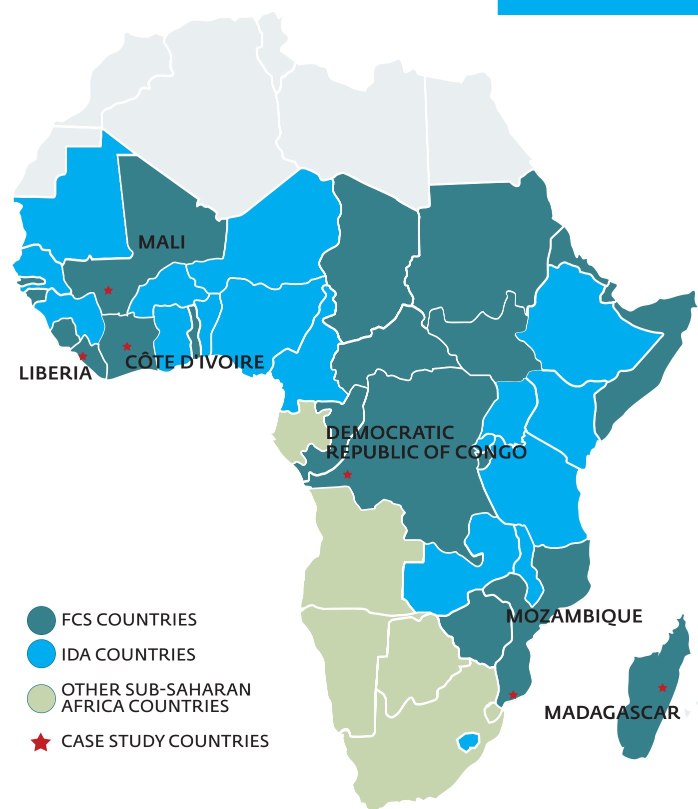
IFC SME Ventures: summary

Investing in Private Equity in Sub-Saharan African Fragile and Conflict-Affected Situations

Background

1

Foreign direct investment (FDI) in fragile and conflict-affected situations (FCS)[1] represents just 1% of global FDI flows, more than five times less per capita than the world average.[2] However, to grow businesses beyond the micro level, most entrepreneurs need financing. In fragile states, risk capital investments can have a significant catalytic impact.[3] Funds in these markets often help spur the emergence of new sector leaders and domestic challengers and/or partners to multinational firms. New jobs are created, providing training and formal sector social protections such as health insurance. Such investments have meaningful impact on the overall investment ecosystem, decreasing costs of doing business for others, bringing better practices into the markets, and paying taxes that support government services. The International Finance Corporation's (IFC) Small and Medium-sized Enterprise (SME) Ventures program is one of the few initiatives supporting entrepreneurs and high growth companies through investing in private equity funds that deploy risk capital in fragile states.



This report, researched in partnership with CrossBoundary LLC, highlights the critical success factors when investing in fragile states, as well as existing innovations being developed by current investors.[4] While the challenges of investing in FCS are well known, the most effective approaches and factors required for success are still being explored. New financial instruments, fund structures, and types of technical assistance are constantly being designed and tested. The lack of shared information, including results and best practices for developing and delivering mechanisms to invest in FCS can lead to missed opportunities for limited partners (LPs) and general partners (GPs).

[1] For the purpose of this report, the IFC definition of FCS is used. FCS are countries or territories with (i) a harmonized country policy and institutional assessment (CPIA) rating of 3.2 or less, and/or (ii) the presence of a UN and/or regional peacekeeping or political/peacebuilding mission during the last three years. Throughout the report, the countries considered are referred to as either fragile or FCS, and can also be categorized as frontier markets – although the latter is not always associated with a post-conflict or fragile situation.

[2] Alexandros Ragoussis and Heba Shams, "FDI in Fragile and Conflict-Affected Situations", Global Investment Competitiveness, Chapter 5 of Global Investment Competitiveness Report 2017/2018, Digital Object Identifier (DOI): 10.1596/978-1- 4648-1175-3., 2017.

[3] Dr. Josh Lerner, Ann Leamon, Andrew Speen, and Chris Allen, "Risk Capital in Emerging Markets and the SME-Ventures Model", Bella Research Group for IFC, 2015.

[4] CrossBoundary LLC is a frontier market investment advisory firm with offices in Nairobi, Johannesburg, Bamako, Lagos, Dubai, New York City, and Washington, D.C. CrossBoundary's work was led by Jake Cusack and Soline Minière, with support from Bryan Epps, Nathan Kelly, and Marcos Sampablo.

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Findings

2

Companies operating in fragile states face challenges that are often more severe and sometimes unique compared to those in emerging markets or developed markets. In this operating and investment context, average risk-adjusted returns are lower. Reasonable net returns (5%-10%) are more difficult to achieve in FCS and require a tailored approach. Investors need to adopt context-specific methodologies, adjusting to market/population size and growth, currency risk, and political uncertainty, among other factors.

While fragile states share similar characteristics, investors should adopt a context-specific approach

The strategy to approaching fragile states must be tailored to the local context, with the country-level environment presenting different challenges and opportunities depending on a number of factors. For example:

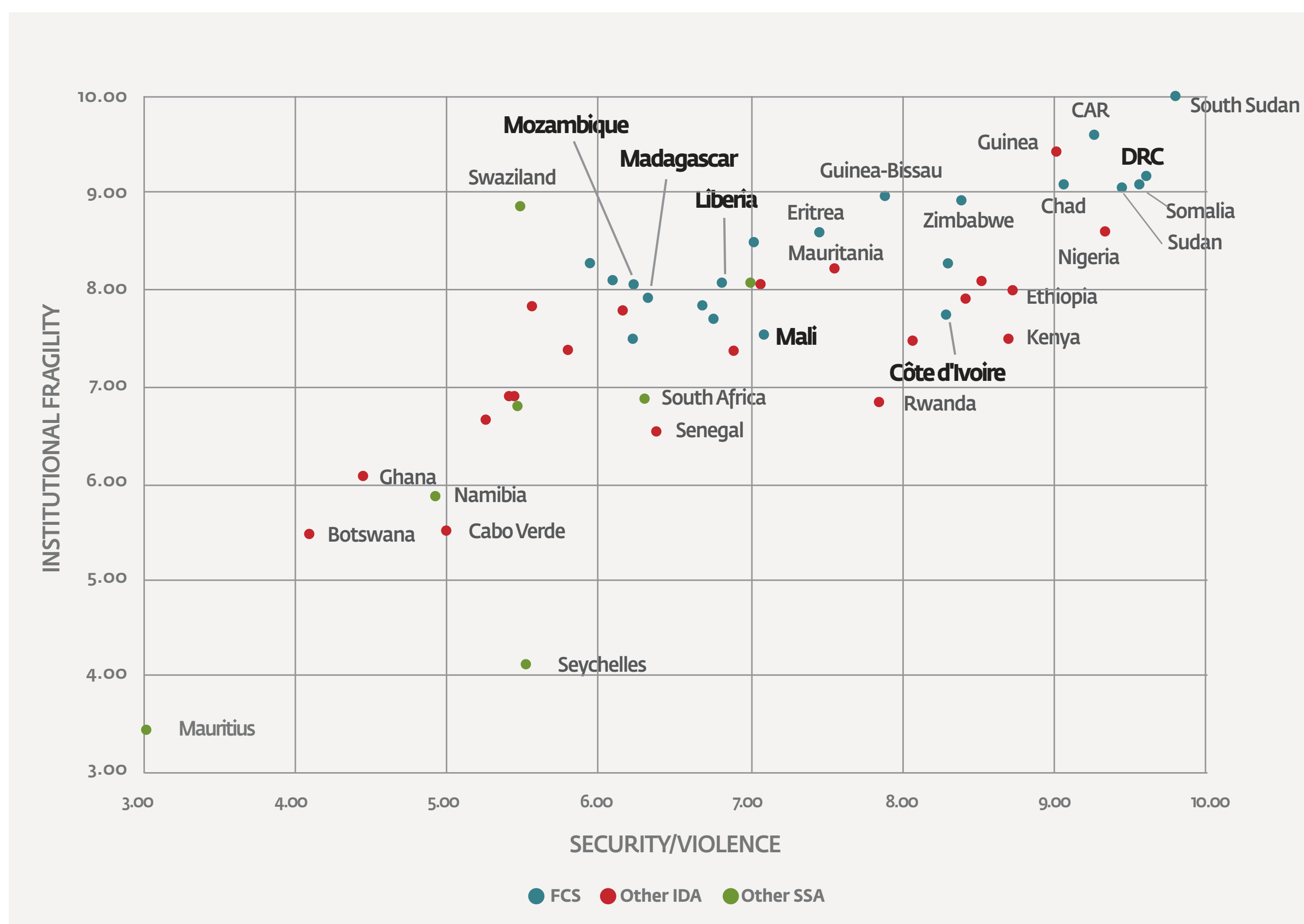
- Agriculture, as a necessary basic good and labor-intensive activity, is relatively resilient (albeit fragmented) and typically contributes a higher share of GDP in fragile states compared to services and industry.[5]
- Fragile countries vary in population size, but often experience market access challenges due to disruptions in trade routes and enabling infrastructure. However, in countries with low accessible local demand, there remains an opportunity for investors with a regional or export-led investment strategy.
- In markets with volatile currencies investors often seek export or foreign-currency oriented sectors such as tourism.

The most specific risks for fragile states are (a) security challenges arising from political conflict and/or (b) institutional fragility or lack of government capabilities.[6] Figure 1 illustrates how countries in SSA compare on a select set of dimensions.

5 Alexandros Ragoussis and Heba Shams, "FDI in Fragile and Conflict-Affected Situations", Global Investment Competitiveness, Chapter 5 of Global Investment Competitiveness Report 2017/2018, DOI: 10.1596/978-1- 4648-1175-3., 2017.

6 Ibid

FIGURE 1: DIMENSIONS OF STATE FRAGILITY IN SSA[7]



Risk capital has a strong development impact and is desperately needed in fragile states

The risk capital gap is most significant in fragile states. A recent survey of finance providers in one FCS country found that the local IFC SME Ventures fund was one of the sole providers of flexible risk capital (including loans with tailored and flexible repayment schedules, royalty-based lending, convertible loans, and equity), while others that existed primarily deployed more standard debt instruments. In Liberia, before the IFC SME Ventures fund, very few small/mid-size risk capital investments had recently occurred (today, several private equity funds are exploring entry).[8]

Risk capital investments can have a significant catalytic impact, even with relatively low commercial returns.[9] A 2013 IFC study found that firms having even just a loan or overdraft facility had a 3.1% higher rate of growth in permanent employees than firms without access to finance.[10] A study of 200 private equity funds conducted by the African Private Equity and Venture Capital Association (AVCA) in Africa between 2009 and 2015, found that private equity backed companies generated a net increase of 10,990 jobs.[11] The additional impact through potential spillover effects of FDI has

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7 Derived from the Fund for Peace (FFP) Failed State index (FSI): http://fundforpeace.org/fsi/. Security and violence values were computed using the average of security apparatus (C1), factionalized elites (C2), and group grievance (C3). Institutional fragility values were computed using the average of state legitimacy (P1), public services (P2), and economic decline (E1).

8 As of January 2018, several funds, including Pan African Capital and Gemini Capital, were being raised in Liberia with the purpose of investing in the country or in the larger Mano River Union area.

9 Dr. Josh Lerner, Ann Leamon, Andrew Speen, and Chris Allen, "Risk Capital in Emerging Markets and the SME-Ventures Model" (Bella Research Group for IFC, 2015).

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

11 Aubrey Hruby, "The developmental difference of African private equity", Financial Times, 25 January 2017, https://on.ft.com/2FXgeml.

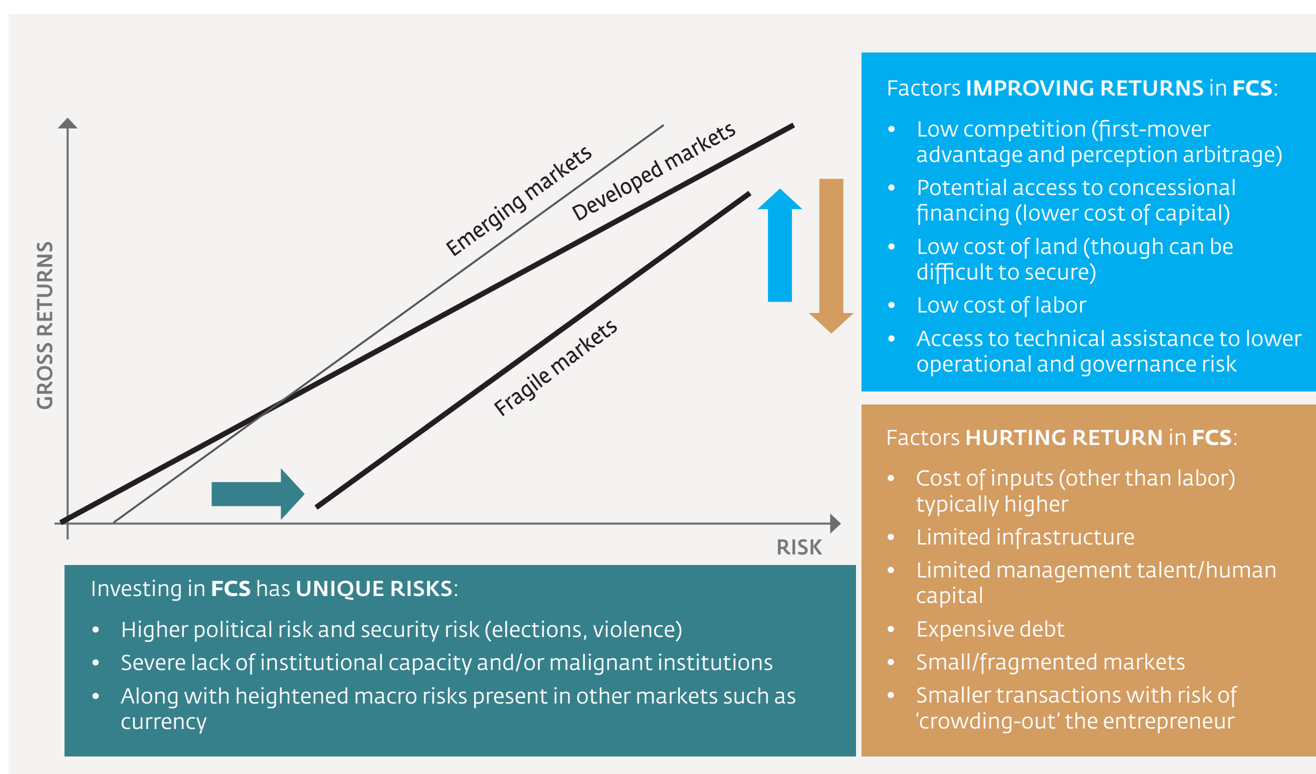
been measured in a recent World Bank research, and is enhanced by local sourcing.[12] Job creation and domestic linkages are of particular importance in FCS where unemployment is often higher and access to basic services is difficult, potentially driving extremism and violence.[13]

Supporting the entry of new risk capital providers can also create the well-functioning financial intermediaries that are frequently absent from FCS.[14] Such intermediaries are an effective tool to improve corporate governance, boosting productivity and growth.[15] Additionally, increased risk capital provision spurs the development of the business ecosystem (lawyers, accountants, and consultants) and an appropriate regulatory environment. Development finance institutions (DFIs) should seek to back locally based GPs in FCS, as they can be particularly beneficial in this regard.

FCS gross return expectations must be appropriate

Investing in FCS presents significant challenges, and gross returns are, in general, lower than in other markets. GPs can, and should, still seek 15%-20% returns on individual investments, as their portfolio companies should be experiencing sustainable growth even within the complexities of a fragile state. In general, if targeting lower gross returns than that, the fund may not be sustainable and/or investments are not in sufficiently high growth and job-creating companies. However, LPs must be realistic in grading their GPs given FCS challenges. For example, when appropriate to the sector of the investment, gross performance should be judged in local currency terms first.

FIGURE 2: STYLIZED FRAMEWORK OF GROSS RETURNS FOR INDIVIDUAL INVESTMENTS IN FCS[16]



[12] Thomas Farole and Deborah Winkler, "Making Foreign Direct Investment Work for Sub-Saharan Africa - Local Spillovers and Competitiveness in Global Value Chains." (International Bank for Reconstruction and Development / The World Bank, International Trade Unit, 2014) p87-114.

[13] "Plan of action to prevent violent extremism", UNDP https://www.un.org/counterterrorism/ctitf/sites/www.un.org.counterterrorism.ctitf/files/plan_action.pdf.

[14] Ross Levine, Norman Loayza, and Thorsten Beck, "Financial Intermediation and Growth: Causality and Causes", World Bank Policy Research Working Paper No. 2059, February 1999.

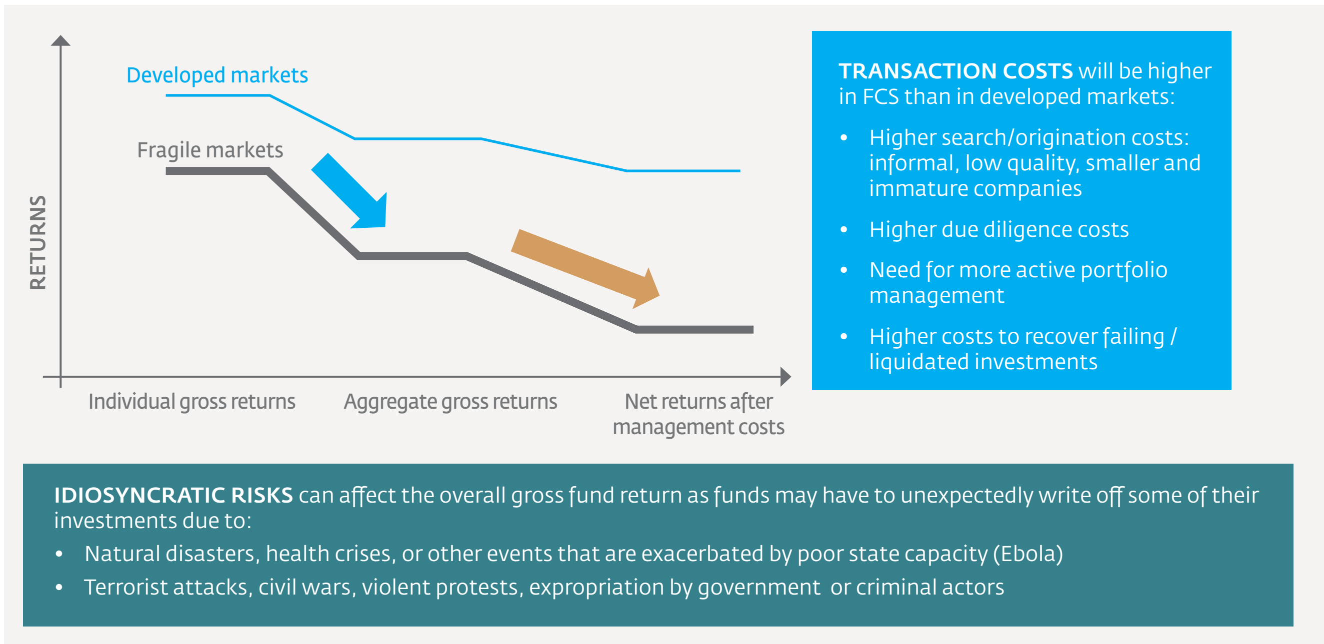
[15] Valerie Bencivenga and Bruce Smith, "Some consequences of credit rationing in an endogenous growth model", Journal of Economic Dynamics and Control, 1993, vol. 17, issue 1-2, p97-122.

[16] CrossBoundary analysis based on a literature review and field interviews with GPs and LPs investing in eight SSA fragile states.

Net return environment is particularly difficult

In African fragile states particularly, the gap between the net and gross IRR is higher than in other emerging markets. In the specific context of FCS, a 5%-10% return net of management costs can be considered good performance, expecting improvement from a first-time fund to subsequent funds raised.

FIGURE 3: FROM GROSS RETURNS TO NET FUND PERFORMANCE



IDIOSYNCRATIC RISKS can affect the overall gross fund return as funds may have to unexpectedly write off some of their investments due to:

- Natural disasters, health crises, or other events that are exacerbated by poor state capacity (Ebola)
- Terrorist attacks, civil wars, violent protests, expropriation by government or criminal actors

Impact metrics and incentive structure are important to demonstrate investment value beyond financial returns

In a context of challenging net returns, the outsize development impact of fragile state funds is important to monitor, evaluate, and showcase. While sustainable development goals (SDG) indicators are often linked to national-level statistics and therefore not suited to fund managers, aligning with well-known and understood impact frameworks helps funds communicate more easily. Currently, two tools are frequently used to measure impact: IRIS (Impact Reporting and Investment Standards) and GIIRS (Global Impact Investment Rating System, which builds on IRIS). Sometimes in alignment with, but also often independently of those tools, many funds design their own frameworks to report impact. Several indicators are very commonly used, such as the number of jobs created, additional taxes collected, tons of carbon dioxide reduced, percentage of women on the board of companies, access to healthcare/insurance for employees, and training and new certifications achieved. The indirect effects of the portfolio company on its clients, suppliers, customers, and competitors are more difficult to report and are often described through narrative case studies.

FIGURE 4: EXAMPLE OF FUND PERFORMANCE FRAMEWORKS

	CATEGORY A	CATEGORY B	CATEGORY C	CATEGORY D
SOLON CAPITAL PARTNERS	**Level of impact**: government service delivery, tax collection, legal compliance and business ethics enforcement, market productivity	**Sectors of impact**: human capital development through jobs and skills, supply chain benefits and reduced barriers to entry, new technologies, upscaling of service delivery, SDGs addressed	**Quantified returns**: from invested capital: local tax paid, incomes, goods and services purchased locally	**N/A**
INVESTISSEURS ET PARTENAIRES (I&P)	**Impact on staff**: job creation, job patterns (gender, wages, etc.), employee training and other advantages	**Impact on clients**: quantity of goods/ services provided (company-specific metrics), number of clients (company-specific)	**Impact on suppliers & distributors:** number and share of local suppliers and distributors	**National value added**: contribution to state revenues, GDP and exports
MARIS LTD	**People**: number of current jobs, number of jobs post-investment, % of national employees	**Community**: taxes, royalties, community program spending	**Environment**: trees planted (relevant to teak investment), environmental incidents, solar installations	**N/A**

In addition, fund investment in fragile states creates value in the overall ecosystem – and such impacts are more difficult to quantify, including improving a specific value chain, decreasing costs of doing business for other funds/companies, and raising ESG and compliance standards in the market. Though difficult to easily measure and compare, these include visible changes with lasting impact on the local economy.

Throughout the impact measurement process, the cost in both time and money should be taken into consideration. If LPs expect significantly more data than simple-to-collect metrics (such as jobs created), it will come at a management burden, particularly for the smaller funds in more fragile states.

Further, impact and return performances should be evaluated and incentivized in parallel. As fund manager I&P has argued: “In practice, it is often necessary to make trade-offs between profit and impact”.[17] LPs expecting to have a meaningful impact in the toughest ecosystems may need to compromise on (net) returns or liquidity, particularly in the early years of more flexible equity-like capital entering a specific FCS market. In interviews, I&P highlighted that they believed the trade-off has been worth it – in their markets, small ticket equity capital is very rare, and they found in an analysis of approximately 80 equity investments that only three of them were in competition with other equity providers.

Impact performance indicators can also be used to incentivize fund managers, for example by including a ‘social carried interest’ component in the compensation structure.[18] When net returns are particularly difficult to achieve due to a fund’s desired impact model – for example, for funds investing more time and expense in helping a local early-stage entrepreneur – tailored incentive structures can help ensure that GPs and LPs are aligned.

Lastly, there are crossover indicators that drive both returns and development, even though they are not typically mentioned in the context of fund performance frameworks. These include governance metrics such as delivering accurate, timely reports, accounts, and audits; having regular and appropriately documented board meetings; and being in full compliance with external entities/stakeholders – all of which are relatively easy to monitor without creating new reporting burdens. Beyond that, tracking the successful mobilization of commercial capital and concessionary funding for each dollar invested by an LP in fund capital and advisory services is a way to gauge the investee’s success and sustainability from a high-level perspective.

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[17] Elodie Nocquet, Clémence Bourrin, and Emilie Debled, “There is no impact but only proof of impact!”, I&P, p6.

[18] The Global Impact Investing Network has provided examples of this: https://thegiin.org/assets/documents/pub/impact-based-incentive-structures-aligning-fund-manager-comp.pdf

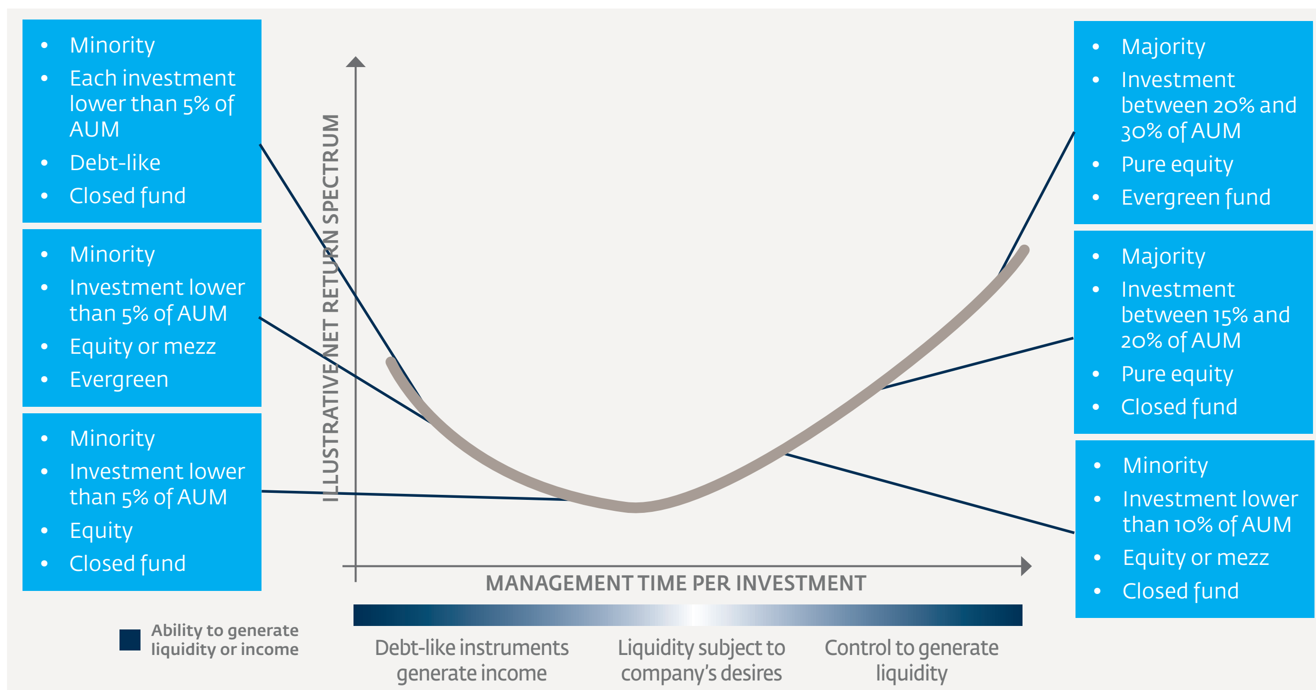
Several observed patterns and best practices lead to more successful funds in FCS

3

Funds investing in FCS with better net returns often tend towards two ends of the strategy spectrum

Based on research, FCS funds with better net returns tend to either be highly active and in control positions on select investments or deploy standardized (but flexible) debt-like instruments to a larger group of investments. One hypothesis is that this is due to balancing management time per investment with potential returns, as well as the ability of the investor to generate income/liquidity from investments. Small funds with a large array of minority equity positions can struggle to both realize liquidity and adequately manage their investments. Nonetheless, investors operating in this mid-spectrum, with a philosophy of 'backing entrepreneurs, not companies' (i.e. not replacing management or otherwise taking control), also have a distinct positive development impact. Separately, otherwise potentially viable majority investment opportunities were sometimes not feasible due to political exposure risks in the context of particularly corrupt environments.

FIGURE 5: FCS FUNDS WITH BETTER NET REALIZED RETURNS OFTEN TEND TOWARDS TWO ENDS OF THE SPECTRUM: STANDARDIZED FLEXIBLE DEBT-TYPE INVESTMENTS OR MAJORITY CONTROL POSITIONS



Sectors can be selected based on observed patterns of success in comparable environments, nuanced by unique local context

GPs can look to invest in companies serving the local demand and requiring high level of capital. Often such sectors provide an import substitution arbitrage — facing high relative costs of transport (high volume/low weight) or services that inherently need to be provided locally:

- GPs in FCS have successfully invested in food and beverage companies such as bottling companies or biscuit companies, as well as business hotels and transport companies (car and truck leasing). In the aftermath of conflict, sectors relevant for reconstruction, such as construction and associated locally produced materials, can see good returns.
- Countries with extractive sectors attracting foreign investors can provide sets of products and services along the supply chain. For instance, in the DRC and Mali, the mining industry brings a set of local companies to supply the needs of the sector (food, transport and housing). Other adjacent opportunities to existing businesses could include producing packaging or printing materials for locally produced goods, ranging from bags for cement to labels for foodstuffs.

FIGURE 6: FUNDS IN FCS COUNTRIES TEND TO INVEST IN COMPANIES WITH THE FOLLOWING CHARACTERISTICS

	Companies with revenues in hard currency	Companies with insulation from international competition (basic goods & essential services)	Companies with restricted domestic competition (monopoly/oligopoly/first mover)	Opportunistic comparative advantage companies
Description	Focus on exports or providing goods / services to international customers in-country. Illustrative sectors include tourism, export oriented agriculture, and mining/oilfield services.	Produce essential non-tradeable goods or produce goods with high transportation costs. Illustrative sectors include logistics, construction, FMCG retail, business services, hospitality, and healthcare.	Provide services that have a restricted license to operate or provide infrastructure that has high capital costs/barriers to entry. Illustrative sectors include telecoms, toll roads, energy, and any other sole licensee businesses.	Leverage a comparative advantage of the country to build an enterprise with unique advantages. Illustrative sectors include extractives or unusual crops native to the region.
Examples	Maris Ltd invested in separate housing and warehouse companies for multinationals in Mozambique. Adenia Partners invested in a beach hotel in Madagascar. Solon Capital invested in Flash Vehicles, a vehicle rental company in Sierra Leone. African Century invested in an equipment leasing company in Mozambique and Tanzania.	XSML invested in a digital printing company in the DRC. TLG invested in a healthcare provider in Liberia. WAVF invested in a bakery providing products to locals. XSML invested in a clinic in the DRC. Beverage investments include WAVF in Sierra Leone, SABMiller in South Sudan, Heineken in Sierra Leone, and Coca-Cola in Somaliland.	ManoCap invested in the largest fishing company in Sierra Leone. Whatana Investments invested in a major telecom provider in Mozambique. Kinyeti Capital invested in an airport logistics company in South Sudan. WAVF invested in a company providing logistics services to the airport in Monrovia.	AgDevCo invested in tree crops (like cashews) in Mozambique that have comparative advantages for export markets. Maris Capital invested in a teak company exporting from South Sudan. I&P invested in a lychee exporter in Madagascar.

Vertical integration can potentially enhance any investment by reducing risk along uncertain supply/value chain

Additionally, several GPs concentrate their origination process on export-led businesses and sectors, though typically outside of extractives. Those GPs are using the country's comparative advantage, either regionally or globally, to increase the probability of good returns. Investments in these sectors lower the currency risk and may take advantage of the low cost of labor often found in frontier environments.

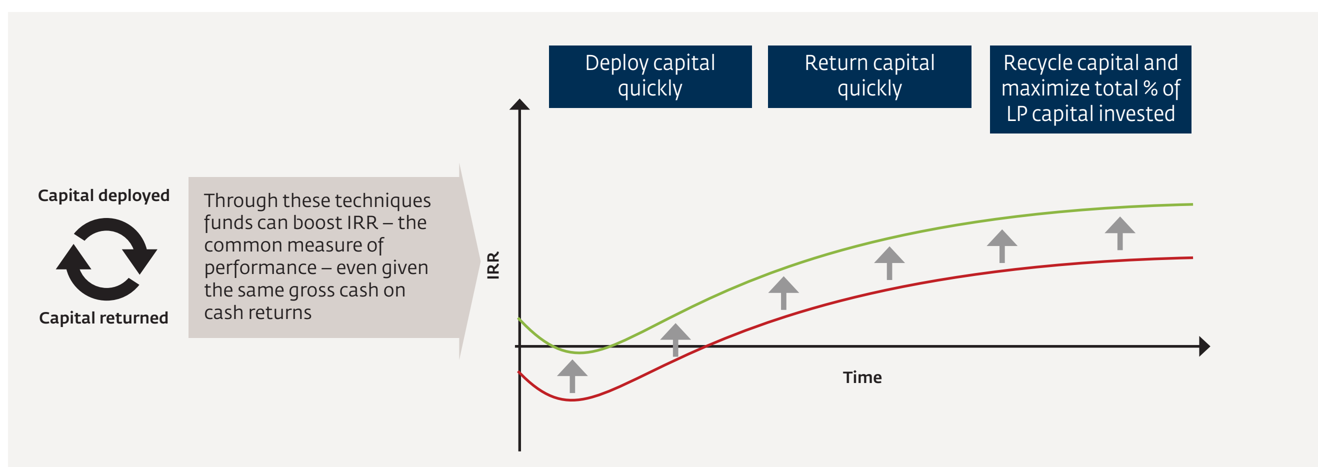
- Differentiated weather conditions and seasonality can result in niche export opportunities. In Madagascar, the lychee industry (two weeks of harvest per year) can provide a living to farmers for a year.
- Shared language can also support investment in tradable services. Call centers, computer programing, and other back office services represent unique opportunities to take advantage of relative low cost of labor.

Higher velocity and recycling of capital improve IRR

Because the most common metric for fund performance is IRR rather than multiple of money (cash on cash return), it is useful to consider how to improve IRR given similar underlying performance, to enhance the track record for raising future funds. Methods for this include:

- **Deploying capital quickly**: Through a previously developed pipeline of opportunities or providing the ability to warehouse deals pre-close, fund managers can execute transactions earlier in the fund lifecycle. Pipeline development can be optimized through formal and informal partnerships with other ecosystem actors, including accelerators or other donor programs that seek to facilitate investment.
- **Bridging capital calls**: By using a bridge capital call facility, which are not typical in the FCS contexts, funds can boost IRR by first drawing debt at a rate of LIBOR + 2% (for example) before bringing in the more "expensive" LP capital six to even nine months later.[19] This both enhances IRR and potentially eases administrative burdens by allowing GP to proceed with transactions quickly in advance of LP draws. However, some argue that such subscription capital call lines are tools of 'financial engineering' and a distraction for developmentally minded funds.
- **Returning capital quickly**: By using debt-like income generating instruments or exiting investments quickly, funds can shorten the capital return period and boost IRR.
- **Recycling returned capital**: Without recycling, a 10-year small fund with a 3% annual management fee may only put 70% of its capital to work, with the remaining 30% covering management costs. More generous recycling provisions (such as an 18-month recycling window) can allow a fund to effectively invest 100% or more of its capital. In discussions, one fund of funds investor identified the inability of African funds to fully invest 80% of their capital as a major challenge, resulting in too much or disproportionate fee drag.

FIGURE 7: VELOCITY OF CAPITAL... DRIVES FUND PERFORMANCE J-CURVE



[19] Also called a Subscription Credit Facility – "provide short-term funding on a revolving basis to private equity funds to bridge the time between when an investment is made by the fund and when capital contributions are received from investors to finance that investment. Loans are repaid with capital contributions once received from investors."

Specific mitigation strategies at all stages of the investment process can also improve the risk/return profile

GPs encounter challenges at different stages of the investment process. Below are several mitigation strategies they use to address these.

- **Origination**: In many cases, the investment opportunities will be earlier stage than typical private equity, facing higher risk of failure than that of more mature enterprises.[20] To address this, GPs can (i) continue to back an entrepreneur into related businesses, once trust has been built and performance demonstrated, (ii) partially incubate greenfield projects in house to improve control and results, and (iii) GPs can also diversify their initial sources of revenue to allow patience in sourcing investments, for instance by providing advisory services in addition to their investment activities.
- **Investment**: In many cases, before risk capital can be deployed an investor needs to educate the prospective investee on both the value and characteristics of equity or mezzanine instruments, given most businesses are used to working with debt to meet capital needs. To close better transactions, GPs can (i) adapt and innovate in terms of investment instruments to each fragile country, (ii) sustainably leverage donor/concessional capital, and (iii) work with the diaspora and "second generation" to explain value of equity investment to family-owned companies.
- **Management**: Monitoring costs can be high if the fund management is far from its entrepreneurs, and if the portfolio is widely disbursed geographically. Funds should (i) be hands-on to ensure returns on investment, (ii) be local, (iii) enforce monitoring/governance reporting for each portfolio company, while still (iv) adopting initiatives to decrease relative management costs.
- **Exit**: GPs and LPs mention the lack of flexibility in the timing of exits as among the biggest challenges faced in countries with limited or no secondary market. Exit opportunities are limited to management buy-out or trade sales, and IPOs are very rare.21 Beyond the self-liquidating type of instruments that many employ, several funds seek to mitigate this challenge by (i) identifying the exit opportunity pathway before investing, (ii) working towards that exit strategy while being flexible on opportunistic chances to sell, or (iii) adopting a holding company structure with no fixed time requirements for exit.
- **All stages of the investment process**: The lack of data and, in general, accurate and trustworthy business information hinders fund strategy development, pipeline creation, and monitoring of investments. A second cross-cutting issue is the scarcity of skills, mainly due to undeveloped national education sectors, high rates of emigration and brain drain, and improper labor standards. This affects both the quality of the investees themselves and the support ecosystem of accountants and consultants. Those GPs that do have better access to local experts, local teams, and local talent can fare more successfully.

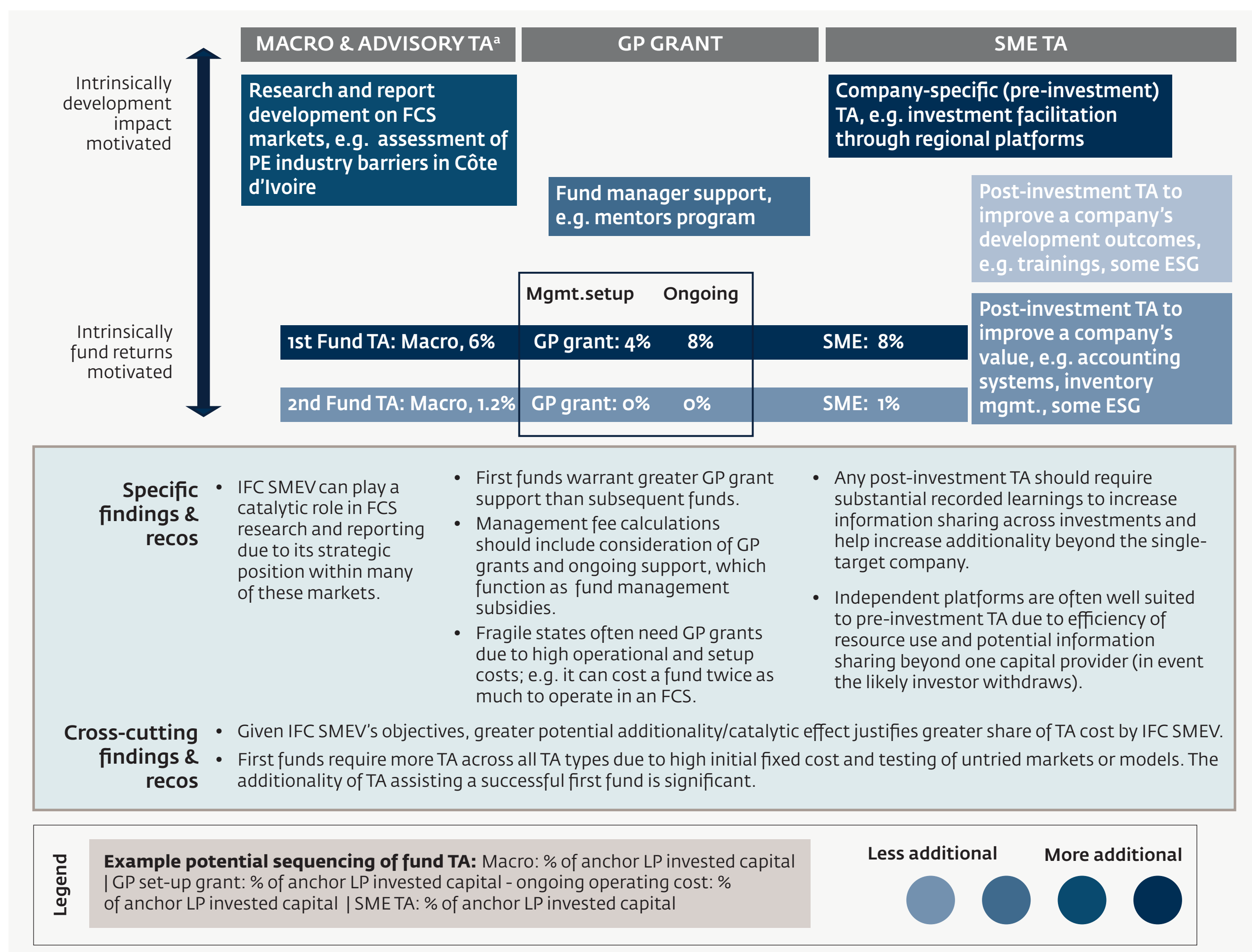
Technical assistance is an important tool that requires a nuanced approach

Technical Assistance (TA) should be used to pay for expertise that directly increases revenue/EBITDA, reduces costs, or addresses other challenges like environmental, social, and governance considerations of the investment. TA can be in the form of grants through the GPs and channeled as concessional loans, often zero interest and/or cost-share arrangements to the portfolio companies. TA is often highly dependent on the presence of DFIs as LPs of the fund. Funds with no DFIs as LPs will be less likely to hear about potential TA opportunities and will have more difficulty receiving TA facilities. Separately, TA can also be used for direct support of the set-up of the GP in first-time funds and for cross-cutting macro support (for example, PE regulatory environment reform). LPs providing significant TA directly to a fund can reasonably expect to have slightly expanded rights in fund governance and oversight, commensurate with their increased support (and also the likely riskier country/operating environment).

[20] "IPDEV a pioneering initiative to promote African SMEs" Investisseurs et Partenaires, May 2017.

[21] "Due Diligence in Emerging Markets" International Finance Corporation World Bank Group and OPIC, Vancouver Conference - Institutional Limited Partners Association, October 2011.

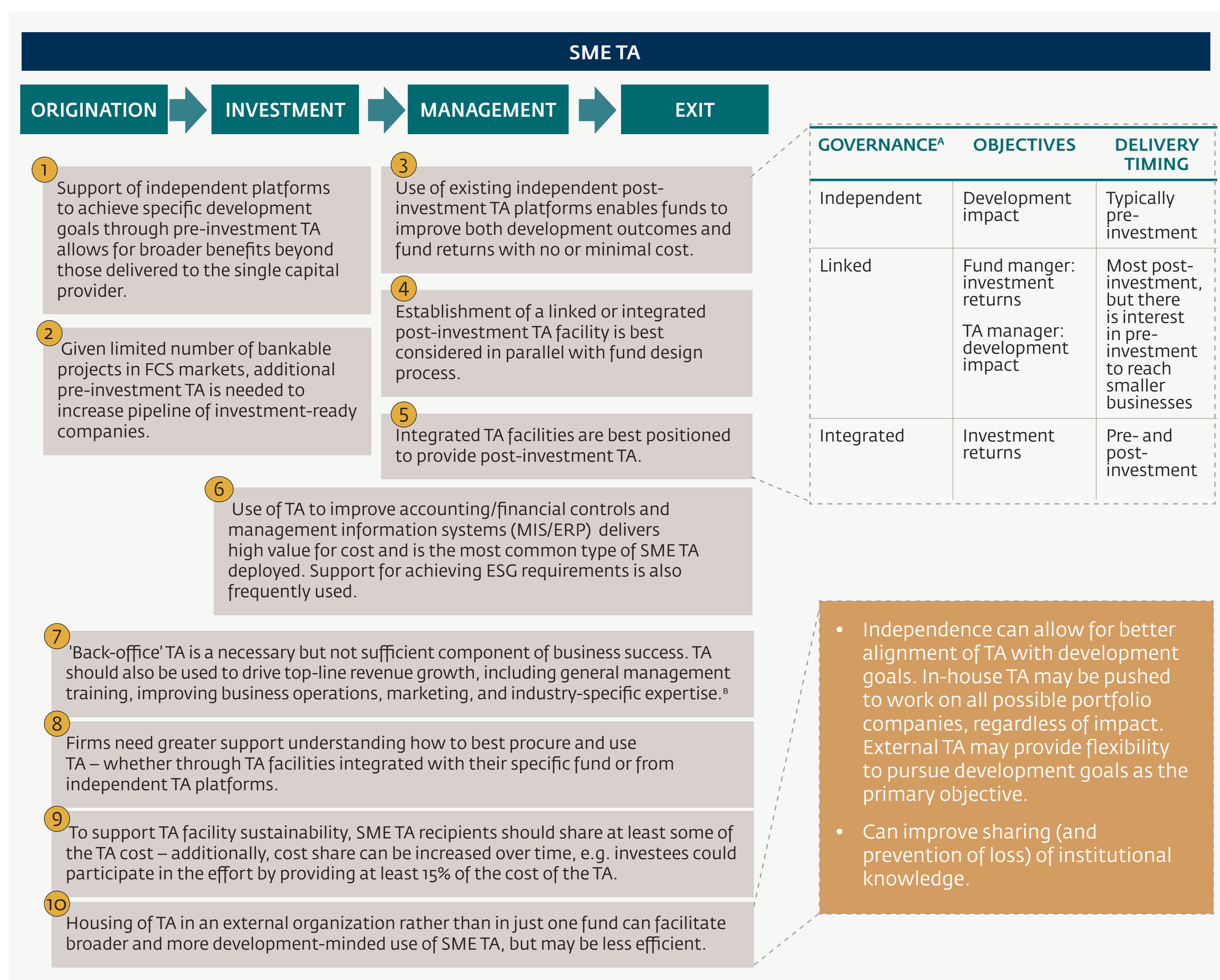
FIGURE 8: FRAMEWORK FOR DEPLOYING TECHNICAL ASSISTANCE[22]



GPs investing in SMEs in FCS note the crucial role of TA in supporting their portfolio companies. Most funds have limited resources because of their small fund size and correspondingly limited management budgets, which also means they have primarily generalist rather than highly specialized investment professionals. Some companies may need extremely niche support (e.g. a francophone expert on fertilization of sea cucumbers) that only TA can answer. Other more back-office TA (e.g. IT, accounting, other ERP systems) is often needed as well, and SME funds run into bandwidth and cost-efficiency limitations into installing and implementing such systems themselves with multiple companies. Marketing assistance and KPI management systems are useful tools to drive top-line revenue growth, typically the most important determinant of investment performance. Lastly, TA is also used for environmental, social, and governance improvements, which have both operational and development benefits.

[22] Note: the spectrum of TA activities from development impact motivated to fund returns motivated can be correlated to Enclude and Technoserve's TA governance model spectrum (from independent to linked to integrated) where independent facilities are intrinsically development impact motivated and integrated facilities are intrinsically fund returns motivated. [a] Adapted from: IFC Private Equity – SME Ventures, "Interim Report", February 2018.

FIGURE 9: FINDINGS ON TA FOR SMES IN FCS COUNTRIES[23]



More broadly, the standard fund model is not well adapted to investing in SMEs in FCS

Fund structure should be adapted to the local context and vary depending on strategy, sectors, and instruments identified by the investment strategy. Currency, cyclicality, level of local demand, and secondary market, among others, must be considered when developing the fund structure. For example, LPs who might advocate for a low maximum limit on investment size or constrain focus to a single fragile country could hinder the ability of a fund to identify suitable investments or diversify their risks.

The standard features of a 2/20 fund model with a 10-year life cycle are not optimized for private equity investment in FCS and are not well adapted to the needs of local companies. For instance, in a large fund a 2% management fee may adequately cover the costs of the needed investment professionals (IP). In other contexts, strategy, ticket and fund size may create very different requirements for management time and total investment professionals. As an example, our research showed the average large cap (~US$1 billion) fund has a ratio of 0.3 to 0.8 investments per investment professional, whereas the typical SME fund (< US$100 million) has more than three investments per professional. Put differently, large cap funds may have 10 times more investment professionals per portfolio company than small funds.

[23] Notes: A Adapted from Enclude's framework, "Transforming Agriculture by Linking Technical Assistance to Blended Finance: Trends and Lesson," August 2017; B GIIN, "Beyond Investment: The Power of Capacity-Building Support," October 2017; Additional sources: Stakeholder interviews; AAF TAF, "Reflection on the effectiveness of TA Facilities linked with investment funds;" The World Bank, " Private Equity and Venture Capital in SMEs in Developing Countries: The Role for Technical Assistance," April 2014.

Some SME funds seek more efficient monitoring through rigorously standardizing and enforcing reporting, or using debt-like instruments. Debt-like instruments also decrease the time and effort required to search for exit opportunities.

As management fees are easily measured and compared with funds in more developed markets, they can be a source of tension between LPs and GPs. One manager noted that a 0.25% increase in fee could be a major sticking point, even though they believed the need for additional staff to drive fund performance was clear. The management fee for small and fragile funds should not only be based on a simple % benchmark but also consider the strategy and desired impact of the fund.

Additionally, other incentives are often not aligned. Fund personnel in FCS may never see carry due to low net commercial returns (though potentially high development impact) and too high of a hurdle rate. If carry is low or unlikely, salary is the only incentive for GPs to recruit skilled professionals. Lower hurdle rates (i.e. 5%) or hybrid incentive schemes should be considered in FCS. In general, LPs and GPs should work together to ensure HR compensation policies are appropriate and meaningfully incentivize personnel, rather than being seen as promises that are unlikely to come to fruition.

It is possible, and advisable, to tailor the lifetime, economics, instruments, and strategy of a fund to suit the specific FCS context. Potential adaptations of the standard private equity model to fragile states include:

- Increase the fund's lifetime, on a conditional basis, to lower the pressure to disburse money and exit companies on artificial timelines (examples could include closed-end funds with more flexible periods such as 10+1+1+1+1+1, or 5+5+5, as well as permanent capital vehicles [PCVs]).
- Increase the spectrum of funds and consider being the anchor or sole LP (on a temporary basis) for unique fund strategies/structures.
- Encourage funds to use some portion of self-liquidating instruments, especially closed-end funds in countries with a limited secondary market.
- Invest in funds and/or non-bank financial institutions (NBFIs) with smaller tickets and shorter holding periods (one to two years), with the possibility to revolve several times to support working capital or trade finance.
- Explore funds that seek similar advantages to typical holding companies and PCVs: mutualizing services for portfolio companies, finding economies of scale along a value chain, and encouraging portfolio companies to contract with one another (subject to appropriate governance constraints).
- There are several examples of funds that started as classic funds and switched towards different structures:
  - During 2013-14, Maris switched from a fund to a holding company, via a simultaneous capital raise and transformation. Maris gave all LPs the opportunity to exit and those that did received an approximately 24% net IRR on their investment. The total value of exiting LPs was broadly matched by existing LPs investing additional funds. Since transformation to a holding company, Maris has been investing and operating its companies from that structure, and now has a bi-annual trading window for its shareholders where they can buy and sell among themselves or to new investors.
  - I&P decided to move towards evergreen funds for IPDEV2, which is a platform for local country investment vehicles. The ability to create open-ended local funds in FCS allows local GPs to potentially create more added value and long-term flexibility.

Several types of interventions can support risk capital entering fragile states

IFC SME Ventures has played a crucial role in developing the investment landscape in fragile states in SSA. The SME Ventures pilot programs established four funds between 2010 and 2015: two funds (the West African Venture Fund and the Central Africa SME Fund managed by XSML) in four SSA fragile states and two other funds in Asian fragile states. IFC SME Ventures was often the sole initial investor. FMO, Lundin Foundation, and Cordaid joined the Africa funds later with smaller, but important, commitments. IFC SME Ventures was catalytic in developing these first time funds and supporting them in building a track record and developing the investment ecosystem. IFC SME Ventures is now

entering the next phase of mobilizing other LPs to join IFC in follow-on investments. Funds such as African River Fund (XSML's follow-on fund), Oasis Africa Fund, and I&P Afrique Entrepreneurs 2 (IPAE 2) have already mobilized the majority of their capital from LPs beyond IFC.

In addition to the many GP/LP best practices and recommendations already discussed, below we briefly explore three additional but complementary angles to spur further risk capital into FCS: first, methods for attracting additional LPs and innovating on fund structure, second, a suite of shared services and toolboxes to support FCS GPs, and finally, country- or region-centric platforms to facilitate investment from a broad range of risk capital sources into a variety of FCS companies.

First, some types of LPs, such as family offices, are becoming more interested in fragile states, and existing LPs should encourage them while experimenting in parallel with more innovative structures. In FCS, the closed-end fund model has limitations due to the challenge of exiting during a certain time period, which can be partially overcome through alternative capital structures.[24] These models should be tested by LPs, while still continuing to support more traditional GP structures. For instance, CDC recently invested in Solon Capital Partners, a West African investment manager structured as a holding company. Additionally, the integration of commercial financing and concessional capital into blended finance vehicles can be catalytic. By impact-minded LPs taking first loss or subordinated capital positions, the appeal to risk-adverse LPs can increase, growing fund size, increasing economies of scale for the manager, and increasing fund impact.

Second, market enabling organizations can support comprehensive shared services and tailored toolboxes for GPs to ease their entry into FCS. This model is akin to some of what the impact investment firm Capria seeks to provide as a GP accelerator/seed vehicle. The goal should be to provide GPs with a ready-to-use toolbox that can lower the costs of setting up a fund in fragile regions and increase the chances of long-term success. The toolbox can include detailed recommendations on the legal structure, accounting systems, governance/reporting tools, pre-identified local service providers (including consultants, lawyers and accountants), lists of likely interested LPs, initial sector/pipeline information, potential to access bridge/warehouse financing, and/or subscription lines of credit to optimize liquidity management. Even after fund close, common services and knowledge exchange are often needed by multiple funds, such as access to international counsel or sub-sector specific expertise for similar companies, and these could be shared across several GPs.

Third, providing country or regional investment facilitation platforms can catalyze risk capital provision. While the 'fund set up in a box' model and associated services are GP-centric (and likely limited to a select set of funds), there is also an opportunity for interventions oriented around a specific country or region, and working with a broader range of potential investees and sources of risk capital. To support the origination process and provide regional risk capital providers with local knowledge and shared learnings, local investment facilitation platforms could be established.[25] These platforms are local or regional technical assistance hubs that, rather than just being linked to one fund, are neutral intermediaries to connect transactions to multiple potential capital sources. A country investment facilitation platform (entry, origination, and transaction support) can provide a set of tools to pool the costs of identifying and due diligencing transactions for local, regional, and international investors.[26] These transactions can be "shopped" to multiple risk capital providers, lowering their transaction costs and addressing the inherent information asymmetries between companies that have never taken outside capital and investors that may have never invested in the country.[27] Such a platform, based locally, could serve as a temporary catalyst to a more robust risk capital ecosystem and provide assistance to multiple GPs interested in the country.

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[24] Andrea Armeni with Miguel Ferreyra de Bone "Innovations in Financing Structures for Impact Enterprises: Spotlight on Latin America" Multilateral Investment Fund, Rockefeller Foundation, Transform Finance, 2017.

[25] See also description of "*Information and Networking-and-Oversight Hubs*" in "How to Scale up Responsible Investment and Promote Sustainable Peace in Fragile Environments", OECD, January 2018.

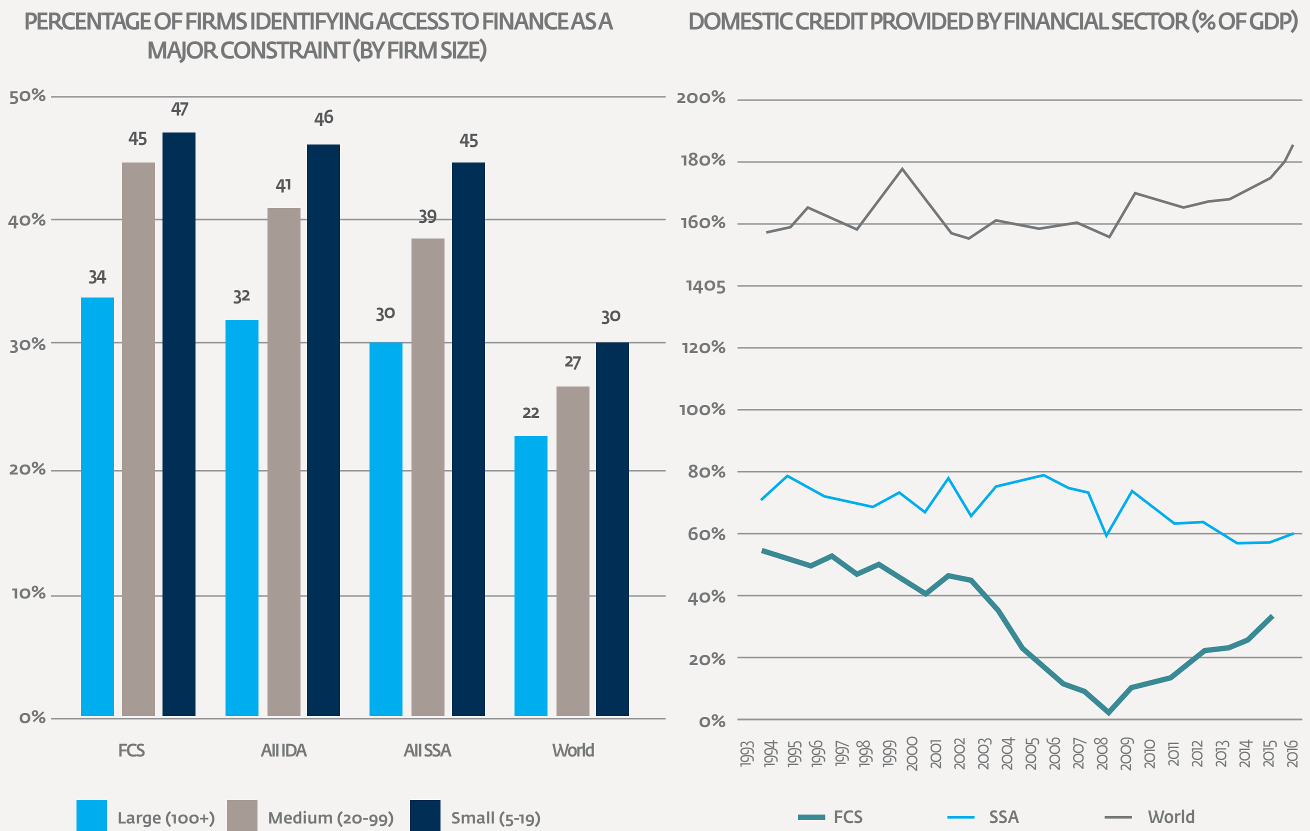
[26] Jake Cusack and Matt Tilleard, "Investment Facilitation in Transitional and Fragile States" CSIS, December 2013.

[27] "Investing in Africa's Small and Growing Businesses", Investisseurs et Partenaires, ANDE, EY, INSEAD, Tony Elumelu Foundation, 2016.

Conclusion

The need for risk capital in fragile states is stark — not just to finance potential high growth companies and drive inclusive economic expansion, but to increase resilience and buttress nascent state stability to benefit the country and the region. A skeptic might point to the mixed track record of fragile state funds and other intermediaries, and argue that private investment is impossible and that support activities should rather remain the preserve of pure donors. This conclusion would be short sighted. Many of the ultimately financed companies in fragile markets repeatedly noted they would have had 'no other financing' option and point to the jobs they have created, the social/consumer goods and services they have provided, and the benefits that have been created for the local economic ecosystem. While net returns that are fully commercial and risk adjusted may take a few iterations to achieve, supporting these funds provides an accountable, cost-effective, results-oriented, and inherently sustainable alternative to the purely grant-based initiatives that tend to dominate fragile state interventions. Moreover, the lessons learned and the incipient strategies discussed above are a foundation for a more adaptive risk capital approach to FCS that will continue to drive longer-term and more flexible investment into some of the world's most underserved markets.

FIGURE 10: SMES IN FCS ARE THE MOST AFFECTED BY LACK OF ACCESS TO FINANCE



Source: World Bank Data; Enterprise Survey.

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About IFC

IFC – a sister organization of the World Bank and member of the World Bank Group—is the largest global development institution focused on the private sector in emerging markets. We work with more than 2,000 businesses worldwide, using our capital, expertise, and influence to create markets and opportunities in the toughest areas of the world. In FY17, we delivered a record $19.3 billion in long-term financing for developing countries, leveraging the power of the private sector to help end poverty and boost shared prosperity.

About FCS Africa

IFC's Fragile and Conflict-affected Situations (FCS) Africa program was established in 2014 to support and help grow IFC's investment and advisory engagements in African FCS. The FCS Africa program was built on years of experiences of the Conflict Affected States in Africa Initiative (CASA), which was launched in 2008, funded by Ireland, the Netherlands, and Norway. CASA is a flagship program of the FCS Africa program and is currently active in 13 countries.

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