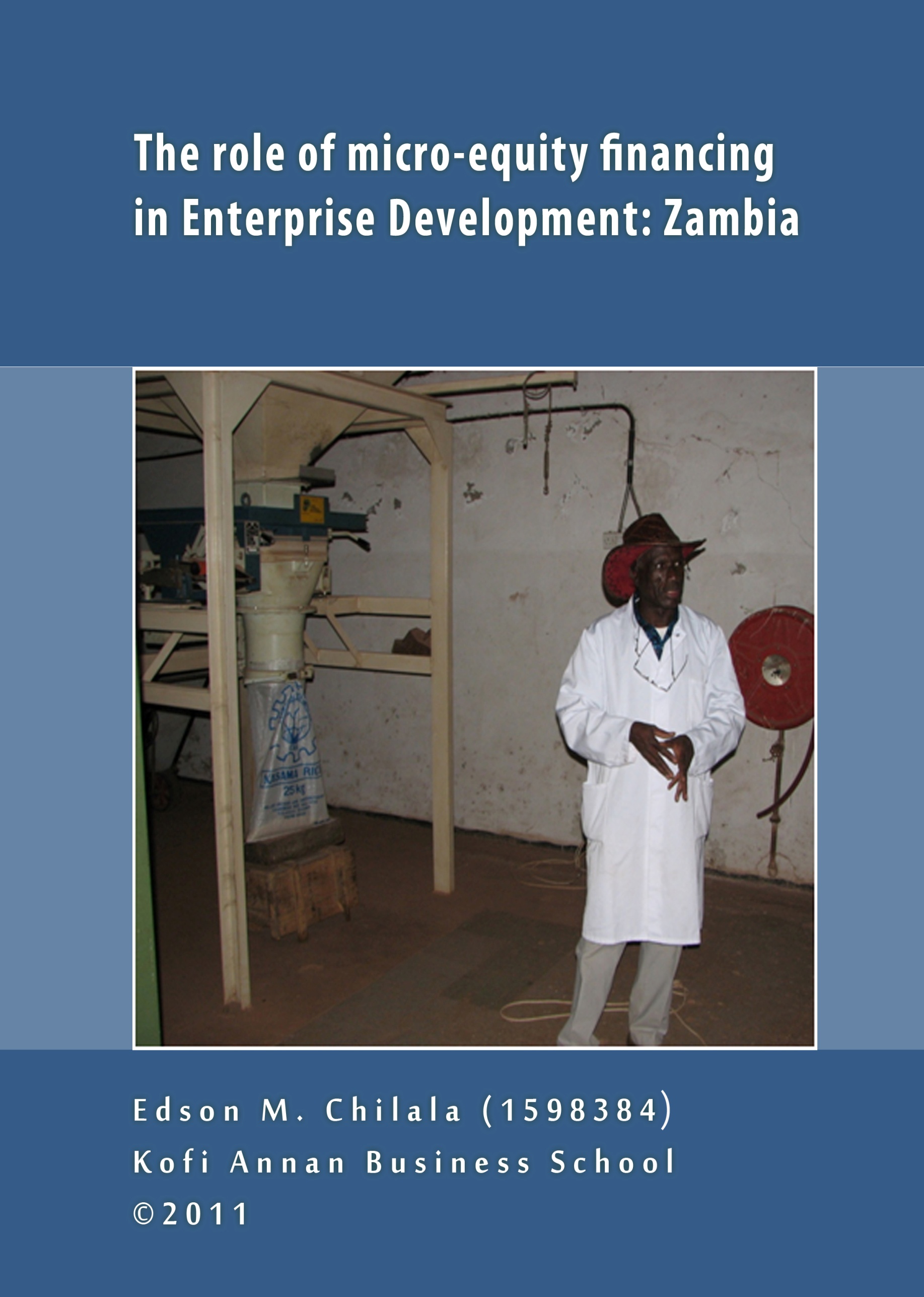
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**The role of Micro-equity financing in Enterprise Development: Zambia**

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# Abstract

Small and Medium Enterprises (SMEs) play a key role in lifting emerging economies from the burden of poverty and job creation. But their impact is demeaned because of financial exclusion from traditional sources of finance. Research and Woord en Daad’s experience in SME finance further indicates that SMEs need business development services as much as they need finance, as is evidenced by the lack of capacity among entrepreneurs to efficiently handle and leverage the short term loans they receive from MFIs.

A case in point is the Zambian financial services industry where most MFIs are specialized in short term-salary backed loans accessible by mostly micro-businesses and government workers along the line of rail. This means that SMEs, especially rural based ones, are excluded from access to financial services and products while those that have access cannot utilise it for growth purposes due to the prohibitive nature of debt finance.

Palpable low levels of education among Zambian entrepreneurs present an inevitable lack of pertinent business management and accounting knowledge needed to efficiently and effectively run and grow thriving businesses. In remedying this situation, some organisations have tried to provide classroom based trainings. The problem is that the trainings are un-tailored and do not address idiosyncratic needs of each SME. Besides provision of financial services and products, SME tailored training (BDS) stands as a necessary ingredient in helping to amp the sectors level of GDP contribution.

Because micro-equity has the capacity to address both financial and BDS needs of SMEs, it presents a possible alternative to W&D AED’s intervention in Zambia. The opportunity for AED is in terms of meeting its objectives of job creation and poverty alleviation through sustainable partnerships brought about by the equity (interest) in the SMEs. The partnership instead of Lender/Borrower relationship has potential to reduce the burden of repayment deadlines while adding expertise and technological transfer and knowledge to the investee SME. The critical differences between micro equity and debt finance are presented below;

|  |  |
| --- | --- |
| Micro-equity | Debt Financing |
| Performance-based repayment | Strict (Fixed) repayment deadlines |
| No obligation for Interest payments | Interest payments obligation |
| Typically growth based (oriented) funding (strategic and operational leveraging) | Mainly operational leveraging |
| Shared risk + returns | Venture obliged to pay even when it fails |
| Coupled with BDS/TA | Typically without TA/BDS |
| SMEs focused/ Long-term | Micro-Enterprise focused/ Short term |
| Participation in decisions/voting rights | No participation in decisions |

Some important conclusions from the research include, but not limited to;

* Micro-equity presents an ideal avenue for W&D AED to implement its white paper policy approach of providing finance, BDS and facilitating chain organisations.
* BiD, IFC and other players on the market indicate that there exists potential and opportunity to make social profits and achieve desired impact.
* Transaction costs, due diligence costs and the ‘information’ issues, i.e. market information, credit histories, sectoral/industry risks can largely be overcome through partnerships and information disclosure between local market stakeholders.
* Adopting a local focus also aids in deal flows, due diligence, deal generation, legal aspects, and pre-investment appraisal.
* Creativity with financial product combinations (mezzanine or royalty model) helps reduce costs and eases exits.
* Micro-equity is not sector specific
* Most micro-equity funds are structured around the private equity and venture capital models, with much more emphasis on Impact/Mission Related/ Social Investing.
* IFC suggests that going regional and pooling resources by wide geographic outreach can lead to minimized transaction costs and eased fund management

To Chileleko & Bwembya for opening my eyes to a world of joy, happiness and smile,

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# Acronyms

**AED** Agri-Business and Enterprise Development

**BDO** Business Development Organization(s)

**BDS** Business Development Services

**BiD** Business in Development Network

**BP** Business Plan

**GDP**  Gross Domestic Product

**IFC** International Finance Corporation

**IPO** Initial Public Offering

**M&A** Mergers and Acquisitions

**MFIs** Micro Finance Institution(s)

**M (SMEs)**  Micro, Small and Medium Enterprise(s)

**NFS** Non-Financial Services

**S&P** Standard and Poor’s

**SEAF** Small Enterprise Assistance Fund

**SIDBI** Small Industries Development Bank of India

**SROI**  Social Return on Investment

**TA** Technical Assistance

**W&D** Woord en Daad

**W&D FS** Woord en Daad Financial Services

**ZATAC** Zambia Agribusiness Technical Assistance Centre

**ZDA** Zambia Development Agency

**ZW** Zambia Works

# 1.0 Introduction

Small and Medium Enterprises, formal and informal, form the backbone of a strong market economy[[1]](#footnote-1). This is chiefly because the sector employs a huge percentage of the labor force in most economies of the world. Studies on the macro‐economic effect of development programmes reveal that the dynamics in the economy depend on the small enterprise sector rather than the micro enterprise sector[[2]](#footnote-2). This social significance and economic role of SMEs is even more significant in emerging economies.

However, the potential of the SME sector in emerging economies has been undermined by a palpable lack of access to financial services. The stalled growth is evidenced by their paltry contribution to GDP. Even in cases where financial services are present, their offering has fallen short of stimulating growth in terms of employment, higher income levels, innovation, development of local markets and supply chains from the sector (Brau & Woller, 2004; Thorsten Beck, 2007).

Aside from the challenges of access to finance, SMEs also face growth needs that demand technical expertise, but are often poorly equipped or trained to start (grow) their business[[3]](#footnote-3). This trend beckons us to the reality that small enterprises require adequate training and assistance as much as they need capital[[4]](#footnote-4). It comes as a reminder that Private sector stimulation must also address non-financial services (integrated business support/development services (BDS) such as technical assistance, network development and training, education and governance) of the enterprises[[5]](#footnote-5).

The rise of Micro-finance[[6]](#footnote-6) successfully opened a new avenue to allow micro-enterprises to access financial services but has had a hard time translating the micro-enterprises into SMEs and making the desired impact. This is because Microfinance “oftentimes has more consumption substitution[[7]](#footnote-7) than investment growth effects on firm formation, sustainability, job creation, and scalability for long-run development impacts[[8]](#footnote-8).” Its focus on micro enterprises also means that the SMEs with most tangible contribution to economic growth and job creation[[9]](#footnote-9) have been unattended to. Other factors that have exacerbated Microfinance’s inability to help emerging market SMEs have been its growth taxing strict (Fixed) repayment deadlines and interest payments; its lack of management and/or governance capacity building (TA/BDS), its Short term nature, among others.

This has left hanging Small and Medium sized Enterprises that have proven too big for Micro-Financing Institutions (MFIs) and too small for traditional commercial banks. An SME group that has come to be referred to as the ‘missing middle’- financially unreached. Sanders and Wegener (2006) illustratively depict this financing gap in Figure 1Figure 1. The depiction indicates SME financing needs as ranging from $5,000 to $500,000.

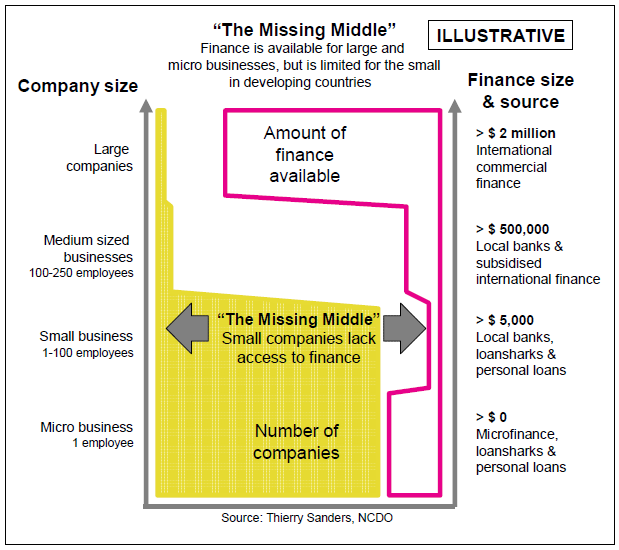


Figure 1:The Missing middle part of SMEs, Sanders and Wegener (2006)

Efforts must be made to overcome the challenges faced by the “missing middle” SMEs and those identified from the Micro financing experience. This will be necessary in increasing the social significance and economic role of SMEs in emerging economies. To achieve this, it will be important to creatively structure financial options that harbor the interests of the ‘middle middle’ with a focus on packaging financial and non-financial services (BDS).

In that regard, this research seeks to explore role of Micro-equity financing in Enterprise Development. Micro-equity financing is a non-asset-based funding to an SME in exchange for a minority share of the company. It is geared and tailored for entrepreneurs with growth needs in emerging economies by providing the finance as well as integrated business development services (earlier identified as technical assistance, network development and training, education and governance, among others). This is done in recognition of the fact that finance is as necessary as the capacity to manage it.

‘Micro-equity’ as defined in this paper will be referring to participations, ranging from US$20,000-US$300,000, in the so called ‘missing middle’ SMEs.

## 1.1. Background

### 1.1.1. Woord en Daad[[10]](#footnote-10)

Woord en Daad (W&D) is a Christian not-for-profit relief & development organization based in The Netherlands, legally established in 1973. It operates in three continents and currently 18 countries, namely;

* Latin America: Colombia, Guatemala, Haiti, Honduras, Nicaragua
* Asia: Bangladesh, the Philippines, India, Sri Lanka, Thailand
* Africa: Benin, Burkina Faso, Ethiopia, Sierra Leone, Chad, Uganda, Zambia and South Africa

W&D focuses on the following themes: education, vocational education and training, job mediation, enterprise development, basic facilities (health, agriculture, water) and emergency aid.

### 1.1.2 W&D AED Program[[11]](#footnote-11)

Agri-Business and Enterprise Development (AED) one of W&Ds program interventions in its quest to fight poverty from a Christian perspective. It is concerned with stimulation of economic development by providing access to credit and financial services, knowledge and networks for small and medium scale enterprises. The aim of W&D AED is to create income and employment opportunities and this way contribute to W&D overall mission of poverty alleviation. Its projects and programs are executed in emerging economies with business partners; Business Development Organizations (Non Governmental Organizations, Banks, Financial Institutions, Business Service Providers). The aim of these partnerships is to develop enterprises that empower different economic actors (suppliers, producers, buyers, traders, etc.) which stimulate economic growth and reduce poverty.

**1.1.2.1 Approach[[12]](#footnote-12):**

The AED program via its partners uses a three-fold approach for its interventions; Financial Services, Business Development Services and strengthening chain organizations.

* **Improve access to finance/ financial services**: W&D does this on the premise that to strengthen access to financial services the supply side needs to be strengthened.
* **Improve access to BDS and improve quality of those services:** W&D considers that finance without access to BDS reduces the impact and increase the risk of the services provided.
* **Strengthen Chain organization:** W&D considers thatinclusive growth and equal opportunities for development need additional efforts apart from assistance to individual enterprises. It also understands that impact can be realized if efforts take place to actively link enterprises at different aggregation level of value chains.

**1.1.2.2 Services with partners**: Funds under Management, Loans, Subsidies, Start up of Business Development Services, Expertise and now contemplating exploring Equity investments via a Dutch investment vehicle.

**1.1.2.3 Focus SMEs**: those having difficulties of access to financial resources due to insufficient collateral, informal operational practices operate from rented premises, among others; Enterprises in productive sectors (with potential multiplier effect): such as agribusiness, agro industry, manufacturing and tourism. Enterprises in value chains and/or interact often with small economic actors’ e.g. micro entrepreneurs, streets sellers etc.

**1.1.2.4 Desired Impact**: at SME level, impact is measured in terms of sales, profit and asset increase and for the final W&D target group, it is measured in terms of opportunities (jobs created, poverty alleviated and linkages facilitated)

**Some results**: From the start of the program in 2006, W&D has provided microloans to over 15,000 new micro entrepreneurs. Over 3600 persons have found a job through assistance to SME starting from 2007[[13]](#footnote-13).

### 1.1.3. Challenges from the current SMED Funds

About 7 years of micro-enterprise financing via partner organizations in Zambia, Nicaragua and Bangladesh, among others, seem to have presented W&D AED with some valuable experience. Chief of these are;

**1.1.3.1** **Lack of Business Management skills**: most entrepreneurs lack the necessary skills necessary for them to efficiently manage the finances and end up finding themselves in Cashflow planning and management problems, which increases the risk and rate of default. This lack of business skills makes it very hard for most micro-enterprises to develop into SMEs or create the desired impact in creating jobs and alleviating poverty

**1.1.3.2 Insufficient BDS**: Most BDS offered to emerging economy entrepreneurs is classroom based (group) training and does not address the specific needs and challenges needed to grow. Perhaps the BDS is done communally because tailored BDS in comparison to small (micro) loan amounts could be expensive.

**1.1.3.3 Mismatch between planning and implementation**: Most entrepreneurs are helped by BDOs in crafting their business plans without the entrepreneur fully understanding the market information and knowledge necessary for implementation. In reality the entrepreneur implements the business plan in isolation. This makes it very hard for the entrepreneur to realize the plans and ultimately increases the default risk.

**1.1.3.4 Lack of Strategic Vision**: developing a strategic vision and direction of an enterprise requires a great understanding of the market and a good deal of expertise. Most entrepreneurs lack this key aspect of business success. This means that most SMEs usually operate without a strategic vision, which makes it hard to make strategic steps aimed at strategic growth, hence, the stalled growth among SMEs.

## 1.2 Problem Statement

The challenges from current operations have left W&D AED with a need to respond in a way that should stimulate sustainable growth of their focus SMEs. The problem here becomes how to provide BDS (build capacity while providing finance)? And whether doing equity in an SME (micro-equity) can help solve the observed challenges and achieve desired impact.

1.2.1 Research objective: the main research objective, then, is to; Frame W&Ds micro-equity model aimed at alleviating poverty, stimulating competiveness and growth of the SME sector.

1.2.2 Research Focus (scope): In order to achieve clarity in defining problem variables, solutions and developing the model, the research will focus on Zambia. This is because Zambia is one of the countries in the AED program with an extensive program (apart from Nicaragua and Bangladesh) and has a huge rural setting for a large intervention (multiplier effect). Besides, there are plans, by W&D AED, to increase presence and portfolio with the AED Programs in Zambia.

### 1.2.3 Specific Research Questions:

1. Why is micro equity a good model and preferable above debt financing?

Taking into account, above all, the impact W&D would like to realize, the profitability of the business models of W&D as well as the growth and profitability of the SME clients.

1. What are the available micro-equity financing options (instruments)? What are the various models for micro-equity financing and their advantages/disadvantages?
2. How to structure deal flow, pre investment appraisal, deal structuring, due diligence, legal issues, mentoring and advice to investees, exit strategies and transaction costs of such an undertaking?
3. Would this work in certain sectors or not, would this work with certain class of entrepreneurs?
4. What are the experiences so far with micro equity? Who is offering it, how, why? (Do’s and don’ts, lessons learnt, best practices)
5. What could W&D do in this area, where and how? How does the proposed model deliver value for W&D?
6. How can W&D Business Platform get involved in the micro-equity business models of W&D?

1.3 Methodology: This research is descriptive in nature. The aim is to get insight into how other players on the market are doing it and taking stock of lessons. The lessons will be used to frame a micro-equity financing model for SMEs in Zambia.

It is mainly a desk research benefiting from W&D AED documented data and other similar published sources. It also benefits from personal interviews, discussions and email exchanges with the Netherlands based network of (social) investors and entrepreneurs-Business in Development (BiD), the Micro & Small Enterprises Division of the Zambia Development Agency and the W&D AED department.

Smart Draw VP will be used to generate necessary graphs, model(s), and diagrams.

1.3.1 Limitations: the research is not exclusive of limitations and the anticipated ones are;

* There’s no opportunity to test, in a practical setting, the workability of the model after it has been developed
* Limited scope of the research study. Although the hope is that lessons will be drawn for use in other similar W&D operations.

# 2.0 Landscape on Zambia (AED Program, Economic, SME Sector, Financial and BDS)

## 2.1 AED Program in Zambia

Figure 2: Map of Zambia

|  |  |  |  |
| --- | --- | --- | --- |
| Province | Partner |  | Services |
| Eastern, Northern, Lusaka Provinces | Zambia Agribusiness Technical Assistance Centre (ZATAC) |  | Loans to agro processing SME’s and SME’s active in rural areas/sourcing from rural areas. BDS and CO services for portfolio SME’s |
| Western Province | Zambia Works |  | Micro-credit and extension services to famers |

Table 1:AED Program landscape in Zambia

**2.1.1 ZATAC Ltd[[14]](#footnote-14)**: is a legally registered, independent non-profit organization providing agribusiness project management services in Zambia. Its mission is to assist commercialize and diversify smallholder production, processing and trade in Zambia. It plays an important role in providing financial and non-financial services to small and medium enterprises and thereby catalyses employment in the rural areas of Zambia. The collaboration with W&D is to support Small and Medium Enterprises in tourism, natural resource products and agriculture via the SMED Fund.

**2.1.2 Zambia Works**: is a not for profit Company operating in the Western Province of Zambia. Its aim is to assist local communities in the generation of income. Operating in a predominantly agricultural country, Zambia Works is focusing on vegetable farming (partly under irrigation through treadle pumps), poultry, animal feed processing and has recently started a small cashew processing company. The collaboration with W&D is to support Zambia works in meeting the income generating needs of the local community they operate in.

2.2 Economic landscape**[[15]](#footnote-15)**

In the period 2005-2010, Zambia’s major macro-economic variables suggest a very stable and resilient economic growth economy as indicated by an average growth rate of 6.2% (See Table 2[[16]](#footnote-16),). This is mainly due to an improved macroeconomic environment, strong copper prices and increased production and activities in key economic sectors[[17]](#footnote-17). From a political stand point, Zambia boasts a history of no conflict and not much changes in political ideologies. In 2011, Zambia managed to get a sovereign credit rating of B+ with a stable outlook, from Fitch rating[[18]](#footnote-18)and S&P. This positive outlook provides a very good basis for improved investment from the International community.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
| Real GDP Growth (End year %) | 5.3 | 6.2 | 6.2 | 5.7 | 6.4 | 7.6 |
| GDP per capita (end year US$) | 654 | 908.1 | 949.0 | 1174.0 | 1058.6 | 1152.0 |
| Annual Inflation end period (%) | 15.9 | 8.2 | 8.9 | 16.6 | 9.9 | 7.9 |

Table 2: Major Macro-economic Indicators 2005-2010, Bank of Zambia , 27th May, 2011

Notwithstanding the aforesaid, Zambia still continues to face the problem of lack of diversification and incentives for other economic activities other than Mining. Minerals continue to be the largest export and hard currency earner, with copper and ancillary products comprising about 70% of total exports[[19]](#footnote-19). On the contrary, the mineral sector accounts for a paltry 2% percent of employment and its industry. This makes the economy vulnerable to copper prices while rising imports and the repatriation of mining profits could weaken the current account[[20]](#footnote-20).

Zambia, like most emerging economies, suffers from the paradox of Agriculture being the largest employer but making the least contribution to GDP. This is illustrated by Figure 3 and Figure 4. Figure 3 indicates that 88% of the work-force in Zambia is employed by the informal sector, of which 62% are in informal agriculture activities and 26% in informal services. Figure 4 on the other indicates that Agriculture has the least GDP contribution. These statistics present the need to stimulate the largest employer, Agricultural sector, for an expanded reach.

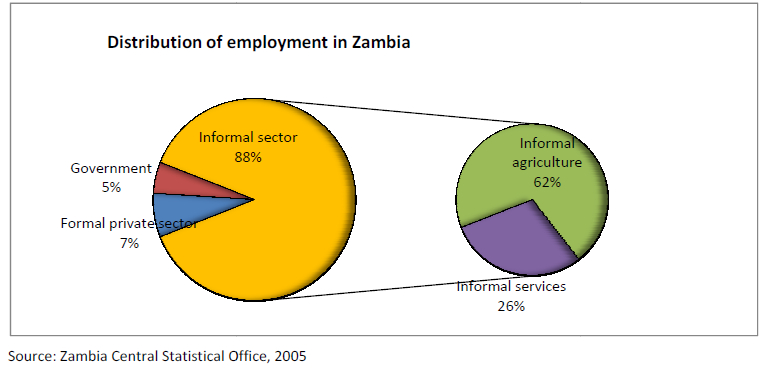


Figure 3: Distribution of employment in Zambia

Figure 4: Composition of GDP by Sector

## 2.2.1 Distribution of Zambian SMEs

The majority of Zambian SMEs are tiny, microenterprises – that are mostly informal, owner-operated businesses[[21]](#footnote-21). Most have no paid employees and are more like home-based, income-generating activities than clearly structured businesses.

SMEs follow the same trend as that highlighted by the general economic landscape. They are the biggest employer, 88% of the labor force[[22]](#footnote-22) work for informal enterprise with less than 5 employees yet they still have the least GDP contribution. Reasons for this SME outlook are, inter alia, lack of hard infrastructure (transport, energy, water) and soft infrastructure (Financial services and education)[[23]](#footnote-23). Figure 5 indicates that a 70% portion is occupied by MSMEs engaged with Agriculture activities.

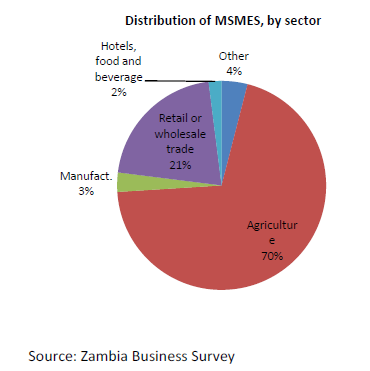


Figure 5: Distribution of MSMEs by Sector

**2.2.2 Possible Opportunity**: the economic and SME landscape indicate that agriculture is by far the biggest employer yet constrained in terms of its contribution to economic growth. This picture suggests that if the goal of increasing the social and economic significance of SMEs is to be achieved, Agri-business presents a great opportunity. This is because most Zambian SMEs are located in rural areas (81%), and are involved in agricultural production (70%) or wholesale/retail trade (21%).

## 2.3 Financial landscape

**2.3.1 Access to finance:** Access to financial services and bank credit is a serious constraint on MSME performance in Zambia[[24]](#footnote-24). Findings from the ZBS 2010 show that access to finance is perceived by more than 20% of MSMEs as a “very severe obstacle” to the current operations of the business, while a further 29% rate it as a “major obstacle”. This concern is not only echoed by SMEs but also by large enterprises who similarly rate access to and cost of, finance as serious obstacles to doing business in Zambia. The reasons given for this situation were;

* The prohibitive nature of most loans given by MFIs,
* The fixed payment obligations and
* High interest rates due to perceived risk of the target group

**2.3.1.1 Micro-finance**: The MFI sector in Zambia emerged in the 1990’s following the financial sector reforms[[25]](#footnote-25) that came with the shift to a free market economy. Although the sector has continued to grow, from 4 MFIs in 2005 to 25 in 2009[[26]](#footnote-26), the range of financial products offered is very narrow and focuses mostly on credit services[[27]](#footnote-27). Most of the MFIs operate along the line of rail providing mainly salary-backed loans[[28]](#footnote-28). The fact that most operate along the line of rail and on salary backed loans means a great financial exclusion of “missing middle” SMEs. In a FinScope report[[29]](#footnote-29), the access frontier for a loan from a microfinance institution indicates a very low accessibility (18%) of loans by business owners as depicted in Figure 6.

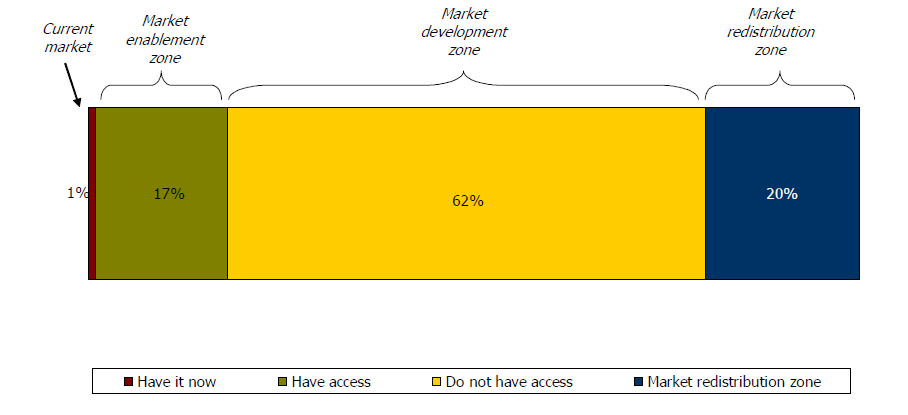
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Figure 6: Access frontier for a MFI loan – business owners

From email exchanges with the Director of SMEs division in the Zambia Development Agency, there seems to be very limited supply of SME tailored finance as only three arrangements were pinpointed, namely;

* The W&D funded Loan facilities under ZATAC and Zambia Works.
* An SME facility designed to finance growth oriented entrepreneurs in five key sectors namely; Agro-processing, Construction, Manufacturing, Tourism, by African Development Bank in collaboration with Zambian National Commercial Bank (ZANACO) and Investrust Bank.
* Advanced discussions for a possible collaboration for setting up the Zambia Enterprise Development Fund, between ZDA and the Development Bank of Zambia (MoU already in place). The intended purpose of this arrangement is promoting economic growth, employment, income generation and wealth creation and is committed to addressing financial market failure with respect to SME’s low access to appropriately priced and structured financial services. The fund will make available seed capital and technical know-how to the entrepreneur.

2.4 Business Development Services**:**

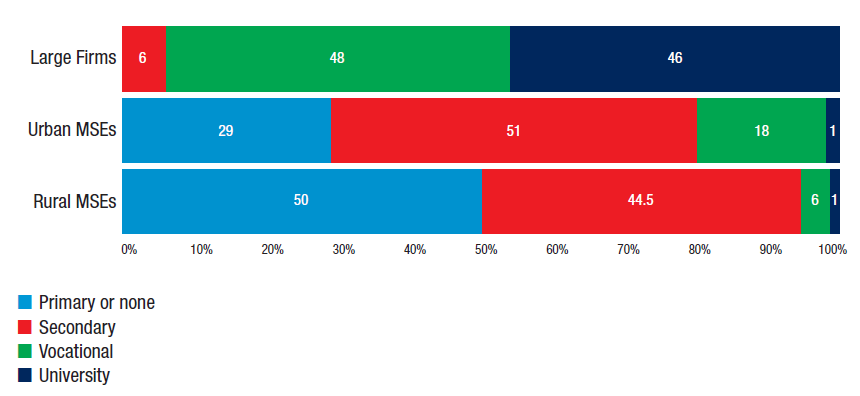
Low levels of education and business knowledge, as presented in Figure 7, among the entrepreneurs in Zambian SMEs means a lack of better business and financial management and a lower propensity to adopt technology such as irrigation or cellphone based financial services[[30]](#footnote-30). Findings from the ZBS 2010 indicate that almost 73% of MSMEs would be prevented from accessing loans because they do not keep adequate business records.

Figure 7: Highest education level reached by entrepreneur/top manager: percentage of firms, ZBS, 2010.

The findings further indicate that SMEs with better educated owners are more productive than other MSMEs in both the agricultural and non-agricultural sectors[[31]](#footnote-31). In the face of such truths tailored BDS instead of communal and classroom based trainings must be encouraged. This is because the current form of BDS does not address the specific needs of the entrepreneur as they relate to his business. Doing this will help SME owners to keep business records, identify more profitable lines of business, develop business plans, and to improve general business administration. It will also allow them to increase productivity and make it easier for them to access the more traditional financial services. When this is done, the objectives of both W&D and the SME would have been met.

**2.4.1 Possible opportunity**: looking at Zambia’s finance and BDS landscape, there’s a great need and therefore opportunity for SME financing that will eliminate the challenges identified from the MFI interventions as well as bridge the knowledge gap and expertise needed to run the SMEs.

# 3.0 What is needed to generate Impact?

The management of small enterprises requires adequate training and assistance as much as it needs capital[[32]](#footnote-32). This entails that interventions to help SMEs must not only offer affordable and sustainable finance but also strong business development services. Malhotra et al[[33]](#footnote-33) puts this assertion in perspective when they echo that, “Regardless of evidence that lack of access to finance constrains many MSMEs, actual effective (or bankable) demand may itself be constrained by weaknesses in firm management and the dossiers their management can present when applying for credit”.

Therefore, in order to generate the desired impact, all efforts must address both financial and management needs in ways that minimize the current challenges in SME finance. This will involve;

* **Focusing on growing micro-enterprises into SME**: in order to increase the social and economic significance of the SMEs, focus must be on turning micro-enterprises into growth-oriented SMEs. It is when micro-enterprises become medium-sized that growth-oriented SMEs make their most tangible contribution to economic growth and job creation[[34]](#footnote-34). As you’ll see from the other three reasons below, it is very hard to achieve using micro-finance.
* **Establish flexible repayment schedules for SMEs**: the way micro-credit/lending is offered places a huge burden of repayment and interest on the entrepreneur. These fixed deadlines from MFIs become too taxing on a SMEs ability to leverage its growth.
* **Long-term instead of short-term funding**: with growth needs, an SME’s focus becomes capital investment which is very hard to achieve short cycles of small amounts/funding. This is because the SME needs some more time before they can fully grow after a capital injection.
* **Capacity building (technical assistance)**: the trends presented on Zambia in terms of BDS and level of knowledge among entrepreneurs call for an approach that encompasses capacity building. This is because MFIs only offer the entrepreneurs monies and expect them to pay it back

# 4.0 Micro-Equity finance as a possible remedy

Micro-equity finance[[35]](#footnote-35) is a non-asset-based funding to an SME in exchange for a minority share of the company. It is an investing approach that is geared and tailored for entrepreneurs with growth needs in emerging economies. It addresses the financial and business management challenges faced by SMEs by providing finance as well as integrated business development services (technical assistance, network development and training, education and governance, among others). It is based on shared risk and shared rewards with the SME/entrepreneur. This allows the investor the opportunity to collaborate as a partner who shares in the firm’s challenges as well as the triumphs. It allows the investor to participate in decisions and be able to contribute to the strategic growth of the SME.

It has the over-arching goal of societal gains through the development of strong and sustainable local businesses that eventually lead to creation of employment and stimulate competitiveness of the local SME Sector[[36]](#footnote-36). This is achieved by the resulting increment in employment, higher income levels, innovation, and development of local markets and supply chains from the sector. The approach comes in the wake that micro-finance is only but a limited intervention especially in terms of delivering sustainable development and eliminating poverty[[37]](#footnote-37).

## 4.1 Possible micro-equity target SMEs

* Enterprises focused on production issues, without planning and control of the rest of the functional areas,
* Enterprises needing financial interventions for expansion at survival and consolidation stage of their business model but having difficulties of access to financial resources due to insufficient collateral
* Enterprises that have capacity for fast growth and scalable and replicable business model
* Enterprises with other employees besides the owners family members but low-skilled to generate innovation and competitiveness
* Enterprises in the following sectors; agriculture, agro industry, manufacturing or tourism, prioritized on the premise that these are sectors with potential multiplier effect.
* Enterprises that interact often with small economic actors’ e.g. micro entrepreneurs, streets sellers etc.
* Enterprises that are willing to implement new ways of management, including opening the enterprise for additional capital or debt.

## 4.2 Possible Benefits from Micro-Equity for W&D (in meeting objectives)

**4.2.1 Early warnings of default**: the investor’s engagement in management means early benchmarks and reduced risk. It also gives an opportunity, among others, to remedy possible defaults in the early stage.

**4.2.2 Partnership vs. strained Borrower/Lender Relationship**: In reiterating the core benefit of micro equity Ayayi[[38]](#footnote-38) asserts that, “By becoming a stakeholder in the venture rather than a lender, the micro-equity provider is in a more tightly coupled relationship, providing knowledge and guidance necessary for ensuring success of the venture…access to knowledge is essential for success.” The interest in the success of the company allows the investor to serve in an advisory role.

**4.2.3 Voting Rights and Participation in decisions**: The equity stake as a minority shareholder will give the investor a vote on the board and an opportunity to participate in decisions. This gives W&D a chance to contribute to the strategic Vision and growth of the SME. Ultimately, the investee SME blossoms to the advantage of W&Ds objectives too.

**4.2.4 Reduced debt repayment burden:** Unlike debt (micro) finance which places a burden of repayment and interest on the entrepreneur, equity capital entails relinquishing some degree of ownership and control on the part of the entrepreneur[[39]](#footnote-39). Equity finance investors do not usually have a legal right to charge interest or to be paid at a particular date. This allows a lot of room for the business to operate comfortably without Cashflow worries due to pressures of repayment deadlines[[40]](#footnote-40). In such circumstances, it becomes relatively easy for the SME to grow and create employment while increasing local income to reduce poverty (meeting the investor’s objective).

**4.2.5 Strengthen Financial Position (Equity boost):** Equity and most quasi-equity instruments come as unsecured loans, meaning that no collateral is posted so that the new loan appears as increased equity in the company. The equity boost makes the SMEs bankable to traditional sources of finance. When this happens the SME can leverage debt and equity for productive growth activities that creates employment and increases income for the locals. This also meets W&Ds objective of employment creation and poverty alleviation.

**4.2.6 Performance based repayments (Injections)**: both the investors return (in sales royalties, dividends) and the capital injection in the SME are paid on performance basis i.e. growth and profitability of the business. This stimulates the SME to more growth while at the same time increasing the investor’s returns. Injecting capital into the SME based on the current needs of the SME can, to a great extent, reduce the risk associated with SME investment.

**4.2.7 Long-term engagement**: Unlike Debt finance which is usually short term, Equity and quasi-equity instruments are invested over a long-term period. This patient, non-asset-based capital, helps facilitates the expansion of innovative and expanding companies[[41]](#footnote-41). This is especially useful because most SMEs need the money for capital investment in technology. The realization of returns may take time but usually well paying when all is settled and the machinery is up and running. This element of micro-equity facilitates SME growth along with meeting W&D AED’s objectives of facilitating an enhanced private sector in emerging economies.

**4.2.8 Shared risk and returns**: As a partner instead of the lender, an equity investor will more easily share in the returns as much as the risks (losses). Shared risk results from equity being the last source of finance to be repaid out of any residual assets in the event that the business fails. Shared return results from a successful business venture paying more in royalties, dividends and more return on the owners initial investment (capital gain).

**4.2.9 More likely to create employment and reduce poverty**: as noted earlier, most MFIs in Zambia are into salary backed loans (credit) along the line of rail. To create employment in such circumstances becomes very hard. Besides, the few other micro-finance funded entrepreneurs are usually engaged in the same businesses and concentrated in the same place. This makes the competition among themselves and their repayment even harder. Karnani (2007)[[42]](#footnote-42) points out that, “we are overly estimating the level of entrepreneurship in emerging economies” by supporting many micro-enterprises that have no growth aspects or ambition to grow into SMEs. He backs his argument by stating that in developed countries only 10% of the possible work force is engaged in entrepreneurship. Most entrepreneurs would be willing to quit their business to go work in a factory for a more stable and steady income flow.

Support of SMEs via micro-equity will more likely create more employment and incorporate the small entrepreneurs ready to give up their businesses for a more stable income flow.

**4.2.10 Incorporates Training (BDS):** Training allows for reduced risk on the investment. This is because it capacitates the entrepreneur to manage their enterprise well and diligently. It is especially when helpful when tailored according to the needs of the SME. A research carried out by Kessy and Temu (2010)[[43]](#footnote-43) to assess impact of training on performance of MSMEs found that entrepreneurs/enterprises that were trained exhibited a growth in sales revenue, firm’s asset value and employee numbers. The assertion reiterates the fact that business skills training is salient for firms performance, growth and improved owners living standards. The addition of BDS to financial access in micro-equity ultimately provides greater impact in meeting the poverty alleviation objective on the part of W&D AED.

4.3 Possible micro-equity challenges**,**[[44]](#footnote-44)**,**[[45]](#footnote-45)

Micro-equity financing is however not without its own challenges. Listed here are some of the anticipated challenges;

1. Low potential for IPOs, M&A, and trade sales due to the illiquidity of the SME equity market.
2. Difficulty in monitoring performance.
3. Requires investment banking talents which are not readily available for smaller, higher-risk funds.
4. high transaction and due diligence costs,
5. political and currency risks,
6. difficulties identifying suitable targets for financing,
7. Legal and regulatory concerns,
8. A heavy dose of 'entrepreneurial support' and donor funds are needed, as is a financially seasoned NGO to run the funds on behalf of private investors.

## 4.4 Possible solutions to the challenges

Research indicates that most of the challenges can be addressed through pooling of local efforts, creativity with financial instruments, among others. Below are some of the possible solutions to the above challenges;

**4.4.1 Low potential for IPOs, M&A, and trade sales due to the illiquidity of the SME equity market**: It is always prudent to never do pure equity in a small company to so as to allow for proper exits, especially in the face of not fully developed capital markets[[46]](#footnote-46). In this regard, a possible solution is creativity when structuring financial instruments. The financial instruments must be structured in such a way that there’s an exit option from the on set[[47]](#footnote-47). In a small company, this can be achieved through quasi-equity instruments (part debt, part equity) [[48]](#footnote-48) e.g. Mezzanine and the shareholder loan model.

**4.4.2 Difficulty in monitoring performance**: Research indicates that Private equity (a means through which most micro-equity interventions are undertaken) is a very local business. IFC[[49]](#footnote-49) emphasize that the way to risk mitigation can be achieved through leveraging of local talent and local mechanisms. BiD Network equally emphasized as a do; that you need to support, monitor and constantly keep in touch with Entrepreneur,. This is easily done when you have someone around locally to be able to visit the company often for support and as a means of monitoring performance.

**4.4.3 Requires investment banking talents which are not readily available for smaller, higher-risk funds**: attracting quality executives to investee companies requires sufficient trust and belief in the General Partner (ZATAC/ZW in this case) for local executives to leave safe and prestigious positions[[50]](#footnote-50).

**4.4.4 High transaction and due diligence costs**: From BiD’s perspective, the costs are largely dependent on the size of the participation. They assert that;

*It may in some cases make financial sense to do no or little due diligence at all. This situation arises once there is better insight into SME risk and bankruptcy. If for example SME failure rate is 40%, but the total sum of due diligence costs is greater or equal to 40% of the invested amounts, it is wiser to invest the money in the SME and support services rather than spend it on consultants and accountants investment to do due diligence, its better to invest the money with very basic due diligence[[51]](#footnote-51).*

IFC also contends another very local approach by saying that “adequate due diligence depends on an intimate knowledge of local accounting, governance and regulatory quirks”. The local approach is more likely to reduce the burden of having to spend too much money during the transactions. This is only possible when there’s a high level of trust in the local partner and management of the portfolio.

Tailored financial product combinations, as earlier noted, can add a lot of value in terms of risk abatement, hedging of business environment characteristics and reinforcing financial product effectiveness[[52]](#footnote-52).

**4.4.5 Political and currency risks**: Zambia boasts of a very stable political environment as well as a quite stable kwacha. Besides the stable environment n Zambia, IFCs experience indicates that investors tend to focus on macro and political risks and legal system and governance issues, ultimately concluding the risks are high. They forget that there are benefits at the operating level in private equity in emerging markets worth consideration for a more informed picture of the risks.

**4.4.5.1 Risk mitigants at the operational level:** from its experience with private equity venturesIFC identifies four key risk mitigants at the operational level[[53]](#footnote-53);

**4.4.5.1.1 Downward trending risk**- brought about by;

* 1. the emergence of local private equity capacity across a wide range of countries,
  2. the longer experience of private equity and associated longer track records, and
  3. Strong domestic growth permitting private equity firms to invest primarily in companies linked to domestic demand rather than export.

**4.4.5.1.2 Focus on Domestic Growth**: brought about by a growth-off-a-constrained-base which creates domestic momentum somewhat insulated from global macro trends.

**4.4.5.1.3 Low leverage:** in emerging economies the focus of micro-equity is based upon growth, not financial gearing. This growth is what leads to development which is manifested usually in sales growth, employment, among others.

**4.4.5.1.4 Relatively less competition for transactions**: mainly because emerging markets remain relatively under-penetrated compared to the statistics in developed markets.

**4.4.6 Difficulties identifying suitable targets for financing (Deal flow/generation):** BiD[[54]](#footnote-54) suggest that a well publicized Business Plan Competition with well outlined purpose (and/or criteria) is a very helpful deal generation tool. This can be done via an (online) executive summary that highlights main components to avoid dealing with too many low quality business plans. In such cases it’s also very helpful to work with banks, SME Banks and MFI’s so that they may complement or give leads to clients whom you can serve for Equity, who already have a track record with these institutions. But this is usually helpful if they perceive your efforts as complementary and not as competition.

**4.4.7 Legal and regulatory concerns**: The Zambian government has been advocating a pro-investment agenda and has tried to make the investment climate as private sector oriented as possible. Nevertheless, IFC experience again shows that this is another problem in which local focus can be very handy.

**4.4.8 A heavy dose of 'entrepreneurial support' and Donor funds are needed, as is a financially seasoned NGO to run the funds on behalf of private investors**: the critical debate against micro-equity is that transaction costs may soar due to a heavy dose of technical expertise. However, research indicates that ***standardizing the business training tools*** can help a great deal in reducing the transactions costs associated with micro-equity as Wood, Pratt and Hoff (2006)[[55]](#footnote-55) assert;

*Opportunities exist especially in the standardization of business training tools, where technical assistance in support of SME financing has the potential to be standardized through collaborative action among capital aggregators, investors, and other interested parties, reducing the transaction costs for individual deals. Similarly, pipeline development for various forms of sustainable development may best be performed by specialized organizations who receive public or philanthropic subsidy.*

It seems clear that there’s need for donor money for a tailored SME equity investment as Glenn Yago[[56]](#footnote-56), points out that,

*Equity investments in SMEs in emerging markets have* ***not*** *proven to be commercially viable on a large scale without donor money of some form.**Key funds are either**fully or partially funded by:**a governmental organization (e.g. Swedfund); an international organization (e.g. SEAF)****;*** *a state bank (e.g. SIDBI Venture Capital Limited)**or a combination of the above entities.*

# 5.0 How to do equity

This chapter will address the specific research questions that have not yet been attended to in the previous section. It will delve into how equity can be undertaken and what financial options can be used, including their advantages and flops. It will also scan a few market players and their approach to this type of financing.

## 5.1 Investment Process

Investment in emerging economy SMEs, in Zambia, requires expertise and experience to analyze the terms of the often times complicated business transactions. This is especially hard because the decision has to be made on limited collateral and inadequate financial information. To adequately appraise the investment may require an in-depth knowledge of not only the local market but the local financial regulations/requirements, tax obligations/incentives, development policy, legal implications, among others.

The best possible way possible would be to have a much more local focus and orientation. This is the advice that IFC gives from their experience with private equity in emerging economies. They advise that;

*The way to risk mitigation on the operating level during due diligence is through leveraging of* ***local talent*** *and* ***local mechanisms****. Access to transactions requires the* ***right local connections*** *to build trust and credibility with company owners; adequate due diligence depends on an intimate knowledge of* ***local accounting****,* ***governance*** *and* ***regulatory quirks****; attracting quality executives to investee companies requires sufficient trust and belief in the General Partner for local executives to leave safe and prestigious positions; and, finally, local knowledge helps to obtain the best access to limited local debt finance[[57]](#footnote-57) to be used to leverage further growth prospects after the SMEs equity side of the Balance sheet has been boosted. A typical due diligence process will include, among others*;

5.1.1 Possible (Detailed) investment Process and Actions: W&D can via ZATAC/ZW publicize the BP Competitions and issue the pre-drafted executive summary to interested entrepreneurs. After this process, possible candidates can be shortlisted together with those graduates (from micro-enterprise loans) for general but detailed free BDS services. The candidates can then go and work out their business plans for pitching at the competition. After this, W&D AED via its local investment vehicle can then commence their investment process. Figure 8 shows a possible investment process;



Figure 8: Possible investment process for W&D AED, adapted from Terra Nex’s[[58]](#footnote-58) process

## **5.2 Deal Structuring (Possible financing options)**:

Tailoring financial products to serve companies with unique financing needs…can add a lot of value in terms of risk abatement, hedging of business environment characteristics and reinforcing financial product effectiveness[[59]](#footnote-59). It is especially helpful to bear in mind that full equity in an emerging markets can face the challenge of financial illiquidity[[60]](#footnote-60). Milken Institute[[61]](#footnote-61) in their 2009 financial lab report echoes the same sentiments by saying that;

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

With this in mind, we shall explore two possible quasi-equity (part debt, part equity) financial instruments that W&D AED can use to finance Zambian SMEs, namely; Mezzanine finance and Shareholder loan model.

5.2.1 Mezzanine**:** mezzanine capital[[62]](#footnote-62) is a form of financing that is part debt and part equity. It is provided to a company that cannot borrow from the traditional banks, and has a repayment profile often back-ended over a 5 to 7 year period.

Incorporated in its structure are equity-based options, such as warrants. It has a lower-priority debt to provide flexible long term capital for use in buy-outs or growth financings.

Mezzanine instruments and products offer a risk/return profile that lies above that of debt and below that of equity.

In a broader sense, mezzanine debt may take the form of convertible preferred debt, junior debt, subordinated debt, private "mezzanine" securities (debt with warrants or preferred equity), second lien debt, and is sometimes referred to as quasi-equity[[63]](#footnote-63).

Mezzanine financing usually gives the lender the right to either ownership of the company or an equity interest in the company if the loan is not repaid[[64]](#footnote-64).

Its performance-related fees and partial participation in losses allows enterprises to durably increase their equity ratio. This makes the SMEs eligible for traditional forms of finance.

**5.2.1.1 Possible advantages for W&D AED [[65]](#footnote-65)**

* The SME will gain capital and increase their leverage for growth prospects. The implication being that the W&D AED put its capital to use at an attractive rate while achieving its social objectives.
* The SME receives less rigid terms when compared to ordinary lending (debt) allowing for more growth, more economic and social contribution to the advantage of W&D AEDs objectives.
* Reduced weighted average cost of capital (WACC) for the SME which increases its ability to finance assets and its return on equity (ROE).
* Flexible exit route in undeveloped emerging markets through an MBO on the part of W&D AED.
* Long-term nature allows for leveraging growth that increases impact desired by W&D AED
* Board participation entails participation in decisions and availability of technical expertise/assistance for SME.

**5.2.1.2 Possible disadvantages[[66]](#footnote-66)**

1. Most entrepreneurs are in business because they love their independence. Therefore, not all business owners may be willing to relinquish some measure of control, give seat on the board or allow an outsider significant abilities to take decisive action if the SME does not perform well.
2. When without board or active participation, it may include restrictive covenants due to investor’s marginal or no direct security interest in the assets of the borrower. This may almost be like the usual funding (without BDS to it)
3. Resistance from entrepreneurs because of restrictions in how they spend their money in certain areas, such as compensation of important personnel, with pay cuts affecting themselves and/or a limit on dividend payouts.
4. Can be more expensive than traditional or senior debt arrangements.
5. Can be a lengthy process as most deals are estimated to take at least three months to arrange and sometimes twice that long to complete.

5.2.2 Shareholder Loan Model: The shareholder loan model[[67]](#footnote-67) incorporates royalty based financing with equity finance benefits but *usually* without dividends. This is chiefly because of the compensation from royalties (a claim on sales based on performance). Royalty finance is an equity investment in future sales of a product with a less formal process than angel or venture capital investing[[68]](#footnote-68).

**5.2.2.1 Framework of the model**: To allow us to get an in-depth outlook on how the model is structured, we shall look at an example of the details of the model as expounded by Tom Gibson[[69]](#footnote-69) and Scherer et al[[70]](#footnote-70). Care must be taken to note that the model figures are merely a framework and can be changed depending on investor needs (as well as type of SMEs):

* **Equity**: Minimum 26%, maximum 49% ownership, no dividends paid, and tag-along/drag-along rights.
* **Loan term**: over a 3 - 6 years period
* **Interest Rate***:* below “prime”, no greater than prime.
* **Royalty**:1-5% and based on greater of projected or actual sales (performance based).
* **Collateral Requirement***:* 25% in pledges of business andpersonal assets pledges, plus pledge of shares,but no requirement for 100% coverage.

**5.2.2.2 Strategic elements of the Model[[71]](#footnote-71)**:

To help us understand the strategic elements of the model, Scherer et al, give an example of the model in a fund set up. Here is Figure 9 indicating the investment example and below are the fundamental elements identified from the model;



Figure 9: Example of the shareholder loan model in practice

It is designed for the typical SME expansion situation in which the investee’s pre-investment equity is considerably less than the amount of required expansion financing. The investment is for 33% of shares while exposing only 20% of its money in equity.

1. The fund is a full partner in the business, generally with a seat on the investee’s board, and holds an amount of shares surpassing the usual threshold of 26% often needed to block decisions requiring a super-majority of votes.
2. The investment is essentially “self-liquidating,” as opposed to requiring liquidation of the investment by sale to a third party. The Fund’s up-side is being paid throughout the life of the investment through the payments of royalties rather than waiting four to six years for an uncertain exit through a trade or financial sale.
3. The nominal repurchase price of the equity is sufficiently low for the entrepreneur to be able to repurchase the Fund’s shares at an amount which is likely to be available through a combination of personal funds and distributable earnings of the business.

**5.2.2.3 Possible advantages of the model**

Gibson (2007) and Scherer et al (2009) further present the advantages of this model as below;

1. 80% exposure in debt means less risk (because you invest in equity 20% and the rest in debt).
2. Less pressure on exits means more easily managed by local talent (most often local bankers who are “tinkerers”).
3. Current income from interest and royalties means early benchmarks, reduced risk.
4. Current income means investments easier to monitor by management.
5. Current income means projections more firm and portfolio easier to monitor by investors.
6. Less pressure on exits means more time on portfolio Investees.
7. Eliminates argument over earnings.

**5.2.2.4 Possible disadvantages**

1. Has a huge component of debt in contribution than the equity, which may bring up the challenges faced by the current forms of funding.
2. More emphasis is placed on leveraging of finance than on improving the business skills of the entrepreneur, transfer of technological know-how and expertise through active participation in investee SME.

## 5.3 Micro-equity Market Landscape

In an effort to draw lessons for W&D AED’s possible micro-equity implementation, we shall take a landscape view of how other organizations are implementing their micro-equity programs. Based on the research needs, focus and questions, parameters[[72]](#footnote-72) of interest have been developed as a point of reference. The framework has been presented in table 5.0 and the lessons from the market landscape presented in section 5.5.

**5.3.1 Specific Case Study (Detailed) on Grofin[[73]](#footnote-73)**

GroFin presents a classic example of financing that includes BDS in SME interventions as their mantra indicates in Figure 10. Key to its approach is the focus on entrepreneurial ability to efficiently manage the business and the ability of the business to generate positive cash flows. However, it has been separated from Table 3 because it has many SME sub-funds in various countries under the Titles Aspire followed by country (i.e. Kenya, Nigeria, Rwanda, South Africa, Tanzania, and Uganda).

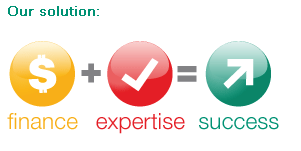


Figure 10: GroFin’s Mantra

It is a leading multi-national ***financier*** and ***advisor*** to small and medium enterprises (SMEs). It has been engaged in growth finance since 2004 and invests in future value and potential of entrepreneurs who own businesses at any stage of development (from start-up through growth to expansions), and across all sectors (except primary agriculture).

GroFin's business model combines financing with business mentoring, mainly targeting high risk under-served start-ups (registered) and early-stage (registered) SMEs with funding ranging from a minimum of $50,000 and maximum of $1m. When selecting entrepreneurs to fund it looks for integrity, drive and a vision for the business. GroFin gives early-stage ***ongoing business support*** and ***expertise***, a relationship that may not be possible with the traditional forms of banking. This kind of approach in turn facilitates the transfer of knowledge in areas of planning and cash-flow analysis, skills that are lacking in SMEs.

**5.3.2 General market landscape**

In Table 3 we take a look at the general outlook of the market. The organisations are selected based on criteria as set out in appendix A.

**Key to Abbreviations in the Table:**

\*Venture Capital/Private Equity

\*\*Non-Financial Services/Financial Services

\*\*\*Triple Bottom Line Accounting

\*\*\*\*Foundation

\*\*\*\*\*Assets under Management

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Type** | **Region** | **Interventions** | **Sector (s)** | **Investment range** | **Target SMEs** | **Type of Finance** | **Sources** | **\*\*\*\*\*AuM** | **Criteria** | **Impact** | **ROI (%)** |
| Aavishkaar[[74]](#footnote-74) | \*VC/PE | Asia | \*\*NFS/FS | Agric & Food... | 20K-500K (USD) | Young SME | Equity, Debt, Mix | Private Investors | 6.000K (USD) | Env. & Social | \*\*\*TBL | 12-18 |
| Agelos[[75]](#footnote-75) | F | Africa, Asia,  Latin-  America | NFS/FS | Many | 50K-500K  (EURO) | Early stage | Equity, Debt, Mix | Agelos Foundation | - | Env. & Social | Other | 5 |
| Agora[[76]](#footnote-76) | VC/PE | Latin-America | NFS/FS | Agric & Food... | 25K-250K  (USD) | Start up, Young, SME | Equity, Debt, Mix | USAID, Argidius  DOEN  Private Individuals | Target 2.000K | Env. & Social | TBL | - |
| EcoEnterprises Fund[[77]](#footnote-77) | VC/PE | Latin-America | NFS/FS | Agric & Food and Tourism | 50K-780K  (USD) | Young, SME | Equity, Debt, Mix | TNC, IDB, CAF, Individulas | 52.000K | Env. & Social | TBL | 18 |

Table 3: Selected organizations offering Micro-equity to SMEs in Africa, Asia and Latin America

## 5.4 Investment Vehicle and its possible structure

Evidence observed from the market landscape section seems to suggest that most participation from organizations like W&D are done through specialized investment (social) funds or for-profit but socially driven businesses.

On the part of W&D, this can be done by setting up a 100% W&D Dutch investment vehicle or a corporate entity that sets up locally managed private equity fund in Zambia (and perhaps other countries). The shareholding can be among the Country partner, W&D AED ltd[[78]](#footnote-78) and the W&D business platform[[79]](#footnote-79), in the ratio 10%, 70% and 20% respectively. The fund can be managed by ZATAC/ZW who will be motivated to do a good job since they are part of the fund that shall invest in investee SMEs.

When this fund is localized it means that there shall be minimized due diligence costs and worries of understanding the politics and legal issues are almost taken care of. The funds local orientation will mean a great deal of readily available supervision (management) and focus on the investee SMEs.

The investee SMEs will be sourced from ZATAC/ZW (graduate micro-enterprises with good track record will also minimise the costs of due diligence required). Checking other already existent networks with already existing strong SME linkage can also prove helpful to efficiency of the fund.

### 5.4.1 Example Model

A classic example of a micro-equity model for an international development organization could be like that framed by Alan Patricof [[80]](#footnote-80). The model places a very strong emphasis on a localized management team and specialized BDS.



**Investment Flows**

Figure 11: Investment flows

In this model, the first part (Figure 11) indicates the investment flows and the arrow shows the direction of the investment. The donor groups handle the soft investments part (training and education, human resources, capacity building) and the equity investment vehicle invests in preferred equity. These investments are made into the local fund. The locally managed fund then provides finance by investing equity and quasi-equity in portfolio SMEs. At the same time, grants are used by the BDS provider to provide TA to the investee SMEs.



**Realization Flows**

Figure 12: Realization flows (returns from the investment)

The above depiction (Figure 12) shows the returns realized from the investment and the direction of the flows. The fund receives Cashflow and appreciation (capital gain) from investee SMEs. The returns are then shared as depicted and re-used (kind of revolving)

### 5.4.2 Possible micro-equity model for W&D AED



Figure 13: Possible (suggested) Micro-equity model

1. Two points of approval: The W&D FS investment committee and the Zambia’s Fund Board.
2. The interventions should be only with quasi-equity instruments (performance based release of the finances)

#### 5.4.2.1 How it shall deliver Value for W&D, and SME sector

The best part of micro-equity is that it gives W&D AED an opportunity to make meaningful contribution to private sector stimulation in emerging economies. It also gives it an opportunity to fully implement its three pillar model of intervention as stated in the introduction (approach of W&D AED) i.e. provide financial services, BDS and facilitation of value chain organizations. The contribution can even be more enhanced if the the SMEs that will, apart from creating employment, source their raw materials from the small-holder (micro) farmers.

#### 5.4.2.2 W&D Business Platform’s involvement in the model

The business platform will have a role to provide expertise advice to the SMEs via board participation or special request for BDS/management in client SMEs. They will further have the opportunity to co-invest in the localized Private Equity Venture Fund.

## 5.5 Taking stock of lessons (recommendations) for W&D

This section will appraise lessons/recommendations resulting from the material presented in the course the research.

**5.5.1 Sectors**: Micro-equity is not sector specific[[81]](#footnote-81) as can also be seen from the landscape view of the market. Zambia, however, seems to present a good opportunity for agribusiness especially that it is the largest employer. This means that support to the sector is much more likely to achieve W&Ds desired impact in terms of increased employment, increased income and poverty alleviation.

**5.5.2 Use a PE/VC Model:** the landscape suggests that most micro-equity funds are structured around the private equity and venture capital models, with much more emphasis on Impact/Mission Related/ Social Investing. This is flexes the model to be able to provide grants for capacity building and TA, in addition to the finance.

**5.5.3 Cast the net widely by raising a regional fund:** Research by IFC as well as by Milken Institute suggests that going regional and pooling resources by wide geographic outreach can lead to minimized transaction costs and eased fund management[[82]](#footnote-82). Keeping the fund size small leads to high costs relative to overall revenue and lowers net returns[[83]](#footnote-83) . In the words of Peter Tropper of the International Finance Corporation, “It’s very expensive to run a fund, and it’s very expensive to run a small fund in a small country.”

**5.5.4 Focus on Promising startups/graduate micro-business/young SMEs**: What the landscape highlights is the fact that in achieving their triple bottom-line impact and SROI, Funds tend to focus on SMEs that are promising to grow or are already trying but struggling to thrive. W&D AED can also start dealing with such kind of SMEs but placing emphasis on the need for such SMEs to link the small holders to their business for a much broader and extensive reach that will allow for creation of Jobs and increase of incomes among the local communities.

**5.5.5 Leverage local partnerships:** as earlier alluded to private equity is very much a local business. W&D AED already prides in its strong partner network which it must leverage for a more cost effective intervention. While it’s strong business platform relations will play a key role in making business efficacy of the investments by providing expert advice to W&D AED as well as the investee companies.

**5.5.6 Consider the royalty model**: Successful investments in developing-country SMEs do not usually consist of straight equity. Instead, the deals typically combine royalties and loans with an equity or equity-like component[[84]](#footnote-84). This kind of structured finance will also provide for an easy exit route in the face of undeveloped capital markets in most emerging economies.

# 6.0 Conclusion

The opportunities that the nascent field of micro-equity financing presents signal a possible alternative for sustainable SME finance in emerging economies. Its ability to creatively combine a broad mix of debt and equity promises a chance to minimise and/or eliminate the challenges faced in the micro-financing intervention.

Evidence indicates that this is better done with a strong focus on the local human resource and already existing organizations so as to achieve economies of scale and lower costs of operations. This kind of approach not only seems cost effective but is key to generating deals flows, conducting inexpensive due diligence while ensuring profitability and impact for W&D.

As to whether profitability is possible with micro-equity depends largely on creativity with financial tools, Focus SME’s size, casting the net widely, regional funds pooling, and leveraging of already existing local players/partners to allow for easy but careful monitoring and support of SME Client. It is, however, worth noting that there’s a great need for donor support for such arrangements to function at their best, hence the need for BDS/TA grants as part of the Impact/mission related investing.

From the demand side it seems very clear that there is a lot of opportunity in various sectors, especially Agribusiness, in Zambia. Agribusiness presents a good opportunity because Zambia is predominantly an agricultural country with a huge dependency on minerals for GDP contribution. The agribusiness sector is huge and needing growth capital to increase productivity, competiveness, and increase GDP contribution while ultimately eliminating poverty through job creation because of its rural reach. The outcome of which allows W&D to create employment and increasing income.

Finally, am of the opinion that it would not be an exaggeration to claim that micro-equity presents a better hope in meeting the international development finance objectives, lifting the SMEs to productive enterprising and complementing the efforts that Micro-finance has made in the last thirty years.

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# 8.0 Appendices

## Appendix A: Parameters for Empirical framework companies/Organisations

|  |  |
| --- | --- |
| **Type of Organization** | Foundation or venture capital/private Equity Firm |
| **Region of operations** | Asia, Latin-America and Africa (All of W&D’s regions) |
| **Interventions** | Both Business Development and Financial services |
| **Sector(s)** | Agriculture & Food, Industry, Services, Tourism, Trade and Transport |
| **Investment range** | $20.000 - $500.000 |
| **Target SMEs** | Start-ups, Early stage and Growth SMEs |
| **Type of Finance** | Mix of Equity and Debt |
| **Sources of Finance** | Private Investors, Government support and/or Grants |
| **Assets under Management** | Depends on SME-catchment size |
| **Criteria** | Social, Environmental, |
| **Measures of Impact** | Triple Bottom Line (Social, Environmental and Financial) and Social Return on Investment (SROI) |
| **Return on Investment** | 5-15 % |

## Appendix B: Operationalised Interview Guide/Questions

1. What are the circumstances necessary for micro-equity to be considered a good option and preferable above debt financing in SME (Agri-business) Financing?
2. What are the required preconditions to be able to do micro equity in smaller SMEs (Agri-business)?
3. From your experience, would you say that some sectors and entrepreneurs are more open to micro-equity than others? Which ones could those be and why?
4. How do you think the business models must be structured to ensure profitability of the Investor as well as the growth and profitability of the Investee (SME clients)? i.e. along the lines of ;
5. Deal flow

Deal structuring

Due diligence

Legal issues

Mentoring and advice to investees

Transaction costs

Exit strategies

1. How profitable is equity for smaller SME’s in the end taking into account the transaction costs (Deal flow, Pre investment appraisal, Deal structuring, Due diligence)?
2. What are the Do’s and Don’ts, lessons learnt, best practice vis-à-vis your experience?
3. Are there any specific models? And what are the advantages/disadvantages of these various models for ME Financing?

## Appendix C: List of people Involved in Discussions and interviews

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Name | Organisation | Position | Discussion/Interview | Contact Details |
| Mr. Maarten de Jong | BiD Network Foundation | Coordinator-Investor Matchmaking | Interview | [maarten.dejong@bidnetwork.org](mailto:maarten.dejong@bidnetwork.org) |
| Mr. Windu Matoka | Zambia Development Agency | Director - Micro & Small Enterprises | E-Exchange discussion | [wmatoka@zda.org.zm](mailto:wmatoka@zda.org.zm) |
| Mr. Maarten Van Middelkoop | W&D Foundation | Director-AED | Regular Discussions | [m.middelkoop@woordendaad.nl](mailto:m.middelkoop@woordendaad.nl) |
| Mr. John Lindhout | W&D Foundation | Consultant-AED | Regular discussions | [j.lindhout@woordendaad.nl](mailto:j.lindhout@woordendaad.nl) |
| Mr. Corstiaan Van Aalsburg | W&D Foundation | Consultant-AED | E-Exchange | [c.vanaalsburg@woordendaad.nl](mailto:c.vanaalsburg@woordendaad.nl) |

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72. Check appendix A [↑](#footnote-ref-72)
73. Their Website: [http://www.grofin.com](http://www.grofin.com/) [↑](#footnote-ref-73)
74. Aavishkaar Venture management services private Limited, Mumbai, India and had 28 Participations as of 2008. Other Sectors Include: Development, Energy, water & utilities, healthcare, ICT, Telecom & Technology, services: [www.aavishkaar.org](http://www.aavishkaar.org) [↑](#footnote-ref-74)
75. Agelos Social Ventures GmbH, an arm of Agelos Foundation and also operates in Europe & Middle East: [www.agelos.com](http://www.agelos.com) [↑](#footnote-ref-75)
76. Agora Venture Fund, under Agora partnerships, other sectors include Clean energy, Industry, Services, Tourism, Trade and Transport. It had 5 participations as of 2008. Supports company size of between 5-10 employees. Its mixes 50% Equity and 50% Debt + Royalties : [www.agorapartnerships.net](http://www.agorapartnerships.net) [↑](#footnote-ref-76)
77. EcoEnterprises Fund, an arm of Nature Conservancy. It has invested in 23 companies in 10 countries: [www.ecoenterprisesfund.com](http://www.ecoenterprisesfund.com) [↑](#footnote-ref-77)
78. Assuming AED is set up as a private limited investment fund [↑](#footnote-ref-78)
79. The business platform will act as a key resource from which technical and professional expertise for board seats and advise to investee SMEs will be drawn [↑](#footnote-ref-79)
80. Alan Patricof (2007) “Venture Capital for Development: Establishment of an East African Venture Capital Fund ” Concept paper quoted in:Glenn Yago (2007), ***“Financing the Missing Middle: Transatlantic Innovations in Affordable Capital”*** , October 22, 2007, Washington, DC [↑](#footnote-ref-80)
81. Ibid BiD Interview [↑](#footnote-ref-81)
82. Tom Gibson, ***“shareholder loan funds for SMES in developing markets”***, January 2009, Technical Brief No. 8, USAID publication under the Business Growth Initiative Project. Available here : <http://pdf.usaid.gov/pdf_docs/PNADO127.pdf> (9/06/2011) [↑](#footnote-ref-82)
83. Ibid. Milken Institute Financial lab report [↑](#footnote-ref-83)
84. Ibid [↑](#footnote-ref-84)