On the Frontiers of Finance
Investing in Sustainable SMEs in Emerging Markets

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1.1 Introduction

Small and medium enterprises (SMEs)\(^1\) are a critical component of vital economies. They play an important role in innovation, economic growth, employment creation, and the provision of goods and services to underserved communities, especially in rural areas. Sustainability oriented SMEs that work in environmental sectors or those that serve low-income communities generate additional benefits for society and the environment. Through its New Ventures Project, the World Resources Institute has promoted the creation and growth of such enterprises in emerging economies since 1999. With the sustainable enterprise sector gaining considerable momentum, we feel that it is timely to offer some scrutiny of our own experience from working with entrepreneurs and investors, as well as that of other practitioners in the sustainable SME finance sector. We teamed up with the Boston College Institute for Responsible Investment (IRI) to compile the information and provide it as a basis for discussion in this paper.

With the support of the UN Foundation the IRI convened two working groups of Sustainable SME funds during 2006. The purpose of these dialogues was to promote greater understanding of the impact of these funds and to identify ideas to overcome the challenges they face in achieving scale.

Much of this paper is informed by interviews we conducted with 20 fund managers that operate SME funds in emerging markets and developing countries, most of them focusing on sustainable SMEs. In addition we convened a group of these 17 fund managers at a workshop co-convened with the International Finance Corporation (IFC) in May 2007. An overview of the funds and their investment models is provided in section three and in a summary matrix in the annex.

The aim of this study is to provide an overview of the current landscape of sustainable SME finance, clarify key challenges, and inspire discussion among fund managers, investors, entrepreneurs, and the donor community. We see a clear demand for an action oriented dialogue on how the sustainable enterprise sector can best be supported to reach scale, attract additional finance and become more effective in meeting return expectations and development goals. We invite you to join this process and welcome your comments and feedback on this paper.

This paper is divided into five sections:

1. Our rationale for supporting sustainable SMEs;
2. A summary of the key issues in SME finance;

\(^1\) As a global orientation to define SMEs, the IFC established a metric in 2003 that defines a Small Enterprise between 5 and 49 employees, and a Medium Enterprise between 50 and 250 employees.
3. An overview of the VC funds and Capital Aggregators surveyed for this paper;
4. A discussion of these funds’ major challenges and innovative financing models;
5. Suggestions for bringing the sustainable enterprise finance sector to scale.

1.2 Why focus on sustainable SMEs?

The focus of this paper is “sustainable SMEs”, in particular sustainable SME finance. We define sustainable SMEs as companies that capitalize on commercial opportunities while generating environmental and social benefits as part of their core business. For example, these companies could be operating in the renewable energy, healthcare, organic agriculture and housing sectors. Through a series of interviews with leading practitioners, we have identified the financial structures that are being used to direct capital to sustainable SMEs in developing countries and emerging markets and analyzed key elements of their business models.

We believe that targeted investment in emerging economy sustainable SMEs makes good sense for both business and sustainable development. While this view is not uncontested, there are many arguments for targeted support to these SMEs that corrects market failures and allows these companies to realize their full potential to contribute to dynamic, healthy economies and societies. In addition, sustainable SMEs can make tremendous contributions to environmental protection, poverty alleviation, improved quality of life and also provide the innovation and role models required to chart out more sustainable models of economic development. The benefits provided by sustainable enterprise can be divided into three categories: ²

- Economic benefits: monetary benefits to target populations, such as increases in employment and wages; taxes paid; cost savings; enhancement of overall economic environment;
- Social benefits: improvements in the quality of life of the target populations;
- Environmental benefits: reduced energy and resources consumption; land and species conservation; improved air and water quality, among others.

Economic benefits

SMEs promote development and alleviate poverty by increasing competition and innovation and creating jobs. The development impact of jobs created by SMEs is noteworthy because they primarily employ local, low-skilled labor and make significant investments in training.³ SMEs also make important contributions to the formalization of the economy, by creating enterprises that pay taxes. Unlike microenterprises, which generally do not pay taxes, or some large firms, who have political power to avoid taxations, the tax contributions by SMEs can support the public sector as they generate private returns. In addition, the SME sector serves as a fundamental link in the supply chain between small-scale producers and urban, national, or export markets, and SMEs often operate in underdeveloped markets, especially in rural or impoverished urban areas that lack the infrastructure necessary to support larger scale public or business activity.

³ Small Enterprise Assistance Funds, 2005. The Development Impact of Small and Medium Enterprises: Lessons Learned from SEAF Investments. Washington, DC.
Those who question the effectiveness of SMEs as providers of economic benefits argue that larger firms exploit economies of scale and invest more in research and development. They further assert that SMEs are neither inherently more labor-intensive nor better at job creation, and thus do not provide additional poverty alleviation.4 However, our experience is that SMEs driven by local entrepreneurs can exploit market gaps and, given appropriate financing and business support, can become stable employers in the long term with the potential to grow into large enterprises and employers.5

<table>
<thead>
<tr>
<th>Selected arguments for and against SME development contributions</th>
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<tbody>
<tr>
<td><strong>Arguments for SME contributions to growth and poverty reduction</strong></td>
</tr>
<tr>
<td>○ Enhance competition and entrepreneurship, which increases the economy’s efficiency, innovation, and productivity growth.</td>
</tr>
<tr>
<td>○ Generate disproportionate share of new jobs, many of which engage low-income groups.</td>
</tr>
<tr>
<td>○ Support the formal economy, contribute to tax revenues, and often serve underdeveloped markets.</td>
</tr>
</tbody>
</table>

**Social benefits**

SMEs have a vested interest in contributing to the well-being of the communities they are a part of. They often invest in local education, health and infrastructure, and contribute to building social capital by supporting local initiatives and empowering women employees. In comparison to large firms, SMEs are also more likely to re-invest profits locally.

SMEs can turn their superior knowledge of local circumstances into a competitive advantage that benefits the community as well as the company. SMEs are in an advantageous position to understand market opportunities that address unmet needs in their communities, such as access to clean water, health services and housing. Similarly they are very suitable providers of products and services that empower poor people, such as microfinance or affordable telecommunications. Moreover, because of their understanding of local culture, SMEs are well positioned to

**Building opportunities for marginalized communities**

Fideos Coronilla is a Bolivian-based company that offers organic, gluten-free snacks made from traditional Andean grain. The company purchases the grains for its products from local farmers’ cooperatives, directly benefiting 6,800 farmers and their families. One of Coronilla’s inputs, the rare Andean grain cañawa, is grown in remote and isolated areas of the country. The population of these isolated regions belongs to the poorest of the poor in Bolivia and the sales to Coronilla are helping greatly in raising their living standards.

The company is also an important source of employment, training and education for the community. Coronilla provides employment and benefits, such as healthcare, milk subsidies and formal education, to more than 30 workers a high-proportion of which are low-skilled and female. The company contributes to a local educational organization, coordinates educational meetings on health and hygiene and sponsors a student award. As a result Coronilla’s employees are healthier than the average local worker and have increased the chances for their children to lead healthier and more productive lives.

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4 Beck et al.’s 2005 study of emerging economy SMEs fails to support the conclusion that SMEs exert a causal impact on long-run growth or poverty alleviation. However the study also falls short of showing any negative correlation. Beck, Thorstenl. 2005. “SMEs, Growth, and Poverty: Cross-Country Evidence” Journal of Economic Growth, 10(3), 199.
engage low-income communities as producers, for instance through support for agricultural co-operatives. Additionally, many SMEs engage in business that preserves and enhances local culture, such as arts and crafts, sustainable agriculture or forestry, and – if well managed – eco-tourism. The example of Fideos Coronilla highlights the difference a socially oriented company can make by engaging marginalized communities as employers, employing low skilled labor and providing critical benefits and support to the community.

Environmental benefits

SMEs that address environmental challenges primarily operate in the following sectors: clean technology, renewable energy and energy savings, organic agriculture, certified forestry, eco-tourism and green construction. The deterioration of ecosystems and their decreasing ability to provide natural resources and vital regulating services, such as the climate system and water cycles, is creating market opportunities for products and services that address these challenges. Some sectors such as renewable energy, and organic food products have already developed strong commercial potential in developed markets and are increasingly profitable in emerging economies. Sustainable SMEs tap into these opportunities, innovate locally oriented solutions to environmental challenges and drive the development of “green markets” that value environmental externalities.

Often, environmentally sound products are particularly relevant for developing country conditions. For example biomass, solar or wind energy can be well-suited to provide electricity in rural and off-grid communities and in the process reduce the unhealthy and environmentally damaging use of firewood and charcoal.

Section 2: Overview financial actors

2.1 Types of SME finance and financial actors

In well functioning financial systems, SMEs are able to access a range of financing options as their business grows. For example, a typical SME in the US will start with a combination of personal savings, contributions from friends and family, debt from banks and potentially start up funds from angel or venture capital investors. As their needs change, SMEs can access additional sources of capital, including trade finance/supplier credit, factoring, leasing arrangements, commercial debt, private equity (venture capital) and ultimately aim for an initial public offering to obtain further financing. Each of these

Transforming coffee supply chains
Richard Trubey and the rest of the team behind Solar Trade Corporation (STC) have created an innovative coffee drying system powered by biomass and solar energy that cuts nearly 90 percent of electricity and eliminates the use of firewood or diesel in coffee drying. STC is also offering hermetic storage systems that preserve the quality of dried coffee at origin and in transport. With its Café Solar® brand, STC aims to transform the coffee supply chain.

STC’s comprehensive approach gives local farmers the independence to dry and store their own coffee while providing a 34 percent production cost savings. STC is also using its low-emission system to capitalize on emerging opportunities in carbon-trading markets. The enterprise is working with the government of Honduras to set a goal of transitioning 1/3 of the country’s coffee production to solar power and design a carbon market for trading by producers. Farmers using the STC system will easily out-compete producers using conventional dryers that consume large amounts of increasingly expensive energy.

options brings firms into contact with different financial actors and the sources of capital that are best suited to different parts of the business cycle. The ability to graduate from one form of financing to the next is critical to the company’s success.

SMEs in developing countries typically operate in a less supportive environment. Often SMEs are too small for commercial lenders, and too big for microfinance institutions. Reasons for this situation are varied and include an incomplete financial institutional infrastructure, a lack of competition among local banks, restrictions on capital allocations by local investors, or macroeconomic policies that emphasize government debt. The lack of familiarity of banks with business opportunities in the SME sector, perceived risk, high transaction costs and asymmetrical information pose additional difficulties, compounded by lack of credit scoring mechanisms and experience with relationship lending – lending based on a close, long-term bank-borrower relationship.7 For providers of risk capital, the historically poor market for exit and low shareholder protection mechanisms are impediments to investment in developing countries.

Partnering with local banks: Shorebank, Shared Interest and Rio Bravo

ShoreCap International (a subsidiary of ShoreBank Corporation) invests in local banking institutions in developing countries. A key part of ShoreCap’s approach is to provide technical assistance to investee institutions through its affiliate ShoreCap Exchange. Such assistance can encompass a variety of institutional capacity building measures, including transfer of specialized micro and small business lending technologies, as well as more specific training on assessing the environmental risks associated with investments.

Shared Interest operates an open-ended, loan guarantee facility through a related entity in South Africa, Thembani International Guarantee Fund (Thembani). Guarantees are provided to businesses providing services to rural and underserved communities including micro-finance, low-cost housing, small manufacturing, retail businesses, and agriculture. Thembani works closely with local banks with a two-way referral service for clients. Thembani’s guarantees allow these businesses to access loans that would otherwise be unavailable which, in turn, exposes local banks to the SME sector creating opportunities for them to gain a better understanding of these customers.

Rio Bravo, a Brazilian investment firm, is partnering with a large Brazilian bank for a $125 million sustainability venture capital fund that is about to be launched for fundraising. The partnership will allow Rio Bravo access to the bank’s extensive network of commercial relationships across the country and the bank in turn will gain experience in the field of sustainability driven business.

This combination of factors creates few incentives for banks and other financiers to expand their products and services targeted at SMEs. The situation is particularly difficult in rural areas and product sectors in which most sustainable SMEs operate because there are high sunk costs and unproven markets with which to contend. The following diagram provides an indication of the restrictions on the supply of financial capital in developing countries as compared to developed markets.8

8 Graphic prepared by Marc de Sousa Shields, based on his extensive consulting experience assisting developing market SMEs. The diagram is intended to be illustrative of the experience of his firm Entreprising Solutions Global Consulting (http://esglobal.com/index.php)
2.2 The missing middle

The consequence of this market failure in the supply of capital to SMEs is a missing middle in the economic structures of developing countries, meaning that SME density drops below an efficient level and existing SMEs cannot realize their full potential to provide the attractive economic opportunities they could otherwise. The impact of this “missing middle” of SMEs is all the more acute when the relative contribution of SMEs to employment, innovation and as engines of economic growth are taken into account.

2.3 Growth of private equity in emerging markets

Although we have highlighted the restrictions on financing options for SMEs in developing countries, recent trends suggest that there is increasing interest among investors, both domestic and international, to place private equity investments in emerging markets. The foreign capital flows are driven by a number of factors, including the increasing allocations to alternative assets generally, greater understanding of the opportunities that emerging market firms present for investors, the existence of local co-investors which creates greater opportunities for exit or trade sale, and government policies that create improved financial stability. Attractive return prospects coupled with these improvements to the investment climate have led to substantial increases in flows of international capital to emerging market private equity funds. In 2006, private equity funds in emerging markets raised $33.2 billion in capital commitments. This represents a 29 percent increase over the $25.8 billion raised in 2005 and more than a 400 percent increase over the $6.5 billion raised in 2004. Moreover, a 2007 EMPEA survey of Limited Partner interest in emerging market private equity reveals promising trends. Just fewer than 80 percent of those interviewed expected to increase their commitments to emerging markets over the next three to five years.

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11 EMPEA is the Emerging Markets Private Equity Association founded in 2004, comprised primarily of private equity fund managers, but also includes institutional investors, service providers and others with an interest in the asset class.
In addition to increased international flows, in many emerging markets, there is also a growing pool of local capital that is seeking out alternative asset classes, including private equity. With changes to macroeconomic policy making government bonds less attractive and growing pools of local savings through shifts to pension policies, local institutional investors are looking for ways to maintain returns and diversify their portfolios. There is also growing awareness of the virtuous cycle that is created for economic development through well-functioning financial markets and the need to harness local savings to contribute to facilitate market development.

**Experience of the Small Enterprise Assistance Funds (SEAF) in Colombia and Peru**

SEAF has a long history of investing in SMEs and proving the market for SME financing. To establish a fund in Colombia and Peru, SEAF, with the support of USAID, worked closely with the governments of both countries to amend regulations that restricted the investment choices available to public pension funds. These restrictions did not permit private equity investment limiting the funds’ ability to diversify their portfolios.

SEAF tackled the problem with an integrated approach: The patient capital provided by USAID permitted SEAF to establish a fund administrator and build credibility in Colombia and Peru while it worked with the multiple regulators and the pension funds to identify the regulatory barriers, negotiate and draft the needed modifications and push the changes through the various levels of government. SEAF brought in experienced US venture capital and small business investors to make the case to the government and regulators, demonstrated its capacity to meet the transparency, valuation, fiscal control and reporting requirements for a regulated fund administrator and lined up a pipeline of potential investments. With a viable private equity investment vehicle and investment commitments from international development finance institutions such as SECO, BIO and USAID, the local governments had an incentive to approve the required regulatory amendments and the pension funds and insurance companies were ready to invest. The groundbreaking result was that, for the first time, pension funds and insurance companies were able to invest in private equity funds. As a result, SMEs in these countries were able to access regulated capital that had previously been off-limits. Opening the door to these new sources of capital is a critical piece of the development equation because it means that domestic resources can now be channeled toward helping the local economies grow.

### 2.4 A view on sustainable enterprise finance in China

For Chinese entrepreneur Chen He, one would think that finding financiers for her Tianjin Lotus Biological Technology Company would not be a problem. After all, the firm, which produces non-toxic seed fertilizers that strengthen crop growth while reducing the use of chemical fertilizers, has been doubling its revenues for each of the last three years with annual sales now topping 675,000 RMB. However, Chen He has not been so fortunate. “I have not received any loans or any private investment. The banks and venture capitalists say my company is too small and that I have too little collateral to justify the risks,” explained Chen He. With the exception of a 70,000 RMB municipal government grant, she has invested over close to 3 million RMB of her own money into the company since its founding in 2003.

Chen He’s predicament reflects the continued financing challenges of China’s SMEs, which number over 4.3 million firms and account for 60 percent of China’s GDP. Despite the country’s booming economy and the massive surges in foreign investment, SMEs still find it difficult to raise the necessary capital to build up their businesses. This situation is particularly evident for smaller businesses and those in new sectors, such as the green industries that are being promoted by the government to counter China’s worsening ecological conditions. Of the $420 million cleantech venture capital that was estimated by Clean Tech Venture Capital to be invested in China in 2006, very little made it into the hands of SME entrepreneurs, such as Chen Jing of the Jiangsu Ruikang Organic Food Corporation. With the help of some bank loans her small business has grown to a 10 million RMB gross revenue earning firm, but is still unable to attract venture capital investment. According to Chen Jing, the reason for her rejection is that the revenues are simply not big enough: “How can I grow without the investment? It’s like the old Chinese saying – having the horse run without feeding it grass!” When looking at potential firms, most venture capitalists use the benchmark of 50 million RMB in gross revenues, before taking a serious look at the growth potential of the business.

The reasons for SME’s financing struggle are not simply because of size. Stephen Guo is director of research at China Environment Fund (CEF), a fund that invests exclusively in Chinese green industries. According to Guo, venture capital investors are hesitant about the smaller companies because they often lack proven management and finance skills. “A lot of these businesses are run by people who are technical experts and not managers,” said Mr. Guo who meets as many as 80 firms a month.
To make matters even harder, China lacks a culture of angel investors, affluent individuals who are willing to front start-up costs during the difficult phase of setting up an enterprise. As a result, the remaining formal channels of capital for SMEs are the banks and government. But banks are reluctant about lending to the small businesses because of their little collateral and perceived inability to service their debt. Institutions that do loan require their borrowers to have their debt collateralized through credit guarantee centers, which can be extremely expensive. Ruikang Organic Food Corporation was only able to secure a 2 million RMB loan from the local bank after paying the credit guarantee center a fee of 500,000 RMB. Although this amount was later deducted from the principal borrowed, as a down payment it represents a prohibitive proportion of the capital requirements for many SMEs.

Liu Zheng, of the Shenyang SME Credit Guarantee Center noted that too many lenders inappropriately use the same measures of performance for smaller companies as they do for larger ones, and the risks are often overestimated. “For SMEs, non-financial factors are comparatively more important than the financial ones,” said Liu who uses the seven standards – character, ability, margin, purpose, amount, repayment, and insurance, when evaluating perspective clients. The center has provided guarantees for over 1,000 SME loans worth a total of 400 million RMB. Out of the total amount borrowed, bad debts accounted for less than .001 percent.

Fortunately, there is help. Organizations like the World Resources Institute’s New Ventures Program, which helps sustainable entrepreneurs improve their management and finance skills, while working with venture capitalists to invest in the more promising companies. The Chinese government is also trying to better the situation and reduce the bottlenecks of SME financing. Policies already implemented include a three-year business tax exemption for qualified SME credit guarantee centers. Another big boost has been the passage this year of a new property law, which should help SME collateralize their assets and secure bank financing.

What could be the biggest saving grace for sustainable SMEs is that China’s deteriorating environmental problems have created enormous demand for new technologies and services. Deutsche Bank projects environmental investments in China to grow annually by 16 percent and reach a cumulative USD230 billion by 2010. With the ability to develop niche and cutting edge products, smaller firms are in prime position to capture the demand that could lead them to financial success. “China’s environment needs all the help it can get. The more companies in the sector, the better it is for the environment,” observed CEF’s Guo. Indeed, the belief that they can make a positive contribution for China’s development is driving many of China’s small green entrepreneurs to overcome their struggles. “My product can really help farmers and protect the environment,” said Chen He of the Tianjin Lotus Biological Technology Company. “I know the problems I am facing now are only temporary!”

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**Section 3. Overview of existing funds & Capital Aggregators**

**3.1 Information gathering**

Recognizing the positive social and environmental impacts as well as the financial opportunities, that can be achieved through a vibrant sustainable SME sector, a number of innovative financial intermediaries are identifying ways to channel more capital to sustainable SMEs whether through direct investment or using other mechanisms to bridge the financing gap. Poor management is frequently cited as the principal reason for small business failure, with inadequate or ill-timed financing a close second. By providing access to the right sort of capital, at the right time, coupled with technical assistance and business development services, these funds are helping to create long-lasting businesses that have tangible environmental, social and economic impact.

In order to gain a better understanding of the ways that funds are overcoming the barriers to sustainable SME investment in emerging markets, we conducted 20 interviews with leading funds and convened 17 of them in a workshop with the IFC. The purpose of our interviews was to find out how the funds were structured and identify the challenges they

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are facing in bringing their operations to scale. In this section we provide a brief overview of the funds, while in the next we discuss their challenges.

The interviewed funds are listed below and further details about size, sector focus, funding sources and investment mechanisms are provided in the annex.

- Acumen Fund
- Axial Par
- Asia West Environment Fund III, Asia West
- China Environment Fund, Tsing Capital
- E+Co
- Econergy Clean Tech Fund, Econergy
- Environmental Investment Partners (Continental Wind Partners, European Investments & Partners)
- Evolution One Fund, Inspired Evolution Investment Management
- Fondo EcoEmpresas, The Nature Conservancy
- Grofin
- Photovoltaic Market Transformation Initiative, Impax and IT Power UK & India
- Rio Bravo Sustainability I
- Root Capital (formerly Ecologic Finance)
- Shared Interest
- Shorebank
- Small Enterprise Assistance Funds (SEAF)
- Southern African Cleantech & Sustainability Fund, Inspire South Africa
- Stratus VC III, The Stratus Group
- Triodos Renewable Energy for Development Fund, IT Power India
- Verde Ventures, Conservation International

**3.2 Characteristics of the funds examined**

The funds interviewed are all focused on investing in sustainable SMEs in emerging markets and developing countries. Some funds are based in country, while others are internationally based with local offices and investment teams. The range of different business models they represent can best be captured by looking at the two ends of the spectrum that emerged:

- Locally based venture capital funds that are realizing opportunities for financial and sustainability returns by targeting growth sectors such as cleantech and renewable energy (VC Funds).

- The second group we describe as “capital aggregators” - internationally based funds with a primary focus on creating positive economic, social, and environmental impact by supporting sustainable SMEs and generating financial returns for investors (Capital Aggregators).

We found that the local VC Funds tend to have higher levels of risk while the Capital Aggregators use a blended capital approach, combining capital from fully risk adjusted sources to softer mission-focused funds from donors (elaborated in section 4.2).
VC Funds tend to make investments of between $1 million and $5 million, putting them at the “medium” end of the SME spectrum. These funds are mostly structured as limited partnerships, and primarily target opportunities in growing environmental markets, such as renewable energy, energy efficiency, organic food products and new materials. In contrast, the Capital Aggregators tend to make investments between $20,000 to 1 million, using a variety of instruments from “standard” equity investments to straight debt, with a range of quasi-equity structures in between that permit the fund to participate in the upside of the portfolio company while being structured as a debt investment.

The returns generated also varies across funds, with the local VC Funds seeking market rate equity returns and the Capital Aggregators’ targets and performance ranging from preservation of the initial capital to market rate debt returns. For many funds, the local regulatory environment has a strong influence over the structure of their investments. In some cases creditors receive greater practical protections than shareholders, while in others it is the preference of the SME/entrepreneur to obtain debt rather than equity financing due to either cultural preferences or capacity to receive and manage an equity investment.

Some of the key features of these two groups are listed in the table below.

<table>
<thead>
<tr>
<th></th>
<th>VC Funds</th>
<th>Capital Aggregators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Size of fund (USD)</td>
<td>10-35 million (current fundraising up to 150m)</td>
<td>5-20 million per fund (NB some managers were operating multiple funds with up to $100 million in total assets).</td>
</tr>
<tr>
<td>Av. investment size (USD)</td>
<td>1-5 million; mostly medium sized companies</td>
<td>20,000 – 1 million</td>
</tr>
<tr>
<td>Investment model</td>
<td>VC model, equity investments and some convertible debt; seeking risk adjusted rates of returns; fund managed locally</td>
<td>Mix of debt &amp; equity; HQ often in US/EU; return expectations range from proving model to local interest rates</td>
</tr>
<tr>
<td>Funding model</td>
<td>Patient capital &amp; commercial investment; Early investors mostly family offices and development finance institutions, now increasingly local institutional investors</td>
<td>Combination of risk capital and soft donor funded capital; instruments include debt; promissory notes; partnership structures; private investment vehicles limited to accredited investors; combination of separately raised equity and debt pools</td>
</tr>
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The interviews and broader conversations also indicate significant growth in sustainable enterprise finance. Many of the VC Funds interviewed were either still in or had recently completed their fundraising phase. In Brazil alone, a new sustainability fund has just started investing and two more are being raised this year. Other players are emerging in Central America, two funds are raising capital in South Africa, and the pioneer in cleantech investment in China, the China Environment Fund (CEF), is raising its third fund, after completing two successful exits through IPO this year. CEF and Axial Par, the oldest VC Funds of those interviewed, were both capitalized by family offices while the more recent funds are targeting local institutional investors and international financial institutions, demonstrating the growing recognition of commercial opportunities in this space. And while the VC Funds have, to date, mostly focused on environmental companies, where the commercial opportunities are clearest, there are indications of a wave of commercial fund creation focusing on BOP business opportunities.

Similar growth is evident among the Capital Aggregators. While some of the older Capital
Aggregators have been operating funds since the early 1990s, many raised their first rounds of capital between 1998 and 2001. Currently, we are seeing existing players growing in size or raising follow-on funds, as well as number of new funds recently created, such as Agora Partnerships and Care Enterprise Partners. All funds have, in some form, combined capital with technical assistance and business development services. Although this model raises costs, it also helps to mitigate the risk of business failure. Further, almost all of the Capital Aggregators are engaged in some form of monitoring and evaluation of their economic, social and environmental impacts. These additional costs are both sources of challenges for the Capital Aggregators, and in some cases the VC Funds, which we outline in greater detail in the following section.

**Section 4 – Challenges**

**4.1 Introductory comments**

SME financing is a complicated business anywhere in the world, but the funds interviewed for this paper were up against an impressive range of challenges from a restrictive business environment, to the lack of a good project pipeline and supportive financial infrastructure to the trials of operating in sectors without a long track record. In the following section we will focus on three challenges cited as significant pieces of the sustainable SME fundraising puzzle by the fund managers interviewed: fundraising and coordination of blended capital; technical assistance to entrepreneurs; and monitoring and evaluation of economic, social and environmental benefits. In our view an analysis of these issues also provides a map for areas of intervention by mission driven investors and development institutions. Smart deployment of capital by investors and donors will go a long way in scaling sustainable SME finance and unlocking additional capital.

The Aspen Institute, Acumen Fund and Dalberg Global Development Advisors launched a “Private Sector in Development Initiative” in 2006 and have convened three meetings of key players in the sustainable SME sector in the US since then. The aim of the Initiative is to build a stronger “movement” around sustainable SME finance, mobilize additional capital and put the building blocks into place that will allow the sector to grow. The Initiative seeks to facilitate the right approaches, services and partnerships required to generate the deal flow, invest responsibly, measure effectively and ultimately build sustainable enterprises. WRI and IRI are part of this Initiative and will engage the other participants for further development of this research.

**4.2 Fundraising challenges**

Among the funds interviewed, there is a clear division between those funds seeking commercial risk capital and those coordinating and “blending” different types of capital spanning commercial capital to philanthropic grants. While some of the fundraising challenges identified are common to both groups, funds seeking blended capital had to overcome different, and some additional, obstacles in obtaining finance. More so than the VC Funds, they have to balance the tension between needing to prove the financial viability of the sustainable SME sector as an asset class and remaining focused on achieving positive non-financial (social, economic and environmental) impacts.

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14 The group’s development of shared metrics is outlined in section 4.3.
Increasing mainstream investor interest in sustainable SME financing

With private equity investment only recently starting to grow in many emerging markets, mainstream local investors are often not very familiar with this asset class. For example, in Brazil (one of the most vibrant equity markets of the regions included in the survey), only recently have investors needed to take on more risk and seek out alternative asset classes beyond government bonds in order to achieve high returns. In some cases, as shown with the example of SEAF in Colombia and Peru (see section 2.3), legislative intervention has been required to permit local investors to consider private equity as an investment opportunity and achieve greater portfolio diversity. Even in those regions where investors are becoming comfortable with private equity investment, there is a lack of familiarity with sustainable sectors. This creates an additional hurdle for funds focused on organic agriculture or renewable energy, for example, as some of these sectors demand a longer investment cycle than traditional venture capital and therefore require investors with longer time horizons and patient capital.

Perhaps the biggest challenge to fundraising identified by participants at the WRI-IFC workshop was proving that the sustainable SME sector can be profitable in the long term. Fund managers raised concerns about the difficulty in attracting international investors when they, themselves, had relatively short track records. This problem, shared with new entrants in developed markets, creates a dilemma for fund managers in that they need capital to create a pipeline and prove the viability of the sector, yet cannot raise the initial capital required to do so. In particular, upfront expenses to train local investment teams and to start creating a pipeline mean that without the support of patient capital - whether from individuals, foundations, or development finance institutions - it can be hard to achieve the scale needed to prove the model.

Challenges of blended capital

The core concept of blended capital is that it brings together investors seeking different rates of single, double or triple bottom line returns, from those seeking purely financial returns to those only interested in the social, environmental or economic impact. In essence, the softer capital operates as a “smart subsidy” for the Capital Aggregators and some VC Funds. These subsidies are justified as the interventions made by the funds help to rectify existing market failures and are made on a commercial basis at the SME level, helping to avoid moral hazard. Unsurprisingly, funds that use this approach feel a tension between maintaining a deal flow that generates attractive financial returns to some investors, while at the same time delivering the non-financial impacts sought by others.

Among the Capital Aggregators we interviewed, a number of different approaches are used in order to bring together different sources of capital.

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15 As set out in the UNCDF’s Blue Book on Inclusive Financial Sectors for Development, the four broad categories of “smart subsidies” are those that seek to overcome the financing gap for SMEs by:
   (1) improving risk mitigation opportunities;
   (2) fostering greater transparency among borrowers;
   (3) increasing efficiency and reducing costs thereby permitting scale; and
   (4) enhancing innovation among lenders.

Offering investors different levels of risk exposure. For example, creating different tranches within the fund or combining a range of different instruments to raise capital are ways to achieve this.

Examples of risk apportioning structures: E+Co and Root Capital

**E+Co**, a small scale clean energy fund, blends public and private capital via a range of instruments to meet its capital requirements. The primary investment vehicle is a managed account with a coherent set of investment guidelines, transparent governance and multiple options for investors, lenders and grantmakers, allowing for a layering of financial, social and environmental returns. This is supplemented with loans (issued as promissory notes) and donations, which covers costs such as business development services and monitoring and evaluation costs. E+Co has also established a subsidiary fund management corporation, E+Capital Latin America, and special purpose partnerships that more closely resemble traditional fund structures. E+Co Capital Latin America manages an Inter-American Development Bank sponsored fund in Central America, CAREC.

**Root Capital** provides short term and long term loans to producers in rural, low-income communities in Latin America, Africa and Asia. Using funds from socially minded investors, Root Capital seeks to prove that these environmentally-sustainable SMEs – such as organic coffee cooperatives, lead-free ceramics producers and ecotourism enterprises – are in fact bankable. To mitigate portfolio risk, Root Capital uses a three-way “factoring” model whereby the loans are guaranteed with future purchase contracts that the SMEs hold with buyers. Contributors to Root Capital’s capital pool include agricultural product importers, international coffee roasters, high-net worth individuals, foundations, religious institutions, and socially responsible investment firms. Some supporters are investors seeking a financial return while others are donors providing grant funding. Root Capital issues promissory notes to investors with interest rates averaging 2.6 percent over a 1-5 year period. In case of a loan default, Root Capital takes the first loss position, followed by their investors who share risk equally. Additionally, for certain Root Capital loans placed under a USAID Development Credit Authority (DCA) Guarantee, the U.S. government provides 50 percent risk sharing on the loan in case of default.

Raising funds explicitly for different purposes and maintaining capital in segregated funds for these purposes.

Segregated funds for blend capital: The Nature Conservancy and Grofin

The Nature Conservancy (TNC) established its Fondo EcoEmpresas as a separate entity, in which it co-invested alongside a group of partners including the Inter-American Development Bank (IADB)/Multilateral Investment Fund, Corporacion Andina de Fomento (Andean Regional Development Bank) and socially responsible investors. TNC purchased its shares with grant-based funds, which allowed a number of smaller donors to contribute to the venture, despite the minimum amount required for direct investment. The total committed risk capital of $5.2 million is supplemented by a separate technical assistance facility, managed through TNC. The technical assistance pool was provided on a grant basis by donors including the IADB, IFC/GEF, foundations, and TNC donors. Interestingly, TNC found that because of the tax benefits afforded by charitable contributions, many individuals preferred to support the venture by allowing TNC to purchase shares with their donations or by contributing to the technical assistance facility than by direct investment in the fund.

While Grofin, an African SME fund, does not find securing capital to be a problem, close attention is paid to the composition of the investor base for its funds. This involves balancing local and international investors as well as considering the non-financial benefits that some investors bring, for example multi-national companies who play a key role in pipeline development. Investors in Grofin’s funds include banks (50 percent), development finance institutions (18 percent), local currency investors (14 percent) and corporations (18 percent), who all participate on equal terms. In order to supplement these equity contributions, Grofin has special co-finance arrangements with local banks whereby a predetermined pool of capital is available to make loans to portfolio companies. Co-finance arrangements are done on the same risk-reward basis as fund capital and Grofin is responsible for administering the pool.
Communicating the nuances of these blended capital structures and maintaining them present significant challenges to the Capital Aggregators, with even the most flexible types of capital coming at a cost. The two issues we focus on here are:

- Difficulties in explaining the concept of blended capital and ensuring transparency around the use of “smart subsidies”.
- High transaction costs associated with coordinating different types of capital due to timeframes, the “fundraising treadmill” and priority areas for different organizations.

*Explaining concept of blended capital and ensuring transparency*

As the idea of blended capital and applying commercial solutions to development problems is still a relatively new innovation, many Capital Aggregators reported difficulty in communicating the benefits and nuances of their approaches to potential investors and donors. In particular, this related to justifying the use of “smart subsidy” in order to preserve returns for commercial parties.

We do not suggest that the application of “smart subsidies” by these funds is inconsistent with best practice. Rather, we emphasize that a key feature of best practice that we identified among fund managers was transparency around their structure and the application of the smart subsidies. There must be understanding of the risks and costs associated with achieving scale in order for the existing funds to play their role of proving the model of sustainable SME finance and encouraging new entrants and investors.

*High transaction costs associated with capital coordination*

Many fund managers observed that considerable time is required in order to obtain different types of capital. Given the relatively small amounts that are being asked of different donors, a disproportionate amount of staff time and resources are required to bring funds to scale. Many funds noted that a more streamlined fundraising process would allow them to focus more time and resources on assisting entrepreneurs and making investments. The difference in the grant funding process (cyclical) and the investment process (ongoing) poses an additional coordination challenge. Funds also noted the need to tailor their pitch so that the social, environmental and economic impacts were both broadly defined to capture a wide audience, but still specific enough to attract those funders that would take the riskier positions in the funds on the basis of the high non-financial returns.

The complicated timing for philanthropic grants can affect the funds ability to provide ongoing technical assistance. For example, Capital Aggregators were concerned that the cycle for SME finance – the shortest of which is ten years – was far longer than the typical program cycles for grant-making institutions. As these grants often fund key components of the funds’ pipeline development, due diligence and risk management processes, they are a critical ingredient for financial success over the term of the fund.

Funds also reported a tension created by the additional costs associated with achieving the social, environmental and economic impact that are required to attract grants both in terms of pipeline development and ongoing technical assistance. In particular, maintaining a focus on those businesses most affected by the financing gap can increase the risk exposure

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of the fund without commensurate increases to potential financial returns. Thus it is important for funds to identify investors and donors that prioritize the non-financial returns, in order to maintain their focus on those sustainable SMEs most in need of financing.

4.3 Monitoring and evaluation

For most of the funds with an explicit focus on sustainable enterprise, the proof of positive environmental and social impacts is key to fulfilling their own mission as well as attracting capital from mission-driven investors. At the same time, monitoring and evaluation is a complex, costly and time-intensive undertaking for a fund. The following section provides a short discussion of the rationale for monitoring and evaluation, the challenges of implementation, examples of current practice, as well as opportunities to move forward with a sector-wide approach.

The key reasons to tackle the monitoring and evaluation challenge can be summarized as follows:

- Understanding, quantifying and monitoring social and/or environmental impacts of its investment activities is essential to fulfilling a sustainability fund’s mandate, and the information is critical for strategic planning and maximizing impact;
- Credible demonstration of positive development impacts helps attract capital from governments and foundations;\(^{17}\)
- A methodology for capturing non-financial aspects of a company can reduce the cost of due diligence, contribute to risk management and to the strategic positioning of the portfolio company.

**Environmental impact tracking paves the way for additional financing**

E+Co, an investor in clean energy enterprises, has a comprehensive indicators matrix for monitoring both environmental and social goals and impacts and has dedicated staff for this in headquarters and field offices. The information E+Co is gathering with its monitoring and evaluation system was useful when the fund started facilitating the sale of carbon offsets for selected companies in its portfolio. E+Co estimates that 80 percent of the required information needed to monetize the carbon value of its investees companies is already collected through their ongoing monitoring and evaluation. This places E+Co in a unique opportunity to access international carbon markets for the benefit of companies in Africa, Asia and Latin America who might otherwise never see financial return from their carbon emission reductions.

Many of the funds interviewed are measuring and reporting on the social and environmental impacts of their investments. In particular, the Capital Aggregators note that the demand for monitoring and evaluation of social and environmental impact is driven by their investors, which is reflected in the more systematic approaches to monitoring and reporting of these funds as opposed to the VC Funds whose investors are generally less concerned with comprehensive proof of non-financial impacts.

**Implementation challenges**

While the benefits of monitoring and evaluation are compelling, the challenges of implementation are daunting. Starting with the selection of the right indicators to the entrepreneur’s capacity to generate meaningful data and the costliness of such an undertaking, the barriers to developing and implementing monitoring systems are

- \(^{17}\) Commercial investors seem less concerned with rigorous proof of non-financial benefits at this point, but this may change as the sustainable investment space becomes more competitive and the credible demonstration of sustainability impacts becomes a competitive advantage.
considerable. In a practical context, there is an inherent tension between credibility and feasibility of a monitoring and evaluation system. The right balance - comprehensive without being cost-prohibitive - is hard to strike. The question is what a monitoring and evaluation system could look like that is cost-effective, scaleable across different sectors and funding models, and still generates meaningful information.

What to measure?

Monitoring and evaluation starts with the question of what to measure. Taking economic, social and environmental impacts as the three main categories of non-financial performance, there is a need to recognize the different challenges for each of these categories. While socio-economic benefits can be relatively easy to measure, environmental and social impacts present greater challenges. Many environmental impacts are quantifiable and, in some cases, where accepted market values such as the trading price for carbon emissions credits exist, they can even be monetized. Others, such as ecosystem change, involve complex science and even in purely qualitative terms, are difficult to convey to a non-expert audience. Social benefits related to quality of life or changes in government policy are equally difficult to capture and are this point mostly reported upon qualitatively.

How to measure?

Precise measurements for impact evaluation, including control groups, and external assurance, is not a realistic expectation for SME monitoring. However, any assumptions used to arrive at conclusions about impact need to be transparent and plausible. The critical elements of the impact chain are outputs (results of activities, such the sale of x-number of biomass cookstoves), outcomes (the change achieved, such as saved fuelwood and improved health), and impacts (the change occurring as a result of the investment). The difficulty of establishing causation has led most funds to track outputs as a proxy for quantitative measures of impact, and to complement this reporting with a narrative description of less tangible outcomes of an investment.18

Examples of Acumen Fund’s quantitative social impact measures:
- Over 3,500 squatters in safe, legal housing
- Over 12,000 new women clients borrowing for sustainable livelihoods
- A bednet that costs $7 is protecting more than 6,000,000 Tanzanians from Malaria for five years.
- More than 100,000 rural villagers in India with access to safe, affordable water from community water systems
- Poor farmers with dramatically increased incomes from the more than 80,000 drip irrigation systems sold in India

Who is measuring?

Measurements can be made by entrepreneurs themselves, the fund managers who have invested in them, or third parties.19 The least costly approach is to have portfolio companies periodically provide data to the investor in preformatted templates. However, the capacity of many entrepreneurs to provide data that goes beyond simple indicators is limited. SMEs, especially in the start-up phase have a range of urgent priorities around financing and basic

business operations that make it difficult to spend time on impact monitoring. Significant involvement of the fund manager or a third party in capacity building and additional investment into monitoring systems may be required to put the entrepreneur in a position to report reliable information independently. New Ventures is building capacity for self-reporting of sustainability impacts among a pilot group of ten entrepreneurs as described in the box below.

**Sustainability reporting for SMEs**

**New Ventures** is piloting a sustainability reporting project with a group of ten sustainability focused SMEs in Brazil, Mexico, China, India and Indonesia. Consultants are working with each company to develop a small sustainability report based on the guidelines for SME reporting by the Global Reporting Initiative. Each report covers 6-8 economic, social and environmental indicators, as well as the company’s vision and policy regarding sustainability. The reports, as well as an analysis of the process will be published in early 2008. It is already apparent, though, that the process is a significant learning experience for the participating entrepreneurs. Despite many challenges, some of them still unresolved, we have already received feedback about the usefulness of this report for marketing, and for conversations with potential investors or buyers with environmental and social standards.

A more time-intensive and costly approach is to send fund representatives into the field to work with the entrepreneur to collect or certify the data and to improve the business’ record-keeping. These field representatives visit the portfolio companies, conduct interviews with employees and other stakeholders, and thus develop a more complete picture of outcomes and impacts. In practice, a mix of self-reporting and technical assistance from the fund manager is often required.

Finally, third-party research studies can be used to develop an in-depth analysis of the non-financial impacts of investment activities. Because of the high cost associated with such an approach, it tends to be used in situations where significant grant funding is available. The approach does not offer itself as an option for widespread monitoring and evaluation, though it may offer a path towards developing a coherent and partially replicable system of measurement.

**Who pays?**

Even without using comprehensive third party studies, many funds that systematically monitor impacts rely on grant funding to finance the additional cost. SEAF distinguished itself by conducting comprehensive impact assessments of 18 portfolio companies in two separate studies, with funding by three bilateral donors and one foundation as described in the box below.

**The development impact of SMEs: Lessons learned from SEAF investments**

SEAF’s impact assessment used a case study approach to analyze the impacts of 18 investee companies from Eastern Europe, Latin America and Asia. Based on IFC methodology, the study measured the incremental effects of each investment over time on stakeholders, such as investors, employees, customers, suppliers, local communities and others. SEAF concluded that every dollar invested in these SMEs generates, on average, an additional 12 dollars in the local economy.

It took SEAF over a year to develop the impact assessment and two full-time staff to develop and implement it for the first ten companies. Another year was spent on the second phase study that added eight more companies and implemented a data survey of 30 additional companies. Some of the lessons learned include that training internal staff as well as the entrepreneurs is critical for success, but time consuming.

The results of the impact assessment are available on SEAF’s website. Beyond the direct analysis of the information, SEAF reports that entrepreneurs and in-country staff felt that completing the impact assessment allowed them to think about development issues as they related to their companies and that it was interesting.

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Among sustainability funds operated by commercial investment management firms, monitoring of extra-financial impacts is less common, though not entirely unusual. This is in part due to a different mandate with stronger emphasis on financial returns, and in part to stricter cost control at the fund level. While several funds have systems in place to monitor very basic environmental and social information, the Brazilian Fund Axial Par stands out for its comprehensive, self-financed monitoring.

Axial Par raises the bar for impact monitoring of venture capital investments
Axial Par, within its team of five, has a dedicated staff person who works with investees to monitor employment generated, biodiversity preservation, creation of industry clusters, development impacts, output/input ratios, product cycles and other indicators. Axial Par uses the Natural Step method for the establishment of benchmarks and the Global Reporting Initiative Guidelines to guide investee companies towards self-reporting on sustainability performance, as well as pursuing independent verification. To date, Axial Par has been able to provide this assistance without external funding.

Moving forward
Currently, the majority of Capital Aggregators and many venture capital funds conduct some kind of impact monitoring and many of them have invested significant time and capital into systems development, staff training and technical assistance to entrepreneurs. Most funds have ambitions to further improve their systems, and new entrants, even in the commercial space, seem to have relatively ambitious goals for impact monitoring.

However, the current situation - where most funds are currently using a home-grown system with different methodologies and indicators - is creating significant inefficiencies. Entrepreneurs may have to comply with varying reporting requirements, and it is virtually impossible to make any meaningful comparison of impacts across different funds. At the same time, intermediaries themselves feel the lack of common standards as they often face a range of different demands from their investors regarding the type and detail of information required. See the box about International Financial Institutions’ development indicators below for a description of a harmonization initiative among these institutions.

Despite the investments already made, many funds and investors agree on the need for standardization, or at least harmonization of what should be measured, who should measure it, and how to verify the information. Not only would it reduce transaction costs, it would also help the sector aggregate data in meaningful quantities and start establishing a basis for comparison of investments.²¹

Acumen Fund, the Aspen Institute and Dalberg Global Development Advisors have facilitated discussions to build consensus among key practitioners toward a common framework, a set of baseline metrics and comparable approach to financial and non-financial accounting. A common metrics platform would encompass capital providers, intermediaries, and enterprises. While no definite list of indicators has yet been established, there is convergence around metrics such as jobs created, wage growth, revenue growth,

number of customers served, local suppliers supported, total “base of the pyramid”
providers, and others. Additional metrics could include additional finance mobilized,
quality of data, comparable charitable impact, and carbon offsets. Acumen Fund and
Google.org are in the early stages of working together to make an on-line portfolio
management data system available to other practitioners in the field to support this
initiative.

<table>
<thead>
<tr>
<th>International Financial Institutions (IFIs) harmonize core development indicators</th>
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</table>
| An IFI working group on Private Equity Funds has started to address monitoring inefficiencies by agreeing
  upon a set of development indicators with common definitions and consistent tracking methods. The four
  core indicators - internal rate of return, employment at investee companies, compliance with international
  environmental and social standards, and compliance with core labor standards – are complemented by 21
  optional indicators that cover economic, social, environmental governance, capital markets and private
  enterprise metrics. The indicators and methodology will be published 22 to support fund managers in tracking
  positive development effects of their investments, harmonize the IFI assessment of development effects of
  private equity financing, and create data-bases calculated according to a harmonized methodology. |

Broad agreement on a set of basic, easily measurable indicators would certainly be a
significant step forward. Further to these, sector specific indicators around environmental
and social impacts could be developed collaboratively by specialized funds. This would
eventually give rise to an evolving list of optional indicators. While every fund may only
monitor and report on a small selection of indicators, the aim would be to achieve
agreement among key players on what and how to measure for a specific sector.

4.4 Technical assistance

In most emerging markets and
developing countries the number of
investment-ready projects is very
limited. SMEs in developed countries
have a wealth of resources that assist
them in steering their businesses on the
most effective path. As these support
services for entrepreneurs are lacking or
insufficient in most developing
countries, it is often the financiers that
fill this gap with extensive support to the
entrepreneur, ranging from accounting to
marketing and business strategy. Often
technical assistance is required from
very early stages, including for the
identification of potential projects,
feasibility and technical studies and for
making business ideas presentable and
bankable.

All funds interviewed provide some type of technical assistance and business development
to their portfolio companies. In the case of the VC Funds this is primarily the involvement
in strategic planning and management typical of VC investors, but often also includes
working with companies prior to investment to get them to investment grade. For the

Examples of areas covered by technical assistance

Financial literacy: After years of providing financial
education and management training on an as-needed
basis during the due diligence process, Root Capital
launched Root Capacity, a formal financial education
program, in 2006. The program, supported with grant
funding from the MIF/IDB and private donors, aims
to strengthen the loan applicant pool and prepare rural
SMEs to obtain financing from mainstream banks.

Strengthening local providers and creating clusters: Verde Ventures, a fund focused on biodiversity
conservation, obtained a grant to increase the local
availability of technical assistance from third party
providers, for example accountants or marketing
consultants. Verde Ventures also works with other
business development providers, such as Technoserve,
which allows the fund to complement its own
technical assistance, which includes building
industries around SME value chains, for example
supporting local jewelry and craft manufacturers in
eco-tourism areas.

22 The indicators library will be hosted at http://www.empea.net/research-information/empea-research-surveys/
Capital Aggregators, support before the investment is even more common. For many of them technical assistance is a key part of the due diligence process as this allows the fund manager to assess the viability of the business and the entrepreneurs (E+Co, Grofin). Other Capital Aggregators focus on strengthening their investees’ operations and facilitating access to international supply chains (eg Root Capital, Verde Ventures, EcoEmpresas). Especially the funds focused on clean energy provide assistance focused on technical knowledge and the specific market (E+Co, Econergy Cleantech Fund, Continental Wind Partners). The costs associated with these services in many cases impacts net returns to investors.

**Covering costs**

Technical assistance costs can take up 10-30 percent of the investment depending on the region and project size. Econergy’s CleanTech Fund, which invests in small scale renewable energy projects and alternative technologies in Latin America, needed one to two years of ground work before starting to make its investments. The fund managers need to work with most projects to get them to the advanced stage of development, until they reached “investment grade” status and when they were able to invest. Without technical assistance, only one or two in 40 projects that apply for funding would be considered investment grade.

Many of the Capital Aggregators use grant money or soft capital, to cover technical assistance costs, while most funds operating with a venture capital approach cover this support with their management fee. Some felt, though, that it was critical that the SMEs themselves were required to contribute to the cost in order to ensure the services were valued. For example Grofin and SEAF charge for the tailor-made business development services they provide. This helps to recoup a part of the cost of providing these services and also ensures that the entrepreneur is invested in the process by attaching a value to the assistance received.

Sometimes the costs of technical assistance can be lowered by investing in an entrepreneur across different growth stages or bundling the assistance with paid-for business development services. Some funds are also beginning to look more intensively for co-investment opportunities, as this may allow them to leverage the experience and insights of different investors, including sharing of due diligence cost. Nonetheless, the fundraising for grants to cover the much-needed technical assistance means additional effort on the part of the fund manager and many cite the lack of technical assistance funds as a significant challenge. Although many in the development community talk about the need to integrate TA funding with investment capital, to date, it has not been the norm for the same international financial institutions to both invest in a fund and provide TA alongside. This has led to the inefficiencies that fund managers describe in the fundraising process.

**Local fund management capacity challenges**

In addition to the lack of entrepreneurial capacity, in many countries private equity/venture capital is a relatively young sector and there are few individuals with the training and experience required for professional fund management. Especially institutions with a large number of funds in different countries, such as Grofin in Africa and SEAF throughout Eastern Europe, South America, Africa and Asia, cite hiring, training and retaining local staff as one of their principal challenges. The Capital Aggregators agree that investors need to recognize the need to support internal capacity building at the fund level in order to bring the sector to scale.
5. Conclusions

Sustainable SMEs that offer economic, social and environmental benefits need to be part of any long-term sustainable development strategy for emerging economies and developing countries. These businesses provide employment, link rural communities to markets, stimulate entrepreneurship and innovation, and have the potential to contribute to poverty alleviation and environmental protection. However, for sustainable SMEs to realize their potential and provide positive societal impacts, they need to be able to access the right type of capital at the right time throughout the business cycle.

However, despite the increasing flows of foreign investment to developing countries, sustainable SMEs continue to fall into a financing gap – both because of their size and a lack of understanding of their specific financing needs. The availability of financial resources is not the main barrier, but rather it is the ineffective deployment of these that creates this financing gap.

Innovations in financial mechanisms and investment practices can address this issue while also providing attractive triple bottom line returns to investors. Several funds are already proving the viability of sustainable SME finance and the commercial markets for these companies are growing. However, as this paper has identified, a number of challenges still exist that prevent the sector from reaching scale at the pace needed to address urgent global issues. Prominent among these are: the existence of a ‘financing gap’; high transaction costs; and a lack of coordination and standardization among current investors.

In our view, the positive externalities of sustainable SME investments may justify the use of smart subsidies in these areas, whether as grants for technical assistance and business development services or below-market rate financial returns. We believe that this approach could significantly increase the financing options available to sustainable SMEs. Scaling up in sustainable SME finance could lead to a tipping point where relevant information becomes more widespread, due diligence costs are reduced, and co-investment opportunities help to mitigate risk, particularly for new players.

Moving forward, we believe that efforts should focus on:

**Greater collaboration between aggregators, VC funds and local banks**

Better coordination and networking between aggregators, local VC funds and banks would provide opportunities for co-investment and pipeline sharing. Feedback from the WRI-IFC workshop indicates that there is significant interest in collaboration, but limited opportunities to do so, particularly across different countries and regions. In addition some aggregators report that collaboration with local banks has been critical to the success of their model.

**Improved coordination and effectiveness of blended capital**

A better understanding of blended capital requirements is needed to fully tap into the potential of this fundraising approach. On the part of the intermediaries, particularly the aggregators, this requires transparency in blended capital accounting. Investors and donors, in turn, need to be educated about blended capital models and then called upon to help improve the coordination of different types of capital and reduce the related transaction costs.

Clarity around the different components of blended capital would allow for more targeted allocation of capital. The participation of different players such as development banks, foundations, commercial investors, and national and international aid agencies needs to be orchestrated in a way that maximizes the effectiveness of the different types of capital
they each can provide: grant funding for technical assistance and business development services; public or philanthropic patient and risk capital; and private sector risk capital.

**Harmonization of monitoring and evaluation**

The lack of standardization in monitoring and evaluation approaches is creating major inefficiencies across the sector. A common methodology and a library of shared metrics would greatly enhance transparency and comparability, reduce transaction cost, and allow for a better understanding of the positive social and environmental impacts of sustainable SMEs. Ultimately, VC funds should also be engaged in these efforts, so as to work towards an approach that can be adapted to a variety of financing models, including return driven funds. A commonly accepted approach may also allow fund managers to satisfy a broader number of investors and donors with one reporting template.

Today’s world is the richest it has ever been. Global GDP (PPP) is up to $66 trillion (2006 est.), yet 4 billion people are unable to benefit from this growing wealth and continue to struggle in a cycle of poverty. A financial system that prioritizes short term gains leads to overexploitation of natural resources and is undermining nature’s regulating services that are vital for life on this planet.

Given the right support, sustainable SMEs can be critical actors in building more inclusive economies with a vibrant, innovative private sector that provides smart business solutions to environmental and poverty challenges.

This paper aims to stimulate a greater dialogue among stakeholders and private and public sector leaders. It will be reviewed by a group of stakeholders, revised and released in Spring 2008. We welcome all comments and questions. Please send yours to Mareike Hussels at mhussels@wri.org.
### Annex – Funds Interviewed

<table>
<thead>
<tr>
<th>Name</th>
<th>Region</th>
<th>Sector Focus</th>
<th>Year</th>
<th>Size (USD)</th>
<th>Type of Capital</th>
<th>Type of Inv</th>
<th>Avg Inv Size</th>
<th>ROI / IRR</th>
<th>TA</th>
<th>M&amp;E</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEAF</td>
<td>Central &amp; Eastern Europe, LA, Asia.</td>
<td>SMEs, some funds have more specific focus</td>
<td>1989 (CARE); 1995 as indep. inst</td>
<td>$8.5-30m per fund; $180m AUM in 17 funds (Sept 2007); 400m AUM since 1989.</td>
<td>DFIs, local SME support org.; SRI; local institutional investors; development agencies; foundations.</td>
<td>Risk capital fund (typically equity; also mezzanine and debt financing)</td>
<td>$1-2m in earlier funds; now up to $5m.</td>
<td>Net IRR to the investors is in high teens.</td>
<td>TA as part of fund management/investment relationship; some via dedicated TA facilities. Includes strategic/operations assistance, BDS; market research; networking; education &amp; training</td>
<td>Ongoing monitoring; Comprehensive development impact case study reports in 2004 and 2007 (economic return per $ invested). Portfolio-wide dev impact survey on annual basis. Ongoing monitoring.</td>
</tr>
<tr>
<td>E+Co (incl. E+Co Capital Latin America “CAREC”)</td>
<td>Africa, Asia, L.A.</td>
<td>Clean energy production and use</td>
<td>2019</td>
<td>$180m, 'evergreen' facility</td>
<td>DFIs, SRI, Private Investors, Foundations, gov. agencies, religious groups.</td>
<td>Mostly debt, with a few equity examples</td>
<td>$50K-$1m; $150K avg (seed cap. focus). CAREC – $1.5m.</td>
<td>Rate after write-offs (ex TA &amp; services): 8.3% (Debt), 6.6% (Eq); CAREC – 10% (Eq); 7.5% (Debt)</td>
<td>Wide range of basic mgmt and financial skills, strategy and clean energy markets. Carbon monetization</td>
<td>Comprehensive TBL scorecard incl: access to energy, efficiency gains; dirty fuel replic; 3 party $ leveraged</td>
</tr>
<tr>
<td>Photovoltaic Market Transformation Initiative (Impax and IT Power)</td>
<td>India, Kenya and Morocco</td>
<td>Photovoltaic retail and market development</td>
<td>2008</td>
<td>$35m</td>
<td>DFI</td>
<td>Loans, equity, guarantee funds</td>
<td>$1-1.75m (varies from country to country)</td>
<td>TA varies across countries; services include technical capability, mgmt, business plan dev.</td>
<td>TA as part of fund management/investment relationship; some via dedicated TA facilities. Includes strategic/operations assistance, BDS; market research; networking; education &amp; training</td>
<td>Technical indicators developed in conjunction with IFC and additional impact research by IFC</td>
</tr>
<tr>
<td>Root Capital (formerly EcoLogic Finance)</td>
<td>LA, Africa and Asia</td>
<td>SMEs working in sust. ag., wild-harvested products, handicrafts, certified fisheries, eco-tourism</td>
<td>1999</td>
<td>$18 m</td>
<td>Debt &amp; grant capital from SRIs, DFIs, individuals, foundations (PRIs), corpor., religious groups.</td>
<td>Short term debt secured against purchase agts; long term debt secured against fixed assets.</td>
<td>$25,000-750,000; avg 180,000</td>
<td>Covering 80% of operating cost</td>
<td>Financial education (grant funded)</td>
<td>Not systematically</td>
</tr>
<tr>
<td>Verde Ventures (Conservation International)</td>
<td>High biodiversity risk regions. Current: LA, Africa, Asia.</td>
<td>Biodiversity impact: biodiversity hot spots; high biodiversity wilderness areas; marine priority areas</td>
<td>2000</td>
<td>$6.75m</td>
<td>Loans from corporation, DFIs, foundations, donors.</td>
<td>Primarily debt (with quasi-eq structure). Consider partial eq. Security vs future cash flows</td>
<td>$30,000 - 500,000</td>
<td>Target 8% IRR incl all operating costs. Investors receive 2.5-5% interest on loans.</td>
<td>Directly and through others (TechnoServe) Build industries around investment. Grant funded TA for early stage SMEs.</td>
<td>TBL impact env (Hectares/species preserved); fin &amp; soc (total beneficiaries). IFC grant for monitoring program.</td>
</tr>
<tr>
<td>EcoEmpresas (The Nature Conservancy)</td>
<td>LA &amp; Caribbean.</td>
<td>Consv. impact. Sust. Ag, aquaculture, forestry, ecotourism, non-timber forestry.</td>
<td>2000</td>
<td>$6.4m risk capital + $3.5m TA facility.</td>
<td>DFIs, SRI, TNC. Grants from DFIs; foundations, TNC. donors.</td>
<td>80% debt; 20% equity; 19% debt &amp; eq 14% eq as interest exp.</td>
<td>$325,000</td>
<td>Projected IRR 1% (net of op costs); Gross IRR 11%</td>
<td>Separate TA facility. Fund pays 3% fee for BDS.</td>
<td>Since inception using fact sheet, scorecard, comp. specific follow-ups, local TNC staff verify reports</td>
</tr>
<tr>
<td>Triodos Ren. Energy for Dev. Fund (IT Power India)</td>
<td>South East Asia</td>
<td>Broad renewable energy focus</td>
<td>2000</td>
<td>3.5m</td>
<td>Solar Developm. Corporation, Triodos Bank</td>
<td>Loans and preferred stocks</td>
<td>$100,000</td>
<td>Technical assistance covered by mngt fee</td>
<td>Not systematically</td>
<td></td>
</tr>
<tr>
<td>Acumen Fund</td>
<td>South Asia and Africa</td>
<td>Businesses serving BoP across 4 sectors: water, healthcare, housing and energy.</td>
<td>2001</td>
<td>$20m</td>
<td>Donations from corporations; foundations; individuals.</td>
<td>Primarily debt, but moving towards more equity.</td>
<td>$500,000-750,000</td>
<td>Revolving fund. For debt, the aim is 10%; for equity aim is debt like returns.</td>
<td>TA in design, marketing, pricing, distribution.</td>
<td>Monthly reporting 4 key criteria: fin sustainability, social impact (BoP custs served), scale, cost effectiveness</td>
</tr>
<tr>
<td>Name</td>
<td>Region</td>
<td>Sector Focus</td>
<td>Year</td>
<td>Size (USD)</td>
<td>Type of Capital</td>
<td>Type of Inv</td>
<td>Avg Inv Size</td>
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<tr>
<td>Axial Par</td>
<td>Brazil</td>
<td>Health, food, forestry, biomaterials, renewable energy, env. services</td>
<td>2001</td>
<td>$30m</td>
<td>Private individuals</td>
<td>60% equity; 40% debt</td>
<td>$5m</td>
<td>Expected IRR: 25%</td>
<td>Intensive involvement in management, strategy and sustainability</td>
<td>Env/Soc benchmarks for each investment monitoring achievement; independent verification</td>
</tr>
<tr>
<td>China Environment Fund (Tsing Capital)</td>
<td>China</td>
<td>Renewables, energy eff., recycling, new materials, waste</td>
<td>2002 (CEF1); 2005 (CEF2)</td>
<td>CEF1: 13m; CEF2: 30m; CEF3: 150m (raising)</td>
<td>Family office, mutual funds, corporations, DFIs</td>
<td>Equity</td>
<td>$1-3m, now $2-5m</td>
<td>Expected IRR: 25%</td>
<td>In the sense of VC involvement in company strategy and management</td>
<td>Environmental and social review with company once a year</td>
</tr>
<tr>
<td>GroFin</td>
<td>SA, East Africa, Oman, Nigeria.</td>
<td>SMEs: Start-up and growing enterprises All sectors.</td>
<td>2003 (RAPS est. ’99)</td>
<td>8 funds 5-30.6m Total $102m; raising new $130m</td>
<td>Africa fund</td>
<td>Banks; DFIs; Local currency investors; Corporations; Foundations.</td>
<td>Prefer debt/self-liquidating instruments, some equity.</td>
<td>$50,000-1m per transaction avg 400,000</td>
<td>Target 10% net in USD terms to investors after all costs, write-offs and fees.</td>
<td>Tailored made business development assistance to clients for duration of investment term</td>
</tr>
<tr>
<td>Eoney Energy / Clean Tech Fund</td>
<td>LA</td>
<td>Small scale renewables, energy projects and alternative technologies</td>
<td>2004</td>
<td>$25.2m</td>
<td>DFIs, local govt banks, parent company</td>
<td>Primarily equity</td>
<td>$ 3m</td>
<td>Target IRR above 18%</td>
<td>Grant funded TA prior to inv. To get the project investment-ready</td>
<td>Monitor env/soc performance of the company and report back to shareholders</td>
</tr>
<tr>
<td>EIP II (Environmental Investors Partners)</td>
<td>EU countries in Central Europe</td>
<td>Environmental products and services relating to infrastructure</td>
<td>2005</td>
<td>$5m</td>
<td>Private individuals, or their foundations and funds</td>
<td>Equity and exceptionally quasi-equity</td>
<td>$1m</td>
<td>Expected 12%</td>
<td>Ongoing in the sense of VC involvement in company strategy and management</td>
<td>Not in a formal way</td>
</tr>
<tr>
<td>Stratus VC III (The Stratus Group)</td>
<td>Brazil</td>
<td>Applied Technology, Cleantech/Biotech, Environmental Technologies</td>
<td>started investing in 2007</td>
<td>$28m</td>
<td>Local institutional investors, DFIs</td>
<td>Equity, long-term &amp; mezzanine debt, carbon financing</td>
<td>$1.2m - 2.8m</td>
<td>30% annual ROI</td>
<td>In the sense of VC involvement in company strategy and management</td>
<td>Requires reports on env/soc management and performance</td>
</tr>
<tr>
<td>Continental Wind Partners (Env. Investm. Partners)</td>
<td>EU countries in Central Europe</td>
<td>Wind power infrastructure</td>
<td>2007</td>
<td>$27m</td>
<td>Private individuals, their foundations and funds</td>
<td>Equity and exceptionally quasi-equity</td>
<td>$2m</td>
<td>Expected 25%</td>
<td>In the sense of VC involvement in strategy &amp; management</td>
<td>Not in a formal way</td>
</tr>
</tbody>
</table>

**Fundraising Stage**

<table>
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<tr>
<th>Name</th>
<th>Region</th>
<th>Sector Focus</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Rio Bravo Sustainability I</td>
<td>Brazil</td>
<td>Eco-attractive enterprises exerting positive impact on the env., society or both</td>
<td>2007</td>
<td>$100m (target)</td>
<td>Local and intern. Institutional investors, DFIs</td>
<td>quasi-equity with convert.; common and preferred equity.</td>
<td>$ 5m (target)</td>
<td>Target ROI: 25%</td>
<td>In the sense of VC involvement in company strategy and management</td>
<td>Establishing env/soc performance indicators to be achieved during the year</td>
</tr>
<tr>
<td>Evolution One Fund (Inspired Evolution Investment Mng.)</td>
<td>Southern Africa</td>
<td>Clean tech and Environmental goods and services sectors and sub-sectors</td>
<td>2007</td>
<td>$140m</td>
<td>Parent company, corporations, local and international institutions and DFIs</td>
<td>Long-term &amp; quasi-equity, Combinations of senior debt, mezzanine debt &amp; carbon financing</td>
<td>$1.4 - 28.3m</td>
<td>Expected Gross IRR &gt;= 30%</td>
<td>Involvement in management, strategy and sustainability.</td>
<td>Est. env/soc performance indicators and development of customized sustainability toolkit.</td>
</tr>
<tr>
<td>Southern African Cleantech &amp; Sustainability Fund (Inspire South Africa)</td>
<td>Southern Africa (SADC)</td>
<td>Renewable energy non-polluting replacement tech; enterprises serving the BOP</td>
<td>2007</td>
<td>$25m (target $35m)</td>
<td>DFIs, Parent company</td>
<td>Equity and Quasi-equity</td>
<td>$2m</td>
<td>Expected 20% per annum in SA Rand terms</td>
<td>Not formally exploring funding for more systematic TA from local development organization</td>
<td>Company specific indicators, bi-annual summary reports on environmental and social impact at fund level</td>
</tr>
</tbody>
</table>

The other two institutions interviewed were Shared Interest and Shorebank, are not included in this matrix as they don’t make direct investments into SMEs.