

# **African Small and Medium Enterprises Fund of Funds**



# Market Opportunity

## Opportunities

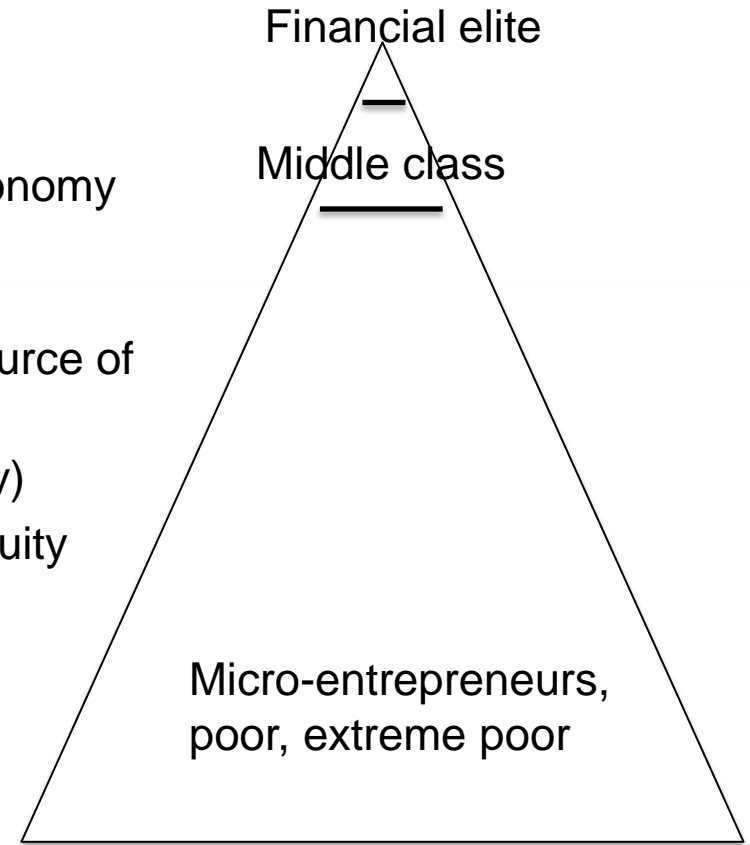
- Institutional investors need impact investing options
- Funds targeting SMEs can't close
  - Too small for institutional investors (~\$50mm)
  - Not diversified
  - Difficult fund manager selection process

## Proposal

- Propose a Fund of Funds comprised of a diverse set of
  - 5-7 SME-focused funds
  - with a target IRR of 12-15%
  - over 10-year fund life

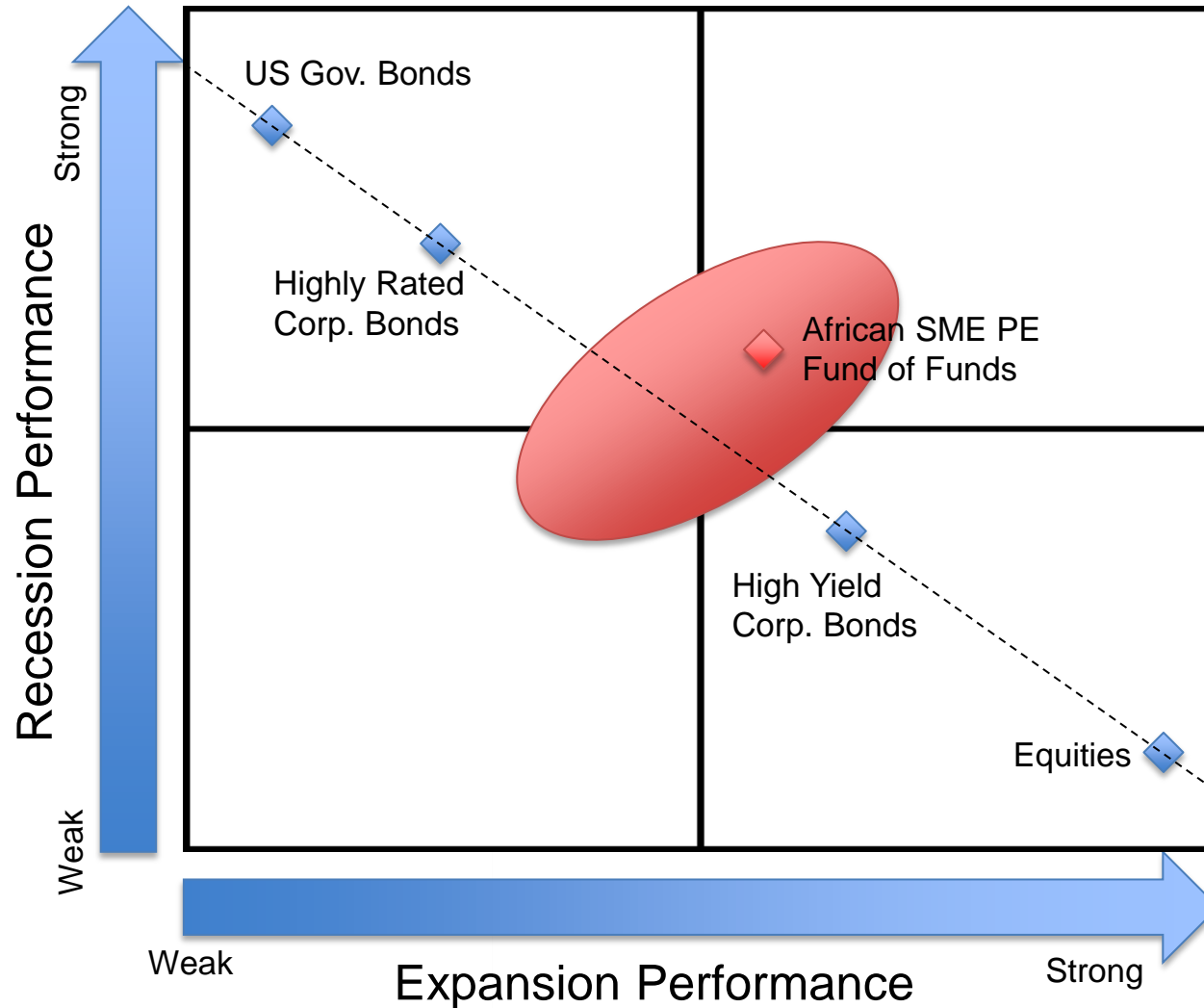
# Why SMEs in Sub-Saharan Africa (SSA)?

- Financial elite
  - Large corps. with low job creation
  - Risk exposure to the rest of the global economy
- Small middle class
  - Private sector SMEs a major untapped source of job growth
  - Estimated \$160B financing gap (McKinsey)
  - No collateral or access to liquid private equity
- Micro-entrepreneurs
  - Low-profit, not scalable
  - Not every ME wants to be one
  - Served by microfinance



**Development hypothesis: grow middle class**

# Investment Opportunity



# Fund Manager Selection

**Qualitative Assessment:** Best-in-class defined by “African competency” – not “VC mindset”

- African experience
- Business, financial models rooted in African realities
- Length and breadth of experience
- UNEP PRI, IFC Perf. Std. understanding
- Cultural know-how including techniques to reduce risk and promote ethics

**Quantitative Performance Metrics:** FOF looks for “preferred” performance characteristics

- Return history
- Length of track record
- Asset class experience – SME scaling, mid cap
- Management controls

**Portfolio Fit:** Fund’s strategy and risk/return must fit within existing portfolio

- Maintain SME-focus
- Preference to S/H loan/equity with royalty feature
- Little geographic or sector overlap
- Uncorrelated industries less susceptible to corruption / regional risk

*E.g., SEAF was co-founded by a lawyer and an aid worker with degrees in French literature – no prior investment experience.*

# Fund Manager Due Diligence

## Due Diligence Process

1. Initial interest in strategy

2. Analyze fund (or company) track record

3. Full documentation review

4. In-depth manager review

5. Manager due diligence write-up

6. Investment committee approval

In-depth manager review is focused on six critical areas:

- Reputation and character
- Investment process and risk management
- Administrative and internal controls
- Reporting and transparency
- Industry and country knowledge
- Social value orientation

# Fund of Funds Structure

- Proposal: US\$500mm FOF
- Target return: 12-15%
- FOF life: 10 years (with 2-year extension option)
- Number of funds: 5-7 (open or closed-end) (each fund makes 25-35 investments)
- FOF management fee: 0.25% (taken out of fund's management fee)
- Target fund portfolio investment size: \$500k - \$5mm in SMEs with \$2-\$10mm annual revenue
- No fund more than 30% of total allocation

Target return: 12-15%



# Target Fund Deal Structure

## FOF prefers funds that:

- provide 3-6 year financing to SMEs for working capital or capex
- provide technical assistance to Investees
- provide for tag-along and claw-back rights to ensure *pari passu* gains in case of non-MBO exit.
- provide for co-investment rights to FOF Investors
- provide follow-on loans to Investees
- make investments of \$500k - \$5mm in SMEs with \$2-\$10mm annual revenue
- minimize equity exposure risk through shareholder loans with a revenue-based royalty feature



# Preferred Financing Model

## Goal

### Decrease risk and return gap

- Perceived risk of 40-50% with expected returns of 0-5%
- FOF aims for 12-15% return on estimated 20-30% risk

## Financing Model Parameters

- Equity value around 2X sales
- Invest in small amounts of equity, 10-20%
- Provide shareholder loans at 4-8% interest
- Determine exit multiple, usually 3X
- Receive MBO payments through royalties on sales, 5-10%, greater of actual or forecasted

Increased predictability does not leave out high upside expectations

# Financing Example

Example companies: poultry, juice concentrate, website design, high-tension wire, cement, auto parts, apparel, transportation services

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Comments
Sales	2,500	3,000	3,600	4,320	5,184	6,221	Assume 20% y-o-y growth
Royalty (%)	6%	6%	6%	6%	6%	6%	Percent in the 5-10% range
Royalty (\$)	-150	-180	-216	-259	-311	-373	Total equals \$1500 target
Principle pmts	0	-250	-250	-250	-250	0	Four year payback
Interest pmt	-60	-53	-38	-23	-8	0	Six percent interest
Net Sales	2,290	2,518	3,097	3,788	4,615	5,848	Remainder for expenses, RE
Equity Value	5000		S/H Loan amt	1000			
Inv. Equity Stake (%)	10%		Interest rate	6%			
Inv. Equity Stake (\$)	500						
Required multiple	3						
Desired exit amt	1500						

IRR on Shareholder Loan	5%
IRR on Royalty Payments	36%
<b>Blended IRR</b>	<b>15%</b>

# Risks

## Sub-Saharan Africa is a high-risk region

- Volatile country and local politics
- High sovereign risk
- Economic and business regulations need improvement
- Judicial systems unfavorable (contract law, legal rights of shareholders)

## SMEs are a high-risk asset class

- Fund Investees typically need technical assistance, capacity building expertise
- Little additional institutional support
- No data is available: private equity, low information context

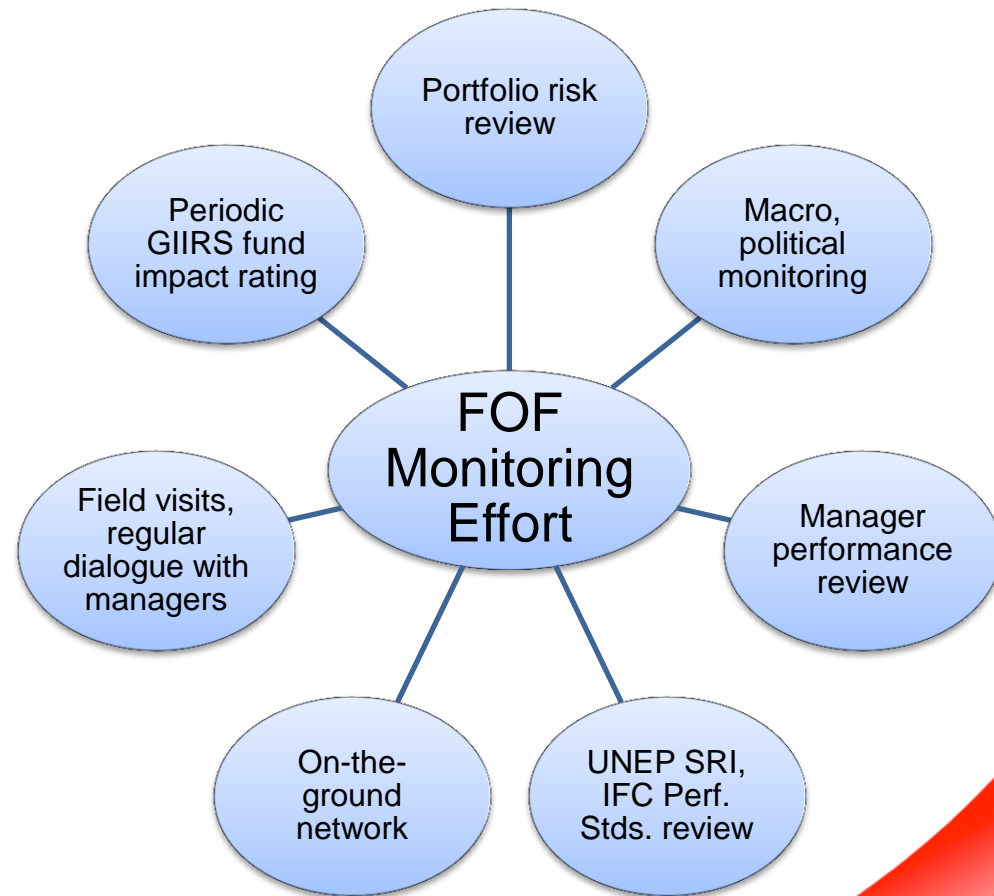
FOF diversifies across geographies, industries, market capitalization, and fund managers.

Most risks are idiosyncratic.

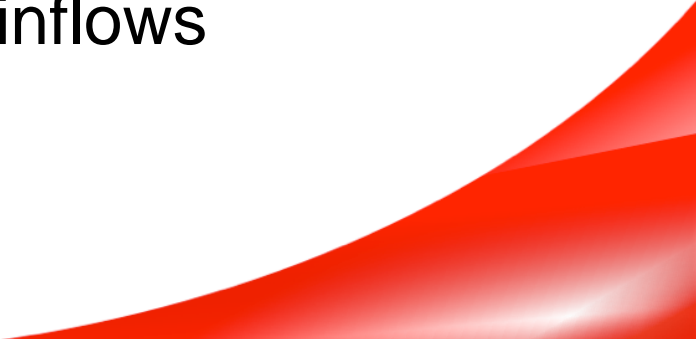
# Strategy Focus

## The African SME Fund of Funds limits the number of underlying funds

- **Permits intensive monitoring approach:** A smaller number of underlying funds allows FOF to closely monitor performance of specific investment strategies, strategy development, changes in risk tolerance, social objectives, ESG issue adherence, etc.
- **Preserves best-of-the-best SME deal flow:** Underlying funds should not overlap geographies and sectors, identifying only the best, un-tapped investments within their investment strategy.



# The Impact in Impact Investing

- Jobs growth (increased, stable incomes)
  - Educate management on best business practices
  - Encourage African-to-African trade and export
  - Economic multiplication effects
  - Formalize economies
  - Economic diversification
  - Institutional and governmental reform pressure
  - Tax payments
  - Demonstration effects to future SME funding, FDI inflows
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# Solutions and Benefits

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SME fund size **too small**



**Fund of funds** model scales and shares investment

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SME funds currently risky due to high **equity exposure**



Target SME funds that minimize equity exposure through **shareholder loans**

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Private equity is an **illiquid market**



Royalty feature builds in liquidity event, **MBO exit**

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**Geo-political risks** can be devastating



**FOF diversifies** across countries, industries, fund managers, and market caps

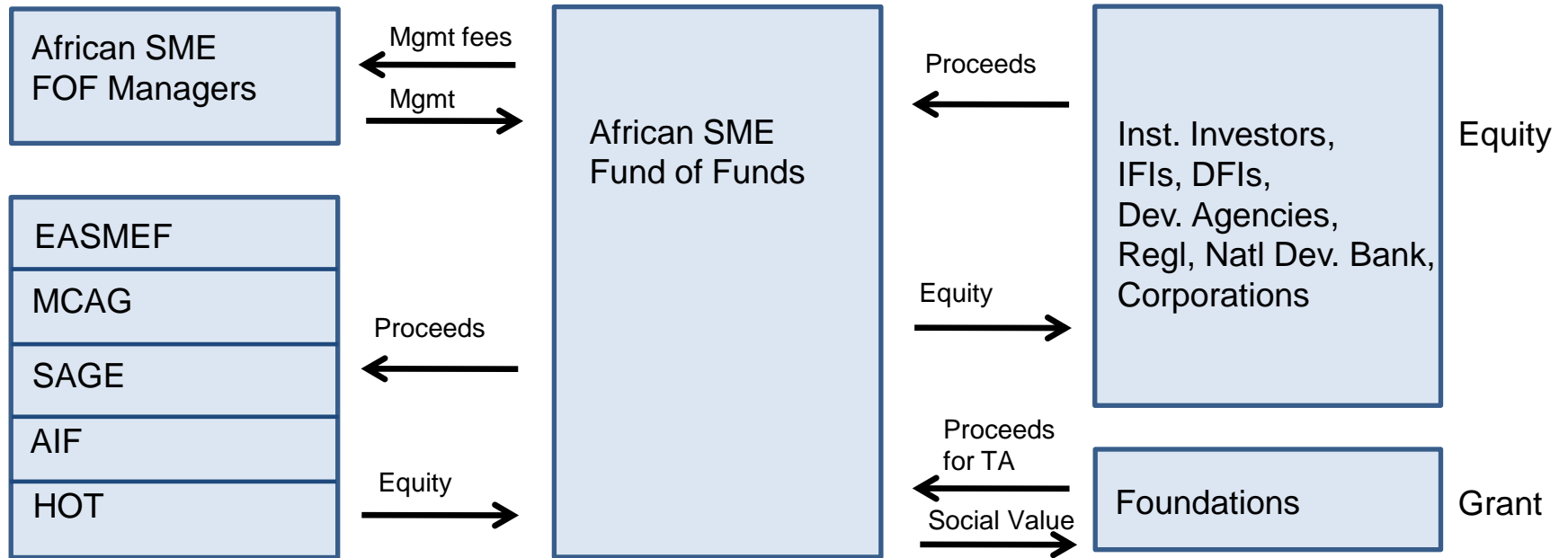
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## Additional benefits

- **Low correlation** to traditional investment options
  - Additional equity exposure in **high growth** region
  - **Create wealth** for investors and African communities
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# FOF Structure and Flow





# African SME FOF Illustrative Portfolio

Allocation	Target Investment	Fund Name	Profile, reasoning	Industry	Geography	SME Investee Profile	Target returns
10%	\$50mm	East Africa SME Fund	Serve growing middle class	Agribusiness, Energy	East Africa	3+ year track record, 1-5mm rev	12-15%
30%	\$150mm	Mid Cap Africa Growth	Weathered global financial crisis better than most, current equity values depressed	Manufacturing, Retail, CPG	Southern Africa	5+ year track record, 5-10mm rev	12-18%
30%	\$150mm	South Africa Growth Equity	High growth gazelles, high job creation, capturing entrepreneurial talent in lower-risk countries	Technology, Consulting	South Africa	1+ year track record, some seed funding	12-15%
25%	\$125mm	Africa Infrastructure Fund	Small scale infrastructure developments, improve trade and quality of life	Industrial Infrastructure, Construction Materials	Western and Southern Africa	3+ year track record	8-10%
5%	\$25mm	Healthcare Opportunity Trust	Fast-growing industry, increasingly private	Healthcare	East Africa	1+ year track records, 1-5mm rev	8-12%

# FOF Financials

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Dividends	\$1.7	\$5.3	\$9.4	\$14.1	\$19.6	\$24.2	\$26.1	\$24.5	\$17.9	\$9.3
Revenues	\$-	\$-	\$-	\$-	\$-	\$40.59	\$131.51	\$247.24	\$270.72	\$156.42
Fund Mgmt Fees	\$(10.0)	\$(10.0)	\$(10.0)	\$(10.0)	\$(10.0)	\$(10.0)	\$(10.0)	\$(10.0)	\$(10.0)	\$(10.0)
Capital Calls	\$(50.0)	\$(100.0)	\$(100.0)	\$(100.0)	\$(100.0)	\$(50.0)	\$-	\$-	\$-	\$-
Net Cash Flow	\$(58.3)	\$(104.8)	\$(100.6)	\$(95.9)	\$(90.4)	\$4.7	\$147.6	\$261.8	\$278.6	\$155.7

**IRR: 12.38%**  
**Cash-on-cash: 1.80**  
**Duration (years): 5.52**