

NEW PERSPECTIVES ON FINANCING SMALL CAP SME'S IN EMERGING MARKETS

THE CASE FOR MEZZANINE FINANCE

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The conclusions in this paper are only based on the views of a limited number of experts and relies heavily on the interpretations of the authors. Due to the confidential nature of (performance) information, our methodology is almost entirely qualitative and relies heavily on the interpretations of the authors. This paper is one step to better understand the segment. More detailed quantitative research of a larger pool of funds and investors is required to obtain a more complete picture of the relative performance of the various SME mezzanine funds and SME mezzanine instruments and to draw firmer conclusions.



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EXECUTIVE SUMMARY

The Missing Middle and the challenge of small cap SME financing

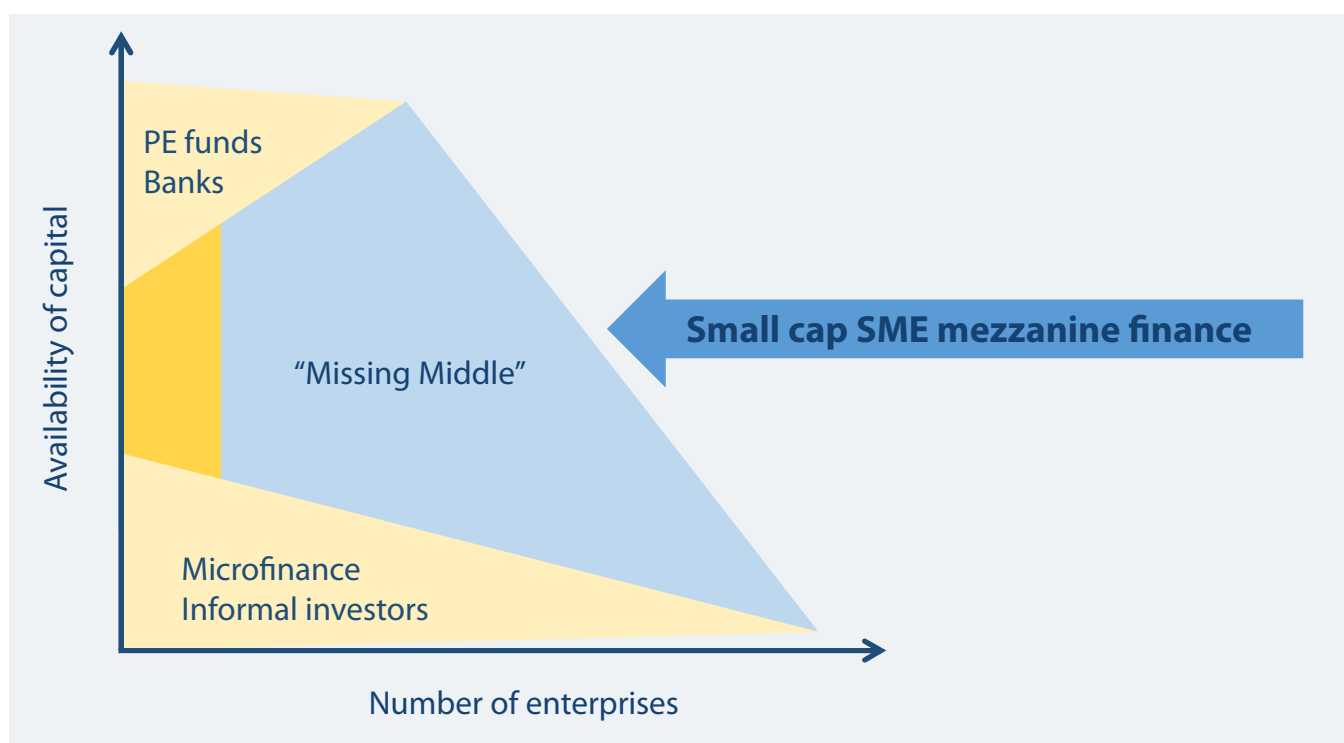
SMEs form a crucial part of the economies of emerging countries. Limited access to finance for these SMEs is commonly seen as their main barrier to growth. The lack of financing options is particularly problematic for SMEs in the so-called missing middle, which refers to entrepreneurs that are too big for microfinance and informal investors, but that are too small or too risky for regular banks and private equity firms. In the context of this study, we consider the missing middle segment to consist of SMEs in emerging markets requiring medium to long-term financing in ticket sizes in the range of USD 100k – 2m, which we refer to as “small cap finance”.

In most emerging markets, missing middle SMEs with a convincing combination of collateral, track record, positive cash flow and/or net profit, can generally obtain financing from local banks. However, the more this combination is lacking, the more missing middle SMEs will find it impossible to find financing. There is a pervasive lack of providers of risk capital catering to these non-banked SMEs. For finance providers, the missing middle forms a challenging segment to serve. From their perspective, the missing middle segment is associated with high risks and low returns, caused by high transaction costs relative to transaction sizes, and high failure rates. The reason for high transaction costs are multi-fold, including lack of necessary information and management skills at the SME level and wide population and hence SME geographic dispersion. The lack of risk capital for missing middle SMEs in emerging markets is a significant economic development issue, as the very SMEs that might be poised for growth, and thus represent critical job creating engines, are stuck with funding their own growth from internally generated cash flow. This is the challenge of the missing middle.



Innovations in small cap SME risk capital

In search for solutions to address this problem, small cap SME finance is high on the agendas of development institutions. Many institutions are stimulating the development of innovative models to provide risk capital, especially to growing and innovative SMEs that drive growth in emerging economies. In the past, these were often structured as private equity funds. Whereas there have been some successes, many small cap SME private equity funds have yielded lower financial returns than expected, due to currency fluctuations, lack of third party exits, high transaction costs and challenging business environments. Besides this, the private equity model is not designed to handle large volumes of deals, as private equity funds typically only invest selectively in the most promising businesses. In search for new models to provide risk capital, several small cap SME mezzanine providers have been able to scale up, and claim that their model can improve the risk-return balance of small cap SME finance. Mezzanine finance is a generic term for financing techniques that incorporate elements of debt and equity in a single investment. A key aspect of these growing small cap SME mezzanine providers is that they are adapting existing models to address some of the main risks associated with small cap SME investing. A few fund managers have realized some degree of scale and higher degrees of standardization and efficiency. Some expect that mezzanine can make small cap SME investing more attractive for investors, with more capital being deployed to this niche and more missing middle receiving financing that better suits their needs.




Financing “missing middle” enterprises in Emerging Markets

Small cap mezzanine finance to missing middle SMEs

Mezzanine is a catch-all phrase of a range of investment structures somewhere between pure equity and straight debt. The more debt-like mezzanine instruments are typically relatively risky, (partially) uncollateralized, flexible and long term loans, and often capture “upside” - indicating that the finance provider shares in the profits if the company performs well, contrary to a conventional loan which has a fixed interest rate. The more equity-like mezzanine instruments typically involve equity instruments with some sort of self-liquidating mechanism.

The following instruments are the main small cap SME mezzanine finance instruments:

The main small cap SME mezzanine instruments

	INSTRUMENT	DESCRIPTION
 <p>Debt-like</p> <p>Equity-like</p>	Partially unsecured / Junior loans	Loans with tailored repayment structure and flexibility regarding collateralization requirements. Payments to the fund manager are sculpted around the specific situation of a company, often allowing for long grace periods or seasonality on principal repayments and interest payments
	Royalty based lending	Provides the investor with a base interest plus royalties, which are payments that are dependent on the performance of the company, usually a percentage of revenue or EBIT(DA)
	Convertible loans	Typically a loan with a maturity date and a regular repayment schedule, and an option to convert the loan into shares of the company
	Preference shares	Shares which have preference over ordinary shares, including priority in receipt of dividends and upon liquidation, often with a fixed annual dividend
	Redeemable equity	Mostly similar to ordinary shares, but with a right to sell the shares back to the entrepreneur (put option), typically using a predetermined price or a formula

The suitability of certain instruments for a given deal depends primarily on the company’s cash flow generation and exit potential (see appendix 2), with all mezzanine structures requiring at least one of these two characteristics to be present. However, restrictions to some instruments can also relate to (financial and tax) regulation and other local factors, making some instruments less suitable for certain regions.

Overview of small cap SME mezzanine fund managers

For this paper, we studied several leading fund managers that invest in missing middle SMEs in emerging markets through small cap mezzanine instruments. Even as we do not pretend to be exhaustive, at this moment few small cap SME mezzanine funds exist, and we do believe we have made a representative

selection of the main existing small cap SME mezzanine fund models and strategies. The fund managers we studied for this paper are BPI (Business Partners International), GroFin, Gazelle Finance, I&P (Investisseurs & Partenaires), Pyme Capital, GBF (Grassroots Business Fund), SEAF (Small Enterprise Assistance Funds) and XSML (eXtra Small Medium Large). These fund managers all have funds under management that start investing in ticket sizes below USD 2m through mezzanine instruments.

Current position of SME small cap mezzanine in SME finance landscape

Small cap SME mezzanine currently only takes a modest position in the overall small cap SME finance landscape. There are still relatively few funds active in this area, and the total amount of capital they are managing is very small compared with the total SME financing gap. Although the overview of the 8 funds analyzed for this study (see chapter 2) is not exhaustive, it includes the main and biggest small cap mezzanine providers. Yet these 8 funds “only” have about USD 1.2 bn under management. It is difficult to quantify the market share of small cap SME mezzanine due to the overlapping deal sizes and other challenges to classification, but, in contrast, IFC estimated the current credit gap for formal SMEs to be USD 1.2 trillion (in 2011).

Classification of small cap SME mezzanine funds and fund managers

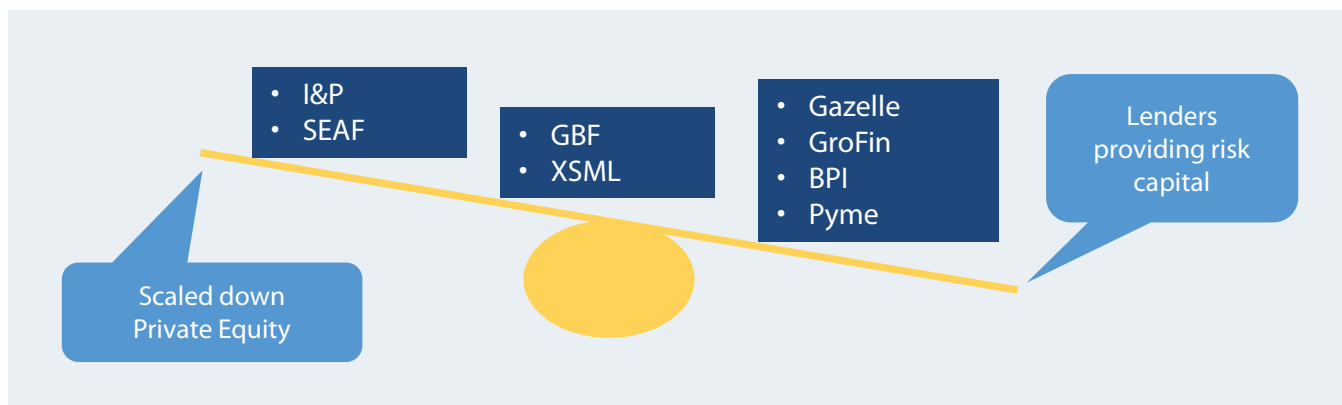
Making a classification of small cap SME mezzanine fund models based on investment instruments used is challenging for several reasons. First, most fund managers manage several different funds that can have different strategies and operate in different regions. Second, most individual funds offer a variety of different investment structures. Third, detailed data on the operations and actual performance of funds segmented by region, ticket size and/or instrument is hardly available, as small cap SME mezzanine is a relatively young niche with few players, with performance data being confidential business information. This makes it challenging to analyze and compare different fund managers, models, strategies and investment instruments.

It is also important to bear in mind the thin line between structured equity and mezzanine. Equity investing in missing middle SMEs already is almost by definition done in structures that try to capture upside potential while limiting the risks common to small cap SME investing, so structures that would qualify as mezzanine are not exclusive to mezzanine fund managers, as they have been used for small cap SME private equity funds for a long time. The mezzanine models that are the subject of this study have in common that they systematically seek to adapt existing investment instruments to allow to better serve missing middle SMEs in emerging markets and seeking ways to address the lack of exit options and high transaction costs relative to deal size.

Two archetype models of small cap SME mezzanine fund managers

Interviewees for this study were generally of the opinion that in the < 2m USD segment, the main factor to distinguish different fund strategies and models is the dependency on third party exits. This largely determines the required level of involvement of fund managers with their investees, and is generally seen as a key differentiating factor as this has significant impact on how time-consuming deal sourcing and selection, due diligence, negotiations and monitoring are and how stable and predictable returns are.

In line with the above distinction of more debt-like and more equity-like mezzanine instruments, we identified two main archetypes of models of small cap SME investment funds. First what we call **'Scaled down private equity funds'**, or **'equity-like mezzanine providers'** with tailor made structures, substantial involvement at investees and focused on maximizing value creation and focusing mainly on third party exits. Second are **'Lenders that provide risk capital'**, or **'debt-like mezzanine providers'**, who aim to provide capital to a larger number of SMEs while minimizing transaction costs and risks using standardized self-liquidating structures. We classify the fund managers that were interviewed for this study as follows:



Classifying the funds into archetypes

It is important to note that this is a simplified categorization, and one needs to bear in mind that some of the above fund managers operate many different funds in various regions, and often also focus on ticket sizes well above USD 2m.

A clear trend in the market is the shift towards permanent capital vehicles. In general, the fund managers preferred the evergreen structure. An important reason is that it better enables the fund to provide long-term loans (or equity), offers more stability and continuity, and allows leverage at the fund level.

Investors in small cap SME mezzanine funds

The bulk of the funds of the 8 abovementioned fund managers was raised in the last couple of years, with debt-like mezzanine funds being responsible for most of the growth. Public Development Finance Institutions such as IFC, FMO, DEG and CDC and Foundations such as Lundin Foundation, Shell Foundation and the Calvert Foundation are the main investors in small cap SME mezzanine finance.

Most interviewees confirmed that some established DFIs seem to be moving away from SME mezzanine investments via investment funds, as many funds have not been able to meet the return expectations of DFIs. Interviewees (including at DFIs) indicated that so far, over a longer period and across regions, SME funds have on average realized net returns in hard currency of around 5 - 6%. It needs to be noted that this includes SME equity funds with larger ticket sizes, the net returns on funds focusing on the < 2m USD segment being probably even lower. In any case, the returns on small cap SME investing are substantially below requirements of most DFIs, as they typically require IRRs of 10-20% for equity funds. However, DFIs acknowledge the importance of stimulating SMEs because of their contribution to economic growth and job creation, and DFIs are generally involved in SME support programs and lending to SMEs via local banks. The interviewees generally were of the opinion that foundations are also playing an increasingly important role in small cap SME mezzanine finance, increasing invested amounts and supporting innovation.

Fund economics: scale is key

For small cap SME mezzanine finance funds, especially the ones focusing on the <1m USD segment, it is always a challenge to make their economics “work”, due to the unfavorable ratio of transaction costs versus ticket sizes and high failure rates, acknowledging that views differ on what “attractive returns” to investors are. Some investors with a specific impact focus are willing to accept lower financial returns in combination with a high risk profile. Also a range of subsidies can be applied to different levels (for example at fund manager level or at investee level) in a variety of different structures, to reduce the problem of challenging fund economics of small cap SME mezzanine funds. Some of the DFIs and foundations interviewed noted that, during fund raising, fund managers often present cases based on unrealistic assumptions and therefore unrealistic return expectations. They would rather see fund managers using realistic assumptions based on actual market practices and using a smart combination of investor capital and subsidies to make their model work.

Interviewees indicated that an (unsubsidized) fund needs to have a minimum size of between USD 30m and 70m in order to be sustainable, the exact number being highly dependent on the geographic span of the fund, other components that make up the strategy of a fund, and return expectations.

When asked about the minimum deal size required to be financially viable, the practitioners interviewed for this paper mentioned a wide range of transaction sizes. GroFin ‘intuitively’ sees round USD 350k as the minimum of what they can do with their model, while BPI even says to be able to go as low as 50k USD. Fund managers providing more equity-like investments typically mention a USD 1 to 2m as minimum ticket sizes. A representative of a leading DFI was even of the opinion that it is not possible to do SME finance with transactions below USD 10m. The wide difference is probably caused by different interpretations of what net returns are expected from this segment.

Interviewees gave the overall picture that the economics of funds focusing on equity-like mezzanine structures are especially difficult below 1m USD. Within the range studied for this paper, equity-like mezzanine instruments are mostly used for somewhat larger deals, typically above USD 1m (although dependent on geographical factors such as staff costs, overall business environment, etc.), while debt-like mezzanine structures are especially suitable for the < 1m USD segment. This was specifically confirmed by from the larger fund managers managing a variety of different funds who are able to compare the different models.

Strategies of small cap SME mezzanine finance providers

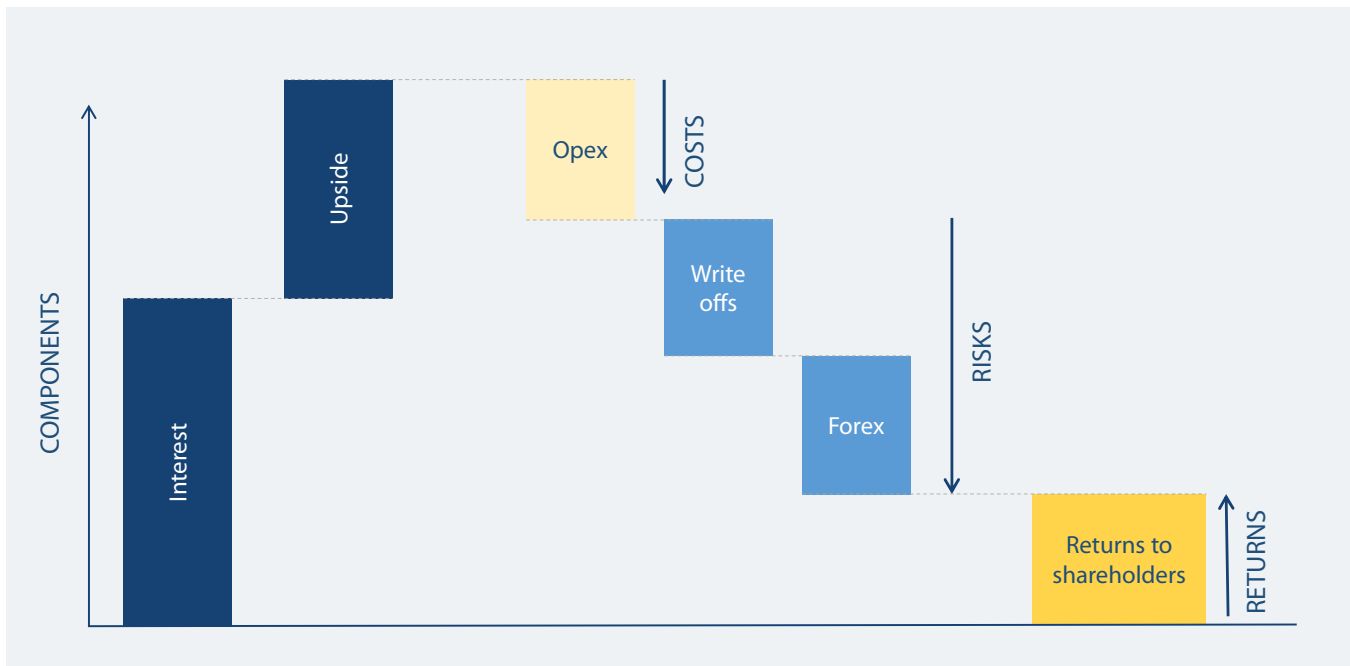
As mentioned, small cap SME mezzanine is currently a relatively small segment of the SME finance ecosystem. According to the interviewees, small cap SME finance will remain a challenging segment, with a risk-return balance that will not easily attract large amounts of capital from other investors than DFIs and foundations, such as pension funds and insurance companies. However, most agreed that there is room for further improvement of mezzanine models, which could also lead to growth of the segment and attract more and other investors.

We distinguish four main categories in which the use of small cap SME mezzanine can grow further:

1). Improving the risk-return balance, by:

- a. Improving currency risk management.** Interviewees generally stated that currency losses were the single most impact factor to negatively impact their net returns in the past, as practically all capital comes from developed countries in hard currency, while most fund managers provide financing in local currency. As this problem is related to macro-economic fundamentals, this is a difficult problem to address. One key observation is that funds focusing on debt-like mezzanine funds have less currency exposure than equity-like mezzanine funds, due to the regular payments of loan-type instruments. With equity investing, generally more time passes between disbursements and receiving proceeds back from the investment, hence there is higher currency exposure. We did observe some other interesting views from fund managers on how they manage their currency risks:
- Fund capitalization through **local investors**. An example is I&P, which is setting up evergreen funds that will receive the majority of its funding (around two thirds) from local investors such as local banks, insurance companies and individuals, thus limiting the currency risk exposure of the fund. One interviewee mentioned that some see local capitalization of small SME funds as a holy grail of the sector, and recommended other fund managers also to seek strategies aimed at eventually attracting local capital.
 - Investing in companies that **obtain revenues or price in hard currency** in hard currency (e.g. exporting firms), thus avoiding currency risk. Pyme Capital is an example of this. Also XSML is mainly active in countries where US Dollars are the main currency and firms thus price in US Dollars.
 - Investing only in countries that have their **currencies pegged to a hard currency**, such as the CFA-region ¹. I&P is focusing mainly on CFA countries.
 - **Geographic diversification**. Having multi-country funds reduces currency exposure. This is also one of the factors that plea for fund managers to reach scale.

¹ CFA refers to two currencies used in Africa (the West African CFA franc and the Central African CFA franc) that are guaranteed by the French treasury.



Improving Risk/Return Profile of small cap SME mezzanine finance providers

- b. Shifting towards permanent vehicles:** In search for working models, the market is moving away from traditional limited life private equity structures towards permanent capital vehicles (also known as evergreen structures). Main benefits of permanent vehicle structures are that it allows funds to be leveraged, it is better suited for longer timelines required for small cap SME investing, and that it provides more stability, flexibility and continuity to the fund manager. However, fund capital providers, including DFIs, can be cautious with permanent capital vehicles given their need for liquidity within their individual timelines. Limited life funds provide a clear liquidity path while permanent capital vehicles might provide windows of redemption with restrictions in timing and amount. Having said this, the mezzanine instrument for SME can be very suitable for permanent capital vehicles, especially for debt-like mezzanine given the predictable investment reflows which provide cash flow to capital providers. Further, such predictable investment reflows can provide early and sustained profitability to the vehicle, which can be requirement of listing on a stock exchange, if this were an objective of the vehicle.
- c. Standardization of products and procedures.** This is specifically relevant for debt-like mezzanine fund managers. Standardization has been key to the strategies of GroFin and BPI, who state that standardization allows them to achieve economies of scale and more efficiency. They reduce costs by working with relatively short deal lead times and relatively cheap local staff. For equity-like mezzanine fund managers, the main challenge has been to find local staff with sufficient skills to find and manage equity-type deals at acceptable salary levels and to organize investment teams with a combination of local staff and international private equity experience.

- d. The use of information technology**, for example for assessing credit risk and monitoring of sales and finances at SMEs to increase efficiency and effectivity. Information technology can be additional to regular risk assessments, because it allows fund managers to easily compare key ratios of SMEs within a sector. When a fund manager has invested in an SME, information technology can enable the fund manager to track sales and cash flows.
- e. Using new products and methods.** An example is credit methodology based on psychometric parameters. This is basically a series of assessments of individuals that are predictive of a person's future success as an entrepreneur in an objective, quantitative, scalable way by assessing skills, abilities, personalities, and intelligence. The assessments can have the potential to be more effective and cost-efficient than traditional assessments.

2). DFIs supporting the further development of small cap SME finance, through direct investing, or through the use of technical assistance and grants. Some interviewees claim that DFIs place their debt-like mezzanine funds in the same category as SME private equity, while they claim that they should be seen as a different asset sub-category. They claim debt-like mezzanine to be an asset class somewhere in between banking and private equity, with returns potentially lower than (or potentially even comparable with) private equity, but that are more stable and predictable.

3). Improving transparency, impact measuring and reporting could mobilize more and new investors. An important lesson appears to be that realism should remain in the sector. Fund managers should strive for transparency regarding their returns, but this is difficult because sometimes it is simply not (yet) clear and from a fundraising perspective they have an incentive for rosy prospects. There are a lot of conflicting views on the performance of small cap SME funds, mystifying the sector. DFIs have a key role to play here. They possess a lot of information and could be able to publish sector-wide performance numbers.

Most interviewees also indicated some of the existing impact measuring and rating systems as somewhat complex in practice, or not sufficiently geared towards the desired impacts of SME investing. Given the fact that, irrespective of the innovations, small cap SME finance has an unfavorable risk-return balance, its main justification is the positive development impact it generates. However, the precise impact created can differ per fund, and a better impact system could lead to a better match between funds and investors.

4). Regulatory reform in the field of tax and other financial regulation, such as laws regarding the use of movable assets as collateral can increase the geographic applicability of small cap SME mezzanine. This means exerting a program of removing tax and other legislative barriers to SME mezzanine at national levels.

Conclusion

Mezzanine financing is an important financial instrument to address the financial needs of missing middle entrepreneurs. However, this financial instrument certainly has its limitations and should not be viewed as some type of panacea for the missing middle entrepreneurs. Even relatively successful fund managers have produced relatively modest financial returns using small cap mezzanine finance. Nevertheless, capital providers, financial intermediaries, donors and governments should recognize the potential of the instrument to address the missing middle financing needs. Each has an important role to play in ensuring that small cap mezzanine financing is provided to SMEs in emerging markets.

DFIs should continue to take a leading role in encouraging innovation. This includes allowing leverage at the fund level and allowing permanent vehicle structures. Government of developing countries can stimulate the use of small cap SME mezzanine finance through regulatory reform.

Small cap SME mezzanine finance providers are beyond the stage of pioneering but not yet at the stage where – similar to microfinance or larger scale private equity investing - the approach can be brought to scale. There are opportunities to reach scale in the sector and to play a more significant role. The use of evergreen structures and – to a certain extent – product and process standardization contribute to this opportunity. Reaching scale will decrease relative transaction costs (as a consequence of economics of scale), which improves fund economics of small cap SME mezzanine providers.

Small cap SME mezzanine is a relatively new and small field in the SME finance landscape. Understanding the specificities, diversity and complexities of it, notably in differentiating this segment with debt and equity models, is critical in order to spur innovative thinking on both the fund managers and investors sides so products may be improved and models may be more scalable. This study is the first of its kind and represents a first step into building small cap SME mezzanine finance as an asset class on its own.



1. SMALL CAPITAL SME FINANCING: CONTEXT AND RESEARCH

1.1. The challenge of small cap financing

SMEs (Small and Medium Sized Enterprises) form a crucial part of the economies of emerging countries. Limited access to finance for these SMEs is commonly seen as their main barrier to growth. In most emerging markets, banks will typically only finance SMEs that have been in existence for several years and that can offer fixed assets worth at least the financing amount as collateral. The SMEs that qualify for bank financing are usually confronted with high interest rates, and often they need longer loan tenors than banks are able to provide. There are a few alternative finance providers, such as private equity funds, but only a small percentage of the SMEs meets their requirements. As a result, for many SMEs in emerging economies, it is very difficult or impossible to obtain suitable financing.

The lack of financing options is particularly problematic for SMEs in the so-called missing middle, which refers to entrepreneurs that are too big for microfinance and informal investors, but that are too small or too risky for regular banks and private equity firms. Although SME risk finance is also seen as challenging up to ticket sizes up to USD 2 - 5m (some even say USD 10m), in the context of this study, we consider the missing middle segment to consist of SMEs in emerging markets requiring medium to long-term financing in ticket sizes in the range of USD 100k – 2m, which we refer to as “small cap finance”².

There is a pervasive lack of providers of risk capital catering to these non-banked SMEs. For finance providers, the missing middle forms a difficult segment to serve. From their perspective, the SME segment is associated with high risks and low returns³. Key factors causing this unfavorable risk-return balance are the high transaction costs relative to ticket sizes, and high failure rates. Missing middle SMEs have a degree of scale and complexity for which small business banking based on personal relationships and microcredit mechanisms (such as group based lending) do not work anymore. To finance SMEs above that lowest segment, finance providers need to deploy a certain minimum amount of resources per transaction for screening, due diligence, closing, and monitoring and supporting investees through business development assistance. The required resources are not entirely proportionate to the size of the transaction, and the informality of smaller SMEs even poses specific additional challenges⁴. Finance providers need to factor in these issues and transaction costs into their pricing, products and selection requirements. As the relationship between transaction costs and transaction size is particularly unfavorable in the missing middle bracket, SMEs in this segment are confronted with unfavorable terms and conditions and strict selection criteria for financing. The lack of risk capital for missing middle SMEs in emerging markets is a significant economic development issue, as the very SMEs that might be poised for growth, and thus represent critical job creating engines, are stuck with funding their own growth from internally generated cash flow. This is the challenge of the missing middle.

² See <http://english.dggf.nl/investment-funds-local-smes>

³ This is confirmed in our interviews with DFIs, which traditionally have been the main investors in this asset class. There is limited aggregated public data available specifically on the performance on private equity funds. The main cited challenges of the PE model are the high costs of experienced staff with a PE-skill set, exchange rate losses and the lack of exit options.

⁴ Financing SMEs poses a difficult challenge for financial institutions everywhere, but particularly so in lower income countries. Unlike larger corporates, SMEs offer very little public information, and rarely keep accounts in standard and comprehensive formats, let alone in audited formats. SMEs possess limited fixed assets, and few low income countries have legal and regulatory environments that encourage the use of movable assets (equipment, inventory, accounts receivable, etc.) as collateral. Also, the inability to cost effectively collect problem loans due to unclear, lacking or inefficient bankruptcy laws, is a “hidden” transaction cost for banks. SMEs also need “high touch” services, involving time-consuming operations based on personal relation and physical access points.

Small cap SME mezzanine finance

Mezzanine finance (a generic term for financing techniques that incorporate elements of debt and equity in a single investment), as provided by companies such as BPI and GroFin, is increasingly seen as a promising model to serve missing middle SMEs. Their mezzanine instruments typically involve more risky (less collateralized), flexible and long term loans, and often capture “upside” (indicating that the finance provider shares in the profits if the company performs well), contrary to a normal loan which has a fixed interest rate. In the past few years, several mezzanine providers have been able to scale up their operations and achieve higher degrees of standardization and efficiency, and claim that their model can improve the risk-return balance of small cap SME finance. Some expect that this trend will make small cap SME investing more attractive for investors, with more capital being deployed to this niche and more small cap SMEs receiving financing that better suits their needs.

1.2. Objectives of this paper

The Dutch Good Growth Fund

The DGGF (Dutch Good Growth Fund), part Investment funds local SMEs, has been set up to increase access of local SMEs to finance in emerging markets and developing countries. The DGGF is primarily a fund of funds that invests in investment funds that invest in businesses in the DGGF countries, hence reaching and benefiting the missing middle entrepreneurs. To foster sector-wide learning and exchange of knowledge, the DGGF commissioned a study to research the market practices, key trends and growth potential of small cap SME mezzanine finance.

The central research question of this study is: “How can small cap SME mezzanine finance best serve missing middle SMEs in developing countries and emerging markets?”

So far, few research reports have been published specifically focusing on small cap mezzanine finance for missing middle SMEs. The available reports typically have a broad focus, discussing the entire SME finance landscape (which also involves, for example, SME banking and other types of SME financing), impact investing in general (focusing on a broad range of fund strategies and transaction sizes), or mezzanine finance in general (typically referring to larger investments, mostly in developed countries). Because of the importance to finance missing middle entrepreneurs, the focus of this paper is specifically on small cap SME mezzanine with transaction sizes between USD 100k and USD 2m, zooming in on a specific segment of the market compared with the Emerging Markets Mezzanine research report published in 2014 by EMPEA, which discusses mezzanine in emerging markets in general across a broader range of ticket sizes ⁵.

This study discusses to what extent and under which conditions mezzanine can best serve the missing middle. The study aims to offer in-depth insights into the economics of mezzanine providers focusing on small cap SMEs. We discuss the specifics of their business models and analyze the mechanisms that impact the risk-return balance, and we identify the key bottlenecks currently hampering further development of this asset sub-category.

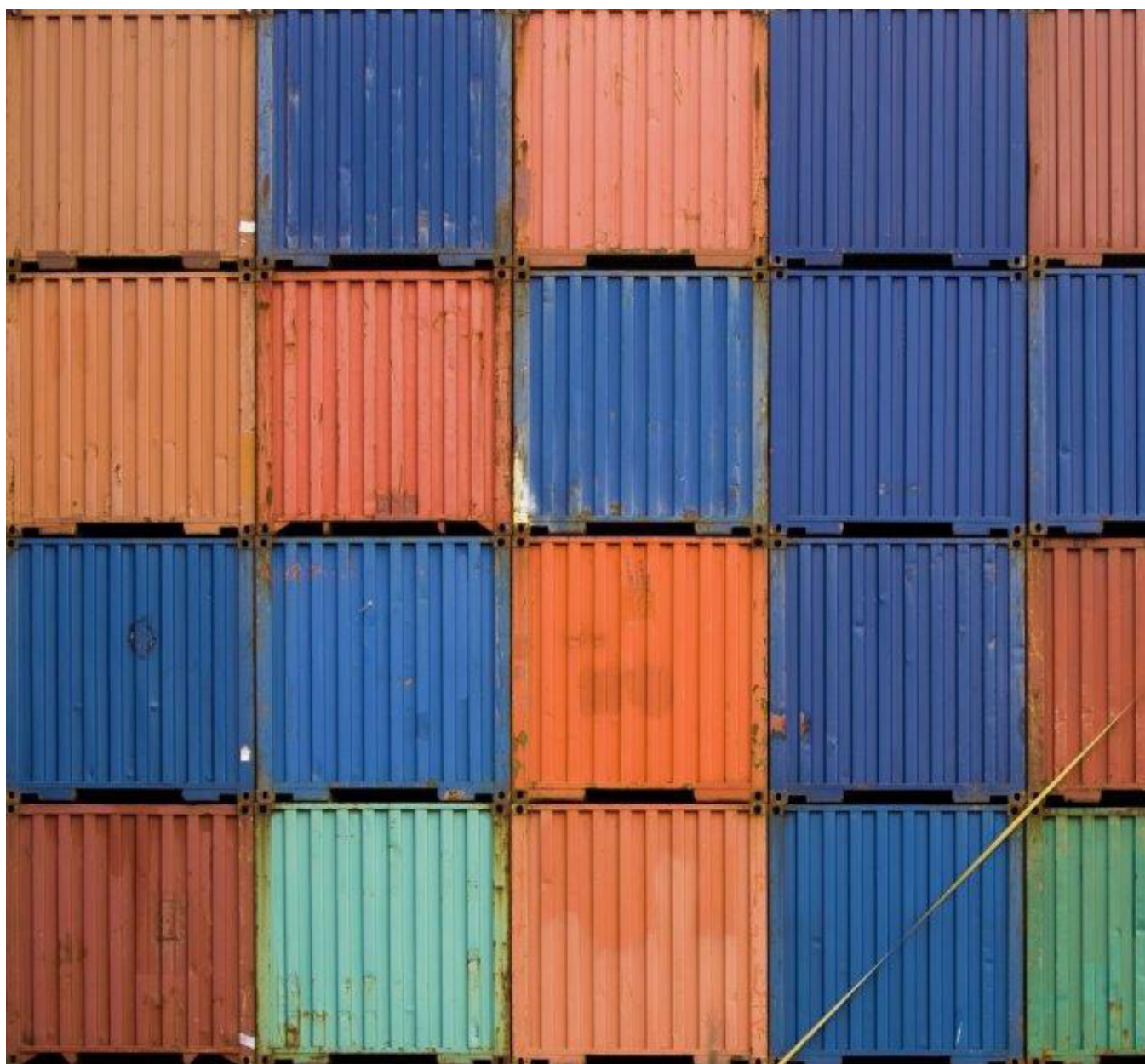
⁵ EMPEA Consulting Services, 2014. Emerging Markets Mezzanine Report

1.3. Research: literature study and interviews

The findings in this paper are based on a combination of a literature study on recent reports on SMEs finance in developing countries and emerging markets and interviews with selected fund managers of 8 selected funds, Development Finance Institutions (DFIs) and foundations active in small cap SME finance (see Annex 3).

1.4. Structure of the paper

The paper starts with a snapshot of the small cap SME mezzanine market, including overviews of a number of leading small cap SME mezzanine finance funds and their main investors, and a discussion of the main mezzanine instruments. Chapter 3 provides a detailed discussion on the fund economics of SME mezzanine funds. Chapter 4 discusses the outlook on SME mezzanine and what is needed for further growth of the asset class. Chapter 5 draws conclusions based on the previous chapters, and provides a set of recommendations to fund managers, investors and policy makers.



2. SMALL CAP SME MEZZANINE FINANCE OVERVIEW

In this chapter we further define small cap SME mezzanine (2.1) and we provide more insight in a number of small cap SME mezzanine funds (2.2-2.7). We describe the investors in the funds (2.8) and discuss the applied instruments (2.9 and 2.10).

2.1. Definition of small cap SME mezzanine finance

In global financial sectors, mezzanine is commonly seen as a generic term for financing techniques that incorporate elements of debt and equity in a single investment. In developed countries, mezzanine is a relatively sophisticated instrument that is part of a layered capital structure of a company, ranking above equity and below senior debt. The traditional market (mainly in developed countries) for commercial mezzanine finance has been upper-tier SMEs, with high credit ratings and demand for tickets substantially above USD 1m.

The aforementioned EMPEA-study emphasizes that mezzanine investing in emerging markets is markedly different from its developed market counterpart. In emerging markets, mezzanine is about filling a funding gap instead of filling a gap in the capital structure. It is about supporting good companies, typically in the mid-market, that are not able to access traditional bank funding; not able to access the bond or Initial Public Offering markets because of their size and depth; and do not want to take private equity (yet) because of the level of dilution and terms ⁶.

Small cap mezzanine finance offered to SMEs in emerging countries is typically not part of a layered capital structure. Small cap SME mezzanine providers are usually the only external investors in a company. The more debt-like mezzanine instruments are typically relatively risky, (partially) uncollateralized, flexible and long term loans, and often capture “upside” - indicating that the finance provider shares in the profits if the company performs well, contrary to a conventional loan which has a fixed interest rate. The more equity-like mezzanine instruments typically involve equity instruments with some sort of self-liquidating ⁷ mechanism. For the purpose of this study, we use the following definition of the term “small cap SME mezzanine”.


Small cap SME mezzanine is a long-term finance product between USD 100k and USD 2m for existing companies, that is more flexible than bank financing in terms of collateralization and repayment profile, that is typically self-liquidating and often contains an upside capturing mechanism.

⁶ The repayment schedule and maturity of a self-liquidating loan are designed to coincide with the timing of the assets' income generation.

⁷ The repayment schedule and maturity of a self-liquidating loan are designed to coincide with the timing of the assets' income generation

The following instruments are the main small cap SME mezzanine instruments. The instruments will be discussed in more detail in section 2.9.

Table 1: the main small cap SME mezzanine instruments

	INSTRUMENT	DESCRIPTION
 <p>Debt-like</p> <p>Equity-like</p>	Partially unsecured / Junior loans	Loans with tailored repayment structure and flexibility regarding collateralization requirements. Payments to the fund manager are sculpted around the specific situation of a company, often allowing for long grace periods or seasonality on principal repayments and interest payments
	Royalty based lending	Provides the investor with a base interest plus royalties, which are payments that are dependent on the performance of the company, usually a percentage of revenue or EBIT(DA)
	Convertible loans	Typically a loan with a maturity date and a regular repayment schedule, and an option to convert the loan into shares of the company
	Preference shares	Shares which have preference over ordinary shares, including priority in receipt of dividends and upon liquidation, often with a fixed annual dividend
	Redeemable equity	Mostly similar to ordinary shares, but with a right to sell the shares back to the entrepreneur (put option), typically using a predetermined price or a formula

2.2. Overview of selected small cap SME mezzanine fund managers for this study

For this paper, we studied a number of leading small cap SME mezzanine fund managers. We selected 8 fund managers that invest using mezzanine-like instruments⁸ in ticket sizes overlapping with the scope of this study (USD 100k – USD 2m). The table below discusses the main characteristics of these fund managers. Even as we do not pretend to be exhaustive, we do believe we have a representative selection of the main existing small cap SME mezzanine fund models and strategies. We interviewed most of the fund managers in the overview below (see Annex 3 for the list of interviewees). We have also drawn lessons from conversations with BPM and Aspada, but they are not listed in our overview of fund managers, as their ticket sizes are outside the scope of this study.

⁸ Although sometimes the fund managers also manage funds that do not make use of SME mezzanine, they mainly focus on mezzanine-like instruments.

Table 2: overview of selected SME mezzanine fund managers in the USD 100k – 2m segment

FUND MANAGER SNAPSHOT			
<p>Business Partners International (BPI) is a fund management company that supports SME growth by providing financing, sectoral knowledge and added-value services to SMEs. BPI was established in 2004 as a subsidiary of Business Partners Limited. Business Partners Limited has over 30 years of experience in South-Africa. BPI provides equity and debt, its main instrument is royalty based finance.</p>			
Geographical focus: Malawi, Namibia, Zambia	#Vehicles: 3	Capital: USD 60-80 m	No specific sector focus
<p>GroFin is a development financier specializing in financing and supporting SMEs. GroFin was founded in 2004 to support entrepreneurs with capital and business support. GroFin provides mainly flexible, partially unsecured loans.</p>			
Geographical focus: Africa and Middle East	#Vehicles:10	Capital: USD 460-480 m	No specific sector focus
<p>Gazelle Finance provides growth-oriented risk capital to promising, high-growth SMEs in the Eurasia region, providing a combination of income participation loans and self-liquidating minority equity investments. Gazelle Finance is in the final stages of fund raising.</p>			
Geographical focus: Georgia, Armenia, Kyrgyzstan, and Moldova	#Vehicles:1	Capital: N.A.	No specific sector focus
<p>Investisseurs & Partenaires (I&P) is a family of impact funds investing in Sub-Saharan Africa. I&P was created in 2002. The investments are mainly (minority) equity investments and royalty based loans.</p>			
Geographical focus: Sub-Saharan Africa and in the Indian Ocean	#Vehicles:4	Capital: USD 80-100 m	No specific sector focus
<p>Pyme Capital is a SME-fund, founded in Panama in 2008. Pyme focuses on royalty based loans and equity investments.</p>			
Geographical focus: Latin America (Bolivia, Colombia, Nicaragua and Guatemala)	#Vehicles:1	Capital: USD 8-12 m	Sectors: Tourism, Agriculture, Manufacturing and Renewable Energy

Grassroots Business Fund (GBF) is a hybrid organization. It is a for-profit private investment fund and a donor funded non-profit organization. The capital structure of GBF's for-profit private investment fund, allowing it to make equity, mezzanine, and straight debt investments.

Geographical focus: Latin America, South Asia, Africa

#Vehicles:1

Capital: USD 50 m

Sectors: Agriculture, artisanal manufacturing, goods and services for the poor

SEAF is a global fund management group, headquartered in Washington, D.C. and Amsterdam. SEAF started operations in 1989. SEAF invests growth capital in early stage and SMEs in emerging and frontier markets. SEAF also provides business assistance to small cap SMEs in emerging and transition markets. More than half of its investments are equity investments. A range of different mezzanine instruments are often used.

Geographical focus: Central and Eastern Europe, Africa, Asia and Latin America

#Vehicles:35

Capital: USD 499 m

No specific sector focus

eXtra Small Medium Large (XSML) is an investment fund manager with a focus on frontier markets, particularly those in Central Africa. XSML applies mezzanine or quasi-equity instruments, including debt with profit sharing or a royalty scheme, preferred shares, convertible debt, or subordinated debt with warrants.

Geographical focus: Central African Region

#Vehicles:2

Capital: USD 65 m

No specific sector focus

Of the 8 funds we have identified for this paper, 7 are currently active, while Gazelle Finance is finalizing fundraising. Nevertheless, we included Gazelle Finance in this study as this is a fund with experienced founders who are explicitly using the model of BPI, who pioneered small cap SME mezzanine in South Africa and Sub Sahara Africa, to new regions (Central Asia, Eastern Europe and the Caucasus).

Ticket size ranges

In figure 1 the total range of ticket sizes of the fund manager across different funds is displayed.

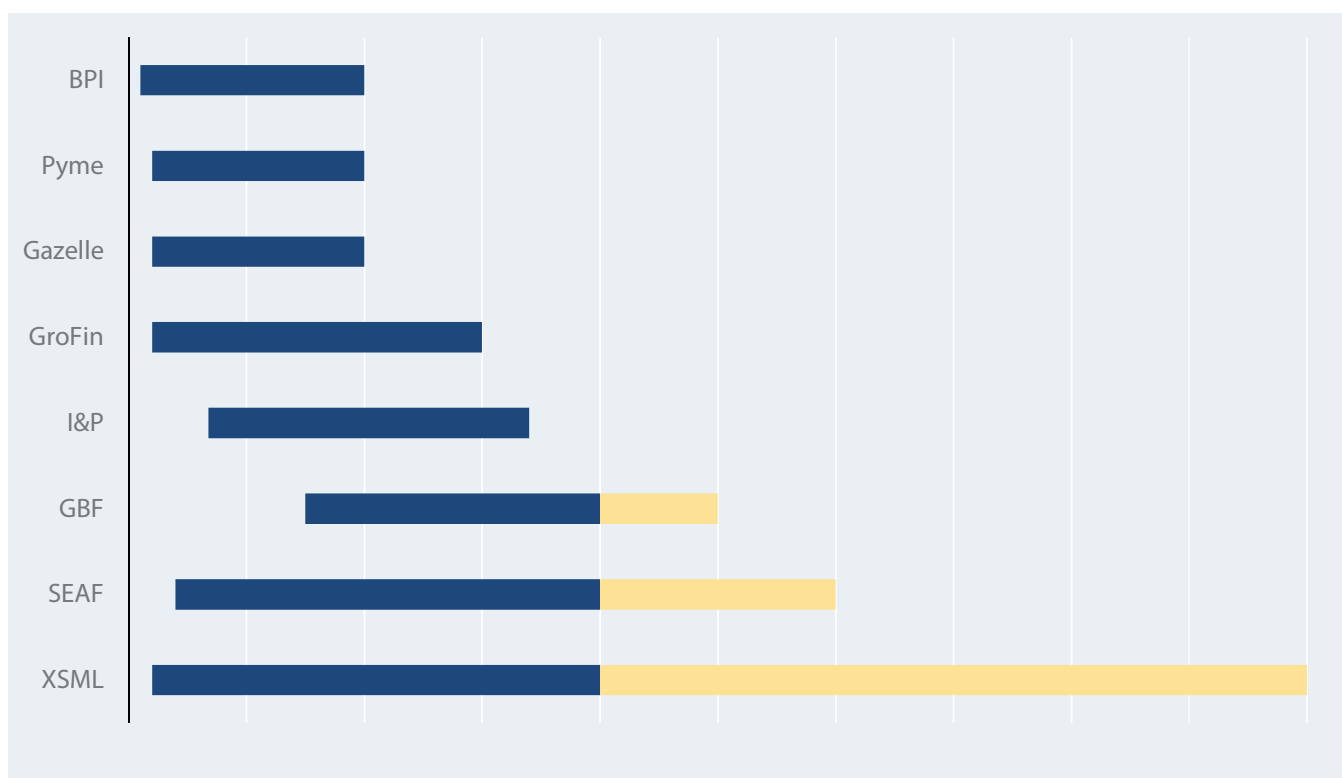


Figure 1: funds investing in ticket sizes in scope of this study

2.3. Current position of small cap SME mezzanine

Small cap SME mezzanine currently only takes a very modest position in the overall SME finance landscape. There are still relatively few funds active in this area, and the total amount of capital they are managing is very small compared with the total SME financing gap. Although the overview of the 8 funds analyzed for this study is not exhaustive, it includes the main and biggest small cap SME mezzanine providers. Yet these 8 funds “only” have about USD 1.2 bn under management. It is difficult to quantify the market share of SME mezzanine due to the overlapping deal sizes and other challenges classification mentioned earlier, but for comparison, IFC estimated the current credit gap for formal SMEs to be USD 1.2 trillion (in 2011).

2.4. Classification by investment instrument

Making a classification of small cap SME mezzanine fund models based on investment instruments used is challenging for several reasons:

- First, most fund managers manage several different funds that can have different strategies and operate in different regions.
- Second, most individual funds offer a variety of different investment structures.

- Third, detailed data on the operations and actual performance of funds segmented by region, ticket size and/or instrument is hardly available, as small cap SME mezzanine is a relatively young niche with few players, with performance data being confidential business information.

This makes it challenging to analyze and compare different fund managers, models, strategies and investment instruments. It is also important to bear in mind the thin line between structured equity and mezzanine. Equity investing in small cap SMEs already is almost by definition done in structures that try to capture upside potential while limiting the risks common to small cap SME investing, so structures that would qualify as mezzanine are not exclusive to mezzanine fund managers, as they have been used for small cap SME private equity funds for a long time. The mezzanine models that are the subject of this study have in common that they seek to adapt existing investment instruments to allow to better serve small cap SMEs in emerging markets and seeking ways to address the lack of exit options and high transaction costs relative to deal size.

To provide an overview of the most common structures, figure 2 shows the proportional composition of instruments used by the selected fund managers, with the more debt-like mezzanine instruments in blue and the more equity-like instruments in yellow. Due to confidentiality reasons, we have chosen to present the figure without the names of the funds.

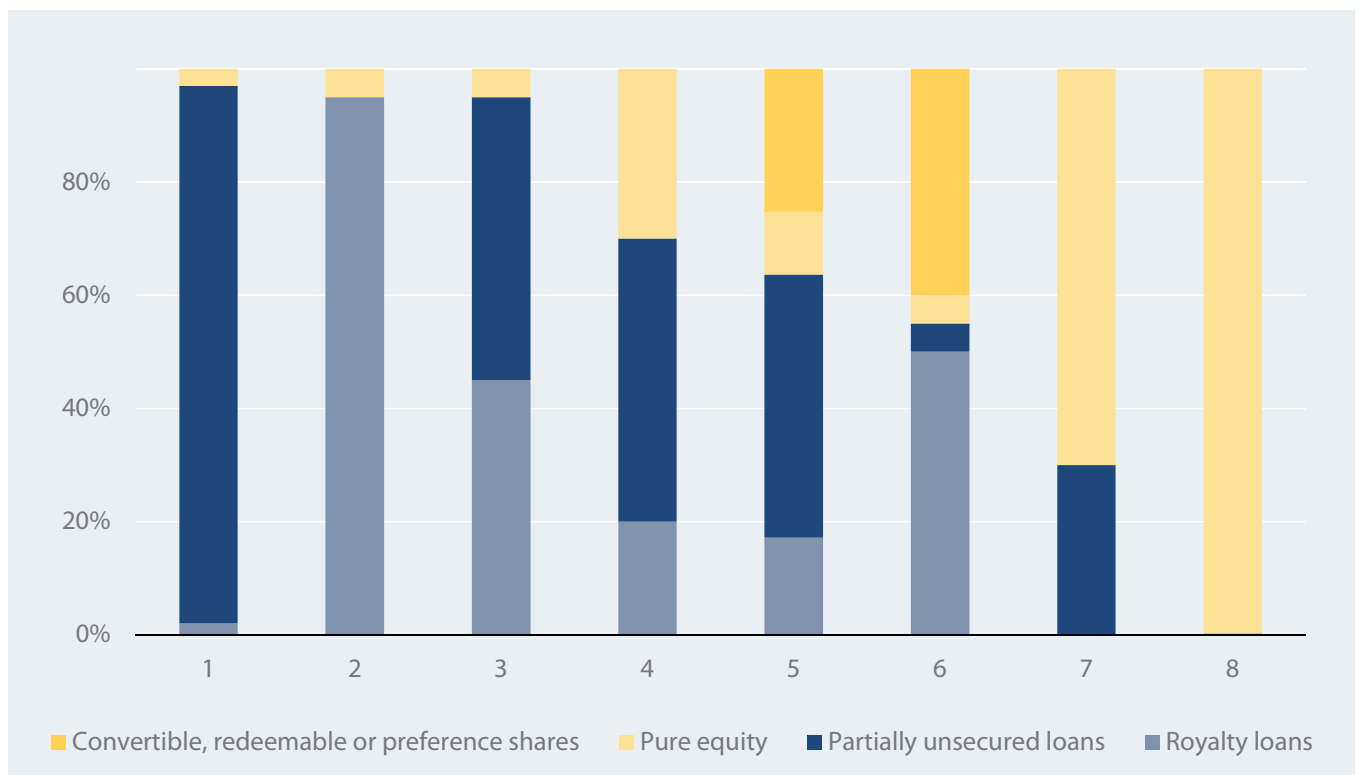


Figure 2: instruments put to use by the fund managers

2.5. Two main archetypes of small cap SME mezzanine funds

Interviewees for this study were generally of the opinion that in the < 2m USD segment, investment instruments used are an important, but not the only factor to distinguish different fund strategies and models. The dependency on third party exits, which largely determines the required level of involvement of fund managers with their investees, is generally seen as a more important differentiating factor, as this has significant impact on how time-consuming deal sourcing and selection, due diligence, negotiations and monitoring are and how stable and predictable returns are.

In line with the above distinction of more debt-like and more equity-like mezzanine instruments, we identified two main archetypes of models of small cap SME investment funds. First what we call **“Scaled down private equity funds”,** or **“equity-like mezzanine providers”** with tailor made structures, substantial involvement at investees and focused on maximizing value creation and focusing mainly on third party exits. Second are **“Lenders that provide risk capital”,** or **“debt-like mezzanine providers”,** who aim to provide capital to a larger number of SMEs while minimizing transaction costs and risks using standardized self-liquidating structures. I&P and SEAF can largely be qualified as scaled down PE-funds, and GroFin, BPI, Gazelle Finance and Pyme are examples of Lenders that provide risk capital. GBF and XSML are somewhere in between the two archetype models. It is important to note that this is simplified categorization, and one needs to bear in mind that some of the above fund managers operate many different funds in various regions, and often also focus on tickets sizes well above USD 2m.

The figure below illustrates our categorization of the interviewed fund managers:

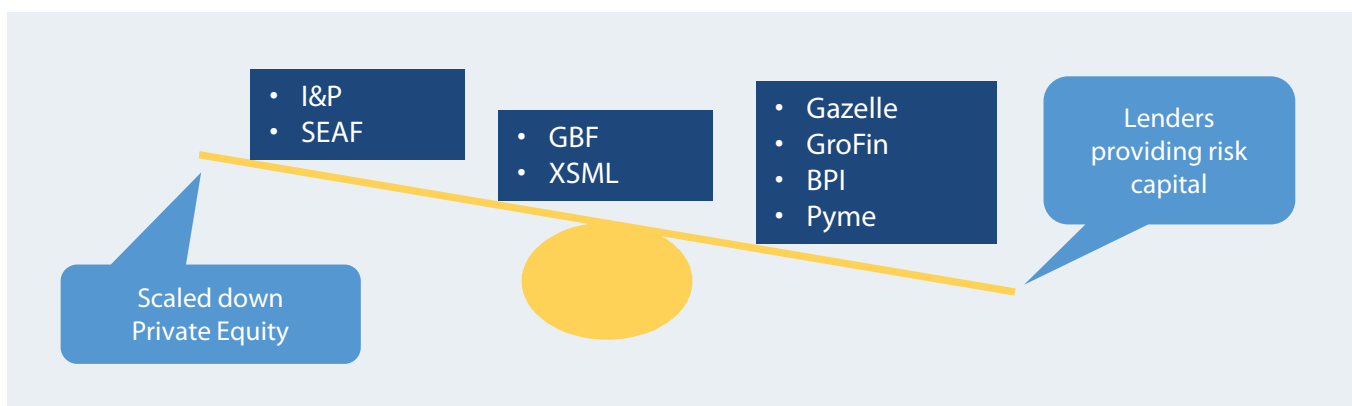


Figure 3: categorization of the interviewed fund managers

Scaled down private equity funds

As we will discuss in more detail in Chapter 3 on fund economics, especially the extent to which fund managers use equity-like structures and operate like traditional private equity funds has a significant impact on how much time needs to be spent per deal. The private equity model is based on the use of equity-like structures (through instruments like convertible debt, preference shares, redeemable equity and other combinations of debt and equity) to achieve high returns. This is done by selecting the best companies and adding value through active involvement with the investee companies. However, this also means that transaction costs are high compared with loan providers. Private equity investors are co-owners of a company, which comes with very specific dynamics. Usually, investors take board seats at their investee companies, and they spend a considerable amount of time supporting the SME’s management with their strategy, operations, financial management, human resource issues, marketing, etc. Also the transaction process itself is very time consuming. Only very good deals with both high growth potential and exit potential qualify. Furthermore, there needs to be a fit with the entrepreneur, both in terms of alignment with the entrepreneur’s (exit) strategy and a cultural fit with the investment team. These factors lead to very time consuming deal selection processes, with low conversion rates (from lead to closed deals) and long lead times to build a relationship with the entrepreneur and to negotiate a deal.

Given the already challenging nature of small cap SME finance, the economics of private equity funds in the SME segment are challenging. In western markets, the private equity model is mainly used for transactions well above USD 1m. Equity investors investing in ticket sizes below USD 1m are more technology start-up type deals on which exponential returns are expected to be made (venture capital approach). As many fund managers in emerging markets use a private equity-like model for smaller SMEs with less exponential growth potential and whereby much lower financial returns are achieved than in their western counterpart due to unfavorable fund economics, we call this a “Scaled down private equity fund”.

Lenders that provide risk capital

The model of Lenders that provide risk capital is very different from the private equity-like approach of the scaled down private equity funds. The typical deal structures are debt-like, such as royalty based loans (which is the main model of BPI) and unsecured/junior loans (which is the model of GroFin). This model aims to serve a large number of small cap SMEs while minimizing transaction costs and using self-liquidating structures. The model is about providing risk-capital by aiming for lower returns than equity-like mezzanine providers, but focusing more on efficiency and lowering transaction costs and other operating costs. Standardization of deal structures, term sheets, contracts, financial models, etc, allows for faster turnaround time of deals. Fund managers do not take board seats and are not dependent on third party exits, so also portfolio management is significantly less time consuming than for equity-like mezzanine providers. Debt-like mezzanine investments involve a less close relationship with the entrepreneur than equity-like investments, allowing the investor to be less picky in the area of personal fit, shareholder dynamics and exit potential. In Chapter 3 on fund economics, we will discuss the main parameters of this type of funds in more detail.

A view shared by most interviewees was that especially for the <1m USD segment (but in general also for deals up to say USD 3m), it is very difficult to make the economics “work”, also recognizing that various interviewees have different opinions on what working models and acceptable returns are. Specifically from the larger fund managers managing a variety of different funds, we obtained the picture that equity-like structures are mostly used for somewhat larger deals, typically above USD 1m (although dependent on geographical factors such as staff costs, overall business environment, etc.), while debt-like mezzanine structures are especially suitable for the <1m USD segment.

2.6. Vehicle types used

In general, we see that the funds in the missing middle SME segment are moving away from limited life funds. Most of the fund managers have experience with both limited life funds and permanent funds. A clear trend in the market is the shift towards permanent capital vehicles, which are at least better suited for debt-like vehicles. The type of vehicle is quite important; some fund managers explained that in managing a fund, vehicle type is more important than type of instrument. In general, the fund managers preferred the evergreen structure. An important reason is that it enables the fund to provide long-term loans (or equity) and allows leverage at the fund level. The evergreen structure also offers more stability:

- With limited life funds the realized return can be very much influenced by last-minute exchange rate adjustments;
- Fund managers and investment officers can focus on their job, without having to wonder where the money of DFIs will be focusing next;

- Fund managers see investment officers leaving limited life funds before the end of the fund.

The table below describes the vehicle types applied by the funds. In chapter 3 we will discuss the implications of fund structure in more detail.

Table 3: overview – type of vehicle

FUND	TYPE OF VEHICLE
BPI	The 3 BPI-funds have permanent vehicle structures
GroFin	The latest funds of GroFin have permanent vehicles, e.g. the GroFin SGB Fund (USD 150 m). GroFin also manages limited life funds of 10 yrs (e.g. the GroFin Aspire Fund)
Gazelle Finance	Gazelle Finance will apply a limited life fund structure
I&P	IPAE is a EUR 54m fund launched in 2012 with a classical 10 year close-ended structure. I&P manages 3 national funds (Niger, Burkina Faso and Senegal) that are evergreen
Pyme Capital	The first fund of Pyme Capital is a limited life fund (USD 8.5 m). Pyme is now moving towards a new fund with a permanent structure, it aims to raise USD 20 m in 2016 for a fund with an permanent structure
GBF	GBF manages one 10 year, limited life fund as well as a non-profit fund that provides technical assistance. With its proposed GBF 3.0 it introduces an open ended structure, as well as an investment management company
SEAF	Of the 36 vehicles, most have the typical 2/20 structure ⁹ ; in Afghanistan and Bangladesh SEAF manages permanent vehicles. In the future, SEAF expects a shift towards permanent structures.
XSML	All funds managed have limited life fund structures

2.7. Capital under management

The gross assets under management of these 8 funds are more than USD USD 1.2 bn, gathered in fund raising in the period 2001-2015. Mostly, the fund managers manage more than one fund. Figure 4 points out that at least the fund managers covered by this study have been able to step up their activities. In the period 2001-2010 almost USD 300 m was raised (which equals USD 28 m per year), while in the five years after more than USD 400 m (or USD 77 m per year) was raised. If we include the amount for which fundraising is in progress, the number increases further. Results from the interviews and desk research point out that fund managers plan to raise USD 135 m in 2016 for funds that will apply tickets in the range of this paper¹⁰.

⁹ Referring to a standard private equity structure, with a 2% management fee and a 20% carried interest and a 10 years fixed life

¹⁰ November 2015 - April 2016

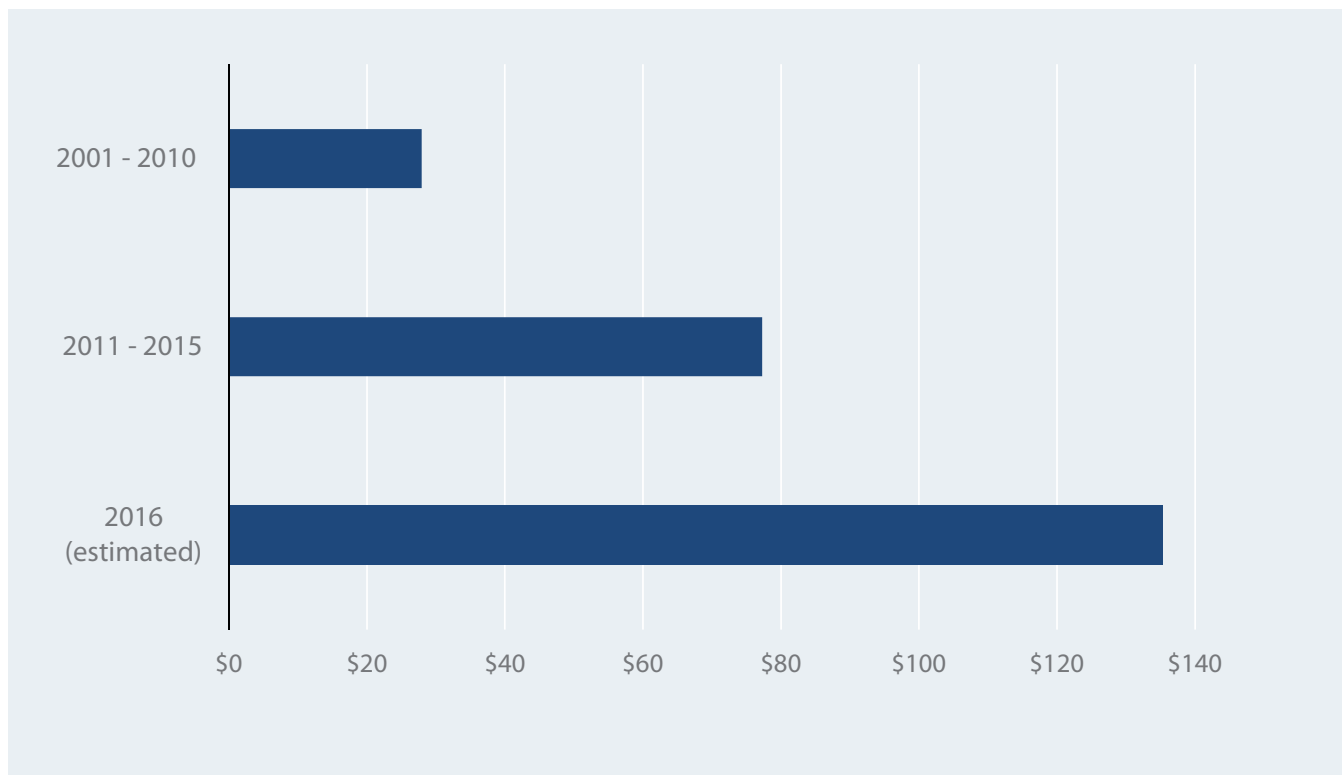


Figure 4: funds raised by 8 SME mezzanine funds 2001-2016 ((depicted numbers are averages per year)

2.8. Small cap SME mezzanine investors

Roughly, we see two main types of investors in the small cap SME mezzanine funds: DFIs and Foundations (family offices, CSR funds from multinationals, NGOs etc.). So far, investments (or donations) from other institutions or individuals play a minor role. During the interviews, fund managers have confirmed that interest of foundations is increasing. The DFIs are still seen as anchor and (local) pension funds are showing increasing appetite. For a nice illustration of the different (types of) investors, the annual report of GBF of 2015 provides an overview distinguishing the various types of investors in a clear and transparent way¹¹.

2.8.1. DFIs investing in small cap SME mezzanine finance

Although DFIs are still the anchor for SME mezzanine funds, the structure and internal procedures of DFIs form key constraints for investments in the funds. Usually DFIs provide debt to financial institutions or equity to funds. The structure is a constraining factor if fund managers want to use evergreen fund structures and/or want to provide debt to SMEs.

Most interviewees confirmed that some established DFIs seem to be moving away from SME mezzanine investments via investment funds, as many funds have not been able to meet the return expectations of DFIs. Interviewees (including at DFIs) indicated that so far, over a longer period and across regions, SME funds have on average realized net returns in hard currency of around 5 - 6%. It needs to be noted that this includes SME equity funds with larger ticket sizes, the net returns on funds focusing on the < USD 2m segment being probably even lower. In any case, the returns on small cap SME investing are substantially below requirements of most DFIs, as they typically require IRRs of 10-20% for equity funds.

¹¹ The annual report can be found at www.gbfund.org/publications

We do see however, that DFIs acknowledge the importance of stimulating SMEs because of their contribution to economic growth and job creation. DFIs are generally involved in SME support programs and lending to SMEs via local banks. For example IFC, Norfund and Obviam have strategies focused on SME finance. OPIC is able to provide finance to fund managers under its Innovative Financial Intermediaries Program (IFIP). And while DEG does not focus on investing in SME funds anymore, they are very much involved in lending to SMEs via local banks. Many of the interviewed representatives of DFIs stated that they hope that new innovations and continuous improvement of existing models will improve the risk-return balance of small cap SME investing, so that the segment becomes more attractive to DFIs. However, the general opinion seemed to be that nobody has been able to crack the model yet.

It is not practical from a financial point of view for DFIs to invest directly in SMEs (as DEG has done in the recent past). One of the interviewees estimates that as a consequence of internal procedures the DFI would face transaction costs that are 100k-150k per deal above those of SME-funds. High internal transaction costs are the result of being under banking regulation and may also be the result of being a larger organization with more bureaucracy.



Table 4 gives an impression of the funds covered in this study and the DFIs that have invested in them.

Table 4: DFIs and governments investing in the selected SME mezzanine funds

FUND	DFIS AND GOVERNMENTS
BPI	IFC, EIB, CDC, EADB, Proparco, FMO
GroFin	KfW, DGGF, Norfund, CDC, FMO, USAID, AfDB, EIB, IFC, Fisea (managed by Proparco)
Gazelle Finance	Currently fund raising
GBF	DEG, FMO, OPIC
I&P	AfDB, EIB, Government of Monaco, FMO, Proparco, BOAD (West African Development Bank)
Pyme Capital	Deutsche Bank, IDB
SEAF	BIO, EBRD, DEG, FMO, Finnfund, IFC, Kazak National Innovation Fund, Norfund, OPIC, Swedfund, SIFEM (Swiss Investment Fund for Emerging Markets), USAID
XSML	IFC, FMO

2.8.2. Foundations investing in small cap SME mezzanine

The rise of other development institutions, such as foundations, as an important category of investors in SME funds reflects a broader trend. It is widely acknowledged that foundations play an increasingly important role in supporting the development of emerging markets. The table below provides an overview of investments by development institutions – other than DFIs – into the funds covered by this paper.

Table 5: Foundations and other development institutions investing in the selected SME mezzanine funds

FUND	FOUNDATIONS
BPI	Stichting Doen
GroFin	Shell Foundation, Calvert, Scholl Foundation, Lundin Foundation, Triodos Foundation, Finnfund,
Gazelle Finance	Currently fund raising
GBF	GBF has received funding from 9 private foundations
I&P	Rothschild Foundation, Small foundation, Caritas,
Pyme Capital	Cordaid, Oikocredit, Fundación Bolivia Exporta, Avina Foundation
SEAF	Ford Foundation, The Rockefeller Foundation
XSML	Lundin Foundation

In the above tables we see that there is a wide variety of development institutions investing in SME mezzanine funds. Among these are very small investors, with ticket sizes varying from 100k to 300k, Foundations like Shell Foundation are able to deploy a relatively high sum of money. Shell has invested USD 207 m, of which 91% is grant funding.

From the interviews with the foundations, we can conclude that their core interest is in (stimulating) scalability and impact. They appear more flexible than DFIs, and they are less restricted by procedures, policies or structures. Foundations are more often able to support evergreen structures and innovative financial products.

2.9. Overview of SME mezzanine instruments

The table below provides a brief overview of the main mezzanine instruments that are commonly used to finance SMEs in emerging markets. Annex 1 provides a detailed overview on the main pros and cons of these instruments both from the perspective of fund managers and SMEs.

Table 6: SME mezzanine instruments

MEZZANINE INSTRUMENT	DESCRIPTION
<p>Uncollateralized / Junior long term loans</p>	<ul style="list-style-type: none"> • Loans with tailored repayment structure and flexibility regarding collateralization requirements. Payments to the fund manager are sculpted around the specific situation of a company, often allowing for long grace periods or seasonality on principal repayments and interest payments • Principal repayment patterns can have many different forms, such as an escalating repayment structure, or a bullet loan (full repayment of the principal at once at the maturity date) • The same flexibility can be applied for interest payments (rolled up interest, redemption premium, etc) • The model can accommodate various types of investments, incl. start-ups • Providers also distinguish themselves from banks with less strict criteria and more flexibility regarding collateral (type and percentage of collateralization) • Pricing highly dependent on collateral; with rates slightly above bank rates for fully collateralized loan, and moving towards equity-type returns for unsecured loans • GroFin is currently doing less royalty based lending and is now mainly using this type of loan
<p>Royalty based lending</p>	<ul style="list-style-type: none"> • Provides the investor with a base interest plus royalties, which are payments that are dependent on the performance of the company, usually a percentage of revenue or EBIT(DA) • Base interest rate is often equal to or below bank lending rates to prime corporates • The targeted blended returns (base rate + expected returns from royalty payments) typically range from bank lending rates to around 10% above bank lending rates (depending on collateral) • Funds usually use highest of actual or projected revenues as basis for royalties • Requires companies to have a transparent business model and proper financial systems and reporting, allowing for good monitoring of performance • Model has been pioneered by BPI in South Africa, and is now also used by other funds such as GroFin, XSML and Gazelle

MEZZANINE INSTRUMENT	DESCRIPTION
Convertible loans	<ul style="list-style-type: none"> • Typically a loan with a maturity date and a regular repayment schedule, and an option to convert the loan into shares of the company • Exercising the option terminates the debt component, and repayment of debt cancels the conversion option • Before conversion, financial covenants give the ability to act on underperformance. After conversion, fund manager has shareholder rights • A fund manager typically has the right to exercise its conversion option in case of breach of covenants • Can be structured in many ways with different objectives • The fund manager sees the investment primarily as an equity investment, but structures it as a convertible loan as the entrepreneur does not want to dilute, or for tax optimization reasons • The conversion option is only an added “sweetener” to the deal; potentially boosting the returns just in case there is a third party exit • Examples of fund managers using these structures are GBF and SEAF
Preference shares	<ul style="list-style-type: none"> • Shares which have preference over ordinary shares, including priority in receipt of dividends and upon liquidation, often with a fixed annual dividend • Venture capitalists generally make investments in the form of convertible preference shares • Not too common in small cap SME finance due to complexity
Redeemable equity	<ul style="list-style-type: none"> • Mostly similar to ordinary shares, but with a right to sell the shares back to the entrepreneur, typically using a predetermined price or a formula • Also called a put warrant or put option • GroFin uses equity in a only about 5% of their transactions, and usually in the form of redeemable equity

Fund managers continue to develop and improve new (mezzanine) models, such as the demand dividend model. As with other mezzanine debt instruments, the demand dividend model provides risk-adjusted capital to those SMEs that lack sufficient collateral for a bank loan and are in the later early stage phase. It has the additional benefit of matching repayment to a venture's free cash flow, lessening a firm's financial risk ¹².

Box 1: The Demand Dividend model

Demand Dividend is a variation on a debt royalty structure, modified to fit the realities of investing in frontier economy enterprises. Demand Dividend has four central features ¹³:

- 1). Payments based on free cash flow: Demand Dividend holds a claim on a minority of cash flow from operations (25% to 50%) – leaving most of the cash flow available for reinvestment. Payments are first applied to term debt equal to the amount of the initial investment. Unlike royalty-based financing which pays based on revenue, Demand Dividend requires payment only if operating profits are generated. This relieves the burden of servicing debt when there is no operating income.
- 2). An abeyance (“honeymoon”) period: The repayment obligation is deferred to allow investment proceeds to accelerate enterprise revenue and profit growth. Duration could range from 10 to 24 months.
- 3). A fixed total obligation: The claim on enterprise cash flow remains until a multiple (1.5 to 3x) of the initial investment has been paid. This multiple of investment compensates the investor for the risk associated with SGBs, frontier markets, and subordination to asset-backed credit. The obligation extinguishes when payment is complete.
- 4). Business model as an integral part of term sheet: A cash flow focused financial forecast is attached to any Demand Dividend term sheet. This forecast, equal to the length of the debt term, ensures alignment of investor and entrepreneur expectations and reduces the potential for accounting irregularities due to associated covenants.

As mentioned in section 2.1, mezzanine structures are deal structures that combine aspects of debt and equity. This can be in a single instrument or through a combination of several instruments. In appendix 2 section we will discuss a number of typical mezzanine structures including combinations of several instruments. The suitability of a certain transaction structure for a given deal depends on aspects like the company's cash flow generation and exit potential, with all mezzanine structures requiring at least one of these two characteristics to be present.

¹² <http://www.scu-social-entrepreneurship.org/impact-capital-overview/upload/Demand-Dividend-Description.pdf>

¹³ Miller Center for Social Entrepreneurship, 2015. Demand Dividend: creating Reliable Returns in Impact Investing

2.10. Factors determining the applicability of mezzanine instruments

2.10.1. Regulation

The usability of small cap SME mezzanine varies significantly over regions and countries, depending on cultural differences, different regulatory frameworks, deepening of the financial sector (see EMPEA) ¹⁴ and regulatory framework, in particular the taxation of different forms of financing

Mezzanine is less used in regions where interest payments are not tax-deductible. This is the case in India and China, while in South-East Asia lending can be challenging, because it can be difficult to enforce collateral. For debt-like mezzanine a problem is that the more exotic collateral (cars, personal, etc.) is very difficult to enforce, so the downside protection is in practice limited. Specifically for stand-alone funds it is difficult and expensive to exercise collateral rights in court. In some countries, such as Mozambique and Angola, only banks are allowed to provide loans. This is a serious barrier for small cap SME mezzanine.

2.10.2. Quality of the workforce

Apart from the regulatory framework, other geographical factors can determine the applicability of SME mezzanine. Several interviewees mentioned the varying quality of the workforce. One DFI mentioned a country like Sri Lanka has a fairly high level of (financial) education compared with most Sub Saharan African Countries, where there are generally not a lot of skilled investment officers. A specific problem for fund managers focusing on smaller deals is that their best investment officers often get poached by funds focusing on larger deals. This is indirectly a problem of fund economics. It changes if viable models can be found. A fund manager pointed out that there are alternatives in Latin America to work in alliances with institutional investors, in part as an alternative to investment officers. He used the alliances also as a measure to squeeze fixed costs. He hires institutional investors for transactions on incidental basis; this enables the fund to move forward without increasing fixed salary costs.

2.10.3. Population density

Another factor to take into account in especially Africa, is the relatively low population density. According to one of the DFIs, the low density of population makes scalability a big challenge.

2.10.4. Social differences between the funding and funded country

A last factor to take into account when deciding on the geographical scope of investments is the coherence within the fund. Some fund managers stated that it should be avoided to be active in countries that are very different (it does not matter whether countries are next to each other, but whether they look like each other in terms of economy and regulation etc.).

¹⁴ EMPEA Consulting Services, 2014. Emerging Markets Mezzanine Report

3. THE ECONOMICS OF A SMALL CAP SME MEZZANINE FINANCE PROVIDER

Fund economics is the relationship between investment strategy, operational set-up and performance of a fund, ultimately translating into net returns and impact realized for the funds' investors. As discussed in chapter 1, in small cap SME investing the time a fund manager needs to spend per transaction is not proportional to the size of the deal. In other words, a smaller transaction does not automatically lead to lower transaction costs. Often the smaller deals will even be more time consuming due to the lack of information and professionalism of the investee. This phenomenon is probably the most important challenge to small cap SME investing. In this section we will discuss the need to get the fund economics right, and we will present an overview of the main drivers of fund economics. The chapter ends with the question how to make it work: the use of subsidies.

3.1. The importance to get the fund economics right

A commonly recognized phenomenon, especially among (new) impact fund managers, is that fund managers do not fully see the practical implications of their chosen strategy and therefore work with an unrealistic combination of assumptions. For example, a commonly recognized example is the fact that many new fund managers overestimate the number of deals that they can handle with a given team size. Many starting funds first require a lot of time to get to know the market, build a team, work out their internal governance and procedures, build a pipeline and select the first deals. It typically takes up to several years to develop routines in these activities. Many new fund managers do not properly factor in this ramp-up period in their plans, and tend to underestimate the time required in the beginning. As a result, a new fund manager may perform well compared with peers in terms of its ability to find and close deals, but will in fact quickly lag behind its own projections because its own expectations were too optimistic.

The danger of this perceived underperformance is that investors and other stakeholders quickly become dissatisfied, increasing the pressure on the fund manager to do deals quickly, thereby rushing investment processes and lowering quality standards, or sometimes terminating or reducing their commitment to (further) invest into the fund. The fund manager may also quickly be required to take measures, such as getting additional grants, closing (pro-bono / low-bono) deal flow partnerships, expand or change the team, to increase productivity, which distracts the fund manager from its core business of managing deals. Lastly, a common effect of not getting the fund economics right at the beginning, is that fund managers in this situation often move up in deal size to improve fund economics, thereby often drifting away from their original mission.

For these reasons it is important to use realistic assumptions when designing a fund strategy. When fundraising, it is important to present a case with realistic assumptions based on market practices, and it is important to work with realistic return expectations. In practice, we still see new fund managers in fundraising promising net IRRs to investors of more than 8-10%, while even the most steady performing funds in the <2m USD segment have not been able to consistently realized net IRRs above 5-6%, as generally confirmed by DFIs based on a large sample of funds. DFIs generally mentioned that they would rather see fund managers using realistic assumptions based on actual market practices, using a smart combination of investor capital and subsidies to make their model work.

3.2. Drivers of fund economics

This section is meant to illustrate the economics of SME investment funds. We applied some simplifications in calculations and assumptions, to help increase understanding of the main mechanisms for non-practitioners.

3.2.1. Fund size

The size of a fund is measured in terms of the amount of capital committed by investors to a certain fund. The management fee is often a percentage of the fund size for limited life funds but can also be budget based, which is more common for permanent vehicles. The management fees (together with subsidies) determine the operating budget for the fund manager, from which it needs to pay for costs like salaries, office costs, travel costs, and usually also legal and tax advisory costs. Obviously, while keeping ticket sizes constant, a larger fund benefits from economies of scale as overhead costs can be divided over a larger number of deals. Interviewees indicated that an (unsubsidized) fund needs to have a minimum size of between USD 30m and 70m in order to be sustainable, the exact number being highly dependent on the geographic span of the fund, and the overall strategy of a fund, as well as the use of technical assistance.

As the management fee is usually paid from the funds under management, the height of the management fee has a significant impact on the net returns to investors of a fund. The economies of scale are further amplified if one fund manager manages multiple funds. GroFin and BPI respectively manage 10 and 3 funds¹⁵, with total funds under management of respectively more than USD 500m and USD 62m¹⁵, and quoted their economies of scale as important ingredients for success.

3.2.2. Average ticket size

As mentioned in chapter 1, the informality¹⁶ of SMEs makes the economics of a small cap SME mezzanine fund challenging¹⁷. When asked about the minimum deal size required to be financially viable, the practitioners interviewed for this paper mentioned a wide range of transaction sizes. GroFin intuitively sees round USD 350k as the minimum of what they can do with their model, while BPI can even go as low as transactions of USD 50k. Fund managers providing more equity-like investments typically mention a minimum of USD 1 to 2m. A representative of a leading DFI was even of the opinion that it is not possible to invest in SMEs below USD 10m. The wide difference is probably caused by different interpretations of what net returns can be expected from this niche.

3.2.3. Management fee structure

The management fee constitutes a big section of the costs. It is often calculated as the fund size x the management fee %, but also fixed amounts or other formulas are possible, and typically lies in the range of 2.0 – 4.0% of fund size. Usually the management fees are higher during the investment period, reflecting that this is a more labor intensive phase. Funds doing smaller deals require higher

¹⁵ This only concerns the funds managed outside South Africa.

¹⁶ The IADB has held a survey in Latin-America (IADB, Banks and the missing middle), to be able to provide motives of banks for not investing in SMEs. The main reason was 'informality'. Informality presents itself in various forms that are critical to the credit decision-making of banks; for example, a lack of audited financial statements, credit history, guarantees, etc. The smaller the business is, the more informal it may be. Thus, it is not surprising to find that for 51% of banks surveyed, informality is a major obstacle, which leads them not to serve businesses that are smaller than those they are currently serving.

¹⁷ Let's illustrate this with an example of two fund strategies. Fund A is doing investments of USD 500k on average and Fund B does deals of USD 1m on average. In order to disburse USD 10m to investees, fund A needs to do 20 transactions and fund B needs to do 10 transactions. Accepting that doing a transaction of USD 500k roughly takes the same amount of time as a USD 1m transaction, in other words the number of deals per investment officer is the same for both funds irrespective of deal size, fund A needs to have twice the amount of investment officers compared with fund B. The consequence is that Fund A, due its smaller ticket size, needs to have a substantially higher operating budget to deploy the same amount of capital.

management fees than funds doing bigger deals in absolute terms. This has several implications. Firstly, a higher management fee leaves less funds to be disbursed to SMEs. Secondly, a higher management fee will lead to lower net returns to investors.

Practitioners generally confirmed that deal sizes of between USD 100k and USD 1m form the most difficult segment, and the smaller the average deal size becomes, the bigger this problem becomes. As mentioned before, fund managers that use a wide range of ticket sizes (and usually deploy multiple funds) confirmed that the smaller ticket sizes are usually done using debt-like structures.

3.2.4. Operating budget

As mentioned above, the operating budget available to a fund is determined by its management fee, plus any grants and subsidies available to the fund manager. The operating budget that a fund requires is a factor of many different elements that make up the operational strategy of a fund¹⁸. As described in the previous paragraphs, transaction size and fund size are important drivers of the required size of the investment team, which again is the main cost component of an investment fund. However, there are many other factors determining the operating costs of a fund manager. Below we discuss some of the main drivers of operating costs.

- **Geography:** the geographical focus and organization of a fund will have significant implications on the operating costs of a fund. Countries differ substantially on their business environment, knowledge levels, languages, (financial and tax) regulation, infrastructure, population density, etc (also see chapter 2) that determine easiness as investment destination. However, there seems to be consensus that for successful SME investing, it is key to maintain close relationships with entrepreneurs and to be on top of the investments. A lot of frequent personal contact is needed, especially when deals get into trouble. To spot good deals before others and conducting due diligence efficiently also require a good knowledge of the local markets. The practitioners interviewed for this paper confirmed that fund managers operating remotely: on a distance from their investees have generally performed less than funds with strong local presence. For funds with centralized fund management (i.e. serving multiple countries from one location), especially based in Europe or the US, travel costs quickly become very high in relation to the (smaller) transaction amounts. From this perspective, much of the investment work should be done on the ground close to the target companies. On the other hand, funds should try to achieve economies of scale and avoid duplication of costs by centralizing some functions. A reason to have geographic diversification is to mitigate political and currency risks. Especially currency risks are quoted by fund managers as negatively impacting net returns to investors.
- **Level of involvement of fund manager and technical assistance:** an important strategic choice of (impact) investment funds is the level of involvement. As discussed in chapter (2.5), the Scaled down private equity funds and Lenders that provide risk capital indicate very different types of mezzanine providers, the main difference being the level of involvement with investee companies. Scaled down private equity funds such as Investisseurs & Partenaires (I&P), operating mainly in West Africa, manage to have significant involvement with their deal companies. They operate similar to private equity firms in developed countries, by creating value to entrepreneurs. They do this by taking board seats and making extensive use of investor rights, such as required approval of key management and financial decisions, and playing a leading role in facilitating an exit. I&P has confirmed that this is a challenging model, as transactions and dynamics with entrepreneurs

¹⁸ And the gap between what is available and what is required could be bridged with subsidies, as will be discussed in section 3.5

are very time consuming. The model is different from lenders such as GroFin and BPI, that do not take board seats and are not dependent on third party exits. Some funds also provide technical assistance, usually in the form of a pool of money available to hire consultants to undertake short-term interventions at investee companies. BPI is known to make use of such TA funds. When these funds are externally funded (for example by donors), TA funds can be an effective way to improve the performance of investees without increasing operating costs of the fund.

- **Team composition:** not only the size of investment teams is important, also the required skills and composition of the investment teams is a key determinant of fund economics. Investing (especially equity investing) is often seen as a profession that requires a lot of experience to master, as it is based on judgment of entrepreneurs, markets and specific situations that is formed based on years of experience. In many developing countries there are few professionals with such experience. Bringing in such experts from developed financial markets as expats typically comes at very high costs, for which there is usually little or no room in the operating budget. On the other hand, local professionals with relevant investment experience are very scarce in low income countries, and therefore they can often earn salaries significantly higher than they would earn in developed countries. Therefore it is key to develop methods to provide risk capital with a team of professionals that is not too expensive. GroFin and BPI both have a strategy of focusing on hiring and training local staff, hiring fresh graduates and working with standardized investment processes, deal structures and analytical tools to provide risk capital with relatively lower average salary costs.
- **Type of investments and impact focus:** The operating costs are highly dependent on the type of companies and investments the fund is focusing on. The impact focus, sector focus, company stage, etc. will have an impact on how time-consuming the transactions will be and how efficient pipeline generation will be. Generalist funds have the benefit of having a larger pool of potential deals than a with limited sector focus, but funds with sector focus (such as energy, IT or agriculture) have the benefit of building up specialized sector knowledge. This can make it easier to find good deals early on, and can allow the fund manager to deliver more added value to their investees. When a fund's mission is to actively support early stage, base of the pyramid companies and steer heavily on impact, this can be time consuming as well.
- **Investment instruments:** the type of investment instruments a fund uses to deploy capital has a significant impact on the operating costs of a fund. We distinguish 4 factors that are influenced by the choice for an instrument.
 - Firstly, the team needs to have the required experience for the used instruments. For example, a mezzanine fund that provides more equity-like products needs to have team members with the specific broad skill set and long experience associated with equity investing. For debt-like mezzanine products it is key to have team members on board with experience in loan structuring, registration of collateral and debt collection. Typically individuals with a private equity background are more expensive than individuals with a microfinance or SME lending/banking background.
 - Secondly, in line with the previous point, the investment processes, systems and procedures are highly dependent on the type of investment instruments. Debt-like mezzanine are more suitable for standardization of deal structures, term sheets, contracts, financial models, etc, allowing for faster turnaround time of deals. For funds providing equity-like mezzanine, it is not uncommon to require several months turn-around time, as evaluation of a lead is very personal (focused on the entrepreneur), and companies requiring equity often have less existing cash

flows than companies seeking debt-like financing. GroFin and BPI have been able to develop their investment criteria, market intelligence and screening process such that investment officers can close or process deals much quicker. BPI mentioned that their investment officers can process one deal a month, whereas more equity-like funds are often able to process less than one deal per year per investment officer.

- Thirdly, closely related to the previous point, the type of investment instruments used has an impact on the deal selection process. With an equity-type deal, a fund manager effectively becomes co-owner of a company. Often an SME investor is the only external investor into a company. Therefore, the relationship between fund and investee is very personal and time-consuming. This also has the consequence that the selection process of an equity-like investment is more time-consuming than the selection process of a debt-like investment. For an equity deal, besides it having to be a good company with growth potential, there also needs to be a fit on interpersonal level, the company needs to have sufficient exit potential and there needs alignment with the company's views on the fund's impact mission, etc. In practice, finding good equity deals is like searching for a needle in a haystack. This is also reflected in the conversion rates of equity deals. Some pure equity funds have to review up to 100 deals to close one. Based on our interviews, funds providing more debt-like structures have much lower conversion rates, with around 1 out of 20 to 50 leads eventually receiving investment. This is caused by the fact that debt-like mezzanine investments involve a less close relationship with the entrepreneur than equity-like investments, allowing the investor to be less picky in the area of personal fit, shareholder dynamics and exit potential.
- Fourthly, the type of instruments a fund uses has a large impact on a fund's cash flows. Whereas in a pure equity investment the cash remains trapped until the exit has been completed, which typically can take between 3 and 7 years, debt-like mezzanine structures generate cash in the form of interest and repayments that can be reinvested. The effect of reinvesting can be very significant on fund returns, especially with longer term funds or permanent capital structures.

3.3. From strategy to net returns

The net returns of a fund are typically measured over the entire life of a fund, which is typically between 9 and 12 years. When talking about a fund that generates net returns of 10%, this is the average return over the entire life of the fund measured in IRR (Internal Rate of Return) over all cash invested into the fund and received back from the fund. In this section we will discuss the various components that determine the net returns to investors of a fund.

- **The gross returns of the portfolio:** the portfolio are the returns at the level of the fund manager (so excluding costs of the fund manager), purely derived from the cash invested and received back from investees. The gross returns are mainly a factor of the:
 1. **Targeted returns at the level of individual transactions:** for debt investments, this is the interest rate, while for the equity and other performance related components, this is the expected return based on the (fund manager's view on the) financial projections of the investee. The pricing of mezzanine products versus bank financing is a strategic choice. GroFin and BPI typically price their products above bank financing, reflecting the higher risk they are taking. However, a key component in pricing their deals is the percentage of collateralization, where a fully collateralized loan would be priced close to a bank loan, and a fully uncollateralized loan would be requiring pricing close to equity returns. The percentage of collateralization is reflected in the targeted return on investments.

2. Portfolio performance: the actual performance of the portfolio compared with targeted returns. There are significant differences in the strategies of mezzanine fund managers regarding success rate of their investments.

- Typically, debt-like mezzanine funds such as GroFin and BPI would expect to write off between 10% and 15% of their loans. A few investments in the company's portfolio would outperform against expected returns, while the majority of their portfolios performs in line with expectations. Both GroFin and BPI only take equity in a small portion of their deals, and the upside from equity and other performance related component is relatively limited. BPI is still using royalty based structures in a significant portion of their deals, while GroFin has abandoned royalty based structures due to the practical challenges in enforcing these (see chapter 2).
- Institutions with a more equity-type focus such as I&P aim for more upside, doing fewer deals, having closer involvement in their investments and offering more value addition. The model of equity funds is also to aim for a few winning deals that make up losses or nominal performance of the rest of their portfolio. We know of one private equity like SME fund that is expecting to realize a net IRR of around 7% largely caused by two very successful deals, while the rest of the portfolio of around 10 deals has performed below expectations.

Most of the fund managers we interviewed target gross returns typically in the range of 10 to 20%. In spite of a fund's strategy, the portfolio performance is highly dependent on the quality of the execution of the investment team. It is very difficult to predict the performance of mezzanine funds, especially for funds without a long track record. However, GroFin and BPI claim that their focus on volume, scale and diversification results in more predictable and consistent returns compared with more private equity-like funds.

3. Management fee: as discussed, the height of the management fee has a significant impact on a fund's bottom line, higher management fees on the one hand in principle leading to lower returns, but on the other hand also allowing for a bigger team which might improve fund performance. The percentage of management fees we observed ranged between 3 and 4% of committed capital.

4. Currency effects: usually funds receive their funding in hard currency, like USD or EUR, while they provide funding to SMEs in local currency, as SMEs are usually not able to carry exchange rate risk. Interviewees for this study often mentioned currency risks as one of the main problems of SME investing. See chapter 5 for ways to mitigate portfolio risks.

The combination of a fund's gross returns (targeted returns and fund performance), its management and operating costs determines the net returns to investors. According to a well-informed respondent at a leading DFI, measured over a long period in time and across regions, mezzanine funds in the below USD 2m deal size category have typically generated net returns of around 5 - 6%. We note that it is difficult to establish a clear pattern; there have been equity-like mezzanine funds realizing returns ranging from 0% to 10% with smaller portfolios and a more hands-on approach. At the same time, debt-like mezzanine funds have also shown returns between 0% and 8%. Nevertheless, we are under the impression that the variance in realized net returns of debt-like mezzanine funds is smaller. In other words, the returns of funds like GroFin and BPI are becoming more consistent and predictable as they achieve more scale and refine the systems and procedures.

3.4. Typical ratios

During the interviews conducted for this study, we obtained a lot of valuable insights into the operations of small cap SME mezzanine fund managers. In the overview below we summarize a number of key parameters determining fund economics for the fund managers we interviewed for this study. For confidentiality, we publish this information anonymized.

- **Net returns:** all net returns of the funds that could be reported on by the fund managers have been between 0 and 9%.
- **Management fee:** the management fee of the fund managers who were willing to share the number is between 2 and 4%.
- **Number of deals per investment officer per year:** there is most variation in this number. At a couple of funds, investment officers close a bit more than one deal per year. At some funds this is significantly higher (with more than 4 deals per year). There is one outlier (11 deals per year). There is a clear pattern that more equity-like funds are closer to one deal per year per investment officer. The funds that manage to handle significantly more deals per person are more all more debt-oriented funds.
- **Funds under management per staff member:** the funds per staff member is in the range of USD 3.6 m – USD 3.9 m. This can be explained by the fact that the relatively lower productivity of investment officers of equity-like mezzanine providers compared with debt-like mezzanine providers is offset by the generally larger ticket sizes of equity-like mezzanine providers, and vice versa.

3.5. How to make it work: the use of subsidies

As we discussed in chapter 2 of this paper, an important factor that limits the availability of capital for small cap SME finance, is the fact that the returns typically achieved with SME finance are below the return requirements of the main categories of investors. The net IRR required by most DFIs on SME private equity funds is at least 10-20%. Most purely commercial investors require even higher risk-adjusted returns. On the other hand, there is also a large category of more impact focused investors willing to accept lower returns from investment funds that play a role in achieving their missions. Many institutions provide some sort of subsidy to make the fund economics work. Especially smaller funds require subsidies before they can achieve sustainable scale. For example, the Shell foundation acted as the first loss investor in GroFin, and has contributed significant subsidies for GroFin to develop their model and scale up. In any case, for SME funds, especially the ones focusing on the <1m USD segment, it is always a challenge to make the economics work. A critical success factor in making it work is the smart use of a combination of investor capital and subsidies.

Figure 5 provides an overview of the main types of subsidies that are used for small cap SME mezzanine funds.

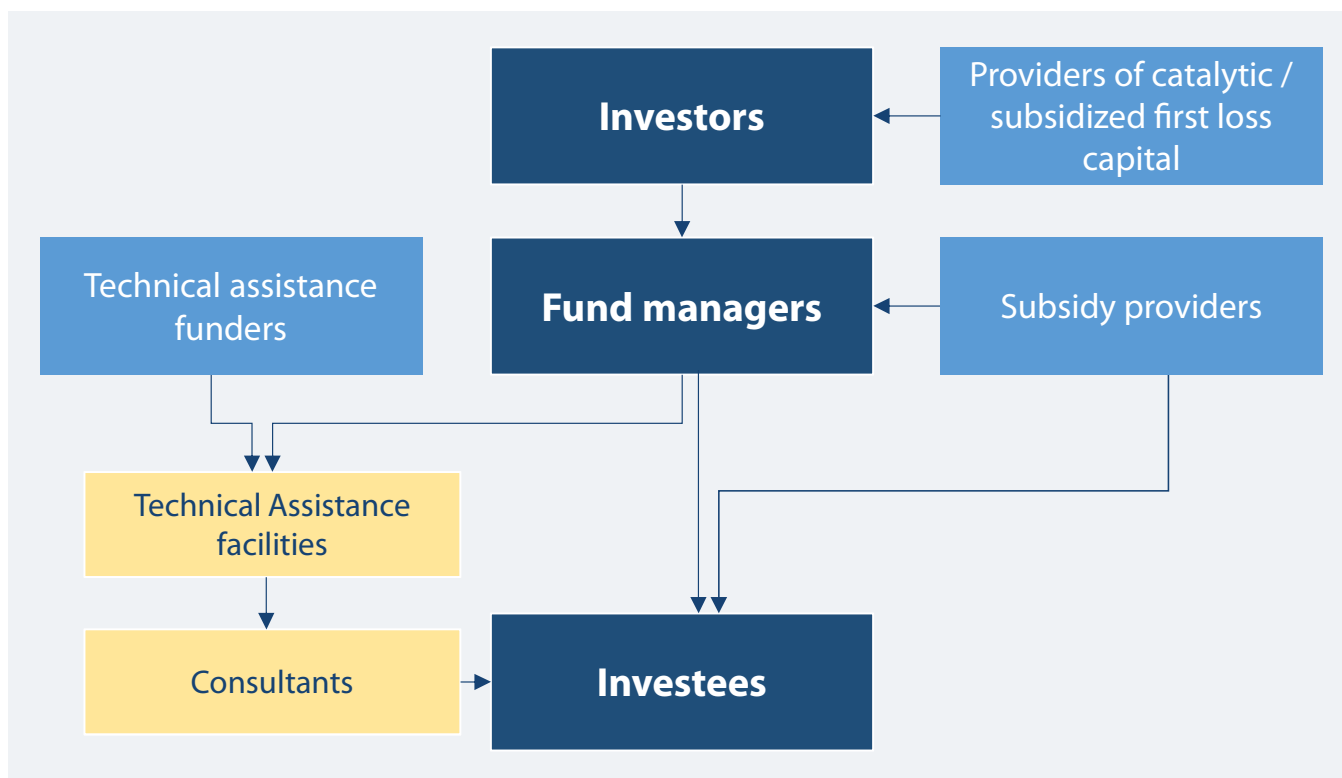


Figure 5: main types of subsidies used for small cap SME mezzanine funds

We distinguish three levels on which an investment fund can receive subsidies:

1. Investor level

As discussed above, it can be argued that every dollar invested in risk capital investments into SMEs in emerging and developing countries is already subsidized. However, there are institutions taking even more risks than others to encourage them to invest. They provide first loss capital, meaning there are several share classes into a fund, including a first loss tranche. In case the fund loses money, the providers of first loss capital are the first ones to lose their money. A first loss position protects other investors and encourages them to invest into a fund. Also sometimes funds have a category of investors on board class with relatively low returns, boosting returns for the other investors.

2. Fund manager level

As discussed in this chapter, the economics and productivity of fund managers are a critical factor in SME finance. The fund managers can receive subsidies and grants to support their operations, basically allowing a fund manager to cover their operating costs with a lower manager fee, which boosts returns to investors. Another important category of (implicit) subsidy is the use of pro-bono / low-bono partners. For example, many strategy consultants, law firms, multinationals and business schools have partnerships with fund managers to assist them with pipeline screening, market studies, due diligence, negotiations, legal documentation and deal monitoring. There is also a wealth of individuals willing to receive salaries far below their market rates, or contribute to the operations of a fund manager through unpaid mentoring, providing expertise to investees, internships, etc. There are several interesting initiatives such as Capria and MaRS²⁰ that have developed models and platforms aimed at providing seed capital, knowledge transfer and other forms of support to new fund managers.

3. Investee level

Also at the level of the investee there are several ways to receive subsidies. The main category is the use of technical assistance facilities. Many leading SME funds have such technical assistance facilities to support their operations. These are facilities typically funded by donors. They can be managed by the fund manager, by a third party, or jointly. These facilities are mainly used to hire consultants to temporarily assist a fund's with a specific issue. This can be technical, financial, legal, etc. The average size of TA facilities in relation to the fund size is 5 – 10% ¹⁹.

3.6. The capital stack of a fund

An investment strategy needs to be designed such that it can actually deliver to its investors, subsidy providers and other partners. Any fund manager should be realistic about market practices and incorporate market based assumptions into their plans, based on practical lessons learnt from other fund managers. A key success factor of fund raising is to properly match the fund manager and its investment strategy with the right investors and grant providers. A fund manager often has a combination of different investors/contributors with different objectives, rights and obligations in one fund. These different layers of motivation for funding are called the “capital stack” of a fund. A fund may have both more commercial investors primarily seeking a certain financial return, and grant providers and less commercial investors primarily seeking impact. The smart use of investor capital and subsidies is often key to make the economics of a fund work.

¹⁹ See capria.vc and <http://impactinvesting.marsdd.com>

²⁰ Based on own research among 12 fund managers

4. FUTURE OUTLOOK: SMALL CAP SME MEZZANINE AS A GROWING ASSET CLASS

As mentioned, small cap SME mezzanine is currently a relatively small niche. According to the interviewees, small cap SME finance will remain a challenging segment, with a risk-return balance that will not easily attract large amounts of capital from other investors than DFIs and foundations, such as pension funds and insurance companies. However, most agreed that there is room for further improvement of mezzanine models, which could also lead to growth of the segment and attract more and other investors. We distinguish four main categories in which the use of small cap SME mezzanine can grow further: 1. improving the risk-return balance; 2. DFIs supporting the further development of small cap SME finance; 3. mobilizing more and new investors by improving impact measuring and reporting; and 4. increasing the geographic applicability of SME mezzanine through regulatory reform.

4.1. Improving the risk-return balance

The interviewees for this study mentioned that developments in the following areas can further improve the risk-return balance of SME mezzanine.

- **Managing the currency risk:** as mentioned before, the currency risk is often seen as one of the main factors negatively impacting returns, and thereby restricting further growth of small cap SME mezzanine. For SMEs, it is risky to attract finance in hard currency while most of their revenues are obtained in other than hard currency. Fund managers see their returns diminished by currency risk. The extent to which funds carry currency exchange risk depends on their product offerings. In case of debt-like SME mezzanine, regular repayment mitigates currency exposure for fund managers. One possible other way to mitigate currency risk is hedging. For example, GroFin is using currency hedging, but some other funds see it as too expensive.

We have observed some other interesting views on how currency risk can be managed:

- **Fund capitalization through local financing.** An example is I&P, which is setting up evergreen funds that will receive the majority of its funding (around two thirds) from local investors such as local banks, insurance companies and individuals, thus limiting the currency risk exposure of the fund.
- One interviewee mentioned that some see **local capitalization of small SME funds** as a holy grail of the sector, and recommended other fund managers also to seek strategies aimed at eventually attracting local capital.
- **Investing in companies that obtain revenues or price in hard currency** (e.g. exporting firms), thus avoiding currency risk. Pyme Capital is an example of this. Also XSML is mainly active in countries where US Dollars are the main currency.
- **Countries with pegged currency.** Currency risk can be managed by investing in countries that have their currencies pegged to a hard currency, such as the CFA-region for I&P.

- **Geographic diversification.** Funds that operate in different regions are, to a certain extent, able to manage their currency risk by geographic diversification. GBF, operating in Kenya, Peru and India, is an example of a fund that spreads its currency risk through a wide geographic diversification.
- **Standardization of products and procedures:** fund managers increasingly try to work with standardized products and procedures, allowing them to provide risk capital in a more time and cost efficient manner. This is specifically relevant for debt-like mezzanine fund managers. The companies that work with standardized products and/or procedures are able to train and deploy young, local staff. Using a broad variety of tailored deal structures makes structuring, negotiating and monitoring investments more time consuming and requires experienced fund managers. Furthermore, such tailored deal structuring requires a diverse skillset and comes with high requirements to investment officer staff. GroFin uses standard pricing mechanisms, term sheets, contracts and standard investment processes that are similar across country offices, while allowing for a lot of flexibility on a limited number of parameters, such as grace periods and repayment profile. BPI does not primarily aim for standardization of the products they offer to SMEs, but strives for highly standardized procedures in the back-office (“a factory”), which allow BPI to have quick turnaround times. BPI can close a deal in 60 days, while it can take other fund managers many months to close a deal. On the other hand, a more equity-like mezzanine provider like I&P does not aim for standardization, but sees knowledge transfer to the team as a key success factor, aiming for a situation in which the whole team is able to make a term sheet and negotiate a deal.
- **Adopting technology to increase efficiency:** to reduce the cost of operation, fund managers are increasingly using IT to support their operations. Technology can increase the productivity for investment officers and as such stimulate the scalability of investments. An example from the interviews is technology used in online retailing, used among others by supermarkets in South Africa. The application gives insight in sales history, which can be used by fund managers (and banks) to assess credit risk. Technology can also be used in better capturing the upside of small cap SME mezzanine loans with royalties. Fund managers are able to monitor sales through IT-applications. It is important to monitor among others the revenues of companies. Setting up the monitoring system requires a company specific approach. BPI cited the importance of IT to make their investment processes more efficient. According to some, it will be challenging to further bring down the operational costs of small cap SME mezzanine.
- **New products and methods to determine financial discipline:** In order to overcome the barrier that informality represents, banks combine various methods for analyzing the credit risk of SMEs: cash flow analysis, on-site client visits, and credit scoring. In their quest for innovation, some banks in Latin America and the Caribbean are piloting a credit methodology based on psychometric parameters. This methodology analyzes, among other characteristics, the personality, aptitude, and intelligence of women entrepreneurs, aspects that correlate with success and payment willingness, as proven by thorough academic research. Since the methodology is not based on the (collateral) assets that the entrepreneurs possess, it is considered to be a more neutral methodology for analyzing the credit risk of women entrepreneurs, given that women tend to have less access to the accumulation of physical assets ²¹.
- **Permanent vehicles:** In search for working models, the market is moving away from traditional limited life private equity structures towards permanent capital vehicles (evergreen structures).

²¹ Banks and the missing middle, IADB

The permanent capital vehicle is more suitable because:

- Mezzanine provides more predictable and stable returns, which allows funds to be leveraged.
- The time required for investing in small cap SMEs is too long for typical 10 year funds. They need a longer time horizon.
- With limited life funds often fund life dictates the exit. A permanent structure is more flexible and enables funds to determine an exit that is in line with economic circumstances.
- The incentive structures of private equity funds are geared toward equity transactions, ensuring investment officers to make investment decisions focused on long term value creation. Also the returns of small cap SME funds are too low and risks are too high (especially currency risk) to make common carried interest structures work.
- Evergreen structures provide more stability and continuity to the fund manager. A few interviewees mentioned that limited life fund structures could lead to high employee turnover due to uncertainty whether a next fund can be raised.
- Limited life fund structures require new fund raising rounds, which may distract the team from current fund implementation.

Fund capital providers, including DFIs, can be cautious with permanent capital vehicles given their need for liquidity within their individual timelines. Limited life funds provide a clear liquidity path while permanent capital vehicles might provide windows of redemption with restrictions in timing and amount. Having said this, the mezzanine instrument for SME can be very suitable for permanent capital vehicles, especially for debt-like mezzanine given the predictable investment reflows which provide cash flow to capital providers. Further, such predictable investment reflows can provide early and sustained profitability to the vehicle, which can be a requirement of listing on a stock exchange, if this were an objective of the vehicle.

4.2. Development institutions supporting the further growth of small cap SME mezzanine

As we have seen in chapter 3, some DFIs have moved away from small cap SME risk capital due to the challenging risk-return balance of the segment. In figure 6 we have clustered the statements about realized, required and expected IRRs of the studied fund managers. Although not all participants were able to share their realized IRRs (some just finished fundraising) and expected IRRs (“time will tell”), this gives an idea of the discrepancy and between realized and required IRRs.

Based on anecdotal evidence from several experts, the average return on SME private equity portfolios of DFIs typically thought to be around 5% - 6%. Note that this number includes many funds with ticket size well above USD 2m with much better economics than the funds that are at the core of this study. For the <2m USD segment, most experts agree that historically returns to investors have often even been close to or below 0%. This is a very big gap with the minimum returns of 10% - 20% that investors are seeking on investments into PE funds (depending on risk profile). That does not mean that there are no suitable investors for small cap SME risk capital funds. Small cap mezzanine finance fits well within the portfolios of donors, foundations, etc. But the funding sources of these financiers are limited by nature. Some participants have explained that the sector is harmed – seen from an investors perspective - by

funds that overpromised and under-delivered in the recent past. Also, many DFIs have less budget than some years ago.

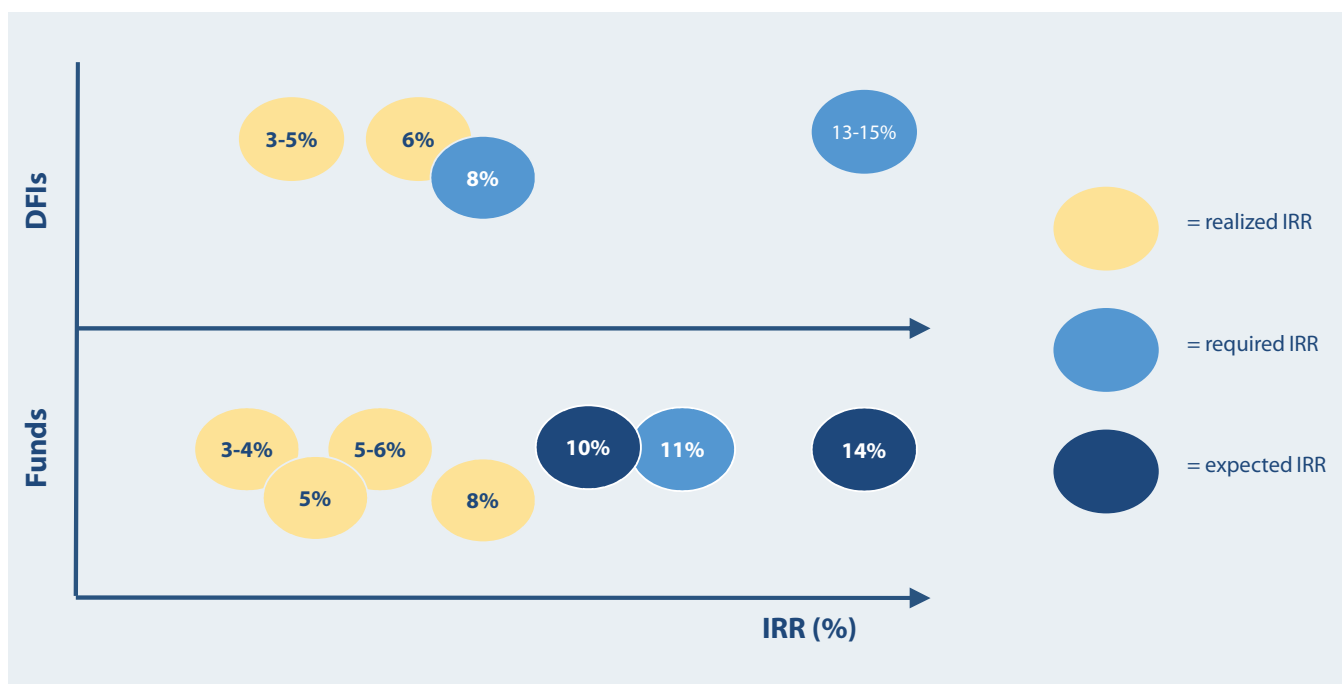


Figure 6: statements about returns from DFIs and Funds, about required realized and expected IRRs

While some of the DFIs may have focused less on SME funds, foundations and other development institutions are increasingly prominent in this space. Examples are impact investors like Stichting Doen (a Dutch Foundation), Shell Foundation, Skoll Foundation, Oikocredit and governmental funds like DGGF. According to the interviewees (both DFIs and fund managers) it is important to have institutions on board that can invest below market terms. This makes it possible to blend investment with grants (see also section 3.5).

4.3. Mobilizing more and new investors by improving transparency, impact measuring and reporting

According to one of the fund managers, fundraising has become more difficult due to overpromising. An important lesson appears to be that realism should remain in the sector, otherwise the sector risks losing its credibility on the long term. Funds should also strive for transparency regarding their returns, but this is difficult because sometimes it is simply not (yet) clear and from a fundraising perspective they have an incentive for rosy prospects. There are a lot of conflicting views on the performance of small cap SME funds, mystifying the sector. Sometimes, it is not (yet) clear what the results are. DFIs play a key role here. They possess most information and could be able to publish sector-wide performance numbers.

As small cap SME mezzanine often yields returns that are not in line with requirements of commercial investors, it is mainly justified through the positive impact that is generated. Therefore, it is key that this impact is measured consistently and reported transparently. Most interviewees mentioned impact measuring and reporting as a key challenge for the sector. Some interviewees argued that a better sector-wide monitoring system should be implemented. Existing systems are usually seen as being too complex and existing systems are not sufficiently geared towards the goals of the sector.

4.4. Increasing the geographic applicability of small cap SME mezzanine through regulatory reform

Some of our interviewees mentioned the regulatory environment is the main inhibitor to the use of mezzanine. Regulation does not always allow the use of certain small cap SME mezzanine instruments. In some of the countries only banks can give loans (for example in Angola and Mozambique). Therefore it is important to put regulation in place for non-banking financial institutions. Also enforcement of collateral is sometimes difficult in developing countries. In the words of a DFI-representative, “a big challenge is that the upside is capped, while the downside protection is not really what you think it is”. It is much more difficult to enforce more exotic collateral. More specific for the use of mezzanine, usury laws – laws that set the maximum amount of interest that can be charged for a loan – can have the negative side-effect that investors do not enter the risk-capital area or cannot capture the upside. See for an example of a regulatory reform in practice Box 2.

Box 2: Successful regulatory reform to improve lending to SMEs

Recent financial infrastructure reforms in China demonstrate the effects of regulatory reforms in improving SME lending. In 2004, China began a reform of its movable collateral framework to encourage financing against valuable moveable collateral. Before the reform, bank lending took place mainly through real estate collateral, which SMEs often did not possess. Moveable assets accounted for over fifty percent of assets owned by Chinese SMEs. There were three main phases to the establishment of the movable collateral framework which included: the development of a property law; the creation of an electronic registry for pledging assets; and training for lenders in order to teach them how to use moveable assets as a basis for lending. In the first two years following the adoption of the property law and the establishment of the electronic registry for account receivable, total commercial loans involving moveable assets grew by an annual rate of 21 %, while the value of loans increased by 24 %. By May 2013, in a period of 5 ½ years, cumulatively about one million registrations—including loans based on accounts receivable and financial leases—have been recorded by the Credit Reference Center (collateral registry) in China. These transactions involved at least CNY 36 trillion in total amount disbursed (USD 1 = YNY 6.2) ²².

²² See China Credit Reference, a monthly publication (in Chinese) by the Credit Reference Center of the People's Bank of China; also IFC China Team/ or IFC, closing the credit gap for formal and informal MSMEs

5. CONCLUSIONS

- Small cap SME is an important financial instrument to address SME missing middle entrepreneurs' financial needs. However, this financial instrument certainly has its limitations and should not be viewed as some type of panacea for the SME missing middle. For any form of SME risk capital, the issue of transaction costs relative to transaction size remains, and many self-liquidating mezzanine instruments require SMEs to either be cash flow positive or be on the clear road to such. Also other financial instruments, such as leasing, asset finance, small ticket size project financing, factoring and invoice discounting, should be developed further - to cater to SMEs in different situations and with different requirements - to help reducing the SME financing gap.
- Even relatively successful fund managers have produced relatively modest financial returns using mezzanine finance. Nevertheless, capital providers, financial intermediaries, donors and governments should recognize the potential of the instrument to address this missing middle. Each has an important role to play in ensuring that mezzanine financing is provided to small cap SMEs in emerging markets, despite its limitations.
- Small cap SME mezzanine finance providers are beyond the stage of pioneering but not yet at the stage where – similar to microfinance or larger scale private equity investing - the approach can be brought to scale. There are now more opportunities to reach scale in the sector and to play a more significant role. The use of evergreen structures and – to a certain extent – product and process standardization contribute to this opportunity. Reaching scale will decrease relative transaction costs (as a consequence of economics of scale), which improves the economics of the fund.



- DFIs have a key role to play, legitimated by the development impact of investments. The dependence of the sector on DFIs means the DFIs should continue to take a leading role in encouraging innovation. This includes allowing leverage at the fund level and allowing permanent vehicle structures. Government of developing countries can stimulate the use of small cap SME mezzanine finance through regulatory reform. This means exerting a program of removing tax and other legislative barriers to SME mezzanine at national levels, as some countries have recently implemented.
- An important insight is that equity-like mezzanine providers and debt-like mezzanine providers need to apply different strategies regarding risk management and standardization to make the economics work. Scaled down private equity fund managers are mostly trying to embrace risk (including currency risk) and try to get to near commercial returns not too far off their larger private equity cousins by being cost efficient with local staff. For debt-like mezzanine providers the goal is often to create stable, predictable returns through low write-offs, efficient operations and cost reduction, diversification and direct or indirect currency risk management. Some fund managers created hybrid constructions, selectively using equity-like and debt-like instruments to create a blended risk/return profile seeking to find an optimal combination between the extremes.
- Small cap SME mezzanine is a relatively new, diverse and small field in the SME finance landscape. Understanding the specificities (and often complexities) of it, notably in differentiating this segment from debt and equity models, is critical to spur innovative thinking on both the fund managers and investors sides so products may be improved and models may be more scalable. This study is the first of its kind and represents a first step into building small cap SME mezzanine finance as an asset class on its own.

Annex 1: Pros and cons of small cap SME mezzanine instruments

	MAIN PROS (FOR FUND MANAGERS)	MAIN CONS (FOR FUND MANAGERS)
Partially Unsecured / Junior loans	<ul style="list-style-type: none"> • Downside protection through collateral • Less requirements on financial systems of investees compared with royalty based lending • Simplicity (compared with royalty based structures): no monitoring on royalty payments and recalculations required • Less strict and early prepayment less complicated than with royalty based lending • In case of regular repayments, this mitigates currency exposure for fund managers • Allows providing risk capital with a relatively quick investment process compared with equity investments, as a consequence transaction cost is relatively low. • Can offer a stable basis in a portfolio that also includes riskier investments 	<ul style="list-style-type: none"> • Less upside compared with royalty based lending • In competition with banks • Entrepreneurs often see it as an expensive loan structure • Fund manager has less influence on strategy, impact and ESG policy compared with equity investing • Downside protection often difficult to exercise • Taking out much cash of the company may harm its growth
Royalty based lending	<ul style="list-style-type: none"> • Sharing in upside through royalties • Does not require a sale of shares to a third party • Creates alignment between investor and investee; both benefit from long term growth of the company • Regular repayment mitigates currency exposure for fund managers • “Highest of actual and projected turnover”-mechanism encourages entrepreneurs to produce more realistic business plans • Downside protection through collateral • Covenants can be used to act in case of underperformance on financial, social or other criteria • Transaction cost are low compared with equity 	<ul style="list-style-type: none"> • Entrepreneurs often see it as an expensive loan and/or a complex loan structure • Can lead to conflict with investee, especially in case of strong growth of the company • Refinancing can be challenging (dealing with foregone royalty interest) • Fund manager has less influence on strategy, impact and ESG policy compared with equity investing • Challenging to administer and monitor (payments vary periodically, requires corrections, etc.) • Downside protection often difficult to exercise • Taking out much cash of the company may harm its growth

	MAIN PROS (FOR FUND MANAGERS)	MAIN CONS (FOR FUND MANAGERS)
Convertible loans	<ul style="list-style-type: none"> • Has many benefits of a loan (downside protection through collateral, regular loan repayment, entrepreneur does not need to dilute, etc.), while allowing the fund manager to share in a company's upside in case of an equity exit • The option to convert is usually at the discretion of the fund manager up to a certain moment in time • Gives the fund manager strong rights to step in; covenants often include the right to convert into equity • Creates alignment between fund manager and investee; both are incentivized to maximize equity value • Can be appealing to entrepreneurs as the loan component can be priced below bank rates, as fund managers expects to make additional returns through conversion and sale of equity • Powerful "threat" to convert in case of breach of covenant 	<ul style="list-style-type: none"> • This structure (initially) mainly works as a loan, but bares with it many of the difficulties associated with equity deals • Depending on the shareholding after conversion, the fund manager may act like an equity holder from the beginning • This means having a close relationship with the entrepreneur, which makes deal selection, negotiation, due diligence and monitoring far more time consuming than subordinated or royalty based debt instruments, which drives up transaction cost • Potential valuation issues at negotiating the deal, conversion and exit • Complexity: requires agreements on equity and debt investment • Requires experienced investment staff with diverse skillset
Preference shares	<ul style="list-style-type: none"> • Can be of use in specific situations, for example when required to strengthen the company's balance sheet • In some cases these shares also have redemption rights, preferential voting rights, and rights of conversion into ordinary shares • Can also be used to provide the investors with an equity-like position without having to dilute the entrepreneur (for example to a minority position) 	<ul style="list-style-type: none"> • A disadvantage compared with loans is that investors cannot take security over the company's assets and cannot use financial covenants • Dividends and redemptions cannot be made if there are no distributable reserves • Complexity; more suited for more sophisticated investments in more mature companies (partly due to high transaction cost)

	MAIN PROS (FOR FUND MANAGERS)	MAIN CONS (FOR FUND MANAGERS)
Redeemable equity	<ul style="list-style-type: none"> • Has many of the benefits of equity investments: <ul style="list-style-type: none"> - Potentially benefitting from upside through a sale to a third party - Allows the fund manager to have influence into the company's strategy and key decisions - In addition, the problem of being dependent on a third party exit to make financial returns is mitigated, as the fund manager has the option to sell back the shares to the entrepreneur 	<ul style="list-style-type: none"> • Also has many of the difficulties of equity investments of equity investments. This leads to high transaction costs: • Time consuming investment process and deal monitoring • Upside from third party exit is uncertain • Currency exposure due to long time period • Can only be exercised when the entrepreneur has the financial reserves available to purchase back the equity. Company can be required to hold financial reserves

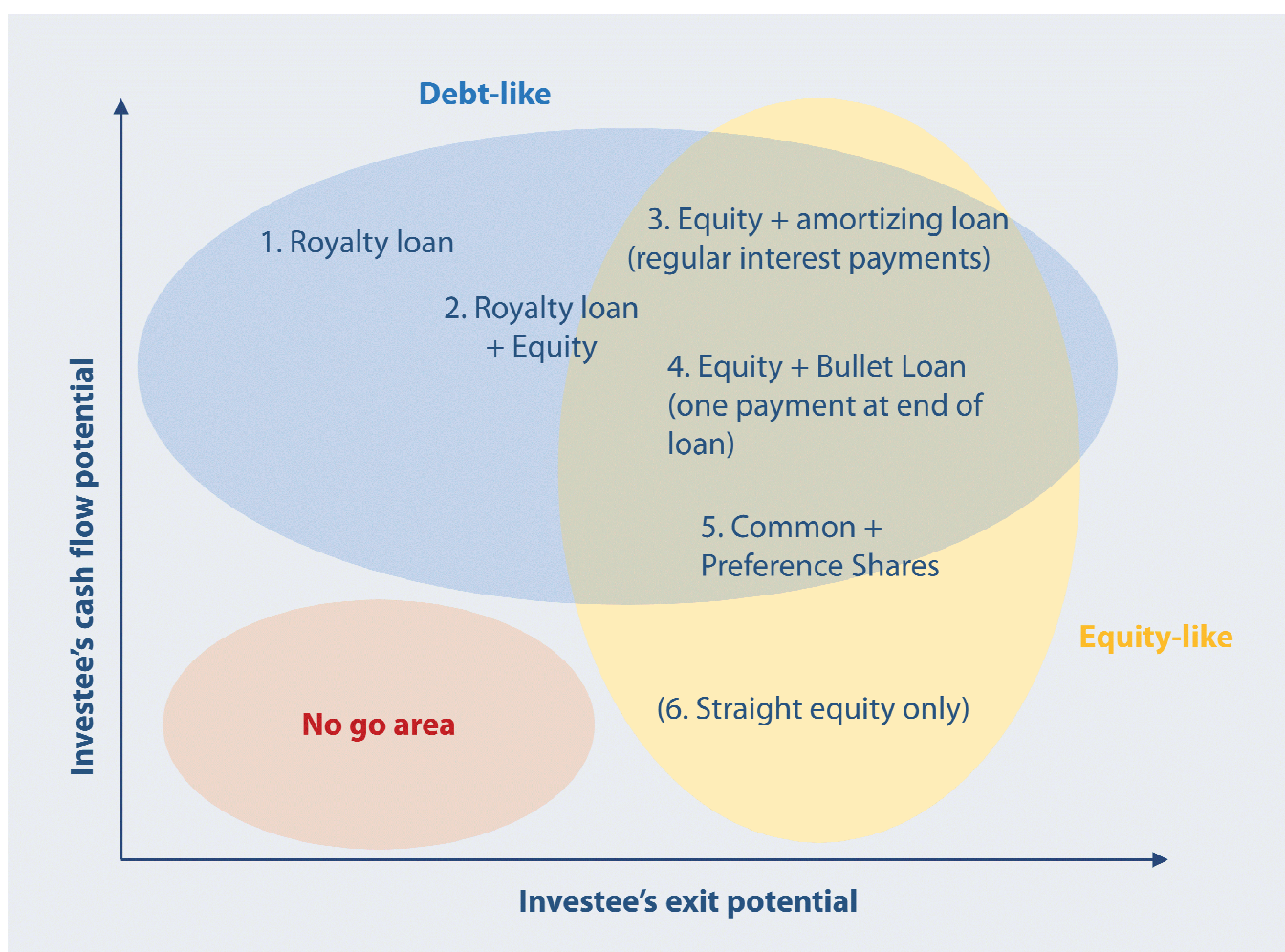
Annex 2: Typical small cap SME (mezzanine) deal structures

As mentioned in section 2.1, mezzanine structures are deal structures that combine aspects of debt and equity. This can be in a single instrument or through a combination of several instruments. In this Annex we will discuss a number of typical mezzanine structures including combinations of several instruments to clarify optimal transaction structures under different circumstances.

When determining an investment structure for a SME investment, two of the most important aspects to look at are the cash flow potential and the exit potential of the company. In principle, an investor should only take equity in a deal when there is sufficient chance that a (third party) exit is possible. Exit potential may be limited due to the absence of potential buyers or the unwillingness of the entrepreneur to sell the company. In this case the instrument needs to allow the investor to make its returns from the cash flows of the company instead of from a sale to an external buyer. Debt instruments have the additional benefit that they can be covered by collateral.

There are various ways to structure loans, depending on the timing of cash flows generated by the company (short term vs long term and regularity). Investors will generally prefer to receive regular payments as early as possible, but some companies may need a long time to generate sufficient cash flows the figure below. Figure 7 illustrates how various mezzanine instruments, including combinations of pure debt and equity and mezzanine-type instruments, can be optimal given the cash flow and exit potential of a deal. A brief explanation of these six examples of transaction structures is given below.

Figure 7: landscape of common small cap SME (mezzanine) transaction structures



1. Royalty based loan

Best suited for an investment into a growing company that has high potential to generate sufficient, regular and predictable cash flows, but that is not likely to be sold to an external party. Only suitable for companies with a transparent business model and proper financial systems and reporting, allowing for easy monitoring of (financial) performance.

2. Royalty based loan in combination with a small equity portion

Fit for an investment into a growing company that has sufficient potential to generate sufficient, regular and predictable cash flows, but for which there is also a chance that the company could be sold to an external buyer. Investors typically do not rely on an equity sale to make their returns, and the equity portion is usually a small component of the deal. The equity portion is a “sweetener”, to capture additional upside “just in case”, and could be structured as ordinary shares or convertible debt.

3. Straight (amortizing) loan in combination with an equity-type instrument

This structure can best help a growing company with high exit potential and high cash generation potential. The component of the loan with regular payments (amortizing loan) is attractive due to downside protection and other benefits of receiving regular cash payments, such as mitigating currency risk. The upside from the transaction is realized through a sale of the equity, which could be structured as ordinary shares or convertible debt.

4. Bullet loan in combination with an equity-type instrument

This structure is suited for an investment into a growing company with high exit potential and low short term cash generation potential, but high long term cash generation potential. The loan with a bullet payments (one payment upon reaching maturity of the loan) can be used in situations where a company is expected to need a longer time (up to several years) to generate cash, and can offer downside protection. The upside from the transaction is realized through a sale of the equity, which could be structured as ordinary shares or convertible debt.

5. Combination of straight equity with preference shares

Preference shares are relatively less common in small cap SME investing due its perceived complexity. It can be beneficial to provide investors with an equity-like position, while ranking higher than holders of ordinary shares, and leading to less dilution for the entrepreneur. Preference shares can have many different forms, but they are generally redeemable and pay a fixed dividend (when there is sufficient cash to do so).

6. Equity only

Investing into a small cap SME with equity (meaning that there is no debt component in the deal) should only in principle only be done when a company has low cash generation potential, but has a very high chance that an exit to a third party can be made. Note that this is not a mezzanine structure, but the structure is given here to give an overview of a wide spectrum of risk capital instruments.

Annex 3: List of interviewees

FUND MANAGERS	
Aspada Investment Advisors	Kartik Srivatsa (Co-Founder and Managing Partner)
BPM Mezzanine Fund	Pawel Zabrzycki (Partner)
Business Partners International (BPI)	Nazeem Martin (Managing Director)
Gazelle Finance	Jeffrey Liebert (Chief Executive Officer)
Grassroots Business Fund (GBF)	Harold Rosen (Chief Executive Officer) and Jaime Ramirez (Chief Investment Officer)
GroFin	Guido Boysen (Chief Investment Officer)
Investisseurs & Partenaires (I&P)	David Munnich (Investment Officer)
Pyme Capital	Jorge del Castillo (Managing Director)
SEAF	Bert van der Vaart (Chief Executive Officer)
XSML	Jarl Heijstee (Managing Partner)

DEVELOPMENT FINANCE INSTITUTIONS AND FOUNDATIONS

Calvert Foundation	Songbae Lee (Senior Investment Officer)
CDC	Holger Rothenbusch (Head of Mezzanine and Structured Finance)
DEG	Detlef Geldmacher (Investment Manager, Department Corporates & Funds Asia; Equity-Mezzanine / Risk Capital)
FMO	Magchiel Groot (Senior Investment Officer Private Equity)
Lundin	Steven Nairne (Managing Director)
IFC	Tracy Washington (Senior Investment Officer Private Equity and Investment Funds)
OPIC	Mitchell Strauss (Special Advisor Socially Responsible Finance)
Shell Foundation	Pradeep Pursnani (Deputy Director)

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Annex 5: List of abbreviations

DFI	Development Finance Institution
EMPEA	The Emerging Markets Private Equity Association
IPO	Initial Public Offering
IRR	Internal Rate of Return
PE	Private Equity
SME	Small- and Medium sized Enterprise
TA	Technical Assistance

Annex 6: Glossary

Capital Stack	Different layers in funding of a fund: a combination of different investors/ contributors with different objectives, rights and obligations in one fund
Capital under Management	The value of all investments and assets that a firm manages and oversees
Convertible loan	Typically a loan with a maturity date and a regular repayment schedule, and an option to convert the loan into shares the company
Dilution	A reduction in the ownership percentage of a share of stock caused by the issuance of new stock
Flexible loan	See junior long-term loan
Partially unsecured / junior loan	Loans with tailored repayment structure. Payments to the fund manager are “sculpted” around the specific situation of a company, allowing for long grace periods on principal repayments and interest payments
Mezzanine	A generic term for financing techniques that incorporate elements of debt and equity in a single investment
Preference share	Equity investment often structured as redeemable shares that pay a fixed dividend
Redeemable equity	Mostly similar to ordinary shares, but with a right to sell the shares back to the entrepreneur, typically using a predetermined price or a formula
Royalty payment	Provides the investor with a base interest plus royalties, which are payments that are dependent on the performance of the company, usually a percentage of revenue or EBIT(DA)
Self-liquidating	The repayment schedule and maturity of a self-liquidating loan are designed to coincide with the timing of the asset’s income generation
SME mezzanine	In the context of this study: a debt product that is more flexible than bank financing, usually contains an upside, that is between USD 100k and USD 1m, that serves as long-term finance for existing companies and that is typically self-liquidating.
Subordinated loan	See junior long-term loan
The missing middle	A financing gap for entrepreneurs that are too big for microfinance and informal investors, but that are too small or too risky for regular banks and PE firms.
Ticket size	The amount invested by a fund manager in a particular SME

