
FUND CONSTRUCT AND SOURCE OF CAPITAL	• Principally short-term/revolving capital needs • Working capital funders • Lower risk profile investors	• Longer term capital sourcing of 3-5 years • More risk tolerant capital	• Medium-term capital • Low risk profile seeking asset collateral coverage	• Longer term funding sources • Higher risk tolerance • "patient" capital • IRR highly sensitive to duration
PIPELINE AND PORTFOLIO CONSTRUCTION	• Small business owners that are part of supply chain needs of local community and industry • Small to micro-financing needs • Strong personal reputation associated with entrepreneur	• Growth-orientated enterprises that are part of supply chain needs of local community and industry • Permanent working capital and business operational funding needs	• Vendor/supplier credit financing needs • Productive assets for business growth • Leverage value of assets to finance "intangible" growth needs	• Management team capacity and business model potential • Need to assess market growth opportunities • Monitoring business growth and performance targets
FUND AND INVESTMENT MANAGEMENT	• Risk mitigated by direct "line of sight" between use of monies and repayment source • Factoring and receivable documentation tracking • Staff based "in market" know community first hand	• On-going portfolio monitoring • Risk mitigated due to role within local value/supply chain • Regular interaction with entrepreneur	• Risk mitigated by asset backed finance • Asset valuation and monitoring capacity • Develop asset portfolio management capacity	• Experienced SGB financiers • Cashflow-based financing requires high level portfolio interaction with portfolio enterprises • Monitoring business growth and performance targets
PORTFOLIO DEVELOPMENT AND MONETIZATION	• Less sophisticated entrepreneurs • Requirement for BD services on financial management, book keeping, etc • Self-liquidating repayment through inventory sales and receivable collection	• Business and cash flow growth to repay financing • Strengthening management and business capacity a therefor priority for BD services	• Fixed-term repayment aligned with productive life of underlying assets • Potential for asset securitisation take-out financing	• Business development support • Repayment via: - Business and cash flow growth to repay financing - Follow-on capital from later-stage investors - Local bank financing

5.3. LEVERAGING GROWTH LEVERS

The archetype models have been developed to standardise the learnings by observing and assessing the stronger performing funds. Each of the fund managers engaged has spent years iterating on their business model in order to best align their Performance Determinants. Also, acknowledging that their portfolio represents entities that are traditionally considered "unbankable", these managers are acutely aware of the benefits of well-targeted subsidies to enhance their fund performance, and how smart capital can be applied in a targeted manner in order to either bolster existing drivers of success or address untapped growth levers.
The following table illustrates the applications that came of discussions based on the distinctive fund archetypes.

Table 3: Achieving alignment between fund archetype and their key performance drivers

GROWTH LEVERS	INCLUSIVE VALUE CHAIN: Working Capital	VALUE CHAIN: Growth	SMALL TICKET ASSET-BASED	VENTURE DEBT
FUND CONSTRUCT AND SOURCE OF CAPITAL	• Increase and diversify local capital sources • Increase supply chain partnerships • Tap local ESG/ Foundation stakeholders	• Tap existing funding relationships • Layer capital along risk, yield and duration profiles • Develop data on underlying supply chain	• Tranche capital to provide asset-coverage to low risk investors • Target lower yield orientate investors • Develop lease/ securitised receivable vehicle structures	• Target yield-orientated investors • Capital tranching to align investors with different yield/ duration/security levels • Offer equity-like return tranche
PIPELINE AND PORTFOLIO CONSTRUCTION	• Expand geographic coverage • Broaden industry supply chain • Assist diversity and inclusivity of corporate supply chains	• Expand geographic coverage and sectors • Increase % financing that is not supported by receivables • Multi-year bullet maturity structures • Develop standardised factoring contracts	• Partner with manufacturers to provide vendor type financing • Online proposal submission platform • Apply data and valuation analytics to simplify credit approval	• Develop targeted pipeline sourcing (e.g. accelerators, VC, equity funds etc.) • Target enterprises with clear path to next round of debt/ equity funding
FUND AND INVESTMENT MANAGEMENT	• Apply tech tools to ease small ticket processing • Use AI and data tools for risk assessment • Develop pre-approval mechanisms	• Develop low-cost portfolio BDS services • Apply simple and timely data tracking mechanism	• Apply data tracking on asset values and residuals • Develop standardised SPV vehicles for different asset classes • With data metrics, standardise valuation and advance rates	• Orient portfolio management towards high engagement model • Develop low cost enterprise support mechanisms • Pool of experienced mentors
PORTFOLIO DEVELOPMENT AND MONETIZATION	• Strengthen financial acumen of entrepreneurs • Link borrowing rates to demonstrated management skill development • Connect enterprises to follow-on capital	• Apply quasi-equity payment mechanism • Build partnerships with take-out financing FI's • Structure bullet repayment mechanism	• Develop pooled asset SPV vehicle to sell into • Develop locally listed vehicles • Partnerships with local FIs for follow-on growth capital • Develop long-term constant yield instruments for pension funds refi	• Strong investment thesis alignment with follow-on capital providers • Develop strong industry ties for corporate acquisitions • Apply equity-like payment instruments • Apply investment terms to encourage timely take-out refi

"Smart capital can be systematically placed once growth levers are identified"

In funds where the underlying SGB investees require predominantly working capital or small equipment to sustain operations (such as those in "Value chains: Working Capital" and "Small Ticket Asset Based"), economic and job growth is likely to come from increasing quantum of and access to finance. Growth mechanisms include:

- Tranching the fund's capital structure to increase the amount of capital available to the fund managers. Investors can be incentivized if the impact value proposition is strengthened and/or the balance of risk/reward is structurally aligned.
- Enhanced risk management tools to increase investable businesses and pipeline assessment methods to increase access by a larger pool of early stage and smaller SGBs.
- Modify fund vehicle construct and post investment processes/support to alter the risk return profile of SGBS they are prepared to invest in.
- Increase readiness of follow-on capital players and vehicle constructs to speed exit opportunities.

In funds where the underlying SGB investees require predominantly growth capital for their operations (such as those in "Value chain: Growth Capital" and "Venture Debt"), economic and job growth is likely to come from increasing the size of the underlying investee, as well as improved fund performance through accelerating pipeline development process and optimizing exit opportunities. Mechanism include:

- Increasing available funds through quasi-equity return mechanism for investors, achieving "upside" return potential.
- Pre-investment support enables fund managers to screen and groom SGBs with potential, thereby increasing their potential pool of investees and their chances of success.
- Accelerating business model performance through cost-efficient, and measurable, post-investment TA support. Post-investment support is critical not only to support standard business functions but to drive strategic growth through enhancing the unique value proposition of the SGB.
- Establishing partnerships with capital providers that target larger entities or lower risk transactions, creates a reliable pipeline of investible opportunities for such players.

ROLE OF TECHNOLOGY AND DATA IN ACCELERATING FUND PERFORMANCE

It is also important to note that, across the board, fund managers are significantly increasing the role of technology in operations. Technology is being applied in data analytics for portfolio risk and performance assessment pipeline development and acquisition facilitation via web-based tools and enhanced portfolio performance monitoring. Fund managers were in agreement that in order to serve SGBs cost effectively they need to consider not only automating their back offices, but also alternative underwriting methodologies.

The use of digitisation in the Smart Capital Fund and recipient funds can be leveraged to accelerate and refine learning. Thus, it is still critical that fund management teams are sufficiently "technology" resourced. This is essential across all the archetypes, although there may be potential to subsidise or incentivise in different ways depending on the growth strategy of the fund being either increase in AUM or in SGB size.

5.4. APPLICATION OF SMART CAPITAL MECHANISM

INFORMATION ASYMMETRY AND SMART CAPITAL

The determination as to applying smart incentives versus smart subsidies is based on a degree of confidence as to the level of understanding as to the relationship of key business and investment models and the desired development outcomes. The authors hypothesis that while great strides are being made in the broad fields of impact investing and development finance, there is a frustrating dearth of information as to the correlation of investment activities and specific socio-economic outcomes. The sector continues to lack the data – let alone an understanding of the implications behind the data – as to the requisite drivers of the desired SDG outcomes. This information asymmetry is particularly true for the field of SGB finance. A key value proposition of the Smart Capital Facility is applying specific assessment tools and methodologies in order to document and monitor the impact, hereby building the data set – and understandings – to increasingly move from subsidies to market-based incentives structures.

Accepting this reality of the stage of the sector, the Smart Capital Fund will look to apply smart incentives where the correlation can be credibly supported, and thereby allowing for a valuation metric. In other situations, in order to (i) drive socio-economic outcomes, and (ii) increase the sector's understanding of the correlation among specific investment activities and the targeted outcomes; the SCF will apply highly targeted smart subsidies.

HOW DOES USING THE SMART CAPITAL FUND DIFFER FROM BUSINESS AS USUAL?

For the field building investors that see the value of the smart capital application, the key performance determinants allow for a more explicit alignment with the growth drivers of the underlying SGB business models and needs. The incentive mechanisms recommended are less prescriptive, allowing fund managers flexibility to use smart capital to optimise any of the Key Performance Determinants within the contextual sense.

Graphic 2: Achieving accelerated impact – Building a case for the application of Smart Capital

1 APPLY	2 LEVERAGE	3 ACCELERATE
Smart Subsidies & Incentives →	**SGB Oriented Fund Archetypes** →	**SGB Funds' Sustainability & Portfolio Reformance**
Commentary/Observations		
• Subsidies are often: - Market distorting - Fail to achieve target outcmes • "Smart Subsidies" support targeted business needs of enterprises • "Smart Incentives" align business support with specific outcomes	• Align smart capital with the Key Performance Determinates of the different fund archetypes • Target a fund's performance determinants, building upon its key success drivers while mitigating performance-related bottlenecks.	• SGB funds target enterprises that are often smaller, are earlier in refining their business model and therefore carry higher risks • Smart capital, properly aligned with fund archetype can enhance performance of fund portfolio entities
Apply: • Smart capital that targets specific performance outcomes of the underlying portfolio enterprises • Avail to different instruments that best meet needs of enterprise	**Leverage:** • Fund manager's investment thesis and portfolio development activities • The existing capabilities and resources of a given fund archetype and management team	**Accelerate:** • Portfolio enterprises business model and overall fund performance by providing targeted resources that accelerate the growth levers and sustainability of underlying portfolio

SMART CAPITAL: SUBSIDY OR INCENTIVE APPLICATION?

As noted, the application of incentives versus subsidies is based on the degree of confidence as to the relationship of the action / intervention to the desired outcome. Incentive mechanisms can be applied where we have targeted applications and a measurable degree of correlation to the targeted outcomes. Where that confidence factor is missing, we apply subsidy mechanisms, with a more aspirational expectation of alignment between the intervention and targeted outcomes. That said, “smart subsidies” are where we target – and measure – subsidies to specific outcomes, applying market-based mechanisms. Smart capital refers to the use of concessionary/ catalytic capital or grants in the form of market subsidies and incentives that are utilised at their maximum potential to create socio-economic impact avoiding market distortion and unintended consequences. The Smart Capital Fund will tailor appropriate metrics and mechanisms in partnership with fund managers based on the fund archetype frameworks that have been developed in this research.

The table below provides a walkthrough of some of the key considerations in determining the selection of subsidies over incentives.

Table 4: Smart subsidies and smart incentives – a comparison

	SUBSIDY				INCENTIVE		
	Is there information asymmetry in the market or positive impact that the market will not pay for?				Is there an evidence-based intervention that can be enhanced to increase impact or can impact be monetised?		
DESCRIPTION	A subsidy is applied when there is a lack of information in the market and the additional funding has the chance of creating a demonstration effect; or when the market is unlikely to pay for non-financial impact and it is the interest of field builders (e.g. governments, donors) to do so in order to improve the existing socio-economic status quo. Funders stipulate key performance determinant(s) and/or fund archetype to which the subsidy will apply based on predetermined theory of change. The archetypes identified are not exhaustive, but the Key Determinant Alignment Framework can be used to discern the growth levers of any SGB fund.				An incentive is applied to drive a behaviour change that materially affects the likely known outcome of a process in comparison to what usually happens. Apart from encouraging behaviour change, impact-linked finance incentives can help to calculate the value of the non-financial impact that is created. Incentives can thus enhance results and funders can ensure that they only pay for impact over and above what would have happened anyway (e.g. the incremental value creation). Funders stipulate indictors and targets upfront and the investor, fund manager or enterprise is given flexibility to achieve results in any way they want to.		
	Source Of Capital	**Portfolio Construction**	**Fund management**	**Portfolio development**	**Increase fund size and sustain SGB growth**	**Grow SGBs**	**Monetise impact**
	Can additional similar or new capital be attracted to increase size of fund?	Can the risk profile of the portfolio be segmented to increase pool of investees?	Can operational support help to seed new and grow existing funds to sustainable size?	Can business development support be used to sustain and grow SGBs	Will incentives drive behaviours that grow fund size and number of SGBs?	Will incentives drive behaviours that grow the size of individual SGBs?	Are funders willing to pay for impact outside of financial performance?
TYPE	First loss guarantee, Concessionary debt or equity	Support earlier stage or smaller SGBs, or riskier business models	Start-up or ongoing operational funding support	Technical assistance funding	Financial and non-financial indictors, e.g. portfolio-level indictors	Financial and non-financial indicators, e.g. Individual and aggregated SGB level indictors	Direct outcome linked payment such as job linked payment
IMPLEMENTATION	1. Selection criteria of fund/vehicles 2. Articulation of Key Performance Determinants and identification of growth levers 3. Determination of value proposition and the related subsidy pricing 4. Determination of milestones / outcomes 5. Build flexibility into contract				1. Selection criteria of funds/vehicles 2. Selection of indicators 3. Setting triggers 4. Pricing and valuation of impact (input costs/competitive bid) 5. Selection of payment mechanism 6. Build flexibility into contract		

5.5. DESIGN CONSIDERATIONS FOR SMART CAPITAL FUND

As discussed, one of the objectives is that the Smart Capital Fund is to increasingly move from subsidies to market-based incentives structures as comparative data becomes available. The trend towards the monetisation of impact as way of framing the use of concessionary capital enables field building funders to clearly see and value the impact that they care about. These catalytic approaches, combined with commercial market mechanisms and ongoing data analytics, can accelerate the scale and impact of SGB oriented fund vehicles. Ultimately, the desired impact of resilient businesses and communities is created by the additionality of the capital with the resultant job creation through thriving and growing SGBs.

It is therefor crucial to collect the type of financial and non-financial data that will support the market demonstration effect as well as the transition regardless of whether subsidies or incentives are applied. Although funds would not be held to performance targets in the case of a subsidy, this data would be important to set performance targets in future. The valuation of the impact applies to both subsidies and incentives although payment mechanisms would be different based on where payment is based on ex ante or ex post data.

SELECTION OF INDICATORS AND SETTING OF TARGETS

Job-based mechanisms and alternatives

The process of pricing and verifying a job remains a stumbling block to the development of a simple, contextually appropriate subsidisation model. Bearing in mind the inadequate comparability of data cost per job studies range from 5-2,00 direct jobs per $1 million invested. That is before you consider the multiplier effect of investment including job quality, indirect jobs, induced employment and secondary effects on the economy. It would be ideal to be able to create a benchmark cost for job in a similar way to how the market prices carbon. For example, the Climate Disclosure Project enables over 1,000 companies representing over $100 trillion in capital, to internally price carbon on a standardised basis. This requires scale and standardisation.

With regards to the hypothesis asked of the researchers on job-based incentives, for the time being the market stakeholders have recommended that SGB enterprise growth is a more suitable metric than job creation alone,

although theoretically once further evidence has been generated to be able to compare similar jobs in similar geographies an impact kicker for job creation can be considered. As noted early, the recommendation given these current realities is to focus on fund and enterprise growth as proxies for job creation. Creating targets would be done in conjunction with fund managers and are tied to SGB growth. These can be measured by more than one financial indictor at SGB or portfolio level. Table 5 provides an overview of potential business growth indicators that can be applied in setting performance-related metrics.

Table 2: Debt Fund Archetypes – Addressing the Capital Needs of Target SGBs

INDICATOR	CALCULATION	Measurable	Ease of measurement	Attribution	CONSIDERATIONS (+/-)
Revenue	Revenue	•	•	•	Demonstrates customer traction/market acceptance Could be misleading if read in isolation of cash flow.
Profitability: Net Profit Margin %	Net Profit / sales	•	•	•	Demonstrates ability to profitably and sustainably manage enterprise. Trade-off of profits versus investing in business for future growth.
Liquidity: Current Ratio	Current assets / current liabilities	•	•	•	Demonstrates ability of SGB to pay off debts in short term. Can be used as a binary indicator where anything less than 1 (negative working capital situation) is considered unsuccessful.
Liquidity: Debt service coverage ratio	Net operating income (EBIT)/Total debt service	•		•	Liquidity measure is very helpful with SGB finance. SGB should start out at 1. Could rather assess through efficiency ratio. Debt could be restructured giving false impression of ability to cover debt payments.
Liquidity: Cash available for Debt Service (CADS)	Cash flow/ Total debt service	•		•	Cash flow gives a better idea of sustainability. Calculating cash flow on less frequent basis than other ratios . Have to have worked out EBIT to get to this figure, so getting more bang for your buck.
AUM	Capital raised: Capital committed: Capital deployed	•	•	•	Gives indication of pipeline and speed of deployment.
Number of transactions		•	•	•	Relevance dependent on strategy Most relevant for small ticket working capital loans.
Impairment/ Portfolio Performance	% AUM that is non recoverable	•	•	•	Potential to re-structure loans to avoid impairment. Payments in arrears treated differently between funds so would need to clarify definition, e.g. number of SMEs in the past year that have an outstanding payment. Each fund has optimal level of impairment which may differ due to strategy or risk profile.
Return on Invested Capital (ROIC)	NOPAT/Invested Capital	•		•	Gives a sense of how well a company is using its money to generate returns.

VALUING AND PRICING IMPACT MECHANISMS

Ideally, subsidy or incentive pricing should be designed based on the value created – and where market participants are willing to pay for it. However, currently, there are no standard values for determining the incentive pricing for such outcomes as job creation. Therefore, when pricing, the application of input costs becomes the most practical methodology.

The value of impact would be based on the existing information as to the differential between commercial expectations and current market realities. Fund economics are challenging because of high transaction costs caused by small ticket sizes and high TA requirements; and the risk profile of businesses causing higher than usual impairment levels. This would be done with a view to reducing the gap between the two through the bolstering of growth levers, data transparency and competition. Examples, include:

- **Return enhancement.** DFIs expect 10-12% return and are achieving 5-6%, which would mean impact was valued at ±5% AUM.
- **Operational cost offset.** Alternative approach is where fund managers are paid 2-4% of AUM whilst operating costs range between 5-18% meaning impact is priced at ±10%. Or technical assistance is not covered by investors but costs between 10-20% of AUM meaning impact can be priced at 10-20% AUM.

Table 6 on the following page illustrates the types of pricing considerations (a.k.a. benefits) in the design of such mechanisms.

Table 6: Improved fund performance – indicative impact valuations

DETERMINANT	INPUT COSTS	COMMERCIAL EXPECTATION	CURRENT REALITY	RESULT
SOURCE OF CAPITAL	• Rate differential between "appropriate" rate for SGBs and market investors perceived return requirements	• DFI: 10-12% venture funding • Impact Investors: 5-18%	• IRR 5-6% venture funding	• Allows for blending of investors return expectations, expanding the pool of available wholesale capital into growth oriented SGBs
PORTFOLIO DEVELOPMENT	• Costs associated with deal origination and pipeline management	• Fund manager absorbs set up costs of new fund	• High barrier to entry and expansion, so little activity	• Expanding the number of enterprises that a fund can discover and invest in.
FUND MANAGEMENT	• Cost of operating a fund according to size of fund and ticket size	• 2-4% AUM	• 5-18% AUM	• Lowering barrier to entry
PORTFOLIO DEVELOPMENT	• Costs associated with business development support for portfolio companies	• Average management fees do not cover cost of de-risking portfolio through TA	• 5-30% of AUM • Average 10-20%	• Drive performance of underlying SGBs

SELECTION OF PAYMENT MECHANISM

Incentives can be paid upfront or on verification of success. If they are paid upfront as repayable grants or forgivable loans, then they would need to be clawed back or repaid over time. Payment frequency can be selected according to time needed to achieve target, availability of performance data, and effect on cost of capital. Table 7 provides a categorisation of the alternative mechanism available for incentive structures.

Table 7: Typical incentive mechanisms that can be applied at investor, fund manager or SGB level.

DETERMINANT	MECHANISM	EXAMPLE
INVESTOR	• Enhance investor returns by linking to IRR	• Social Success Note • Tax incentive
FUND MANAGER	• Fixed or sliding annual bonus • Linked to % AUM • Linked to % carry • Linked to number of outcomes/outputs • Linked to IRR and benefit accrues to fund manager • Linked to SGB performance. Benefit accrues to fund manager	• Bonus payment on achievement of results • Increase % fee on achievement of results • Impact linked performance fee usually alongside finance linked performance fee based on 2&20 VC fee structure • Impact Bond • Outcomes fund • Results based fund • Discounted interest rate on achievement of targets • Forgivable loan depending on achievement of targets e.g. IMDB supported fund in Caribbean
SGB	• Linked to SGB performance. Benefit accrues to SGB	• Discounted interest rate or preferential terms e.g. Social Impact Incentive

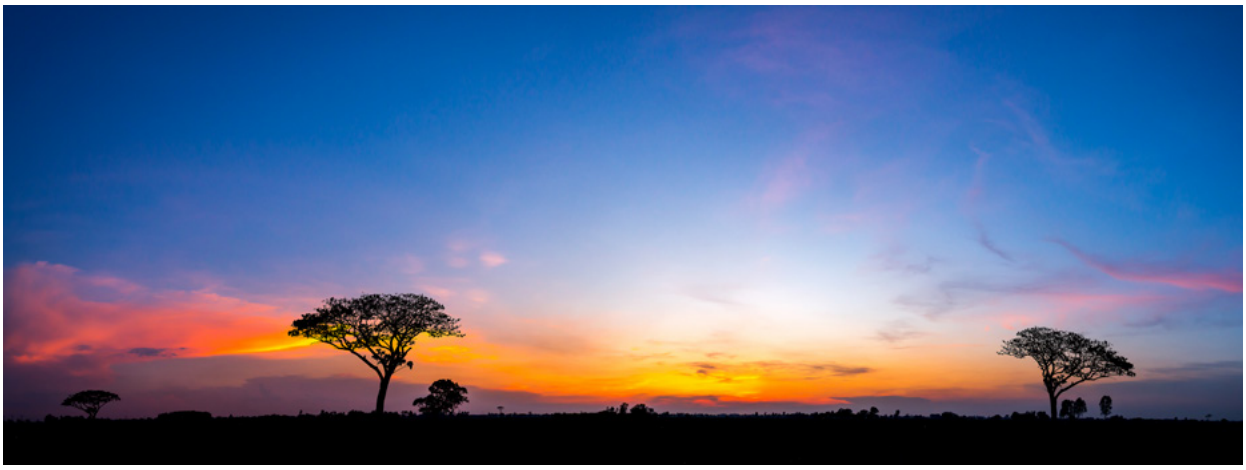
> "The smart capital mechanism concept can be applied broadly"

APPLICATION OF SMART CAPITAL MECHANISM

Because an incentive application would be highly speculative at this point, Table 8 applies to smart subsidy application based on the methodology outlined above.

Table 8: The performance implications of applying subsidy to growth levers in 4 archetypes

	ILLUSTRATIVE GROWTH LEVERS	IMPACT CATEGORIES	INDICATIVE PERFORMANCE MULTIPLIERS	IMPACT CONSIDERATIONS
INCLUSIVE VALUE CHAIN: Working Capital Increase economic and job growth likely to come from increasing amount of capital and businesses financed				
SGB Portfolio Performance	**Portfolio development**: Post TA support	• Loan Impairment ratio	• ±50% Loan Loss reduction for fund	• Low skilled, informal economy entrepreneurs. • First order strengthen basic business skills, simple operating procedures as opposed to highly strategic input. **Impact**: Growth in the number of resilient micro and small businesses, demonstrated ability to hire and maintain small workforce
Fund Capacity & Performance	**Pipeline**: Increase value chain impact by expanding fund's geographic/ sector coverage	• AUM Growth Rate • Lower operating Cost per Financing Transaction	• AUM increase of 30%	• Support expansion of local staff hires and/or local office infrastructure. • If corporate open supply chain to local SGBs then business model easily transported into new communities or supply chains, and capital follows. • Subsidy supports new hubs during community entry phase **Impact**: Decrease in operating costs as % of AUM improve viability of fund operational model.
VALUE CHAIN: Growth Increase economic and job growth likely to come from improvement in SGB and fund performance				
SGB Portfolio Performance	**Pipeline**: Increase financing advance rate and/or leverage level	• Accelerate ROA of business. • Allow entrepreneur to invest in non-working capital assets/ infrastructure	• Increase ROA by ±30% pa	• Supply chain provides competitive advantage so specialist funders have grown to support corporate needs • Fund growth of businesses through long term and intangible assets • Growth keeps pace with corporate growth or additional corporate supply chains secured **Impact**: Increase access to capital permits enterprise to accelerate growth trajectory
Fund Capacity & Performance	**Portfolio monetisation**: Apply quasi-equity payment mechanism	• Debt service coverage ratio	• Increase ROI by >1.25 • Decrease portfolio enterprises' leverage ratio by 25%	• Monetisation happens partly through increase in company value so debt repayment requirements can be less onerous. **Impact**: Exchange current pay interest for revenue-based future pay out, allowing enterprises to use current cash to strengthen operations.



	ILLUSTRATIVE GROWTH LEVERS	IMPACT CATEGORIES	INDICATIVE PERFORMANCE MULTIPLIERS	IMPACT CONSIDERATIONS
SMALL TICKET ASSET-BASED Increase economic and job growth likely to come from increasing amount of capital and businesses financed				
SGB Portfolio Performance	**Pipeline**: Apply data and valuation analytics to simplify and increase accuracy of credit approval and monitor portfolio	• Impairment ratio	• Tweak preferred impairment rate depending on risk return strategy	• Supply chain provides competitive advantage so specialist funders have grown to support corporate needs • Fund growth of businesses through long term and intangible assets • Growth keeps pace with corpor Fintech lenders spend ± half operating cost on technology whilst more traditional funds spend that on BDS. • Technology easier to scale and enables real time analytics • May require combination of both
Fund Capacity & Performance	**Investment thesis:** Tranche capital to provide asset-coverage to low risk investors	• AUM	• 3x leverage	• Structural limitations to bank funding this segment • Specialised fund manager better able to assess perceived risk than bank • Additional capital supports fund economics
VENTURE DEBT Increase economic and job growth likely to come from improvement in SGB and fund performance				
SGB Portfolio Performance	**Portfolio development**: Post investment TA/BDS services to strengthen strategic and operational capacity of high growth companies	• Rate of Enterprise level rate of growth • Level of EBITDA across portfolio	• Accelerate enterprise level revenues by 33% • EBITDA accelerated by 25%	• SGBs receiving high quality high touch TA similar to VC support • TA orientated to maximise use of investment capital for growth **Impact**: By accelerating the growth trajectory, achieve increased enterprise level sustainability and job retention resilience.
Fund Capacity & Performance	**Portfolio monetisation**: Strong investment thesis alignment with follow on capital providers **Pipeline Sourcing**: Tap into local angel networks and accelerators	• Number of enterprises in portfolio. • Rate of revenue and EBITDA growth	• Portfolio has 25% greater number of enterprises • Enterprises demonstrate 20% greater revenue and EBITDA growth rates	• Hybrid funding instruments used to capture upside • Upside only captured if management buy-out through cash reserves or follow on finance **Impact**: By working with established early stage investment networks and enterprise development incubators, able to access higher quality portfolio with lower level of investment in due diligence and post investment TA support.

6

BUILDING ON THE SMART CAPITAL VEHICLE

HOW CAN THE FRAMEWORK BE APPLIED AT A SECTORAL OR THEMATIC LEVEL?

When specifically targeting job creation, a sectoral approach may be preferable for a number of reasons. Thematic and sector oriented SCF fund of funds examples include; green energy, gender lens investing/finance, agriculture/food supply chain, as well as regional/geographic focused funds. A sector or thematic approach may reduce the investment and transaction complexities associated with financing heterogeneous SGB business models. The selection of sub-sectors needs to take into account a number of other factors particularly given the SCF's focus on job creation. These include the sector's labour intensity as well as competitiveness, growth potential (i.e. new market opportunity or import substitution), secondary factors (e.g. food security), skills demand, innovation (i.e. addressing market barriers leading to impact multiplier), expected size and likely use of investment required, aligned national policy initiatives (e.g. concurrent fiscal stimulus) and economic additionality.

The global energy sector has tended to be capital and not necessarily labour intensive, contributing 10-15% of global GDP but employing only 1-2% of the global workforce. For example, the Renewable Energy Independent Power Producer Procurement project in South Africa assessed that 38 jobs are created for each 10,000 people living off-grid and for whom stand-alone solar-LED lights are suitable (IRENA, 2018). Considering that there are currently 112 million households globally that currently lack energy access, this translates to approximately 2 million new direct jobs, ±50% of which will be in Sub-Saharan Africa. Thus, theoretically, the Green Energy Sector would appear to be a suitable candidate to promote economic growth and job creation through the financing of SGBs.

HOW CAN THE FRAMEWORK BE APPLIED TO EQUITY FUNDS?

As noted, this paper has predominately focused on debt and alternative debt fund models.
The Key Performance Determinant framework and Smart Capital construct can be used to meaningfully analyse the growth levers of both debt and equity funds.
The framework described can be applied to understand and support the Key Performance Determinants in order to grow the size, number and performance of these funds. Early market feedback has indicated a need for patient capital as exit times are longer, set up costs to enable local actors to participate without the support of parent companies with deep pockets, ability to retain local talent, a revision of the traditional 2&20 fee management model and TA models that hold providers to account.
Also, the relevant applications of smart capital may vary. As an example, Section 12J of South Africa's Income Tax Act provides tax incentives that are predicted to increase the amount of early stage capital available from R3.7 billion to R5.5 billion by the end of the current financial year.

SMART CAPITAL FUND – SUMMARY DESIGN

Building upon the (i) types of metrics, (ii) pricing valuation mechanisms, and (iii) indicative valuation of strengthening a fund vehicle's performance, Table 9 provides a summary description of the Smart Capital Fund and its basic terms. Smart capital in the form of targeted subsidies and performance-linked incentives can increase amount of capital available for SGBs in the "missing middle".

This research presents the market as we are today. As evidenced by the multitude of efforts to drive capital towards explicit socio-economic outcomes reflects the need – and potential – for such instruments. The SCF is a key step in testing market-based mechanism that can expand the availability and scale of capital targeting explicit socio-economic drivers. Going forward the authors see several key steps to be considered:

- The structure and investment terms of Smart Capital Fund should be further refined and co-designed with market players and field builders – leading to an anchor capital provider to launch the implementation of the fund.
- Development of a pipeline of investible funds across the archetypes, including potential construct of a "warehousing" facility tranche to support the immediate capital needs of such funds, expediting the application of the smart capital.

In addition, further learnings and recommended additional research:

- As noted throughout this paper, data and data analytical tools will play a paramount role. Along these lines, focused resources to expand and standardize the use of such tools will be required.
- Build out assessment of impact mechanisms and application to fund structure. In partnership with fund managers, test out mechanism against the fund archetypes.
- Consider the expansion of the SCF with sector or thematic applications.
- Further refine Smart Capital Fund vehicle construct.

Table 9 The performance implications of applying subsidy to growth levers in 4 archetypes

INDICATIVE TERM SHEET	SMART CAPITAL FUND
Summary Description	The Booster Fund seeks to accelerate the formation of sustainable jobs in green economy. In addition to the inherent environmental benefit of renewables, the Booster Fund rewards fund managers and their portfolio companies for achieving job growth and other social outcomes for the local economies.
Amount	$[50] million
Tenor	[3-5] years
Impact Kicker Concept	Drive smart capital into SGB funds. This can be done through targeted subsidies but predominantly through performance linked incentives rewarding portfolio and enterprise growth.
Portfolio	[10-15] financial intermediary funds with AUM of $[500] million.
Archetype Criteria	Evergreen debt financings fund archetypes that target small & growing green businesses in emerging markets; including the following funds: (i) Value chain working capital, (ii) Value chain growth capital, (iii) Small-ticket asset based, and (iv) Venture Debt.
Jobs Proxy Triggers	In lieu of jobs metric, the trigger metrics will be the improvement in the financial strength and resiliency of green enterprises. Research supports that such enterprises are best positioned to grow sustainable jobs in their local economies.
Kicker Mechanism(s)	Depending upon intermediary fund archetype: Portfolio level debt coverage improvement Enterprise level operational and financial performance
Trigger Value	To be agreed upon by investors and fund managers to best aligned with greatest impact on strengthening a fund vehicle's capacity to accelerate the growth of its portfolio SGBs.

7

APPENDIX ILLUSTRATIVE ARCHETYPE FUNDS

7.1. PHAKAMANI IMPACT CAPITAL

FUND ARCHETYPE	INCLUSIVE VALUE CHAIN: Working Capital
Since	2015
AUM	$10 million
Number investees	>100
Std. Loan Amounts	Average $20,000 (Range $1,000 - $100,000)
Business Stage of Enterprises	Early stage
Target IRR to Investors	0%
Default Ratio	15%
Purpose of Financings	Working capital and small assets
Standard tenors	<1 year
Security/Collateral Requirements	Cession agreement, personal surety and asset-backed
Lending Rates (%)	Prime[2] -2%

[2] *Prime lending rate in South Africa is currently 10.25%*

7.1.1. HISTORY & BUSINESS MODEL

Phakamani Impact Capital is a capital advisory firm headquartered in Johannesburg, with offices in 14 mining towns in South Africa. Phakamani is a contracted investment manager for 8 mining companies and corporates to manage their B-BBEE investment activities. The mining companies are governed by the Mining Charter, which states that >70% of goods and >80% of services must be procured from South African-based, preferably black-owned or BEE-compliant companies.

Phakamani manages the investment pipeline, risk analytics due diligence process, IC memo preparation and presentation, documentation, funds disbursement and post-investment portfolio management. The investment decision remains with the individual corporates for funds that they are provided. Phakamani works closely with these corporates, and has established investment criteria arrangements, translating into an almost 100% corporate IC approval rate.

Phakamani is highly decentralised, with 50% of overall expenses spent in regional hubs on staff located in the markets they serve, 40% of which is spent on TA. A typical loan office in a mining town is staffed with two individuals. Mining companies pay a fixed annual fee (paid upfront), which covers the cost of the regional business development hub in their mining community and a portion of the head office overhead costs. The fee is fixed regardless of the size of AUM and number of transactions, which vary between hubs. The threshold investment level is yet unknown as thus far no hub has needed to be staffed by more than two people.

Phakamani benefits from the key role of Nick van Rensburg. His extensive 25+ years' experience allows for informed assessment of borrowers, facilitating and accelerating the pipeline development and loan approval process. In addition, he brings high degree of confidence with the corporate ICs, further facilitating the loan approval process.

As a manager of B-BBEE loan investments, Phakamani's business model is to put assets to work. Yield returns are not a priority for the funders, but rather maintenance of principal.

7.1.2. PORTFOLIO DESCRIPTION

80% of investments are made into black-owned SGBs in the value chains of mining companies. 20% are made into black-owned SGBs serving surrounding communities such as abattoirs, bakeries and small farmer initiatives. Most of the businesses are women-owned. Typically, these SGBS cannot obtain bank loans because of risk profile and credit history, the only alternative being unregistered lenders who charge upwards of prime +30%. They require short-term working capital loan and small asset financing. Capital under management being lent out up to three times per year, and about 20% of the portfolio classified as follow on lending.

7.1.3. KEY FINANCING CONSIDERATION

Security comes in the form of cession agreement based on accounts payables finance structure: SGB cede payment for services to Phakamani, which means that mining houses pay Phakamani directly. In return the SGB receives a portion of the funding as working capital loans to pay salaries, petrol etc. The remainder is spent on behalf of the SGB by Phakamani to buy raw materials used in the production of goods or services. This significantly reduces the risk of non-repayment and enables the fund to extend financing beyond what traditional risk metrics would allow. Phakamani assumes the risk that the entrepreneur will not deliver on the contract. Personal surety is required and if Phakamani finances an asset they remain the title holder of that asset until it is paid off. Risk of default is also mitigated by the extension of post-investment TA, both in the form of collective business courses including modules like tendering and cash flow; as well as individual support provided by Business Development Officers in community.

Phakamani Impact Capital: Fund Archetype Review & Growth Levers

	PHAKAMANI KEY PERFORMANCE DETERMINANTS	PHAKAMANI GROWTH LEVERS
SOURCE OF CAPITAL	• Access to low cost corporate B-BBEE funds at 0%. Able to on-lend at ±12% • Investors seeking annual IRR return of 0%	• Access to lower cost capital • Expand corporate B-BBEE clients, and the associated funding. • Warehousing loan facility to commit monies on more regular basis and in advance of formal credit approval from corporate ICs. • Co-investors, including local DFIs
PORTFOLIO CONSTRUCTION	• Borrowers traditionally small livelihood-oriented entrepreneurs • Business development staff from the local communities. - Strong knowledge of local market dynamics. - Salaries lower than traditional FI lending officers • Pipeline developed from supply chain and deep understanding of local community business needs • Require trade receivable from credible counter-party	• Geographic expansion. Each new community offers potential to increase loan portfolio • Increase diversity and inclusiveness of supply chain by large corporates (currently, material percentage done with larger businesses based in secondary cities) • Alter credit requirements of secured receivables, increase portfolio and financing purpose
FUND AND INVESTMENT MANAGEMENT	• Centralized portfolio management and risk monitoring system - Simplified loan process and disbursement procedures • Key man role of Nick van Rensburg. - Deep lending and portfolio management experience - Allows for small senior management team • IC remains with corporate funders	• Enhanced data systems for loan information processing from remote locations • Increase training for local staff, and retention incentive mechanisms. • Access to consultants with deep business experience. Deliver on low cost basis.
PORTFOLIO DEVELOPMENT/ MONETIZATION	• Financings are largely self-liquidating working capital loans, provide reliable yield to investors. • Provide access to experienced business managers and technical experts • Staff provide hands-on mentoring of local entrepreneur	• Low cost and web-based financial and business literacy for entrepreneurs • Arrangements with local FIs to refinance clients as loan amounts increase

7.2. INYOSI EMPOWERMENT

FUND ARCHETYPE	VALUE CHAIN: GROWTH CAPITAL
Since	2012
AUM	$25 million
Number investees	50
Number investments made	>100
Std. Loan Amounts	Average $150,000 (Range $50,000 - $300,000)
Business Stage of Enterprises	Early and growth stage
Target IRR to Investors	Prime
Default Ratio	0%
Purpose of Financings	Long-term productive assets and working capital
Standard tenors	3-5 years
Security/Collateral Requirements	Asset-based collateral: Accounts receivable/ equipment/property/inventory
Lending Rates (%)	Maximum of Prime +1.5%

7.2.1. HISTORY & BUSINESS MODEL

Inyosi Empowerment (Inyosi) was created in partnership with Stellar Capital Partners Ltd (diversified JSE listed investment holding company) and Mineworkers Investment Company (MIC) Pty Ltd (broad-based black-owned investment holding company). It was set up with a view to aggregating and investing capital made available by corporates through the B-BBEE regulation, into black-owned enterprises with a preference for those enterprises in corporate value chains. It is set up as three open capital vehicles where investors are encouraged to remain invested for five years although they can withdraw capital after 30 days with a penalty for early withdrawal. The majority of capital has been raised from over 500 corporate investors who focus on the benefits they receive in respect of their BEE contributions, rather than purely on financial returns. Enterprise Development (ED) investment is made available with inflationary return expectations and Supplier Development (SD) investment is made available at 0% return expectation. As such the funds aim to deliver a financial return in line with capital preservation benchmarks.

Inyosi Empowerment runs out of a centralised office based in Cape Town with a team of 10 people, and investments made across 9 provinces. The fund levies a fee on AUM with the majority of operational funding raised as a result of cheap cost of capital and low return expectations.

According to the fund manager the lack of a performance incentive enables the fund managers to focus on growing a sustainable portfolio and providing the most favourable terms possible for portfolio investments.

As a manager of B-BBEE loan investments, Inyosi Empowerment has no obligation to grow underlying businesses, but tends to achieve an average growth rate in excess of 20%.

7.2.2. PORTFOLIO DESCRIPTION

Pipeline is long and strong with investment focus on direct investments into dynamic businesses typically in a range of corporate supply chains. The capital is used to finance long-term productive assets and facilities as well as working capital. For instance, it is required to build new capabilities and business processes, including the staff and skills required to implement new business lines.

The fund has not considered using hybrid instruments because they philosophically do not want to extract the upside away from the entrepreneurs that they support and has observed predatory behaviour in the market in this regard. Thus, businesses are offered reducing balance loans at tailored, affordable rates which the fund manager has observed is one of the keys to their survival and growth.

7.2.3. KEY FINANCING CONSIDERATION

Businesses ideally need to have a three- to five-year track record with working capital secured by accounts receivable; growth capital secured by tangible assets and a smaller percentage of investments secured based by intangible assets which generally requires a longer standing relationship between lender and borrower. Although Inyosi does not provide pre-investment TA, significant financial assistance is provided during the due diligence process. Most of this TA is performed remotely with oversight by Inyosi, and apart from being funded by corporates willing to forgo returns, there is also a requirement on the SGB to contribute. After a joint business assessment, business plans are tailored by the SGBs themselves with a wide range of non-prescriptive interventions driven by the unique requirements. Most of the TA is done by either volunteer mentors or technical specialists in network. In the fund managers' experience, they have much greater success in relying on the entrepreneur to identify the issues and growth levers rather than dictating the interventions on the SME's behalf.

Inyosi Empowerment: Fund Archetype Review & Growth Levers

	INYOSI KEY PERFORMANCE DETERMINANTS	INYOSI GROWTH LEVERS
SOURCE OF CAPITAL	• Access to low cost corporate B-BBEE funds at between 0 and 8%. Able to on-lend at ±10.25% (prime lending rate) • Investors seeking annual IRR return of 10.25% • Access to local DFI capital on matched basis which enabled fund to scale initially	• Expand corporate B-BBEE clients, and the associated funding. • Co-investors, including local and international DFIs • Raise commercial capital by blending with concessionary investment
PORTFOLIO CONSTRUCTION	• Borrowers traditionally dynamic and growth orientated entrepreneurs • Centralised head office but investing throughout South Africa - Strong knowledge of local market dynamics. - Salaries lower than traditional FI lending officers • Pipeline developed from supply chain • Require trade receivable from credible counter-party	• Deepen relationship with corporates to engage additional parts of supply chain • Increase portion of portfolio not supported by receivables particularly with existing borrowers with track record • Extend portfolio to enterprises outside of supply chains especially if commercial capital available
FUND AND INVESTMENT MANAGEMENT	• Centralized portfolio management and risk monitoring system - Simplified loan process and disbursement procedures • Highly experienced and aligned team - Deep lending and portfolio management experience - Allows for small senior management team - Management given leeway to make portion of investment decisions without IC approval	• Increase team size to increase fund raising capacity and deal making potential as pipeline is robust • Situate additional office in another financial centre to enable ease of access to investees • Digitize credit application and management functions
PORTFOLIO DEVELOPMENT/ MONETIZATION	• Term loans with reducing balance - Terms deliberately designed and tailored to be affordable to business • Trust relationship built with SGB - Highly accountable business development led by and done in close partnership with SGB - ProBono and low bono mentoring support offered through wide networks	• Develop hybrid funding terms to capture upside of higher risk investments • Consider bullet payment terms for growth assets • Develop partnerships with other Fi's to ensure follow on funding post repayment or for co-investment purposes • Systematize accountable post investment technical assistance support that does not rely on volunteers

7.3. BUSINESS PARTNERS

FUND ARCHETYPE	SMALL TICKET ASSET-BASED
Since	1981
AUM	$70 million in 2018
Number investees	265
Std. Loan Amounts	Average $150,000 (Range $30,000 - $3 million)
Business Stage of Enterprises	Low- or medium-growth dynamic SGB
Target IRR to Investors	6%
Default Ratio	4%
Purpose of Financings	Working capital facilities, equipment purchases and management buy-outs Property finance
Standard tenors	5 years
Security/Collateral Requirements	Asset-based Cash flow projections Second lien
Lending Rates (%)	Prime +1 with royalties which can reach upwards of Prime +5

7.3.1. HISTORY & BUSINESS MODEL

Business Partners (BP) is an unlisted public finance company specialising in debt finance to SGBs in South Africa. The company was founded in 1981 with an equivalent amount of public and private development investment to specifically support this underserved segment of the market. After the first democratic elections in 1994, the government divested a portion of their shareholdings from what was a sustainable company, and the AUM have continued to grow due to re-invested earnings. Due to the nature of its capital base, BP functions more like a non-bank financial institution than a limited fund construct. Half of investments are property and half are term finance to enable purchase of productive assets. BP has no intention of raising further investment, partly because the type of development-focused finance used to capitalise the company is no longer available in this form in the South African market. Corporates would now prefer to invest their capital into their own initiatives and achieve BEE points in the process. The BP fund is growing in size because of reinvestment of retained revenue, although were BP to raise additional funding they would likely do so from the debt capital markets as a diversified unlisted investment proposition.

Additionally, BP has access to a $4 million technical assistance facility funded on a 50:50 matched basis by SECO to be in operation over five years.
Revenues are generated through interest on loans and dividends received through equity holdings. This is supplemented through royalty fees earned on agreements with businesses to which debt financing has been extended. Additional revenues are earned through rental agreements in respect of the commercial property investment portfolio

7.3.2. PORTFOLIO DESCRIPTION

Portfolio companies include manufacturing, retail, tourism and services businesses, with an explicit exclusion of primary agriculture and underground mining. BP not only directly invests in business owner-occupied, real estate purchase investments but also owns and manages a large commercial property portfolio, which accounts for 30% of its total investment portfolio. 30% is invested in black owned businesses although this is not mandated as per the ESD fund structure in south Africa. The majority of investments are made in the three most economically active provinces in South Africa including 30% in Gauteng, 24% in Western Cape and 20% in KwaZulu Natal

7.3.3. KEY FINANCING CONSIDERATION

Collateral requirements are asset based although BP take a much more forward view than the banks do in terms of cash flow projections. Risk calculation based on secured and unsecured portion of the loan. For small ticket financing BP take a second lien on the operational facilities and target businesses that have been rejected by the banks for the wrong reasons.

A preliminary evaluation of a SECO-funded post-TA funding facility for BPI showed that default rates dropped from 22% to 8%, which provided impetus to set up a similar facility in South Africa. All investees are provided with technical assistance, the costs of which are included in the cost of financing received although terms of the TA loan are 0% and paid back over two to three years. These can reach a size of up to 30% of investment and is paid directly to business support providers rather than directly to the SME although the SME is allowed to choose from a list of providers. The decision to use that facility is left up to the entrepreneur and is currently not being drawn down as quickly as either SECO or BP had expected.

Business Partners: Fund Archetype Review & Growth Levers

	BP KEY PERFORMANCE DETERMINANTS	BP GROWTH LEVERS
SOURCE OF CAPITAL	• Shareholding structure with corporate and government shareholders. Initially concessionary but now run on close commercial terms • Investors seeking annual IRR return of ±18% • Access to TA funding provided on matched basis by development agency	• Target lower yield orientated investors that are still looking for commercial returns • Increase shareholding of company • Attract local institutional capital such as public pension funds looking for development investments
PORTFOLIO CONSTRUCTION	• Borrowers traditionally dynamic entrepreneurs in manufacturing, retail, tourism and services businesses • Collateral based on assets or cash flow projection – take more progressive views than banks and often take on deals banks have turned down + second lien on the operational facilities • Material part of risk assessment based on entrepreneur evaluation • Use property portfolio to balance higher risk term financing	• Expand portfolio mix by increasing part underwritten by cash flow or intangible assets • Extend flexible or preferential terms to SGBs who may risk default simply because of financing terms
FUND AND INVESTMENT MANAGEMENT	• Centralized portfolio management and risk monitoring system - Simplified loan process and disbursement procedures • Well established team with highly standardised processes • Systems shared across BP and BP International	• Automate application, credit assessment, payments and monitoring • Standardise all back end functions • Develop alternative credit scoring systems
PORTFOLIO DEVELOPMENT/ MONETIZATION	• Term finance with royalties with revenues generated through interest on loans, dividends on property holding and royalties.	• Relationships with banks to access investable SGBs that has been rejected through highly conservative credit processes • Create pooled vehicles aggregating similar funds that can be securitized or listed • Increase uptake of BDS facilities

7.4. GROFIN SGB FUND

FUND ARCHETYPE	VENTURE DEBT
Since	2014
AUM	$108 million
Number investees	217
Std. Loan Amounts	Average $500,000
Business Stage of Enterprises	Early and growth stage
Purpose of Financings	Growth and expansion capital
Standard tenors	2-8 years
Security/Collateral Requirements	Asset- and non-asset-based collateral Personal contributions of entrepreneur to ensure buy-in
Lending Rates (%)	15-35%

7.4.1. HISTORY & BUSINESS MODEL

The Grofin SGB fund is an open capital vehicle domiciled in Mauritius, that extends debt and hybrid finance to SGBs in 11 African and 3 Middle Eastern countries.

GroFin has developed a layered capital structure in order to attract investors with a range of risk/return appetites. Impact-focused investors with a relatively higher tolerance for financial risk can leverage more commercial investment. The anchor Class C equity was designed as a first-loss tranche to de-risk the fund for more commercially oriented and risk averse investors in Class B and A equity, as well as debt. The fund has had 11 investors, of which just under 60% if from DFIs and development agencies and the remainder for foundations, impact investors and family offices. This tiered fund structure has enabled Grofin to attract a significantly larger capital pool than if it catered to only one investor class. The Business Support Trust funded by donor capital is not only for technical assistance, but for purposes of footprint expansion, business support costs, technical and capacity assistance and development.

The fee model is dependent on the size of the fund and includes a management fee and incentive fee, which is earned against achievement of agreed KPIs. Deal origination is handled primarily by local investment and business support teams in each country of operation. A fund advisory committee is appointed by the limited partners, and the IC appointed by the general partner. Local offices are setup in each country of operation and consist of investment and business support teams. 60% of fund management costs are salaries business development support absorbing between 30% and 60% of that.

7.4.2. PORTFOLIO DESCRIPTION

The fund supports SGBs in 15 developing countries with a focus on high impact sectors such as healthcare, education, agri-business, manufacturing, and key services (water, energy, and sanitation).

Investments are made to SGBs in all stages of the growth cycle, though limits are set on start-up exposure. In addition, criteria are set in terms of the size of the company in respect of number of employees and annual turnover (fewer than 150 employees and less than $15 million annual turnover). The fund offers medium term, self-liquidating loans to local, owner-managed businesses in need of growth capital. These SMES may be relatively established and have access to an overdraft, debt factoring or revolving credit, but they do not have access to expansion capital. The capital is used predominantly for expansion and is spent on productive fixed or moveable asset such as classrooms, clinics or new production lines.

7.4.3. KEY FINANCING CONSIDERATION

Asset and non-asset-based collateral are considered valid as well as personal contributions of entrepreneur to ensure buy-in.

GroFin distinguish between BDS and TA. BDS is an inherent part of their model and risk management whereas TA is specific and addresses particular issues and growth opportunities for business model. GroFin does not provide technical assistance itself but does refer the entrepreneurs to local service providers when it deems necessary. The fund used to split pre- and post-support between teams but have found it much more fruitful to maintain continuity throughout relationship with the fund. There is, however, a separate credit team that evaluates the investment. Business support services are financed through a combination of donor funding provided through the Business Support Facility Trust, and transaction fees paid by investees themselves.

GroFin SGB: Fund Archetype Review & Growth Levers

GroFin SGB: Fund Archetype Review & Growth Levers

	GROFIN KEY PERFORMANCE DETERMINANTS	GROFIN GROWTH LEVERS
SOURCE OF CAPITAL	• Capital stack attracting concessionary and commercial funders in four layers • Ability to offer flexible grant funding facility available for BDS or expansion in place until sustainability achieved	• Access to additional equity or high risk capital if impact can be clearly demonstrated • Target yield orientated investors that might otherwise invest in VC • Attract local capital including angel investment • Attract local currency to offset currency risk • Co-invest with equity investors
PORTFOLIO CONSTRUCTION	• Borrowers traditionally dynamic and growth orientated entrepreneurs • Portfolio diversified across sectors and countries • Local country teams originating deals	• Identify and target specific sectors once sufficient pipeline identified • Foster strong alignment of practice with local accelerators to increase high growth SGB pipeline • Increase depth of pipeline in existing countries (for example in secondary cities)
FUND AND INVESTMENT MANAGEMENT	• Medium term, self-liquidating local currency denominated loans so businesses can invest in long term assets and intangibles in order to grow • Local and centralised business model - Local deal teams sourcing pipeline and supporting investees • Fee model dependent on size of AUM which enables early cushion of support	• Provide consistently high engagement model of support to investee companies • Tie fund management fee model to growth • Increase speed of deployment • Standardise deal structuring as far as possible
PORTFOLIO DEVELOPMENT/ MONETIZATION	• Provide access to experienced business managers and technical experts • Technical assistance outsourced to bank of local and international service providers	• Targeted pre investment support to develop deals, expand pipeline and develop appropriate investment terms • Develop low cost model of high intensity post investment business development support – identify shared service requirements that could be shared across SGBs • Develop hybrid exit strategies • Develop relationships with banks or equity investors for SGBs to graduate onto larger investment opportunities

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