“Thought Paper”: The Role of Small and Medium Enterprises in Frontier Capital Markets

#3: “Types of Private Equity”

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This paper is the third of a series of “thought papers” published by the Network Science Center at West Point addressing issues facing Small and Medium Enterprises (SMEs) in the developing world. As our team conducts their analyses, certain findings and insights might arise that are not directly related to the research question at hand but, we believe, are important to both the academic and policy communities. This particular series of “thought papers” will address insights concerning economic development issues.

The Network Science Center at West Point has been involved in ongoing research exploring the network topologies of Capital Markets in Frontier Capital Markets. Frontier Markets are essentially a subset of Emerging Markets with lower market capitalization and liquidity. Our team’s research has involved extensive data collection including numerous interviews with financial leaders and innovators in these emerging economies.

During the course of this data collection and the subsequent analysis, the research team has identified additional topics that we believe are ripe for analysis. We believe that addressing these research topics is vital to understanding and devising potential innovations in economic development.

Our initial visits to these Frontier Markets focused on larger firms, financial institutions, and macro-economic issues. During the course of these visits, especially in Africa, our teams observed a culture of vibrant entrepreneurship as we met with owners and founders of numerous SMEs. Because of the impact of our discussions with these entrepreneurs, we have decided to explore the importance of these businesses and their potential impact of economic development, at large, and their potential contribution to the development of these frontier capital markets. Our second paper focused on the financing challenges faced by SMEs. This paper will address the categories of private equity available to SMEs and explore three case studies of firms that attempt to address the “missing middle” finance challenge faced by entrepreneurs in the developing world.
Introduction

In order to ensure their growth, SMEs often require private equity financing in order to grow and develop. Private equity refers to a variety of different forms of financing, which traditionally come into play at different stages of the company’s growth. Private equity is customarily divided into three different categories:

1. **Angel Financing**: Angel investors contribute their own capital and experience to help companies with potential for growth.\(^1\) Traditionally, this type of financing is provided very early in the growth of a firm.

2. **Venture Capital**: When private equity is invested in new businesses it is known as venture capital, these firms not only provide financial support but also provide support with management. In most cases, this is a “second round” of funding.

3. **Private Equity**: Private equity can be many different types of investments made with private money as it “covers not only the financing required to create a business, but also includes financing in the subsequent development stages of its life cycle.”\(^2\) The main goal of private equity firms is to “seek out companies with the potential for growth and with the aim to put in place the capital, talent and strategy needed to permanently strengthen the company and raise its value.”\(^3\)

Africa has seen a rise in all of these forms of equity financing. It is important to consider each variant and determine what will help African SMEs to the greatest degree in order to create an environment that encourages and enables economic development.

Angel Investors

Angel investing is a type of venture capital in which personal money is invested in an entrepreneurial company. Angel investors will provide small loans to companies in the beginning phases of their development. If a business needs a loan of $25,000 - $250,000 a venture capitalist will not be interested but an angel investor might.\(^4\) Angel investors tend to not be motivated by profit alone, as they “focus on building successful sustainable companies, not just creating wealth through successful exit.”\(^5\)

While there is no set definition of what an angel investor will or will not do, they tend to focus on businesses with potential for growth that are in their early stages of development. Besides providing monetary support, they also “generate new ideas,

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\(^3\) Ibid.


\(^5\) Ibid.
contribute innovative technologies to the marketplace, and inject much-needed vitality into complacent industries." The types of roles they may become involved with range from passive to proactive, if they are “proactive [they] also invest time and energy in such roles as director, advisory board member, consultant, adviser, counselor, and may perform a functional role on a temporary or interim basis, for example, as [Chief Financial Officer] CFO or [Chief Executive Officer] CEO.”

**Venture Capital**

Venture capital is a type of private equity. It is defined as “the search for significantly above average long-term investment returns accomplished primarily through equity ownership of or involvement in risky start-up or emerging companies, companies typically managed by experienced executives.” Venture capitalists look to provide funds for companies that, while they are just beginning, they are forecasted to have a great deal of growth potential. Venture capitalists will also provide equity investments for businesses that are looking to expand. While this type of investing in developing and expanding SMEs carries with it the potential for above average earnings, it also has above average risk.

This risk is the result of the following:

Venture investors typically concentrate in industries with a great deal of uncertainty, where the information gaps among entrepreneurs and investors are commonplace. These firms typically have substantial intangible assets that are difficult to value and may be impossible to resell if the firm fails. Similarly market conditions in many of these industries are highly variable. The nature and magnitude of the information gaps and uncertainty at each stage of the cycle leave many opportunities for self-interested behavior by the various parties.

This risk must be properly balanced in order for venture capitalists to be willing to invest in any business as they are highly unlikely to do so if they are not going to see a profitable return on their investment.

Venture capitalism can be seen as a cycle that: “starts with the raising of a venture fund; proceeds through the investing in, monitoring of, and adding value to

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firms; continues as the venture capitalist exits successful deals and returns capital to their investors; and renews itself with the venture capitalist raising additional funds.”

**Private Equity**

Private equity can be defined as “the provision of equity capital by financial investors – over the medium or long term – to non-quoted companies with high growth potential.” Private equity involves a variety of different activities from “securing funds from investors, [to] utilizing those funds in a range of investment transactions and, eventually delivering a superior return on investment to the investors”. As the investments that private equity firms enter into are long-term in nature, they do expect a very high rate of return. In order to ensure this high rate of return investors acquire a majority interest in the company to control the day-to-day operations and hence the performance of the firm they have invested in.

One can see the structure of a private equity market in the figure below. There are three main role-players in this market: (1) investors, (2) intermediaries and (3) issuers of private equity and the flow of activity between them is clearly marked using arrows.

**Angel Investors and Africa**

According to the Managing Director of Angel Finance Group, Douglas Oppong:

At my last count, there were over 2300 Angel Investors in USA, over 60 in UK, and similar numbers in other European countries. On the African continent, only South Africa has over 15 Angel Investors. Ghana has 2, Nigeria – with all its oil billionaires, has 2, Kenya 1, Tanzania 2 and so on! The answer to my question: Do Angels really exist in Africa, is therefore a resounding No! Even with the scanty numbers shown above, I am yet to hear of any real business project funded by Angel Investors on the African continent. Yet, apart from the USA, there are more churches in the African continent than you will find anywhere else in the world. Even in the European continent, particularly in the UK, there are more African churches than European ones, yet there are less Angels for African businesses.

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12 Ibid.
14 Ibid.
16 Ibid.
Therefore, it does not appear that this is something that African SMEs can rely upon to improve their businesses.

Private Equity and Venture Capital in Africa

A number of private equity firms are willing to invest money in SMEs in Africa but the average deals range anywhere from the hundreds of thousands to the multi millions. In fact, minimum investment for most venture capital firms is around a million dollars.\(^{18}\) There are very few that are willing to put in money in the 10s of thousands to help smaller businesses.\(^{19}\) While private equity interest in Africa has greatly increased, South Africa continues to be the market leader accounting for 17% of funds by value,

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\(^{19}\) www.privateequityafrica.com
followed closely by Nigeria at 10%. While the private equity market outside of these countries remains nascent, new funds continue to emerge across the continent.

The venture capital funds that claim to desire to fund the “missing middle” in Africa actually act like traditional private equity firms. Venture capitalists are meant to “enable innovation by taking risks and to drive high returns to investors whilst helping to change the world,” instead, they are “often funding companies already doing well and generating cash to which they can put their capital to work.”

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**Equity Investment Activity by Country, 2009–YTD 2010 (US$m, No. of Investments)**

- **(US$444m, 20)**
- **(US$723m, 34)**
- **(US$20m, 3)**
- **(US$96m, 6)**
- **(US$173m, 11)**

**Total: US$1.5B, 74 investments**

- **South Africa**
- **Nigeria**
- **Kenya**
- **Ghana**

Source: EMPEA.

Note: Other includes 2009 US$350 million investment in Helios Towers Africa, which operates across multiple Sub-Saharan African countries. Note: YTD as of July 2010.

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22 Ibid
While there is great potential in Africa right now and the level of growth continues to expand, there are many hurdles, which keep investors unwilling to take such risks at present. The private equity money that is going to Africa is most often not reaching the informal SMEs because of the host of management and day-to-day problems they pose to private equity investors. Of course, the amounts that they are looking to invest are far above what the regular SME would most likely be looking for so the private equity firms would be helping more established businesses and sectors such as infrastructure, technology, energy, and agribusiness.23

EMPEA in the Emerging Markets Private Survey 2011 found that Africa is not seen as an extremely attractive market for investment – it is far below Asia, some South American countries (like Brazil), and India.24 South Africa, while it has one of the most sophisticated private equity industries among all emerging economies, the impact of private equity activities on its financial markets overall was found to be relatively limited.25 This is most likely the result of the fact that Africa is still considered to be a very high investment risk:

A “shortage of experienced [general partners]” ranked first as the greatest barrier to first-time private equity investment in the region, followed closely by political risk, and a weak exit environment. Anecdotally, many investors also cite fragmented markets, lack of infrastructure and health concerns, including persistently high rates of HIV infections, as key factors limiting their willingness to invest in the region.26

Private Equity and Ghana

Long-term equity financing is virtually non-existent for SMEs. The funds that have been created in partnership with USAID, Commonwealth Development Corporation, and foreign countries as well as venture capital companies in Ghana have a minimum buy-in of anywhere from $100,000 - $250,000. This means that investors are looking more at larger enterprises and while there is potential in the SME market the risks and costs involved in managing investments in these firms on a day-today basis have made them an unpalatable risk for these investors as they will be unlikely to recoup their comparatively small investment. To date, credit schemes have been ineffective in Ghana, and across Africa because of: (1) the lack of an adequate institutional framework, (2) the lack of an adequate legal and regulatory framework, and (3) lack of appropriate management skills at the SME level which leads to lack of available

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25 Ibid.
financing.\textsuperscript{28} The key may be to have governments support equity financing within their countries by earmarking certain monies to create government backed venture capital funds.\textsuperscript{29}

In Africa where domestic private equity is scarce, there are few real government-funded venture capital funds. There are a number of reasons for this equity shortage for SMEs:

1. Equity investors seek highest return consistent with the risk of the investment
2. SME investments are difficult to evaluate
3. SME investments take time to mature
4. Investments are difficult to liquidate
5. Major institutional investors such as insurance companies are not allowed to invest in private SMEs.\textsuperscript{30}

Africa needs to take a lesson from other countries as “virtually every major government in the world has some kind of a support program to encourage direct investment in young SMEs.”\textsuperscript{31} If the government backs these programs then investors will be more likely to be interested in investing their time and money into SMEs as the “government support programs are designed either to increase the potential profit to the investors or to reduce their risk of loss”.\textsuperscript{32}

According to Mensah, the government cannot simply back them; they also have to have the following characteristics to be successful:

1. Non-governmental co-investors
2. Managed by independent fund managers who are motivated by receiving a portion of the ultimate profit from the investments of the fund
3. Governments willing to increase the potential rate of return to other investors by limiting the profit it will take on the Government investment or loan to the fund
4. Governments willing to satisfy economic development objectives by limiting the right of the fund to investment only in businesses that are smaller or younger than prescribed limits.\textsuperscript{33}

\textsuperscript{29} Ibid.
\textsuperscript{30} Ibid, 13.
\textsuperscript{31} Ibid.
\textsuperscript{32} Ibid.
\textsuperscript{33} Ibid.
Case Studies

Acumen Fund

A global nonprofit venture fund since 2001, the Acumen Fund invests in enterprises that focus on bringing “critical goods and services to low-income markets.” Since October of 2010 it has “invested $17.4 million in sustainable, scalable enterprises delivering affordable health, housing, sanitation, and agricultural inputs and services to low-income communities in Kenya, Tanzania, Uganda and Rwanda. Investees include a sanitation company building pay-per-use toilet facilities; a seed distribution company addressing the lack of maize productivity among smallholder farmers; and enterprises developing innovative products to combat malaria.” The Acumen Fund does not only provide monetary support but also helps with the search for talent, management issues, advice, technology etc.

Acumen Fund’s business model is comparable to venture capital firms but it uses its capital to make either loans or provide equity financing to businesses, which will yield social AND financial returns. They are not solely looking to make a financial return on their investment rather, they are looking for “enterprises that can generate a return on capital, grow by a factor of 10 over the life of the investment, and provide breakthrough insights in the fields of health, water, housing, and energy.” This model allows them the “flexibility to invest in very difficult environments, while helping market-oriented solutions move towards financial sustainability.” The return that they receive on all of their investments is used towards investing in other businesses with potential.

However, the Acumen Fund still does not work with companies that are brand new or that need financing in the tens of thousands. They are looking for companies that have a “2-3 year operating history with an established business model and revenue stream…. [to invest] $300,000 to $3 million… [in which it] takes a minority stake… between 10% and 33% of the capitalization.”

These factors mean that this model is probably not the best to follow for the incredibly diverse population of SMEs in Africa.

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37 Ibid.
38 Ibid.
39 Ibid.
GroFin

GroFin is a finance company which “includes business development making it a ‘one-stop-shop’ for committed entrepreneurs with viable business ideas – from start-ups, through all the phases of business growth, up to and including established businesses that need up to a $1 million in finance.”

GroFin prides itself on providing not only financial support but also the necessary business development, skills training, and management knowledge to SMEs to allow them to grow and become successful and be able to handle the financial support it receives from its investors. GroFin helps “entrepreneurs maximize the profitability of their businesses as well as assisting them through the challenging times and growth phases.” In comparing GroFin to banks, the difference is clear:

GroFin considers finance applications on the basis of viability, not collateral. It ensures that they understand the entrepreneur’s business and its needs. GroFin sees the relationship as a long-term partnership, taking ownership in the entrepreneur’s success.

GroFin does not have one solution that it makes every SME fit into, rather it tailors its financial and professional support to the viable business; this includes the interest rate that it charges its entrepreneurs.

This shows promise for a wider base of African SMEs as this model allows for small, short-term loans to entrepreneurs and will be tailored to the particular business and its needs.

Root Capital

Root Capital is “a nonprofit social investment fund that provides affordable loan capital and financial training to sustainable grassroots businesses operating in environmentally-sensitive areas of Latin America, Africa and Asia.” It focuses on businesses in the remote areas of these developing countries where traditional lending institutions are, for the most part, nonexistent.

Root Capital provides loans, which range from $25,000 to $750,000 and are targeted at “rural businesses where small-scale producers have organized themselves

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40 Ibid, 17.
41 Ibid.
42 Ibid.
into cooperatives and associations to achieve the economies of scale required to side-step local intermediaries and export their products more directly.”\textsuperscript{45} The goal is that these grassroots businesses will be able to join the global market. The loans are secured based on “producers’ future sales rather than their existing assets, using cash flows tied to consumer demand for ethically and sustainably sourced goods, as security against the credit it provides to grassroots businesses, local processors, exporters and other supply chain actors.”\textsuperscript{46}

Root Capital looks at risk differently than traditional lending institutions:

Root Capital… places value on ethical supply chains, which emphasize product quality and long-term relationships, not just price. It uses factoring, a form of cash flow lending, as a risk mitigation strategy for 80% of its portfolio, including both short-term and long-term loans. The remaining 20% of the portfolio consists of more traditional asset-backed loans, where equipment and/or land serve as collateral.\textsuperscript{47}

This model has a great deal of promise for a diverse population of African SMEs because of the size of the loans, the willingness to enter into both short-term and long-term relationships, and the fact that risk is defined in a different manner which is favorable to these types of entrepreneurial businesses. The only potential issue with Root Capital is the fact that they are a niche loan provider as they are only focused on providing support to those businesses dealing with farming and processing of goods for sale on the global market. While this model will help some businesses, it will certainly not help them all.

Conclusion

After considering these different types of equity financing and applying them to the environment faced by African SMEs, the conclusion is that none of these are a perfect fit. Private equity in its various forms is generally not going to be interested enough in these small firms to consider investing in them. Venture capitalists will need to take greater risks if they are going to be able to see any sort of development across the African continent and/or Africa needs angel investors who are well versed in technology that will help small companies work to a level where a venture capitalist will be interested in investing.\textsuperscript{48}

There are a host of operational “missing middle” funds that focus on the early stages of business but does the average SME owner know this fact? It is most likely

\textsuperscript{45} Ibid, 21.
\textsuperscript{46} Ibid.
\textsuperscript{47} Ibid.
formal SMEs (those who already have an affiliation with a bank through holding accounts) not informal SMEs (those who have no relationship with financial institutions) who will benefit from being able to gain access to credit.\(^{49}\) To improve financing to these SMEs it will be a multi-stage process that will involve the government as well as changes in the legal and regulatory structures of the countries and financing that is affordable and willing to help with more than just monetary support.

**The Way Ahead**

A model that shows great promise is the creation of incubators throughout Africa which are “sharing best practices and networking amongst each other across the continent to make it an increasingly smaller place.”\(^{50}\) For example, the Meltwater Entrepreneurial School of Technology in Ghana is a training school as well as an incubator:

Graduates are expected to work on a startup idea upon graduation that feeds into the incubator. Funding from $20-200k is provided for promising ideas....[it is] backed by a successful tech company with resources and talent globally they can leverage to provide the best assistance to fulfill their mission. If a graduate decides to take a full time corporate job, they can still come back later and join the incubator and secure funding once they have an idea they’d like to pursue.\(^{51}\)

This is what is necessary – training for entrepreneurs and future leaders as well as the education they need and the encouragement to create ideas and work to make them a reality. However, “such models are inherently time intensive and patience for the long term is required to see the results.”\(^{52}\)

The final paper in this series will consider the intriguing model of the incubator in Africa and what it can do for African SMEs.

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\(^{51}\) Ibid.

\(^{52}\) Ibid.