



## **VENTURE CAPITAL FOR DEVELOPMENT**

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### **Introduction**

The developing world, and Africa in particular, faces a dearth of risk capital that has and will continue to constrain growth. Donors need to face the reality that the young companies that can really move the needle on innovation, inspiration and employment need high-risk, reasonably-sized, equity investments to grow, not the limited doles of short-term, high interest debt currently provided.

In the developed world, the young growth companies critical to innovative capacity and employment generation are financed with long-term, permanent equity capital. When a company is growing rapidly, it cannot generate sufficient cash through its current operations to support the investment required to generate future growth, nor can it afford to pay current interest or amortize the principal associated with loans. Angel investors and venture capitalists provide the equity capital that enables young businesses to take risks, build plants, develop technology and implement their long-term strategies to compete on a global basis.

Yet, companies in the poorest countries of the world have almost no access to this type of capital. Entrepreneurs struggle to build businesses with meager personal assets that rarely allow them to achieve the scale of operations required to be competitive. When entrepreneurs can get a loan—the only form of financing available in the market—the requirement to service the capital on a current basis puts undue pressure on their balance sheet, their ability to re-invest in the growth of their business and their willingness to take risks.

This past year has seen a renewed call to action to address persistent poverty in the developing world, especially in Africa. The key message from most of the discussions has been a call for an increase in development aid. But just spending more money is not going to build the long-term functional economies that will create the employment and wealth creation to get Africa and other poor countries out of their poverty trap. We need to get money into the hands of entrepreneurs who can build the businesses to enhance Africa's global competitive advantage and produce goods and services affordable to the world's poor.

We propose a specific program, an equity investment initiative funded by donors, which can have a real impact on business formation in the developing world. In partnership with local governments and investors, the program would provide equity capital and technical assistance to the subset of young Small and Medium Enterprises (SMEs) in developing countries which are truly growth-oriented and which the capital markets are not adequately supporting. These suggestions are offered as a beginning not an end; any initiative must strive to create over time viable private capital markets that can provide appropriate commercial instruments with reasonable financial rewards.

## **Growth Matters More than Size**

The current landscape of companies in Africa and other poor countries and their requirements for capital and assistance is most often described in terms of the size of companies. The “Micro” enterprise sector is typically defined as companies with less than 10 employees and generally includes small-scale traders, artisanal producers and farmers. Increasingly, these types of enterprises have been provided with capital and technical assistance by the burgeoning and successful microfinance industry. The “Large” enterprise sector is typically defined as anything with more than 100 employees and therefore includes multinationals and almost all established local companies such as privatized infrastructure providers and financial institutions. In most cases, local and international capital markets provide these types of companies with the necessary capital. The in-between, small and medium-enterprise (“SME”) sector, however, remains both the life-blood of the economy and the most challenging for policy makers to understand and financiers—whether commercial or donor—to serve.<sup>1</sup>

This one-size-fits-all categorization of companies with between 10 and 100 or more employees as SMEs hides variations in characteristics that are critical to their capital and assistance needs, and their potential development impact. Most of the companies in the SME-size category in developing countries are similar to micro-enterprises in that they provide basic employment and income generation for a family or farming cooperative group. Because these types of “necessity entrepreneurs”—traders, niche domestic service providers and agricultural producer groups—are oriented toward generating immediate income, they are unlikely to have or be able to re-invest capital in

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<sup>1</sup> Size definitions vary by country and organization; “small businesses” or SMEs are typically defined as companies with less than 100, 250 or 500 employees. Micro-enterprises are typically defined as less than 10 employees.

their businesses and take risks to grow significantly. As a result, these types of enterprises are unlikely to reach an economic scale to become globally competitive. On the other hand, they can also usually generate enough cash flow to service some form of debt. Many access working capital or trade finance through informal networks and a number of specialized providers of debt financing for this type of company have recently emerged.

A smaller segment of companies in this SME-size category, including high potential start-ups, have the potential to grow and become modern, globally competitive enterprises. These types of companies are run by “opportunity entrepreneurs” committed to innovating, adding value to exports, applying technology, achieving scale in production and re-investing profit in their business. And like their U.S. counterparts, they can have a *multiplier effect* on employment and overall economic growth. If these companies are successful in growing and reinvesting capital in their business, they can continue to expand direct employment, increase indirect income generation through sourcing local inputs, and pay taxes. Perhaps as important, successful companies and entrepreneurs can have a powerful demonstration impact: seeding and stabilizing clusters of related firms, inspiring other entrepreneurs to grow their businesses and serving as role models for youth. Unlike their “necessity entrepreneur” brethren, the impact of the capital invested in growth-oriented SMEs run by “opportunity entrepreneurs” can continue to have a compounding development impact.

But unlike in the United States and other developed economies, in most developing countries these segments of growth-oriented SMEs are virtually absent. In high-income countries, the SME sector has been estimated to contribute more than 50% to gross GDP, not to mention being the engine of new job creation and a source of as much as half of the innovation in these economies. In low-income countries, however, the contribution of the SME sector to gross GDP has been estimated at 16% and, in most African countries the SME sector has been estimated at less than 10%.<sup>2</sup> This absent segment of companies that are undergoing the risky but creative process of growing from small to medium to large-scale could explain much of the weakness in the overall economic growth of developing countries.

There are three basic explanations for the underdevelopment of the SME sector in developing countries: a weak business environment, a lack of managerial or technical capacity, and a lack of access to capital. We will not attempt to explain all three factors but will focus on the access to capital for growth-oriented SMEs.<sup>3</sup> It should be noted, however, that without progress by local governments in creating an investment climate and business environment that is supportive of entrepreneurship and growth-oriented businesses, any policies related to increasing access to capital for SMEs will have limited impact.

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<sup>2</sup> Source: Meghana, Demigurc-Kunt, Beck, “Small and Medium Enterprises Across the Globe: A New Database,” World Bank Policy Research Working Paper No. 3127 (August 2003)

<sup>3</sup> For a full discussion of all three factors see: Patricof and Sunderland, “Big Ideas: Small is Still Beautiful,” The Milken Institute Review (2<sup>nd</sup> Quarter 2005) pp. 90-94

## **Risk-Reward Imbalances**

In developed country environments, young companies are financed by various types of risk capital providers through a number of rounds of investment: friends and family supplying very early capital; angel investors such as retired businessmen providing start-up capital; and formal venture capitalists providing early-stage and growth capital. Each of these types of investors has specialized skills and information to evaluate the risks and rewards of the business plan at each stage of investment and to help the entrepreneur build the business. By the time a successful young company has graduated out of this risk capital market, it should have the cash flow and/or track record to access more formal capital markets such as banks and public markets. These public markets and mergers and acquisitions activity provide the critical high potential exit for the early risk capital providers.

Almost all developing countries lack this early risk capital market. This does not reflect neglect from development experts at the development finance institutions (“DFIs”). Surveys of the SME sector in developing countries have consistently identified lack of access to capital as a key constraint to growth.<sup>4</sup> In response, over the last two decades a range of schemes, from direct investments in the SME sector to venture capital programs and SME loan guarantee programs, have been attempted.

Most of these DFI-funded programs, however, have had limited success. Loan programs have often suffered from lack of utilization by the SME sector, high default rates and currency devaluations. Equity investments in SMEs through the nascent private equity and venture capital industry have generated mostly poor returns and many business failures. As evidenced in recently gathered data on the emerging market private equity industry, private equity funds in emerging markets (including a mix of both venture capital and larger private equity transactions) have globally only returned capital to investors, delivering a -0.3% IRR return over a 5 and 10 year horizon. Venture capital investments have been shown to be even more difficult to manage. Data from EBRD’s analysis of its funds in Eastern Europe shows that investments of less than \$2.5 million didn’t even return capital while investments greater than \$10 million delivered returns significantly above the emerging market private equity benchmark.<sup>5</sup>

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<sup>4</sup> There are numerous region and country-specific surveys of the dynamics of the SME sector and constraints to growth. For a most recent general evaluation of the SME sector in 54 countries see: Beck, Demirguc-Kunt, and Maksimovic, “Financial and Legal Constraints to Growth: Does Size Matter?” *Journal of Finance* (Volume 60 Issue 1 February 2005) p. 137

<sup>5</sup> Statistical performance data from Cambridge Associates Emerging Market Venture Capital and Private Equity Index have only recently been made publicly available. See *Emerging Market Private Equity Newsletter* (Volume 1, Number 2, June 2005) for a summary of the data. The EBRD analysis of the performance of its investments funds between 1992 and 2002 was presented in detail at the IFC Global Annual Private Equity Conference May 2004. General performance data for the EBRD sponsored funds is available at [www.ebrd.com/country/sector/fi/index.htm](http://www.ebrd.com/country/sector/fi/index.htm).

For investments of less than \$250,000 the challenges to delivering net returns to investors becomes even greater. Analyzing the portfolios of leading global SME funds shows that, without even taking into account transaction costs, the gross realizations and valuations on these investments barely return capital to the funds, compared to healthier multiples on larger investments. When even small transaction costs are incorporated into the returns calculations, the base capital on the small investments is quickly eroded.<sup>6</sup>

The result of these historical returns is that commercial investors in developing countries necessarily migrate toward larger deals. Even the leading global SME funds, reacting to pressure from their primarily DFI investor base to demonstrate commercial returns, have increasingly abandoned smaller SME equity investments and migrated toward minimum size investments from \$500,000 to \$1M, and most frequently to \$2M, with a large component of their investments structured as interest bearing securities.

With the renewed focus on private sector development and the importance placed on the SME sector, however, the development finance industry is desperately seeking a scaleable solution for delivering capital to the SME sector. As evidenced in the returns data, the difficulty with such a model is that, in most cases, the challenges of building growth-oriented companies in these markets mean that equity investments cannot deliver returns that justify the risks on a commercial basis.

There are a number of reasons for this:

- *Early Stage of Investment.* In many of the most promising developing countries, a stabilized economy and adequately functioning business environments have only been a condition of the past decade. Unless a product of privatization, high growth potential companies will often be start-ups or early stage companies with unproven products and marketing strategies, and limited track records. Investing in start-ups is notoriously difficult and risky—even commercial venture capitalists in the sophisticated U.S. market like to have some proof of a business plan and as a result leave the earliest stages of investment to angel investors.
- *Weak Managerial Capacity.* Many developing countries have extraordinary raw entrepreneurial talent -- as evidenced in the traders who effectively move large flows of goods across borders. But building and managing a modern enterprise that can add value and compete in international markets requires significantly different business language, contacts, and technical skills to which few of these raw entrepreneurs have access. For example, the stringent needs for quality control and timely delivery on contracts can be challenging for a businessman accustomed to the chaotic African trading environment to understand.

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<sup>6</sup> The Authors have worked closely with leading SME funds, including evaluating the underlying portfolios of the funds and the key factors affecting returns. The Authors wish to acknowledge the support of these fund managers in contributing to the development of the ideas in this paper.

- *Business Environment Risks.* In addition to the usual risks of starting and growing a company, these entrepreneurs must battle the hurdles created by government regulation, infrastructure weaknesses and even cultural impediments. Studies have shown that weaknesses in the business environment disproportionately affect smaller businesses.<sup>7</sup> What these studies do not adequately convey is the day-to-day drain on resources and morale of dealing with issues such as official corruption, power outages, lack of communication, and poor roads that destroy vehicles and increase delivery times.
- *Few Exit Opportunities.* While local capital markets have been established in many developing countries, they have thus far been open primarily to large and established companies. The M&A market in most of these markets also remains nascent. Therefore, with limited possibility for exits from equity investments, investors have focused on debt instruments that are appropriate only for cash flow generating companies.
- *High Transaction Costs and Limited Deal Flow.* For the investors themselves, investing in the SME sector presents difficult challenges. Investing in a small company takes many if not more resources than a larger transaction. Furthermore, the scale of most of these markets means that there just isn't, at this point in time, the potential to create that many high growth-oriented companies in any given country. As a result, the overhead costs involved in setting up an investment operation can be extremely high on a per deal basis.
- *Currency Risk.* For international investors, currency volatility can further erode returns. Many positive return investments produce negative or minimal returns when converted to U.S. dollars.

These factors make SME investing in growth-oriented companies in developing countries difficult, if not impossible, to justify in commercial terms. The companies themselves are most often early stage under any definition with unproven and inexperienced entrepreneurs. The markets in which they operate exacerbate the company risks. Even if the companies are successful, the rewards are difficult to achieve. The investor will have trouble getting liquidity from the investment and the transaction and overhead costs associated with investment management activity further erode the returns.

Without some form of balancing incentive, therefore, commercial investors who expect returns to justify their risks are not likely to invest in the SME sector in these countries in the near future. At the same time, to meet the financial objectives established by their shareholders, most of the DFI investors continue to demand commercial level returns from SME investing. Because their incentive structure often rewards large top-line

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<sup>7</sup> See Beck 2005 cited above. See also: Mead and Liedholm, "The Dynamics of Micro and Small Enterprises in Developing Countries," *World Development* (Vol. 26, No. 1 1998), pp. 61-74, for a discussion of the relationship between firm growth, failure rates and macro-economic conditions.

disbursements of capital, the DFI investors also rarely get excited by the volume of capital appropriate to the SME segment.

This does not mean that DFI investors should abandon the sector. Rather, it is time for the DFI investors to be realistic about what effective investing in this sector really takes, and adjust their thinking and benchmarks accordingly. We strongly believe if the DFI community wants to build young, growth-oriented SMEs in these markets, they will need to accept the risk-reward imbalance and begin to promote models for SME investing that take into account the high risks, high transaction costs, low volume, and below market rates of returns endemic to the sector.

## A Balancing Act

This type of reorientation in approach sounds simple in concept but is difficult to execute in practice because it requires a careful balancing act between creating market-driven incentives that enforce commercial discipline at the investment and company level and achieving the development objective of building businesses. Distorting capital markets with too much cheap capital or creating uncompetitive companies is always a danger when providing below-market funding to the private sector. Therefore, any initiative must strive to create over time viable private capital markets that can provide appropriate commercial instruments with reasonable financial rewards.

We propose, therefore, a program to create a pool of capital to invest equity or equity-like instruments in growth-oriented SMEs. The funds would, as much as possible in a given market, seek to leverage and build the nascent commercial risk capital market.

- *Capitalization.* Capital for the funds would be sourced from DFI investors, from local governments, and, crucially, with some participation, however modest, from private local sources. The donor investors and governments should be willing to accept very modest rates of return and directly support operating and transaction costs, allowing local private investors to manage the investments and take a disproportionate amount of the returns.
- *Investment Activities.* Capital from these funds should be available in amounts ranging from \$100,000 to \$2 million to invest in SMEs with the demonstrated ability to absorb capital and a growth strategy that can have a multiplier effect on employment. Investments should be in the form of quasi-equity with no forced amortization or current servicing required. Investors will receive returns from appreciation in the value of equity ownership where possible but more often in the form of payments linked to participation in increased revenues and free cash flow as generated.
- *Linkages to Pure Commercial Markets.* In addition to being managed by local private investors, the funds should work closely with other local financial institutions to graduate their companies for later stage financing from purely commercial sources. This could be achieved through pre-financing of companies

referred by the banking sector, working closely with banks to get loan financing for existing portfolio companies, and co-investing at later stages of financing with commercial venture capital funds.

- *Technical Assistance.* Capital alone will not be enough to develop growth-oriented SMEs in these markets. These companies need management training, advice from experienced business people, technical knowledge of equipment and processes, market information and insights to build their businesses. A parallel component of the funds will be dedicated to grant funding for technical and managerial assistance to the portfolio companies through existing assistance programs. The technical and managerial assistance component of the program should be fully integrated into the investment activities.
- *Investment Skills.* If local investors have appropriate skills and knowledge, they are much more likely to understand the risks and rewards of the SME sector and will be better placed to manage them on a day-to-day basis. Pairing local investors with skilled international fund managers could transfer the necessary knowledge and skills. Involving experienced venture capitalists in the overall management of the program should also allow for transfer of knowledge and skills.
- *Linking with the Diaspora.* The flow of entrepreneurs from the Indian and Chinese diasporas has had a significant impact on the quality of the young companies in those economies. The African diaspora has also begun to generate both the capital and the entrepreneurs that could significantly boost the SME sector's potential. The program should provide incentives for investment by the diaspora communities, encourage diaspora entrepreneurs to develop new companies in their home countries and involve senior business people from the diaspora in the program.
- *Commitment of the Companies.* The companies themselves will also need to be active participants in the program; in exchange for capital, they would commit to produce audited statements, pay taxes and abide by the rules of corporate governance.

The program will need to be adapted to the on-the-ground characteristics of the SME sector, the human resources, and the financial markets in a given country or region. Equity capital is not a one size-fits-all solution for the SME sector. In fact, in smaller or less developed countries, it may only be appropriate for a few companies. Regional funds therefore may be appropriate for regions with fragmented local markets and limited deal flow. The risks associated with the investments will also vary by the characteristics of the macro-economy and the financial markets. Smaller investments with higher leverage rates may be needed in underdeveloped markets whereas larger investments with lower leverage rates may be acceptable in more developed markets.

## **Conclusion**

In all of the discussion of aid and poverty, we sometimes lose sight of the fact that making the poor not poor requires employment, and preferably employment sustained by productive economic activity rather than capricious donor funding. Foreign direct investment can provide some of this employment and micro-enterprise activity can support basic income generation. But a vibrant indigenous private sector presents the best prospect for enduring progress in creating the employment and wealth creation that will pull Africa and other poor countries out of poverty. A “private sector”, however, does not spontaneously emerge from the pages of commission and consultant reports. Rather, young businesses must grow to become the larger, established institutions that can really move the needle on employment.

Apple Computer, Microsoft and Fedex did not start out with loans. If their founders had been required to finance their early growth with the short-term, collateralized, high interest loans currently available in developing countries, the businesses would not even have gotten off the ground. Instead, friends and family, angel investors, venture capitalists and even the U.S. Government’s Small Business Administration provided risk capital to build these successful U.S. companies.

In developing countries, we must similarly find a way to get equity capital into the hands of entrepreneurs who have the capacity to build young businesses. We believe our program provides a good place to start.