Using catalytic capital to foster the emergence of African entrepreneurs in underserved markets

EXECUTIVE SUMMARY

INVESTISSEURS & PARTENAIRES

With the support of:

Catalytic Capital Consortium

AgroServ Industries ©Olympia de Maismont

Foreword

The **Catalytic Capital Consortium (C3) is an investment, learning, and market development initiative to promote greater and more effective use of catalytic capital**, in recognition of its essential role in achieving the UN Sustainable Development Goals (SDGs) and realizing the full potential of the impact investing sector. C3 is led by the John D. and Catherine T. MacArthur Foundation, Omidyar Network and The Rockefeller Foundation.

The idea of **scaling-up the impact finance sector and spreading best practices** is at the heart of the C3 initiative. This partnership is an outstanding opportunity for Investisseurs & Partenaires, as an impact investor committed to providing access to financing to African SMEs.

ABOUT I&P

I&P is a pioneering impact investment group dedicated to supporting Sub-Saharan Africa small and medium enterprises. I&P currently has over €400 million in assets under management that have been raised or are advised by I&P and its partner funds. The team is based in 10 African countries (Niger, Mali, Senegal, Cote d'Ivoire, Burkina Faso, Kenya, Madagascar, Uganda, Ghana and Cameroon) as well as in Washington, D.C. and Paris. I&P's mission has always been to "go where others don't go" by financing SMEs that are the "missing link" of African economies, mostly in fragile and Least Developed Countries, and to support the growth of entrepreneurial ecosystems. I&P's model is based on four complementary activities, which respond to the current challenges of African SMEs:

I&P ACCELERATION

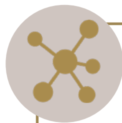
Scaling-up young businesses through seed funding and/or training programs

I&P DEVELOPMENT

Sponsoring a network of African funds to finance small companies with high potential in amounts ranging between €50,000 and €500,000

I&P EXPANSION

Supporting and providing equity financing to mature SMEs and start-ups in amounts ranging between €500,000 and €5 million



I&P ECOSYSTEMS

Promoting the emergence of entrepreneurs and investors in Africa and fostering the development of a business environment conductive to their prosperity

In this report, I&P aims to demonstrate the effectiveness of catalytic capital in supporting African small and medium enterprises, share insights gained from two decades of experience in impact investing, and offer recommendations to accelerate and expand the use of catalytic tools. The conclusions of this report are notably supported by a unique database of over 255 African companies, supported by I&P since its inception thanks to catalytic capital instruments.

© Investisseurs & Partenaires, 2023. All rights reserved

Introduction

Developing a fabric of formal small and medium-sized enterprises is key to ensure sustainable and inclusive growth in Sub-Saharan Africa. When formal, SMEs notably create stable and decent jobs, improve local access to essential goods and services while structuring the local economies and fostering self-sufficiency by promoting import substitution.

In Africa, formal SMEs are the real missing middle of African economies. According to the World Bank's Enterprise Survey tool (consulted in 2023), the first obstacle to private sector operations in Sub-Saharan Africa is "**Access to finance**", with nearly a quarter (24,5%) of companies concerned compared to 14,5% worldwide. The lack of reliable sources of capital is a major constraint to their growth as they do not meet the criteria of traditional financial institutions such as microfinance institutions and commercial banks. As for private equity funds and international investors, they traditionally require investor-ready metrics and track records, but also provide high-ticket sizes compared to SMEs' needs. The available financing is not only insufficient but also ill-suited to SMEs, as they are often perceived as too risky and unable to meet the guarantees and financial history requirements set by financial operators.

The private sector has the potential to bridge this capital gap, but financing positive-impact SMEs presents many barriers, including high risk, high initial investment costs, long lead times, and the challenge of operating within non-existent, nascent, or unreliable regulatory frameworks. Therefore, the needs of SMEs in terms of flexibility, accessibility and conditions call for a new type of capital and investors. **Catalytic capital is a tool that is likely to address these challenges.**

“As defined by Tideline, catalytic capital refers to:
We define catalytic capital as debt, equity, guarantees, and other investments that accept disproportionate risk and/or concessionary returns relative to a conventional investment in order to generate positive impact and enable third-party investment that otherwise would not be possible”

Tideline – Catalytic Capital:
Unlocking More Investment and Impact, 2019

What is catalytic capital? Illustration of possible catalytic mechanisms

Expected return on investment may be **lower than market rates**

+ Yield-enhancing effect for commercial capital

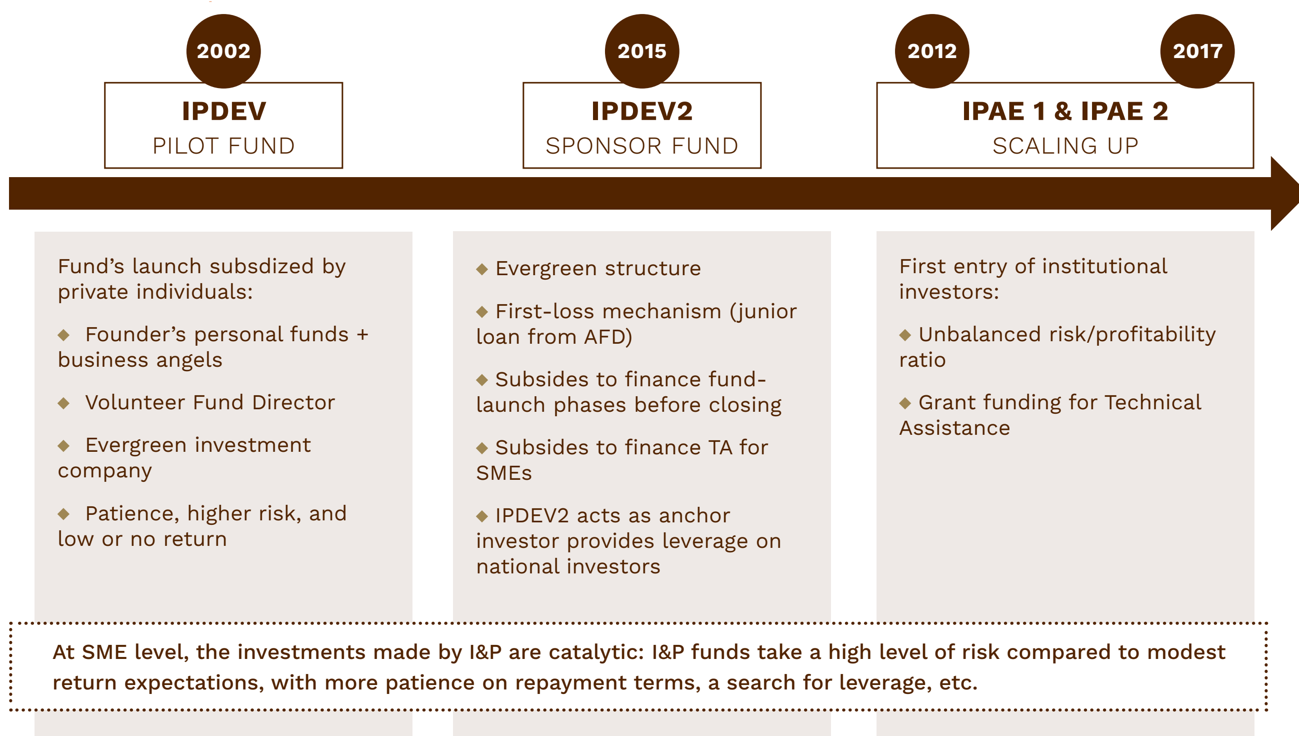
Hedging liquidity risk: the catalytic capital provider agrees to be repaid last (e.g. subordinated/ junior debt)

Patient capital: the investor can accept a longer and more uncertain time to exit

The investment can include **non-traditional terms** (size of investment no collateral, etc.)

Investisseurs & Partenaires uses different forms of catalytic capital (first loss equity, junior debt, convertible notes, guarantees…) to finance and support different types of investees, ranging from early-stage enterprises to new local funds. To generate the long-term impacts previously described, we are convinced African SMEs must be economically sustainable. They therefore need access to long-term financing, governance, and management skills. It is from this perspective that I&P began its activity as an impact investor with the objective of addressing this underserved segment. Since 2002, I&P has gradually extended its scope of intervention to **provide financing to SMES of the missing middle** and offers a **continuum of funding mechanisms** to sustain the growth of businesses at all their development stages. In addition, I&P uses catalytic capital to sponsor and set up new local investment funds and mobilize local private capital through leverage.

Progressive deployment of catalytic mechanisms at I&P: what makes each fund catalytic?



I&P has been widely recognized for its achievements in supporting and financing both African SMEs and local investment funds. Its model has demonstrated how capital catalytic, coupled with a hands-on approach and a robust monitoring and evaluation system, can converge to successfully address a persistent gap. In this document, we articulate some of the main conceptual and practical lessons underpinning I&P's model. A full version of the report has been published to present the comprehensive research and knowledge documents.

This study extends beyond I&P's impact and embraces a broader objective. **Ensuring that catalytic capital is better directed toward African SMEs is a collective effort, to be carried out by the entire SME-support value chain**. I&P aims to share insights into improving the conditions and availability of catalytic capital. Our goal is to actively participate in the collective learning process that will unlock additional financing to bolster impact investing initiatives across Africa.

Key takeaways

KEY TAKEAWAY #1

I&P has demonstrated the long-term impacts of financing SMEs through catalytic capital

Private equity stands out as one of the most effective tools for SME financing as it surpasses the constraints imposed by philanthropic subsidies, which, while essential, can sometimes obstruct the establishment of a sustainable long-term business model. Private equity is also more suited in many cases than debt instruments, which can put high pressure on SMEs' balance sheets when used at initial stages. **Impact investing through private equity enables SMEs to achieve financial sustainability, ensuring the longevity of their impact**.

One of **I&P's main additionality commitments** is to operate "where others don't go" and to bring catalytic capital to **underserved geographies**. If Sub-Saharan Africa is the 4th most popular region for impact investors[1], this progress hides major disparities with more than half of the investments concentrated in Nigeria and Ghana. I&P chooses to target underserved markets to maximize its impact: among the 260 million invested by I&P investment vehicles, 87% of the investments have been made in the least developed or fragile countries.

I&P's outcomes are reflected in its impact thesis, which is based on six key impact pillars[2]:

◆**Accompanying the emergence of a new generation of African Entrepreneurs in frontier markets:** 89% of companies supported by I&P are run by African entrepreneurs.

◆**Creating decent jobs and training opportunities:** direct employment has grown by 50% since I&P's investment and 42% of SMEs provide a complementary health insurance.

◆**Densifying the local economic fabric:** 79% of portfolio company suppliers are local players.

◆**Easing access to essential goods and services:** 71% of companies offer goods or services that contribute directly to the SDGs.

◆**Promoting Gender equality and women's empowerment:** 28% of portfolio companies are run by women and 67% of I&P's portfolio is considered a gender lens investment according to 2X Challenge.

◆**Fostering sustainable growth:** 24% of portfolio companies implement green projects and 13% of them use sustainable energy.

1. Global Impact Investor Network (GIIN), Impact Investor Survey (2020) - 2. I&P Annual Impact Report (2022)

KEY TAKEAWAY #2

Portfolio companies perform well despite challenges, but strong economic performance does not always maximize exit or fund-level shareholder value (IRR)

We might have assumed that investors' lack of interest in African SMEs derives from their lower profitability compared with that of larger corporations. However, the structural profitability of the companies is not what differentiates the performance levels of instruments dedicated to large corporations or to SMEs, as illustrated by the present report. Indeed, **our study of 255 portfolio SMEs revealed that they do perform well economically with the right support**: on average, a SME will triple its turnover after 6 years of investment. In terms of profitability, despite a decline in the first year, due to the structuring phase led by the investor, we observe a subsequent rebound after about 5 years - the EBITDA of I&P investees gaining 4 times its absolute value over 6 years. This encouraging performance is even more impressive when we take into account all the external factors that affect the economic performance of the SMEs, such as the cost of accessing finance, infrastructure limitations, recruitment obstacles, expenses linked to formalization, political crises, and more.

However, from an investor's perspective, well-performing companies do not necessarily translate into a good financial valuation.

The following factors dampen the financial returns:

◆**Premature exits** forced by the legal structures of the "**closed-end fund**" model, derived from the practice of more mature markets but unfit for structural investments in small companies and fragile countries.

◆**Market conditions,** characterized by low liquidity and limited exit opportunities, result in lower multiples compared to mature markets. These challenging conditions do not facilitate EBITDA growth between investment and exit.

◆**Currency depreciations** that weigh excessively on domestic market-oriented companies.

◆**Fund management costs** related to the small size of the investments.

In Africa, **front-end and management costs are exceptionally high compared with the unit values of the transactions,** in an industry where fixed costs are the rule. This has, therefore, an automatic knock-on effect on net profitability for investors. Moreover, when investment objectives are innovative, profitability may be limited, resulting in extended investment periods or higher losses than the portfolio average. These considerations explain the relatively lower engagement of investors in this target category – and, as a consequence, the low number of management teams dedicated to this sector. **Prioritizing impact outcomes leads us to adopt a unique economic model** that fosters successful businesses but may not match the net performance of conventional finance or standard market returns.

This makes catalytic tools more necessary than ever to balance out the financial returns for impact funds.

KEY TAKEAWAY #3

Catalytic capital provides essential leverage for impact funds' economic model, but limited access and structural constraints in frontier markets hinder its expansion in Africa

Impact investing is still not sufficiently widespread on the continent: a report published by the GIIN reveals that, while 52% of impact investors plan to increase their allocations to Sub-Saharan Africa, only 11% of the total assets under management has actually been disbursed in these geographies[3]. SME impact funds face challenges accessing catalytic capital. **Although catalytic capital is starting to be deployed in Africa, it often doesn't reach frontier market SME funds** due to the lack of flexibility of financing options, including investment horizon, management fees, return expectations, and fund size.

The standards established in developed markets are not aligned with the needs and specificities of emerging markets. Fund durations are often too short (and usually extended) and financial expectations are too high. The main performance indicator, the IRR, should be reviewed, as it pushes investment teams to exit in a premature manner from portfolio companies, even though a longer investment period would maximize impact creation and financial returns[4].

Thus, we face a twofold challenge: **increasing the availability of catalytic capital (quantitative) and improving the characteristics of deployed catalytic capital (qualitative)**. These challenges are key for developping mechanisms that better match the needs of our ecosystem's stakeholders (risk-return radio and investment geographies).

Gona Maroquinerie © Atchioua Photography

3. GIIN, Annual Impact Investor Survey (2019) - 4. According to the several studies (Insights on SME funds performances, Shell, Omidyar Network, Deloitte, 2019; Across the Returns Continuum, Omidyar Network, 2020), emerging markets funds comparable to I&P's funds approximately take 15 years to reach their full potential and break even a positive gross IRR

KEY TAKEAWAY #4

By integrating more flexibility into their financial and legal frameworks, catalytic capital providers could better reach SME funds and generate significant impacts in frontier markets

◆ **FUND LIFETIME AND EVERGREEN STRUCTURE:** Allowing for **longer or flexible exit timelines** provides SMEs the chance to grow sustainably. Changing **the legal structure of financial vehicles** from closed-end funds to open-ended or permanent vehicles would help them reach higher financial returns, albeit at the expense of liquidity. This is a constraint which most Development Finance Institutions (DFIs), foundations, and impact-oriented investors could potentially manage to address with sufficient leadership.

◆ **ACCOMPANYING GRANT SUPPORT:** As seen before, the "**cost of impact**" may ultimately affect the profitability of SME impact funds. Covering some of the **fund's operating costs through donor funding** is a way to overcome the impact/return dilemma. At the fund level, such grant subsidies can help covering some of the general partner costs (ESG & Impact activities, pre-investment technical assistance and support...) or having concessional capital pay for a higher management fee. At portfolio company level, impact investors can partner with DFIs and donors to secure grants for ESG and Impact issues such as the environment (and thus cover for corporate energy audits, feasibility studies for solar panels or other renewable energy installations, pre-financing of environmental equipment, etc.)

◆ **PRE- AND POST-FINANCING TECHNICAL ASSISTANCE:** Most companies need support to be "**investment ready**". Their preparation is an important but costly and time-consuming prerequisite for impact funds. To ensure that financial and impact objectives are met after investment, **a recurring process of technical assistance and monitoring is required**. This assistance is often financed by grants from DFIs, but is currently insufficiently directed towards the pre-investment phase.

◆ **GUARANTEE:** Due to an insecure environment, most lenders require significant guarantees and collateral. Lower loss-coverage ratios or innovations in terms of mortgage guarantees (cooperatives, grouped guarantees) would make more SMEs eligible. **First-loss coverage guarantees** are one of the most popular de-risking mechanisms, in particular for DFIs. **Guarantee funds** currently exist but are not sufficiently oriented towards SMEs due to high costs and complex administrative procedures.

◆ **CO-FINANCING: Risk can be shared** within members of the SME funding ecosystem by matching their investments with specific types of needs. For example, banks may be willing to fund equipment when less risk-averse institutions, such as impact funds, can finance working capital or highest perceived risk operations.

KEY TAKEAWAY #5

Frontier-market SME funds must demonstrate and value their impact better

◆ **IMPROVING THE IMPACT MEASUREMENT AND INCREASING THE RESOURCES DEVOTED TO MEASURE IT:** We suggest that philanthropic investors and DFIs agree to subsidize the costs of impact measurement and reporting, at least partially, through mechanisms similar to those of technical assistance. This would help decrease management costs and bring them closer to commercial terms. This sponsorship would also enhance precision in impact measurement and increase the visibility of impact results, thereby encouraging more investors to provide capital to these SMEs.

◆ **PROPOSING INNOVATIVE METRICS TO ASSESS SOCIAL PERFORMANCE** and work on standards to capture key "internalities": we suggest that impact funds set a target Economic Rate of Return (ERR), which would capture the direct and indirect added value of the investments. This approach could also take into account specific negative externalities, such as carbon emissions and workplace accidents. The ERR could be compared against the economic cost of subsidizing the fund, while the fiscal return generated by the invested companies could be compared against the fiscal cost of the concessional financing. Hence the social benefit of the concessionality would be made clear. The benefits can be compared with those of other public policies: the acceptable level of direct or implied subsidization could also be discussed on rational grounds.

To access the complete study
https://www.ietp.com/en/content/IP-C3-report-catalytic-capital

IP INVESTISSEURS & PARTENAIRES