

ANDE – Aspen Network for Development Entrepreneurs

Background analysis

July 11th, 2008

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- **Introduction**
- **Small businesses' potential to drive economic growth and poverty reduction**
- **Challenges faced by small businesses**
- **'Small and growing business' community definition, role and challenges**
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Introduction

This document contains the detailed analysis and findings that have helped to shape the Aspen Network for Development Entrepreneurs (ANDE) organization

- **Accompanies and supports the ‘ANDE Call to Action’ document**

The work was conducted by Dalberg Global Development Advisors to support ANDE. It was funded with generous support by the Rockefeller Foundation and Skoll Foundation. Any errors, omissions or misrepresentations are those of Dalberg and not ANDE

The findings in this document have been developed based on

- **Over 25 interviews with intermediaries, funders and other stakeholders**
- **Survey of intermediaries and funders attending the July ANDE conference**
- **Third-party literature, case studies and reports**
- **Additional third-party sources such as intermediary websites and marketing materials**

This document is a work in progress and we would appreciate any feedback. Please send your comments to Andrew Stern or Veronica Chau at Dalberg (andrew.stern@dalberg.com or veronica.chau@dalberg.com)

This document is designed to answer critical questions facing the sector (I)

| Section | Page | Key questions addressed |
|---|-------------|--|
| Small businesses' potential to drive economic growth and poverty reduction | 5 | <ul style="list-style-type: none">• What are 'small and growing businesses' (SGBs)?• Why are SGBs important in developing countries?• What evidence exists for how SGBs support economic growth?• How do SGBs generate impact? |
| Challenges faced by small businesses | 16 | <ul style="list-style-type: none">• What factors are constraining SGB growth in developing countries?• What is the 'missing middle' in access to finance and how has it come about?• How are some of the gaps facing SGBs in developing countries addressed in developed markets? |

This document is designed to answer critical questions facing the sector (II)

| Section | Page | Key questions addressed |
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| 'Small and growing business' community definition, role and challenges | 40 | <ul style="list-style-type: none">• What is the SGB sector definition of:<ul style="list-style-type: none">• Funders?• Intermediaries?• How many SGB funds have been identified? What is their size and vintage years?• What key characteristics define identified SGB funds?• How are SGB intermediaries differentiated?• What role do intermediaries and funders play in helping SGBs overcome barriers to growth and sustainability?• What key challenges does the SGB sector face to achieve efficiency and scale? |
| ANDE's vision and role | 84 | <ul style="list-style-type: none">• What is the ANDE organization's mission?• What is the theory of change for the ANDE organization to reach long term scale and impact for the sector? |

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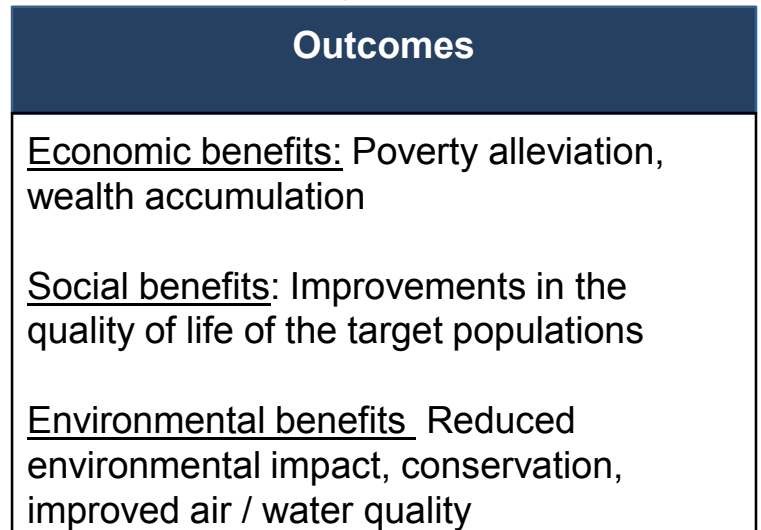
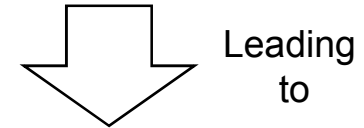
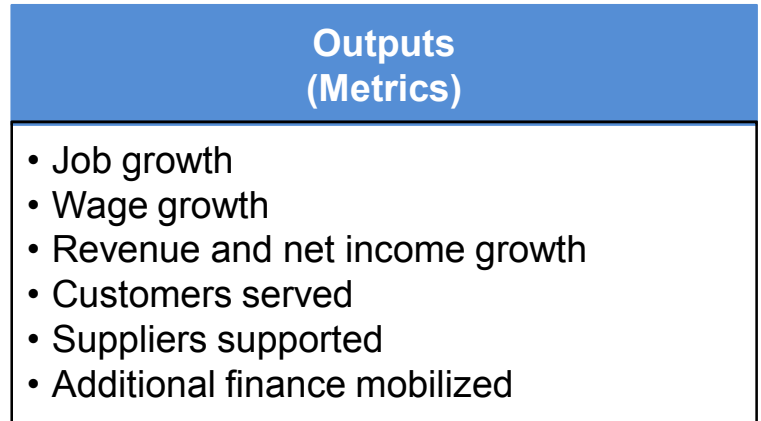
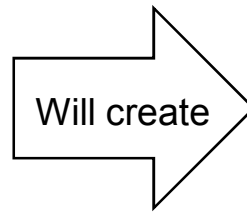
Executive summary

- **‘Small and growing businesses’ (SGBs) have significant potential to drive economic growth and poverty reduction**
 - However, despite social and economic benefits, the formal small business sector in developing countries is small compared with developed economies
- **‘Small and growing businesses’ (SGBs) are commercially viable businesses, often with less than ~250 employees, that have strong potential for growth and thus for creating social and economic benefits in the community and more broadly the economy**
- **SGBs generate benefits through job creation, the products and services delivered to customers or both**
 - At a macroeconomic level, there is a positive relationship between the size of the formal small business sector and economic development
 - At a microeconomic level, case studies reveal that investments in SGBs can realize financial returns and substantial “ripple effects” to other stakeholders

'Small and Growing Businesses' (SGBs) have significant potential to drive economic growth and poverty reduction

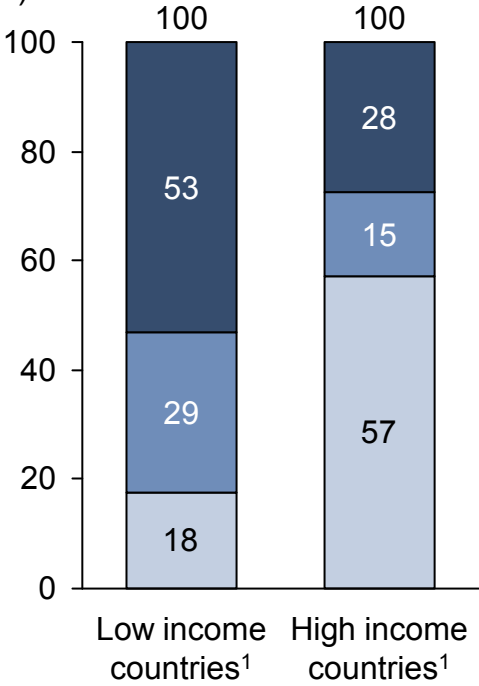


Commercially viable businesses with less than ~250 employees that have strong potential for growth, but constrained by key market failures and inefficiencies

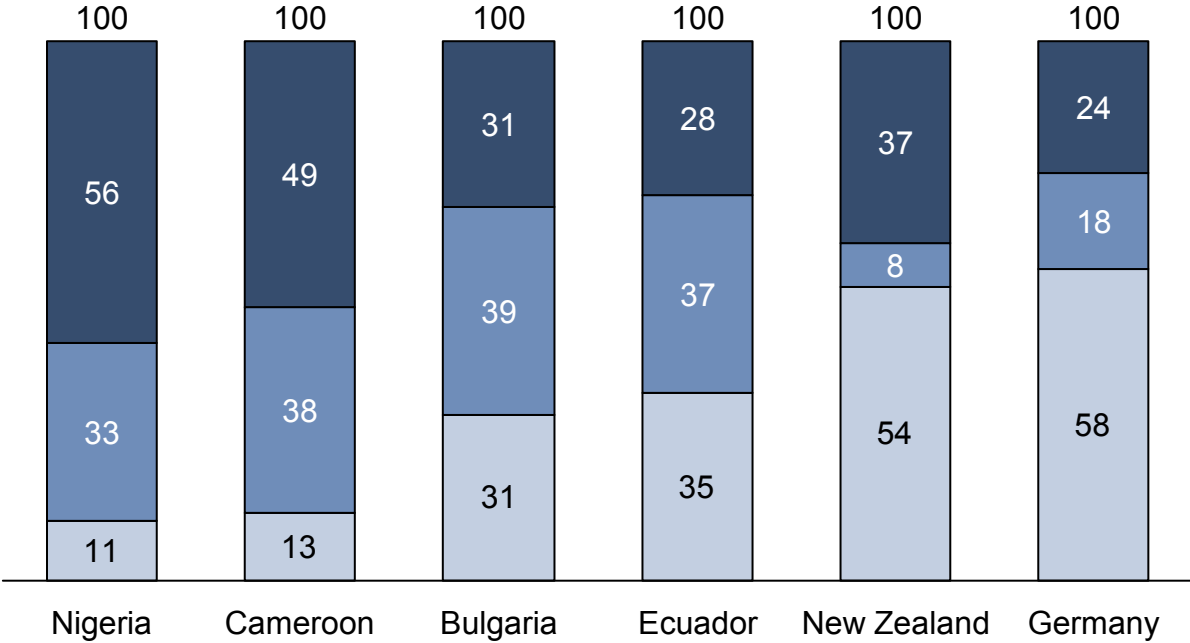


However despite the benefits, formal small business sectors in low income countries are much less developed

Share of total employment (%)



Employment contribution by business type



- Share of employment from other sectors (%)
- Share of employment from informal sector (%)
- Share of employment from formal SME sector (%)²

1. Contribution percents are median values for income group 2. Only includes businesses operating in formal sector
 Source: Ayyagari, Beck and Demircug-Kunt, "Small and Medium Enterprises across the Globe: A New Database", World Bank 2003; Dalberg analysis

SGBs are businesses with potential for growth and impact but are constrained by market failures and inefficiencies

Defining criteria

Small with growth potential

- Small within the context of geography and sector
- Often from seed to expansion stage of growth
- Potential for future growth and commercial viability

Potential to generate impact

- Potential to drive social and economic benefits via
 - Future business growth (e.g., job growth, tax income)
 - Goods/services delivered (e.g., social or environmental products)

Constrained due to market failures/ inefficiencies

- Access to capital or capacity building services constrained due to market failures and inefficiencies
 - Information asymmetries
 - High transaction costs
 - Complementary markets not to scale

Actual business size will vary by geography and sector however SGBs likely have between 5 and 250 employees

At a minimum, most SGBs generate impact through job and wealth creation – some SGBs also create benefits through the products and services delivered

SGBs

How impact generated

- How goods/ services are produced/ delivered

Benefits provided

- Wealth creation, e.g.,
 - New jobs
 - Wage increases
 - Tax revenue

SGBs delivering social or enviro. goods

- What goods/ services are produced/ delivered

- Wealth creation
- Increased access to beneficial products and services
 - Social products/ services
 - Environmental products/ services
 - Products/ services for underserved consumers (e.g., BOP)

SGBs constrained due to information asymmetries and high transaction costs

– SGBs that deliver social /environmental goods also face positive externalities

Market failures and inefficiencies constraining growth

SGBs*

Information asymmetries

- Less transparent and often lack audited financial statements
- Frequently are unable to provide collateral
- Limited third party credit scoring information available

High transaction costs

- Fixed costs higher on per-unit basis due to smaller investment size
- Information asymmetries increase some costs (e.g., monitoring)

Inefficiencies in complementary markets (not to scale)

- Track record often required for SGBs to be eligible for commercial investment however SGBs require capital to establish track record
- SGBs require local markets to support growth (e.g., finance, services) but local markets will not develop without demonstrated demand from SGBs

SGBs delivering social or enviro. goods

Positive externalities

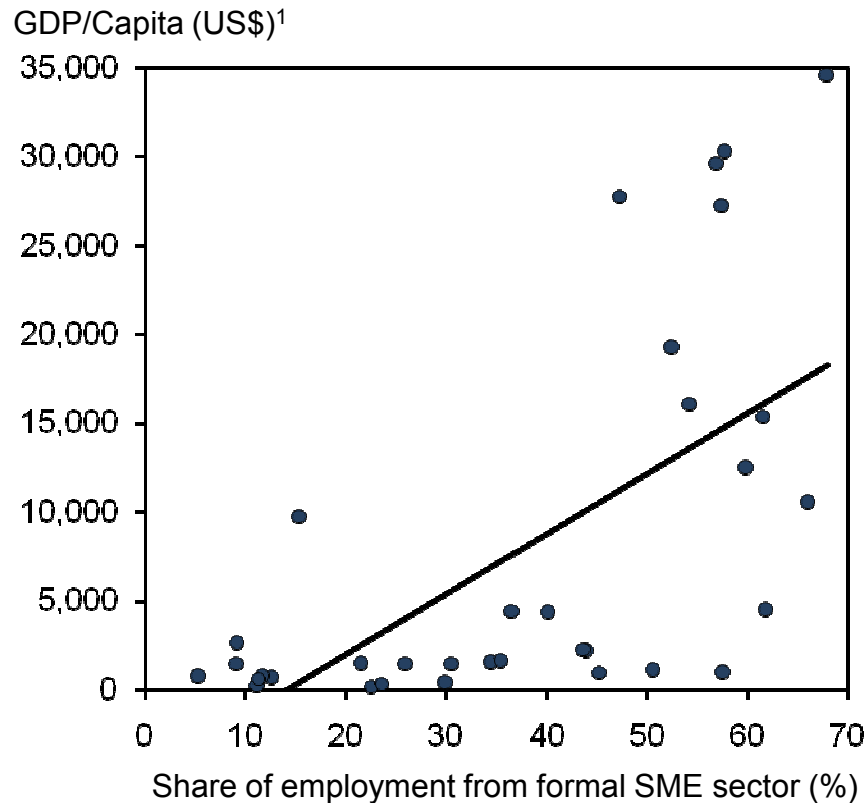
- Produce positive benefits (externalities) not-valued by private investors focused on financial returns

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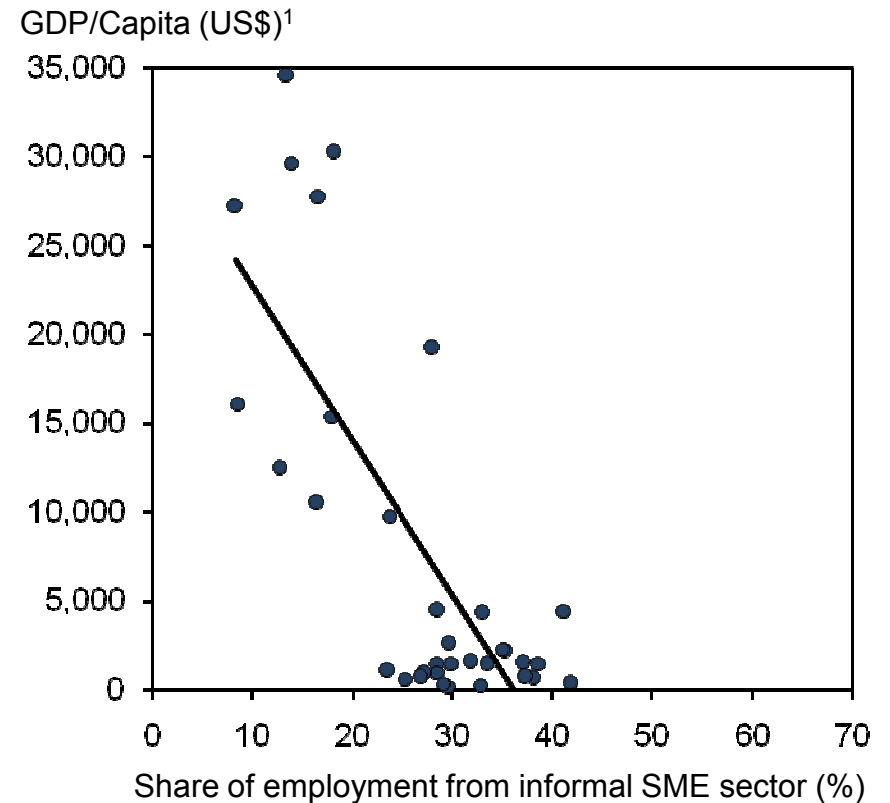
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At a macroeconomic level, there is a positive relationship between the size of the formal small business sector and economic development

GDP per capita positively correlated share of employment from formal SME sector...



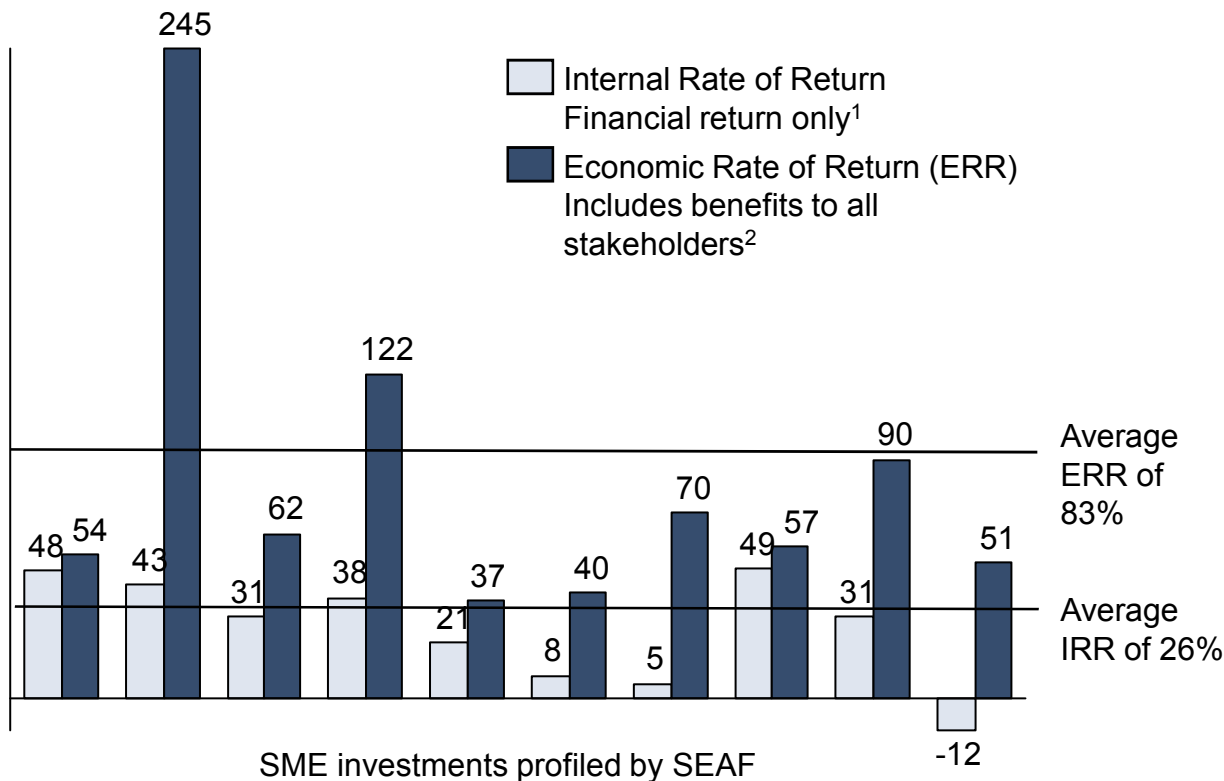
...and negatively correlated with share of employment from informal sector



1. Real GDP per capita in US\$ 2. Only includes countries for which SME definition cut-off is between 200 and 300 employees; SMEs are defined as formal enterprises
Source: Ayyagari, Beck and Demirguc-Kunt, "Small and Medium Enterprises across the Globe: A New Database", World Bank 2003; Dalberg analysis

At a microeconomic level, investments in SGBs can realize financial returns and substantial “ripple effects” to a variety of stakeholders

SEAF IRR and Economic Rate of Return on 10 selected case study investments



Economic Rate of Return includes returns to:

- Employees – wage increases, non salary benefits and labor mobility through training
- Customers – improved quality and/or lower price of goods and services
- Suppliers – increased demand for and sales of goods
- Government – value-added tax revenues
- Broader community – e.g., environmental gains, development of social infrastructure

1. Internal Rate of Return is derived from SEAF’s valuation of each company, based on European Venture Capital Association methodology 2. Economic Rate of Return is derived by SEAF by adding the benefits/costs of investment to stakeholder groups to the model used for calculating the project’s financial returns

Source: SEAF “The Development Impact of Small and Medium Enterprises: Lessons Learned from SEAF Investments

SGB case studies demonstrate the wide range of social and environmental products/ services that small businesses deliver

| | Example SGB description | Social/environmental benefits generated by SGB |
|-------------------------------|--|--|
| Social goods | <ul style="list-style-type: none"> • Delivers high-quality reading glasses to BoP consumers • Trains village-based entrepreneurs who receive a steady income source | <ul style="list-style-type: none"> • Extends the working lives and increases self-esteem of low-income citizens with near vision loss <ul style="list-style-type: none"> • Sold over 90,000 pairs of glasses by 2008 |
| Social infrastructure | <ul style="list-style-type: none"> • Builds and maintains high-quality, public, pay-per-use toilet and shower facilities for low-income populations in urban centers • Public/private partnership model | <ul style="list-style-type: none"> • Significantly reduces risk of diseases through increased sanitation • Reduces urban pollution from human waste • Helps define a new standard of hygiene in community • Restores dignity among urban poor |
| Environmental benefits | <ul style="list-style-type: none"> • Delivers Liquefied Petroleum Gas (LPG) for cooking in households and businesses <ul style="list-style-type: none"> • Provides LPG to clients that own equipment • Delivers filled stoves to clients without equipment | <ul style="list-style-type: none"> • Increases uptake of LPG by improving accessibility and affordability <ul style="list-style-type: none"> • Reduces deforestation by decreasing use of firewood • Improves household health as indoor air pollution decreased |

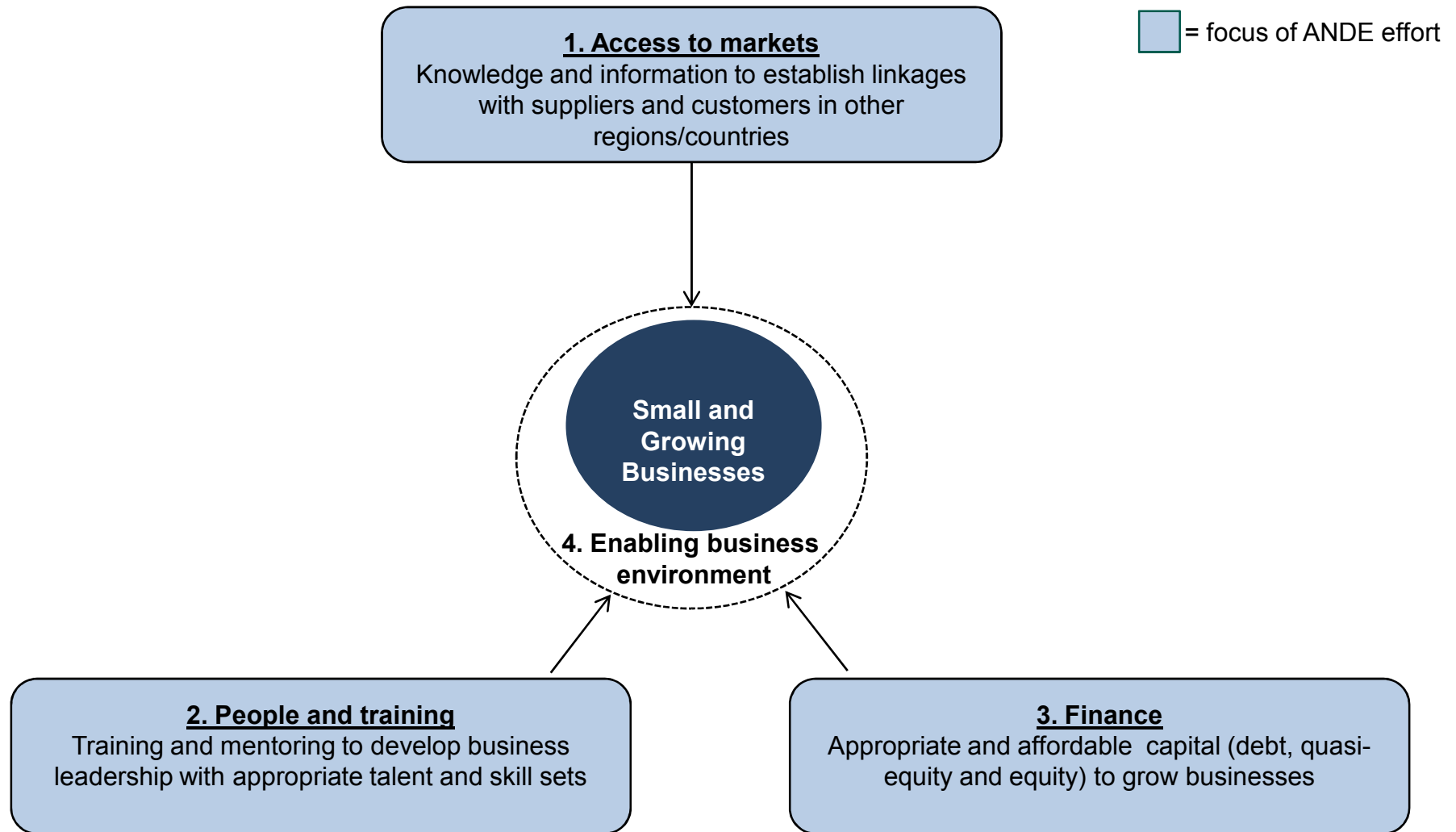
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Executive summary

- **At the highest level, SGB growth in emerging markets and developing countries is currently constrained by four key factors, the first three of which form the basis for the ANDE effort**
 - 1. Access to markets – knowledge and information required to establish linkages with suppliers and customers**
 - 2. People and training – training and mentoring to develop business leadership with appropriate talent and skill sets**
 - 3. Access to finance – appropriate and affordable capital to grow businesses**
 - 4. Enabling operating environment – e.g., business environment, legal environment, infrastructure**

SGBs in emerging markets face four key challenges– three of these challenges form the basis for the ANDE effort



Constraint 1 – Access to markets

SGBs face challenges when entering markets

- Accessing necessary business and market information
- Building relationships with potential buyers
- Producing sufficient quantities and quality of goods
- Managing potential customers' perception of risk if SGB operating in informal sector

In addition, SGBs in developing countries must overcome specific barriers when exporting goods

- Weak physical infrastructure, unreliable communication technology and excessive export procedures can increase export time
- Export time 2-3x higher in middle and low income countries than in high income countries

Providing information and facilitating market linkages is critical to creating successful SGBs

SGBS face challenges accessing and entering markets

Market and business information

- Limited access to market and competitive information such as buyer needs, market prices and competitors' offerings
- Norms such as business language and quality requirements may be unfamiliar

Relationship building

- Difficult to enter informal networks that are tied to family, ethnicity or religion
- Large domestic and international corporations often unaware of SGBs
 - SGBs may lack information technology to promote business

Production quantity and quality

- Limited production volume
 - Lack economies of scale when purchasing inputs and producing outputs
 - Lack production capacity required by large consumers and export markets
- Difficulty complying with external quality standards

Informality

- Many SGBs operate in informal sector
 - Perceived by potential customers as higher risk

Infrastructure

- Weak and/or unreliable infrastructure to bring products and services to market
 - Include roads, electricity and information technology

SGBs in developing countries face additional challenges when exporting goods

Three key barriers increase export time

Weak physical infrastructure

- Lack of adequate electricity, transport and other infrastructure may cut off SGBs

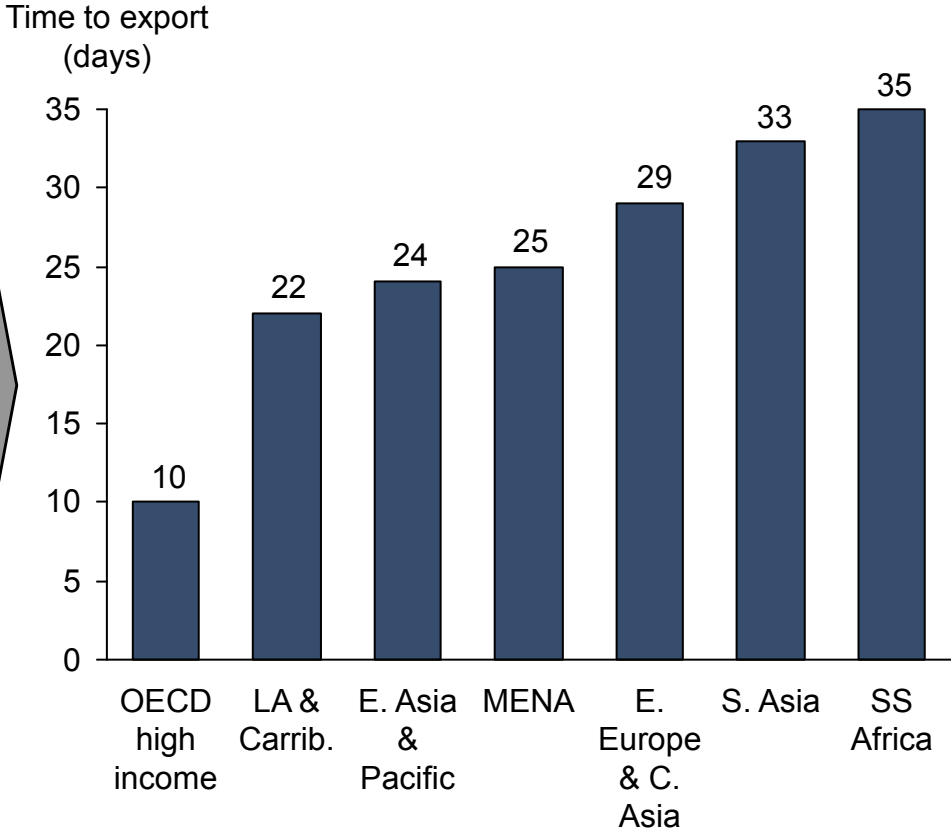
Unreliable communication technology

- Prevents SGBs from maintaining business relationships

Excessive export procedures

- Increases shipping time to international customers
- Incentivizes SGBs remain in informal sector

Export time higher in developing countries



Each additional day that an export product is delayed reduces exports by more than 1%

Constraint 2 – People and training

There is a high level of entrepreneurial spirit and activity in many developing countries

However the growth of these entrepreneurial ideas is often constrained by a gap in the skill sets required to manage businesses including

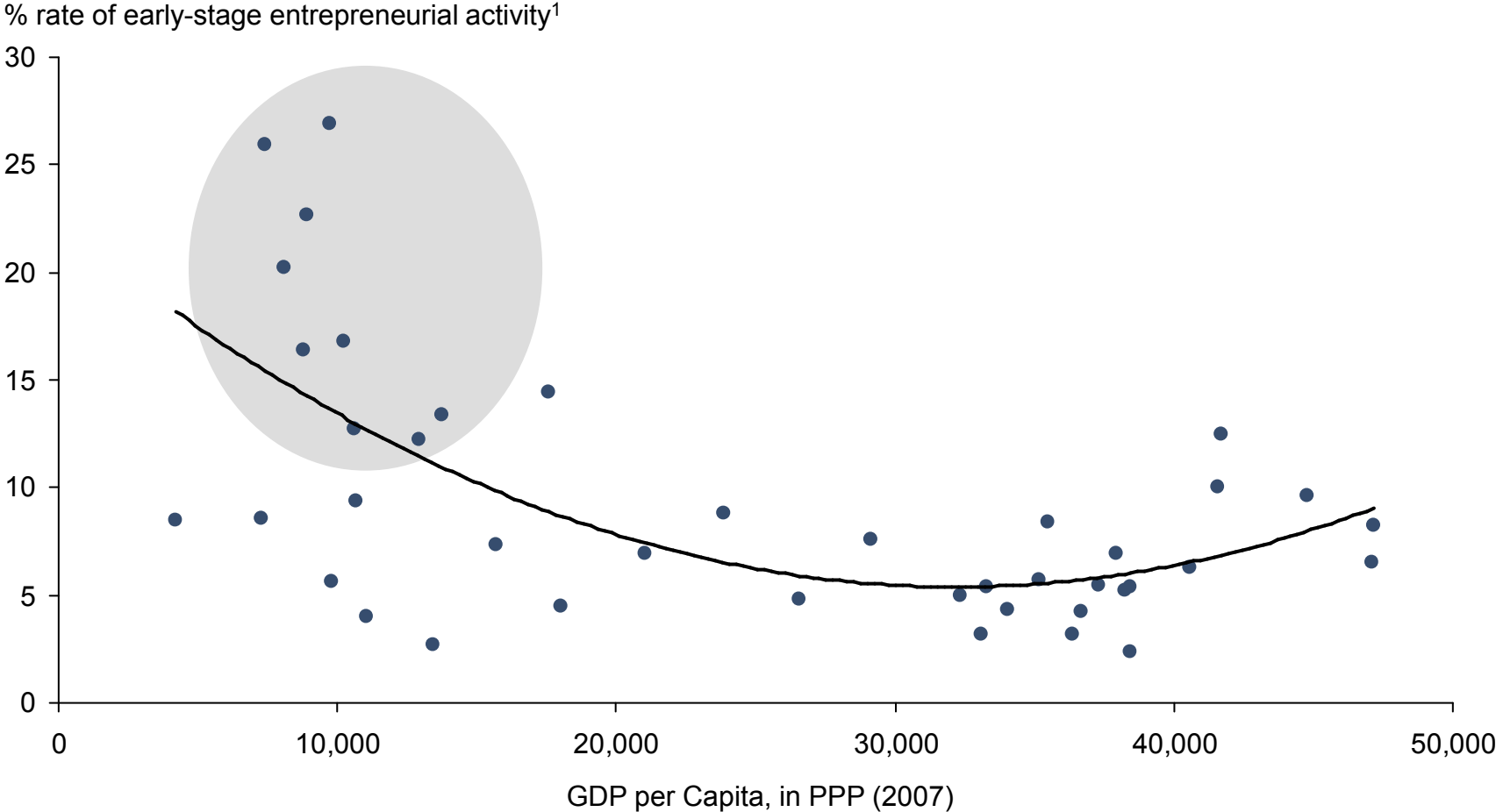
- Business plan developing
- Finance and accounting
- Marketing and market research
- Human resources and management

There are several potential drivers of these gaps

- Lack of necessary training for entrepreneurs and/or managers
- Weak educational infrastructure in some countries
- Outward migration of trained professionals
- High prevalence of family run businesses where relatives may be hired without necessary skills

Capital and capacity building providers must be prepared to invest in training for entrepreneur and/or management team

There is a high level of early entrepreneurial spirit and activity in many developing countries



1. Percentage of 18-64 population who are either a nascent entrepreneur (actively involved in setting up a business they will own or co-own; this business has not paid salaries, wages, or any other payments to the owners for more than 3 months) or owner-manager of a new business (owning and managing a running business that has paid salaries, wages, or any other payments to the owners for more than three months, but not more than 42 months)
Source: GEM 2007 Executive Report; IMF

However the growth of these entrepreneurial ideas is often constrained by a gap in the skill sets required to manage businesses

Entrepreneurs and/or management often lack the necessary skill-set to grow business

Broad skill set required, including:

- Business plan development
- Financial principals
- Accounting
- Inventory management
- Pricing
- Marketing
- Market research
- Technical skills
- Human resources and management
- Contract rules

Several potential drivers of these gaps

Lack of entrepreneurial and/or managerial training

- Entrepreneurs in developing countries often start businesses out of necessity
- Some businesses established and run based on entrepreneur's passion

Weak educational infrastructure in some countries

- Quality of education
- Length of education

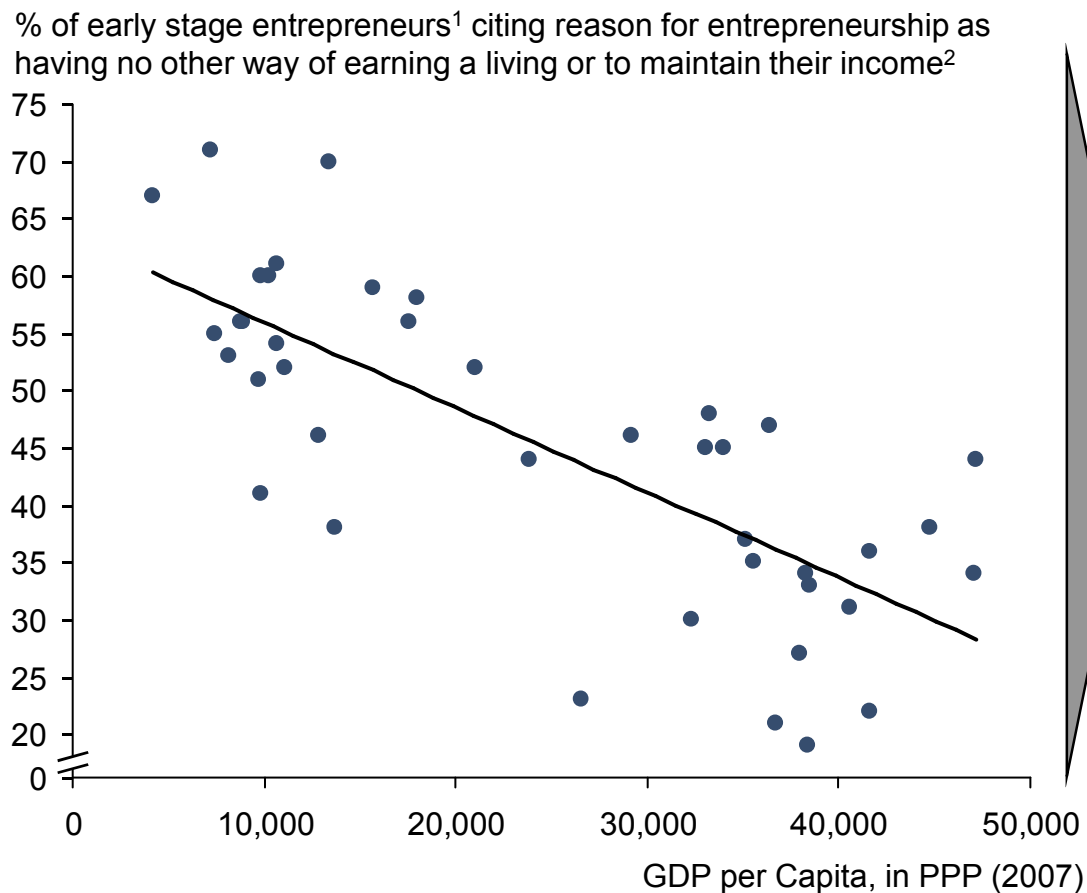
Talent pool constrained by outward migration of trained professionals (“brain drain”)

High prevalence of family-run businesses

- Relatives may be hired without the necessary skills and/or training

Source: Commission on the Private Sector and Development, “Unleashing Entrepreneurship: Making Business Work for the Poor”; Alan J. Patricoff and Julie E. Sunderland, “ Venture Capital for Development”, Shah de Lorenzo, “Entrepreneurial Philanthropy in the Developing World: A New Face for America, a Challenge to Foreign Aid”; GEM 2007 executive report; sector interviews

BACKUP: Because entrepreneurial activity in developing countries is often out of necessity, entrepreneurs are more likely to start businesses without training



When entrepreneurship is based on opportunity, entrepreneurs consider several factors before starting business including

- Quality and quantity of opportunities
- Capabilities including training

However in low income countries, entrepreneurship is more likely to be driven by necessity

- Therefore, entrepreneurs are less likely to evaluate these factors before starting businesses

Without evaluation of capabilities, entrepreneurs are more likely to start businesses without training to build entrepreneurial capabilities

1. Percentage of 18-64 population who are either a nascent entrepreneur (actively involved in setting up a business they will own or co-own; this business has not paid salaries, wages, or any other payments to the owners for more than 3 months) or owner-manager of a new business (owning and managing a running business that has paid salaries, wages, or any other payments to the owners for more than three months, but not more than 42 months) 2. Remaining early stage entrepreneurs are considered opportunity driven and cite reason for entrepreneurship as either to increase their income or to be independent

Source: GEM 2007 Executive Report; IMF

Constraint 3 – Access to finance

Access and cost of finance are significant constraints to small businesses in developing countries

SGBs face a “missing middle” for both debt and equity financing

- Financing often obtained from family and friends and money lenders who can offer relatively low amounts of capital and may charge high interest rates (money lenders)

Smaller enterprises are less likely to use commercial banks for financing

- Interest rates and collateral requirements are high due to small loan size and perception of high risk
- Local commercial banks lack incentives to serve SGBs due to limited competition
- SGBs in developing countries lack government intervention such as SBA loan guarantees in the US

SGBs also face difficulty accessing equity investments from traditional private equity funds

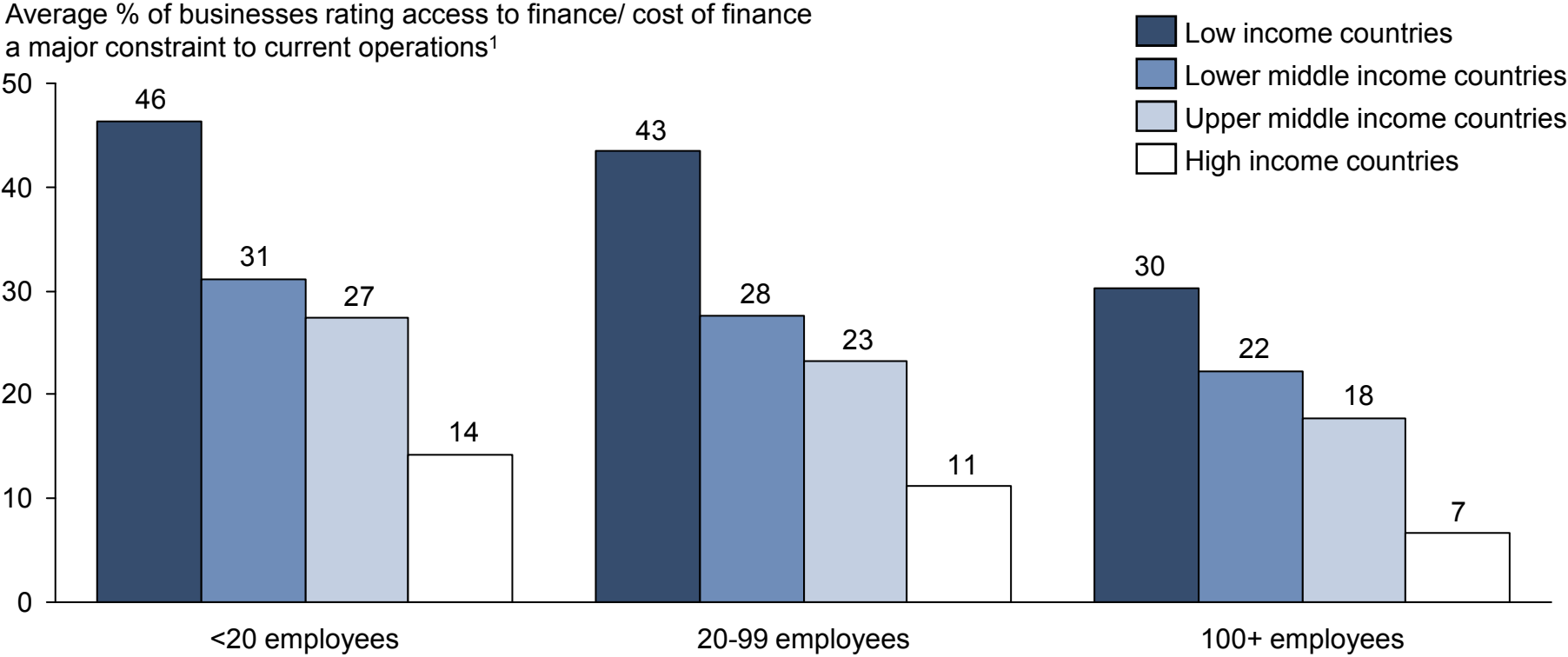
- Due to the economic structure of private equity funds, it is challenging to make investments under \$2M
- In the US, Angel Investors play a key role in filling this gap however these markets are less robust in developing countries

Although microfinance institutions (MFIs) are active in developing countries, most do not serve SGBs

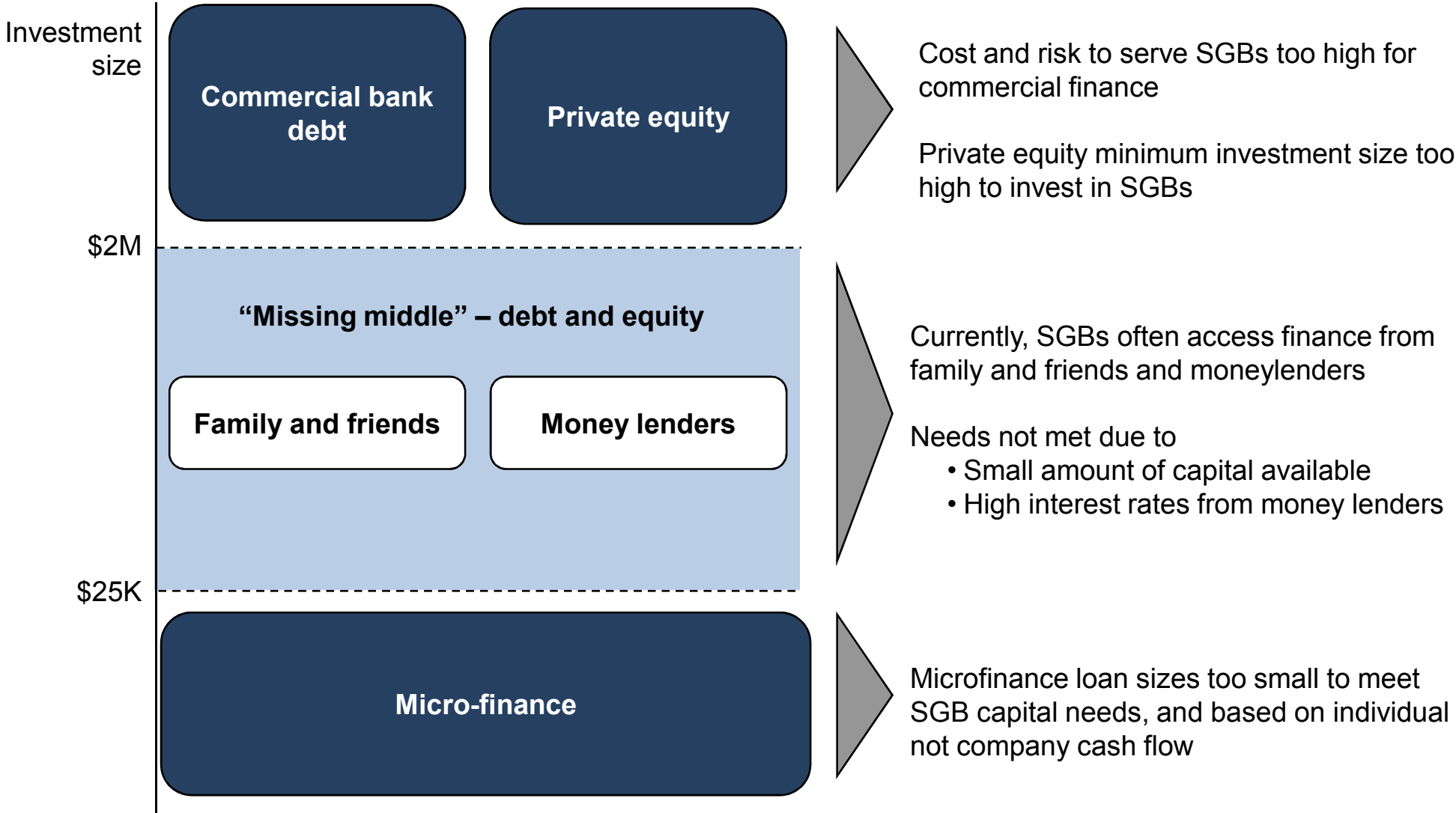
- SGB capital needs are larger than most MFI loans
- Key differences in lending processes decrease MFIs’ ability to lend to SGBs

SGB capital providers must develop innovative products and models to overcome these challenges

Access and cost of finance are significant constraints to small businesses in developing countries



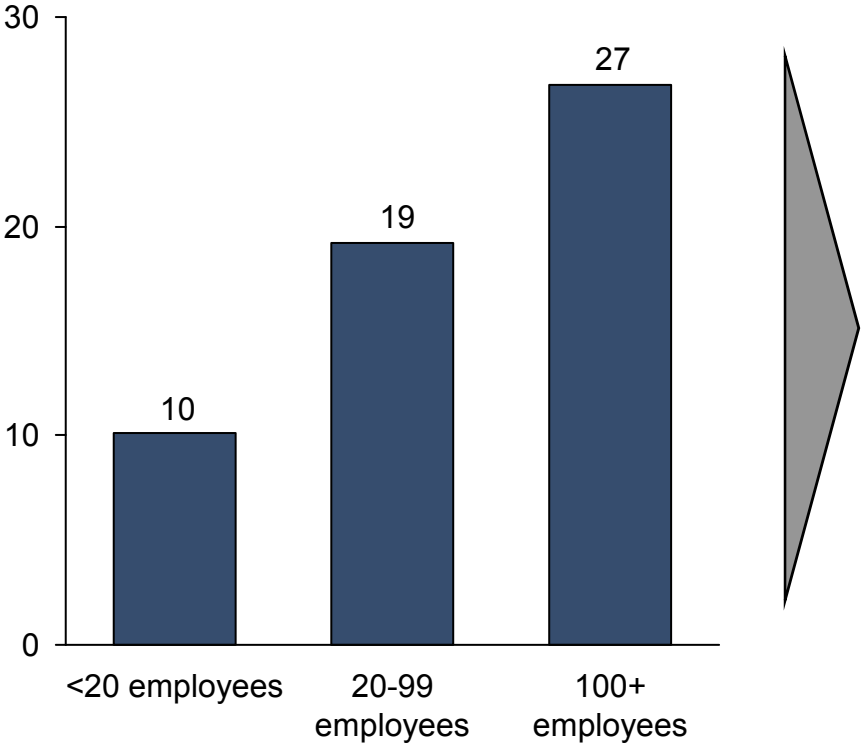
SGBs face a “missing middle” for both debt and equity financing



Source: CFED Desktop Study: SMEs and Poverty Reduction; Thorsten Beck, Ash Demircug-Kunt and Vojislav Maksimovic, “Financing Patterns Around the World: Are Small Firms Different?”; Thorsten Beck and Asli Demircug-Kunt, “Small and Medium Size Enterprises: Access to Finance as a Growth Constraint”

Smaller enterprises less likely to access commercial debt due to high interest rates, collateral requirements and lack of bank innovation

Percentage of firms using banks to finance purchases of fixed assets (%)¹



Low and lower-middle income countries only

Commercial debt-related challenges for SGBs

High interest rates and collateral requirements

- High transaction costs for banks to make and service small loans
- Bank perceive SGBs as more risky
 - Lack of credit information
 - Lack of financial records and/or business plans

Lack of understanding between banks and SGBs

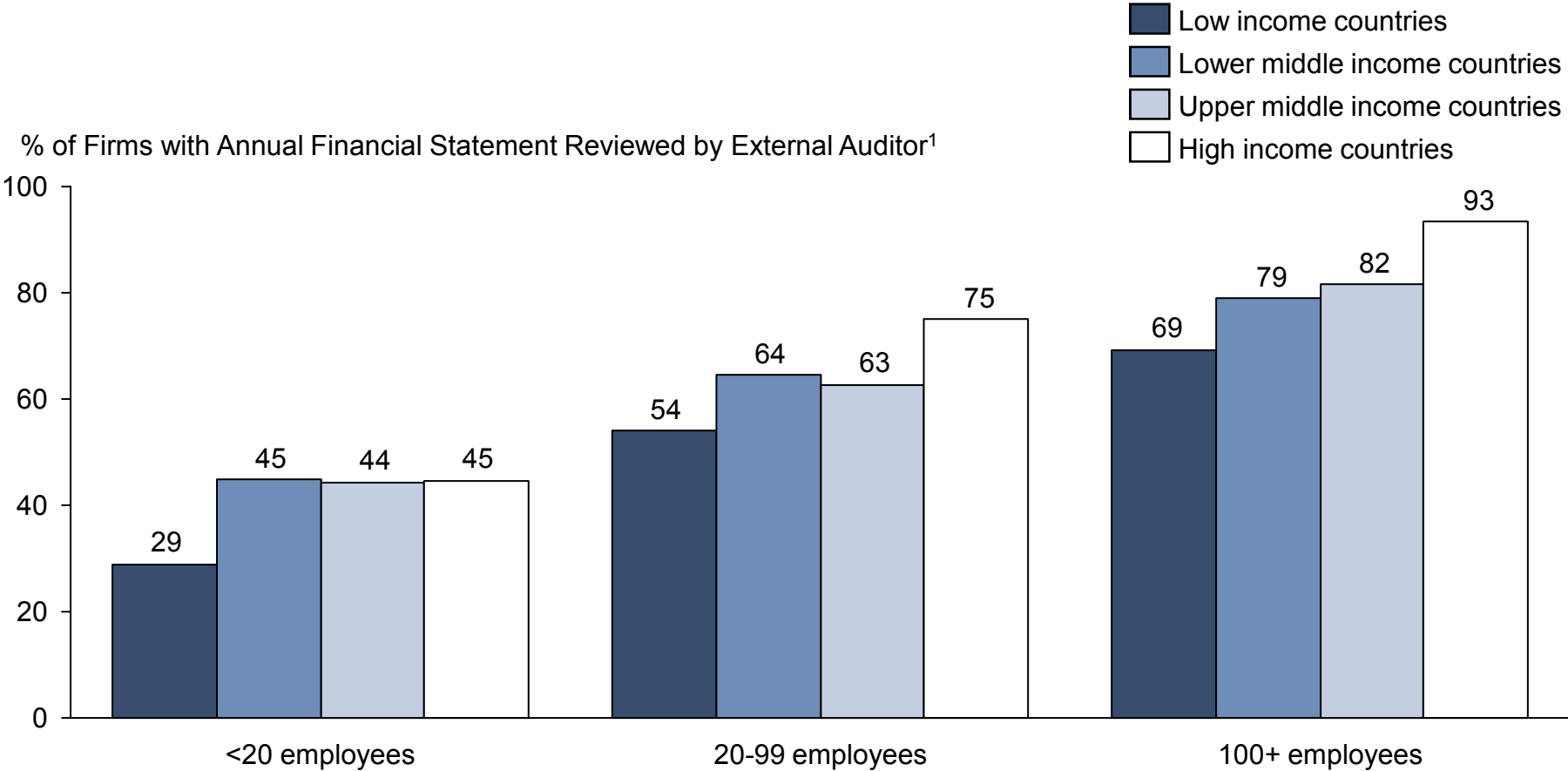
- Bank staff lack training or experience with SGBs
- Small businesses perceive local bank procedures as inconsistent or unclear

Lack of competition among local banks

- Limits incentives to innovate to serve SGBs

1. Countries weighed equally to calculate overall average for income group
 Source: World Bank Enterprise Surveys; World Bank List of Economies; CFED Desktop Study: SMEs and Poverty Reduction; Glenn Yago, Daniela Roveda, Jonathan M. White, "Transatlantic Innovations in Affordable Capital for Small and Medium Sized Enterprises"; Dalberg analysis

BACKUP: Lack of audited financial records contributes to banks' perception of high risk when lending to SGBs



BACKUP: Interest rates and collateral requirements for SGB loans are high across most countries – actual terms vary by country/ region

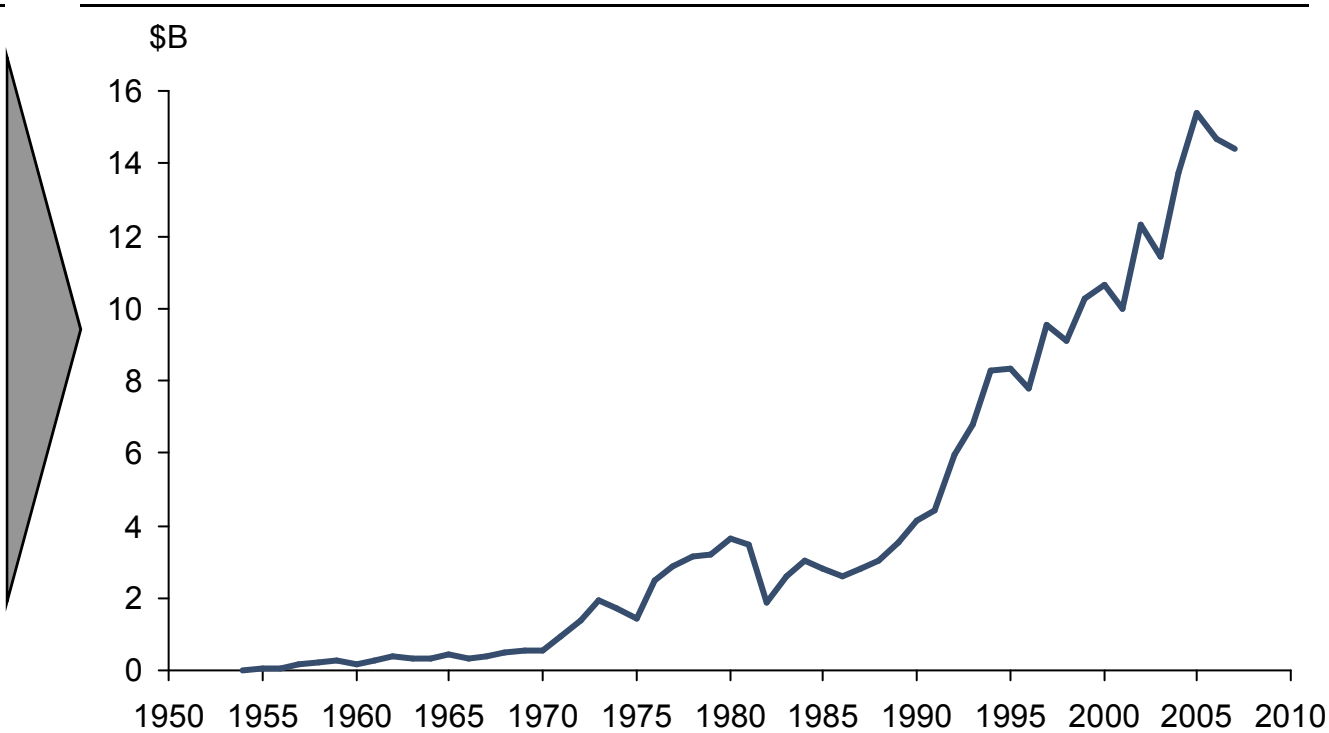
| | <u>Interest rates</u> | <u>Collateral requirements</u> |
|--------------------|---|--------------------------------|
| El Salvador | USD: 9-16% | 1-2 times loan value |
| East Africa | Real: 5-15% (Local currency: 13-24%) | 1-1.5 times loan value |
| Ghana | Real: 10%+ (Local currency: 20%+) | High (actual not available) |

In the US, the Small Business Administration (SBA) offers loan guarantee programs to encourage small businesses lending – similar government subsidies often do not exist in developing countries

7(a) Loan Guaranty is most frequently used type of SBA loan

- Primary business loan program to help small businesses that may not be eligible for loans through normal lending channels
- Can be used for most general business purposes
- Delivered through commercial lending institutions
 - Portion of the loan guaranteed by SBA

Volume of loans backed by 7(a) Guaranty



SGBs often unable to secure equity from traditional private equity funds –profitable investments under \$2M difficult due to economics of funds

Costs

Compared to larger deals, costs on per deal basis are comparable – and sometimes higher – for investments under \$2M

- Small investments require significant staff time for deal sourcing, due diligence and portfolio management
 - Investees are less transparent – e.g., often lack audited financial statements
 - Frequently require pre-investment capacity building services
 - May require closer monitoring and management post-investment
- Some costs are relatively fixed regardless of deal size – e.g., legal, travel, auditing



Revenue and returns

Management fee generally lower for funds that make small investments

- Funds that make small investments are typically smaller in size
- Management fee based on fund size (~2-3% of funds under management)

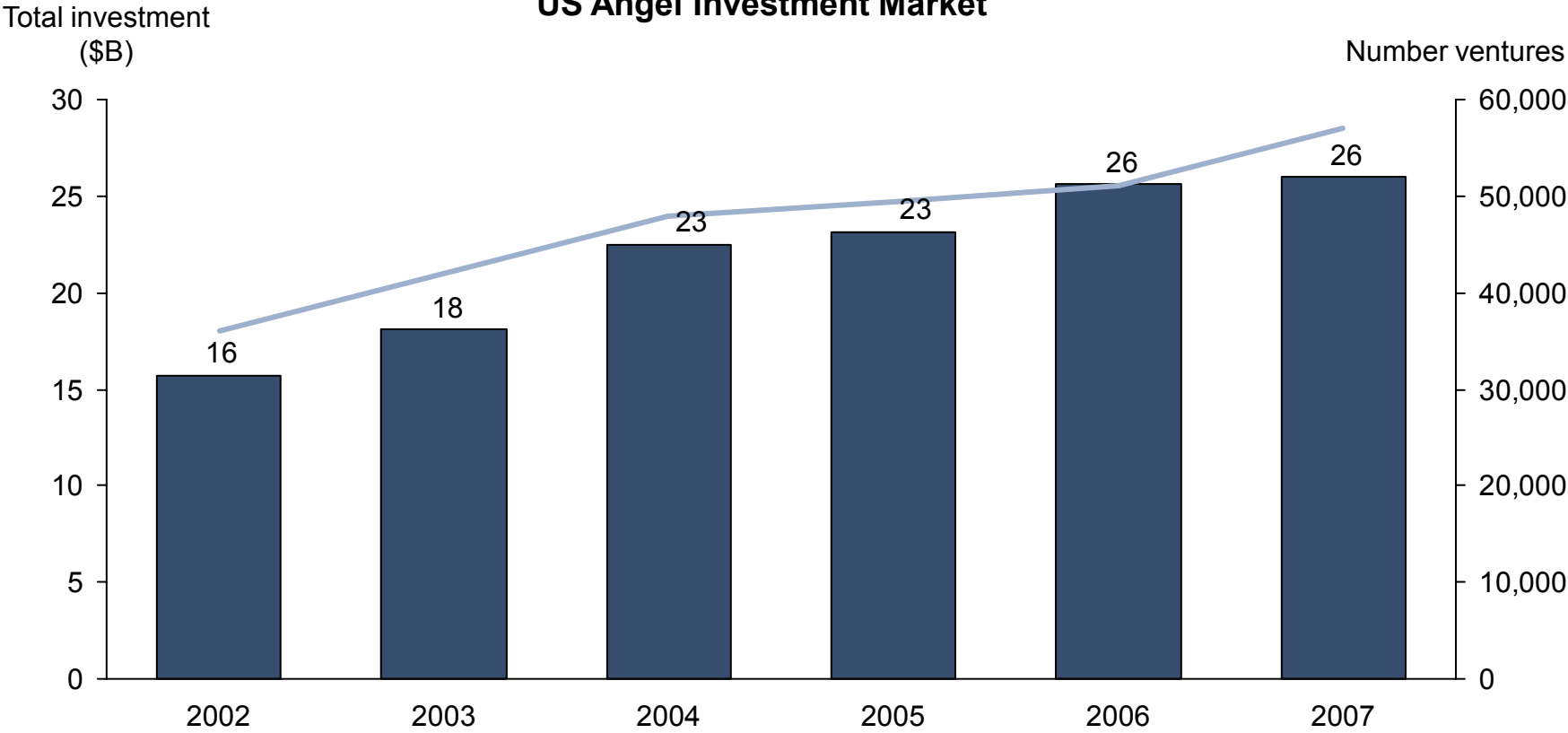
Revenue from carry also likely lower due to

- Smaller investment base size
- Lower return due to high costs

Venture capital funds frequently invest under \$2M due to their different portfolio risk/return model and focus on idea stage, rather than seed to expansion

In the US, PE funds also infrequently invest under \$2M and angel investors help fill this gap – this market is less robust in developing countries

US Angel Investment Market

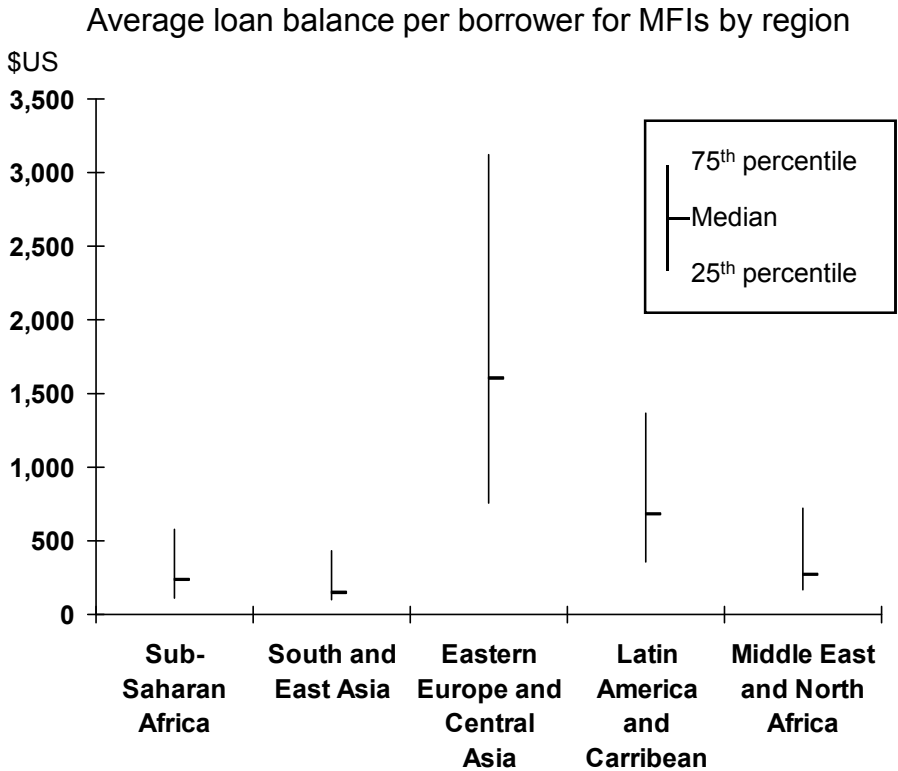


Average investment per venture: 2002 \$436,000, 2003 \$431,000, 2004 \$469,000, 2005 \$467,000, 2006 \$502,000, 2007 \$455,000

— Number of ventures receiving angel funding (000s)
 ■ Total angel investments (\$B)

MFIs are not meeting SGB financing needs due to smaller loan sizes and differences in lending processes

Average microfinance loan sizes significantly below SGB capital needs



Many MFIs are not serving SGBs due to differences in lending processes

SGB loans are longer term

- Risk increased with longer timeframe

Small business risk profiles are more complicated

- Risk analysis extends beyond personal relationships – e.g., includes analysis of project economics, business environment and other factors

SGBs typically require monitoring and management advice

Source: CFED Desktop Study: SMEs and Poverty Reduction; Glenn Yago, Daniela Roveda, Jonathan M. White, “Transatlantic Innovations in Affordable Capital for Small and Medium Sized Enterprises: Prospects for Market-Based Development Finance”; World Bank; TheMix.Org

Constraint 4 – Enabling environment

It is more difficult to do business in low income countries

- Low income countries have lowest average 'ease of doing business' ranking

Doing business is more difficult in emerging markets as key components of the business enabling environment are often not in place

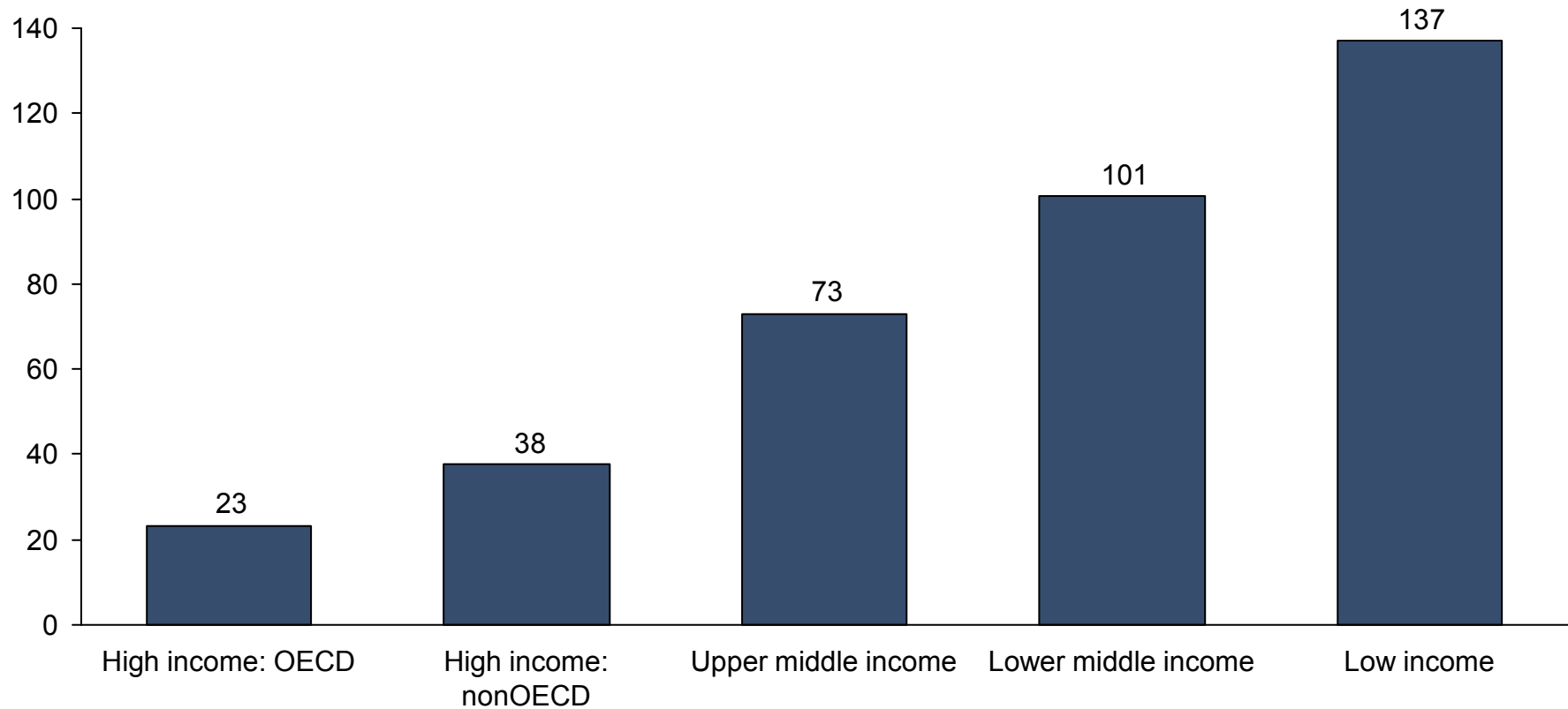
- Well governed markets
- Physical and social infrastructure
- Effective legal system
- Rules that are fair, clearly understood and effectively enforced across all businesses

Lack of a business enabling environment detracts some SGBs from formalizing and negatively impact SGBs' ability to grow

Building successful SGBs in developing countries requires risk management and collaboration with policy makers and other stakeholders to improve enabling environment

It is more difficult to do business in low income countries

Average ease of doing business ranking¹



Doing business is more difficult in emerging markets as key components of the business enabling environment are often not in place

Well-governed markets

- Open markets and high-quality foreign investment
- Predictable and transparent governance and lack of internal/external conflict
- Strong macro-economic policies

Infrastructure

- Physical infrastructure including roads, power ports, water and telecommunication
- Social infrastructure such as basic education and health

Effective legal system

- Written laws that support private sector activities (e.g., commercial laws, contract laws and property rights protection)
- Formal legal systems
- Fair and consistent enforcement of laws

'Level playing field' for all businesses

- Entry, operating and exit rules such as labor laws and bankruptcy procedures
- Credit and tax rules which include credit sharing laws and tax rates and administration

Lack of a business enabling environment negatively effects SGB formalization and growth

Lack of some enabling environment components can detract SGBs from formalizing

Number and complexity of procedures for registering a business can increase time required to start a formal business

- 54 days in low income countries versus 21 days in high income countries

Several factors can incentivize SGBs to remain informal

- High tax rates and/or difficult tax administration procedures
- High cost to comply with formal laws and regulation

Lack of other components can prevent growth of SGBs

A weak enabling environment can limit SGBs' access to critical growth inputs for example

- People – weak educational and/or health systems limit availability of educated and/or healthy workforce
- Market access – unreliable physical infrastructure prevents information transfer and ability to transport goods and materials
- Finance - lack of formal land acquisition laws and/or property rights protection limit SGBs' ability to use land and/or other property as collateral

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 - Intermediary detail and sizing
 - Detailed landscape of intermediaries attending ANDE conference
 - Sector's role in helping SGBs overcome challenges
 - Challenges faced by the SGB sector to achieve scale
- ANDE's vision and role

Executive summary (I)

- The SGB sector is defined as organizations and individuals that support the growth of SGBs through investment of capital and provision of capacity building services
- Due to their need for capacity building, SGBs generate below market returns on total investments in their business – these below market aggregate returns flow back to intermediaries and funders
 - **Businesses:** SGBs are defined as enterprises that meet the following qualitative defining criteria: (i) small businesses with growth potential; (ii) have potential to generate positive social or economic impact; and, (iii) are constrained due to market failures and inefficiencies. While not exclusively, these entrepreneurs are likely to have between 5 and 250 employees
 - **Intermediaries:** The Intermediaries can first be segmented by whether they provide capital or capacity building services only. The intermediaries that provide capital can be further segmented by target investment size, and the SGB sector is defined between \$25,000 and \$2 million in investment size
 - **Funders:** The Funders can be segmented by their target internal rate of return (IRR), which serves as a proxy for their intended financial return and social impact
- Up to \$3.7B identified in SGB funds with minimum investment size below \$2M – additional \$2.5B identified in funds with minimum investment size below \$5M

Executive summary (II)

- **SGB intermediaries have a wide range of organizational focus and goals – differences include**
 - Stage of company supported
 - Primary intended social impact
 - Average investment size
 - Target financial returns (IRR)
- **SGB intermediaries and funders play a key role in helping SGBs overcome challenges**
 - Intermediaries and funders develop a strong set of businesses that will generate demand for local finance and service providers, serve as angel investors and create the constituency to demand an improved business enabling environment
 - When possible, the SGB sector will also support complementary efforts focused on building the local SGB markets
- **The SGB sector is not capital or deal flow constrained however faces challenges to increasing efficiency and scale of intermediation**
 - **Capital:** approximately \$4B in capital attracted from funders to date and there is considerable interest from new and current funders to deploy more
 - **Deal flow:** ANDE conference attendees, which make up a small subset of total identified SGB intermediaries, confirm that a pipeline of deals exist
 - **Intermediation:** four key challenges currently prevent intermediaries from achieving scale
 1. Lack of awareness and support among funders
 2. Increasing the efficiency of capital flow from funders to intermediaries
 3. High transaction costs for intermediaries investing in SGBs
 4. Need for more talent at all levels

The SGB sector is defined as organizations and individuals that support the growth of small and growing businesses through investment of capital and provision of capacity building services

Businesses

SGBs have high potential for growth and impact but are constrained by market failures and inefficiencies

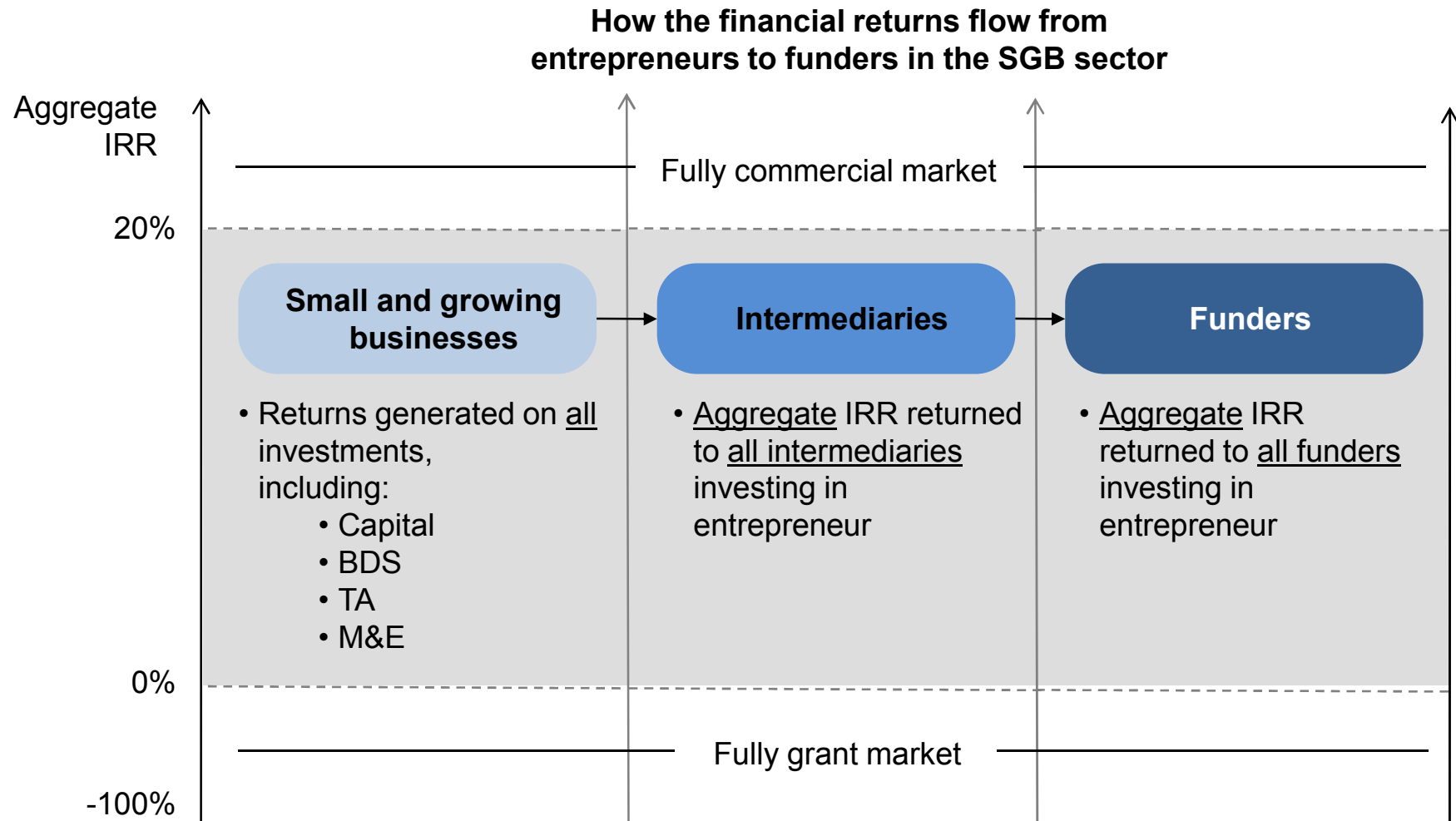
Intermediaries

Intermediaries deploy 'growth capital' and / or capacity building services to SGBs

Funders

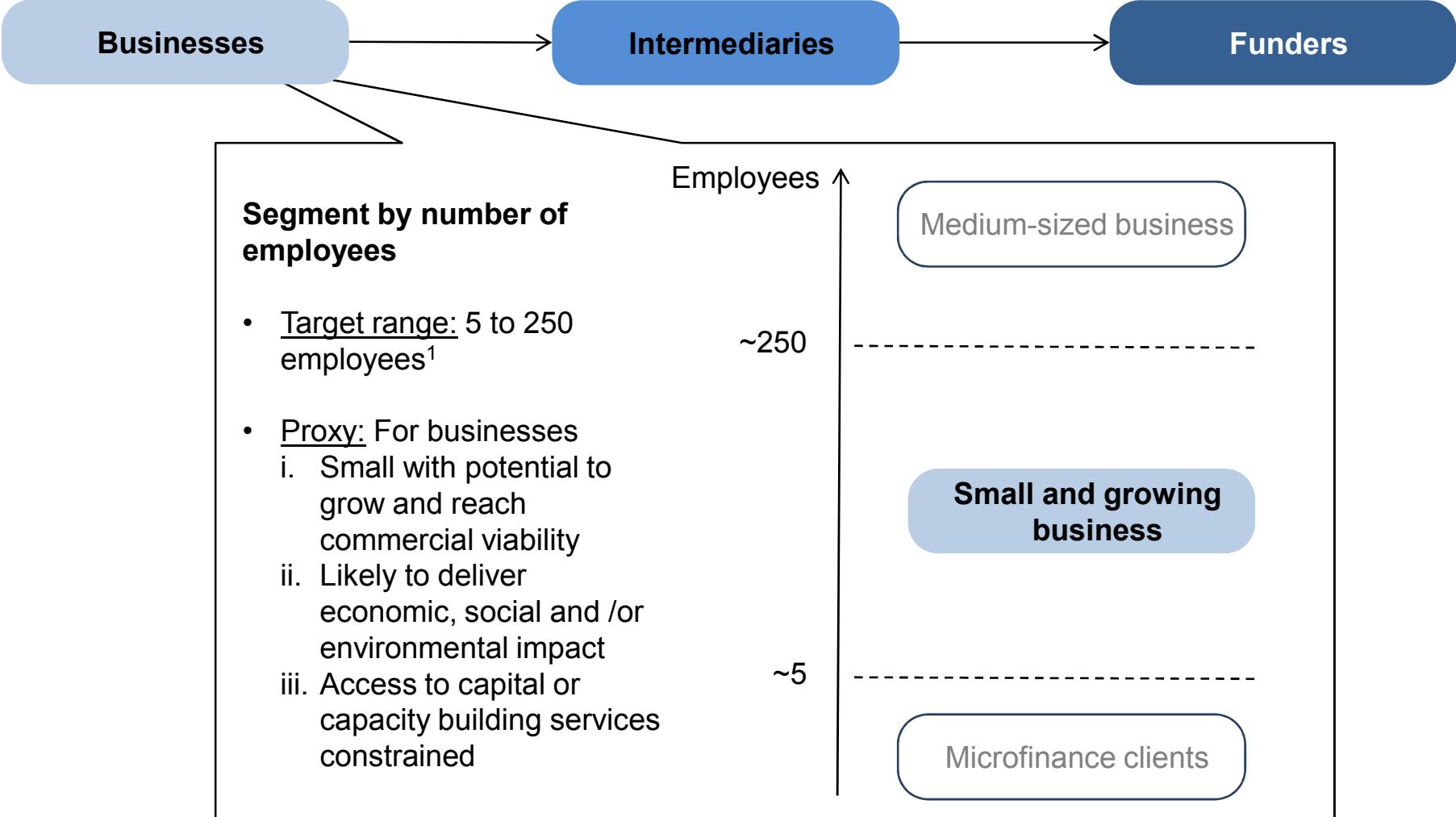
Funders make capital available to SGB intermediaries and may also make some direct investments in SGBs

As a result of the market failures and inefficiencies SGBs generate aggregate returns to intermediaries and funders at below market levels



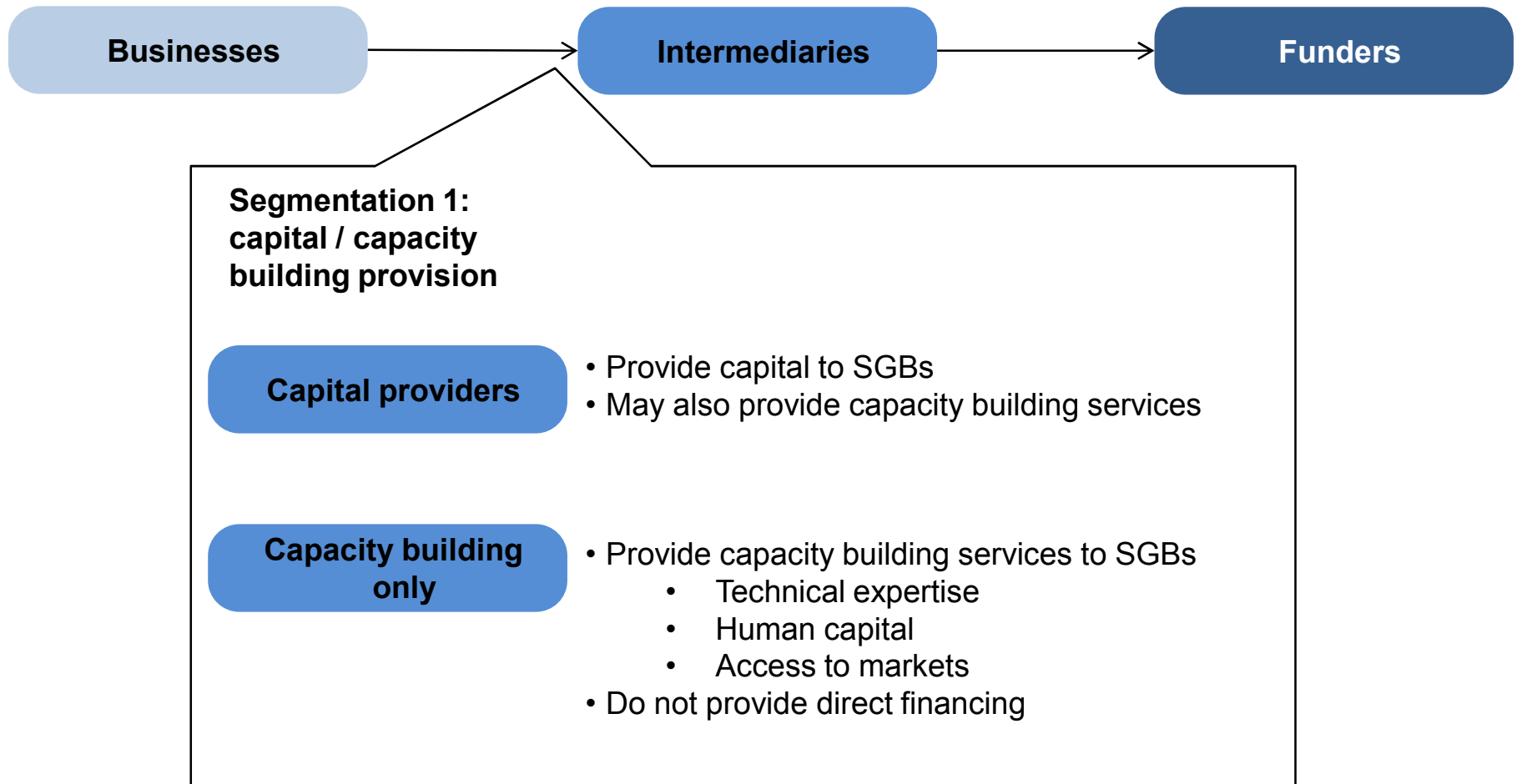
However, the potential for economic, social and environmental returns (i.e., spill over effects) that is not counted in IRR justifies the investment in these entrepreneurs

RECALL: as a ‘small and growing business’, the investees are likely to have 5 to 250 employees, depending on their geography, sector and stage of growth

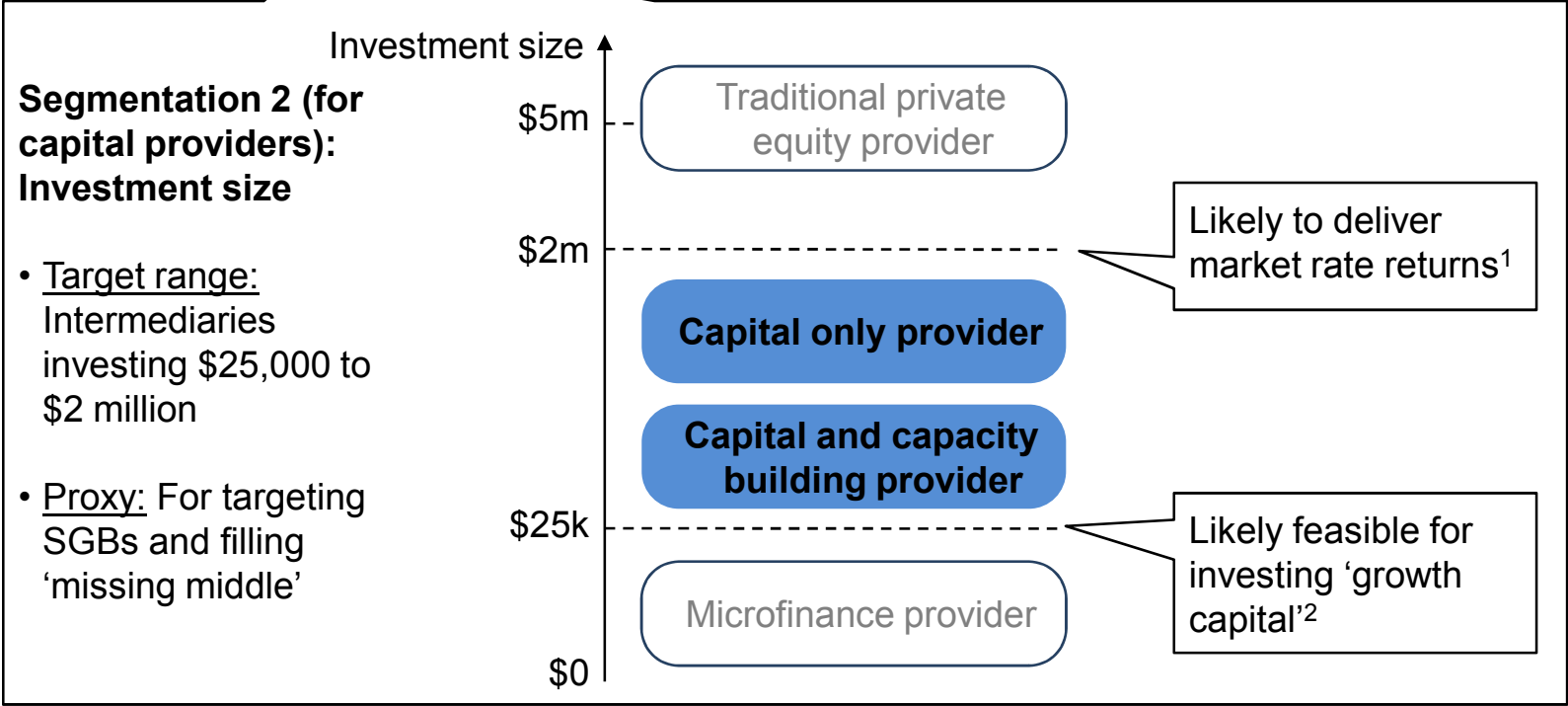
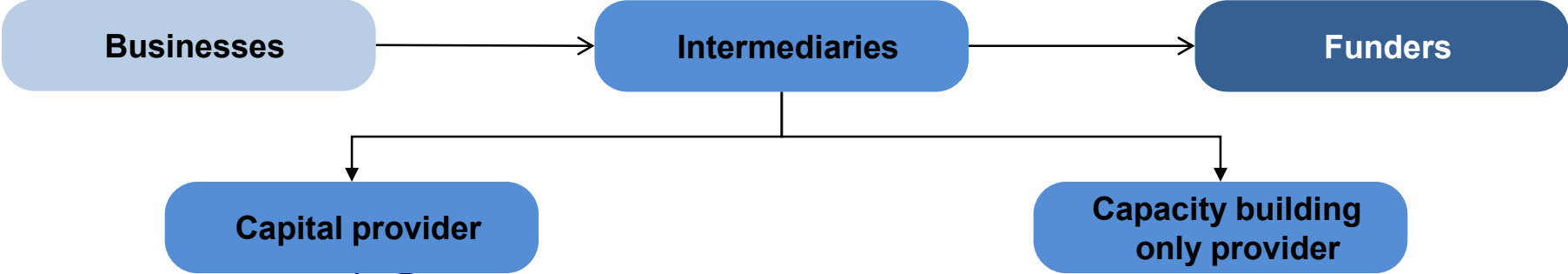


1. Consensus definition across International Financial Institutions but may vary by country; range could also be defined by revenue
 Source: sector interviews; IFC

The Intermediaries can first be segmented by whether they provide capital or capacity building services only

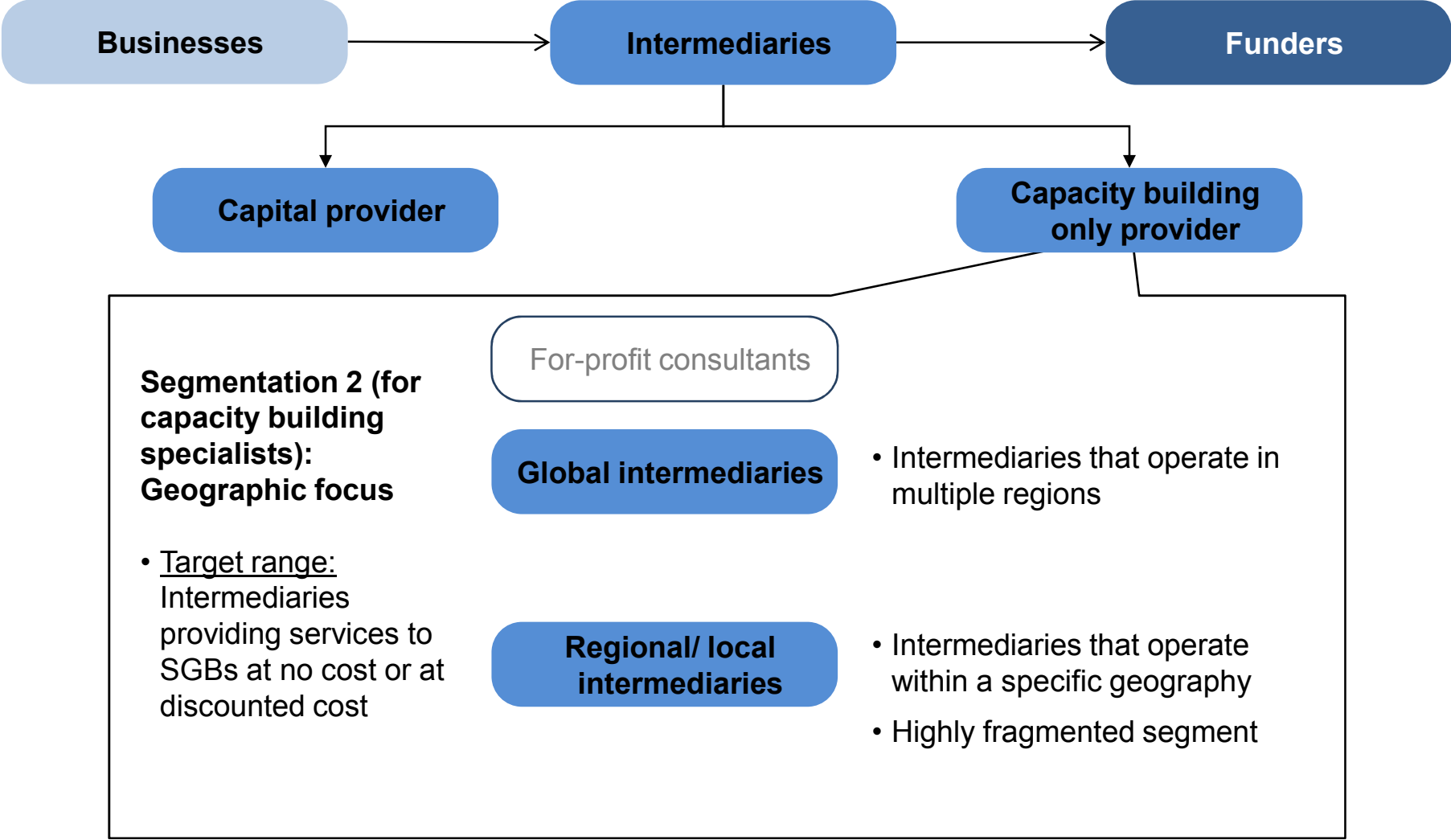


Intermediaries that provide capital can be further segmented by target investment size – SGB sector is defined between \$25,000 and \$2 million

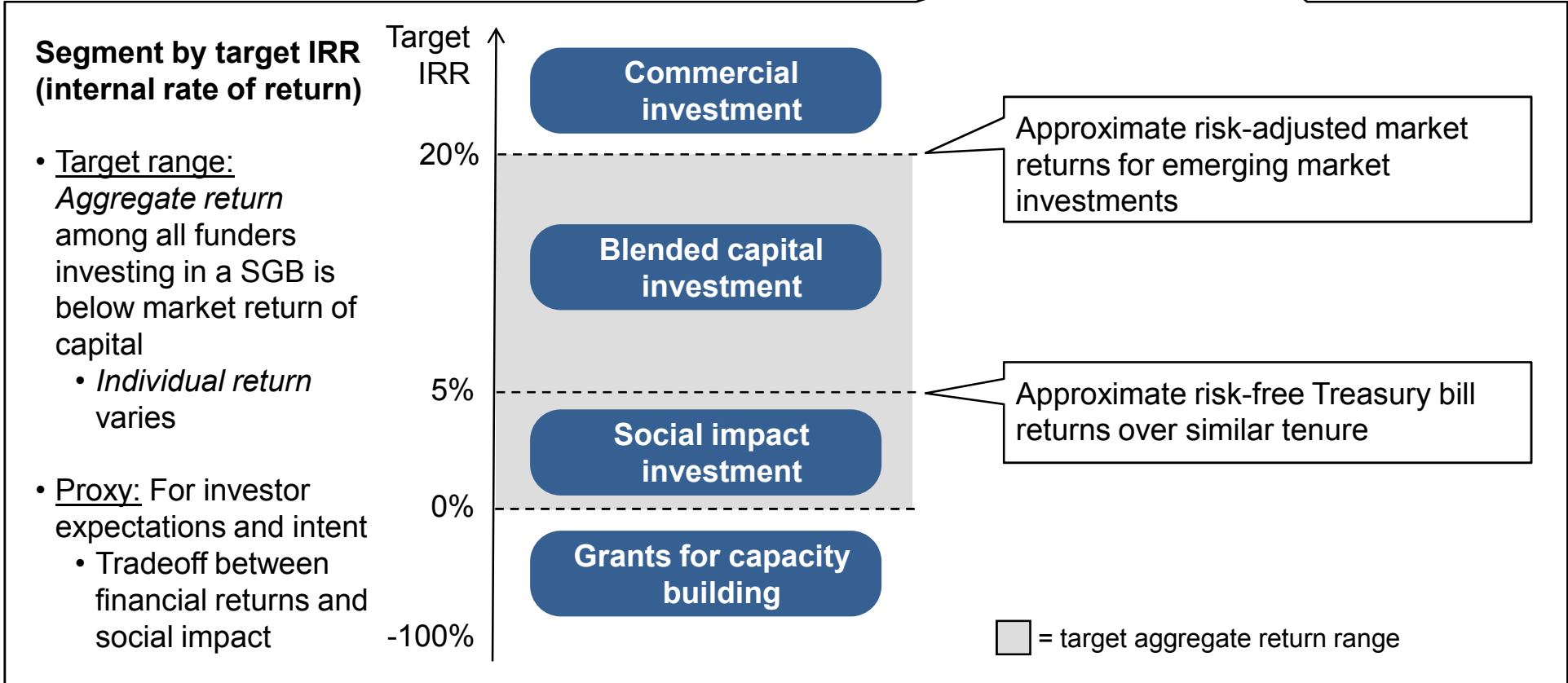


1. Based on economic structure of traditional private equity funds 2. Based on fixed transaction costs for investments
Source: sector interviews

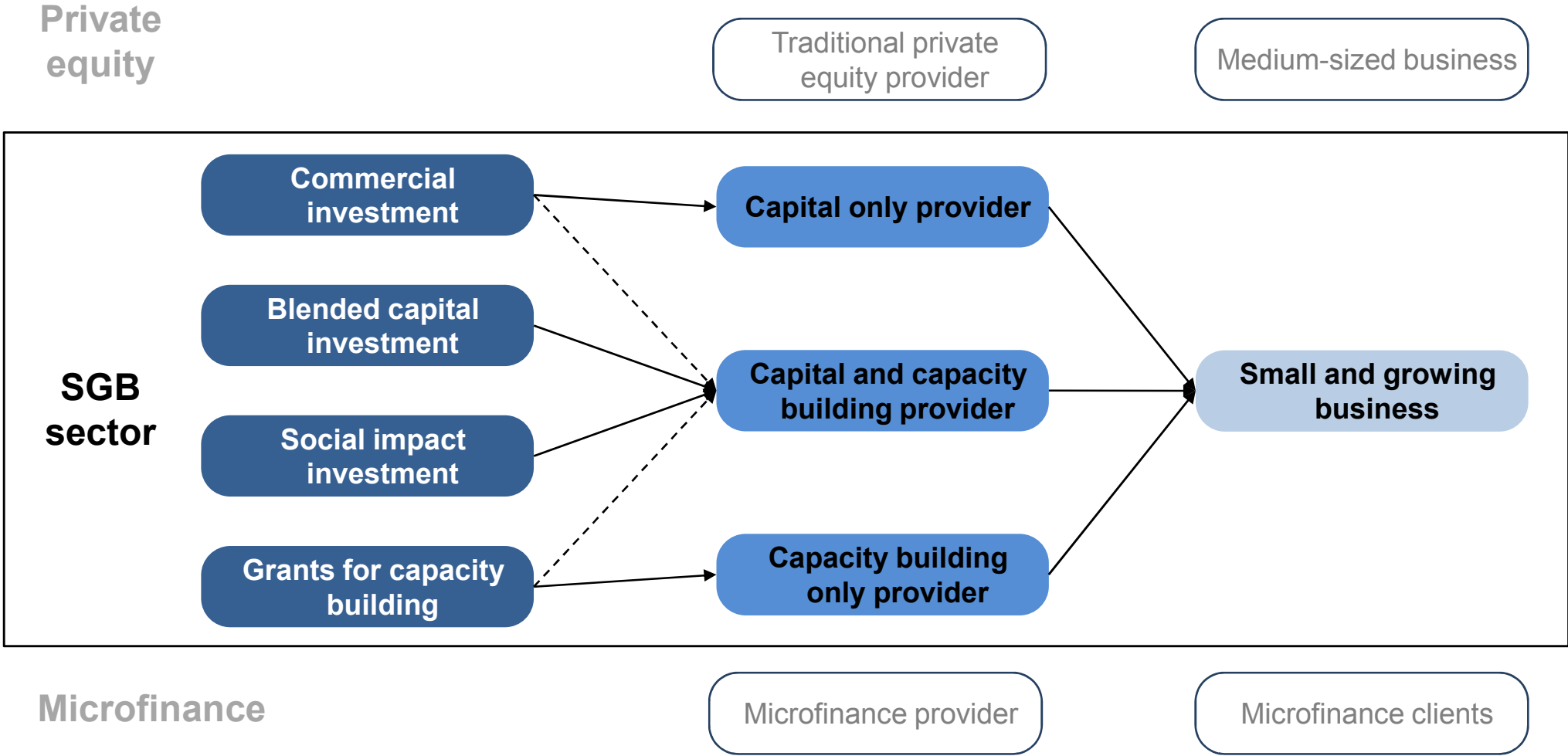
Intermediaries that specialize in capacity building can be segmented by geographic focus



The Funders can be segmented by their target internal rate of return (IRR), as a proxy for their intended financial return and social impact



From a capital flow perspective, funders provide capital to intermediaries that deploy capital or capacity building services to SGBs



Nonetheless, there is a significant role for traditional private equity providers to finance SGBs that have grown or to serve as exit opportunities for SGB intermediaries

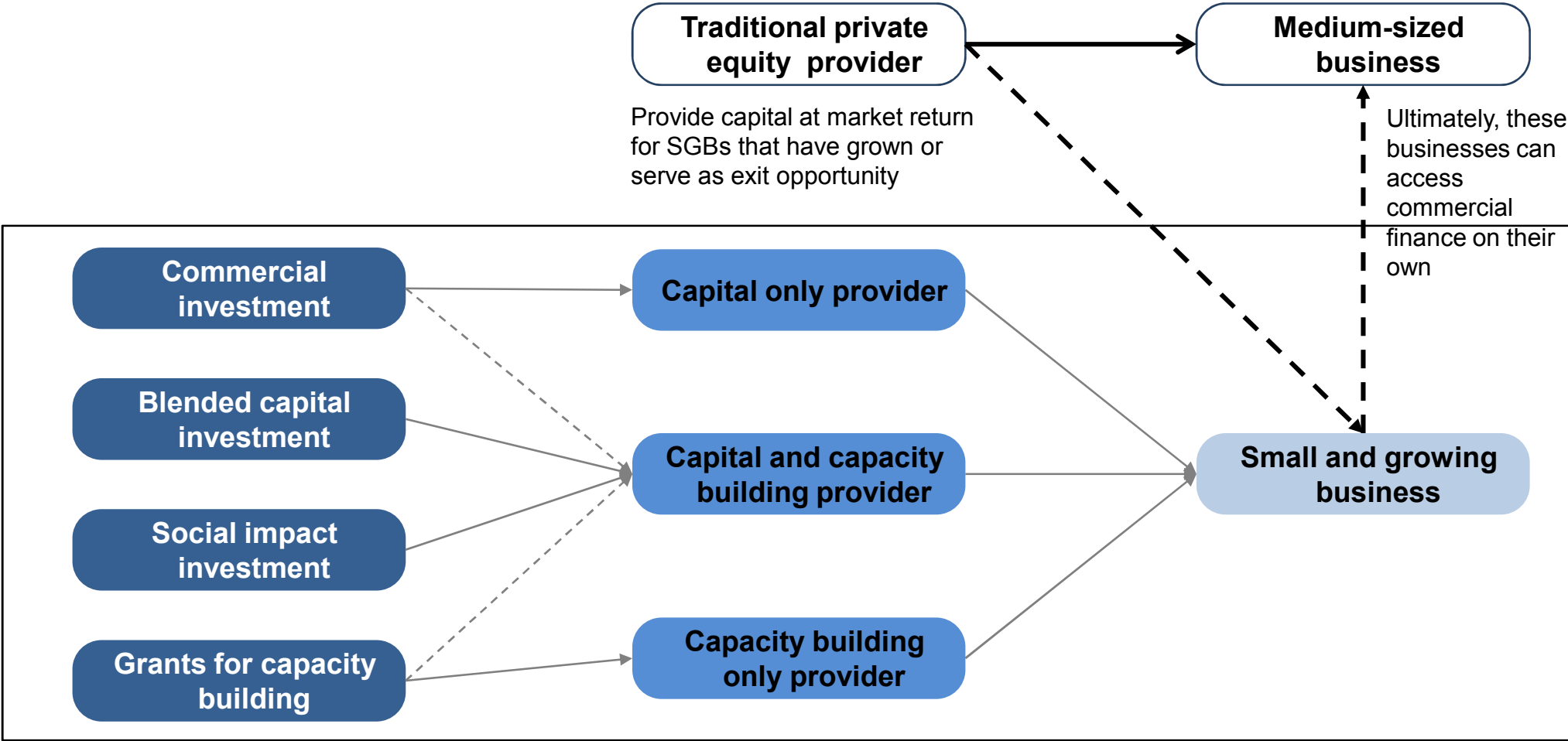


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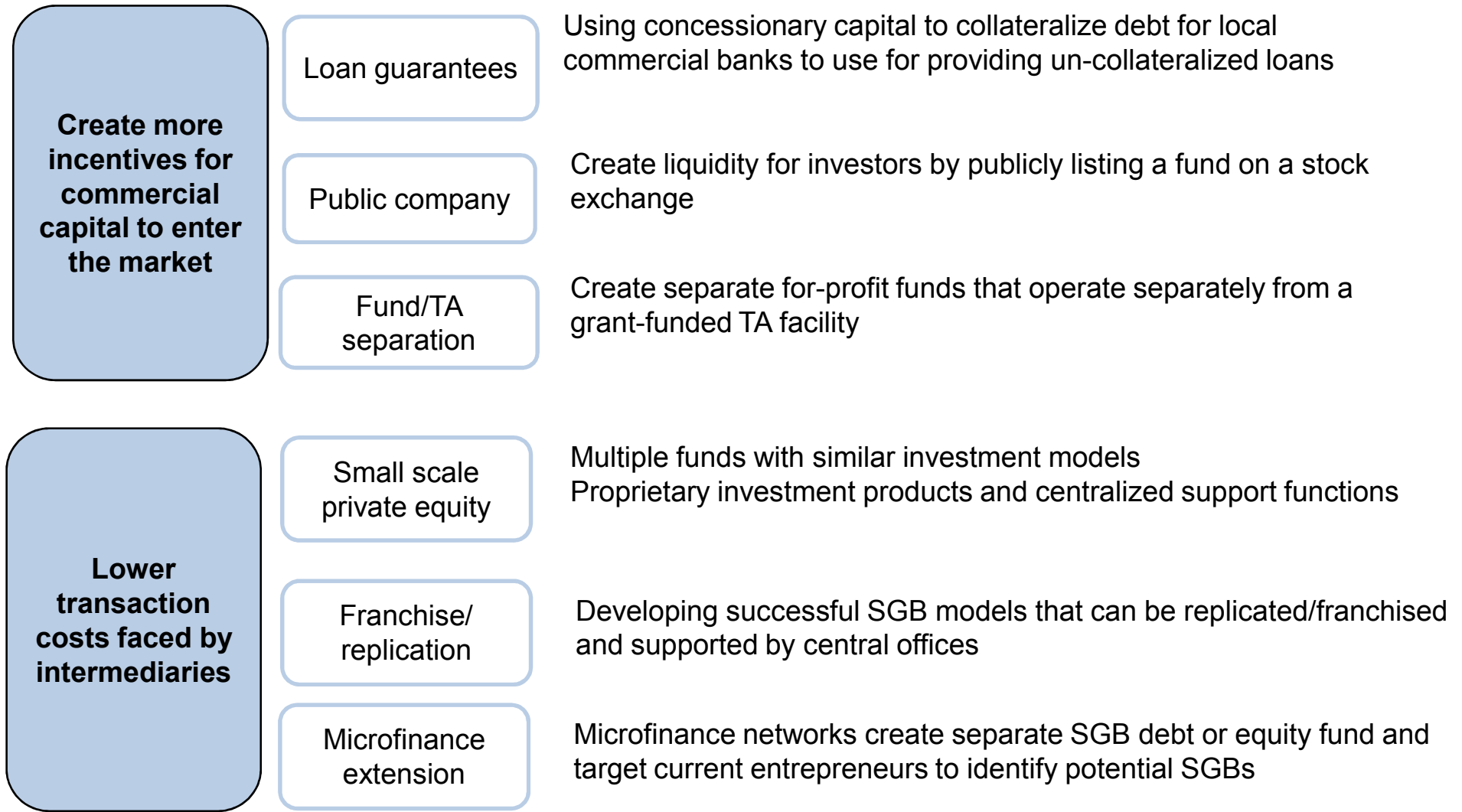
- **'Small and growing business' sector definition, role and challenges**
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 - Challenges faced by the SGB sector to achieve scale

- ANDE's vision and role

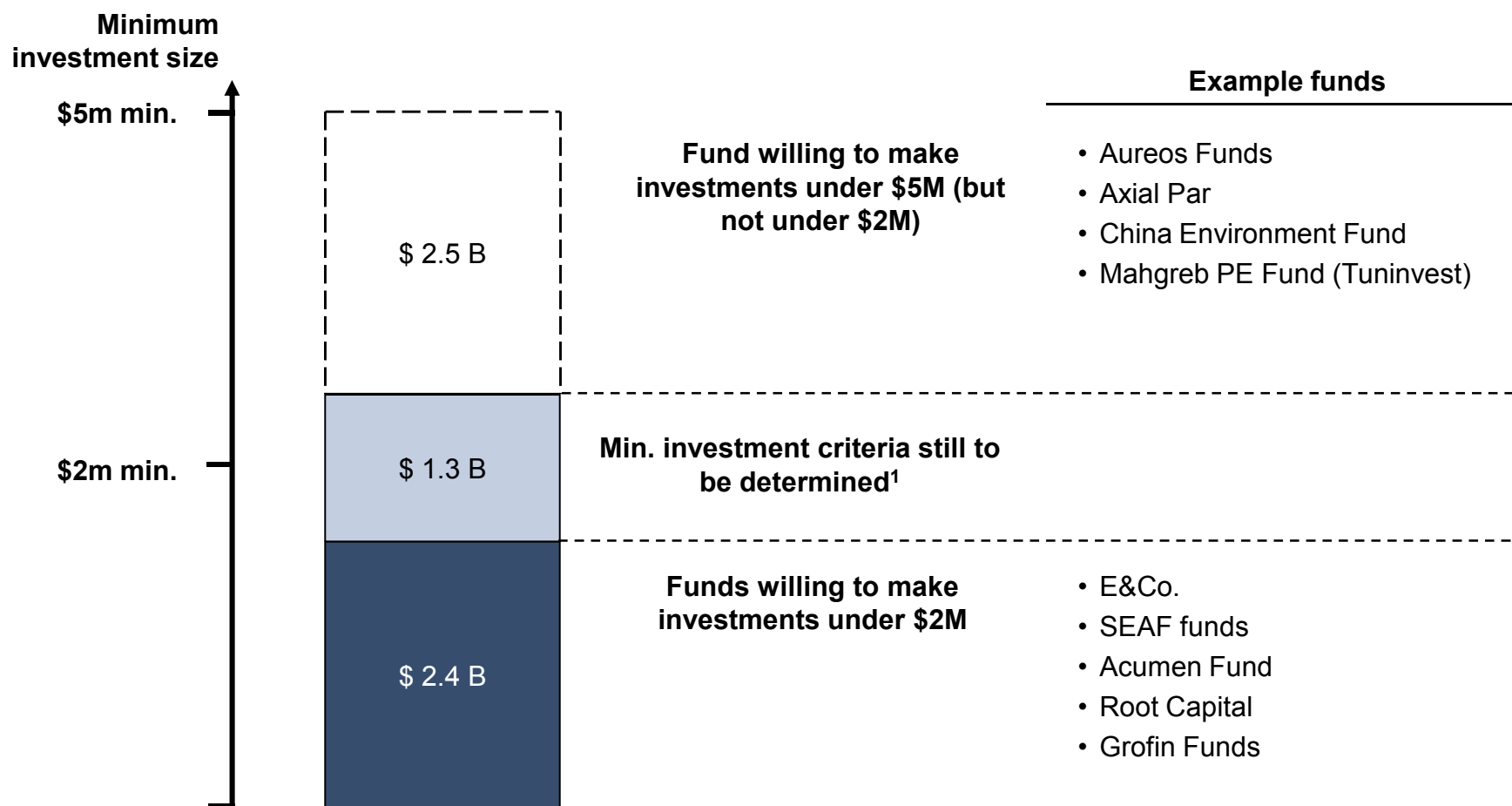
Executive summary

- **Intermediaries have innovated models that address some of the key challenges involved in investing in SGBs and that may be highly scalable**
 - **Models that create more incentives for commercial capital to enter the market**
 - **Loan guarantees**
 - **Public company**
 - **Fund/TA separation**
 - **Models that lower intermediary transaction costs**
 - **Small scale private equity**
 - **Franchise/replication**
 - **Microfinance extension**
- **Up to \$3.7B identified in SGB funds with minimum investment size below \$2M – additional \$2.5B identified in funds with minimum investment size below \$5M**
 - **SGB sector is significantly smaller than the microfinance sector (~\$25B loan volume) and small-scale emerging markets private equity sector (~\$27B in funds making investments under \$15M)**
 - **Sector comprised of smaller funds, with ~55% of identified funds between \$5M and \$50M**
 - **~35% of identified funds are less than 3 years old, contributing to lack of sector track record**
- **There are gaps in the SGB services provided by local commercial service providers and technical assistance providers**
 - **Global capacity building intermediaries provide services to SGBs to fill these gaps in local services**

Intermediaries have innovated models that address some of the key challenges involved in investing in SGBs and that may be highly scalable



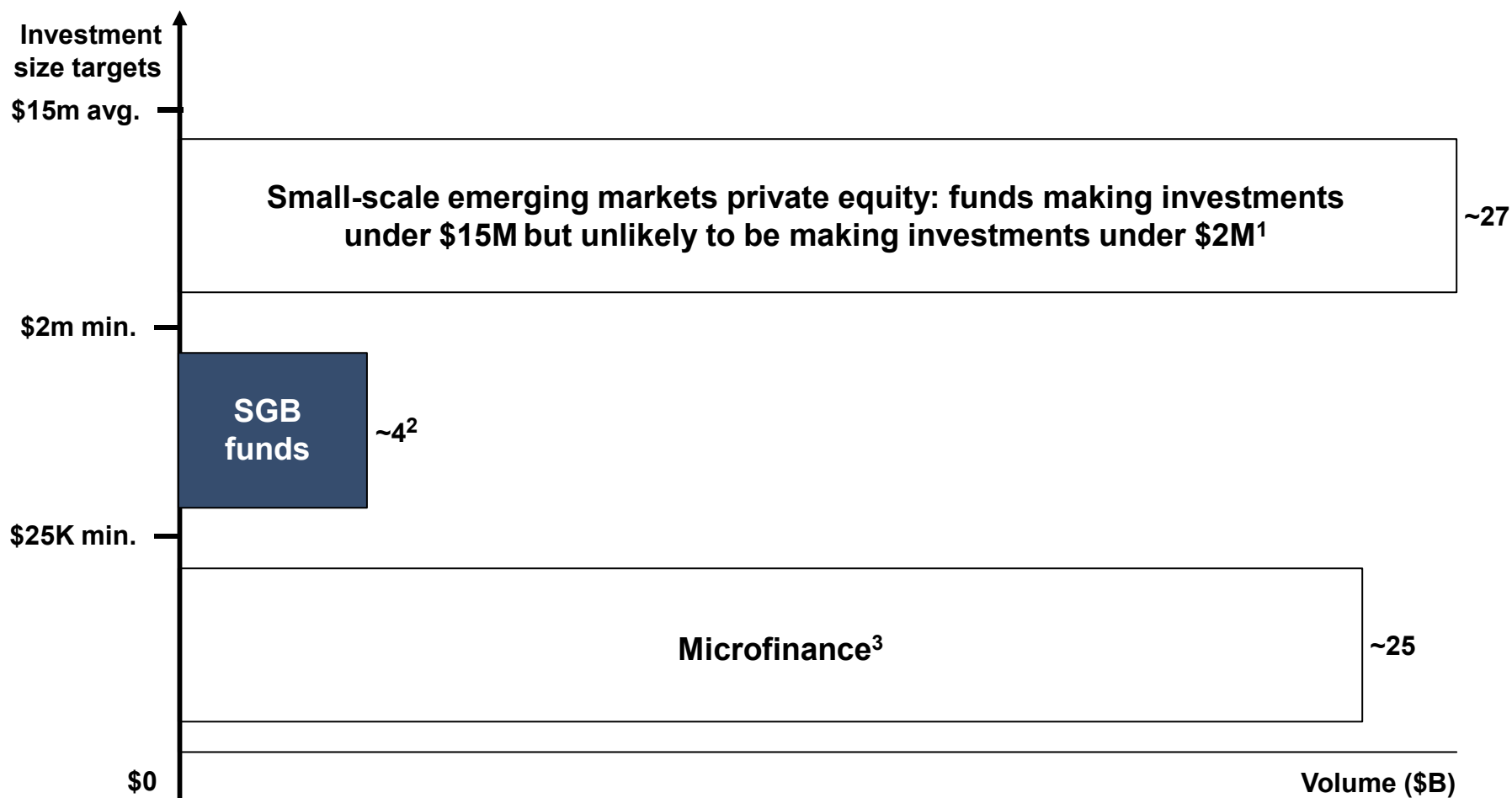
Up to \$3.7B identified in SGB funds with minimum investment size below \$2M – additional \$2.5B identified in funds with minimum investment size below \$5M



1. Minimum investment size criteria currently unknown - \$3.7B estimate may be smaller if these funds do not make investments under \$2M
 Note: \$6B estimate does not include 40 funds for which fund size is unknown; fund size and investment criteria based on publicly available data and may be inaccurate or outdated

Source: Fund websites and publications, “On the Frontiers of Finance: Investing in Sustainable SGBs in Emerging Markets”, “Transatlantic Innovations in Affordable Capital for Small and Medium Sized Enterprises”, DFI websites, Technoserve “Final Report on the Development of an East Africa Agribusiness Financing Facility”; EMPEA; Deutsche Bank Research

The SGB sector is significantly smaller than the microfinance and small-scale emerging markets private equity markets

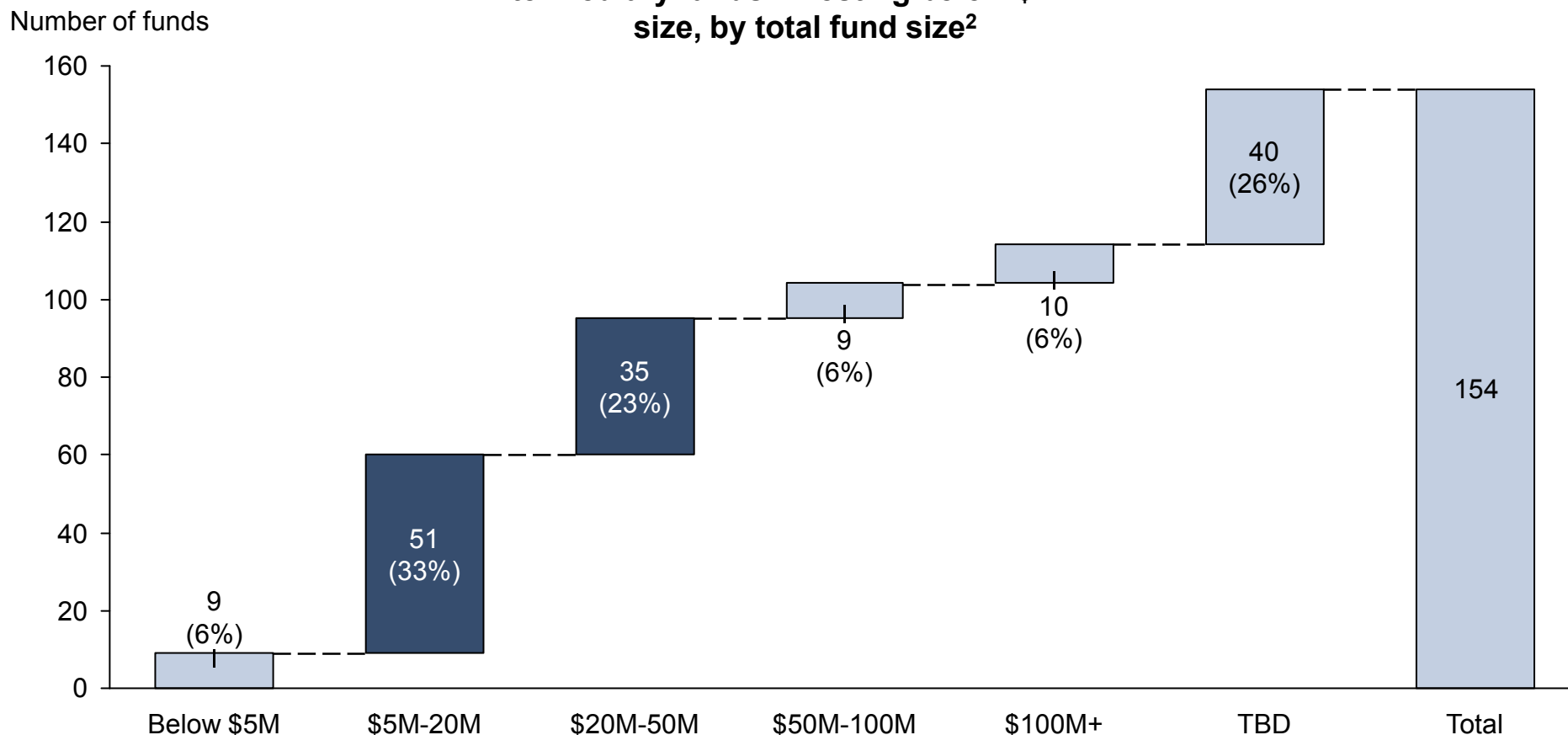


1. Calculated based on fund size goal for EMPEA member funds with fund size greater than \$50M and less than or equal to \$150M, assume 10 deals per fund; assume that funds with average investment size of \$5M or below are likely making some investments under \$2M and therefore are excluded from PE calculation as funds are likely SGB or microfinance-focused funds 2. \$4B estimate includes funds investing under \$2M and funds for which minimum investment size is unknown; fund size and investment criteria based on publicly available data and may be inaccurate or outdated 3. Estimated total loan volume in microfinance sector

Source: Fund websites and publications, "On the Frontiers of Finance: Investing in Sustainable SGBs in Emerging Markets", "Transatlantic Innovations in Affordable Capital for Small and Medium Sized Enterprises", DFI websites, Technoserve "Final Report on the Development of an East Africa Agribusiness Financing Facility"; EMPEA; Deutsche Bank Research

Sector is comprised of smaller funds, with 55% of identified SGB funds between \$5M and \$50M

Intermediary funds investing below \$2m¹ in size, by total fund size²



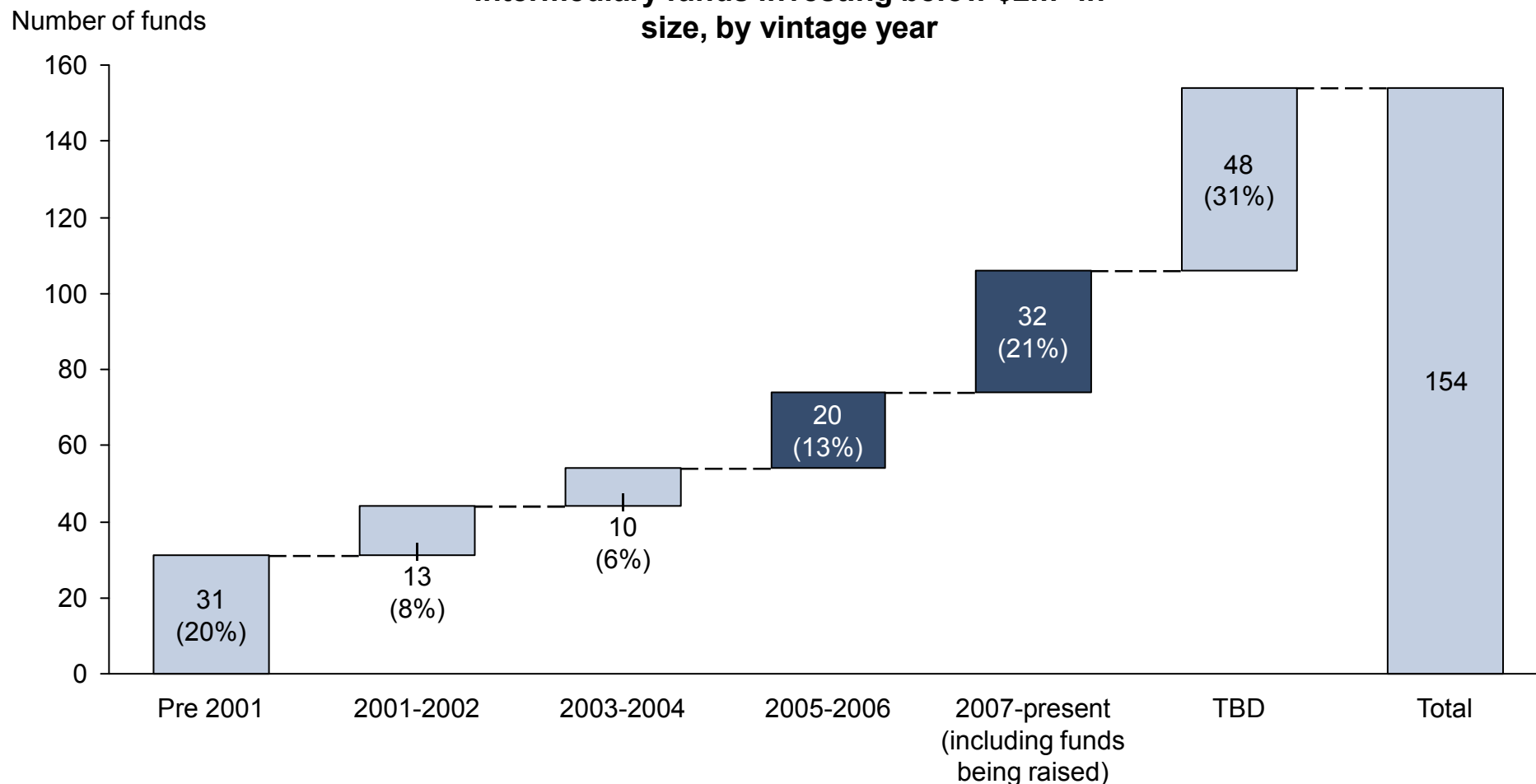
1. Includes funds for which minimum investment criteria is still to be determined (42 funds) 2. Includes capital that is invested, raised and/or targeted to raise

Note: fund size and investment criteria based on publicly available data and may be inaccurate or outdated

Source: Fund websites and publications, "On the Frontiers of Finance: Investing in Sustainable SGBs in Emerging Markets", "Transatlantic Innovations in Affordable Capital for Small and Medium Sized Enterprises", DFI websites, Technoserve "Final Report on the Development of an East Africa Agribusiness Financing Facility"

Sector is young with limited track record – ~35% of identified funds are less than 3 years old

Intermediary funds investing below \$2m¹ in size, by vintage year



1. Includes funds for which minimum investment criteria is still to be determined (42 funds)

Note: fund size and investment criteria based on publicly available data and may be inaccurate or outdated

Source: Fund websites and publications, "On the Frontiers of Finance: Investing in Sustainable SGBs in Emerging Markets", "Transatlantic Innovations in Affordable Capital for Small and Medium Sized Enterprises", DFI websites, Technoserve "Final Report on the Development of an East Africa Agribusiness Financing Facility"

There is a gap in local service and technical assistance providers (I) – South Africa case study

Provider availability

Commercial service providers

- Structural shortage of commercial local service providers for SGBs
- Includes small business-focused accountants, lawyers and marketing professionals

Local technical assistance providers

Proliferation of small business-focused TA providers to fill shortage of commercial providers

- Several government initiatives, e.g.,
- Development Bank of South Africa
 - Sector Education and Training Authorities

- Non-governmental and public/private partnerships have also developed, e.g.,
- The Business Place
 - The Business Trust

Gaps in services for SGBs

Skill gap exists among commercial SGB service providers

- Talent shortage experienced across many industries
- Top service provider talent hired by large firms that SGBs cannot afford

Programs often fail to address the cost of doing business in South Africa

- Do not help SGBs manage and overcome regulatory barriers

Some government-led programs lack necessary real-life and practical approach

- Management and/or staff have not run businesses themselves

There is a gap in local service and technical assistance providers (II) – Brazil case study

Provider availability

Commercial service providers

Availability of commercial providers varies based on region/city

Low priced services available in many areas

- Excess supply of service providers in some professions due to inexpensive, government subsidized education

Local technical assistance providers

Sebrae, the Brazilian Service for Micro and Small Enterprises, launched in 1972

- Offers courses, consulting, publications and networking
- Also works with policy makers to improve enabling environment
- Businesses are largest revenue source

Other non profits (E.g., Junior enterprise Association) also frequently serves small businesses

Gaps in services for SGBs

Quality of service from providers trained through government subsidized education programs varies considerably

Sebrae can not always provide the degree of customization required by SGBs

- Known primarily as a source of mass information and basic aid for micro and very small businesses

Global capacity building intermediaries provide services to SGBs to fill the gap in local service providers

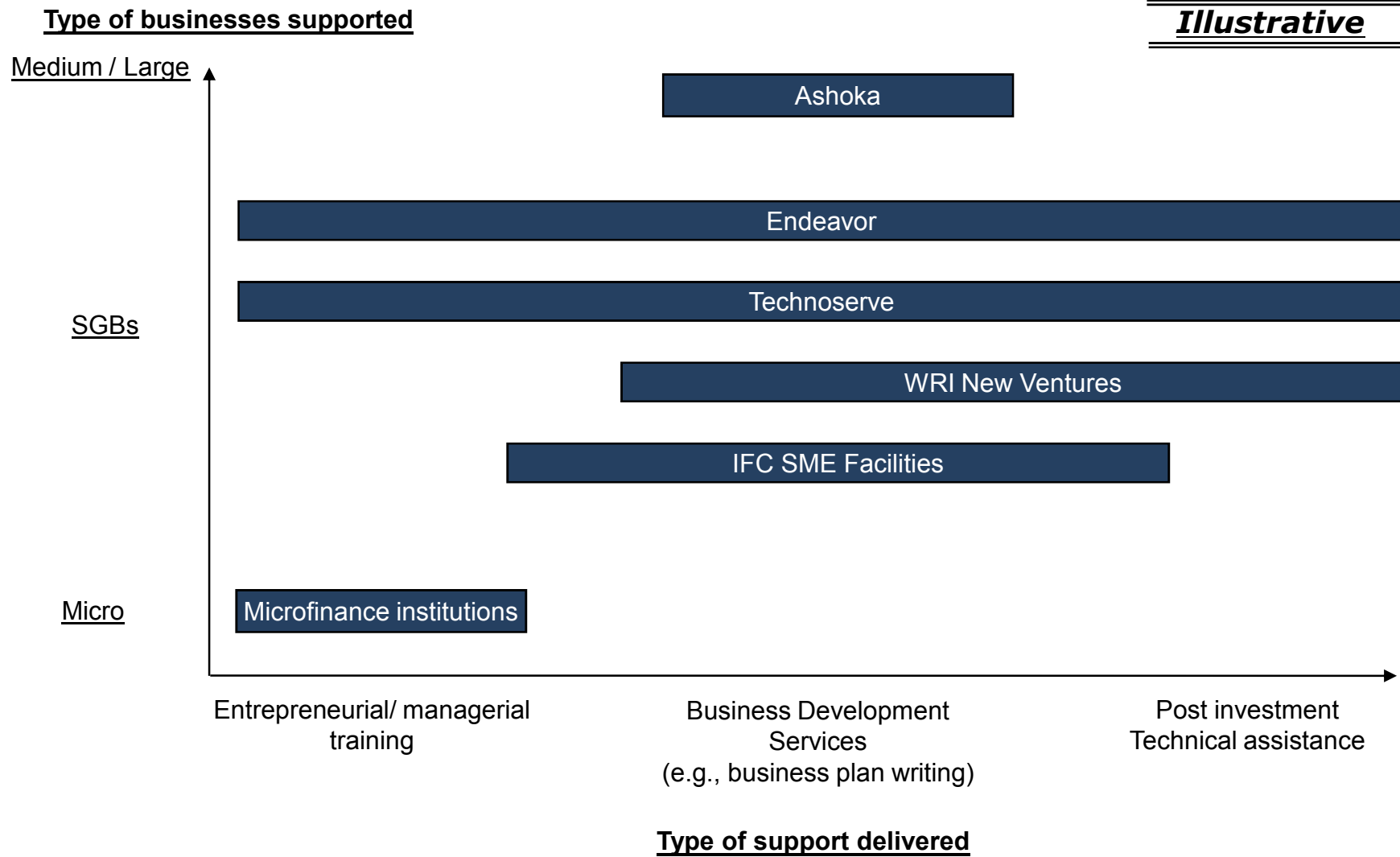


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Introduction and purpose of landscape

Intermediaries in the SGB sector have a wide range of organizational focus and goals

- Stage of company supported – e.g., seed/early stage, expansion stage
- Primary intended social impact – e.g., job creation, social/environmental goods
- Average investment size
- Target financial returns (IRR)

Using these four criteria, we have created a landscape of the intermediaries attending the ANDE conference in July 2008

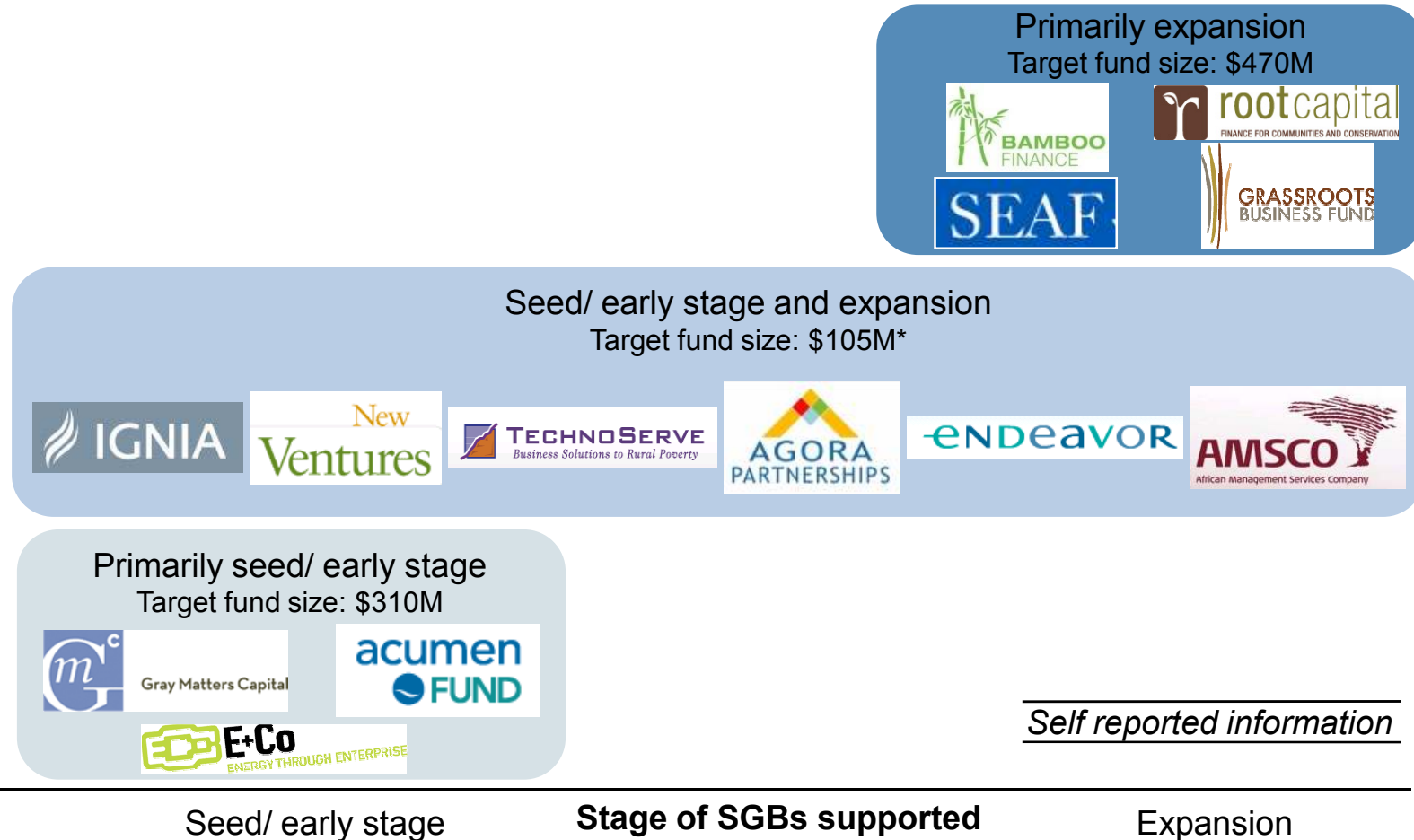
- Full set of identified SGB intermediaries not included as this information is frequently unavailable through public sources

Although only a subset of identified intermediaries, this landscape highlights the wide range of organizations focused on the SGB sector

- In addition, it provides a framework for funders to identify intermediaries with focus and priorities that are aligned

ANDE conference attendees support businesses from seed to expansion stage – most funds that invest capital focus on specific stages however capacity building providers support businesses across range of stages

Stage of SGBs supported

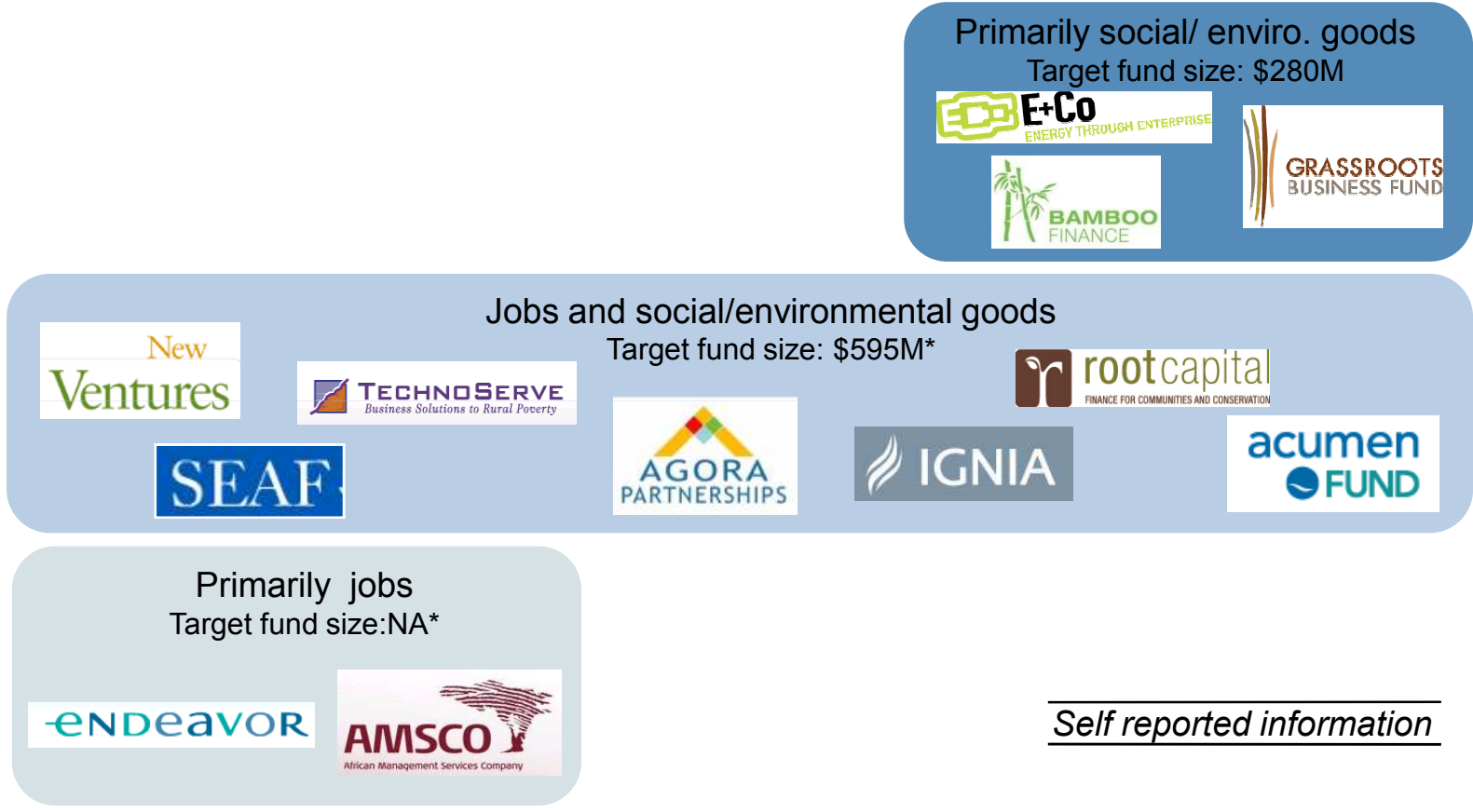


Self reported information

* New Ventures, Technoserve, AMSCO and Endeavor excluded from Fund size as organizations do not invest capital in SGBs and therefore do not manage funds
 Note: Target size of funds based on target fund size reported by intermediaries in segment
 Source: survey of intermediaries

Over 75% of ANDE conference attendees target SGBs that generate impact through social and/or environmental goods or services

Primary intended social impact



Jobs

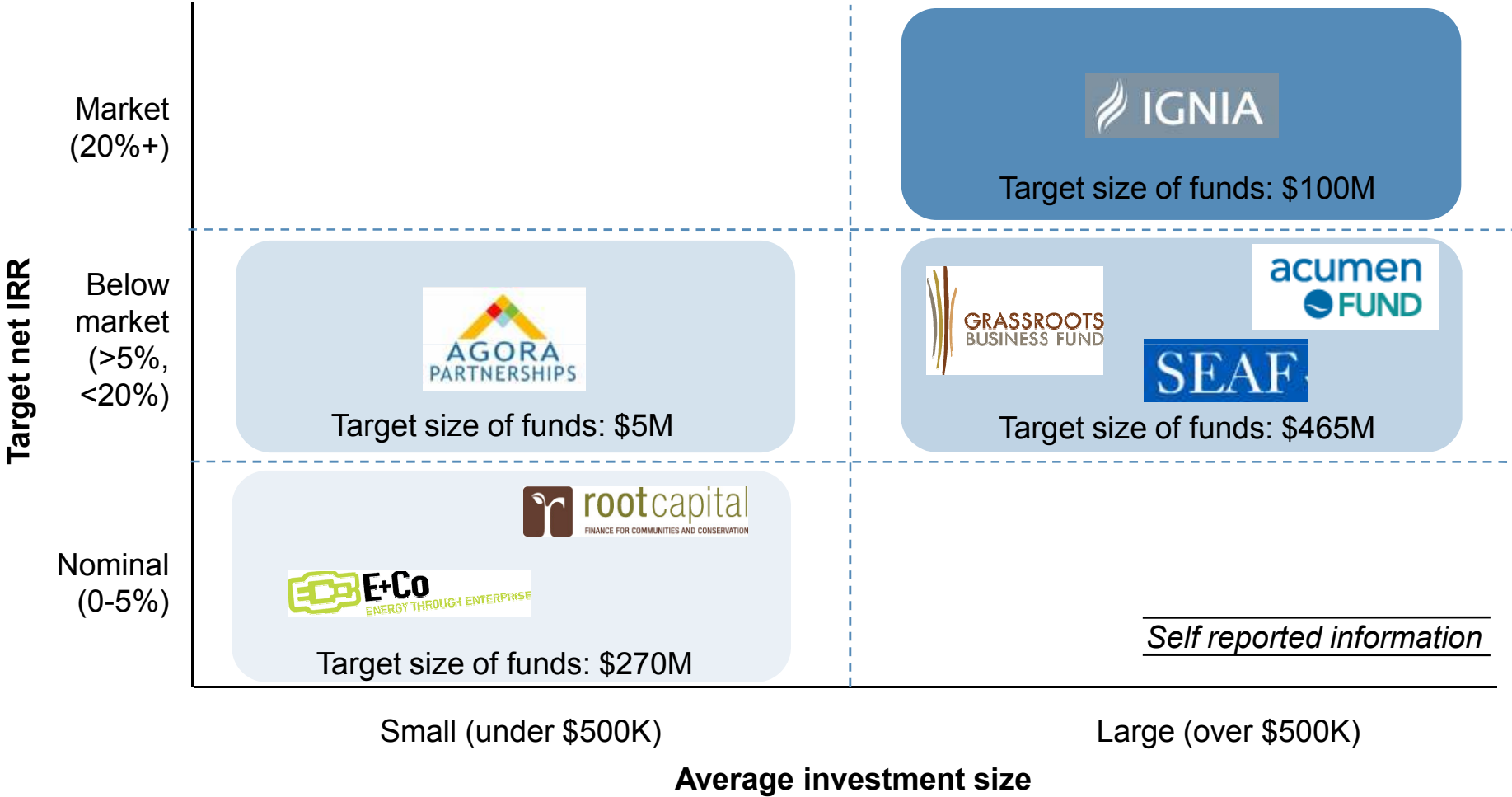
Primary intended social impact

Social/ environmental goods

* New Ventures, Technoserve, AMSCO and Endeavor excluded from Fund size as organizations do not invest capital in SGBs and therefore do not manage funds
 Note: Target size of funds based on target fund size reported by intermediaries in segment; Gray Matters Capital is also a conference participant but has not provided permission to share this information more broadly
 Source: survey of intermediaries

Most conference attendees target below market returns – funds making larger investments target higher returns than most funds making small investments

Target net IRR and average investment size

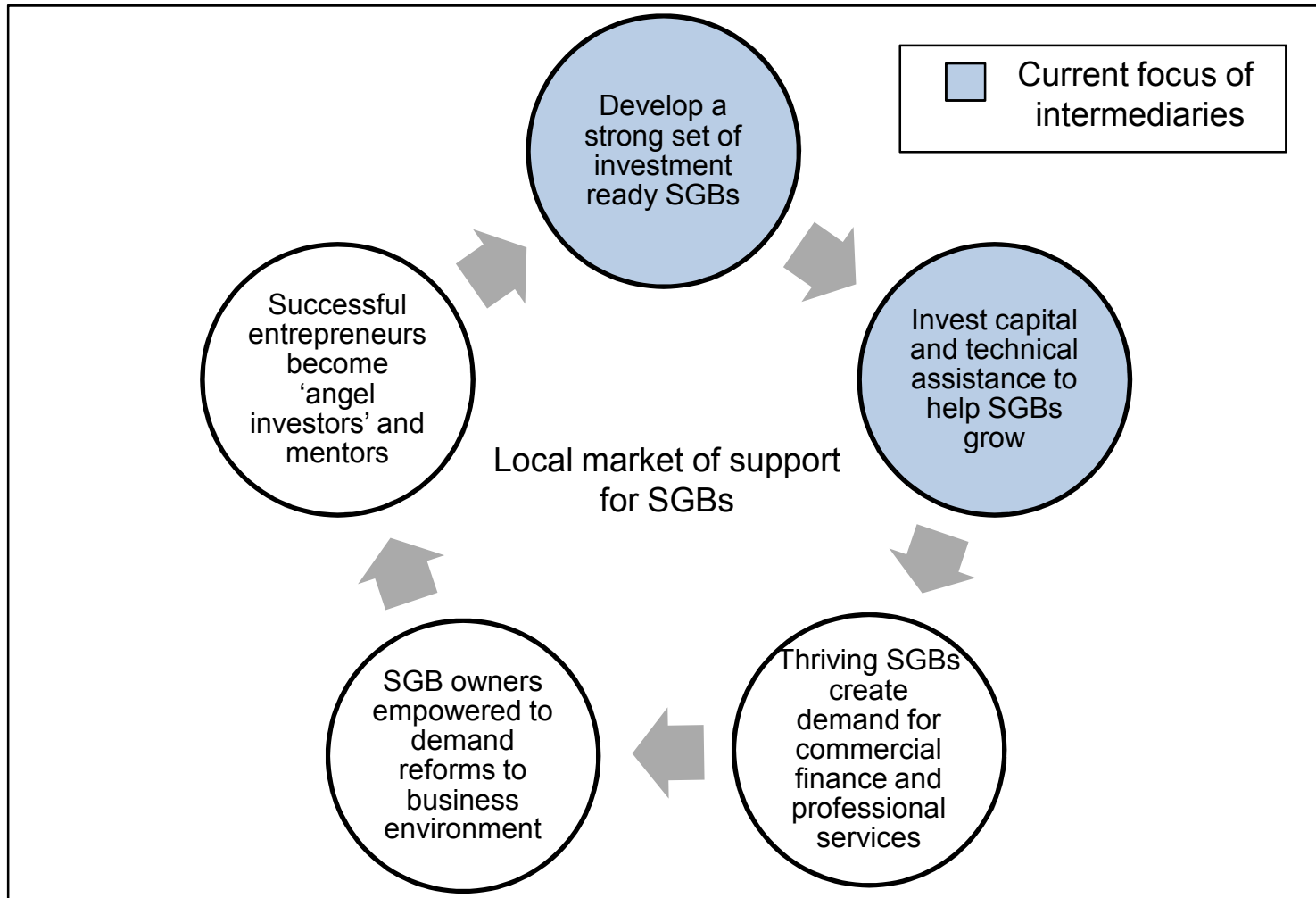


Note: Target size of funds based on target fund size reported by intermediaries in segment; AMSCO, Endeavor, New Ventures and Technoserve excluded as these organizations do not directly invest capital in SGBs; Gray Matters Capital is also a conference participant but has not provided permission to share this information more broadly; Bamboo Finance is also a conference attendee but target IRR and average investment size information is not available
 Source: survey of intermediaries

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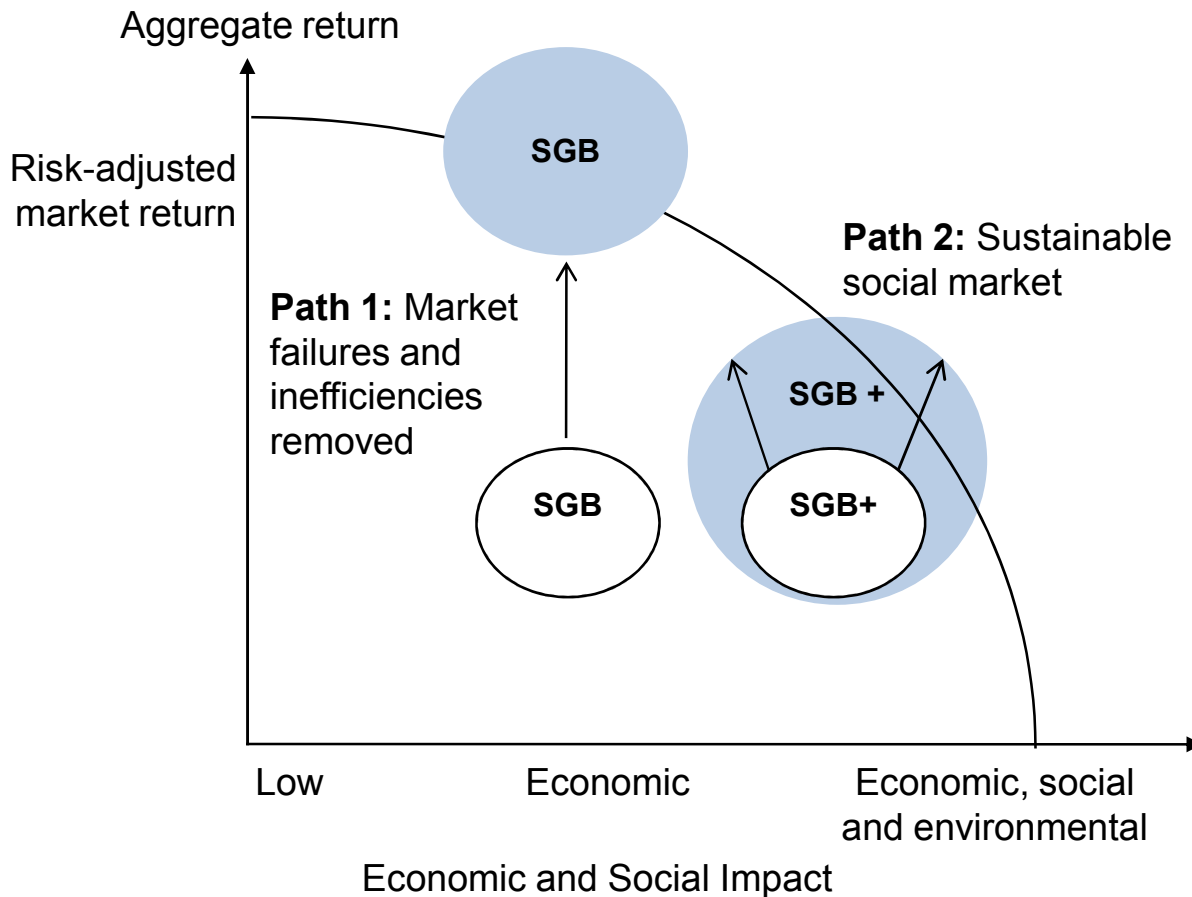
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The SGB sector develops strong SGBs – these businesses will catalyze the local market that can sustainably address SGBs' challenges



When possible, the SGB sector will also support complementary efforts focused on building the local SGB markets

If current challenges are addressed, there are two likely growth paths for SGBs in emerging markets



For Small and Growing Businesses (SGB)...

Path 1: *Market failures and inefficiencies removed*

- Local commercial banks provide debt
- Entrepreneurs become angel investors and fill equity gap below \$2M
- Local provider market responds to demand for services

Interim Path: blended capital with commercial

For Small and Growing Businesses delivering social or environmental goods (SGB+)...

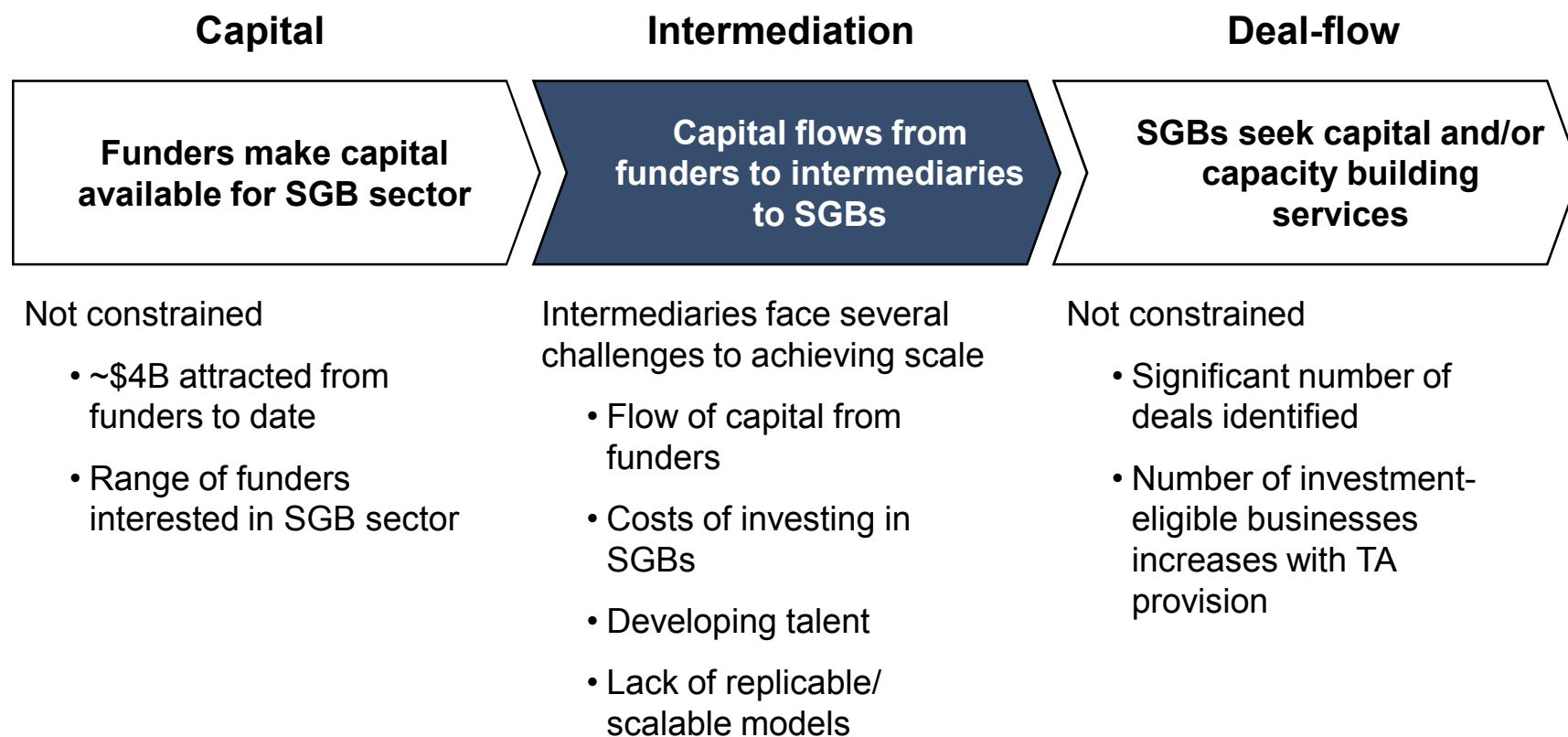
Path 2: *Sustainable social market*

- Metrics and standards enable funders to identify tradeoff between financial and social returns
- Social investors increase investment
- Concessionary funding makes requirements more flexible

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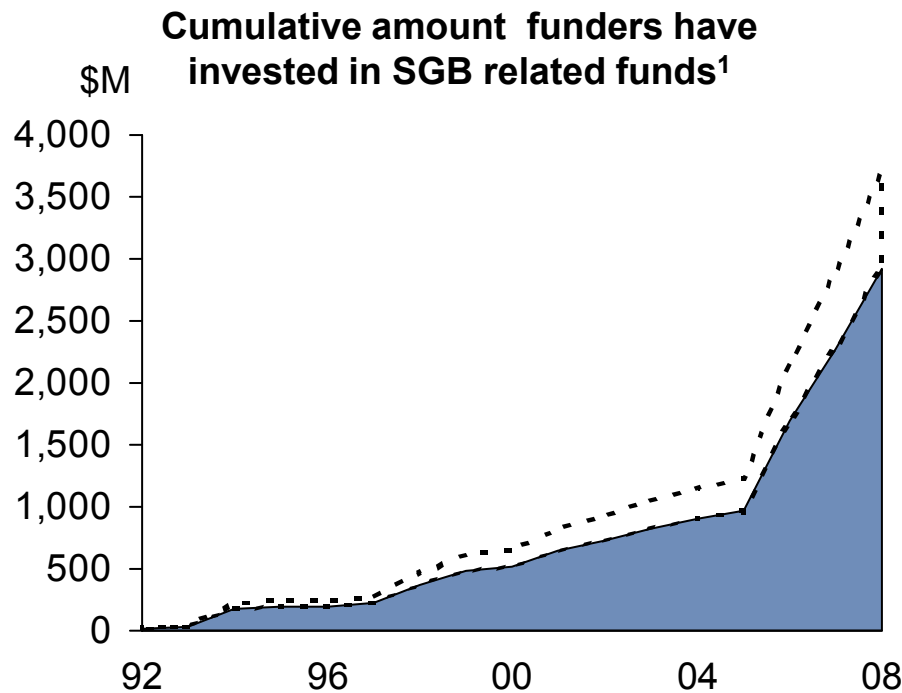
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SGB sector is not capital or deal flow constrained – key challenge is increasing efficiency and scale of intermediation



SGB sector is not capital constrained – approximately \$4B has been invested by funders to date and there is considerable interest to deploy more

Funders have made ~\$4B available to SGB intermediaries to date



Interviews with funders confirm that the SGB sector is not capital constrained

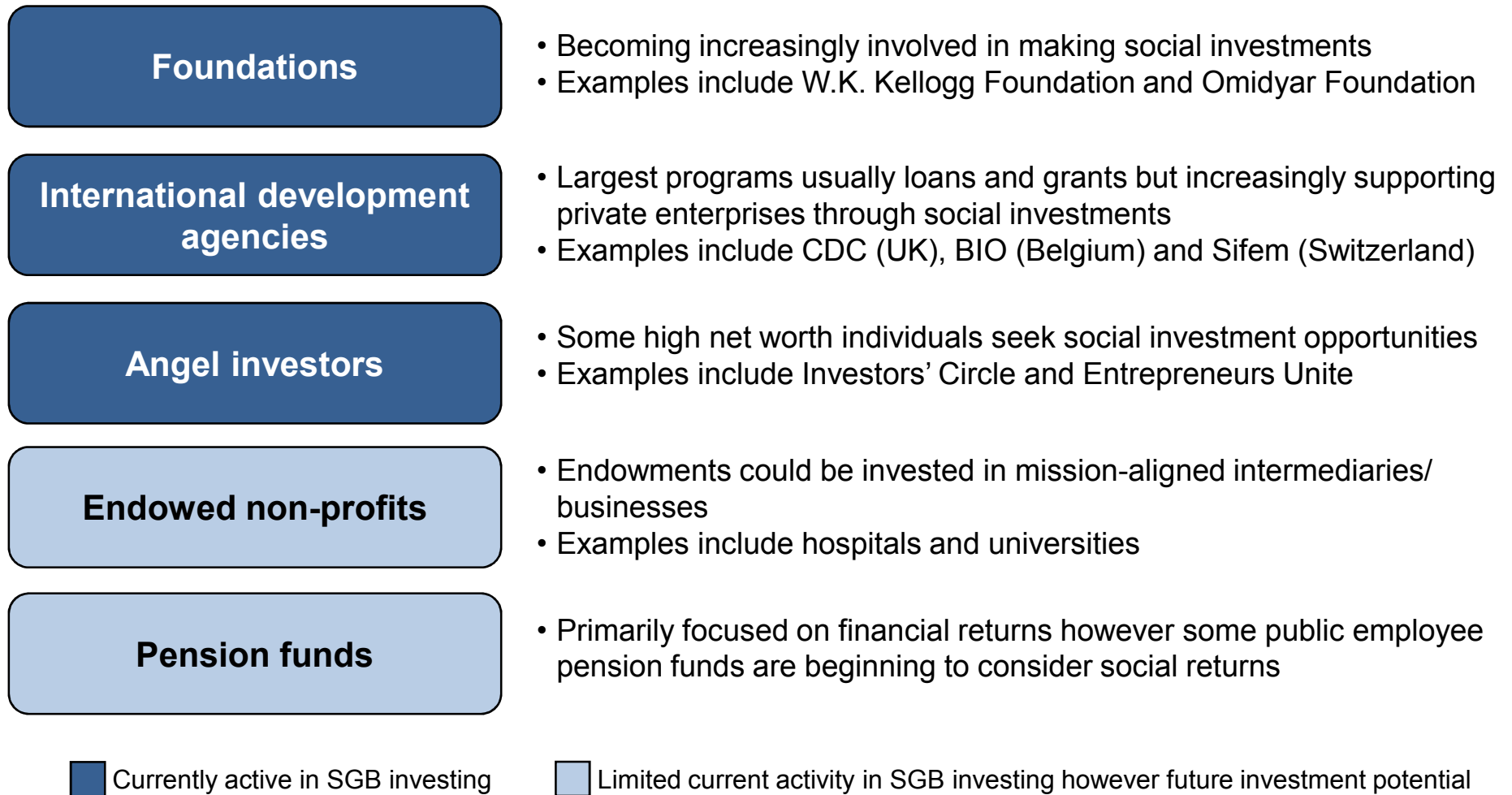
- Most investors interviewed are motivated by social/development goals
- Key challenge is on identifying opportunities for, rather than source of, investment
- Funders looking for intermediaries that
 - Have a robust deal flow
 - Can provide value-adding services in a cost effective manner

1. Vintage year unknown for ~\$800M in funds, assume these funds were disbursed at same growth rate as funds for which vintage year is known; \$4B figure includes funds investing under \$2M and funds for which minimum investment size is unknown; \$4B does not include terminated funds and therefore, additional funds have been invested in sector that are not accounted for

Note: fund size and investment criteria based on publicly available data and may be inaccurate or outdated

Source: Fund websites and publications, "On the Frontiers of Finance: Investing in Sustainable SGBs in Emerging Markets", "Transatlantic Innovations in Affordable Capital for Small and Medium Sized Enterprises", DFI websites, Technoserve "Final Report on the Development of an East Africa Agribusiness Financing Facility"

The diversity of potential SGB funders further support the opportunity for additional capital flow into the sector

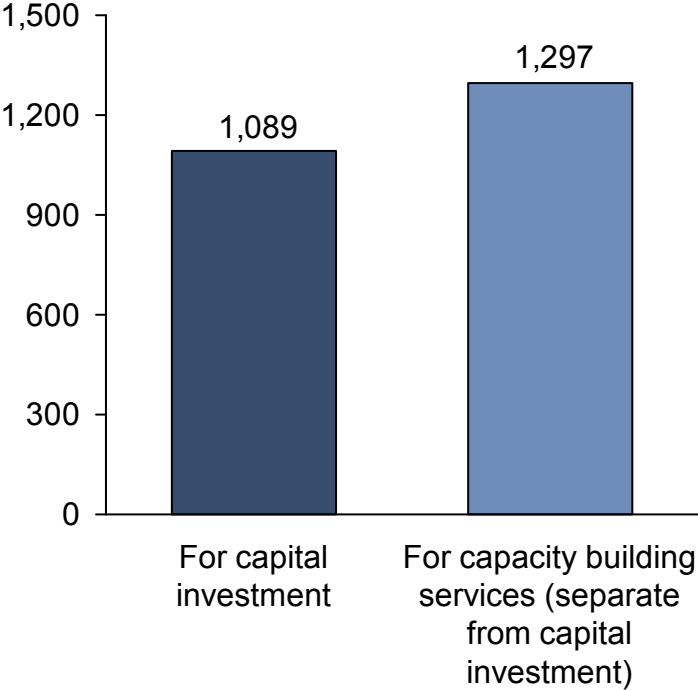


On the SGB side, the sector is not deal flow constrained – ANDE conference attendees confirm deal pipeline for capital and capacity building investments

Over 1,000 deals passed attendees' 'opportunity screen'¹ for capital investment and over 1,200 passed for capacity building in last 12 months

Total sector deal flow pipeline is significantly greater – only 12 of over 150 identified intermediaries² surveyed

Number of SGBs that passed screen in last 12 mo.



intermed. reporting: 8

7

Intermediaries surveyed are a small subset of total SGB sector and therefore, deals reviewed are likely subset of total sector pipeline

- 12 intermediaries surveyed
 - Acumen Fund
 - Agora Partnerships
 - AMSCO
 - Bamboo Finance
 - E&Co
 - Endeavor
 - Grassroots Business Fund
 - Gray Matters Capital
 - IGNIA
 - Root Capital
 - Technoserve
 - WRI

1. Intermediaries asked "In the past 12 months, approximately how many SGBs passed your organization's 'opportunity review' (i.e. first screen) for capital investment/capacity building services) ? 2. ~150 funds include funds that make investments below \$2M and funds for which minimum investment criteria is unknown
Source: intermediary surveys

Furthermore, deal flow would likely increase if additional pre-investment technical assistance provided

All intermediaries surveyed require SGBs to meet one or more of the following criteria to pass 'opportunity screen'

- Legally incorporated as a business (i.e., operating in the formal sector)
- Financial statements (non-audited or audited) available
- Business plan completed

If intermediaries are willing to provide additional pre-investment technical assistance, one or more criteria could be excluded from screen in order to increase eligible deal flow; this TA may include

- Assisting SGBs to complete formalization process and equipping SGBs to manage formal regulations
- Working with SGBs to create financial statements and/or connect businesses with accountants
- Reviewing and consulting on SGB business plans and strategy

By increasing deal flow, intermediaries that provide pre-investment TA play key role in growing the SGB sector

Although the SGB sector is not capital or demand constrained, four key challenges currently prevent intermediaries from achieving scale

Key challenges facing intermediaries and funders

1. Lack of awareness and support among funders
2. Increasing the efficiency of capital flow from funders to intermediaries
3. High transaction costs for intermediaries investing in SGBs
4. Need for more talent at all levels



Sub-issues and drivers

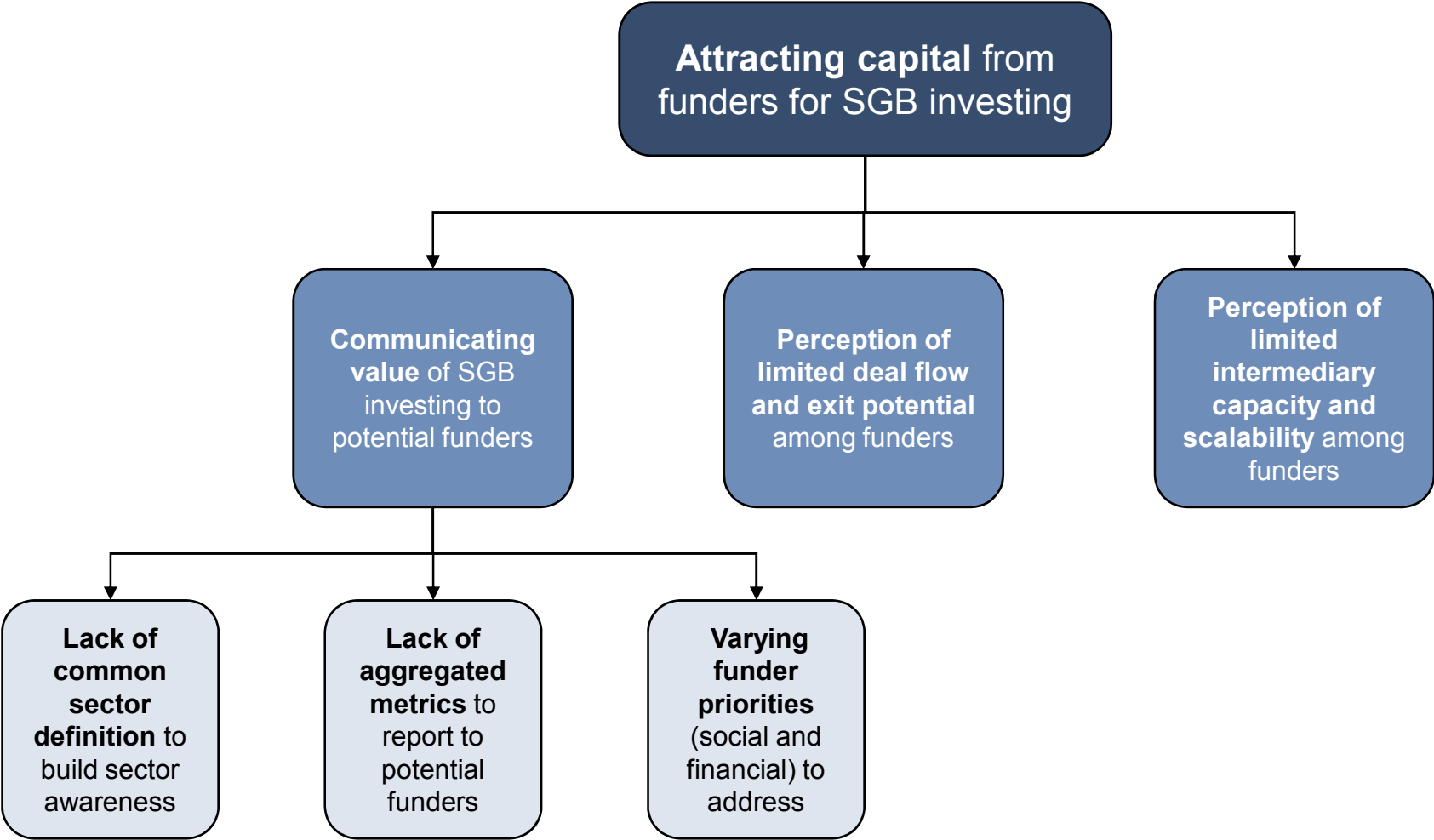
- Communicating the value of SGB investing to potential funders
- Communicating scale of potential deal flow and intermediary capacity
- Difficult to connect funders and intermediaries
- Costs to execute funder investments in intermediaries
- Costs of identifying SGBs/ deal flow
- Costs of due diligence process
- Costs to monitor and evaluate investment performance and impact
- Lack of best-practice sharing within sector
- Finding and retaining intermediary investment professionals
- Deploying technical assistance in order to mitigate risk

Drivers of lack of awareness and support among funders

Sub issues:

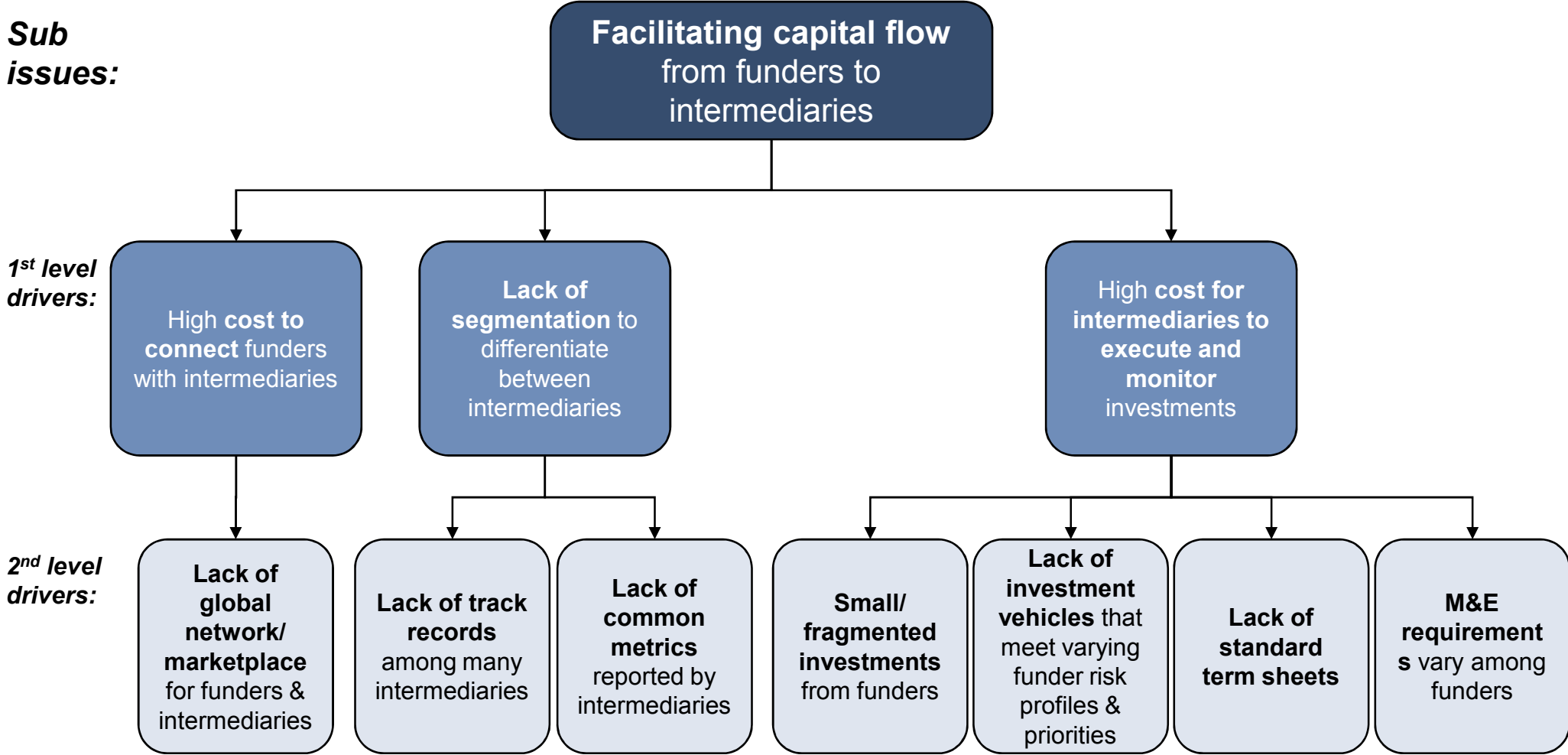
1st level drivers:

2nd level drivers:

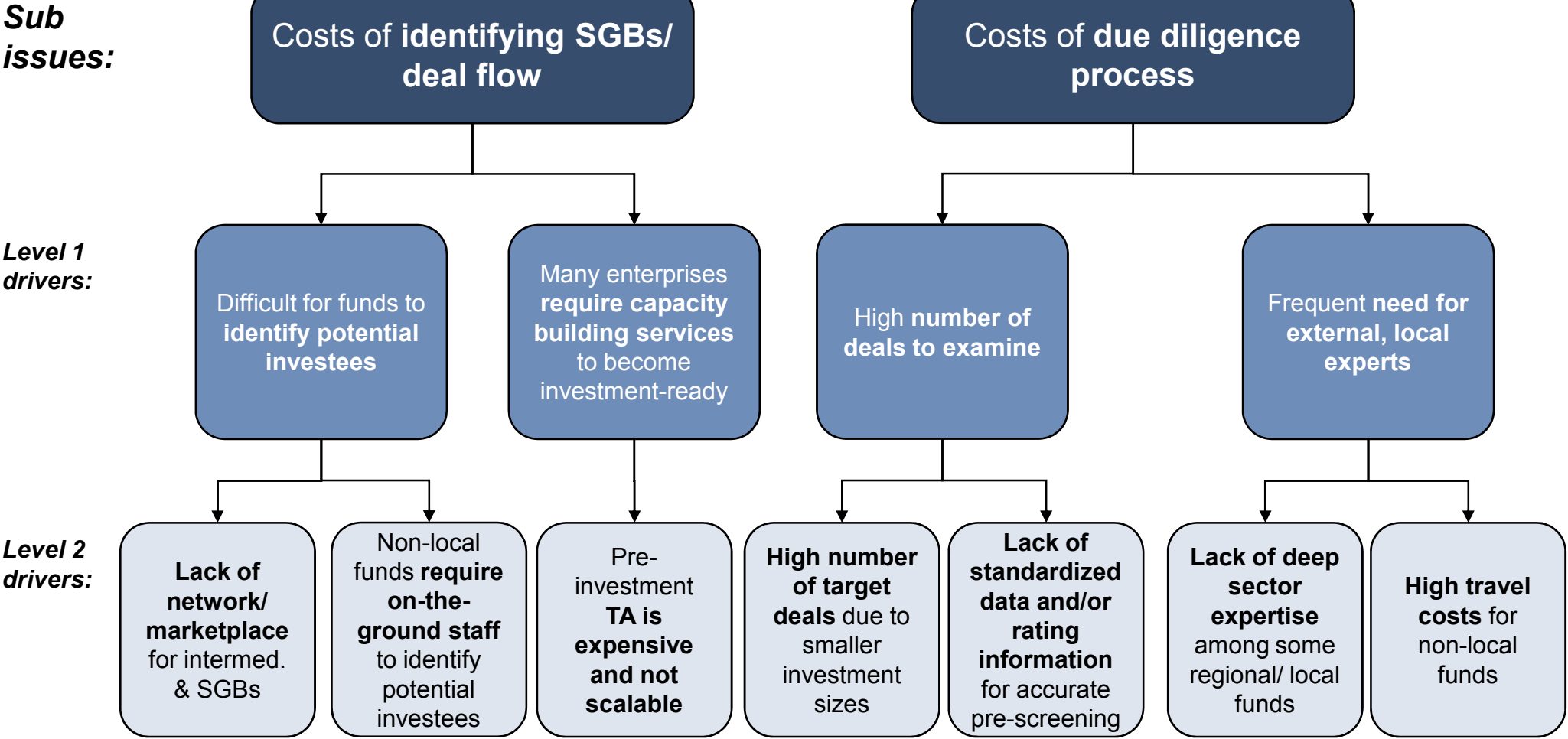


Drivers of inefficient capital flow from funders to intermediaries

Sub issues:



Drivers of additional intermediary costs incurred when investing in SGBs (I)



Drivers of additional intermediary costs incurred when investing in SGBs (II)

Sub issues:

Costs to monitor and evaluate investment performance and impact

Lack of best practice sharing to help identify and develop efficient, scalable models

Level 1 drivers:

Difficult to monitor investment performance

Difficult to evaluate impact of investments

Lack of sector-wide collaboration on specific initiatives

Lack of targeted SGB sector-specific publications

Level 2 drivers:

Lack of investee systems and resources for M&E

High travel costs for non-local

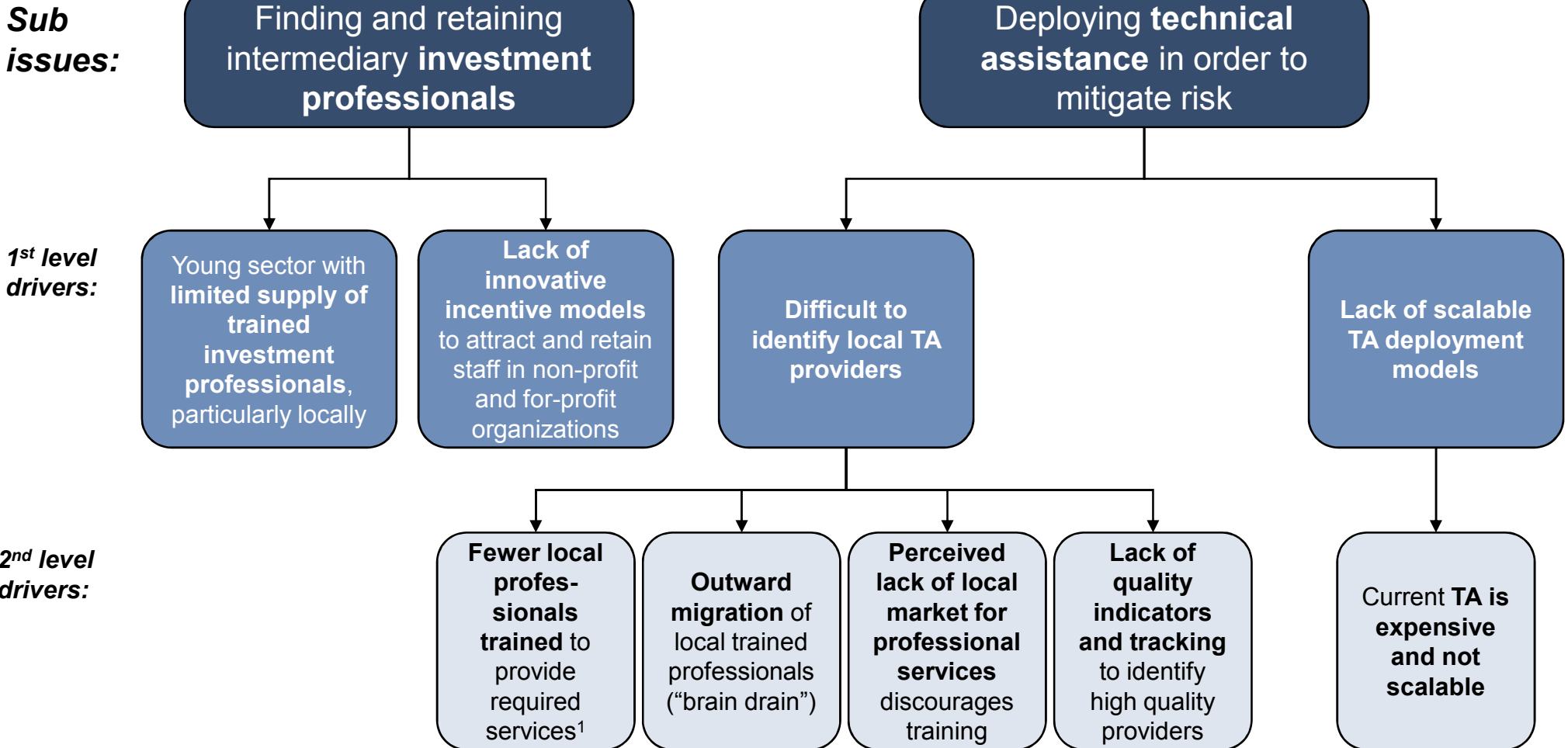
Lack of common performance metrics to consider financial and social tradeoffs

Lack of a SGB sector plan to identify collective action initiatives and set goals

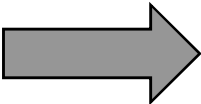


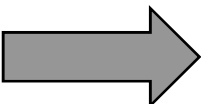
Lack of convening body/ organization dedicated to SGB sector

Lack of sector definition and defined "audience" for such publications

Drivers of intermediary challenges when deploying talent for investing and capacity building



Four primary market failures and/or inefficiencies are contributing to these intermediation challenges

| Market failure / inefficiency | | Types/ examples |
|--|---|--|
| Transaction costs |  | <ul style="list-style-type: none">• Search and information costs• Bargaining and contracting costs• Policing and enforcement costs |
| Information asymmetry |  | <ul style="list-style-type: none">• Adverse selection• Moral hazard |
| Externalities |  | <ul style="list-style-type: none">• Positive externalities• Negative externalities |
| Inefficiencies in complementary markets |  | <ul style="list-style-type: none">• Market requires inputs to grow however input providers will not develop without demand market in place |

Well functioning capital markets exhibit several characteristics which help address these common market failures and inefficiencies

Address transaction costs

- Capable intermediaries that efficiently aggregate supply and connect demand
- Liquidity in deal flow to enable exits
- Replicable investing products and structures that lower transaction costs
- Ability to co-invest efficiently through syndication and low-cost deal sharing

Address information asymmetry

- Common vocabulary, metrics and accounting practices to enable description, valuation and benchmarking
- Information sources that allow learning over time and efficient sharing of descriptive and performance related information

Address additional market challenges – environment and resource deployment

- Policy and regulation that supports players across the market
- Talented people with sector-specific expertise and that are incented appropriately

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- **ANDE's vision and role**

ANDE mission statement and guiding principles

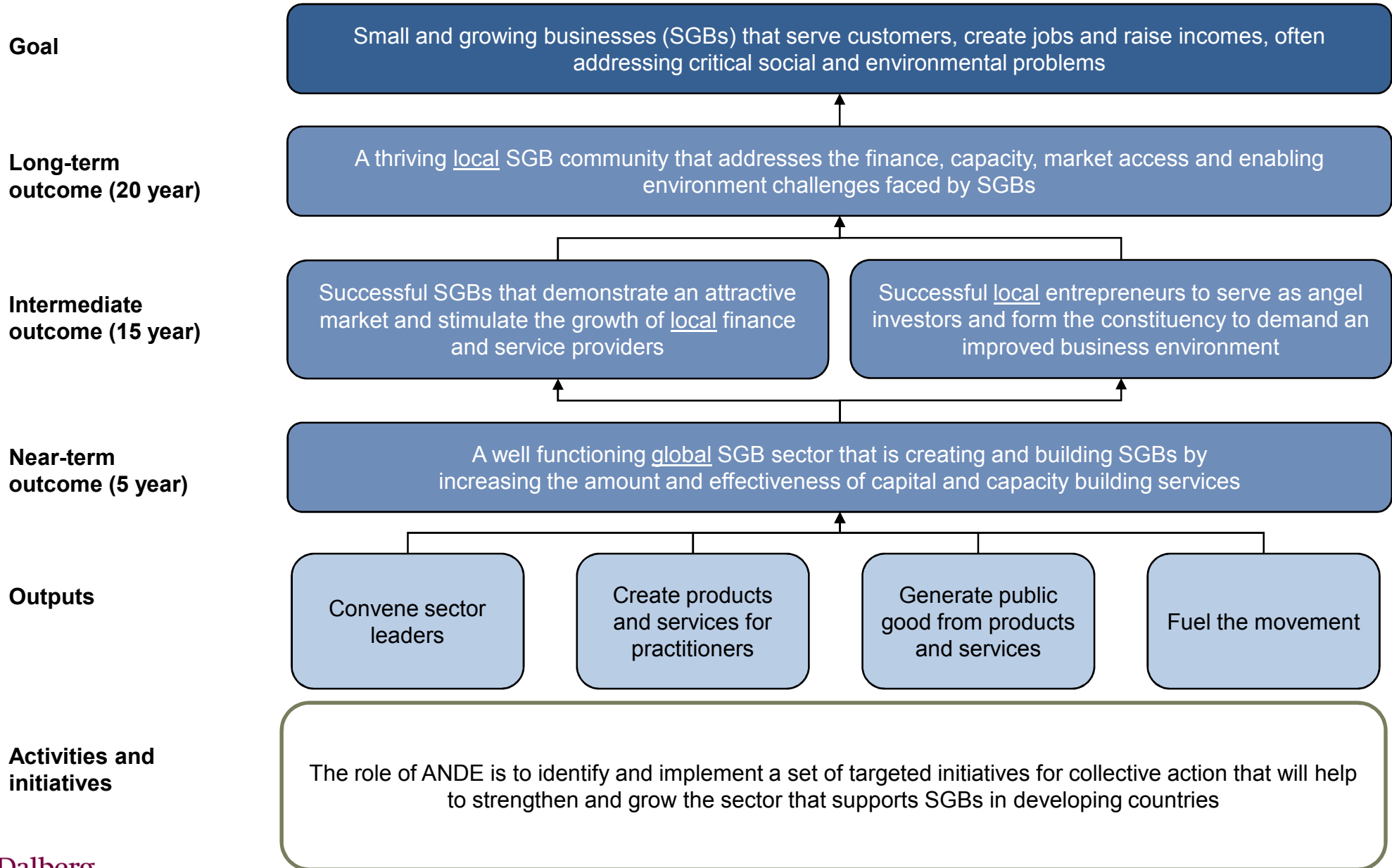
Mission statement

The goal of ANDE is to strengthen and grow the sector of organizations that are working to alleviate poverty and improve lives through supporting and investing in small and growing businesses (SGBs) in developing countries

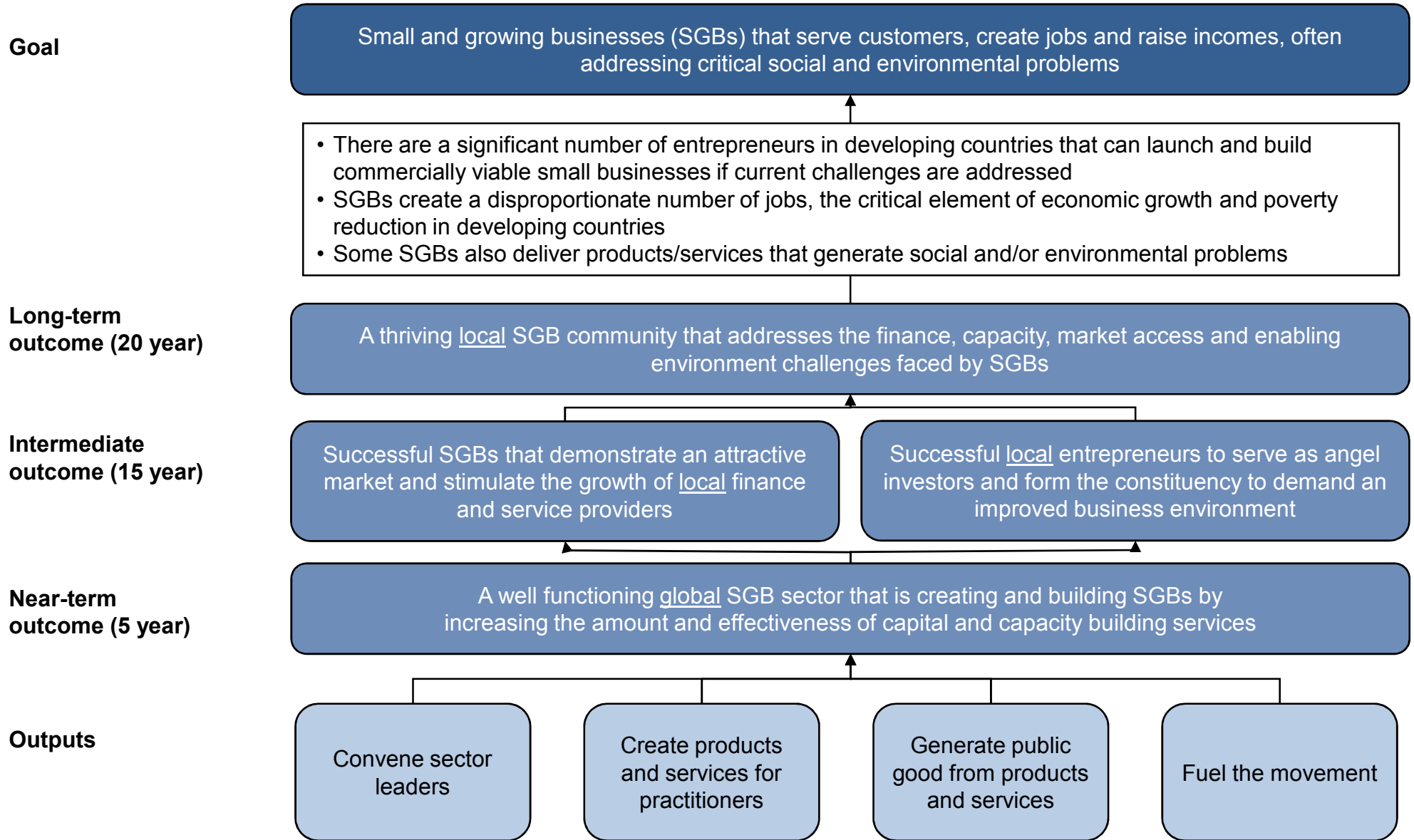
Guiding Principles

- Small and growing businesses in developing countries have enormous potential to help alleviate poverty in their communities through creating jobs, wealth and additional social benefits
- In order to flourish, small and growing businesses require access to finance, technical assistance to develop managerial capacity, access to markets and supportive business environments
- In the long run, healthy economies need strong, local communities of investors and technical assistance providers to cultivate small and growing businesses
- Global efforts to support SGBs in developing countries are a necessary first step to address the local market failures by innovating new models, demonstrating success and stimulating local demand
- Through collaboration and sharing lessons learned, the investors and intermediaries in this sector can better identify and replicate the more scalable, effective models

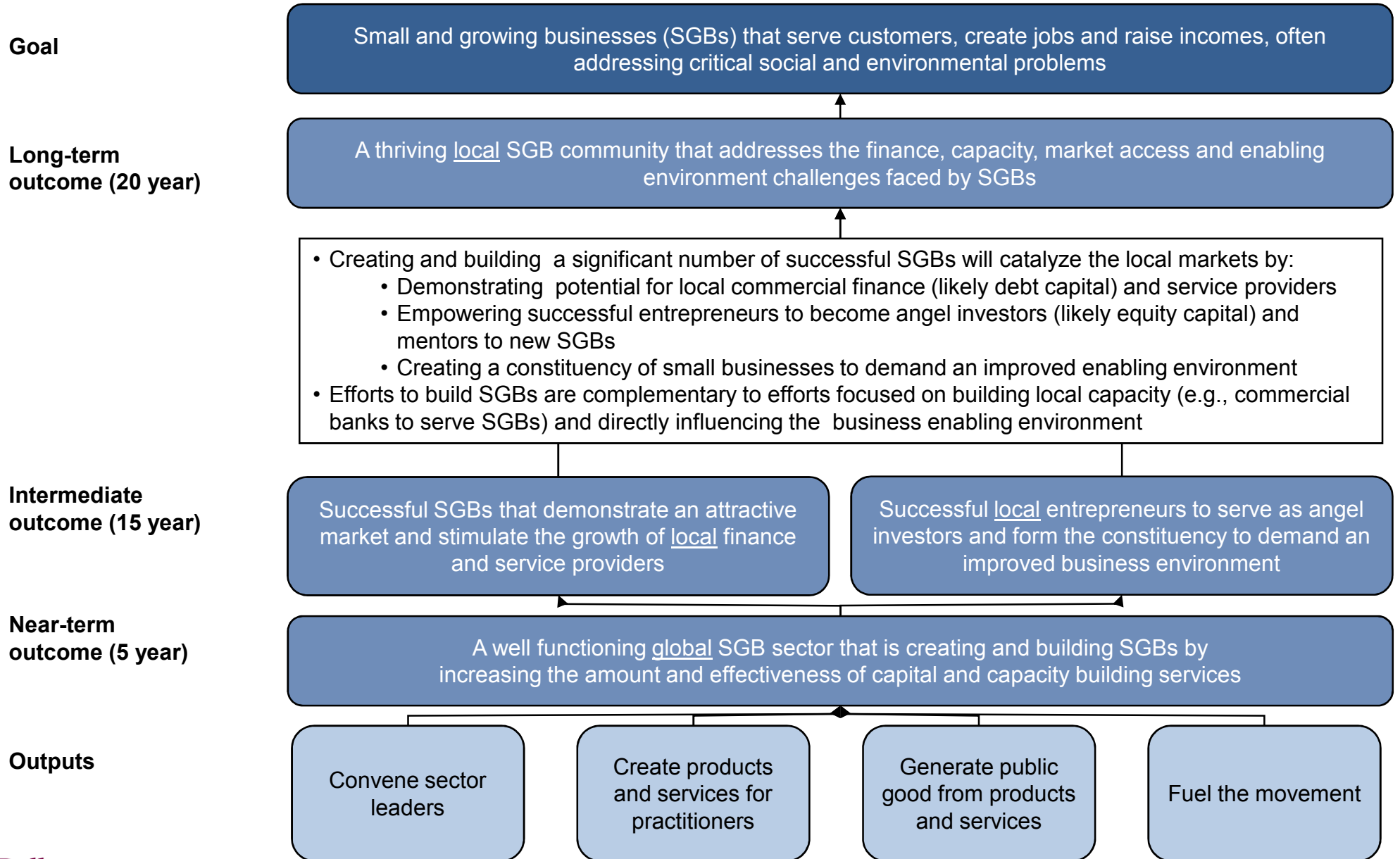
ANDE theory of change



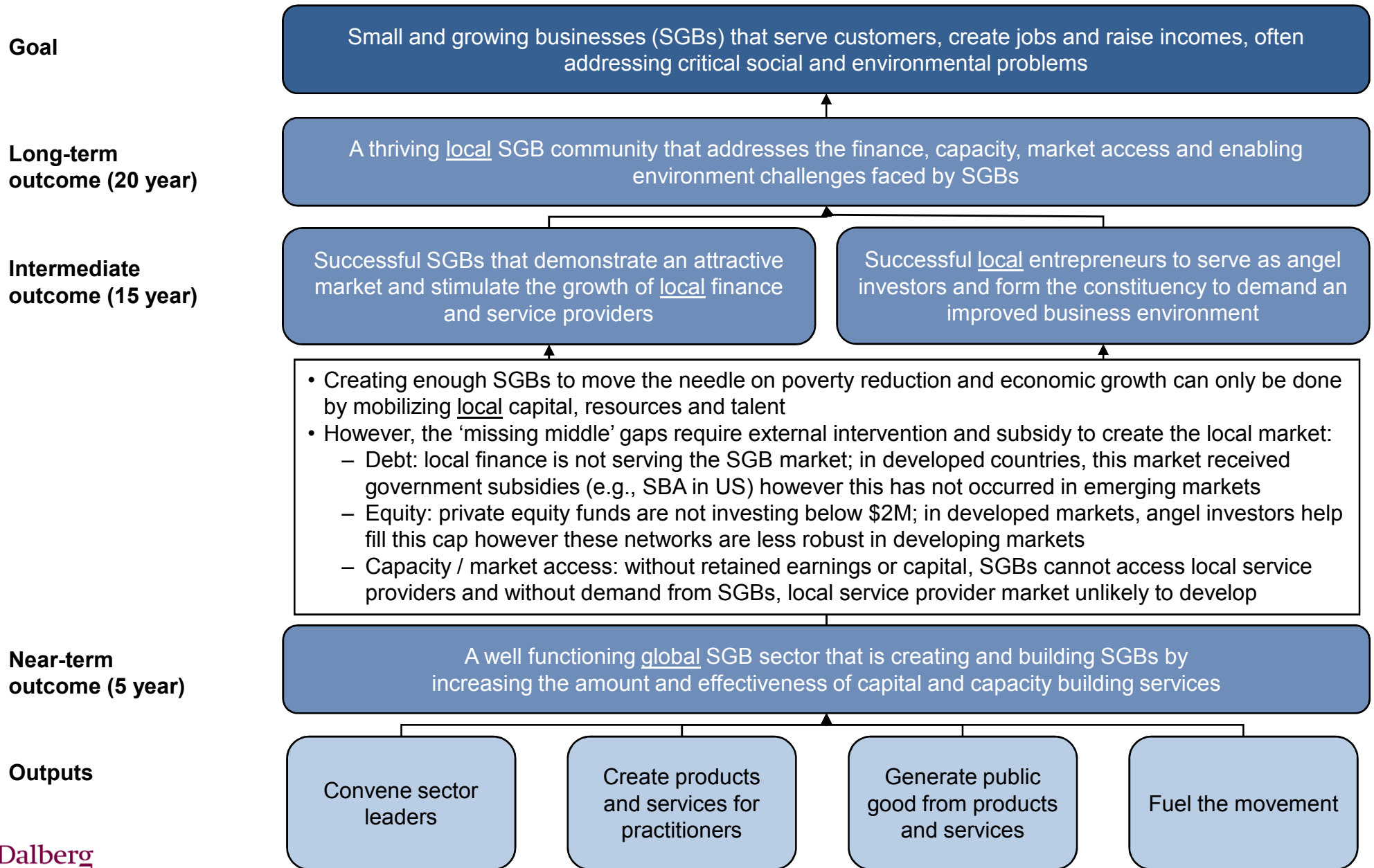
ANDE theory of change – long-term outcome assumptions



ANDE theory of change – intermediate outcome assumptions



ANDE theory of change – near-term outcome assumptions



ANDE theory of change – output assumptions

