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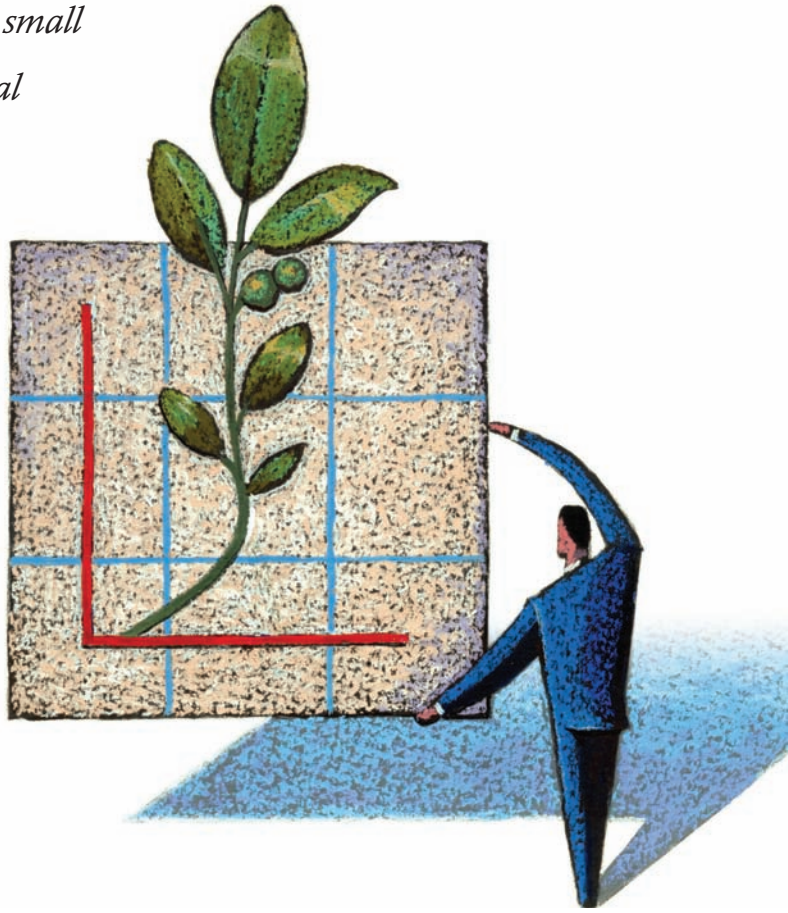
Center for Corporate Citizenship

Investing in the Backbone of Emerging Markets

Small and medium sized enterprises (SMEs) form the backbone of a strong market economy. Yet in emerging markets, there is often a dearth of financing options forSMEs, creating a 'missing middle' in the economic structure. These entrepreneurs, so vital for sustainable development, are too large to qualify for microfinance, but too small to obtain loans from international institutions. Investors are now looking at this issue and seeking a coherent investment framework that would ensure the sustainability of these enterprises, and the maturation of investment in emerging market SMEs.



A Working Paper from Boston College Center for Corporate Citizenship's
Institute for Responsible Investment

Sustainable SME Investment

By David Wood, Ph.D., Cameron Pratt, and Belinda Hoff

This Working Paper reflects a May 2006 meeting hosted by the the Institute for Responsible Investment at Boston College that brought together a group of capital aggregators to discuss current impediments to investing in emerging market SMEs. This working paper summarizes the issues that were identified at that convening.

As part of a project sponsored by the UN Foundation, the Institute for Responsible Investment at Boston College is attempting to identify ways to increase the financing options available to emerging market SMEs in order to foster growth in this vital sector.

While the world of emerging market Small and Medium Enterprise (SME) finance has long presented challenges for both the international development community and interested private investors, it is also beginning to offer investment opportunities.

A recent meeting of representatives from SRI investment funds identified the potential for SMEs to become a viable sector in institutional investment portfolios, particularly for those investors who seek value in blending social, environmental, and economic value.

Many of the barriers that have limited financing for SMEs in emerging markets were acknowledged as legitimate: high transaction and due diligence costs, political and currency risks, the need for technical assistance, difficulties identifying suitable targets for financing, legal and regulatory concerns, the illiquidity of the SME equity market. Nonetheless, the investors believe that with careful scrutiny and research, investment in SMEs present an opportunity to facilitate development in emerging markets while at the same time realizing sustainable financial returns.

This report grew out of a convening of capital aggregators who invest in sustainable SMEs in emerging markets. It proposes that the emerging market SME sector presents an opportunity to create vehicles for sustainable private investment for investors seeking real returns while at the same time furthering vital international development goals by supporting an underserved sector of the economy. Sustainable SME investment presents an opportunity to develop the 'missing middle' of emerging market economies.[1] Sustainable SMEs are precisely the sort of entrepreneurial concerns that triple bottom line investors have learned to support through community lending and social venture funds in the United States. However, promising new vehicles for investment in SME businesses in developing countries have yet to receive the attention necessary for investors to make SME investment in developing countries a significant part of their overall portfolios.

The goal of this paper is twofold. First, it probes the reasons for, and the difficulties associated with, the development of sustainable SMEs as a field of investment. Second it proposes four key areas where coordination and collaborative activity would facilitate the development of new financial products and increased support for investment in sustainable SMEs in emerging markets.

Why SMEs?

- **Growth potential through reaching underserved markets**
- **Contribute to international development goals**
- **Strengthen climate for business and civil society in emerging markets**
- **Maximize positive influence regarding environmental impacts**

Despite the barriers associated with investing in SMEs, financing the SME sector in emerging markets remains an important factor in meeting vital development goals—such as the UN Millennium Development Goals. Though definitions of SMEs vary, rough estimates suggest that businesses with 10-200 employees account for 90 percent of firms and 50-60 percent of employment worldwide.[2] The SME sector offers significant opportunities for economic growth and its related benefits, as well as a fundamental link in the chain from microenterprise to large companies. SMEs can reach underserved markets, especially in rural communities and impoverished urban areas that lack the infrastructure necessary to support larger scale public or business activity. In addition, a more developed SME sector can provide support for the overall business and civil society climate, increasing the overall health of emerging markets.

Though definitions of SMEs vary, rough estimates suggest that businesses with 10-200 employees account for 90% of firms and 50-60% of employment worldwide.

Investors with an interest in the development impacts of their investments should view emerging market SMEs as a crucial part of the overall development portfolio. The sector offers real potential to contribute to poverty alleviation, achieve productivity gains through the infusion of new technologies and business practices, and develop local supply chains that feed into the world's globalized markets. Similarly, investors concerned with the triple bottom line impacts of their investments can find important opportunities in emerging market SMEs committed to sustainable business practices.

The underdeveloped market for developing world SMEs offers a clear potential for social and environmental as well as economic impacts. Investment in SMEs has the potential for positive externalities that offer substantial benefits beyond their immediate financial returns to investors. In some cases, sustainable SMEs could enhance financial return through access to new or growing markets for energy efficiency, clean technology, or fair labor production. In other cases, sustainable SMEs can offer vehicles that maximize environmental and/or social impact in underserved communities.

SMEs and Market Failure

Recently, emerging market SMEs have received increased attention from the development and investor communities. This interest is due to the SME sector's obvious potential for growth, its ability to provide new solutions to important social and environmental problems, and the positive development outcomes associated with a robust SME sector. Investors are particularly interested in new paths through which to allocate capital, and new ways to spread risk across SME investment portfolios—in other words, ways to stimulate an underdeveloped market.

The goal, of course, is to provide funding that leads to the growth of self-sustaining enterprises and a vibrant local business market in the developing world. Why, then, should we not depend on the finance market to allocate capital to the most promising small businesses, and let them grow? As skeptics are quick to point out, subsidies such as below-market-rate loans and loan guarantees can distort local credit markets, making it hard to develop self-sustaining businesses. In the same vein, subsidies for risk mitigation can encourage moral hazard, and can also lead to situations where macroeconomic and political changes can swamp even the best SMEs, but leave their foreign investors untouched.

In response to this skepticism, capital aggregators who work in the SME market identify various points of market failure.[3] The problems for SME financing are intimately linked to the intersections of local and global finance markets and their relationship to development institutions. Despite their intimate knowledge of local market conditions, local banks and other sources of credit typically lack the experience of supporting SMEs—especially those incorporating new technologies or innovative business plans—and are reluctant to take on the risks associated with such ventures. Consequently, their risk mitigation strategies—in part because of the weakness in domestic savings—do not allow for the sort of credit terms that allow promising young companies the time and capital to grow.

Private equity financing presents its own problems. Regulatory issues can play an important role here: poor information disclosure, weak corporate governance, and the lack of strong private property rights can all raise the cost of capital. Low levels of savings, combined with the preference of local angel investors to move their capital abroad, also leave a gap in the private equity markets.

Offshore investors face a range of difficulties that further hinder SME capital markets. Political and macroeconomic risks, which are difficult to both measure and hedge against, raise risk/return ratios to often unacceptable levels. Most emerging market SMEs require money in the $10,000 to $1 million range, with $3 million to $5 million as the upper limit—these relatively small amounts coupled with high transaction costs make SMEs unattractive to lenders.[4] In addition, because of underdeveloped local business skills and climates, technical assistance for emerging market SMEs can increase transaction costs even further. Illiquid equity markets with few exit opportunities make SME financing that much more intractable, and debt financing is also stifled by high due diligence costs in uncertain risk environments.

It is important to remember that many of these problems, to some extent, are also associated with SME finance in the developed world. The United States uses government support from the Small Business Administration, and in particular the Small Business Investment Companies [SBIC] program, to support activity in the small business sector, driven in no small part by the fact that small businesses created 60 to 80 percent of net new jobs annually over the last decade.[5] While regulatory structures, lending and private equity fields are substantially more robust in the richest countries, financing small business remains an important and risky venture throughout the world.

In emerging markets, the SME sector remains a niche market, rather than a developed finance arena. While the microfinance movement has begun the impressive development of the smallest finance markets, and international development funds and institutional investors have made advances in emerging market public equities and sovereign debt, SMEs remain to a large extent the "missing middle." For structural reasons, local investment communities find it hard to raise the capital to fund the SME sector; foreign investors find the costs and risks too great.

Collaborative action that brings the tools of market discipline, backed by smart public and philanthropic subsidy, is perhaps the most likely path forward.

How to develop this difficult market? Fully subsidizing emerging market SMEs could defeat the purpose of developing a stable, growing group of businesses; depending on private investors to develop the finance market in so risky a sector without intervention is a virtual guarantee of paralysis. Collaborative action that brings the tools of market discipline, backed by smart public and philanthropic subsidy, is perhaps the most likely path forward.

Sustainable SME Investing – A Target Market for Developing the Field

In the case of microfinance, growth depended on pioneers who developed effective models, distribution techniques, and fundraising sources to create the potential for a sustainable finance market that serves the lowest end of the spectrum. This market grew in large part because those pioneers believed that the tools of finance – including the introduction of sound business and accounting practices, the possibility of sustainable credit, and a more robust equity market – offered an alternative to top-down development models that often failed to meet specific needs. Philanthropic support provided the fundamental underpinnings for market growth.

The microfinance market thus grew as a result of investors who utilized the tools of private finance, but sought impacts beyond immediate financial returns. While bringing that market to scale remains a difficult task, pioneering work has at least made the scalability of microfinance a viable topic of discussion.

This example suggests that market development should leverage the work of public and private investors who seek to apply private finance for public purpose, with the long-term goal of

cultivating sustainable, commercially viable enterprises and finance markets. The key here is the notion of "blended value," in which financing mechanisms yield social and/or environmental returns as well as a range of financial returns on investment. Blended value investors who support sustainable SME investments in emerging markets, in this view, may also be supporting research and development into the best practices for financing the field more generally.

In many emerging markets, the case for, say, poverty alleviation, is an easy one to make—in some cases, the entire market of SMEs would fit the guidelines for what developed markets call "community investment." The impact of SMEs that create jobs, support supply chains, and pay taxes can yield benefits well beyond the return on investment. Where market failures have occurred, external public/private financing mechanisms can offer important avenues to support small business growth. Indeed, as "Bottom of the Pyramid" investment strategies receive more attention, SMEs offer an attractive opportunity to develop a sector that serves the vast population of underserved people in the world market. Crucially, SMEs can offer vital support for formal economies, creating enterprises that pay taxes and so support the public infrastructure that allows communities and economies to thrive.

Similarly, sustainable SMEs offer valuable opportunities for realizing environmental goals. SMEs can be key resources for biodiversity, for instance, by combining sustainable biodiversity conservation and management with employment opportunities for those who might otherwise be drawn to less environmentally sustainable practices. Sustainable SMEs can be especially good vehicles for providing clean energy services and technologies to rural communities, and in the process reducing the labor-intensive and environmentally damaging use of charcoal. Support for local cooperatives with good environmental and labor practices can help embed corporate social responsibility (CSR) in the business community at large.

In some cases, these social and environmental benefits offer significant potential for enhancing financial returns – whether through improved risk management, as proxies for good governance, or through entry into new markets such as carbon finance. In other cases, the positive externalities associated with these investments may justify subsidies for technical assistance, political and currency risk mitigation, and below-market return on investment.

Developing these markets, however, requires careful attention to the potential costs of subsidizing small businesses. Enterprises that cannot become economically sustainable do not offer good long term bets for sustainable development. Subsidized protection of investors from risk and loss brings the threat of moral hazard. One key question that remains to be answered is how to best organize the public/private partnerships that can grow the field without foreclosing the development of sustainable commercial finance markets in the future.

Ideas for Collaborative Action for Developing the Field

Where are there opportunities to develop this missing middle? The argument for developing the field of SME investment is two-fold:

- SMEs are a crucial component of the overall economies of emerging markets, with high impacts across the economy.
- Public support and private finance, both local and global, have failed to provide the level of investment and support to match the opportunities and need.

What is needed is a model of financial innovation and smart subsidy brought to scale. A successful model would also help manage risk for investors but provides the opportunities and business practices necessary for the sector's development. We believe the field is most likely to develop through the initiative of triple bottom line investors in collaboration with capital aggregators who focus on sustainable SMEs. The experience developed over the past decades in sustainable SME finance may offer the seeds for a sustainable SME sector writ large.

We see four key areas in which coordination and collaborative activity can help better support the field of SME investment:

- New financing mechanisms and technical assistance partnerships that capitalize on public/private financing.
- A more coherent definition of the sustainable SME field.
- Development of more cohesive investment assessment methodologies to reduce investors' due diligence costs in evaluating the social, environmental, and economic impacts of their investments.
- The integration of sustainable SME financing with corporate social responsibility and supply chain management.

1. New financing mechanisms and technical assistance partnerships that capitalize on the potential for public/private financing.

Given the underdeveloped state of the field, and the extensive risks and transaction costs endemic to emerging market SME investment, it is unreasonable to suppose that a vibrant market for private finance can exist without some form of smart subsidy. As noted before, this is the case in developed markets, including the United States. The question is: how best to structure the range of investments in sustainable SMEs so as to enable the maturation of the market?

One way to answer this question is to expand the range of investment opportunities— from full subsidy to reasonable rate of return—that make up the field of sustainable SME investment. Some investments, in high risk areas with high impact potential, may require public or philanthropic funding. This method of funding can nonetheless be considered an investment in the field if it supports the development of small enterprises and offers lessons for identifying viable opportunities for smart subsidy. At the other end of the spectrum would be larger investments, for instance in medium-sized enterprises in more developed markets. These investments offer commercial rates of return on investment, however, for reasons of market failure in local and global lending institutions they require investment from a specialized intermediary.

The impact of SMEs that create jobs, support supply chains, and pay taxes can yield benefits well beyond the return on investment... Crucially, SMEs can offer vital support for formal economies, creating enterprises that pay taxes and so support the public infrastructure that allows communities and economies to thrive.

These extremes help define what is possible in sustainable SME financing. Innovative financing packages that identify smart subsidies from the public sector to support patient capital from private finance may help bridge the funding gap now seen in emerging market SMEs. A clear definition of the range of vehicles available may help match investors to their appropriate place along the spectrum. Here again, there is a key role to be played by triple bottom line investors, for whom the benefits of blended value creation form a core part of their asset allocation strategies. There is also substantial room for the development of local/international partnerships to mitigate currency and transaction cost risks, with capital aggregators partnering, for instance, with local pension funds or banks who cannot (or are unlikely to) invest in SMEs without offshore partners.

For technical assistance, there are opportunities for horizontal integration across the sustainable SME field. Opportunities exist especially in the standardization of business training tools, where technical assistance in support of SME financing has the potential to be standardized through collaborative action among capital aggregators, investors, and other interested parties, reducing the transaction costs for individual deals. Similarly, pipeline development for various forms of sustainable development may best be performed by specialized organizations who receive public or philanthropic subsidy.

2. A more coherent definition of the sustainable SME field, focusing on the shared potential of disparate sustainable SME projects.

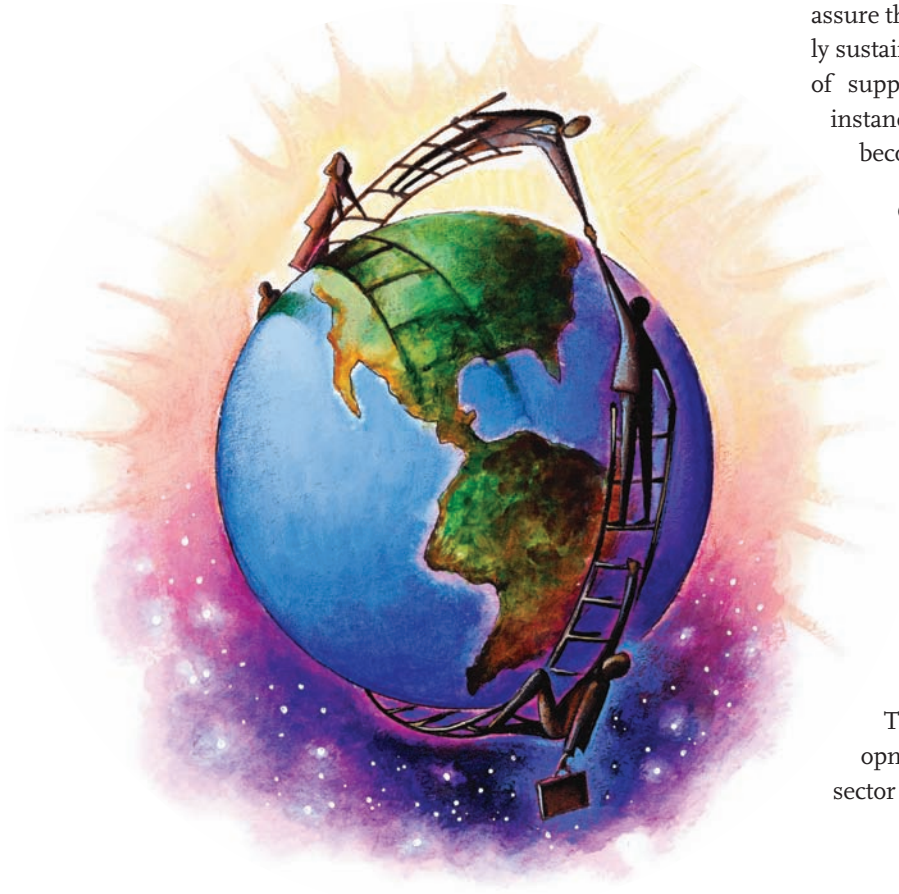
At present, the world of sustainable SME financing consists of disparate capital aggregators and other special purpose intermediaries that link capital to SMEs – these aggregators often have specific goals, such as poverty alleviation, biodiversity and land conservation, clean energy production, support for high-growth potential businesses, and so on. Development agencies, mission-based institutional investors, and philanthropists jointly fund many of these "niche" projects, but to date there is no general place for sustainable SMEs in their investment portfolios.

A more coherent, consensus-based definition of the field (perhaps with the development of a corresponding trade association or related institution) would facilitate a more integrated approach to the field. A collaborative focus might consolidate the shared characteristics of sustainable SMEs: their share of the overall business market, their geographical and social reach, their contributions to the formal economy, and their role in establishing emerging markets' overall business climate. In this way, investors might be encouraged to view the field of SME investment itself as an important asset allocation possibility, rather than to assess each investment as a boutique project. Key to defining such a field will be consideration of the links that SMEs play across the entire chain of business enterprises in the global market.

3. **Development of more cohesive assessment methodologies to reduce investors' costs in evaluating the social, environmental, and economic impacts of their investments.**

Triple bottom line investors need the tools to assess investment impacts in order to justify their asset allocation strategies. A crucial part of field definition is the coordination of a vocabulary to describe and assess the social, environmental, and economic profile of sustainable SME investments, and tools to make disparate finance vehicles comparable in the eyes of their financial backers.

What is needed is not a simple scoring system that places biodiversity conservation projects against "Bottom of the Pyramid" investments. Instead, investors would benefit from a consensus-based evaluation system that places an investment within a range of criteria for impact assessment. SME finance cannot be reduced to a single metric that captures the potential environmental, social, and economic effects associated with successful investments. Nevertheless, an assessment methodology that addressed specific issues, including the risk/return profile of the investment, the intended environmental or social impacts of the investment, the governance systems in place to assure the project's best performance, and a comprehensive, comparable reporting system for impacts, would offer a significant impetus for investors to approach sustainable SMEs as a field of investment. A consensus reporting framework would also reduce the reporting burden on capital aggregators, who now must devise their own system for external reporting.



The development of the field definition and assessment methodologies will require collaborative activity from both investors and the capital aggregators who will place their money in sustainable SMEs. Both are crucial steps in the development of the field.

4. **The integration of sustainable SME financing with strategically-designed corporate social responsibility and supply chain management practices.**

The corporate community is a relatively untapped resource for the development of emerging-market SME financing, and offers significant opportunities for collaborative action. As corporations become more attuned to the strategic alignment of corporate social responsibility and supply chain management practices, opportunities for corporate involvement in smart subsidy become increasingly available.

There are already good examples, for instance of coffee distributors supporting coffee-growing cooperatives in an effort to assure the continued production of high-quality environmentally sustainable coffee. This model might transfer to any number of supply-chain management practices, and may also, for instance through climate change and political risk initiatives, become part of larger corporate risk mitigation strategies.

Corporations also have the potential to develop reputation-enhancing, strategically aligned CSR initiatives in the SME sector. The finance industry has obvious reasons to support CSR activity that develops and helps stabilize potential markets in the developing world. Technology companies have the potential to aid technical assistance programs, and in the process help grow a potential market for their products in the future. Similarly, accounting firms might develop triple bottom line disclosure frameworks for sustainable SMEs, in the process developing tools that can be adapted to new auditing systems. Again, these models are potentially transferable to a number of CSR programs.

The key here is to involve corporations in the field development process from the beginning, as partners in a multi-sector effort to grow the field of SME investment.

Next Steps

It is important, in conclusion, to acknowledge that many efforts are already underway in this field. Development agencies have given SMEs—and sustainable SMEs in particular—a more prominent role in their overall agendas. Many national governments are also focused on this problem. A few foundations are also extending microfinance strategies to SMEs working in developing countries. Organizations such as the UN Foundation, the sponsor of this convening report, are working on new strategies to help pool capital, mitigate risk, and facilitate public-private partnerships that help define and grow the SME investment sector.

In the field of SME finance, there is an important niche market of capital aggregators, many of whom were represented at this meeting, who offer innovative financing and technical assistance to sustainable SMEs, in the process bringing a great deal of research and development to the field more generally. These capital aggregators serve as the interface between triple bottom line investors, emerging market financial and credit markets, and sustainable SMEs in need of financing. Their combined experience can be the starting point for any broader effort to define sustainable SME finance as a coherent field of investment.

With interest growing, there is increased opportunity for continued collaborative action and development of the field. Sustainable SME finance is still at an early stage, yet obvious opportunities exist for information sharing and collective work that will grow the field as a whole. Attendees suggested that an especially valuable next step would be the development of a cross-sector alliance of specialized capital aggregators, institutional investors, emerging market private equity investors, development agencies, public corporations, and related parties to focus on the key issues such as innovative financial products, impact reporting, technical assistance, and corporate involvement in sustainable SME finance.

Endnotes

[1] See Chapter 2 (Mainstream Eye for the MFI) in De Sousa-Shields, M. and C. Frankiewicz (2004) *Financing Microfinance Institutions: The Context for Transitions to Private Capital,* U.S. Agency for International Development: Washington, DC. On the development of the microfinance sector as an asset class.

[2] Raynard, P. and M. Forstater (2002) *Corporate Social Responsibility: Implications for Small and Medium Enterprises in Developing Countries,* U.N. Industrial Development Organization: Vienna.

[3] Small Enterprise Assistance Funds (SEAF) (2004). *The Development Impact of Small and Medium Enterprises: Lessons Learned from SEAF Investments.*

[4] Capital needs vary dramatically between SMEs due to a confluence of factors. Generally, SMEs require financing that is in excess of those loans provided by micro-finance institutions. For example, SME capital needs may require multi-million dollar investments by venture capital funds such as Aureos Capital.

[5] United States Small Business Association (SBA) Office of Advocacy, Frequently Asked Questions, http://www.sba.gov/advo/stats/sbfaq.pdf (accessed July 17, 2006).

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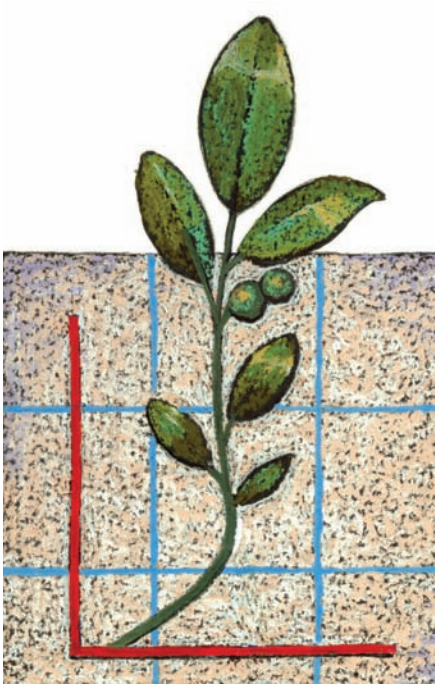

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