

Investing in Africa's Small and Growing Businesses

An introduction to private equity in Africa



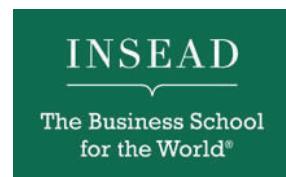
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Acknowledgements

This handbook was designed thanks to an award from the Impact Economy Innovations Fund, financed by the Rockefeller Foundation and the Tony Elumelu Foundation.

It was coordinated by Investisseurs & Partenaires (I&P) and written with the collaboration of INSEAD Business School, the Aspen Network of Development Entrepreneurs (ANDE) and Ernst & Young. We would like to thank in particular the entrepreneurs and the investors who shared their experiences in this handbook, as well as the whole I&P team, Loic Sadoulet and Kim Wilkinson, Randall Kempner and Jenny Everett, Brett Stevenson, Jon Shepard and the Ernst & Young Abidjan team and Morgane Rocher.



THE TONY ELUMELU
FOUNDATION



"Africa is the fastest growing continent in the world. Step by step, it has built the fundamentals for strong structural growth: an unprecedented demographic dividend, improved macroeconomic indicators and the development of a domestic market led by the middle class. These changes have made the continent very attractive for European, North American, Middle Eastern and Asian investors. In just a few years Sub-Saharan Africa has become the new frontier for private investment."

The trend was initially limited to infrastructure, mining and financial services, but is now reaching small and medium businesses, in other words the generators of jobs that can speed up inclusive growth in Africa. In spite of undeniable challenges, many investment funds are proving that investing in Africa's SMEs can be viable and have a significant impact on development.

Today, we must go much further. Indeed, Africa's growth is not generating enough employment and is not sufficiently sustainable. To foster the emergence of Africa's future job-creating champions, we need to invest today in the high-potential small and early-stage businesses looking for 100,000 or 300,000 euros. Yet, their financing needs fall far below the typical ticket size of investment funds. Just like microfinance revolutionized banking practices by adapting financial services to the needs of the poor, now is the time for investors to adapt their tools to the needs of African SMEs. Though a few pioneers have ventured into the gap, this new industry is still in its infancy.

The goal of Investisseurs & Partenaires is to sponsor new African investment teams willing to take up this challenge. This handbook makes its modest contribution by illustrating the practices of the sector and by introducing the specific approach of private equity. It brings together the experiences of investors who have collectively raised and invested several hundred million euros in SMEs in Africa, and shares the view of a dozen African entrepreneurs who received that support.

This document is intended for professionals willing to invest in African small businesses, for African entrepreneurs and for anyone interested in the topic of SME financing in developing countries."

Jean-Michel Severino
Président, Investisseurs & Partenaires

A handwritten signature in black ink, appearing to read "JM Severino".

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- 2) SGBs are key to large-scale job-creation in Africa
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*Find out more on the website
www.investinginafricansmes.com*

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Private equity, a solution for African Small and Growing Businesses

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1

Private equity, a solution for African Small and Growing Businesses

① Small and Growing Businesses are engines of development

1) Africa's growth: faster but not sufficiently inclusive

During the 2000-2010 decade, 6 out of the 10 fastest growing countries were located in sub-Saharan Africa¹. Today, with an average GDP growth of 5% per annum, the region is only surpassed by East Asia. Foreign Direct Investment increased six-fold since 2000 and investor perceptions have changed significantly: private equity investors now identify Africa as the most attractive emerging market². They invested more than 8 billion USD on the continent in 2014³.

Growth in the last decade was underpinned by the rapid expansion of new sectors and greater opportunities for a growing middle class. This growth benefitted from profound structural changes brought about by urbanization, expanding domestic markets, improved governance and more robust macroeconomic fundamentals.

¹ *The Economist*, March 12, 2011.

² EMPEA, 2013 Global Limited Partners Survey.

³ AVCA, 2015, *African Private Equity Data Tracker*.

Nevertheless, growth remains concentrated in a few sectors (telecommunications, infrastructure, oil and gas, mining and financial services) and has yet to pervade more labor-intensive and value-adding activities (such as agriculture and manufacturing)⁴. For example, only 3% of Africans are employed in manufacturing as opposed to 15% in Bangladesh⁵.

Human development indicators are therefore fragile, with 46% of the sub-Saharan population living below the threshold of USD 1.25 per day and only 16% having access to a regular wage-paying job⁶. The poorest countries are also facing serious social tensions resulting from demographic pressures and climate change, two factors that place considerable stress on employment supply and access to basic services.

Recent political crises in West and Central Africa are often rooted in economies and the difficulties young people have in finding employment⁷. With 125 million Africans arriving on the job market between 2010 and 2020⁸, governments and economic operators must find new sources of sustainable employment, both for unskilled workers and for new graduates.

2) SGBs are key to large-scale job-creation in Africa

Increasing productive capacity and creating sustainable jobs are necessary conditions to reduce poverty, ensure political stability and nurture the continent's economic emergence. Unfortunately the African private sector is not structured enough to absorb the newcomers on the job market: only a small number of large formal companies are able to create high quality, sustainable jobs, and the low productivity informal sector (mostly microenterprises and small farms) still accounts for 84% of all employment⁹. Formal Small and Medium Enterprises (SMEs)¹⁰, the pillars of job creation in both developed and emerging countries, are rare in the region. This is the notorious "missing middle" of the African economic fabric.

⁴ OECD, *African Economic Outlook 2013, Transformation structurelle et ressources naturelles en Afrique*.

⁵ World Bank and Agence Française de Développement, *L'emploi des jeunes en Afrique Sub-saharienne*, 2014.

⁶ Ibid.

⁷ International Labour Organisation, *Rapport sur le travail dans le monde 2014*.

⁸ McKinsey Global Institute, *Africa at work: Job creation and inclusive growth*, 2012.

⁹ World Bank and Agence Française de Développement, *L'emploi des jeunes en Afrique Sub-saharienne*, 2014.

¹⁰ According to the World Bank, a SME is a company with a staff of less than 300 and a turnover of less than 15 millions USD.

Formal SMEs not only create large quantities of jobs; they also create good quality jobs. These jobs with higher wages than in the informal sector (50% to 60% higher according to data from Ghana and Tanzania¹¹) are more secure and give access to training and social security¹². In addition to its significant impact on income, the regularity of formal wages enables a family to plan for the future, to save money and improves access to credit, housing and children's education¹³. **Formal employment is a decisive factor to lift unskilled workers out of poverty, and to allow skilled workers to enter the middle class. The development of a fabric of job-creating formal SMEs is therefore a key ingredient for inclusive growth in Africa.**

¹¹ Data collected in Ghana and Tanzania:
ANDE, Small and Growing Businesses:
*Investing in the missing middle for poverty
alleviation*, 2012.

¹² "IFC Jobs Study: Assessing Private Sector
Contributions to Job Creation and Poverty
Reduction", January 2013.

¹³ World Development Report 2013,
"Jobs", UNDP.

¹⁴ ANDE, Small and Growing Businesses:
*Investing in the missing middle for poverty
alleviation*, 2012.

¹⁵ Endeavor Insight, "Why Scale up
companies are critical for job creation in
Indonesia and Colombia" July 2013.



Randall Kempner, ANDE



"Sub-Saharan Africa suffers from the narrowness of its formal economy: there are so few medium-sized companies in Africa that we call them the "missing middle". Yet they are key pieces in the puzzle of Africa's inclusive growth.

It is the Small and Growing Businesses (SGBs) of today that will fill this "middle" by

becoming the fully formal and sustainable medium-sized companies of tomorrow. We define SGBs as small businesses with at least five employees that are led by management with the ambition and potential to expand rapidly. These firms typically seek growth capital between US\$20,000 and \$2 million – above the size of most microfinance loans, but below the size of most international private equity investments.

Our research has found that job creation is historically concentrated on a fraction of firms in the developed world, where "the top performing 5-10% of enterprises in an economy [...] are responsible for 50-80% of employment generation"¹⁴. This has proven to be true in emerging market countries as well: in Indonesia, high-growth enterprises represent 16% of all firms but 52% of job growth; in Colombia the corresponding figures are 8% and 45%¹⁵.

A key challenge for Africa's inclusive growth is to identify these job-creating SGBs and provide them with the insight and finance they need. At the Aspen Network of Development Entrepreneurs (ANDE), we support the organizations that train, finance, and develop these SGBs. Happily, we have seen an increase in the number of actors focusing on SGBs in emerging markets, and especially in Sub-Saharan Africa.

But while the amount of support is increasing, there remains a significant gap in financing for early-stage SGBs, which have as much potential but are a little younger, a little less organized, and typically require initial investments below US\$500,000. Such early-stage SGBs are much more numerous than well-established companies, yet very few investors reach them. Closing this gap is the biggest challenge in SME financing today, and one of the most exciting frontiers of impact investment in Africa."

3) SGBs face three major structural obstacles

Small and Growing Businesses (SGBs)¹⁶ benefit from the resurgence of economic growth and the development of domestic markets; they are teeming with growth projects that can create value and employment. However, their expansion is hampered both by the general weaknesses of the business environment in Africa (weak infrastructures, size of the informal sector, etc.), and by three major obstacles that affect them in particular: lack of long-term finance, limited access to skills and insufficient standards of governance.

■ Access to long term finance

African SGBs suffer from a very limited access to the formal financial sector: more than 40% of them mention access to financing as the major factor¹⁷ limiting their growth. Indeed in most countries, existing financial institutions are not tooled to address their long-term investment needs.

The microfinance sector is growing fast in Africa, but its streamlined procedures (with high interest rates, short term maturities and loans rarely exceeding 20,000 EUR) are not adapted to SGBs that need to make long term investments.

Commercial banks are increasing their penetration of Africa's economic fabric, but the typical SGB remains very far from their typical clientele, because of four structural features:

- SGBs do not produce reliable financial data and most countries do not have efficient credit bureaus: this creates strong asymmetries of information.
- SGBs bear higher levels of risk because they are fragile and work in uncertain environments. As a result, the share of non-performing loans for small businesses in Africa is 14.5% as opposed to an average of 5.5% of developing countries¹⁸.
- SGBs lack the equity cushions and the financial management capacity necessary to mitigate those risks.
- SGBs have small funding needs which generate high relative transaction costs, due to the time necessary to appraise and monitor the loan.

¹⁶ Small Growing Businesses are small businesses with at least five employees, led by a management with the ambition and potential to expand rapidly, and that seek growth capital between US\$20,000 and \$2 million (ANDE).

¹⁷ Enterprise Surveys, World Bank group, <http://www.enterprisesurveys.org/Custom-Query>.

¹⁸ Dalberg, 2011, Report on support to SMEs in developing countries through financial intermediaries.

These four factors increase the cost of financing and the risk perception. With neither the tools nor the incentives to adapt to this risk profile, commercial banks limit their exposure by setting stringent conditions for SGB financing:

- Asset-based and cash-based collaterals that exceed the amount of credit.
- High equity requirements.
- High interest rates.
- Rigid credit conditions with short holiday periods and short maturities.

Few SGBs can meet these conditions. As a result, most banks finance large companies and a few well-known sectors such as trade and real estate. They limit their SGB financing to short term products (e.g. overdrafts and working capital). As a result, credit to small businesses represents only 1.5% of all credit in Africa, four times less than the average in developing countries¹⁹.

Equity investment remains unorganized in most African countries: it essentially comes in limited amounts from the entrepreneur's friends and family circles. It is rare to find structured networks of business angels or investment companies capable of financing a significant number of SGBs.

Challenge #1

In order to grow and create sustainable jobs, SGBs need investors that can adapt to their level of risk and provide personalized long term finance.

¹⁹ Dalberg, 2011, Report on support to SMEs in developing countries through financial intermediaries.

+ Access to skills

Access to finance alone does not guarantee a SGB's success. Indeed, mismanaged growth can weaken a business instead of strengthening it.

Unfortunately SGBs are characterized by important operational limitations: a "one-man-band" entrepreneur concentrates most responsibilities and often plays the roles of financial director, sales director and production director at the same time. Quality middle management is hard to retain and entrepreneurs are often overwhelmed.

Periods of fast growth generate a lot of pressure on the company and in particular on the entrepreneur: strengthening internal capacities is often a matter of survival. Unless financial and accounting practices are upgraded, the company cannot achieve sustainable growth. Similarly, unless the SGB's key operational functions are reinforced (sales, quality, production, etc.), new issues arising from rapid growth may push the company beyond its capabilities and into a minefield of potential mistakes.



Challenge #2

In order to manage growth sustainably, SGBs need support in strengthening their management and operational capacity.

+ Low governance and management practices

There is little awareness of the importance of governance among entrepreneurs: few are implementing satisfactory governance and management standards. Even when a formal governance is set up (e.g. a board of directors), the nature of the shareholding (often a sole shareholder, or friends and family) often deprives this governance of the necessary discipline and checks and balances required to be truly effective. In some cases, this situation can weaken the business by allowing decisions that are not in its long-term interests (recruiting family members, confusing owner's assets or cash-flows with that of the company, etc.). These shortcomings are even more frequent when the entrepreneur is both the single shareholder and the CEO. Finally, the lack of a strong governance deters new investors and banks to establish relationships with the SGB.

The entry of new shareholders can provide the opportunity to improve standards of governance and management (see section 2, 2.1). The single shareholder or family shareholding model is not always an obstacle to development, as proved by the success of numerous family-held companies. Nevertheless, **attracting outside investors with additional skills and networks can be a big advantage for SGBs when they evolve in a context of difficult access to talent and financing.** It will also improve the credibility of the business vis-à-vis external partners.

Attracting outside investors with additional skills and networks can be a big advantage for SGBs when they evolve in a context of difficult access to talent and financing.



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Challenge #3

In addition to the lack of long term finance and skills, most SGBs are hampered in their growth by their own insufficiencies in governance and management practices.

② Private equity in Africa: the partial development of a new solution for SGBs

1) A solution adapted to the needs of SGBs

Private equity investment consists in taking participations in the equity of unlisted businesses for a limited time period, usually 5 to 7 years, at the end of which the investor sells its shares back to the historical shareholders or to new shareholders. The investor may be a majority or minority shareholder and may provide shareholder loans bearing flexible conditions.

Equity investment is a “high depth” and “low breadth” model. Investors select a small number of high-potential companies each year on which they concentrate all their financial and operational resources so these businesses achieve rapid growth. As shareholders they participate in the company’s governance and strategy. Their success is directly proportional to the performance of investees and so it is in their interest to provide the most effective support possible.

Equity investors aim for higher returns than banks: when they provide shareholder loans, they typically bear a higher interest rate than traditional bank loans. By acquiring shares of the company, they also qualify for dividends and profit from increases in the share price. If equity investors fully benefit from the company’s growth, they also share all the risks, just like the entrepreneur.

Compared to other financial institutions such as commercial banks, the equity investor distinguishes itself by its ability to effectively meet most of the needs faced by African SGBs:

- **Personalized long-term risk finance:** SGB investors are equipped to take greater risks since they are very selective and able to closely support entrepreneurs. They can thus provide long-term equity and quasi-equity finance, often without asset-based collateral. The financial structuring is custom-tailored to the needs and cash-flow profile of each investee (see section 2, 1.3.)
- **Accessing skills:** as a shareholder, the SGB investor provides individualized management support to the investees in a number of areas of expertise: strategy, financial management, accounting and organizational procedures, marketing and sales, etc. (see section 2, 2.2, section 2, 2.3 and section 2, 2.4)
- **Improving governance:** as an institutional investor, it structures the governance of the investees and improves management standards (see section 2, 2.1.)
- **Catalyzing effect:** the presence of SGB investors facilitates bank financing by increasing the reliability of financial information, reducing the risk of bad management and increasing equity and assets that can be used as collaterals (see section 2, 2.5).

The SGB investor acts as a growth catalyzer by helping SGBs overcome their three main stumbling blocks: personalized long term finance, management support and improved standards of governance and management. By including SGBs into the financial and banking system, the investor also plays the role of a springboard: it becomes the missing link in the broken chain of SME financing in Africa.

The SGB investor acts as a growth catalyzer by helping SGBs overcome their three main stumbling blocks: personalized long term finance, management support and improved standards of governance and management.

Conclusion #1

Private equity can act as a catalyzer of Africa's private sector development by providing high-potential SGBs with the adequate financial and human resources to grow and become large and formal companies.

2) A very limited penetration of the African SGB segment

Most private equity investors active in sub-Saharan Africa do not invest in companies whose investment needs are below EUR 2 million: out of the USD 34 billion in African private equity transactions between 2007 and 2014, only 2% were in deals below 10 million USD²⁰. Even below 10 million USD, large companies and well-structured medium-sized companies reap most private equity investment. Investors are also highly concentrated in geographic terms: between 2011 and 2013 more than 60% of investments went to only 3 countries: South Africa, Nigeria and Kenya²¹. Finally, private equity investors mostly target sectors where SGBs are not competitive: energy and natural resources represent half of the capital invested in 2013²², followed by telecommunications and financial services.

That being said, the investment landscape has rapidly evolved over the last 5 to 10 years. An increasing number of investors are now targeting SGBs. They are capable of investing less than 2 million EUR per transaction, sometimes as little as 300 000 EUR and can target early-stage businesses or startups. Some of these are “impact investors”²³ who finance businesses that have a strong environmental or social impact, or which are too small to be financed by conventional investors. These investors generally accept below-market returns in order to achieve impact goals.

Nevertheless, most of these investors prefer to finance medium-size and already well-structured businesses; they only exceptionally finance smaller businesses with needs under 500 000 EUR. They also remain largely concentrated on just a few countries (mainly South Africa, Kenya, Nigeria and Ghana):

- Grassroots Business Fund (Kenya)
- Acumen Fund (Kenya, Nigeria, Ghana)
- Cauris Management (French-speaking West Africa)
- Injaro Investments (West Africa)
- Pearl Capital Partners (Kenya, Uganda)
- Maris Capital (East Africa)
- Fanisi Capital (Kenya)
- Bamboo Finance (East Africa)
- Oasis Capital (Ghana)
- SONAPAR (Madagascar)
- TBL Mirror Fund (Nigeria, Kenya, Tanzania, Uganda)
- FIARO (Madagascar)
- Investisseurs & Partenaires, through the I&P Afrique Entrepreneurs fund (pan African).

²⁰ AVCA, 2015, *African Private Equity Data Tracker*.

²¹ EMPEA 2013 Annual Fundraising and Investment Review.

²² EMPEA 2013 Annual Fundraising and Investment Review.

²³ According to the Global Impact Investing Network (GIIN), impact investment is the activity of investing in organisations and funds with the intention of generating positive social and environmental impacts alongside financial return.



Focus on Injaro Investments



Injaro Investments is a fund manager founded in 2009 by a team of West African entrepreneurs. Injaro invests in equity and quasi-equity amounts ranging between 300 000 EUR and 5 million EUR into SMEs of the agricultural value chain, and provides management support for 5 to 7 years.

Injaro is active in Ghana, Côte d'Ivoire, Burkina Faso, Mali, Niger and Sierra Leone. Injaro's sectoral investment strategy stems from its twin objective of

generating positive social impacts on smallholder farmers and low-income populations alongside financial returns.

Since 2012, Injaro has raised 45 million EUR from some of the major international financial institutions active in Africa (DFID, Proparco, FMO, Lundin, SEDF). Injaro has financed 7 businesses in 5 countries, with an average investment of 400 000 EUR. It has offices in Accra and Abidjan and a staff of 8 investment professionals. Injaro is part of the small group of West African investors that can finance young companies with needs under 1 million EUR.



Focus on Investisseurs & Partenaires (I&P)



Investisseurs & Partenaires (I&P) is an impact investment group based in Paris, Abidjan, Accra, Dakar, Douala, Ouagadougou and Tananarive.

I&P's goal is to promote entrepreneurship in Africa by investing in small and growing businesses. I&P acquires minority participations in African SGBs and provides participatory or convertible shareholder loans and close management support for 5 to 7 years before exiting.

Founded in 2002, I&P is one of the first investors dedicated to African SGBs in the Francophone area. It has made more than 50 investments for amounts between 100 000 EUR and 1.5 million EUR in 15 countries: Senegal, Niger, Mali, Burkina Faso, Côte d'Ivoire, Ghana, Benin, Cameroon, Gabon, Democratic Republic of the Congo, Uganda, Namibia,

Kenya, Madagascar and Comoros. I&P has exited 10 companies so far with good gross profits.

I&P manages two investment vehicles: I&P Développement, an investment company of EUR 11 million that targets small businesses and I&P Afrique Entrepreneurs, a EUR 54 million investment fund that finances medium-size businesses for amounts between 300 000 EUR and 1.5 million EUR.

In addition to its direct investment activity, I&P sponsors the emergence of African investment teams that finance SGBs with needs between 30 000 EUR and 300 000 EUR. I&P has so far sponsored 3 investment companies in Niger (Sinergi Niger), Burkina Faso (Sinergi Burkina) and Senegal (Teranga Capital).

A new type of investors can seize the opportunity to promote future African champions by investing smaller amounts, between 50 000 EUR and 500 000 EUR.

A panorama of the African investment landscape shows that few investors are willing to finance the smaller and more early-stage SGBs, although these companies are much more numerous than medium-sized businesses and are led by some of the best entrepreneurs.

These businesses usually have 5 to 50 employees and a turnover of 50 000 EUR to 500 000 EUR; they cannot absorb investments in the range of 1 million EUR. Despite their high potential for value creation and impact, they face the absence of relevant investors in most countries.

A new class of investors can seize the opportunity to promote future African champions by investing smaller amounts (e.g. between EUR 50 000 and EUR 500 000) in early-stage businesses.

Some investors have already demonstrated that this is both profitable and produces a significant impact on development.

These players developed innovative models which adapt to the constraints of financing early-stage SGBs, for example by relying strongly on quasi-equity in their financing packages. Their value creation strategy focuses on turnover growth and investment rather than internal reorganization or consolidation through merger/acquisition.

The following investors target small businesses with needs between 30 000 EUR and 500 000 EUR, generally early-stage businesses or startups:

- Business Partners International (Southern Africa, East Africa)
- XSM (Democratic Republic of Congo, Central African Republic)
- Grofin (East Africa, Southern Africa, Ghana)
- Sinergi (Niger)
- Savannah Fund (Kenya)
- SME impact fund (Tanzania)
- Kukula Capital (Zambia)
- Sinergi Burkina (Burkina Faso)
- Teranga Capital (Senegal).



INVESTOR - Why do equity investors shy away from financing small companies?



Olivier Lafourcade,
President of I&P
Développement

"One of the reasons why small businesses are still poorly financed is the investor's natural behavior of "creeping up": even if an investor begins by financing

small companies, its average investment ticket naturally increases over time. This is what happened with I&P, which began with investments of 100 000 or 200 000 EUR and now invests between 300 000 EUR and 1.5 million EUR.

This trend is largely explained by transaction costs: it is more profitable to make an investment of 2 million EUR in a medium size business rather than to invest 200 000 EUR in 10 different SGBs. Indeed, providing support to ten different companies requires spending 10 times more time, which increases management costs and decreases net profits for the investor.

However, we should go beyond the simple arithmetic of transaction costs: first of all, the sheer number of small businesses allows for a very high selection by investors, focusing on the best entrepreneurs. Also, SGBs are at a stage where rapid growth and substantial gains in productivity are possible. The enormous potential of this segment remains largely untapped."



Focus on Business Partners



Business Partners is one of the first African investors to provide risk finance to small and growing businesses (SGBs). Since 1981, the South Africa based company has invested 1.5 billion USD in 70 204 South African SGBs, has built a network of

22 branches in the country and has a staff of 70 investment officers. With its average investment of 250 000 USD, Business Partners is one of the only investors to reach the segment of smaller African companies.

Business Partners has developed a unique model that differs from traditional equity investors. By mitigating risks and standardizing the investment method, they can broadly scale operations while giving the missing middle the instruments it needs.

Business Partners finances existing businesses with a diversity of products ranging from equity participations to medium term loans, and mostly in the forms of quasi-equity based on collaterals. Business Partners also provides management support through a network of 400 industry experts who act as mentors to the entrepreneurs, and are financed through Business Partners' zero-interest loans.

In 2005 Business Partners teamed up with IFC to reproduce its model in eastern and southern Africa. Today, Business Partners International has branches in 5 other African countries: Kenya, Rwanda, Malawi, Zambia and Namibia. More information on Business Partners is available in the [2013 Impact Assets report](#).



Focus on XSML



"In the countries where we work, there are relatively few large companies. The strongest demand for financing comes from SMEs with capital needs of 50 000 EUR to 2 500 000 EUR. To be effective, investor models must be adapted to these demands.

XSML is an SME investor founded in 2008, geographically focused on Democratic Republic of Congo and since 2011 on Central African Republic. In four years, XSML financed 26 SGBs in a variety of sectors (food and agriculture, transport, education, pharma and health, services), with single investments between 246 000 EUR to 1 million EUR, and an average investment of 495 000 EUR.

This track record makes XSML not only the most active investor in both the DRC and CAR, but also one of the investors in Africa with a track record of successfully financing SMEs.

XSML developed a model inspired by private equity, highly selective and providing close management support. All SMEs are financed through loans secured by guarantees, and XSML acquires minority stakes in about 40% of the companies it finances. This is true "mezzanine" finance, combining equity and debt.

XSML manages the USD 19 million Central African SME fund, raised from international institutions like IFC, FMO and the Lundin Foundation for Africa. The investment and monitoring team consists of 10 people based in DRC, CAR, Netherlands and England."

Conclusion #2

In most African countries, early-stage SGBs have little to no access to equity investments. Very few investors are active on this segment despite the immense needs and opportunities for value creation and impact. Section 2 shows how some of the main actors of this sector have adapted the private equity model to early-stage SGBs.



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2

The private equity approach - Investing, Supporting, Exiting -

1

- **Investing**

- 1) Performing due diligence
 - Analyzing investment opportunities in depth
 - Making each SGB investment-ready
- 2) Valuing a company
- 3) Structuring a deal
- 4) Negotiating the shareholders' agreement

2

- **Supporting the growth of the SGB**

- 1) Setting up the governance
- 2) Formalizing the company
 - Legal and fiscal compliance
 - Accessing reliable information
- 3) Supporting the management
- 4) Organizing technical assistance missions
- 5) Mobilizing additional financing
- 6) Improving environmental and social practices and measuring impact

3

- **Exiting**

- Selling to the entrepreneur
- Selling to a third party

2

The private equity approach - Investing, Supporting, Exiting -

INTRODUCTION

The approach of equity investment can meet the needs of many SGBs in Africa while creating value for investors, both in terms of impact and financial returns. However, investing in small businesses, as one of the first investors in a fragile and unstructured company, is quite different from conventional private equity. It carries a higher level of risk and often means establishing management and governance practices from scratch. In this context the investor's success depends mainly on three factors:

- Selecting the best entrepreneurs.
- Adjusting to the vision of each entrepreneur.
- Providing very close management support tailored to each SGB.

This section is not a technical guide to private equity: pertinent references of the sort are already available. The goal here is to show how some investors adapted the private equity model to African SGBs, and to share the experiences of both investors and entrepreneurs. It is broken down into the three phases of a partnership:



In reality these three phases are interwoven. For example, though exiting takes place in the final phase, the shareholders' agreement signed in the due diligence phase already includes the proposed exit plan.

① Investing

The investment methodology depends on the strategy of each investor: the greater the risk an investor takes, the deeper and longer its due diligence; the more an investor invests in equity, the more emphasis is put on financial structuring and the exit plan. Nevertheless, all players generally follow a common framework.

1) Performing due diligence

■ Analyzing investment opportunities in depth

As opposed to other financial institutions (banks and microfinance institutions), equity investors take the risk of losing all of their capital and often work with no collaterals.

They have to be very selective in the choice of entrepreneurs that will be supported. Conducting an in-depth due diligence is therefore a prerequisite.

Incubators and accelerators are scarce in most African countries. Moreover, the due diligence standards of an equity investor, which are much more rigorous than conventional actors such as banks, are rarely known. As a result, even the most promising SGBs are often far from investment-ready.



The key points of a due diligence

- *The entrepreneur: experience, vision and skills.*
- *The company's track record and progress on the investment project.*
- *The market analysis and competitive advantages of the company, particularly vis-à-vis imports and informal competition.*
- *The human and technical resources needed to implement the project.*
- *The business model.*
- *The expected impact, and management of environmental and social risks.*



ENTREPRENEUR

Djibrilla Hima, Saphar, Niger



Saphar is a distributor of pharmaceuticals founded in 2000 which is today the third distributor of pharmaceuticals in the country, behind two subsidiaries of international groups.

"The due diligence phase was long: we contacted the investment fund in July 2004 and the process concluded in March 2006.

However, it enabled us to establish a relationship of trust and prepare our partnership, to diagnose difficulties, explain insufficiencies and try to find appropriate solutions.

The process, and particularly the financial audit by a firm designated by the investor, revealed financial and accounting weaknesses that were hiding large losses that had escaped our attention."

Rare are the SGBs that can receive an investment before a long due diligence and “maturing” phase. This phase can range from a few months to a couple of years in more complex cases such as start-ups and turnarounds.

Investors first perform an early selection on the basis on the SGBs’ business plan and financial accounts. Since the due diligence phase is highly time-consuming, most applications are rapidly brushed aside in order to save time for the truly promising opportunities.

■ Making each SGB investment-ready

The specificity of due diligence for SGB investors is that analyzing the investment opportunity is just one side of the coin; the other is making the business investment-ready. While performing due diligence, the investor helps the company mature and reduce the risk of its investment project to better absorb financing. **The investor takes an advisory role in a context where SGBs struggle to find affordable quality support to become investment-ready.**

Investors are often deeply involved in the definition of the investment project: they help formulate business strategy, put together a business plan, conduct a market analysis and, where appropriate, choose the machinery or technology. This is a very intense period for the businesses and it weighs heavily on the time of entrepreneurs and their teams. Investors must remain careful in their demands, as too much pressure can have detrimental effects on company performance.

The investor takes an advisory role in a context where SGBs struggle to find affordable quality support to become investment-ready.

**Khady Nakoulima,
Nest for All:**

“I&P maintained a very cautious attitude, questioning everything for about two years before investing. Every aspect of the model was questioned. The role of the investor is to challenge the entrepreneur, but it is impossible to plan for everything.”

ENTREPRENEUR

Gabriel Fopa, ITG Store, Cameroon



Founded in 2006 in Douala by a Franco-Cameroonian tandem, ITG Store provides integration services and outsourcing in information technology.

“The preparatory phase is crucial. At the beginning, the entrepreneur and the investor are speaking two different languages, and their two

different dictionaries have to be harmonized. The due diligence with its preparatory meetings and technical missions inside the company are necessary for the future partners to learn to understand each other.

On one side, you have the entrepreneur, passionate and enthusiastic, convinced that everyone understands what they do, why they do it and why it has such rich potential. On the other side is the financier with its constants: for example, the questions asked about the

market, positioning of the competition, their strengths and weaknesses, etc. The entrepreneur never studies these aspects in detail because what's more important to him is how to capitalize on his own strengths. The investor makes him realize that enthusiasm and technical skills are not enough, but rather the beginnings of what is necessary.

I was initially quite uncomfortable with the due diligence conducted in my company, with the interviews of my customers and my prospects. I felt stripped naked in the marketplace and I almost put a stop to the mission.

However, I soon understood that this was a useful exercise: it highlighted the real perceptions of my customers, the depth of the market and the strengths and weaknesses of ITG, in particular I understood that while the company had real technical and technological capabilities for handling projects, it did not have the financial strength to grow.”

*A relationship
of trust and mutual
understanding
is built.*

While working alongside entrepreneurs during the due diligence, investors show that they can bring value to the business and convince the entrepreneur to welcome them as new shareholders and board members.

A relationship of trust and mutual understanding is built both person-to-person and investee-to-investor. In a context where most shareholding structures associate friends and family, this “convergence of minds” between the investor and the entrepreneur is as important as the convergence of interest.

This reciprocal trust is decisive once the negotiation phase comes: it is often one of the factors that convinces the entrepreneur to open his/her company’s equity.



ENTREPRENEUR

Appolinaire Tchakounang, Freshco, Cameroon



Founded in 1996, Freshco is a Cameroonian company which produces and distributes dairy products (yoghurt and ice cream) and natural fruit juice.

“This was the first time I was asked for so much information. It can be a painstaking phase.

The investor requests details that require setting-up information management procedures and tools.

This creates a lot of pressure, especially when you are running the day-to-day of a company at the same time.

Even if the investor ultimately did not invest in my company, their work and that of the technical experts was very constructive.

The due diligence changed our vision of our company. It enabled us to get our affairs in order, to organize, formulate and implement a business plan, and set up tools for monitoring and supporting our business.

The process can be demanding and time-consuming, but the investor needs it to understand a business, and the entrepreneur benefits by learning a new method of management.”

During the due diligence, investors and entrepreneurs agree on a "term sheet" presenting the essential information on the investment: financial structuring, financial projections, rules of governance, exit mechanism and business valuation.



INVESTOR

Dadié Tayoraud,
Injaro Investments



"Equity investment is new to Africa, and consequently harder to explain to entrepreneurs than something as familiar as debt.

Convincing an entrepreneur to open its equity to a third party needs more than money. Investors must adopt an advisory role and prove that they can contribute strategic and managerial value to the business. This is a long process: in some cases several years of prior relations are needed to eventually make an investment.

During the due diligence, we usually help define the strategy and build the business plan. This joint approach saves time and allows the investor and the entrepreneur to agree on a common strategy and shared vision of the business, which makes the investment possible."



2) Valuing a company

To take an equity stake in a company, one must first value the company's equity. Whether the investor takes part in a capital increase or acquires existing shares, the price of the shares bought has to be calculated. This valuation takes into account the company's market position, assets, goodwill and growth potential.

If the investee is a start-up, its value corresponds to its share capital. Investors generally buy shares at the issue price, in other words with no share premium. In certain cases they may accept a goodwill (valuation of intangible assets) in a limited proportion.

If the investee is an existing company, there are a number of approaches for determining its value.

The three most common methods to assign a value to an African SGB are:

- **Net asset value:** this asset valuation method calculates the difference between assets and debts on the balance sheet. It also determines the possible intangible value (goodwill) that can be added to the book value.



ENTREPRENEUR

Jules Kébé,
Duopharm, Senegal



Duopharm is a Senegalese distributor of pharmaceuticals formed by a group of more than 300 pharmacists-shareholders.

"An agreement has to be found at the very beginning on the mechanism for valuing the company, both at the entry of the investor and at its exit."

The entrepreneur has to be fully aware of the various methods of valuation, and he must have a strategic vision of his business development to prepare the exit of the investor."

■ **Price/earning ratio:** this method values a business by a multiple of its operating margin or net margin (e.g. 7 times net profit). Valuation formulas applied in comparable investment operations (similar sectors and/or countries) can be used as benchmarks.

■ **Discounted cash flow:** this method determines the value of a business by predicting its future profitability. In that case the value depends heavily on the growth assumptions of the business plan.

Business valuation is a sensitive issue for the entrepreneur, and one which is often outside his/her area of expertise. Negotiations can end in an impasse, where no agreement can be reached. Indeed, the entrepreneur usually expects a high price that represents the time and effort spent to build the business, and the optimism about future growth. On the other side, the investor tends to take a more careful approach considering the uncertain business environment, and aims to control risks in a context of asymmetries of information.

Working on the clauses of the shareholders' agreement can break the deadlock of valuation by broadening the sphere of negotiations between the investor and the entrepreneur.

Working on the clauses of the shareholders' agreement can break the deadlock of valuation by broadening the sphere of negotiations between the investor and the entrepreneur.



INVESTOR *Breaking a deadlock on valuation*

Pierre Carpentier,
Investment Director, I&P



"Investors need creativity and a dose of pedagogy to suggest a mutually acceptable solution. Indeed, valuation is their core competency and it is their responsibility to adapt to the constraints of the entrepreneur, who is often less of an expert on the topic.

Valuation matters to entrepreneurs because it has

an impact on three elements: the percentage of equity held by the investor, the allocation of powers between shareholders and the repartition of dividends. However the negotiation on valuation has to be seen as part of a bigger negotiation: for example, to compensate a lower valuation, the shareholders' agreement can offer the entrepreneur preferential conditions on these three elements.

First, the shareholders' agreement can introduce mechanisms to adjust the investor's equity participation

on the basis of actual future performance. For instance, if the entrepreneur accepts the investor's (lower) entry valuation, the investor will agree in the future to transfer a number of shares for free to the entrepreneur provided some performance objectives are met. Thus the entrepreneur will increase his equity share if he proves that his growth projections were correct.

The initial valuation also depends on the exit plan: if the entrepreneur wants to buy back the investor's shares at the end of the investment period, the same valuation formula can be used for entry and exit, a solution that aligns the interests of both parties.

Second, regarding the allocation of powers, the shareholders' agreement can include veto rights for the entrepreneur (regardless of his percentage of equity held) to include him on the strategic decisions on the board of directors, and on the decisions regarding the evolution of share capital taken at the general assembly.

Finally, the shareholders' agreement can also set priority dividends for the entrepreneur."

3) Structuring a deal

One of the strong advantages of equity investors compared to other financial institutions is their capacity to adapt the financial structuring of each deal to the profile of the company and to the vision of the entrepreneur.

There are a number of different models for financing SGBs (see section 1, 2.2): some actors invest mainly in equity, and others in debt or quasi-equity. In reality most investments combine these two approaches and debt instruments are in fact “quasi-equity” instruments with performance-based remunerations. Indeed in the context of African SGBs, the level of risk on a long term debt partially secured by assets does not differ greatly from that of equity, and debt investors provide management support to investees similarly to equity investors. In the end, the main factor for the choice of financial instruments is the profile of the investee.

The SGB investor tailors each deal using an array of financial instruments, the two main ones being the equity participation and the participative and/or convertible shareholder loan (also called quasi-equity):

- **The equity participation** is an instrument whereby the investor brings non reimbursable funds into a company by acquiring new or existing shares. These shares are part of the equity of the company, and are remunerated by dividends as well as by the potential increase of share price. The investor is a shareholder and takes part in the company’s governance.
- **The shareholder loan** can supplement the equity participation. It is reimbursed by the company’s cash flow, but is the last in line in case of liquidation. This loan is remunerated both by a fixed rate of interest, usually below bank interest rates, and by a “royalty” (i.e. performance-based remuneration indexed on turnover or on profits). This mechanism allows a sharing of profits and risks between investee and investor. Under some conditions, the loan may be convertible into shares, enabling the investor to increase his/her equity in the company. A shareholder loan may also grant some access to the company’s governance.

Participation in share capital

► For the investor

+ Advantages

Shares all the profits

Participates to the company's governance

► For the entrepreneur

+ Advantages

No obligation for the company to reimburse a loan
No additional financing cost in the company's income statement

- Disadvantages

Shares all the risks with the entrepreneur

Limited exit options and sometimes an obligation to sell shares back to the entrepreneur

- Disadvantages

Shares all the profits with the investor
Need to buy the investor's shares at the end of the investment period, or accept that they be sold to a third party

Shareholder loan

► For the investor

+ Advantages

Fixed rate of interest providing expected minimum returns

Partial sharing of profits through a royalty linked to profits or turnover

Loan reimbursed by the company's cash flows and not dependent on an outside exit

► For the entrepreneur

+ Advantages

Low overall interest rate in case of poor performance

No impact on the shareholding of the company nor commitment to buy back shares

- Disadvantages

Lower access to the company's governance

Lower upside than equity in case of success

- Disadvantages

High overall interest rate in case of good performance
Need to reimburse the loan from the company's cash flows

**Folly Koussawo,
Trianon Gabon:**

"In Central Africa at best the banks provide very short term financing. The presence of investment funds changes the game, especially in terms of cash management, because it provides the entrepreneur with enough security and visibility to implement medium term projects."

These instruments respect three fundamental principles:

- **Investing over the long term:** African SGBs need long periods of support (5 years minimum) to gain momentum, consolidate and become incorporated into the banking system.
- **Adapting financial instruments to the entrepreneur's vision:** Most entrepreneurs want to maintain control of their company and ask the investor to take a minority equity stake. In order not to take a majority stake, the investor can make part of its investment in a shareholder loan. Deal structuring also takes into account the entrepreneur's vision of the investor's exit: investing more in shareholder loans than in equity makes it easier for an ownership-minded entrepreneur to buy back the company's shares. On the other hand, if the entrepreneur wants the investor to exit on a third party, investing in equity can strengthen the company without accumulating debt.
- **Adapting financial instruments to company performance:** by investing in equity and shareholder loans, the investor accepts returns that depend on company performance, and shares both risks and profits with the entrepreneur.



INVESTOR

**Barthout van Slingelandt,
XSM Capital**



"In countries where we operate, financial resources are not necessarily adapted to the needs of SMEs and are often expensive.

Conventional players such as banks are not always equipped to make loans to SMEs under conditions favorable for growth. That makes an investor like XSM

a good alternative because our investment decision is based not only on collaterals, but also on the company's growth plan, management capabilities, cash flow, etc.

At the same time, exiting a small company remains difficult and that is why equity investments are a risk. We prefer to use quasi-equity instruments, particularly the shareholder loan.

There are two mechanisms for remuneration: a fixed rate of interest at bank rates and a royalty, which is a rate of participation linked to company performance, for example linked to turnover.

Entrepreneurs find this instrument satisfactory because it shares risks and profits: if the company fails to reach its turnover goals, the loan is not very expensive, and if the company makes good profits, the loan will be expensive.

This type of structuring limits the investor's risks as its performance does not wholly depend on the exit. It also maintains a potential upside by making sure that the loan is very well remunerated if the company fulfills or exceeds its goals."

4) Negotiating the shareholders' agreement

The shareholders' agreement is a private contract between shareholders that is subordinated to company statutes. It provides greater flexibility in relations between shareholders through the use of clauses specifying aspects of governance, issue and transfer of shares, etc. It is used systematically by equity investors.

Equity investment is still relatively new in Africa, and SGB investors are often the first non-family or friends shareholder in a company. As a result, the standard clauses of a shareholder's agreement can be met by entrepreneurs with caution and suspicion.

Investors should take the time to debunk the fears around the risks of opening a company's equity, and to explain in details the meanings and implications of each clause of the shareholders' agreement.



ENTREPRENEUR

Jaco Chan,
Indian Ocean Trepang (IOT),
Madagascar



IOT is an industrial aquaculture company installed in southwest Madagascar that raises and exports trepangs (sea cucumbers).

“During the negotiations of the shareholders’ agreement, certain technical terms with specific meanings in finance and law need to be clarified and explained to entrepreneurs who do not necessarily have the required formal training or experience.”

It is often useful to proceed by stages, starting by providing the entrepreneur with a framework document on the general terms of investment. After an initial exchange based on this document, the term sheet can be proposed and discussed. The term sheet includes detailed information on the deal: financial instruments used, valuation of the company, governance clauses, exit plan, etc. It is generally signed by the entrepreneur and the investor after the approval by the investor's investment committee.

Once the term sheet is signed, the investor draws up the shareholders' agreement which translates the term sheet into a legally binding form. This shareholders' agreement is signed by all of the company's shareholders and serves as the legal foundation for the partnership.

The shareholders' agreement generally respects certain key principles:

■ Adapting to the entrepreneur's vision, particularly regarding the exit of the investor

Some entrepreneurs have a vision of long term ownership: they will accept an equity investor for several years, but will want to buy back its shares at the end of the period. Others want to open their company's equity over a longer term because they value the experience of working with partners.



ENTREPRENEUR

Folly Koussawo, *Trianon BTP, Gabon*



Trianon BTP is a construction company incorporated in Gabon by a team of young professionals with a strong professional experience in Europe.

"The shareholders' agreement is a decisive step in the negotiations with investment funds. This is the moment when the partnership

took tangible form for me: I became fully aware of the impact of the fund's entry, and I realized that I was no longer alone as decision-maker and head of my company. The investor's minority stake initially reassured me, but as I read the shareholders' agreement, I understood that the investor was going to be involved in all important decisions and was going to have special rights.

I would say there are two parts to negotiating a shareholders' agreement: first, the work involved in

gaining a purely legal understanding of the document, and then what I would call psychological thought process. I was advised by lawyers and financiers, and I had transparent and open exchanges with the investor, which enabled me to understand the legal terms and their implications, and accept or refuse the constraints that come with the arrival of an investor in the capital of Trianon.

I understood that this agreement contained two different things: the letter and the spirit of the partnership, the legal theory and its practical implementation. I understood the spirit of the agreement, that such a contract is not written for cases where the partnership is working smoothly, but to plan for the more difficult cases: for instance, the investor has to anticipate for the case where the entrepreneur deliberately disrespects the rules of governance. By making the effort to look at the agreement from the investor's perspective and once again from my own position, I understood that it was made to protect the interests of both parties, and not just to restrain me."

In both cases the investor's exit mechanisms (see section 2, 3.) are detailed in the shareholders' agreement. The agreement protects the entrepreneur as well as the investor against breaches of these principles.

■ Aligning the interests of shareholders and management

The shareholders' financial success depends on the performance of the management, and management performs better if it shares in the value created.

If managers hold a significant stake, they already benefit from the increasing value of their shares. However, if the management holds little or no shares, the investor should incentivize them with mechanisms such as salary bonuses, free or preferentially priced shares, preferential dividends, etc.

■ Protecting the interests of minority shareholders

SGB investors must often invest through minority equity stakes and loans with little or no asset-based securities. They are heavily dependent on the investee's majority shareholder, who is often also the managing director. In exchange for adapting the legal and financial structuring to the vision of the entrepreneur, the investor therefore demands clauses that protect its interests as a minority shareholder. These clauses ensure, for example, that the investor will participate in the company's essential decisions through the board of directors and that recourses exist in case of breach of contract or other serious incidents.

Jaco Chan, IOT :

"That an investor holds a minority stake reassures entrepreneurs, and the inclusion of the negotiated exit plan in the shareholders' agreement instills confidence."



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② Supporting the growth of the SGB

Once the shareholders' agreement is signed, the second phase of the investment cycle begins: management support (see section 1, 1.3.i).

Gabriel Fopa, ITG Store:

"Alone we are fast, but together we go very far. The added value of the SGB investor comes from being a partner-developer for the business: not only investing money, but also providing support, helping patch cracks and grow."

Whereas conventional investment funds – those that work with large structured companies – mainly monitor investee performance through the board of directors, SGBs need much closer support. After receiving a significant investment, they enter a phase of rapid growth, become inevitably overworked and need to strengthen their internal skills and procedures.

SGB investors support entrepreneurs in consolidating their company and managing growth. As shareholders, they benefit from detailed information on their investees and are directly interested in their success.

The intensity and proximity of this management support varies from investor to investor. It can be provided directly by the investment team or indirectly through a network of outside experts and mentors. Most investors combine both approaches and as a rule, management support for SGBs is very time-consuming and mobilizes the majority of an investor's team.

The investment officer who conducted the due diligence and negotiated the shareholders' agreement is often the person responsible for management support once the deal is struck. Investee-investor relations are woven on a person-to-person basis and are founded on mutual trust.

A quality partnership depends largely on the personal relationship between the entrepreneur and the investor, and this is especially true for small businesses. This personal aspect of the business relationship is crucial and should be considered very seriously.



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1) Setting up the governance

"Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."²⁴

Effective governance is rare in African SGBs: companies are controlled by the entrepreneur who is often the sole or majority shareholder and the CEO (see section 1, 1.3.iii.). Setting up a good governance helps to clarify the role of each stakeholder in the company (shareholders, managers, etc.) and ensure that decisions are made in the interest of the company in a transparent manner.

The investor generally demands that a board of directors be created. The board of directors is the body whereby strategic decisions are taken. It gathers shareholders and independent members who bring value to the practical aspects of steering a company (voting budgets, drawing up strategic guidelines, etc.). It is usually limited to several members nominated by the shareholders in order to encourage smooth decision-making.

Folly Koussawo, Trianon:

"The entry of an equity investor in the capital of a company imposes a rigor that is absent when the capital is held by the entrepreneur and a few associates."

²⁴ AFIC, *Capital Risque : Guide des Bonnes Pratiques*.



ENTREPRENEUR

Bagoré Bathily, Laiterie du Berger, Senegal



The Laiterie du Berger is the only Senegalese company producing dairy products from fresh local milk. This milk is collected from more than 800 livestock breeders in the Richard-Toll zone of northern Senegal.

"In 2005, I started the Laiterie with significant support from my brothers and sisters.

I was 30 years old and trained as a veterinarian. I really knew little about running a company. I was the youngest member of a group of shareholders who had succeeded professionally and who had invested heavily in the project. It was not easy to emerge as the leader.

In this context, I&P's support resembled coaching and mentoring. It built my confidence and enabled me to develop the skills necessary for managing a business.

It was also necessary to transform our family-based governance system into a more formal structure in which each shareholder has a clear role and decision-making is better organized.

This transition hit a few bumps in the road but in the end we were better equipped to manage crises. Above all it made it possible to attract follow-on investors such as Danone, Phitrust and Grameen Crédit Agricole. I&P was the antechamber where I learned the methods of governance and prepared for the arrival of these new investors. For two or three years, I&P also served as a buffer between these new shareholders and the management, taking time to support the transition.

Today, the governance structure functions very well and the board meetings have truly become the place where strategic decisions are taken. After an initial period of very close support, I&P is exiting and is consequently less involved in the company's steering. However, the other shareholders are very committed."

Jaco Chan, IOT :

“Even if a decision-making process already existed, the investor formalizes these informal work sessions into board meetings with previous notice, minutes, etc.”

The composition of the board of directors is voted in the general assembly of shareholders, which is where decisions are made on company statutes, approval of accounts, distribution of dividends and changes in share capital.

By participating in the governance structure, the SGB investor brings in an outside and experienced point of view with a strong expertise on business strategy. This fosters a space for strategic debate between shareholders and management that often did not exist before. The simple fact of discussing and sharing the burden of important decisions prevents many mistakes during a period of rapid growth. Thanks to this governance, the entrepreneur can confront his/her vision to the experience of an investor who takes on the role of a challenger. A well-structured governance also strengthens the credibility of SGBs vis à vis their partners (banks, large customers, future investors, etc.).

2) Formalizing the company

One of the investor's first tasks after taking a stake in an African SGB is the formalization and the strengthening of financial and accounting procedures. These steps enable the SGB to achieve two necessary steps to building a lasting partnership:

■ Legal and fiscal compliance

The partially informal environment of African SGBs is an unavoidable reality. If their objective is to finance small companies, investors must follow pragmatic selection criteria in that regard.

That being said, if an equity investor decides to finance an existing informal or semi-formal business, soon after the investment is made, he or she will want to rapidly upgrade the business to full legal and fiscal compliance. Respect for legal and fiscal rules is indeed a precondition for long term growth within a formal framework, and key to establishing strong confident relationships with banks, authorities and international partners.

The SGB investor's demand for formalization can have a significant impact by contributing to the improvement of the business environment and the broadening of the State's tax base.



FOCUS

Formalizing a business decreases legal and fiscal risks and is a necessary condition for long term growth.

On the other hand, it can reduce margins and compromise short term competitiveness in sectors dominated by informal businesses. For example, it is difficult for a fully formal company to be the only actor that bills Value Added Tax in a sector where noone does.

The investor must take this constraint into account in the due diligence, and know that it alone may prevent an investment from happening.



ENTREPRENEUR

Sidi Khalifou, CDS, Mauritania



CDS supports access to water and electricity for all Mauritanians, especially in the rural areas of the Senegal River Valley.

“Setting up a management information system may seem like a secondary consideration for an entrepreneur: it is time-consuming for something that is not really production or sales, and there is a risk of getting bogged down in the process.

However, I quickly realized that without this tool it is difficult to have reliable information when needed, and very easy to lose money with bad decisions.

Instead of integrating existing solutions that we did not completely master, we chose to develop our own specific management information system (MIS) adapted to our needs.

Now, it only takes a few clicks to have simple monthly dashboards with indicators that give us a precise view of the business’ activity, compare it to the budget and analyze the gaps. We also setup a cost management system.

Our MIS is an invaluable tool for negotiating sales, for internal audits, strategic steering, as well as for operational and financial reporting.”

Accessing reliable information

Very few African SGBs have reporting methods that enable both management and shareholders to adequately track the company's performance. However, the knowledge of the financial and operational performance of a business is the foundation of proper strategic planning: without reliable analytical information, board members and management act on intuitions rather than facts, which is a dangerous course particularly in a period of rapid growth. In addition to financial and accounting procedures which often need to be improved, if not set-up from scratch, the SGB investor supports the implementation of a management information system (MIS). This monitoring instrument is adapted to the needs of each company and produces monthly dashboards to track financial and operational indicators and follow the budget.

Entrepreneurs often perceive the upgrading of the accounting and financial department as a major constraint. Nevertheless, without this the company greatly increases its risk of taking bad decisions based on inaccurate or incomplete information.

Folly Koussawo, Trianon:

"The major inconvenience is the reporting: it means I spend less time on sales."



ENTREPRENEUR

Mamadou Sanankoua, RICA, Ivory Coast



RICA is an engineering firm that does installation and maintenance of industrial refrigeration equipment, air conditioning and solar energy. It is based in Mali and Ivory Coast.

"Setting up a MIS is laborious and often painful for an African SME."

The process is costly and complex, and the integration of the tool by the team can fail for a variety of reasons.

Nevertheless, this tool is essential for sustainable medium and long term development. For instance, I need to know my company's profitability per segment of activity in order to focus my resources where they will be the most profitable. Each month, I also need a clear vision of my turnover and my costs compared to

the budget. It was already laborious to manage that with Excel, but this year I multiplied my turnover by three and doubled the number of employees. I can no longer follow my business in my head and using Excel would be dangerous, I would have made management mistakes.

Setting up an MIS on the scale of a SME is a real challenge: it requires a project chief who steers it on a day-to-day basis, and often it demands the direct commitment of the CEO. The implications are far-reaching and change company procedures and employee routines. It often means overhauling staff management.

As a result, the software was installed much later than planned and mobilized significant resources. However, I now have a reliable tool for anticipating my cash flow, knowing my margins and better negotiating with my clients and suppliers. Today, I could not work without it."

3) Supporting the management

Based on accurate monthly reportings, investors can support SGBs in full.

The content of this support varies with the needs of each business, but always goes beyond the simple participation in governance. The investor is not directly involved in company management, but acts as a copilot, supporting and challenging the entrepreneur on the topics on which it has the skills to bring added value:

- **Strategy:** marketing and sales strategy, budgeting, geographic expansion, opening subsidiaries, setting up partnerships, etc.
- **Financial management:** training and supporting a financial manager or CFO, improving accounting and financial procedures, developing bank relations, optimizing product mix and margins, etc.
- **Organization:** human resources, internal procedures, etc.
- **Sales:** getting big customers under contract, identifying export opportunities, responding to calls for bids, setting up sales action plans, etc.

Bagoré Bathily, LDB:

“Real support means supporting the entrepreneurs themselves, setting up a mentoring system that develops their capabilities and provides them with the chance to express themselves and succeed.”



Barthout van Slingelandt, XSM_L



“From the investor’s point of view, a small business with financing needs of 200 000 EUR or 300 000 EUR requires a completely different approach than a larger company able to absorb 2 or 3 million EUR. It is simply not the same world.”

A small business usually has very limited financial management and procedures, and the entrepreneur is “a one-man band”. Consequently, an SGB has to make a big effort of internal consolidation to grow under good conditions, as is the case for medium size businesses.

XSM_L’s priority is to provide close organizational support: we work systematically on improving accounting, recruiting quality financial management

staff, consolidating both financial management procedures and the internal organization of the company. All of this work gives the company the means to control its growth. Other more specific needs of the businesses can be handled by missions of outside experts financed by donor subsidies.

Our local network can also put SMEs in contact with customers, strategic partners and consultants capable of supporting their growth. It is important to develop an ecosystem with strong partners in various fields.

Local presence is essential for this time-consuming close support. We have a team of 4 who support an average of 6 or 7 businesses each in DRC and CAR.”



ENTREPRENEUR

Djibrilla Hima,
Saphar, Niger



Saphar is a wholesale distributor of pharmaceuticals founded in 2000 and currently the third ranking distributor of pharmaceuticals in the country, behind two subsidiaries of international groups.

"For me, the most important contribution of the investor is not the financing - certainly a need but not the only one - but rather the support provided in management and organization.

We, at SAPHAR, already had the technical knowledge, the sales network and the import facilities, but our management standards were inadequate. Without the investor, we could have gotten funds from a local bank, but they would have been poorly used.

Together with the investor, we recruited a new head accountant, changed our ineffective sales and accounting software and reorganized the company in order to have exact financial and operational information. The activity was closely monitored, based on a 5-year business plan. This support paved the way to future successes.

In addition, the investor gave an outsider's view on our strategic decisions and medium term plans, an objectivity sometimes difficult for us to achieve when we are caught in day-to-day management. For instance, the investor encouraged us to expand into rural areas to specialize on generic drugs, which enabled us to develop a real competitive edge.

In 2006, when the fund entered into the company's capital, losses had reached 200 000 EUR. In 2013, when the investor exited, Saphar was making a profit of about 210 000 EUR."

4) Organizing technical assistance missions

There are numerous topics on which investors do not have the skills necessary to provide any added value. Outside expertise is often necessary in areas such as production technology, marketing, training, quality control, certification, configuration and setting up of a management information system, etc. These technical topics require experts whose missions can rarely be fully financed by small companies.

Yet, these expertise missions are an essential lever for the growth of a small business working in a context where talent and technology are hard to access. In fact, technical assistance missions are as essential to growth as equity investments and management support.

Access to technical assistance grants are necessary for the success of SGB investors.

These missions mobilize highly skilled national and international consultants who can unlock the growth of a business and diminish its operational risks.

International aid agencies (development banks and international financial institutions) and private foundations have met this financing need by designing lines of subsidies specifically dedicated to the transfers of skills and technology to SGBs in Africa. Depending on the cases, these subsidies may be used by SGB investors for companies already in their portfolio or for those undergoing due diligence. Usually SMEs contribute 10% to 25% of the financing for each mission.

Access to technical assistance grants are necessary for the success of SGB investors. In reality, most investment funds active in the SME segment benefit from this instrument.



ENTREPRENEUR

Khady Nakoulima, *Nest for All, Senegal*



Nest For All (NFA) is a Senegalese medical network providing full monitoring of women and young children, with rates adapted to low-income households.

"In 2012 Nest For All received the support of a French expert, Danièle Clear, to start operations and create its first maternity.

This mission covered the operational management of care: hygiene and sterilization, security, human and material resources, study of circuits, waste and environmental management.

We needed outside expertise on these aspects and I&P helped us find an expert who could provide this support during our startup phase.

We were satisfied with that experience and are going to once again call upon Danièle Clear, this time for a monitoring and evaluation mission.

This is not a one-off support: the mission has a component of staff training and transfer of skills. The management also participated, in order to be able to train employees in the future.

Without the line of financing for technical assistance, we probably could never have paid for this mission."

5) Mobilizing additional financing

SGBs often need follow-on investments. As a shareholder, the SGB investor should be able to react to these events which are characteristic of a phase of rapid growth. If a temporary crisis arises or if a new investment opportunity appears, investors can make new shareholder loans or strengthen their equity participation to enable the company to rebound or reinvest. This can be done quickly because the investor has detailed knowledge of the company.

SGBs also have needs that equity investors may be less able to fulfil, and for which relevant products already exist on the market: short term financing (overdrafts, advances on contracts and working capital loans), and medium term credit. In these cases the SGB investor facilitates access to bank financing.

Alone, a commercial bank faces structural obstacles in financing small businesses (see section 1, 1.3.i), whether for short or medium term financing. The presence of an SGB investor mitigates the risks and decreases the cost of financing for banks.

The SGB investor serves as a catalyst in the financing of SGBs, enabling them to enter the realm of the banking system.

This catalytic effect can also reach other actors, including foreign investors with no local presence such as international financial institutions.



ENTREPRENEUR

Jaco Chan, Indian Ocean Trepang, Madagascar



IOT is an industrial aquaculture company installed in southwest Madagascar that packages and exports trepangs (sea cucumbers).

"IOT managed to get a 750 000 EUR bank loan even though it was a startup with an innovative project in southern Madagascar."

I think there are three reasons why the presence of an equity investor in IOT reassured the financial partners and particularly the banks.

First of all, the investor strengthened the company's equity and solvency.

Second, the investor had conducted its own complete analysis of the company before investing – risk analysis, financial returns and technical studies – which reassured the bank in its own evaluation and analysis of risks.

Finally, the participation of an investment fund in the governance of the company reassured the bank because of the level of organization the investor would promote, which includes regular meetings of the board of directors, reporting obligations and approval of the accounts, etc.

Even if we were already in contact with the Société Générale bank, I believe the presence of a fund at our side during negotiations was a determining factor in the bank's decision to approve the loan."



ENTREPRENEUR

Djibrilla Hima, Saphar, Niger



Saphar is a wholesale distributor of pharmaceuticals founded in 2000 and currently the third ranking distributor of pharmaceuticals in the country, behind two subsidiaries of international groups.

"The fact that an equity investor is a shareholder and administrator, in other words an active partner to Saphar, immediately reassures the

partners and helps us mobilize additional funds. For example, I&P put us in contact with BIO, a Belgian investment group focused on developing countries. We did not know each other prior to this introduction, but they trusted us and loaned us a significant amount even though this was their first financial transaction in Niger."

This relationship of trust was made possible by the presence of I&P in the capital of Saphar, and still persists even after their exit."

6) Improving environmental and social practices and measuring impact

Equity investors are well-positioned to foster the improvement of environmental and social practices within their investees and thereby contribute to the emergence of a fabric of responsible businesses in Africa.

Environmental, Social and Governance (ESG) issues are part and parcel of the due diligence conducted by the investment team for each opportunity. An **ESG diagnosis** identifies the business' main risks such as occupational safety, waste management, legal and fiscal compliance, etc. This diagnosis also identifies the opportunities for positive social and environmental impact, for example: creating jobs and improving their quality, saving energy and decreasing carbon emissions, developing basic products and services for disadvantaged populations, etc.

This pre-investment assessment leads to the design of a first **ESG action plan** to be implemented once the investment is made. Then every year, as the board of directors votes the yearly budget, it also approves the annual ESG action plan which mitigates the most important risks and pursues the strengthening of the company's positive impacts. Investors can encourage the company to follow such action plans by focusing on topics that reinforce the company's competitiveness. For example, improving occupational safety or setting up complementary health insurance involves upfront costs but increases long term employee loyalty.



Focus: A “win-win” training initiative for young graduates in Cameroon

ITG Store, Cameroon



Gabriel Fopa is the founder and director of ITG store, a company specialized in integration services and IT outsourcing in Cameroon: ITG provides data storage and IT management services to major groups that formerly used international service providers.

Strengthening human resources quickly loomed as a strategic priority in the company's rapid growth. The lack of experts in the country forced ITG to hire young graduates (a total of 68 with an average age of 27),

who were trained in-house for an average of one year. In 2012, Mr. Fopa decided to go one step further: ITG Store partnered with the Yaoundé Polytechnic University to set up a training center.

In this well-equipped center, final year university students work on practical cases. This type of hands-on training, formerly absent due to the university's limited resources, was introduced in the curriculum and has so far allowed 30 students (and 33 ITG employees) to be trained for a budget of 40 000 Euros.

Quickly operational, these students constitute a unique pool for ITG's future recruitment needs. Some even get recruited by ITG's customers and become advocates of ITG.

Some stages of the action plan may even be financed by technical assistance subsidies (see section 2, 2.4.) specially earmarked for ESG improvements, thereby limiting the short-term costs for the company.

The ESG methodology relies on a specific internal organization within SGB investors. One useful source is the CDC toolbox²⁵, which provides methodological guidelines that are well adapted to the context of developing countries. One of the investment team members is appointed as ESG officer and will conduct and monitor the application of these guidelines. This officer may receive supervision from a dedicated ESG and impact Committee including shareholders and independent members.

SGB investors also measure the social and environmental impact of their investees by collecting annually a set of indicators.

Key topics are job creation, quality of jobs, impact on suppliers and customers, energy footprint, etc. The choice of indicators and the data collection procedures are both conducted in close collaboration with the entrepreneur.

²⁵ (<http://www.cdcgroup.com/PageFiles/147/finalcdctoolkitforfundmanagers20101.pdf>).
The CDC offers regular 1-day trainings based in London for fund managers.



ENTREPRENEUR

Sidi Khalifou, CDS, Mauritania



CDS mission is to facilitate access to water and electricity for all Mauritians, especially in the rural areas of the Senegal River Valley.

“Providing information on a business’ economic, social and environmental impact requires an additional effort and implies adopting new procedures that take time in the short term. But this effort directly benefits the business in the long term.”

Producing reliable impact indicators can, for example, convince certain kinds of investors: in 2014, CDS mobilized a 15 000 USD loan from Kiva, a crowdfunding platform. This loan was used to equip a village with a water micro-grid powered with solar pumps.

Investors must nevertheless remain modest in the ambition of impact measurement. Indeed it is difficult to take into account all the indirect impacts of an investment, and to evaluate what would have happened without it. The investor's data collection is incomplete and gives imperfect results.

For example, it is easy to monitor the number of jobs directly created by a business, but this is only an incomplete view of its impact in terms of employment. It does not take into account the "indirect" creation (or destruction) of jobs by suppliers, customers and competitors.

Conclusion

All of the actions aimed at strengthening and supporting businesses generate short term costs and are time-consuming, for both the entrepreneur and the investor.

Nevertheless these actions are very useful over the long term. First, the company emerges stronger and more efficient in terms of organization and management, operational and financial capacity and governance. Second, they are also profitable for the investor because they increase the attractiveness and value of the company at the exit.

Indeed, setting up proper governance, upgrading financial and accounting procedures and improving ESG practices set the SGB apart from its less structured competitors and make it more attractive for potential industrial players and investment funds at the time of the investor's exit.

Therefore, structuring and supporting SGBs not only generates positive impacts, but is also key to the financial success of SGB investors.

③ Exiting

SGB investors work under the constraints of their own investors, who provide funds for a limited time period. Their business model usually require to sell their stakes after 5 to 7 years.

The narrowness of the secondary market and the scarcity of conventional exit options deter most actors from investing in African SGBs. Nevertheless, the dozens of exits achieved by the first players in the sector prove that this can be a successful model. While stock market listings are exceptional, a number of alternative options are possible.

They can be separated in two categories:

■ Selling to the entrepreneur

If an investor plans to exit by selling its shares to the company's entrepreneur or historical shareholders, it must prepare for it before investing. For example, the valuation formula at the exit of the investor can be fixed as soon as the investment in order to give visibility to both parties.

A few mechanisms can facilitate the entrepreneur's buyback of shares while protecting the investor's gains, such as preferential share-option plans based on performance goals.

These elements are part and parcel of the negotiation of the shareholders' agreement. They often require that investors limit their returns expectations beyond a certain point in exchange for the entrepreneur's promise to buy back their shares.



INVESTOR

Jerry Parkes,
Injaro Investments



"Selling a minority stake in a West African SME is difficult, but possible. What is important is to prepare the exit at the moment when the investment is made."

Injaro prefers exiting by having the business and its historical shareholders gradually buy back its shares."

We consider exiting on the stock exchange in countries where it is possible.

The Ghana stock exchange, for example, has a market that lists SMEs. If the BRVM of the West African Economic and Monetary Union (WAEMU) offered this opportunity, we would take advantage of it.

In any case, whatever the form the exit takes, the company has to be attractive and we work to increase its value."



ENTREPRENEUR

Djibrilla Hima, Saphar, Niger



Saphar is a wholesale distributor of pharmaceuticals founded in 2000 and currently the third ranking distributor of pharmaceuticals in the country, behind two subsidiaries of international groups.

"The partnership between Saphar and I&P lasted seven years, practically ten years if the due diligence period is added.

From the beginning I&P told us that its mandate was to sell its stake after 5-7 years, and that was included in our shareholders' agreement.

Consequently, we were prepared for the investor's exit and it caused no disturbance or disorder in the company.

We organized ourselves financially, having gradually established reserves and having mobilized acquaintances and trusted individuals who could buy I&P's shares.

We feel that an exit on the entrepreneurs rather than on third parties was the ideal formula, and having this buyback priority included in the shareholders' agreement was reassuring.

For us, the partnership with I&P ended with a successful business that we today control with more than 50% of the capital, and that we want to keep developing."

■ Selling to a third party

In many cases, entrepreneurs appreciate the presence of partners in the shareholding of their company, and prefer that the investor exits on another investor or corporate player that can keep supporting the business in a new phase of development. Sometimes, entrepreneurs will seize the opportunity to sell part or all of their own shares in the process.

Exit routes other than management buyouts are still limited because of the shallowness of African financial markets. Nevertheless, a few long-term trends stimulate the emergence of new buyers for equity stakes in African SGBs:

- **The proliferation of impact investors now active on the continent** (see section 1,2.2) offers secondary buyout possibilities to the investors capable of growing small businesses so they can absorb higher investments (of 1 million EUR and more).

■ **The emergence of regional and pan-African industrial groups**

generates new «trade sales» avenues for exiting SGB investors. The dynamism of these groups was highlighted in a pan-African study led by Ernst & Young and AVCA²⁶.

■ **The international private sector is rediscovering Africa** as a new destination for external growth. Numerous players are looking to gain a foothold on the continent by partnering with well-managed African companies.

These three types of players are actively looking for African investment opportunities and are particularly interested in well-structured businesses that have already benefited from years of support by an equity investor.

²⁶ Ernst & Young and AVCA,
Harvesting growth, 2013.



INVESTOR

Sébastien Boyé,
Investment Director
Investisseurs & Partenaires



“It was perhaps true some years ago that secondary buyouts and trade sales were very difficult in the African SME investing space, and that it chased away investors, but that idea is now out of date.

In reality, investors who came in 7 or 10 years ago have now finalized their initial investment cycle and all have exited through secondary buyouts and trade sales.

For example, out of the 8 full exits and 2 partial exits I&P realized, only two were management buyouts. In the other eight, I&P's stake was sold to third parties such as investment funds, suppliers, customers or industrial players, with the support of the entrepreneurs themselves.

This is true also for reputedly difficult countries like Mali and Niger.

We are operating in rapidly growing zones where the number of investors is increasing, but where SMEs which are sufficiently structured to receive equity investment remain the exception.

In this context, an SME that already partnered with an investor becomes attractive. Its standards of governance, better level of organization and the reliability of its accounts distinguish it from the others. Liquidity as such is consequently no longer a major problem for investors.

Rather than liquidity, it is the exit valuation that remains an issue. It is often difficult to find a large number of competing buyers, and that prevents the investor from getting the best price.”

Selling an equity stake to a third party is time-consuming and complicated to manage. The investor should thoroughly organize the offer and have complete documentation before approaching potential buyers (teaser, investment memorandum and audited accounts). The sale process should only be triggered after lining up several competing buyers, and after setting a clear deadline. Sometimes the investor uses the services of a financial intermediary, but success will often depend on the investor's own network and reputation among the three types of players mentioned above.

Conclusion to Section 2

By focusing all of their resources on a small number of high-potential companies, equity investors are able to contribute significantly to the emergence of well-managed SGBs in Africa. Acting as catalysts of growth for the best entrepreneurs, they can generate both high gross financial returns and strong developmental impacts.

However, investing in early-stage SGBs remains a difficult and demanding challenge: the investor must confront many obstacles, including the fragility of small businesses, their substantial needs for pre-investment maturing and for post-investment management support, and the limited exit options for minority shareholders.

These challenges have not prevented the first actors in the sector from developing sustainable business models by gathering the right mix of ingredients: a skilled investment team, patient capital providers, technical assistance grants and a strong ecosystem of mentors and support structures. Section 3 synthesizes the experience of these actors and suggests a roadmap for launching a SGB investment activity in Africa.



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3

Launching an investment activity targeting Small and Growing Businesses in Africa

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3

Launching an investment activity targeting Small and Growing Businesses in Africa

Since existing players are rare, the growth of the early-stage SGB investment sector will mostly come from new investment teams that will raise their first funds. However, the absence of a track record makes it very difficult for a new investment team to raise and invest a first fund.

While fundraising and looking for investment opportunities, a first-time fund manager will face the competition of experienced teams that have already built a track record, developed their tools and realized their exits.

One way for first-time fund managers to solve this obstacle is to set themselves apart from the competition by choosing a unique investment strategy. Indeed funders are more willing to bet on a new team when it has a first-mover advantage on an untapped segment. The first mover will not only increase its chances of fundraising, but also access more easily the best entrepreneurs in its target segment.

A first mover can also take more time to perform its first investments and to build tools, without the pressure of competitors fighting over the same deals. Choosing a unique investment strategy is therefore a strong way to reduce risks and increase chances of success for a first-time fund manager.

With this in mind, **targeting early-stage SGBs requiring investments below 500 000 EUR offers many advantages for a first-time fund manager**. First, it is a largely untapped segment in Africa, where the more experienced teams tend to “creep up” and prefer bigger deals. Second, investing smaller amounts in a larger number of businesses is a good way to minimize risk and learn-by-doing. Finally, targeting small investments will require a smaller fundraising, which in some contexts can be easier to achieve.

To some extent, **the challenges of investing in early-stage SGBs can be mitigated by building the right setup of capital and skills**.

The following section presents the experience of a few players in building such ecosystems. With no attempt to provide definitive one-size-fits-all answers, it offers a roadmap with 7 milestones for beginning SGB investment activities in Africa.



INVESTOR

Mark Paper, Business Partners



“Investing in SMEs requires a lot of proximity, both for operational success and cost-efficiency.

Having teams on the ground provides a few indispensable assets: local knowledge and networks, ability to source quality and proprietary investment opportunities, ability to develop strong

relationships of trust with entrepreneurs and stakeholders such as banks and consultants. Performing due diligence is also made easier.

Proximity is also key to follow SMEs once you invest, and particularly to contribute to strategic decisions, find the human and financial resources to support them and monitor their performance.

Generally, the smaller the deals, the bigger the need in management support and hence of proximity.

Building teams on the ground requires training and transferring of information and methodologies, but proves to be very cost-efficient on the long term.

At Business Partners we have offices in every region of South Africa and in every country where we operate: they are mainly responsible for deal flow generation and due diligence.

We are very positive about our recruitments in countries as diverse as Malawi and Zambia, and this allows us to penetrate the SME fabric in a way foreign investors can’t.”

1 Building an investment team on the ground

As indicated in Section 2, SGBs need close management support. **Building an investment team in each country of operation is therefore a key success factor.**

SGB investment is a new sector in Africa, still nonexistent in many countries on the continent. It is hard to find people with both a solid track record in private equity and a deep knowledge of the target environment. Therefore, a new investment team may have little prior experience in private equity. In fact, rather than private equity and investment banking experience, it is imperative for the team to have the qualities and skills that fit the needs of early-stage SGBs and the strategies of value creation on the segment:

- **Entrepreneurial spirit:** supporting SGBs requires a sense of initiative and risk-taking, as well as a perseverance in tune with the temperament of the entrepreneur.
- **Experience working with entrepreneurs:** partnerships are woven on a person-to-person basis between an entrepreneur and an investor. Investing in SGBs requires a long experience of working with entrepreneurs and a very good understanding of their needs in order to convince them and adequately support them.

Building an investment team in each country of operation is a key success factor.



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- **In-depth knowledge of the SGB sector in the target area:** identifying the best among a large number of SGBs requires a fine-grained understanding of the economic fabric and of the most effective intermediaries.
- **Analytical rigor:** an investor's success depends largely on its pre-investment due diligence. The investor needs to master strategic analysis, risk analysis and financial analysis to evaluate the potential of each project.
- **A financial and accounting background:** SGBs are characterized by accounting and financial weaknesses. The first challenge of investors is often to consolidate them in these areas.

For a new investment team, teaming up with an experienced investor (individual or institutional) as a sponsor can facilitate fundraising and strengthen operational capacity. In return for this support, the team often gives the sponsor a share of the remuneration and special rights in the governance (e.g. a seat on the investment committee). It is therefore essential to choose the right sponsor, one whose vision and interests coincide with those of the team.



INVESTOR

Omar Cissé and Olivier Furdelle, Teranga Capital

Teranga Capital is a Senegalese investment company focused on the early-stage SGB segment. It was founded by Omar Cissé and Olivier Furdelle in partnership with I&P.



Omar: “Olivier had private equity experience in Europe and Africa, and conducted due diligence for numerous investors.

I brought in experience of supporting startups in Senegal through my past as an entrepreneur and manager of an incubator in Dakar.

We are complementary and so we decided to combine our skills and start an SME fund in Senegal.



Olivier: “We could certainly have launched this project on our own by bringing together individual investors and starting a small case-by-case investment activity, something like a business angels club, for example.

But we were ambitious: we wanted to launch a sustainable investment company with institutional investors and a large investment capacity. For that you need a more conventional track record: you have to know how to manage the investment cycle from the start to the exit, you need 5 to 10 years of practical experience in SGB investment, which we didn't have.”

Omar: “That is why we teamed up with I&P, an experienced SME investor which is the sponsor of Teranga Capital. We benefit from its accumulated track record and know-how: we learn from its successes and mistakes, we integrate a tried and tested methodology. That completely changes the picture when you kick off a fund.”

② Choosing an investment strategy

A new investment team must design a clear investment strategy in order to attract funds.

Every SGB investor will target a certain type of company: one with very strong potential, led by an outstanding entrepreneur who can manage rapid growth, but who lacks financing and support. Yet, behind this general profile lurk many possible configurations and strategies which need to be detailed before fundraising:

- What level of maturity and risk: existing companies, startups or turnarounds?
- What investment range and what average investment amount per SGB?
- What type of targets: social businesses or conventional businesses? All entrepreneurs or specialized segments such as young entrepreneurs or women entrepreneurs?
- Which sectors are targeted and excluded?
- What level of formalization: businesses already formal or in the process of formalization?
- What type of financial instruments? What average proportions of capital and debt/quasi-equity in the investments?
- What sort of management support required by investees? Will support be provided by the investment team or outsourced to mentors and outside experts?
- What average duration for an investment?
- Which objectives in terms of financial returns? On which assumptions?
- Which objectives in terms of impact and ESG?

The investment team will find the answers to these questions by cross-examining three parameters:

- **The market analysis:** the SGB sector is different in each country and must be thoroughly examined in order to choose the investment target and the best-adapted financial instruments.
- **Its motivations:** the team adapts its strategy to its own goals in terms of financial and impact returns, as well as to those of the potential investors it would like to raise funds from.
- **Its internal capacity:** the skills, networks and specific experience of a particular investment team should influence its strategy: for example, targeting a well-known sector or type of business will increase chances of success.



INVESTOR

Jerry Parkes,
Injaro Investments



"Injaro invests exclusively in the West African agricultural value chain with the aim of generating reasonable financial returns whilst making a positive impact on its target class: smallholder farmers and low-income persons. Injaro may invest in a broad range of activities ranging from inputs, primary production, aggregation, logistics and transportation, processing and services.

However processing companies sourcing raw materials from smallholder farmers and input companies providing services and goods to smallholder farmers offer the best opportunities to maximize social impact within its target class. Injaro generally targets existing companies with a strong growth potential and provides them with equity and quasi-equity instruments, while remaining a minority shareholder.

Today, our first 7 investments are working with around 9,000 smallholder farmers.

We chose this investment strategy primarily to achieve maximum developmental impact: we wanted to finance the SMEs that reach out to the largest number

of poor people, and the agricultural value chain was a clear winner amongst the sectors we considered. Agribusiness also benefits from macro demand drivers; such as population growth, increasing demand for food and other products based on agricultural raw materials.

On the supply side African agribusiness opportunities are underpinned by the fact that large proportions of our population depend on agriculture for their livelihood, by the availability in Africa of some 40% of the world's uncultivated arable land, by Africa's relatively low agricultural productivity and by the low number of downstream agribusiness players relative to the demand for food on domestic markets. These features of the agribusiness sector make it possible for us to target both impact and profitability. A first-time fund manager must think carefully through its investment strategy and how relevant the strategy is to its targeted investors at the time of fund raising. Also of importance is the competitive landscape: being on the road at the same time as similar funds with an existing track record can impact the success of the fund-raising effort. Fundamentally the manager must choose a strategy that it believes in and one which the investment team can credibly deliver on. This offers the best possibility of success for fund raising."

③ Building a business model

1) The key assumptions of the business model

The investment target chosen by the investor will determine the structure of its revenues and its costs.

These six indicators are the most important variables of the business plan. Once they are set, it is possible to deduce the necessary fund size (the funds needed from capital providers), as well as the expected returns for investors.



The 6 key variables in the business model of the SGB investor

- 1** Average amount of investment per deal: this will have an important impact on the net profitability of the model.
- 2** Average proportions of equity and debt/quasi-equity committed per investment.
- 3** Average holding period and loan maturity.
- 4** Average expected gross returns on SGB investments, taking into account a failure rate, the market environment and the financial instruments chosen.
- 5** Number of investments per year: this depends on the maturity of the market and on the degree of selectivity of the investor.
- 6** Number of SGBs supported by each member of the investment team: the lower the number, the more personalized the support for each SGB, but also the greater the portfolio management costs.

The model of early-stage SGB investing accepts below-market returns in order to reach strategic and developmental goals based on the emergence of SGBs.

2) Analysis of the business model

- **Evolution of costs:** the main costs are the staff and related costs, which are directly proportional to the size of the investment team. They can be billed to the capital providers as fixed “management fees” or on the basis of actual expenses. Costs increase with the number of companies in the investor’s portfolio, and depend strongly on variable No. 6 above: the greater the number of businesses monitored by each investment officer, the lower the costs.
- **Evolution of revenues:** on the other hand, revenues depend on the average amount invested per deal. The higher the average investment amount, and the higher the revenues.

This business model shows that if gross returns are fixed, a single 1 million EUR investment in a company will be more profitable than five 200 000 EUR investments in five different companies. Indeed, supporting the growth of 5 companies takes much more time and drives down net profitability.

In the relatively noncompetitive context of early-stage SGB investing, the investor is often the only source of appropriate financing for the targets, and gross returns on investments can be very good. Still, if we assume a fixed average profitability of investments, an investor focusing on small deals will have structurally higher costs and lower profitability than conventional private equity investors. The model of early-stage SGB investing accepts below-market returns in order to reach strategic and developmental goals based on the emergence of SGBs.

4 Choosing a legal form

1) Two models

Investors can adopt two different legal structures depending on the nature of their own funders, on the experience of the investment team and on the legal and fiscal environment.

- + **The investment company model**, in which a single investment company whose equity is provided by the funders employs its own investment team. In this case, all the costs linked to the activity are passed on as actual expenses to the funders. This model offers the advantage of transparency for the funders, but gives less room to manoeuvre for investment teams. It is simpler and particularly well-adapted to constraining legal and fiscal environments.
- + **The General Partner/Limited Partner (GP/LP) model** separates the investment activity from the funders: it distinguishes the investment fund (owned by the funders or LPs) from the fund manager owned by the investment team (or GP). The fund manager is remunerated by the investment fund on the basis of an annual charge ("management fee") negotiated at the signature of the agreement between the two entities. This model provides more latitude to the investment team. However, it is more complex and can generate fiscal frictions when this status is not recognized by the law of the country.

2) An example of a legal and fiscal framework for equity investment: the WAEMU zone

Recognizing their developmental role, some states have chosen to encourage SGB investment by giving it legal recognition and special tax treatment. The impact of taxes on the investor's business model is indeed a key element.

The West African Economic and Monetary Union (WAEMU) designed incentives for investment companies by voting a common law recognizing SGB investment as well as issuing a directive granting special fiscal status. Five Ernst & Young factsheets presenting the legal and fiscal framework for equity investment in 5 countries can be downloaded in the toolbox at www.investinginafricansmes.com.

5 Organizing the governance

A governance based on irreproachable and committed individuals and institutions is a key factor in the success of any investment team. Governance bodies help the team make appropriate decisions and supervise the implementation of the investment strategy. They also increase the investment team's credibility vis-à-vis outside partners and investors. The governance plays three roles:

- Making steering decisions that are within their scope: the budget, approval of accounts, design of strategic guidelines, etc.
- Making investment and divestment decisions.
- Providing advice, skills and networks to the investment team, including on operational issues (market analysis on a specific sector, knowledge of an entrepreneur, solving crisis situations, etc.).



FOCUS: Basic principles of governance for an investment fund

- *Investment and divestment decisions are made impartially and in compliance with the strategy approved by shareholders.*
- *Conflicts of interest involving members of the team, the investment committee or shareholders, or that arise between different investees are prohibited.*
- *The investment team is financially incentivized to the financial and impact performance of the investment vehicle.*



Depending on the investment company's legal form (self-managed or with a fund manager), the governance is implemented by various decision-making bodies:

- Investment Committee: approves or rejects investment and divestment proposals made by the investment team, and comments on the financial structuring of investments.
- Audit Committee: conducts an annual review of the portfolio, assessing latent capital gains or losses and making appropriate provisions and revaluations if necessary. This committee includes independent members.
- Environmental and Social Governance (ESG) and Impact Committee: steers and monitors the investment team's ESG and impact strategy.
- Board of Directors
- The General Assembly of shareholders

These bodies can include not only shareholders, but also independent members whose experience and skills strengthen the team's chances of success.



INVESTOR

Djibo Ibrahim, Sinergi



Sinergi is an investment company founded in Niger in 2007 to provide equity financing and management support to small businesses.

"Alone, an investment team cannot meet all the various support needs of SGBs. That's why it is extremely useful to bring in shareholders with additional skills. Sinergi included seven Nigerian entrepreneurs in its pool of investors: they have excellent reputations, come from different sectors and are motivated by the idea of providing support for young entrepreneurs. They get involved in a number of ways. During each due diligence, they guide the investment team with information on the reputations of the entrepreneurs being considered, and on the particularities of each sector."

Their viewpoints are essential because they have field experience, understand local problems and can determine whether projects are feasible or not.

They are also the foundation for our SME mentoring system: each SME receives personal support from one of these investors. As a coach they provide strategic mentoring, share their experience and address book, and mediate in times of crisis. In any partnership, confrontations will crop up between the investor and the entrepreneur: coaches then play the very useful role of arbitrator.

They also participate in the governance of Sinergi, particularly through the Board of Directors and the Investment Committee.

Finally, they bolster Sinergi's credibility, both in terms of local fundraising and dealflow generation: it is always reassuring for an entrepreneur to know that Sinergi is itself headed by recognized entrepreneurs."

⑥ Fundraising

1) Targeting impact investors and strategic investors

Fundraising for SGB investors in Africa is a long and arduous process. This new type of investors is still little known to funders, who tend to lump it together with conventional private equity (with average deal sizes of several million euros)²⁷, even though their needs are fundamentally different for the following reasons:

- **Profitability is not the only criteria:** although long-term financial viability is the primary objective, SGB investors offer a strategy with a strong impact on development and the emergence of entrepreneurs that goes beyond profit maximization.
- **A long-term investment horizon:** the amount of time it takes for SGBs to mature, the limited exit options and the flexibility needed in financial structuring requires patient investors.
- **Relatively small fund size:** the limited amounts invested in each SGB translate into much lower fund sizes than for conventional private equity funds.

For these reasons, SGB investors will generally not meet the standards of conventional international funders. Nevertheless, they can target capital providers with different motives and greater acceptance of these three constraints.

■ Impact investors

Impact investors (see section 1, part 2.2) have substantially improved the financing options for SGB investment teams in Africa. They are foundations, financial institutions and individuals who aim to attain impact objectives alongside financial profitability. They may also be large corporations investing within the framework of social responsibility initiatives. For instance, Development Finance Institutions (DFIs) have played a key role in the development of SGB investment in Africa.

■ Strategic investors

Access to high-potential African SGBs is a major strategic opportunity for many actors, and notably for banks, insurance companies and multinationals.

Financing an SGB investor provides them with access to businesses that will potentially become customers for their own core business (credit or insurance), subcontractors, future investees or partners.

²⁷ *Growth Finance in sub-Saharan Africa.*



André Bayala, SONAR



"SONAR is the leading insurance group in Burkina Faso. There are several reasons why we have invested a significant amount in the investment company Sinergi Burkina.

First of all, it is part of SONAR's strategic vision to develop the nation's SME fabric. The average insurance premium per inhabitant in Burkina Faso is still very low, about US\$ 5; without the presence of an industrial fabric, there is not much chance of long-term growth in the insurance sector.

The solution is to nurture entrepreneurs who want to develop over the long term by financing and supporting them. By multiplying SME investments, we boost the economic fabric and create our future

customers base, since all these SMEs will need to insure their production facilities and workforce.

As an insurance company, and thus as an institutional investor, SONAR also acquires equity stakes in companies, whether large or small. And as one of my friends in the farming business says, the best training is to find out what lies just beyond the hill: by participating in the Sinergi Burkina investment committee, we can observe the methods of a professional SME investor to improve our own practices.

That said, with an investment fund just like with any business, the most important factors are the people involved and their skills. The key element prompting our investment decision was the quality of Sinergi Burkina's management and the investment track record in Africa of its sponsor, I&P."



INVESTOR

Mark Paper, Business Partners



"Raising funds from national financial institutions and corporations can be a very good strategy for new management teams.

The story of how Business Partners was launched shows how local fundraising can work. Business Partners was founded in 1981 and raised an equity of

USD 24 Million, of which 50% came from the government and 50% from South African corporations and financial institutions including banks (ABSA, Nedbank, FirstRand Bank, Standard Bank), insurance companies (Old Mutual Life Assurance), corporates (South African Breweries) and investment groups.

These private shareholders invested with the objective of growing South African SMEs in a profitable way.

They are major banks and financial institutions and it is in their strategic interest to support the emergence of a strong SME fabric in the country.

Their long-term investment horizon gave us the necessary room to manoeuvre to develop a new model geared towards SMEs.

They were very committed to our mission; thirty years later, they are still with us."

Strategic actors have a commercial profile, but the operational synergies between them and the SGB investor create value for their core business and tend to make them much more flexible regarding their profitability and liquidity expectations. They can thus be highly adaptable to the constraints of an investor targeting African SGBs.

Finally, local strategic funders contribute beyond their financial investment. Their solid local presence brings additional credibility and visibility to SGB investors in the local ecosystem.

2) A few lessons from successful fund raisings

Funders who entrust capital to a first-time fund manager targeting African SGBs are taking a considerable risk. To mitigate this risk, they must conduct a stringent due diligence on four key criteria: the team, the relevance of its investment strategy, its track record and the investment opportunities it has already identified (the dealflow).

As a new investment team, fundraising is more challenging and longer than for experienced actors. Success depends on the differentiation from the competition, for example with a first-mover strategy on an untapped market. Above all, it requires particularly convincing arguments (such as a deep local network, a mature dealflow, etc.) and a very credible team.

In addition, first-time fund managers face another, very real challenge. They need to go through a long preparatory phase dedicated to defining the project, fundraising and sourcing the first investment opportunities, during which they do not yet generate income from the fund. Launching a fund is therefore an entrepreneurial risk, and first-time fund managers must finance themselves for a period that lasts often longer than expected and can take more than a year. Therefore, to the imperative of raising funds is added the one to raise them quickly enough to preserve the viability of the team. A key success factor is to prepare for this launch phase by organizing secondary incomes or obtaining supports such as grants.



INVESTOR

Jerry Parkes,
Injaro Investments



"Raising a first fund can be a long and unpredictable process: it took us more than two years and a lot of perseverance to reach our fundraising target. In the end, we managed to raise a total of 49 million USD and achieved one of the largest fund raisings for an SME fund in West Africa, a region where few SME investors are active.

One reason for this success was our agro-focused investment strategy: the investors we approached found that it was clearly articulated and in line with their own impact objectives.

Another reason was that we had already identified and developed several actionable investment opportunities: this convinced our first investors to trust a relatively new investment team. Thanks to their initial seed funding we were able to build track record by investing in some of these companies within our pipeline.

First time fund managers without a relevant track record need to be willing to start small in terms of fundraising: our first closing in May 2012 was at 17 million USD. Whilst this level of capitalization is usually sub-optimal for a fund, it allowed us to build a track record which in turn helped us raise an additional 32 million USD in our second closing."



INVESTOR

Omar Cissé and Olivier Furdelle,
Teranga Capital

Teranga Capital is a Senegalese investment company focused on the early-stage SGB segment. It was founded by Omar Cissé and Olivier Furdelle in partnership with I&P.



Omar: "If I had to summarize the key to fundraising in one word, I would say "credibility." Everything hinges on building trust with institutions for which this type of investment is new. It isn't easy for a new team to get off the ground, so all the boxes must be ticked. A prerequisite to any

discussion is the quality of the investment team and its practical experience with equity investments in African SMEs: in our case, we were two individuals with highly relevant experience in entrepreneurship and private equity, but it was our sponsor I&P that confirmed our credibility in the eyes of investors.

The next stage is setting up a flawless governance headed by individuals recognized for their integrity. Our Chairman of the Board Mr. Lamine Loum, and our Investment Committee President Mr. Cheikh Tidiane Mbaye, reassured our investors and attracted many others. Afterwards comes quality dealflow and the clarity of the proposed business model."



Olivier: "We are more credible to those who already know us. The SME investment model is so new in Africa that only investors who already know and trust us will agree to take the risk to innovate and commit funds to the project. Once this first circle of investors is won over, it is easier to convince others.

I would not recommend launching an investment fund in Africa to someone who does not already have solid working relationships with potential investors and key sponsors."

7 Developing a quality dealflow

Fund managers must prove that they have already identified and convinced a few entrepreneurs that meet their investment criteria.

In order to convince its investors, a fund manager must first shortlist a few companies that will become investees once the funds are raised. The team must show that it has already successfully approached and convinced a number of entrepreneurs that meet the criteria of its investment strategy. This is necessary to prove the relevance of its investment strategy and to show its capacity to deploy capital as soon as it is raised.

It is easy to find SGBs that are looking for financing, but much harder to identify those that meet the standards of an equity investor. This requires very good local knowledge and experience in working with entrepreneurs. Moreover, the long period needed to mature most investment opportunities (see section 2, part 1.1) demands a high level of anticipation by the investment team.

Building top quality dealflow therefore requires:

- **A good reputation:** a number of initial investments and a clear demonstration of the management support provided are required before the SGB investor is fully perceived as credible player by entrepreneurs. This recognition also depends on the efficiency of the investor's communication strategy.
- **A strong network of intermediaries:** building a network of intermediaries requires a good working knowledge of the existing SME ecosystem in the country and a good personal network. It takes time to form a truly productive partnership with an intermediary, because the standards of equity investors are little known. Maintaining a close relationship with a few highly efficient intermediaries is often more rewarding than extending a multitude of more superficial partnerships.



FOCUS: The three channels for identifying investment opportunities

- **Third party referrals** are opportunities already filtered by an intermediary, who saves time for the SGB investor. This requires building a network of intermediaries who have fully grasped the SGB investor's criteria.

- **Spontaneous applications** vary in quality but do not take up much of the SGB investor's time. These requests arrive once the investor's reputation is sufficiently established, as they result largely from word-of-mouth between entrepreneurs.

- **The proactive approach** has the advantage of directly targeting promising opportunities but takes far too much of the team's time to be the sole method.

An effective communication strategy is a key ingredient in building a strong dealflow. It enhances the reputation of the SGB investor and fuels its network of intermediaries. Communication is all the more necessary as equity investment is still little known in most African countries. It fulfills three complementary functions:

- **Building a brand name**, which serves as an essential vehicle for the visibility and credibility of the SGB investor, and is the first step in establishing a long-term reputation.
- **Informing stakeholders**: targeted communication tools (brochure, institutional presentation, website, presence in social media, newsletters, etc.) carry the SGB investor's message and keep entrepreneurs, intermediaries and other stakeholders up-to-date with its news.
- **Raising awareness and strengthening the ecosystem**: the SGB investor can also organize events with a broader focus (roundtables, seminars), as well as press releases to mark key moments in its development (a successful round of fundraising, new investments, first exits, etc.). The fund also makes itself known to its target by approaching relevant organizations (sectorial events, trade organizations, etc.).



FOCUS: Some useful intermediaries to source dealflow

- Business incubators and accelerators.
- Consultants specialized in supporting SGBs, e.g. through fundraising or consulting services.
- Entrepreneur networks and trade associations.
- Business plan competitions.
- Financial institutions that can provide co-financing: commercial banks, leasing companies and other investors.
- State-run institutions (chambers of commerce and connected entities).

Conclusion

Equity investment can efficiently meet the three main needs of African Small and Growing Businesses: access to long-term risk finance, access to skills and improvement of governance standards. In particular, early-stage SGB investment promises substantial value creation along with developmental impact, and stands as one of the frontiers of impact investment.

Working closely with some of the best entrepreneurs in Africa also makes it a very stimulating work. Nevertheless, investing in SGBs is a continuous challenge: a first-time fund manager must combine a number of favorable conditions in order to mitigate the risks associated with this activity.

A few pioneering players have shown that it is possible. They have surrounded themselves with a skilled team, a pool of patient and committed investors and an ecosystem of partners who find a common interest in the emergence of tomorrow's champions. They showed that SGBs led by strong entrepreneurs can overcome structural obstacles and perform extremely well if they receive the right catalytic push.

In order to finance early-stage SGBs, those with investment needs below 300 000 EUR, I&P promotes the emergence of new fund managers in Africa.

I&P has sponsored 3 investment companies in Niger (Sinergi), Burkina Faso (Sinergi Burkina) and Senegal (Teranga Capital).

I&P's strategy is to sponsor the most promising investment teams in ten African countries by providing them with personalized coaching, transfers of methodology and tools, and above all the possibility of a financial and operational partnership.

To find out more.

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- ANDE, East African Legal Guide
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- African Management Institute
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- Khan Academy: Finance and Accounting



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