

ANDE EU Launch Conference

Making SGB Finance Work:
How to connect Capital to
Opportunity

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RISK!



OBJECTIVE AND AGENDA

- Using case studies to illustrate existing issues and mechanisms in SGB financing
- Identify what the intermediary needs to do each type of deal

AGENDA

1. Background
2. Growth Finance Case Study
3. Equity and debt

MISMATCH BETWEEN FINANCE SUPPLY AND DEMAND (\$10,000 TO \$1M)

Risk

Security



Cash flow

Need

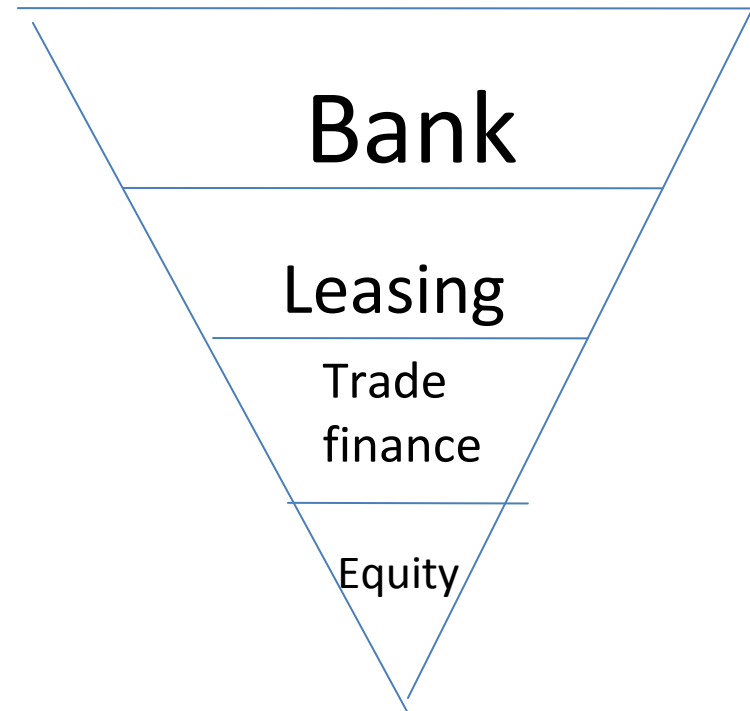
Fixed assets
property

Equipment

Working capital

Growth and
losses

Source



THE SECTOR PROBLEM

- The need is for equity, but most of finance now available needs security
- Developing Market SME investment is high risk
- In general returns have not justified the risk (in open market terms)
- So equity/venture capital model largely unsustainable in the <\$1m deal size
- SME investment volume is constrained

WHY IS SGB RISK DEEMED TOO HIGH?

- Poor collateral/guarantees
- Poor financial controls
- Lack of exit possibilities for equity holder
- Inexperienced management needing considerable support = high cost of investment
- Strategic weakness of SMEs, both in buying and in price setting
- Smaller ones are sole traders/partnerships

PROBLEM WITH THE EQUITY APPROACH

- Return is largely based on capital uplift = needs exit
- Lacking in downside protection so need high upside return
- SMEs cannot IPO and are not strategically attractive to corporates
- Majority of exits end up being sale back to management at a low price
- Equity requires a corporate structure and greater formality
- SME Fund manager needs large and highly skilled team to make equity analysis and judgements, and to provide required level of support
- Lacking in some of the controls/defaults/covenants that lenders have

SO WHAT IS GROWTH FINANCE

- ‘The missing middle’ –where neither banks nor PE players want to invest, too big for MFIs.
- Entrepreneurs short on skill and collateral
- Toughest at the \$50-100k level, one man operations
- Poorly served in nearly all developing countries
- Dangerous to engage in unless you can provide Business Development Assistance (BDA)
- Different approach from VC or PE
- Use debt and ‘self liquidating’ approach (little/no equity)
- Otherwise known as Shareholder Loans

ADVANTAGES OF GROWTH FINANCE (GF)

- Downside protection through loan/security
- Upside secured through royalty share of revenues
- Can invest in unincorporated businesses (sole traders) = flexibility
- Simpler deal structure = reduced judgement and due diligence effort by Fund Manager
- No full or partial share exit required
- Earlier cash capture and return profile
- Can still get shareholder type protections and close contact with management (BDA)
- Aims for a lower failure rate/higher success ratio = better risk/reward ratio

PE SME RISK ANALYSIS

| Type of risk | Growth Finance | Other types of SME PE |
|--|----------------|-----------------------|
| Size related: exposure to economic cycle, negotiating weakness etc | Yes | Yes |
| Management: lack of access to trained management and full teams | Yes | Yes |
| Downside risk in case of failure or partial failure | Reduced | Yes |
| Exit risk: need for corporate event: sale, IPO, buy back to make full return | No | Yes |
| Liquidity risk: lack of alternative sources of finance | Yes | Yes |

COAL DISTRIBUTION CASE STUDY



Barnellan Equity Advice Ltd

GROWTH FINANCE

Business

- South Africa – black women owned
- Coal screening and distribution – managed contracts for producers @ R2.50 per tonne at start
- Established 1 year (2003)

Required

- R115,000 equipment
- R350,000 working capital
- little collateral

SUMMARY FACILITY

| | |
|---------------------|--|
| Total Loan Facility | R 465,000 |
| Interest | 12% (same as Central Bank rate) |
| Longest term | 36 Months (from 2004) |
| Own contribution | 0% (existing business) |
| Collateral Cover: | 0.12 times |
| Uncovered: | R407,500 |
| Shareholding | 0% |
| Royalty | Type: Units of management services sold R0.05 per R2.50 of management services sold (2%) |
| Projected IRR | 25.0% |
| BDS recovery fee | R23,250 plus VAT |

PROSPECTIVE CASH FLOWS

(R'000s)

| Item | Year 0 | Year 1 | Year 2 | Year 3 |
|--------------------------------|--------------|-----------|-----------|-----------|
| Loan | -465 | 162 | 239 | 64* |
| Interest | | 44 | 24 | 1 |
| <u>Royalty</u> | | <u>50</u> | <u>60</u> | <u>50</u> |
| Total | -465 | 256 | 323 | 115 |
| IRR | = 25% | | | |
| * To be repaid during the year | | | | |

SUMMARY TERMS

- Loan and royalty agreement giving full shareholder type rights/controls
- 3 month repayment moratorium, then monthly
- Security over assets plus personal guarantees of directors
- BDA contracted and paid for annually

OUTCOME

- Slow start, contract delays for 3 months
- Business then took off, and substantially exceeded expectations
- Owners had sufficient cash to buy out the Fund at a higher than forecast IRR ahead of full loan repayment

ROYALTY ON SALES

Possibilities:

- Moratorium if early negative cash flows
- Either % of revenue, amount per unit sale, % per unit price
- Continue payments after loan repaid/on early repayment?
- Royalty continues until a certain minimum is returned regardless of when?
- Can be combined with equity if there is a compelling reason, or other forms of participation

Issues:

- Service revenues
- Cash diversion, needs close monitoring
- Prefer unit sales and very strong reporting and control
- Therefore best for manufacturers, distributors

RESOURCES

- Skills required are mid way between Banking and Private Equity
- Greater resource than banking because of mandatory BDA and monitoring effort
- Not many economies of scale so relatively high cost at present (the same as SME PE)

GROWTH FINANCE VISION

- GroFin, Business Partners and SEAF (Vietnam) producing proof of concept
- Portfolio structure has debt security characteristics
- Private Equity fund is not the optimal vehicle
- Ideal would be to establish 'shareholder loan institution', permanent capital, able to raise credit
- Thereby achieve lower cost, replicable model like micro credit movement, and mobilise significant capital

Shareholder Loan Institution (SLI), to match MFIs at lower investment level