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Financial Innovations Lab Report



Stimulating Investment in Emerging-Market SMEs

FINANCIAL INNOVATIONS LAB REPORT



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Financial Innovations Labs bring together researchers, policy makers, and business, financial, and professional practitioners for a series of meetings to create market-based solutions to business and public policy challenges. Using real and simulated case studies, Lab participants consider and design alternative capital structures and then apply appropriate financial technologies to them.

This Financial Innovations Lab Report was prepared by Jill Scherer, Betsy Zeidman, and Glenn Yago.

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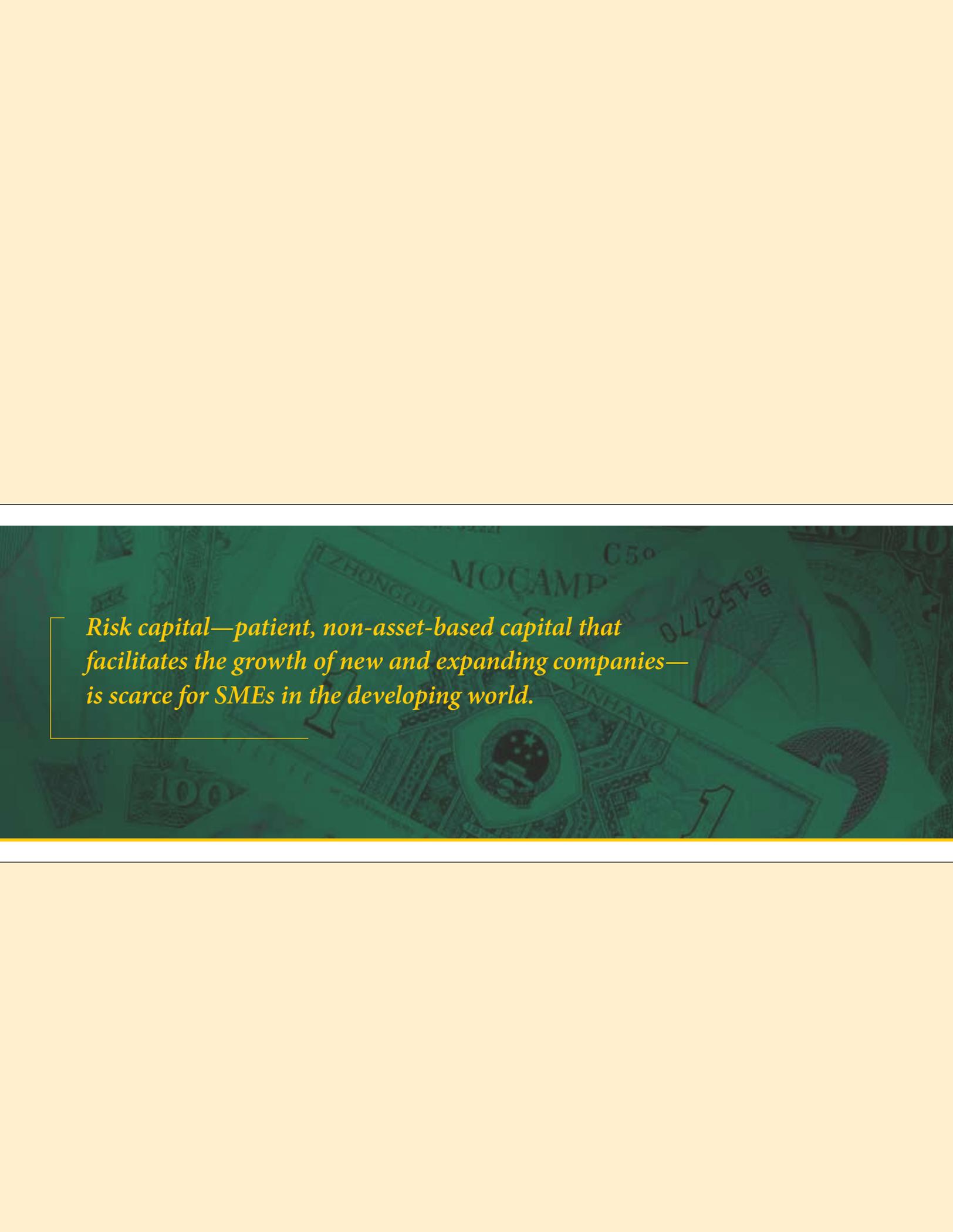
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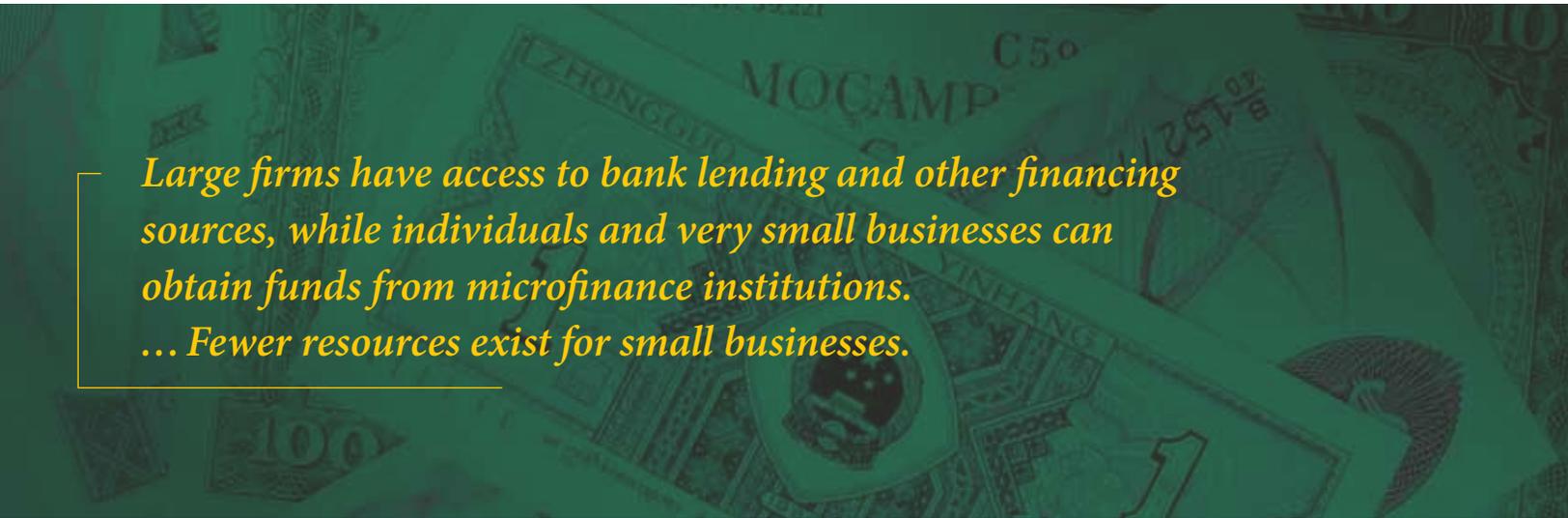
Risk capital—patient, non-asset-based capital that facilitates the growth of new and expanding companies—is scarce for SMEs in the developing world.

INTRODUCTION

Although many large institutions have begun to stabilize and recover from the global financial crisis, a serious credit crunch continues. Small- and medium-sized enterprises (SMEs) face particular challenges to survival and growth. Even in good economic times, these firms lack access to flexible capital, constraining their ability to expand. The current environment exacerbates this difficulty, leading to a dangerous trend because it affects the broader economy.

In February 2009, the Milken Institute held a Financial Innovations Lab in New York City to explore ways to increase the availability of risk capital to SMEs in developing countries. Risk capital—that is, patient, non-asset-based capital that facilitates the growth of new and expanding companies—is scarce for SMEs in the developing world. This lack of flexible capital is due in large part to the illiquidity of these markets. With few apparent exit opportunities, investors are reluctant to risk investing their money in emerging-market SMEs. Capital access is particularly difficult for smaller companies requiring investment in the range of \$100,000 to \$1.5 million. Because SMEs are critical engines of job creation and economic growth, it is important to increase the availability of risk capital to these firms.

The Lab brought together fund managers, investors, entrepreneurs, researchers, and representatives from development finance institutions and foundations to identify obstacles hindering emerging-market SMEs' access to capital and to explore potential solutions. Lab participants examined case studies of successful SME investments, reviewed presentations, and exchanged ideas through moderated discussions. Follow-up conversations among participants continued in the weeks after the Lab, and a roundtable session took place at the Milken Institute Global Conference in April 2009. These discussions provided the opportunity to flesh out some of the solutions identified in the Lab, and these additional ideas were integrated into this report where appropriate.

The background of the slide features a collage of Chinese banknotes, including a 50 Yuan note with the word 'MOQAMP' and a 100 Yuan note with 'YINHANG' visible. The entire image is overlaid with a semi-transparent green filter. A yellow-bordered box on the left side contains the text.

*Large firms have access to bank lending and other financing sources, while individuals and very small businesses can obtain funds from microfinance institutions.
... Fewer resources exist for small businesses.*

ISSUES & PERSPECTIVE

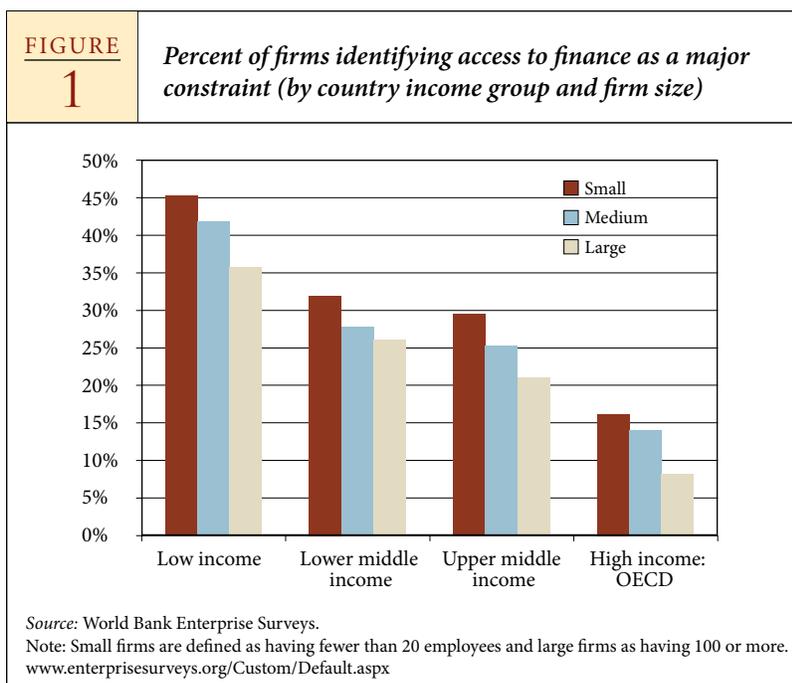
FUNDING CHALLENGES

In developed countries, SMEs are widely recognized as key contributors to employment, innovation, productivity, and economic growth. They account for 57 percent of total employment and just over half of gross domestic product (GDP).¹ In the United States, they have accounted for 60 percent to 80 percent of net new employment since the mid-1990s. Very small firms tend to generate job gains more quickly than larger firms after a recession.²

In developing countries, growth is far more constrained. Among low-income countries, SMEs contribute just 18 percent of employment and 16 percent of GDP.³ If barriers to their growth were removed, SMEs would contribute more to economic development by providing jobs and income, expanding the middle class, broadening the tax base, and ultimately decreasing poverty levels.

Access to flexible capital is among the most significant barriers for emerging-market SMEs (see figure 1). Although securing financing is a challenge for all types of firms in poorer nations, small and medium-sized firms experience greater difficulty accessing capital than large ones, with small firms having the most difficulty. Indeed, Beck, Demirgüç-Kunt, and Maksimovic (2005) find that SMEs face greater financial, legal, and corruption obstacles than large firms, and these challenges constrain the growth of SMEs to a greater degree.⁴

Financing is challenging to secure in emerging markets for several reasons. External sources of financing are difficult to access, and few venture capital and private equity investors operate in developing markets. In addition, many investors put their money elsewhere due to the illiquidity of these markets.



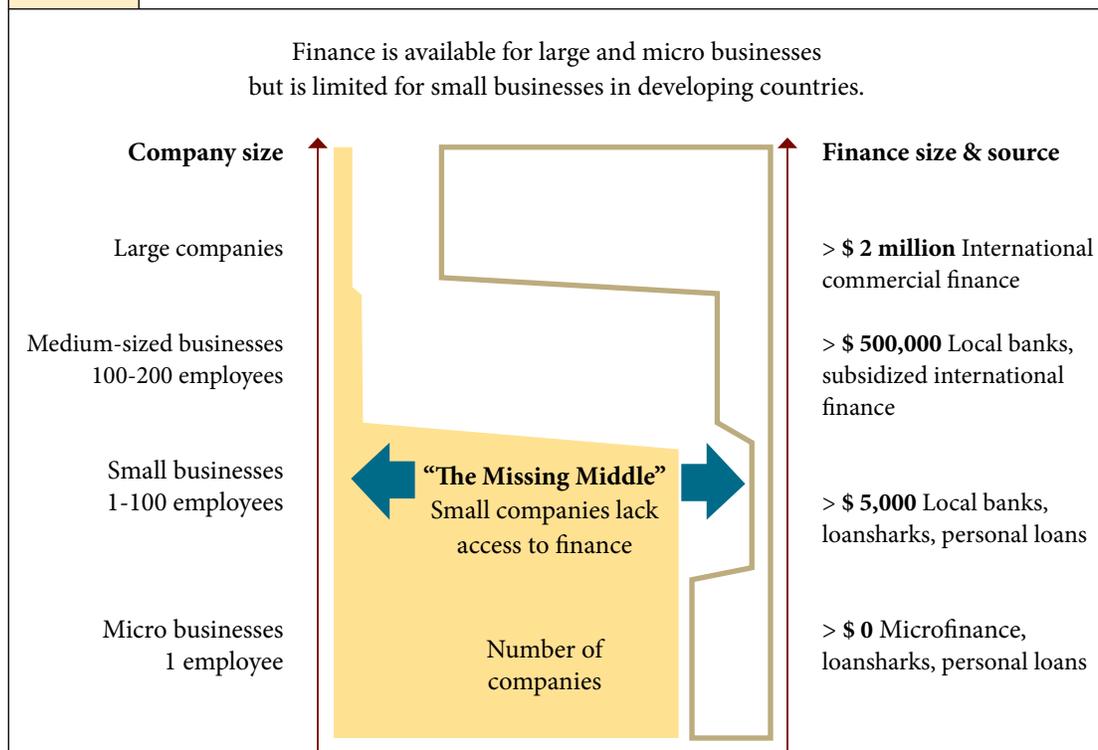
Commercial banks, meanwhile, tend to be conservative in their lending practices, generally allocating capital to more established companies. Providing retail services and short-term credit to the SME sector represents a lucrative business segment for banks, but start-up and expansion capital remains virtually inaccessible. The smaller size and perceived risk of SME transactions reduce the cost-efficiency of serving this market. Additionally, the lack of competition among financial institutions in developing countries means that banks can ignore certain market segments and still be profitable. When they do finance

SMEs, banks usually require full collateral backing on any loans they make, but SMEs typically lack the appropriate assets to meet this requirement. In the absence of bank lending and other sources of capital, entrepreneurs struggle to find adequate external financing to expand their businesses.

This lack of financing, commonly referred to as the “missing middle” in developing countries, is depicted in figure 2. Large firms have access to bank lending and other financing sources, while individuals and very small businesses can obtain funds from microfinance institutions, which have expanded greatly over the past decade. Fewer resources exist for small businesses. Financing this missing middle is known as mesofinance.

FIGURE
2

The “missing middle” in developing countries



Source: Thierry Sanders and Carolien Wegener. “Meso-Finance: Filling the Financial Service Gap for Small Businesses in Developing Countries,” NCDO (September 2006).

The business and legal environment in developing countries is also a major cause of underdeveloped SME sectors. A strong regulatory system, well-defined property rights, transparency, and contract enforcement are critical to their overall success. While we recognize the importance of these factors, this report will focus solely on the funding challenges that SMEs face in developing countries.

WHAT IS AN SME?

No single definition applies to all emerging-market small and medium-sized enterprises. Rather, SME parameters vary by country. Egypt, for instance, defines SMEs as having more than five and fewer than 50 employees, while Vietnam deems a company an SME if it has more than 10 and fewer than 300 employees.

Multilateral development institutions tend to use their own definitions, often describing SMEs in terms of number of employees and amount of revenue and assets. For example, the World Bank defines SMEs as having a maximum of 300 employees, \$15 million in annual revenue, and \$15 million in assets. The Inter-American Development Bank, meanwhile, describes SMEs as having a maximum of 100 employees and less than \$3 million in revenue. Tom Gibson and Bert van der Vaart, both longtime investors in emerging-market SMEs, propose a specific formula to define SMEs based on annual sales, which would produce unique ranges for each country.

In this paper, we use the term broadly to refer to that segment of formal (i.e., government-registered) businesses that falls between microenterprises and large firms. We concentrate on growth-oriented companies as opposed to so-called lifestyle businesses. Specifically, our focus is on SMEs in developing countries and emerging markets, which continually face challenges in accessing the capital they need to grow.

We use the terms “developing countries” and “emerging markets” interchangeably, although we recognize there is a wide range of nations to which these terms apply, each with varying degrees of development and opportunities for investment. Our analysis does not single out any particular geography.

Sources: Marta Kozak, “Micro, Small, and Medium Enterprises: A Collection of Published Data,” International Finance Corporation, January 2007. Tom Gibson and H. J. van der Vaart, “Defining SMEs: A Less Imperfect Way of Defining Small and Medium Enterprises in Developing Countries,” Brookings Institution, September 2008.

THE FINANCIAL INNOVATIONS LAB

Innovative financial instruments and structures can help bridge the funding gap and facilitate the flow of risk capital to emerging-market SMEs. Our daylong Financial Innovations Lab on February 3, 2009, was convened to address particular obstacles and brainstorm solutions. The Lab brought together a variety of individuals, most of them with expertise in investing in and researching the small to medium-sized business sectors of developing countries. A list of participants is included in Appendix I.

The Lab began with a discussion of investor expectations. Investors in these markets explained their reasons for pursuing such investments and what they hoped to achieve with them. Midday discussion focused on case studies, prepared by Tom Gibson of the Institute for SME Finance, profiling two successful SME investments in emerging markets. These examples illustrated first-party and third-party exits (see table 1). Given the difficulty of exiting an emerging-market investment, it was important to analyze the available strategies and the frequency with which they are employed.

TABLE 1		
<i>How investors sell their shares</i>		
<i>EXIT</i>	<i>DESCRIPTION</i>	<i>EXAMPLES</i>
First-party exit	Sale of an investor's shares back to the business owner. This tends to be the most common exit type in emerging markets, given the shortage of buyers and the underdeveloped capital markets.	<ul style="list-style-type: none"> • Management buyout
Third-party exit	Sale of an investor's shares to an entity other than the owner. Trade sales are usually more common than sales to financial buyers. IPOs in emerging markets are rare.	<ul style="list-style-type: none"> • Sale to a strategic buyer (i.e., trade sale) • Sale to a financial buyer • IPO

The case of Business Partners and Swift Micro Laboratories provided an example of a first-party exit, in which the entrepreneur purchased the investor's shares. SEAF-Macedonia's investment in On.net illustrated a third-party exit, as the company was sold to a firm within the same industry (i.e., a trade sale). These cases challenged Lab participants to think about how to replicate the investors' results more broadly. (See the sidebars for a brief summary of each company's particulars; the complete case studies are available on our website at www.milkeninstitute.org.)

After a discussion of these individual case studies, fund managers presented strategies for attracting capital to funds. Finally, participants brainstormed ways to increase scalable risk capital to emerging-market SMEs.

FIRST-PARTY EXIT: BUSINESS PARTNERS' INVESTMENT IN SWIFT MICRO LABORATORIES (PTY) LTD.

Business Partners Ltd., a South African financing company for small and medium-sized enterprises, has been in operation since 1981. The firm was jointly owned by the government and a group of enterprises until private owners purchased a majority stake in 1996. Since then, the business has operated more like a commercial investor.

Business Partners typically invests in the \$100,000 to \$500,000 range, financing approximately 700 transactions per year. It does well despite the risk involved in the SME space, consistently producing returns on equity in the range of 8.5 percent to 11.5 percent. The firm is selective in the deals it chooses to finance, according to Managing Partner Nazeem Martin. In its fiscal year 2008, for instance, Business Partners approved just 15 percent of all business plans that it received.



Business Partners, where Nazeem Martin is managing partner, has been a pioneer in the use of royalties as a way to exit investments in SMEs.

Business Partners has been a pioneer in the use of royalties (a percentage of sales) in emerging-market risk capital investments. In most of its deals, royalties are based on actual sales or the company's sales projections, whichever are greater, allowing the firm to maintain a steady income stream over the life of the investment. One of its particularly successful royalty investments involved Swift Micro Laboratories (Pty) Ltd., a food-testing company.

In 1999, Valme Stewart, a longtime employee of Swift Laboratories (then called CSIR Microbiology Services), decided she wanted to buy the company from the South African government. The company had been privately held before being purchased by the government in 1998, and Stewart and the government owners had come to realize the private sector was a better fit. But Stewart lacked the cash to buy the company and was unable to obtain the necessary financing from local banks.

Stewart approached Business Partners—reluctantly at first, as she was particularly averse to the idea of outside control of Swift. Over the course of working with Business Partners, however, Stewart's skepticism lifted; she felt the investors had given her a fair deal. Business Partners acted as a "risk-royalty partner" in the investment, combining a loan at prime minus 1 percent interest, a 30 percent equity stake, and royalty payments, calculated as the greater of 1 percent of actual or projected gross sales.

Swift Micro Laboratories, as Stewart rechristened the company, ultimately exceeded all expectations laid out at the start of the investment. With an established, loyal client base as her foundation, Stewart made a number of improvements: expanding technical support to clients, enhancing its prevention and training services, opening a second testing laboratory across the country near Johannesburg to lessen the likelihood of specimen contamination, and improving Swift's Cape Town facilities.

In the sixth year of the investment, Business Partners exited through a management buyout. To finance the majority of the buyback, Stewart obtained a loan from a local bank, which Business Partners helped facilitate. Business Partners was rewarded with an attractive internal rate of return (IRR) of 55 percent.

THIRD-PARTY EXIT: SEAF-MACEDONIA'S INVESTMENT IN ON.NET

Created in 1989, Small Enterprise Assistance Funds (SEAF) is one of the world's largest multinational investment organizations targeting SME investments in the range of \$200,000 to \$2 million. SEAF invests directly in SMEs and provides companies with assistance in management and business planning.

The organization maintains a local presence in the countries where it operates, investing through 19 country- and region-specific funds. SEAF-Macedonia, for instance, invests specifically in companies within Macedonia and has a dedicated in-country office and staff.

In 2000, SEAF-Macedonia invested in a new Internet services company, On.net. SEAF made a three-year, \$204,000 loan to the company at 16 percent interest and took a 38 percent equity share for \$190,000, with rights to additional equity in the event of underperformance. The terms also included tag-along rights and clawbacks, which would guarantee certain funds to SEAF if the business were sold to a third party.

On.net's founders, Predrag Cemerikic and Sasho Veselinski, planned to take advantage of wireless technology to provide faster and cheaper Internet service in Macedonia. Along the way, however, they encountered frequent setbacks, largely originating from Macedonian Telecommunications (MT), the state entity that owned the landlines that companies had to lease to provide Internet service. When On.net attempted to bypass MT by deploying wireless technology, MT blocked the way. Meanwhile, price competition from other service providers weighed heavily, and the company performed below expectations during its first five years of operation.

On.net survived, however, benefiting from a contract with the U.S. Agency for International Development (USAID) to provide Internet service to all of Macedonia's schools and eventually gaining access to wireless technology. The company's success was due to its persistent and creative entrepreneurs as well as the technical expertise provided by SEAF.

In 2006, On.net was sold through a trade sale to Telekom Slovenije, a Slovenian telecommunications operator, for \$2.38 million. SEAF earned a 43 percent IRR and capital gains of more than \$2.12 million.



Predrag Cemerikic and a partner sold their Internet services company On.net to a telecommunications company, providing investor SEAF-Macedonia with a third-party exit. With him is the Milken Institute's Betsy Zeidman.

Over the course of the day, Lab participants identified three primary barriers to increasing scalable risk capital to emerging-market SMEs:

Exiting investments is difficult.

1

BARRIER

In developing countries, investment exits are more difficult to arrange, discouraging inflows of funds. The probability of a successful IPO in these markets is low due to inadequate financial architecture or low trading volumes in SME or alternative exchanges. This is part of a more generalized problem: Financial systems in emerging markets are far less liquid, deep, and broad than those in mature economies. External funding for firms is mainly provided by banks, while stock and bond markets remain relatively underdeveloped.⁵

Selling shares back to the entrepreneur is also tricky, as it is often daunting for entrepreneurs to come up with sufficient cash on their own. Moreover, the scarcity of strategic or financial buyers in developing countries reduces the likelihood of selling to a third party.

In developing countries, investment exits are more difficult to arrange, discouraging inflows of funds.

Fund managers at the Lab agreed that their emerging-market investments typically differ from similar investments in the United States and Europe in terms of length. The time horizon tends to be much longer for emerging-market SME investments, partially due to the problem of identifying an appropriate point of exit. With all else being equal, net returns are lower for longer-term investments, discouraging investors from entering these markets. If investors are to increase funding flows to emerging markets, the exit issue must be addressed.

2

SME investment returns are not fully risk-adjusted.

BARRIER

A key reason that financing funds' flows to emerging-market SMEs are insufficient—especially for investments in the range of \$100,000 to \$1.5 million—is that returns are not fully risk-adjusted. Entrepreneurs often need a great deal of technical assistance in putting their companies' financials in order, marketing, and other initiatives that could make their businesses successful. This increases a fund's administrative expenses and lowers net returns to investors. Because they are not fully compensated for the risk, investors have not embraced the opportunities.

Funds need to attract more investors to this space. Because commercial investors are often discouraged by the challenges described above, it may be worthwhile to find a way to leverage the growing number of socially motivated investors with an interest in blended-capital investments. These investors are often willing to accept a lower rate of financial return for the extra-financial benefits (e.g., economic development) their investments produce.

3

Information gaps exist between investors and SMEs.

BARRIER

Robust, comparable data on SMEs in emerging markets are lacking. As a 2006 report from the Organisation of Economic Co-operation and Development states, "Numerous analyses have tried to identify and assess the relative importance of constraints to SME growth in emerging markets. Unfortunately, the lack of hard data on SME characteristics and performance makes such an exercise extremely difficult."⁶ The dearth of comprehensive data on SMEs prevents investors from being able to systematically assess where opportunities lie and the likely outcomes of SME investments in certain regions.

John Wasielewski, director of development credit at USAID, noted this lack of basic information. Without this common starting point, investors and others interested in this space do not know where the need is greatest and are unable to target new efforts effectively. Lack of data also perpetuates the general perception that SMEs are too risky an investment.

At the same time, entrepreneurs lack information on risk capital providers. Not knowing where to turn, they must rely on their own funds or try to borrow from family and friends. In doing so, they miss the opportunity to expand more rapidly and reach the higher level of development that can be achieved with institutional funds. Potential collateral benefits (e.g., job creation) are also lost. Clearly, there is a need to provide investors with better data on SME investments and connect entrepreneurs to sources of capital. Mapping existing data and funding sources could be a great help in bridging these barriers to SME finance.

The dearth of comprehensive data on SMEs prevents investors from being able to systematically assess where opportunities lie and the likely outcomes of SME investments in certain regions.

With these barriers identified, Lab participants discussed best practices that contribute to successful investments in developing countries, help circumvent common obstacles, and tend to result in higher rates of success for investors. These strategies include:

■ **Best practice 1: Plan exits from the outset.**

Given the difficulty of exiting at the opportune moment, investors should start planning their exit as soon as they enter a deal, discussing the range of possibilities with the entrepreneur being financed. Selling back to the entrepreneur is usually less desirable than selling to a third party because the entrepreneur typically lacks sufficient cash to buy out the investor. Selling to the entrepreneur can be considered a floor and used as a backup plan in case a third-party sale does not materialize. An investor can insert a put option into the contract granting the right to sell to the investee after a certain period of time. This not only provides the investor with a safety net but also gives the entrepreneur an incentive to position his company more strongly. Making the company more attractive to outside investors lessens the probability that the often cash-strapped investee would have to buy it back.

Putting the exit and related conditions on paper is important. Jose “Pepe” Pano, director of UBS Pactual in Brazil, noted that it is important to negotiate these matters up front, even if they cannot be enforced. It informs the entrepreneur of the investor’s intentions so there are no surprises later.

Part of the investor’s ability to negotiate a successful exit from the outset depends on the relationship with the investee. “The best exits are made when the entrepreneur is on the same side as the fund. We have to try to find that alignment of interests if at all possible,” Bert van der Vaart, co-founder and executive chairman of SEAF, observed. Getting on the same page with the entrepreneur about exits from the beginning is essential, especially in places that lack widespread knowledge about how risk capital investments work.

For example, Pedrag Cemerikic, a Macedonian entrepreneur who co-founded On.net, said he found it strange that “while we were speaking about investing, somebody was speaking about exiting.”

Good communication and trust between the parties is critical for an investment to be successful. If an entrepreneur understands that the investor can be a value-added partner, he or she will feel more comfortable sharing information. This mutual understanding can develop more easily if the investor is local and understands the culture.

■ **Best practice 2: Structure funds more efficiently.**

If SME funds could achieve higher returns, they would likely attract more commercial investors. One way to increase returns is to reduce the costs of investment. For example, overhead for many SME funds is too expensive and could be lowered by making back-office functions more efficient. Many funds are small



The lack of data on SMEs makes it difficult to determine where the need for investment is greatest, says John Wasielewski, director of development credit at USAID.



“The best exits are made when the entrepreneur is on the same side as the fund. We have to try to find that alignment of interests if at all possible.”
— Bert van der Vaart, co-founder and executive chairman of SEAF

and separate, each with its own overhead. If one back office served a dozen funds instead of each fund having a dedicated administrative operation, costs would decrease for all funds. By structuring the funds more efficiently and taking advantage of economies of scale, emerging-market SME funds may attract more investors.

■ **Best practice 3: Use local investor networks.**

Being local to the investment is critical. If investors are outside the country or based far from where they want to invest, local networks can help identify potential deals and direct capital flows to where they are most needed. Investor networks are appealing because they are nearby and can keep a close eye on the entrepreneur. Networks might be made up of individuals who want to get into investing but lack experience in how to structure deals. Established funds can connect with these networks, learn where opportunities lie, and work with these groups to invest.

Thierry Sanders, director of the BiD Network Foundation, said BiD plans to use local investor networks to increase SME investment. The BiD Network receives business plans from emerging-market SMEs and tries to match the best ones with investors. Many of their business deals now come from Latin America, but the organization has few investors in that region. Their solution is to tap local investor clubs and business angels. To support this, the Dutch government has agreed to make available a fund from which the investor groups can draw down 50 percent of the investment amount. This model not only helps BiD find investors now but also supports the creation of local embryonic funds that may finance more deals in the future.

■ **Best practice 4: Standardize.**

One reason local banks purportedly do not invest in SMEs is because each deal is different, requiring a time-consuming process of evaluating the investment and structuring a unique contract. As a result, these investments carry increased transaction costs. Standardization is crucial to scaling up risk capital and eventually attracting large funding flows to SME investments. This process can take place on several levels, including due diligence, investment products, and financial and social impact reporting. Standardizing due diligence reduces the time investors need to spend researching each deal, allowing more deals to be made. When investment products and reporting are standardized, investments can be aggregated and analyzed more easily. In addition, better data can be compiled, making this space more transparent and attractive to investors.

Business Partners Ltd., the South African SME investment company mentioned previously, has tried to standardize its products. Business Partners offers just four types of risk capital products to investees: royalty partner, risk partner, risk-royalty partner, and equity partner (see table 2). By standardizing its offerings, Business Partners spends less time structuring each investment, so it has lower transaction costs.

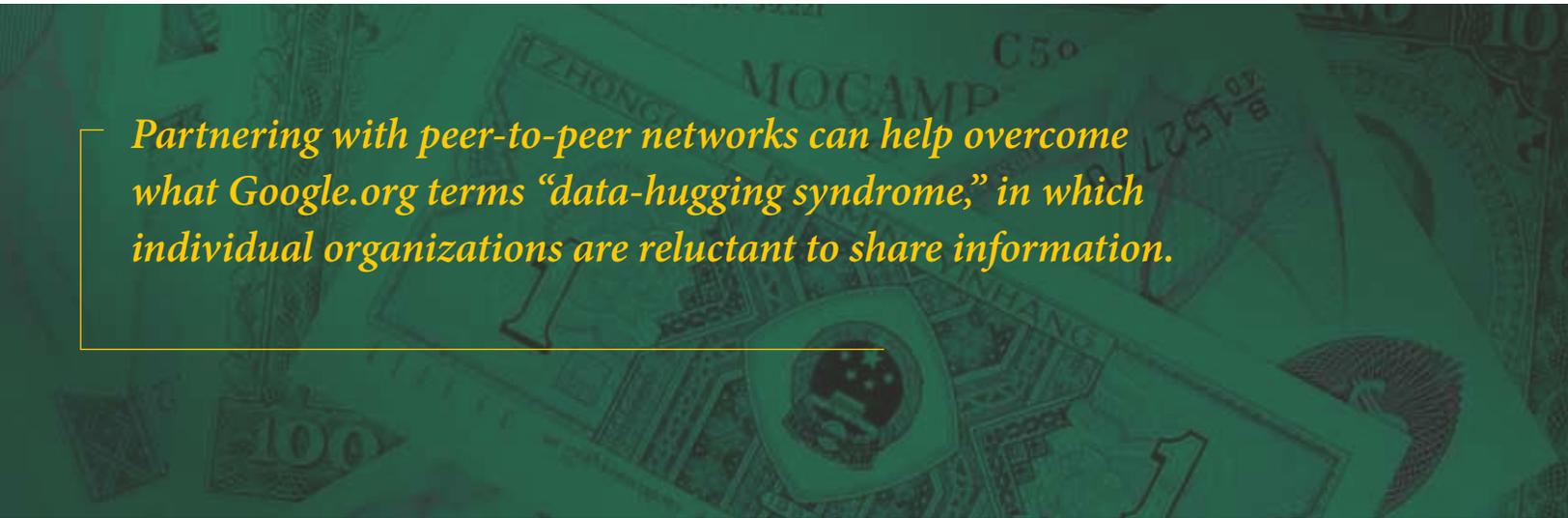
■ **Best practice 5: Reduce information asymmetries.**

Opaque markets increase an investor's risk and discourage investment. Making these markets more transparent involves reducing information asymmetries between investors and investees. Rating agencies, credit scoring bureaus, and other resources would help, as would the use of audited financial statements.

TABLE 2		<i>Business Partners' risk capital instruments (FY 2008)</i>		
PRODUCT	TYPE OF BUSINESS	DESCRIPTION	% INVESTMENTS	
Royalty partner	Smaller companies for which re-incorporation as a private limited company (Pty) is undesirable	<ul style="list-style-type: none"> • Loan at or near prime, typically with five-year term • Royalty on sales or units, typically 0.5% to 3% of gross monthly sales 	70%	
Risk partner	Relatively high-cash-flow lifestyle businesses with limited pre-investment equity, collateral, and cash	<ul style="list-style-type: none"> • Loan at or near prime, typically with five-year term • BP minority share of 25% to 45% of common equity • Exit of equity by predetermined formula, often paid in increments from free cash flow in the later years of the loan term 	7%	
Risk-royalty partner	High-risk, high-cash-flow businesses with low owner contribution	Hybrid of royalty partner and risk partner <ul style="list-style-type: none"> • Term loan at or near prime • Royalty on sales • Minority common equity participation • Typically requires dividend payments 	14%	
Equity partner	Established, profitable businesses undergoing expansion	<ul style="list-style-type: none"> • Generally combines shareholder loan with significant percentage of minority common equity • Exit anticipated and may be incremental during life of the shareholder loan; formula for valuation of equity determined during life of the investment • Investee has first right of refusal 	9%	

Source: Tom Gibson, "Risk Capital for SMEs in Emerging Markets: Case Studies of Two Exit Strategies," 2009.

Because these developments are a long way off for many developing countries, other means of increasing transparency are needed at the investor level. For example, fostering a strong relationship with investees usually gains investors access to more information. Business Partners' use of royalties is also an innovative way of decreasing information barriers. The firm typically asks investees for a percentage of actual sales or projected sales, whichever is higher. Business Partners thus decreases its risk, knowing it will receive a baseline level of returns even if the entrepreneur chooses to obscure actual results.



Partnering with peer-to-peer networks can help overcome what Google.org terms “data-hugging syndrome,” in which individual organizations are reluctant to share information.

FINANCIAL INNOVATIONS FOR STIMULATING INVESTMENT IN EMERGING-MARKET SMES

Building on the best practices outlined in Part I, Lab participants also presented a number of innovative solutions to the funding challenges faced by emerging-market SMEs. These ideas were further developed during a roundtable discussion at the Milken Institute's 2009 Global Conference. (Panelists participating in this follow-up roundtable are listed in Appendix II.) Note that the solutions outlined below are not competing alternatives; rather, they should be used in concert to facilitate capital access.

BARRIER: EXITING INVESTMENTS IS DIFFICULT.

SOLUTION

1

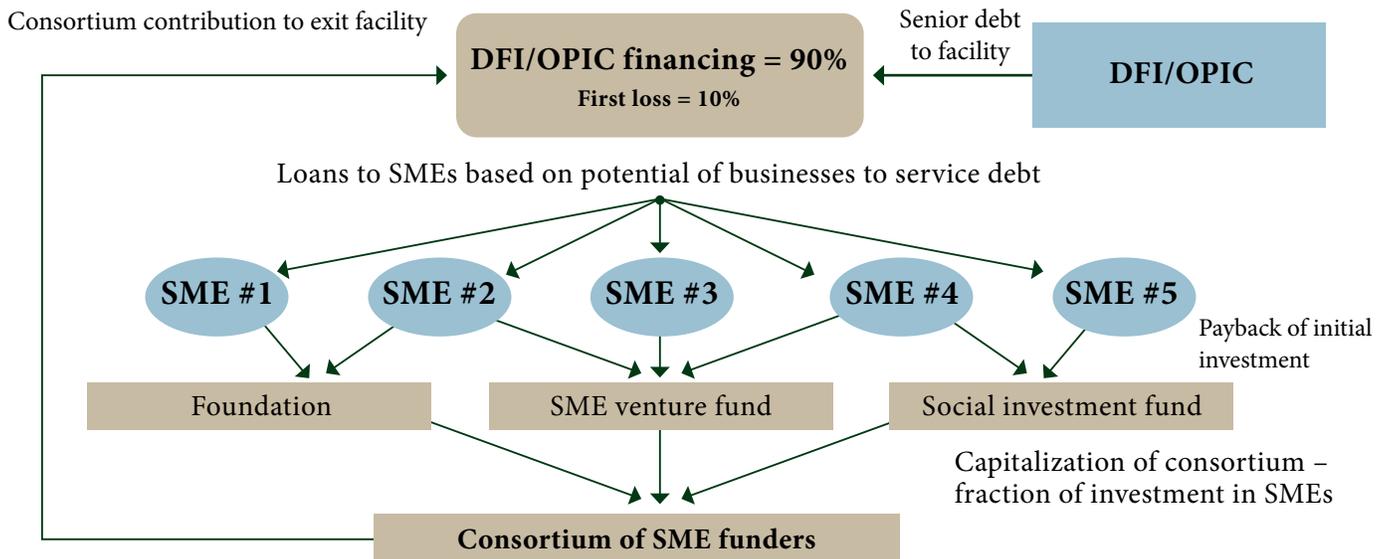
Create an exit finance facility.

Recognizing that the difficulty in selling investments presents a major impediment to increasing capital flows to SMEs in developing countries, the Overseas Private Investment Corporation (OPIC) is developing a self-sustaining exit vehicle. The exit finance facility's purpose would be to make capital available to the entrepreneur or a third party to buy out an investor. Individual SME investment funds would put some capital into the fund, and OPIC or another development finance institution (DFI) would provide the rest. The funds' capital would provide a first-loss tranche that reduces OPIC's risk in lending. In other words, the facility would provide peer-group lending leveraged by OPIC to help investors exit.

The exit finance facility (see figure 3) is designed for mature businesses that are beyond the growth stage and should not be used to force premature exits. Standards would be created between OPIC and the consortium of SME funds for the types of investments the facility would fund. For it to be self-sustaining, the facility should only fund those entrepreneurs who are most likely to follow through and repay the loan in a timely manner. Because the SME funds are also responsible for first losses, this creates peer pressure within the SME consortium to include only the best-performing deals in the facility.

FIGURE
3

SME exit finance facility schematic



Source: John Simon, Center for Global Development.

John Simon, a visiting fellow at the Center for Global Development and formerly vice president of OPIC, provided a scenario to illustrate how the facility would work. For example, an SME fund invests in a company that provides clean water services. After five years, the entrepreneur sees real upside in the company and decides to buy out the fund. If loans are unavailable in the local markets, the exit finance facility could make a five-year loan to this company, providing the entrepreneur plenty of cash to buy out the fund.

This model has not yet been implemented, but OPIC is building a consortium of SME funders. Note that this is an interim solution to the lack of bank loans to SMEs in developing countries. Because the facility carries some currency risk, it might make sense to partner with local development banks.

SOLUTION
2

Create a permanent capital vehicle.

A permanent capital vehicle (PCV) would also facilitate investors' exits and likely increase the flow of capital to SMEs. Because an exit path exists from the beginning of the investment, more investors would be willing to provide capital to emerging-market SMEs.

Two types of PCV structures were proposed. One builds on the best practice of structuring funds more efficiently and outlines a permanent capital vehicle that would decrease a fund's costs and provide a more sustainable source of capital for SME investment. Its structure would be much like a business development company (BDC) in the United States. The second was structured as a mezzanine buyout fund.

A permanent capital vehicle would decrease investment costs by reducing startup and other administrative expenses. Startup costs would only be incurred once instead of each time a new fund is created.

The first type of PCV would address many of the challenges posed by limited-life funds. As SEAF's Van der Vaart said of such funds, "The startup cost, the wind-down cost, the artificiality of having to push out the exit at the time when the macroeconomics may not be correct—you're almost guaranteed to have a poor ultimate return."

In contrast, a permanent capital vehicle would facilitate investor exits because shares of the fund would be liquid and could be traded readily among investors, similar to a BDC. A business development company is a type of permanent capital vehicle created in 1980 by the Small Business Investment Incentive Act. It began as a way to provide capital to private companies that lacked access to debt and equity markets. These private equity funds are traded on public markets and finance mostly SMEs.⁷ Like a BDC, a permanent capital vehicle could sell its shares to retail investors or larger funds. The vehicle could provide mezzanine capital to SMEs, thereby participating in an investee's growth while spinning off current income to investors in the form of dividends.

A permanent capital vehicle would decrease investment costs by reducing startup and other administrative expenses. Startup costs would only be incurred once instead of each time a new fund is created. In many cases, it takes about a year and half to raise money for a fund in what can be an expensive process. Limiting these expenses adds value to the fund. As the fund grows, it also would benefit from economies of scale. Given the reasonable size of gross returns on emerging-market SME funds, reducing costs would result in a much more attractive opportunity for investors. Meanwhile, SMEs would benefit from a consistent source of funds.

In contrast to a limited-life vehicle, a permanent capital vehicle reduces the pressure on fund managers to exit in a pre-determined timeframe to pay off investors. This allows for patient capital and the ability to make follow-on investments as fund managers see fit. By limiting pressure to exit and keeping investments in place longer, a permanent capital vehicle would offer SMEs the possibility of achieving risk-adjusted returns.

SEAF is working with OPIC to create this type of permanent capital vehicle for emerging-market SMEs. These two organizations have already put together \$30 million for a global debt facility and are looking for a matching equity line. In time, they hope to build up to a permanent capital vehicle of at least \$500 million with annual returns in the range of 10 percent to 15 percent.

The second type of PCV would take the form of a mezzanine buyout fund. Wayne Silby, co-chairman of the Calvert Funds, championed this version of the permanent capital vehicle. Once their investment companies are somewhat stable, investors could sell their equity interests into this structure. Their interests could include a residual kicker, such as a percent of revenues, or some preferred equity; however, the PCV would be for the most part a bond fund with 30 or more holdings. The fund would produce income and returns for the investors in the area of 8 percent to 10 percent. Rather than serving as a sustainable pool of capital for venture investors, this form of PCV would not take any venture risk; instead, it would incentivize early risk-takers, providing them with a means to exit their investments.

SOLUTION

3

Use the royalty model.

Successful investments in developing-country SMEs do not usually consist of straight equity. Instead, the deals typically combine royalties and loans with an equity or equity-like component. Royalties, a percentage of a company's revenue or sales, allow the investors to share in the company's upside without taking an ownership stake. When the only exit opportunity is a management buyout, royalties give the investor a stream of capital over the life of the investment and allow the typically cash-strapped investee to make a smaller payment at the time of the buyout.

Royalties are a creative means to increase the return on an SME investment but are not always appropriate. For example, new companies need to retain capital, so payouts to the investor during this initial phase can prevent the company from expanding.

As mentioned previously, Business Partners Ltd. has pioneered the use of royalties, using them to obtain a fair share of an investee's revenue without taking equity. The agreement requires the investee to pay Business Partners a percentage of actual or projected sales or revenue, whichever is higher. In this way, Business Partners participates in the upside when times are good and minimizes the downside with a set minimum in royalty payments.

BARRIER: SME INVESTMENT RETURNS ARE NOT FULLY RISK-ADJUSTED.

SOLUTION

4

Create regional funds or funds of funds.

Building on best practice 2, funds may be structured more efficiently to cut costs and increase net returns. Many funds are small and narrow in focus, targeting their investments to specific geographic areas. Keeping the fund size small leads to high costs relative to overall revenue and lower net returns. Peter Tropper of the International Finance Corporation emphasized this point: "It's very expensive to run a fund, and it's very expensive to run a small fund in a small country."

To resolve this problem, funds could grow in size and become more regional in scope. As a result, fixed costs would decrease relative to fund size, and investors would enjoy higher net returns. Grouping funds together to create a fund of funds creates a comparable effect.

Making funds larger can lead to problems, however, in that it might tempt fund managers to do bigger deals. Tropper found this to be the case with some of IFC's larger funds. When increasing a fund's focus or grouping several funds together, it is critical that fund managers remember that the goal is to decrease costs rather than to move up-market.



"It's very expensive to run a fund, and it's very expensive to run a small fund in a small country," said Peter Tropper, principal fund specialist at the International Finance Corporation.

SOLUTION

5

Use technical assistance funds side-by-side with investment funds.

Technical assistance—consulting an individual or group that has business or finance experience on how to improve various aspects of a business—is critical to emerging-market SMEs and can help enhance a company’s value. Although the cost of technical assistance can be substantial, it is one of the best ways to mitigate investment risk. To prevent technical assistance from draining a commercial SME fund of its revenue, investors can work with development institutions, governments, foundations, and NGOs to create grant-based pools of funding to pay for technical assistance to portfolio investees.



Expatriates could help stimulate entrepreneurship in their homelands with investments of money, time, or skill, says Krishnan Sharma, economic affairs advisor at the United Nations.

The net return on the investment in such a fund should be higher because of the associated cost reductions for the fund itself and the improved performance of portfolio businesses. As a result, more commercial investors would be attracted to these funds while helping philanthropic organizations meet their objectives. Public institutions can use their capabilities to leverage greater private capital for SME investment funds.

Krishnan Sharma, economic affairs advisor at the United Nations, noted how diaspora investors might contribute to the financial and non-financial support of SMEs. Expatriates could help stimulate entrepreneurship in their home countries by contributing equity and venture capital as well as bond finance. This capital could be channeled into SME investment funds. On the non-financial side, diaspora investors might provide remittances to the technical assistance funds or contribute their skills and technology to support SME growth.

Remittances represent a significant source of capital that could be directed toward SMEs. From 1996 to late 2008, remittances represented a larger contribution to developing countries than official foreign aid. Remittances grew 16 percent in 2007—and more than 40 percent for Africa. The recent economic crisis has reduced the growth rate of remittances, but the amount is still increasing. Growth slowed to 7 percent in 2008.⁸

One potential problem with side-by-side funds, as David Scheck, chief investment officer of E+Co, pointed out, is that it may be hard to sustain separate technical assistance funds. In Scheck’s experience, charitable support for technical assistance can evaporate over time. Because these funds are supported largely by donors, it is critical to ensure that funders remain committed.

SOLUTION

6

Use structured finance to broaden the investor base.

Fund managers can use structured finance to align investors' interests and, in doing so, broaden participation in their funds. Instead of offering identical shares to all investors, different types of investors with different tolerance for risk could invest in SME funds and receive varying levels of returns. For example, foundations making program-related investments (PRIs) and governments might invest in SME funds and agree to receive below-market returns in exchange for strong social outcomes. Including such investors in funds would leverage private capital seeking higher returns. In this way, the pool of SME investors can be expanded.

Gibson, of the Institute for SME Finance, developed an example of how such a structured fund would work. Table 3 illustrates a \$15 million fund capitalized by diverse investors. Each investor assumes a different level of risk, uses a distinct investment instrument, and receives a return that corresponds to the risk undertaken.

TABLE
3*Example of an SME fund using structured finance*

INVESTOR	AMOUNT	INSTRUMENT	RISK	RETURN
International financial institution	\$5,000,000	Common equity shares	Highest	Highest
Corporation	\$4,000,000	Preferred shares with low coupon rate	Moderate	Moderate
National development bank	\$4,000,000	Ten-year loan with five-year grace period at an interest rate below preferred coupon	Low	Low
Foundation	\$2,000,000	PRI	Lowest	Lowest
TOTAL	\$15,000,000			

Source: Tom Gibson, "Financing Equity Creatively," 2008.

SEAF has used this concept, categorizing investors in multiple equity classes according to their objectives. As a result, SEAF funds have attracted a variety of investors, including the Belgian Investment Office, Belgium's development finance institution; AFP Integra, Peru's largest pension fund; and New York Life International Inc., a mutual insurance company.⁹

SOLUTION

7

Guarantee funds from local banks.

Local banks represent an important source of capital for SMEs because they are close to the investment and know the culture, but banks now supply too little capital to SMEs. One reason is that SMEs present an unknown risk because of lack of information. To overcome this obstacle, institutions interested in facilitating capital access for entrepreneurs in developing countries could provide guarantees to local banks to cover any losses on SME investments. Reducing their credit risk would encourage the banks to make capital available to SMEs.

Compared to direct investments by foreign investors, guarantees decrease currency risk; the method uses local money and only taps international funds in the case of default. Partial credit guarantees may be preferred over whole guarantees because they give banks some incentive to monitor investments and encourage SME repayment. Guaranteeing funds might ease banks into investing in this space.

Shared Interest, a New York-based nonprofit that offers loan guarantees to South African banks, has encouraged more mainstream banks to lend to community development financial institutions and microfinance institutions (MFIs) serving low-income communities. An evaluation of its guarantee program suggests the fact that banks are offering “more flexible lending terms [demonstrates] that prior positive experiences in lending to MFIs can change banks’ attitudes and make them more receptive.”¹⁰ Shared Interest raises capital from individuals and organizations in the United States and uses it to secure standby letters of credit to South African banks. The program has been very successful; no lender has lost any principal or interest on the loans. Shared Interest has also leveraged large amounts of capital: For every \$1 guaranteed by Shared Interest, more than \$10 has been loaned to low-income South Africans.¹¹

Similar guarantee programs might be set up specifically for risk capital investments in SMEs. Through the European Investment Fund (EIF), the European Union offers an SME Guarantee Facility for certain European countries. The facility supports investments in SMEs with the “aim to stimulate the provision of equity and quasi-equity finance to SMEs, to help them improve their financial structure.” EIF provides partial guarantees up to EUR 500,000 (about US \$710,000) per SME to eligible European financial intermediaries for risk capital investments.¹²

Nonprofit lender Shared Interest has also leveraged large amounts of capital: For every \$1 guaranteed by Shared Interest, more than \$10 has been loaned to low-income South Africans.

BARRIER: INFORMATION GAPS EXIST BETWEEN INVESTORS AND SMES.

SOLUTION

8

Create mechanisms for matching investors and entrepreneurs.

Mechanisms are needed to match investors with projects that need funding. Variants on angel investing are proliferating in the developed world. Fund investors are seeking the angels' more hands-on approach, and angels are seeking the risk diversification of portfolio investing by forming investment groups. A number of new strategies in angel investing should be explored for their practical application in facilitating capital flow to emerging-market SMEs.

Simon, of the Center for Global Development, said such mechanisms would move beyond ad hoc, project-by-project investments to create a more efficient marketplace. This need is especially great given the information asymmetries in developing countries. Investors find it difficult to identify appropriate investments, and entrepreneurs have trouble locating sources of capital. Making opportunities more visible would reduce investors' transaction costs and increase the availability of capital for SMEs.

One way to match investors and entrepreneurs is for individual organizations to act as brokers, identifying and presenting potential deals to investors. In 2008, the BiD Network began offering a matchmaking service to developing-country SMEs and interested investors. Of the thousands of entries it receives each year for its business plan competition and other services, BiD Network presents only the best proposals to investors who register with the organization. In its first formal year of operation, the program facilitated 19 matches and total investments of \$2.8 million. BiD hopes to double the number of matches next year and double it again by 2011.¹³ A similar organization, Washington, D.C.-based Renew, is launching a comparable operation to match U.S. investors with African SMEs.

Another way to link investors with opportunities would be to construct an information-exchange system using the Internet as a platform, as peer-to-peer (P2P) lending organizations have done. P2P has been instrumental in directing large amounts of capital to entrepreneurs in both developed and developing countries. Kiva, for instance, is a P2P organization that connects developing-country entrepreneurs looking for microloans with individual investors through an online platform. Investors can access the profiles of small-scale entrepreneurs in need of funds and select one or more to lend money to through microfinance institutions. Investors do not earn interest but receive the original loan amount back after a specified period of time.¹⁴



MYC4 is a similar online marketplace connecting investors around the world with African entrepreneurs. In contrast to Kiva, MYC4 operates in the higher end of the microfinance market and the lower end of mesofinance, offering loans between EUR 100 and EUR 100,000 (US \$142 and \$142,000). Investors bid for loans by offering competitive interest rates, and the winning bids are determined by Dutch auction. Social investors may ask for little or no interest, while profit-focused investors usually ask for interest rates from 15 percent to 25 percent.¹⁵ Alternatively, MicroPlace, created by the Calvert Foundation with eBay, does not connect investors directly to entrepreneurs but allows them to loan funds to microfinance institutions worldwide by purchasing securities for as little as \$20. Investors choose whether to receive more than just their principal in return and can select a rate of return up to 6 percent.¹⁶

These online platforms have had great success in helping entrepreneurs gain access to capital. A model offering risk capital to SMEs is promising but also presents challenges. Most of these systems so far have involved microfinance. SME investments are much larger and cannot be exited as quickly. Nevertheless, an Internet platform holds potential for financial matchmaking.

SOLUTION 9	<i>Collect aggregate-level data on SMEs.</i>
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Lack of data on SMEs exacerbates the existing funding gap; investors lack information about the companies' performance and are unable to assess risk accurately. Building a database of SMEs and their performance would reduce information asymmetries and help investors make decisions.

Given that the United States does not have a robust system of data on its own small businesses, it is hardly surprising that such information would be lacking in developing nations. But specific initiatives have begun to aggregate SME data in particular countries. For instance, Credit Reporting Information System of India Ltd. (CRISIL), a Standard & Poor's company, generates ratings on overall creditworthiness, assessing business risk, management risk, and financial risk. Information is gathered through surveys and interviews.¹⁷

PAES-MFA is building a database through its Portfolio Analytics Expert System, a credit analytics and risk-management tool that is accessible via the Web. The company designed the tool to use with non-bank financial institutions (such as microfinance institutions and SME banks), credit unions, and regional banks in developing countries. PAES-MFA cleans the entities' data, standardizes it, and provides risk-management services. Eventually, it will direct institutional debt capital to these entities based on the risk analysis. By carrying out this process repeatedly, PAES-MFA will be able to collect and pool data from a number of financial entities within a country. The resulting database will allow investors to assess the performance of each country's SME sector. PAES-MFA is currently working on rolling out the tool in Mexico and Central America.¹⁸

Another way to start building data would be to leverage existing resources. P2P networks, for instance, create large databases that could provide the foundation for a database on emerging-market SMEs. John Lyman, program manager at Google.org, said these networks can be a powerful means of collecting

Given that the United States does not have a robust system of data on its own small businesses, it is hardly surprising that such information would be lacking in developing nations. But specific initiatives have begun to aggregate SME data in particular countries.

data on SMEs in emerging markets. Partnering with P2P networks can help overcome what Google.org terms “data-hugging syndrome,” in which individual organizations are reluctant to share information.

Consortia can also aggregate data efficiently. Standard & Poor’s and SIMAH, Saudi Arabia’s credit information bureau, have a joint initiative to collect and assess default and recovery data from local banks. Member banks will contribute information on their mid-market and corporate defaults. SIMAH’s secure database will hold the information, and S&P will analyze select data points and develop probability of default models.¹⁹ The Pan-European Credit Data Consortium (PECDC), headquartered in the Netherlands, is a cross-border collaboration of 28 banks that pool credit-risk information. Member banks contribute such data as type of borrowers, time and size of exposure, defaults, and collateral recovery rates. Data points are standardized to enable comparisons, and anonymity is preserved to maintain confidentiality. PECDC provides a platform to accumulate and analyze a statistical database, which members can use to benchmark the risk of their portfolios.²⁰

Arguably, the most significant data on SMEs are measurements of sales growth, and sales metrics may be the easiest to obtain on an international scale. Portfolios of loans or risk capital investment in viable developing-country SMEs show that their sales typically grow 20 percent to 30 percent each year. In the past decade, billions of dollars in donor-sourced SME credit lines and guarantee programs have gone through commercial banks in developing countries. Virtually all these banks retain data on the sales of SME borrowers at the time a loan is made and require current financial data from their borrowers until the loan is fully amortized. If donor institutions and SME fund investors were to persuade the vehicles through which they finance SMEs to simply furnish data on average sales growth within a portfolio of loans or investments, this crucial data could be collected through a broad international sampling.



John Lyman, program manager at Google.org, says the information collected by peer-to-peer lending networks would be a powerful resource for building large databases on SMEs in emerging markets.

CONCLUSION

Interest in SME development has grown in recent years as government leaders and development organizations worldwide have recognized SMEs as key drivers of job creation and economic development. For example, in a July 2009 speech in Ghana, President Obama noted the importance of SMEs to a country's prosperity. "From South Korea to Singapore, history shows that countries thrive when they invest in their people and infrastructure; when they promote multiple export industries, develop a skilled workforce, and create space for small and medium-sized businesses that create jobs," he said. Growing interest in SMEs makes it even more critical to find ways to make exits easier, reduce the cost of investment funds, and increase information channels between investors and SMEs. Making the investment process more efficient will help attract investors and sustain interest in these investments.

The next steps in increasing risk capital to emerging-market SMEs should involve concrete development of the two new financial mechanisms outlined above: an exit finance facility and a permanent capital vehicle. These mechanisms will encourage SME investment largely because they facilitate investors' exits.

SME data aggregation is also vitally important. Companies with technological expertise could lead the way. Making SME data available will allow investors to make informed decisions and help debunk some of the misperceptions about these investments. Each of these solutions would support the growth of SME sectors in developing countries and, in turn, advance development in their economies.

APPENDIX I

Financial Innovations Lab Participants

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APPENDIX III

AUTHOR(S)	YEAR	TITLE	PURPOSE	RESULTS	IMPLICATIONS	TYPE OF DOCUMENT
Bank Financing of SMEs in Emerging Markets						
Beck, Thorsten, Asli Demirgüç-Kunt, and María Soledad Martínez Pería	2008	Banking SMEs Around the World: Lending Practices, Business Models, Drivers and Obstacles [DRAFT]	Presents results of surveys of large banks around the world that document the state of SME financing across countries and compare it to large firm financing.	Across countries, banks perceive SMEs as profitable endeavors, and almost all banks have SME clients. Only small differences exist between banking to SMEs relative to large firms; bigger differences exist between developed versus developing countries in terms of exposure, lending practices, business models, drivers, and obstacles to SME financing.	Contrary to popular belief, large banks in developing countries do serve SMEs and find them to be an attractive segment. The authors state that this paper is a “first step in better understanding SMEs financing from the supply side.”	Working paper
De la Torre, Augusto, María Soledad Martínez Pería, and Sergio L. Schmukler	2008	Bank Involvement with SMEs: Beyond Relationship Lending	Questions the common belief that SMEs are underserved by large and foreign banks because SMEs’ opacity makes them dependent on relationship lending, for which small and niche banks have a comparative advantage.	Using data from 12 developed and developing countries, the evidence suggests that all types of banks view SMEs as a strategic sector and are expanding or planning to expand their operations aggressively in this segment.	Since the developing countries studied were middle-income, more research needs to be done on bank involvement in lower-income countries. Furthermore, the evidence does not prove that SMEs in these countries receive adequate financing, but it does show that larger banks find this sector financially attractive and potentially can fill some of the financing gap.	Working paper
Financing Constraints for SMEs in Emerging Markets (General)						
Beck, Thorsten	2007	Financing Constraints of SMEs in Developing Countries: Evidence, Determinants, and Solutions	Surveys empirical research on SMEs’ financing constraints and offers policies to minimize existing obstacles.	Three types of policies would support SMEs in overcoming constraints in accessing capital: market-developing policies aimed at improving a country’s contractual and information frameworks and macroeconomic performance; market-enabling policies, such as regulatory frameworks that enable leasing and factoring and promote competition in the financial sector; and market-harnessing policies that attempt to prevent imprudent lending.	Developing countries’ governments have a clear role in improving their institutional environment, providing regulatory frameworks, and fostering competition; however, it is less clear how successful government may be in market-activist policies, such as credit guarantee schemes.	Working paper

AUTHOR(S)	YEAR	TITLE	PURPOSE	RESULTS	IMPLICATIONS	TYPE OF DOCUMENT
Risk Capital for SMEs in Developed Countries						
Bannock Consulting	2001	Innovative Instruments for Raising Equity for SMEs in Europe	Gives an overview of SME equity finance in Europe and possible ways to close the capital gap.	Public-sector approaches to increase equity capital to SMEs include direct investment in SMEs by publicly funded agencies, overhead subsidy to private SME investors, loss-sharing/loan repayment forgiveness for SME investors and/or upside return boost, minority public investment in SME investment funds on subordinated terms, and leverage to SME investors on moderate commercial terms guaranteed to private funders (like the SBIC program in the United States).	The authors conclude that the European Investment Fund should experiment with a leverage program to increase the supply of risk capital. In comparison, loss-sharing guarantees can be expensive and introduce distortions into the SME investment market.	Report
European Investment Fund	Not dated	CIP: SME Guarantee Facility: Guarantee Policy and Operational Guidelines for Equity and Quasi-Equity Guarantees	Sets out the policy for the European Investment Fund's SME Guarantee Facility, the purpose of which is to support investments in SMEs with growth potential "to reduce the particular difficulties which SMEs face because of their weak financial structure and to assist SMEs achieve business transfers."	EIF provides guarantees, co-guarantees and counter-guarantees up to an amount of EUR 500,000 to financial intermediaries (from eligible European countries) covering investments in the seed and start-up phase, mezzanine financing, and/or risk capital operations.	Equity guarantees may increase the amount invested in SMEs as some of the investor's risk is reduced. Similar programs could be set up for developing country investments.	Policy
Risk Capital for SMEs in Emerging Markets						
Gibson, Tom	2008	Financing Equity Creatively	Reviews the inability of African commercial banks to provide adequate capital to SMEs and presents strategies for increasing SMEs' access to risk capital.	Shareholder loans, as opposed to pure equity, reduce investors' risk and increase their current income. Risk capital intermediaries may capitalize their funds using diverse financial instruments that reflect investors' differing return objectives. Governments can introduce programs such as tax incentives to increase private-sector participation in SME risk capital.	Increasing the availability of non-asset-based financing is critical to support Africa's SME sector and contribute to the continent's economic growth.	Paper prepared for a conference

AUTHOR(S)	YEAR	TITLE	PURPOSE	RESULTS	IMPLICATIONS	TYPE OF DOCUMENT
Hoff, Belinda, Mareike Hussels, Virginia Barreiro, Ray Cheung, Jesse Last, and David Wood	2007	On the Frontiers of Finance: Investing in Sustainable SMEs in Emerging Markets	Provides an overview of the current landscape of financing for sustainable SMEs (companies that capitalize on commercial opportunities while also generating social and environmental benefits), clarifies key challenges, and offers solutions to bring the sustainable enterprise finance sector to scale.	Through interviews with leading sustainable SME funds, the authors identified challenges that the funds faced, including difficulty with fundraising, monitoring and evaluating investments, and providing technical assistance.	To scale up sustainable SME finance, efforts should focus on increasing collaboration among aggregators, VC funds, and local banks; improving the coordination and effectiveness of blended capital (for example, by educating investors and donors about blended capital models); and standardizing monitoring and evaluation approaches.	Paper prepared for a conference
UNEP Finance Initiative	2007	Innovative Financing for Sustainable Small and Medium Enterprises in Africa	Offers recommendations to remedy the demand- and supply-side challenges of SME financing and provides case studies of successful funds, including the Acumen Fund, Grofin, E+Co, and Root Capital.	The author presents the following recommendations to investors working in Africa: educate investors about blended value approaches to financing, build local groups to strengthen local institutions and banks, train African fund managers, conduct more research on SME financing, explore mechanisms to align investor objectives, organize a focused workshop in each region of Africa, and partner or tap into existing institutions and networks to deliver objectives.	Despite the number of challenges faced in emerging markets, the experiences of the four organizations profiled in the study provide lessons on how to invest in these markets successfully.	Paper prepared after a conference
Cumming, Douglas, Grant Fleming, and Armin Schwienbacher	2006	Legality and Venture Capital Exits	Considers the impact of a country's legal environment on exits of private equity investments using a new dataset of 468 venture capital-backed companies across 12 Asia-Pacific countries.	A country's legal system is much more directly connected to facilitating VC-backed IPO exits than the size of a country's stock market. This result is in direct contrast to conventional wisdom that stock markets by themselves facilitate venture capital markets.	The findings indicate that legality is a central mechanism that mitigates agency problems between investors and entrepreneurs, which fosters IPOs and venture capital markets.	Journal article

AUTHOR(S)	YEAR	TITLE	PURPOSE	RESULTS	IMPLICATIONS	TYPE OF DOCUMENT
Ponsolle, Josephine	2006	Equity Investments in SMEs in Developing Countries	Outlines SMEs' need for equity finance, two successful existing models of private equity for SMEs (the U.S. SBA's Small Business Investment Company program and Business Partners' equity fund), IFC's direct equity investments and indirect investments through funds, and some issues that need to be addressed.	Among other topics, the author describes the success of the U.S. SBA's Small Business Investment Company program in stimulating the flow of private equity capital to SMEs, and questions whether international institutions could try a similar public-private partnership.	Issues to address the equity gap include the lack of access to leverage in developing countries, the possibility of instituting public-private partnerships or incentives for funds to improve performance, whether to invest in business angel networks and successful funds like Business Partners, and whether to focus on only high-growth SMEs vs. lifestyle SMEs.	Presentation
Wang, Jiansheng	2006	IFC's Experience in Investing in Private Equity in Emerging Markets	Provides an overview of what private equity funds are and how the International Finance Corporation approaches private equity investment in emerging markets.	The author outlines the process of making private equity investments, which includes surveying markets for deals, performing due diligence, approving the investment, negotiating the contract with management, closing the fund, regular monitoring of the investment, and exit.	Emerging markets pose a number of unique challenges. To maximize developmental impact, IFC looks for skilled fund managers who create value, negotiate control mechanisms (e.g., tag-along and drag-along rights), invest in owners who want to develop a company and then sell it, and have deep knowledge of the local market.	Presentation
Lerner, Josh, and Antoinette Schoar	2005	Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity	Explores how the nature of a developing country's legal system affects private equity investments.	Investments in countries with better legal enforcement typically use convertible preferred stock and have greater contractual protections. Investors in countries where legal enforcement is difficult tend to rely on obtaining majority control of the firms they invest in, use debt more often, and have more board representation.	A country's legal system greatly affects the structure of private equity transactions. Relying on ownership instead of contractual protections seems to be only a partial remedy as these investments tend to have lower valuations and returns.	Journal article

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Oluwajoba Abereijo, Isaac, and Abimbola Oluwagbenga Fayomi	2005	Innovative Approach to SME Financing in Nigeria: A Review of Small and Medium Industries Equity Investment Scheme (SMIEIS)	Reviews SME private equity financing in developed countries, in developing countries (including the experience of Small Enterprise Assistance Funds, SEAF), and in Nigeria through its SMIEIS, which started in 2001 and requires all banks in Nigeria to set aside 10 percent of before-tax profits annually for SME equity investments.	To be successful in private equity financing for SMEs, Nigeria's banks have to attend to challenges related to deal flow, investment structuring, monitoring and value enhancement, and exit strategies.	Nigerian banks may increase equity financing for SMEs by partnering with business development services that will increase the competencies of SMEs, providing training to the banking industry, arranging pre-investment exits, encouraging entrepreneurs to accept external help and ownership, and having a government that can assure a conducive investment and stable political environment.	Journal article
Bachrach, Carlos	2003	Background Paper: Small Enterprise Investment Funds and Capital Markets in Latin America and the Caribbean	Reviews the evolution of venture capital and private equity investments in Latin America, the origins of the venture capital industry in the United States, and Israel's successful venture capital development.	The U.S. and multilateral institutions sponsored the earliest venture capital investments in Latin America and have remained strong contributors. Institutional private equity funds started to appear there around 1995. Latin America must overcome a number of hurdles to improve the environment for private equity investment.	The international experience in venture capital has identified a number of lessons for success, including the need for a supportive legal, regulatory, tax, and financial framework; a large group of skilled VC investors; a large base of entrepreneurs assisted by a network of service providers; success stories that incentivize further investment; and patience and flexibility in identifying appropriate exits.	Report
Leeds, Roger, and Julie Sunderland	2003	Private Equity Investing in Emerging Markets	Discusses the surge in private equity funds in emerging markets in the mid-'90s and the subsequent decrease in funds as their performance did not meet investors' expectations.	Private equity funds in emerging markets underperformed as a result of developing countries' low standards of corporate governance, weak legal systems, and limited options for exit.	Along with local government improvement of regulations and leadership from development finance institutions, emerging market private equity fund managers can improve investment performance by having an on-the-ground presence in the investment country, taking a hands-on role to enhance company value, being more discerning in their deal selection, and mapping out creative exit strategies.	Journal article

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Boot, Gijs M.	2002	Symposium on Winning Strategies in SME Finance: Exits	Highlights the various methods of exits and their advantages and disadvantages.	Possible methods of exit include write-offs, IPOs, trade sales, MBOs, and financial sales. Whereas IPOs are usually not an option for SMEs, trade sales are very suitable and can be a cheaper, faster, and simpler exit. MBOs are often the route when other routes fail. Financial sales are a possibility in some circumstances.	Investors need to address exit issues up front and build the structure of the exit into the deal. A contingency plan should also be included. Exit should be a keystone in the company's strategy. Investors' networks play a key role in identifying potential buyers.	Presentation
SMEs' Effect on Economic Growth						
Beck, Thorsten, Asli Demirgüç-Kunt, and Ross Levine	2005	SMEs, Growth and Poverty: Cross-Country Evidence	Provides the first cross-country evidence on the links between SMEs and economic growth and poverty alleviation using a new database on SMEs.	Although the authors found a strong relationship between the size of the SME sector and economic growth, they could not establish any causal proof. They also did not find a significant relationship between SMEs and poverty alleviation.	Further research is needed to establish a statistical relationship between SMEs and economic growth. Current results do not provide empirical support to subsidize SMEs to produce growth and reduce poverty.	Working paper
Stock Exchanges for SMEs						
Yoo, JaeHoon	2007	Financing Innovation: How to Build an Efficient Exchange for Small Firms	Outlines the steps needed to build an efficient exchange that would provide risk capital for SMEs.	Creating a market for SMEs in a developing country requires running the market as an independent entity either inside or outside the main exchange, supporting competition in the local venture capital industry, and enhancing transparency and coordination in supportive public programs.	A market architecture supported by effective institutions and industrial policies is critical to the success of an SME exchange.	Policy brief
Friedman, Felice B., and Claire Grose	2006	Promoting Access to Primary Equity Markets: A Legal and Regulatory Approach	Examines legal and regulatory measures that can be taken to promote access to the primary market in emerging market economies.	Facilitating the development of primary markets in developing countries would require: (1) a supportive environment (e.g., basic protection of property rights) (2) elements of basic market structure (e.g., fair settlement procedures) (3) disclosure requirements (4) corporate governance requirements, and (5) enforcement.	Although capital market development depends on many factors, including a favorable macroeconomic environment, an appropriately designed and effective legal and regulatory framework can help to encourage market growth and to increase access to finance for all companies, including SMEs.	Working paper

AUTHOR(S)		YEAR		TITLE		PURPOSE		RESULTS		IMPLICATIONS		TYPE OF DOCUMENT
Smith, Brad		2006		Global Review of SME Alternative Markets, Boards of Trade, Stock Exchanges or OTC Markets and Cross Border Listing Programs		Offers a preliminary report on SME alternative markets, boards of trade, stock exchanges or OTC markets, and cross-border listing programs as part of a larger research initiative on capital markets for SMEs.		Based on Internet research, the author identified 51 separate SME exchanges/listings, other lower-tier listings, and OTC boards across 38 countries, including three in Africa, three in South America, and one in the Middle East.		This research indicates a worldwide trend toward the expansion of capital markets and investment listings targeted to SMEs. This comes as countries face pressure to develop their own SME listing programs to avoid outflows of capital.		Report

ENDNOTES

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