Acting sustainably to promote African small business: The challenge facing mission investors

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Africa is the new frontier for private equity, yet the region is having trouble channelling the corresponding financial flows to its woefully underfunded small businesses. The continent cannot adequately develop without an extensive web of sustainable SMEs – currently the missing link in Africa's economy. The emergence of a locally-based private-equity model suited to the realities facing African SMEs is the only viable path to breakthrough innovation in how African economies are financed.

Africa has emerged as the new El Dorado for private equity investors. In 2014, private equity funds raised over USD 4 billion for Sub-Saharan Africa,1 and the trend showed no signs of flagging in 2015, even though falling commodity prices dented GDP growth in several of the region's largest economies. The 2014 figure was the highest since 2007, indicating continued investor interest in Africa.2 Just as striking, however, is the fact that **the continent's small and medium-sized enterprises (SMEs) still receive a mere fraction of the total amount**. In the period from 2007 to 2014, only 2% of all capital invested in Africa involved transactions of less than USD 10 million.3 In the vast majority of cases, private equity flows to a limited group of countries (South Africa, Kenya, Nigeria) and sectors (large-scale infrastructure, telecoms, banking). The primary beneficiaries of such funding are therefore major companies and well-structured medium-sized firms.

> *And yet creating a web of formal-sector SMEs is the key development challenge facing Africa.*

Such businesses should be seen as the "missing link" in African economies. They have a major role to play in the continent's growth and development. The SME universe is an effective driver of social redistribution in that it actively contributes to the emergence of a middle class and the creation of formal-sector jobs that typically offer higher pay and greater security than those found in the informal economy. Many of the companies in that universe directly increase access to essential goods and services in domestic markets and generate major productivity gains that benefit their customers. To provide an illustration, we estimate that 90% of the businesses supported by Investisseurs & Partenaires respond to unsatisfied needs in such crucial areas as medicine, food and construction materials.4

Moreover, as elsewhere in the world, **SMEs are the primary wellspring of employment in Africa**. Over 450 million individuals are expected to enter the labour market between now and 2030, whereas current economic growth forecasts suggest that the formal sector will create only 220 million new jobs during the same period. 5 A gap of that size, which is unprecedented in world economic history, underscores the formidable challenge ahead.

IS PRIVATE EQUITY AN APPROPRIATE FINANCING SOLUTION FOR SMES?

However, another major way to achieve inclusive growth on the continent is garnering attention: supporting high-potential SMEs by giving them access to the capital and skills they need to expand their business. A first key step in that direction is **to recognise just how difficult it has traditionally been for small African companies to get financing**. Microfinance is hardly an option, as the loans seldom exceed EUR 20,000, interest rates tend to be high and term to maturity is usually short. Likewise, although standard bank loans are on the upswing in Africa, they, too, are not geared in most cases to SMEs. Small businesses are characterised by limited owners' equity, considerable financing needs and often a high level of risk, which means that they rarely fit the profile that commercial banks are looking for. Finally, equity investing is still relatively unorganised in Africa. The typical scenario involves a limited circle of friends and relatives putting up small sums of money.

To grow, SMEs need investors who can adjust to their level of risk and offer them tailored, long-range financing. From that perspective, **private equity can in many respects be considered a relevant response to the needs of small businesses for financing and assistance**. Private equity firms tend to acquire long-term stakes in riskier ventures than banks do, often without guarantees. They can provide start-ups with capabilities and organizational assistance by drawing on their own expertise (e.g., in financial management, accounting and marketing) and by encouraging good governance practices at investee companies. In addition, their very presence as investors often makes it easier for a fledgling company to secure bank loans and other additional funding.

At the same time, it is essential to bear in mind **the African market's distinctive features and, more importantly, the special constraints inherent in small businesses**. Investing in an African SME means assuming considerable risk and patiently raising funds for a venture likely to offer below-market financial returns. Investors who target businesses with little formal structure as yet have to prioritise technical and strategic assistance for each of their partners, bringing in outside experts to handle specific tasks as required. The need to monitor each individual company also entails transaction costs that obviously reduce net return on investment (although the growth rates and profit margins recorded by businesses in the portfolio may amply meet investor expectations). To put it another way, it is more profitable to make a EUR 2 million investment in one [medium-sized] company than to invest EUR 200,000 in each of ten small businesses.6

So it isn't hard to understand the reluctance of some private equity investors to pour money into what they view as a low-return market segment offering little in the way of certainty. For the fact is that SMEs simply cannot guarantee returns of the kind expected from high-risk ventures, particularly by investors based abroad who also have to factor in exchange-rate fluctuations and country risk. But even so, we are witnessing **the gradual emergence of private equity funds, often with continental or sub-regional scope, dedicated to Africa's small businesses and prepared to take on investments of less than EUR 2 million**. Many of them describe themselves as "impact investors" or "mission investors", thereby openly embracing a strategy of targeting companies that generate high social impact and/or that are too small to satisfy the requirements of traditional investors. Moreover, because their investors and shareholders are motivated by the prospects of substantial non-financial benefits, they are willing to fund such vehicles. The result is a highly dynamic, but as yet fairly limited sector in quantitative terms. Only a few dozen such firms invest in any real sense in African SMEs, and even fewer of them can claim any significant impact.

DEVELOPING A SUSTAINABLE PRIVATE EQUITY MODEL SUITED TO THE NEEDS OF AFRICA'S SMALL BUSINESSES

The challenge becomes even tougher in the case of start-ups, which are rightly considered the highest-risk investee category, and of the smallest businesses, which are expensive to reach out to.

But what is at stake from a development standpoint overshadows that challenge now that “Africa is establishing its market” and building up a web of entrepreneurial activity. It should be borne in mind that most of the leaders of what will be the top companies in 2050 are still setting up shop in their garages.

While venture capital is a necessary component of the response, in the long run, **nothing can replace the emergence of national investment firms or investment funds when it comes to tackling the challenge of financing start-ups and the smallest businesses** – which we define as those requiring less than EUR 1 million of capital. Such structures are close to their investees, can easily connect up investors with their investments and operate with local expenses that are commensurate with the size of their clients. Furthermore, a majority of their shareholders or investors must be locally-based people who evaluate return on investment without considering exchange rate risk or political risk. All this highlights their significance, both as contributors to development and as drivers of profitability.

The trouble is that national funds capable of responding to the issue at hand are a rarity, and if we put our faith in spontaneous generation, not much is likely to happen for a long time. Africa has extremely few people with private equity capabilities and those that exist understandably gravitate towards large investment funds offering higher returns. Moreover, to set up a venture capital vehicle, you need both money and serious recognition from the investment community. Little wonder, then, that there are so few initiatives – or that even fewer of them succeed.

The need to address this issue was precisely what led Investisseurs & Partenaires to establish a major programme to incubate national investment funds and firms in Africa through an entity called I&P Développement 2 (IPDEV2). Designed to be an incubator and sponsor for African management teams, **this long-term investment company aims for breakthrough innovation in how Africa’s small businesses are financed**. IPDEV2’s strategy consists of incubating ten investment companies or funds in ten African countries within the next decade that can provide adequate financing solutions to small businesses and start-ups in those countries. The funds will acquire minority interests in investees for amounts ranging from EUR 30,000 to EUR 300,000 per investment. 7 Supported by a substantial shareholding group composed of foundations, family offices and mission investors from the private and public sector (such as the AFD Group), IPDEV2 additionally operates a major technical and management assistance programme for both burgeoning investment teams and target companies. This qualitative approach translates into long-term hands-on involvement.

This boldly innovative approach focuses on developing local skills and investor bases – on helping national private equity teams take shape, organising know-how and building up genuine local investment expertise. Three investment companies are already up and running in West Africa: Sinergi Niger, established in 2009, already has eight holdings in its portfolio; Sinergi Burkina, whose official launch we just celebrated in Ouagadougou; and Teranga Capital in Senegal. This strategy has considerable potential to spur private-sector growth and job creation. But local roots are an even more essential feature. While IPDEV2 aims to provide roughly 40% of the capital needed by such investment companies and funds, the rest comes from national investors – business people, national insurance companies and privately owned banks, local subsidiaries of multinational industrial firms and African sovereign wealth funds. Together, these forces form the vanguard of Africa’s venture capital movement. Competent and committed, they are bound to take on growing importance over time.

Such private sector-based development programmes represent a challenge to orthodoxies that have held sway in recent decades on official development assistance, and more broadly on how the economy works. One of those orthodoxies is the conventional view that a business enterprise is merely a profit centre and, in macroeconomic terms, a vehicle for creating jobs. In reality, however, **businesses are human institutions that generate the bulk of the economy’s externalities**, as well as the place where customers, suppliers, employees, creditors and shareholders come together in a dynamic equilibrium. A company must have something to offer all of them. In developing countries, to create value for customers and suppliers alike is to make a major contribution to the reduction of poverty. A second orthodoxy is the belief that improving the overall business environment is the only thing that contributors to development can hope to do effectively. This, however, is to deny the feasibility of industrial policy – unquestionably a crucial ingredient in "the Asian Miracle" – and the power of intervening directly in the workings of finance. Just such a bias has kept the international development community and developing country governments from using instruments that could make up for the failure of existing industrial and service firms to respond adequately to changes in the macroeconomic and institutional environment in which businesses operate. Moreover, underlying that failure is the absence of dynamic forces, along with the trouble that such forces have in emerging, due to structural barriers – to financing for example, as described above.

Mission, or impact, investing is a response to the impasse created by the development community's uncritical endorsement of those two simplistic assumptions for too many frustrating years. Deploying mission investing is a long, slow process, given its highly technical nature and the need for fine-tuned implementation, but in the coming decades it will undoubtedly take off, above all in Africa. In that respect, mission investing resembles microfinance, another grassroots, operations-based response to the conceptual and public-policy deadlock dominating the world of finance. How many people, thirty years ago, would have predicted the scope of microfinance today?

Footnotes:
1 EMPEA, Fundraising and Investment Analysis, Q4 2014.
2 Although Africa currently accounts for a tiny share of the global private equity market – just 3% of worldwide funding (source: EMPEA).
3 AVCA, 2015, *African Private Equity Data Tracker*.
4 I&P Afrique Entrepreneurs Annual ESG and Impact Reporting, June 2015.
5 Fox et al, *Africa's got work to do: employment prospects in the new century*, IMF Working Paper, 2013.
6 2015, *Investing in Africa's Small and Growing Businesses. An introduction to private equity in Africa.*
7 See the recent article by Jean-Luc Koffi-Vovor in the magazine *African Banker* (August–September–October 2015). The author argues for creating "funds of funds" as intermediate vehicles that can channel international capital towards smaller-scale funds.

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