Using catalytic capital to foster the emergence of African entrepreneurs in underserved markets

With the support of:

INVESTISSEURS & PARTENAIRES

Catalytic Capital Consortium

INUA CAPITAL
AN IMPACT INVESTOR DEDICATED TO
Octobre 2022
INVESTISSEURS & PARTENAIRES
IP
20 ANS

Content

Foreword

Investisseurs & Partenaires (I&P) is a pioneering impact investment group dedicated to supporting small and medium-sized enterprises (SMEs) in Sub-Saharan Africa. Since 2002, I&P has been operating in underserved markets, raising and managing funds to provide financing to Sub-Saharan Africa's "missing middle".

I&P uses catalytic capital to finance and support SMEs throughout their life cycle thanks to various funders, public and private donors, and investors. To date, I&P has financed and supported more than **255 entrepreneurs**, leading to the creation of strong local added-value and more than 10,000 jobs. The group currently has over **€400 million in assets under management** that have been raised or are advised by I&P and its partner funds. The team is based in 10 African countries (Niger, Mali, Senegal, Cote d'Ivoire, Burkina Faso, Kenya, Madagascar, Uganda, Ghana and Cameroon) as well as in Washington, D.C. and Paris.

In addition to using catalytic capital investing tools, I&P aims to act as an active partner to entrepreneurs/investee companies, and brings strategy, finance, and management skills to accelerate the growth of its partner companies and build long-term relationships of trust.

I&P's mission has always been to "go where others don't go" by financing SMEs that are the "missing link" of African economies, mostly in fragile and Less Developed Countries, and to support the growth of entrepreneurial ecosystems. Today, I&P's model is based on four complementary business lines, which respond to the current challenges of SMEs on the continent:

I&P ACCELERATION

Scaling-up young businesses through seed funding and/or training programs

I&P DEVELOPMENT

Sponsoring a network of African funds to finance small companies with high potential in amounts ranging between €50,000 and €500,000

I&P EXPANSION

Supporting and providing equity financing to mature SMEs and start-ups in amounts ranging between €500,000 and €5 million

I&P ECOSYSTEMS

Promoting the emergence of entrepreneurs and investors in Africa and fostering the development of a business environment conductive to their prosperity

I&P's countries of intervention

Finally, Investisseurs & Partenaires gives particular importance to the economic and social impacts generated through its investments and has developed tools to assess these impacts on all stakeholders. As an impact investor, I&P places financial profitability at the same level as its positive impact on society.

The Catalytic Capital Consortium (C3) is an investment, learning, and market development initiative to promote greater and more effective use of catalytic capital, in recognition of its essential role in achieving the UN Sustainable Development Goals (SDGs) and realizing the full potential of the impact investing sector.

C3 is led by the John D. and Catherine T. MacArthur Foundation, Omidyar Network and The Rockefeller Foundation.

Catalytic capital is patient, risk-tolerant, concessionary, and flexible in ways that differ from conventional investment, while complementing the full continuum of investment capital. It is an essential tool to support impact-driven enterprises and organizations that lack access to capital on suitable terms through the conventional marketplace. Catalytic capital aims to achieve both breadth and depth of impact and to unlock additional investment that would not otherwise be possible, thus expanding economic growth and fuelling innovation.

To help illuminate when and how catalytic capital can be most effective and what additional tools impact investors need, the consortium has dedicated learning grants to a group of selected funds and ecosystem players that address some of the world's most pressing challenges and build knowledge and awareness on the use of catalytic capital.
As an impact investor operating in underserved markets and geographies to **provide financing to the missing middle in Sub-Saharan Africa** since 2002, I&P was selected as one of the C3 initiative recipients. Since its early days, **I&P** has used catalytic capital in different forms and for different project stages, taking high risks while accepting below-market returns. Through this report, I&P aims to make available the lessons it has learned from 20 years of experience in impact investing, in particular, from the use of catalytic tools. The conclusions of this report are notably supported by a unique financial/impact database of the over 255 African companies I&P has supported since its inception thanks to catalytic capital instruments. The database aims to **reflect I&P's experience** and to share our vision and inform other impact investors willing to **support African entrepreneurs**.

We consider this partnership with the consortium as an **outstanding opportunity to demonstrate the efficiency of catalytic capital in supporting African SMEs and to provide recommendations to accelerate and expand its use**.

Executive Summary

Developing a fabric of formal small and medium-sized enterprises is key to ensure sustainable and inclusive growth in Sub-Saharan Africa. When formal, SMEs notably create stable and decent jobs, improve local access to essential goods and services while structuring the local economies and fostering self-sufficiency by promoting import substitution.

In Africa, formal SMEs are the real missing middle of African economies. According to the World Bank's Enterprise Survey tool (consulted in 2023), the first obstacle to private sector operations in Sub-Saharan Africa is "**Access to finance**", with nearly a quarter (24,5%) of companies concerned compared to 14,5% worldwide. The lack of reliable sources of capital is a major constraint to their growth as they do not meet the criteria of traditional financial institutions such as microfinance institutions and commercial banks. As for private equity funds and international investors, they traditionally require investor-ready metrics and track records, but also provide high-ticket sizes compared to SMEs' needs. The available financing is not only insufficient but also ill-suited to SMEs, as they are often perceived as too risky and unable to meet the guarantees and financial history requirements set by financial operators.

The private sector has the potential to bridge this capital gap, but financing positive-impact SMEs presents many barriers, including high risk, high initial investment costs, long lead times, and the challenge of operating within non-existent, nascent, or unreliable regulatory frameworks. Therefore, the needs of SMEs in terms of flexibility, accessibility and conditions call for a new type of capital and investors. **Catalytic capital is a tool that is likely to address these challenges.**

As defined by Tideline, catalytic capital refers to:

"***We define catalytic capital as debt, equity, guarantees, and other investments that accept disproportionate risk and/or concessionary returns relative to a conventional investment in order to generate positive impact and enable third-party investment that otherwise would not be possible***"

Tideline – Catalytic Capital: Unlocking More Investment and Impact, 2019

What is catalytic capital? Illustration of possible catalytic mechanisms

Expected return on investment may be **lower than market rates**

\+ Yield-enhancing effect for commercial capital

Hedging liquidity risk: the catalytic capital provider agrees to be repaid last (e.g. subordinated/ junior debt)

Patient capital: the investor can accept a longer and more uncertain time to exit

The investment can include **non-traditional terms** (size of investment no collateral, etc.)

Investisseurs & Partenaires uses different forms of catalytic capital (first loss equity, junior debt, convertible notes, guarantees...) to finance and support different types of investees, ranging from early-stage enterprises to new local funds. To generate the long-term impacts previously described, we are convinced African SMEs must be economically sustainable. They therefore need access to long-term financing, governance, and management skills. It is from this perspective that I&P began its activity as an impact investor with the objective of addressing this underserved segment. Since 2002, I&P has gradually extended its scope of intervention to **provide financing to SMEs of the missing middle** and now offers a **continuum of funding mechanisms** to sustain the growth of businesses at all their development stages. In addition, I&P uses catalytic capital to sponsor and set up new local investment funds and mobilize local private capital through leverage.

Progressive deployment of catalytic mechanisms at I&P: what makes each fund catalytic?

2002

IPDEV
PILOT FUND

Fund's launch subsdized by private individuals:

- Founder's personal funds + business angels
- Volunteer Fund Director
- Evergreen investment company
- Patience, higher risk, and low or no return

2015

IPDEV2
SPONSOR FUND

- Evergreen structure
- First-loss mechanism (junior loan from AFD)
- Subsides to finance fund-launch phases before closing
- Subsides to finance TA for SMEs
- IPDEV2 acts as anchor investor provides leverage on national investors

2012 **2017**

IPAE 1 & IPAE 2
SCALING UP

First entry of institutional investors:

- Unbalanced risk/profitability ratio
- Grant funding for Technical Assistance

At SME level, the investments made by I&P are catalytic: I&P funds take a high level of risk compared to modest return expectations, with more patience on repayment terms, a search for leverage etc.

I&P has been widely recognized for its achievements in supporting and financing both African SMEs and local investment funds. Its model has demonstrated how capital catalytic, coupled with a hands-on approach and a robust monitoring and evaluation system, can converge to successfully address a persistent gap. In this document, we articulate some of the main conceptual and practical lessons underpinning I&P's model.

This study extends beyond I&P's impact and embraces a broader objective. **Ensuring that catalytic capital is better directed toward African SMEs is a collective effort, to be carried out by the entire SME-support value chain**. I&P aims to share insights into improving the conditions and availability of catalytic capital. Our goal is to actively participate in the collective learning process that will unlock additional financing to bolster impact investing initiatives across Africa.

Key takeaways

KEY TAKEAWAY #1

I&P has demonstrated the long-term impacts of financing SMEs through catalytic capital

Private equity stands out as one of the most effective tools for SME financing as it surpasses the constraints imposed by philanthropic subsidies, which, while essential, can sometimes obstruct the establishment of a sustainable long-term business model. Private equity is also more suited in most cases than debt instruments, which can put high pressure on SMEs' balance sheets when used at initial stages. **Impact investing through private equity enables SMEs to achieve financial sustainability, ensuring the longevity of their impact.**

One of **I&P's main additionality commitments** is to operate "where others don't go" and to bring catalytic capital to **underserved geographies**. If Sub-Saharan Africa is the 4th most popular region for impact investors[1], this progress hides major disparities with more than half of the investments concentrated in Nigeria and Ghana. I&P chooses to target underserved markets to maximize its impact: among the 260 million invested by I&P investment vehicles, 87% of the investments have been made in the least developed or fragile countries.

I&P's outcomes are reflected in its impact thesis, which is based on six key impact pillars[2]:

◆**Accompanying the emergence of a new generation of African Entrepreneurs in frontier markets:** 89% of companies supported by I&P are run by African entrepreneurs.

◆**Creating decent jobs and training opportunities:** direct employment has grown by 50% since I&P's investment and 42% of SMEs provide a complementary health insurance.

◆**Densifying the local economic fabric:** 79% of portfolio company suppliers are local players.

◆**Easing access to essential goods and services:** 71% of companies offer goods or services that contribute directly to the SDGs.

◆**Promoting Gender equality and women's empowerment:** 28% of portfolio companies are run by women and 67% of I&P's portfolio is considered a gender lens investment according to 2X Challenge.

◆**Fostering sustainable growth:** 24% of portfolio companies implement green projects and 13% of them use sustainable energy.

1. Global Impact Investor Network (GIIN), Impact Investor Survey (2020) - 2. I&P Annual Impact Report (2022)

KEY TAKEAWAY #2

Portfolio companies perform well despite challenges, but strong economic performance does not always maximize exit or fund-level shareholder value (IRR)

We might have assumed that investors' lack of interest in African SMEs derives from their lower profitability compared with that of larger corporations. However, the structural profitability of the companies is not what differentiates the performance levels of instruments dedicated to large corporations or to SMEs, as illustrated by the present report. Indeed, **our study of 255 portfolio SMEs revealed that they do perform well economically with the right support**: on average, a SME will triple its turnover after 6 years of investment. In terms of profitability, despite a decline in the first year, due to the structuring phase led by the investor, we observe a subsequent rebound after about 5 years - the EBITDA of I&P investees gaining 4 times its absolute value over 6 years. This encouraging performance is even more impressive when we take into account all the external factors that affect the economic performance of the SMEs, such as the cost of accessing finance, infrastructure limitations, recruitment obstacles, expenses linked to formalization, political crises, and more.

However, from an investor's perspective, well-performing companies do not necessarily translate into a good financial valuation.

The following factors dampen the financial returns:

◆**Premature exits** forced by the legal structures of the "**closed-end fund**" model, derived from the practice of more mature markets but unfit for structural investments in small companies and fragile countries.

◆**Market conditions**, characterized by low liquidity and limited exit opportunities, result in lower multiples compared to mature markets. These challenging conditions do not necessarily facilitate EBITDA growth between investment and exit.

◆**Currency depreciations** that weigh excessively on domestic market-oriented companies.

◆Fund **management costs** related to the small size of the investments.

In Africa, **front-end and management costs are exceptionally high compared with the unit values of the transactions,** in an industry where fixed costs are the rule. This has, therefore, an automatic knock-on effect on net profitability for investors. Moreover, when investment objectives are innovative, profitability may be limited, resulting in extended investment periods or higher losses than the portfolio average. These considerations explain the relatively lower engagement of investors in this target category – and, as a consequence, the low number of management teams dedicated to this sector. **Prioritizing impact outcomes leads us to adopt a unique economic model** that fosters successful businesses but may not match the net performance of conventional finance or standard market returns.

This makes catalytic tools more necessary than ever to balance out the financial returns for impact funds.

KEY TAKEAWAY #3

Catalytic capital provides essential leverage for impact funds' economic model, but limited access and structural constraints in frontier markets hinder its expansion in Africa

Impact investing is still not sufficiently widespread on the continent: a report published by the GIIN reveals that, while 52% of impact investors plan to increase their allocations to Sub-Saharan Africa, only 11% of the total assets under management has actually been disbursed in these geographies[3]. SME impact funds face challenges accessing catalytic capital. **Although catalytic capital is starting to be deployed in Africa, it often doesn't reach frontier market SME funds** due to the lack of flexibility of financing options, including investment horizon, management fees, return expectations, and fund size.

The standards established in developed markets are not aligned with the needs and specificities of emerging markets.

Fund durations are often too short (and usually extended) and financial expectations are too high. The main performance indicator, the IRR, should be reviewed, as it pushes investment teams to exit in a premature manner from portfolio companies, even though a longer investment period would maximize impact creation and financial returns[4].

Thus, we face a twofold challenge: **increasing the availability of catalytic capital (quantitative) and improving the characteristics of deployed catalytic capital (qualitative)**. These challenges are key for developping mechanisms that better match the needs of our ecosystem's stakeholders (risk-return radio and investment geographies).

KEY TAKEAWAY #4

By integrating more flexibility into their financial and legal frameworks, catalytic capital providers could better reach SME funds and generate significant impacts in frontier markets

◆ **FUND LIFETIME AND EVERGREEN STRUCTURE:** Allowing for **longer or flexible exit timelines** provides SMEs the chance to grow sustainably. Changing **the legal structure of financial vehicles** from closed-end funds to open-ended or permanent vehicles would help them reach higher financial returns, albeit at the expense of liquidity. This is a constraint which most Development Finance Institutions (DFIs), foundations, and impact-oriented investors could potentially manage to address with sufficient leadership.

◆ **ACCOMPANYING GRANT SUPPORT:** As seen before, the «**cost of impact**» may ultimately affect the profitability of SME impact funds. Covering some of the **fund's operating costs through donor funding** is a way to overcome the impact/return dilemma. At the fund level, such grant subsidies can help covering some of the general partner costs (ESG & Impact activities, pre-investment technical assistance and support...) or having concessional capital pay for a higher management fee. At company level, impact investors can partner with DFIs and donors to secure grants for ESG

3. GIIN, Annual Impact Investor Survey (2019) - 4. According to the several studies (Insights on SME funds performances, Shell, Omidyar Network, Deloitte, 2019; Across the Returns Continuum, Omidyar Network, 2020), emerging markets funds comparable to I&P's funds approximately take 15 years to reach their full potential and break even a positive gross IRR

and Impact issues such as the environment (and thus cover for corporate energy audits, feasibility studies for solar panels or other renewable energy installations, pre-financing of environmental equipment, etc.)

◆ **PRE- AND POST-FINANCING TECHNICAL ASSISTANCE:** Most companies need support to be "**investment ready**". Their preparation is an important but costly and time-consuming prerequisite for impact funds. To ensure that financial and impact objectives are met after investment, a r**ecurring process of technical assistance and monitoring is require**d. This assistance is often financed by grants from DFIs, but is currently insufficiently directed towards the pre-investment phase.

◆ **GUARANTEE:** Due to an insecure environment, most lenders require significant guarantees and collateral. Lower loss-coverage ratios or innovations in terms of mortgage guarantees (cooperatives, grouped guarantees) would make more SMEs eligible. **First-loss coverage guarantees** are one of the most popular de-risking mechanisms, in particular for DFIs. **Guarantee funds** currently exist but are not sufficiently oriented towards SMEs due to high costs and complex administrative procedures.

◆ **CO-FINANCING: Risk can be shared** within members of the SME funding ecosystem by matching their investments with specific types of needs. For example, banks may be willing to fund equipment when less risk-averse institutions, such as impact funds, can finance working capital or highest perceived risk operations.

KEY TAKEAWAY #5

Frontier-market SME funds also find ways to better demonstrate and value the impact they generate

◆ **IMPROVING THE IMPACT MEASUREMENT AND INCREASING THE RESOURCES DEVOTED TO MEASURE IT:** we suggest that philanthropic investors and DFIs agree to subsidize the costs of impact measurement and reporting, at least partially, through mechanisms similar to those of technical assistance. This would help decrease management costs and bring them closer to commercial terms. This sponsorship would also enhance precision in impact measurement and increase the visibility of impact results, thereby encouraging more investors to provide capital to these SMEs.

◆ **PROPOSING INNOVATIVE METRICS TO ASSESS SOCIAL PERFORMANCE** and work on standards to capture key "internalities": we suggest that impact funds set **a target Economic Rate of Return** (ERR), which would capture the direct and indirect added value of the investments. This approach could also take into account specific negative externalities, such as carbon emissions and workplace accidents. The ERR could be compared against the economic cost of subsidizing the fund, while the fiscal return generated by the invested companies could be compared against the fiscal cost of the concessional financing. Hence the social benefit of the concessionality would be made clear. The benefits can be compared with those of other public policies: the acceptable level of direct or implied subsidization could also be discussed on rational grounds.

01

SMEs are key components of African economies

When supported and financed, they significantly contribute to meeting the continent's challenges, but they face many obstacles

Macro-economic context: the challenges and opportunities of African economies

Strong growth but a struggling labor market

Before COVID-19, Africa was experiencing **a sustained economic growth**. Indeed, in 2019, six of the world's ten fastest growing economies were in Africa (Rwanda, Ethiopia, Ivory Coast, Ghana, Tanzania and Benin)[1]. The continent's countries were growing rapidly, with an **average annual GDP growth rate reaching 7,2% from 2010 to 2018.** Nevertheless, as in the rest of the world, African countries were not protected from the crisis of COVID-19, in particular because of the disorganization of the international value chain. The continent experienced a recession for the first time in 30 years, affecting 40 of the 54 countries on the continent. Still, COVID-19's post-crisis forecasts called for growth of nearly 4% for the continent.

Moreover, the continent is facing **unprecedent demographic challenges.** Indeed, the African population is expected to grow from today's 620 million to 2 billion by 2060[2]. **By 2050, Africa alone will contribute to 54% of the 2,37 billion increase in population expected worldwide.** By 2100, Africa's population will make up a staggering 40% of the world's population. According to the World Bank, by 2050 an estimated 450 million young people will have entered the African labor market[3], which is already struggling to keep up with the pace of population growth. This influx of workers will not be fully absorbed by the public sector or by foreign direct investment (FDI), which barely represents 1% of global FDI flows in fragile and conflict-affected countries[4]. In addition, only 3 million formal jobs are created on the continent each year. The current growth of the job market is mainly based on sectors with limited employment, such as the oil and mining or the export of raw materials, which represent 55% of African GDP[5] but only employ 1% of the continent's workforce. Since these sectors create few decent jobs with low wages, they do not meet the employment challenges facing the continent. Economic growth in the Sub-Saharan region would create only 0,4% of employment for every % growth in GDP.

African countries are also facing an increasingly **difficult macroeconomic context**: they are vulnerable to external shocks (health crises, political and security-related conflicts, debt crises...), and are particularly vulnerable to **climate change.** The COVID-19 crisis led to a sudden halt in the convergence process that was enabling the continent to gradually reduce its development gap with the rest of the world. Due to demographic growth, GDP per capita in Africa has not yet returned to its pre-pandemic level. According to the World Bank, poverty rates in Sub-Saharan African countries are expected to rise over the next two years. The Human Development Index (HDI) has declined for an unprecedented two years in a row and has led to a five-year setback compared to pre-pandemic projections.

Nevertheless, thanks to dynamic demographic trends and rapid progress in different sectors, domestic markets **are growing and fostering economic growth**. Investing in sectors such as agriculture, health, education, and climate change adaptation and mitigation contributes to meeting the Sustainable Development Goals. African small and medium sized enterprises (SMEs) can play a decisive role in sustainable and inclusive growth while providing the continent with the means to face its current challenges and crises. **In emerging markets, SMEs are critical to driving economic growth, creating jobs, and working towards the Sustainable Development Goals.**

1. BAD, 2020 - 2. Kappel, 2022 - 3. Banque Mondiale, 2017 - 4. Shams, 2017/2018 - 5. French Development Agency, The African Economy 2021, 2021.

Who are these Sub-Saharan SMEs?

Africa has the highest rate of Small Enterprises in the world. SMEs are defined as companies with less than 100 employees in Cameroon, less than 300 in Tunisia, and with a turnover of less than two billion CFA francs in Senegal, etc.[7] The variety of definitions makes it difficult to sum up statistics and therefore to define the number of SMEs and their weight in African economies.

Without a standard official definition across African countries, we will here consider a wide range of firms including very small, small enterprises, and medium enterprises.

Entrepreneurship: Necessity or Opportunity

It is also important to note that there is a real dichotomy between necessity and opportunity entrepreneurship on the continent.8 Entrepreneurs by opportunity are considered as those who pursue a business opportunity they have identified or created. They are contrasted with necessity entrepreneurs, «individuals who are driven to start a business because they perceive no better employment alternative»[9].

SMEs in Sub-Saharan Africa operate in complex environments. Through the following section, we will identify the **main characteristics of these SMEs**. We will use data from the **World Bank Enterprise Survey** (2019), a firm-level survey of a representative sample of economy's private sector (website consulted in February 2023). The survey covers a broad range of business environment topics including access to finance, corruption, infrastructure, gender policies, competition, and performance measures. For the 2019 edition, 129,094 firms were surveyed around the world among 144 countries identified and among them, 30,753 Sub-Saharan African firms. Among the respondents in Sub-Saharan Africa, 89,33% were SMEs which make this survey relevant for our research.

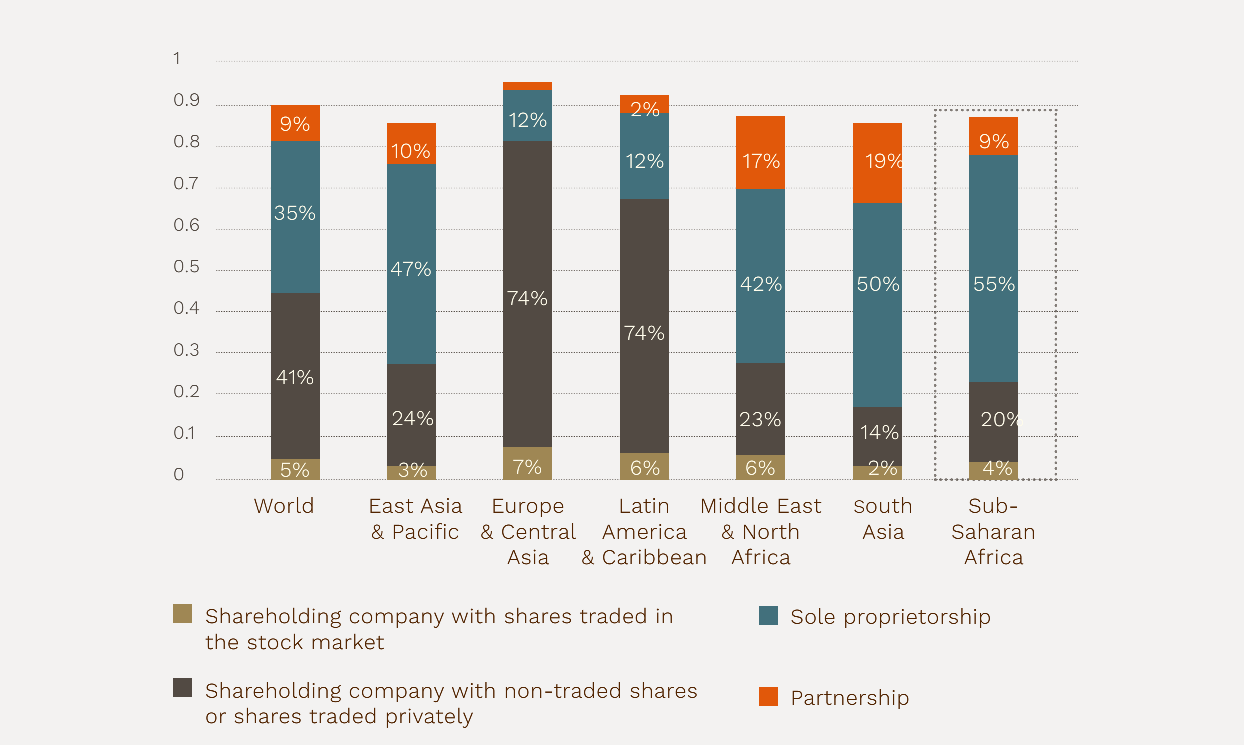
7. Private Sector and Development, 2019 - 8. Shapero, 2015 - 9. Bygrave, 2003 - 10. Rouanet, 2021

African SMEs in Sub-Saharan Africa have different characteristics

A predominance of sole proprietorship status

In Sub-Saharan Africa, the most common legal status for companies is sole proprietorship, **representing 55% of enterprises** (See graph below). This can be explained by diverse factors such as the misconception of financial setups and shared governance, but also social and ethnical norms inherent to each country. The percentage is also largely driven by the proportion of small and medium companies among Sub Saharan Africa respondents. **Indeed, among these companies, 60% are proprietorship.** The following graph compares the legal status of companies around the world.

Legal status of companies around the world (WBES, 2019)



Female ownership remains low

Wage job opportunities are relatively scarce in Africa and this is even more the case for women who often have lower levels of formal education and may face discrimination in hiring practices. When they **choose entrepreneurship, it is often** because of a lack of better opportunities, rather than a choice. Additionally, women tend to be given most of the responsibility for home-based work, so small-scale home-based businesses may be one of the few ways they can generate an income to help cover the needs of their families. According to the World Bank Enterprise Survey 2019, **only 13,4% of the companies are owned in majority by a woman**. This is lower than the world percentage which is of 14,6%, the highest being in East Asia (26,3%). In addition, according to the World Bank report "Profiting from Parity", **women earn lower profits than men, by 34% on average**.

A World Bank study (2015) found that among 40 Sub-Saharan countries, only eight showed a gender balance in SME ownership or a situation in favor of women. In the other 32 countries, women represented a minority of SME ownership: in many countries, less than 20% of SMEs have some level of female owners.

A scarce access to global markets

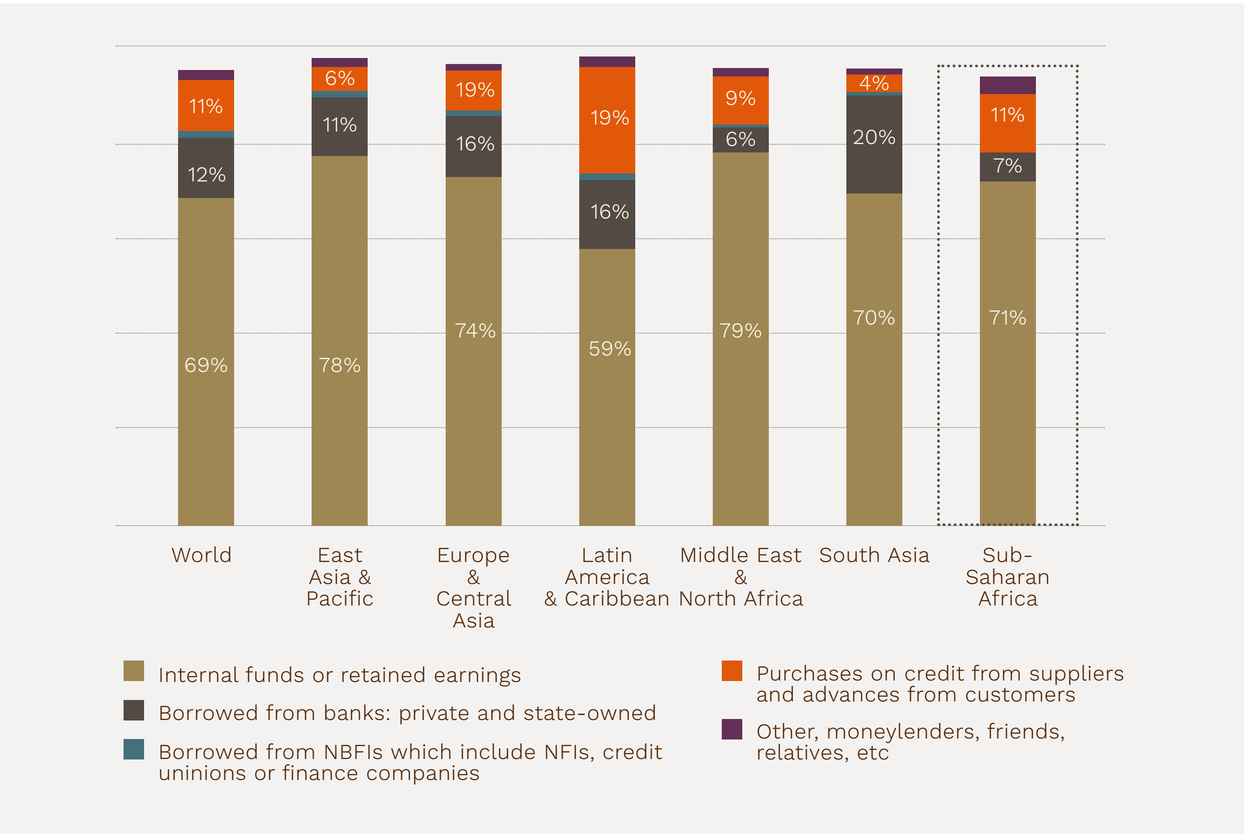
Sub-Saharan African companies sell mainly to the local market and have the smallest share of companies engaging in direct exports (8%[11]), in comparison with the rest of the world (17%). African SMEs have indeed very little access to global markets, **only 10% of them export directly**, compared to 34% of large companies. However, Sub-Saharan Africa is far from being self-sufficient and needs to import to meet local demand of essential goods (food, medicine...). Hence, a scaling-up of SMEs to **answer local demand of essential goods and replace imports is much needed.**

Capital structure: a restrained access to external sources of funding

The capital structure is relatively similar in African firms and in the rest of the world. According to the figure below, Sub-Saharan African SMEs are **financed by internal funds** or retained earnings (71%) compared to large companies (63%). **They borrow less from banks** (7% of capital sources) than large companies do (14%) due to both difficulties to provide adequates collaterals and for lack of adequate financing products.

In summary, African SMEs are largely sole-owned, with a high share of small and very small enterprises. The high share of sole ownership is correlated to an important share of entrepreneurs by necessity. SMEs mainly sell to national or local markets, but it is not enough to meet the local demand. And finally, they evolve in an informal environment and have little access and/or compatibility with commercial banks.

Capital sources of firms (world)



11. World Bank Enterprise Survey, 2019

Supporting the domestic private sector, in particular formal SMEs, contributes to addressing the continent's challenges

In Sub-Saharan Africa, national economies are characterized by a large number of **micro, small, and medium-sized enterprises that provide the majority of employment, often informal**. They contribute significantly to economic growth and are the pillars of job creation. Indeed, they make up **90% of businesses and 40% of the continent's GDP**[12]. They are the main source of employment on the continent, **employing 80% of the population** (formal and informal sectors). When formal, SMEs create formal, stable, and decent jobs, allowing people to earn a decent living wage, strengthening access to health insurance and ensuring safety at work. Formal jobs offer higher and regular wages and thus improve family access to credit, housing, and education.

Moreover, African SMEs significantly contribute to **structuring local economies and fostering self-sufficiency by promoting import substitution**. Successful African SMEs tend to source locally – more than multinationals, which rely on international networks – and structure entire local value chains. As a result, SMEs play a key role in economic diversification, while strengthening agribusinesses, fostering local production, and diversifying economies, which in turn fosters macroeconomic resilience. **By paying taxes**, SMEs foster local economies and fund national policies while contributing to the state's investments in infrastructure, health, education, etc.

Last but not least, SMEs contribute to achieving **sustainable development**, whether through providing environmentally-friendly products and services or by implementing climate change mitigation and adaptation strategies.

I&P's central hypothesis is that financing small and medium-sized enterprises in Sub-Saharan Africa is key to achieving major development outcomes in the region. I&P has demonstrated that these entrepreneurs have the greatest impact on their local ecosystems (employees and their families, clients, value chains, the environment, etc.) and make a significant, concrete and proven contribution to the UN's Sustainable Development Goals (SDGs). However, the current study has a broader objective and aims to go beyond I&P's impact alone so that I&P's results and key learnings benefit as many people as possible and lead to new initiatives that promote supporting and financing SMEs.

12. Private Sector and Development, 2020

However, African SMEs face structural and situational obstacles that challenge their ability to scale up

According to the World Bank's Enterprise Survey tool[13] (consulted in 2023), the main obstacles to private sector operations in Sub-Saharan Africa are similar to those faced in the rest of the world. "**Access to finance**" (24.5% of the surveyed Sub-Saharan companies) and "Electricity" (14%) are the greatest obstacles, followed by "**Practices of competitors in the informal sector**" (11%), "**Political instabilities**" (10%), and "**Tax rates**" (10%).

Access to finance is a key constraint for SME development. Without reliable sources of capital, SMEs are unable to make investments, leading to stagnation.

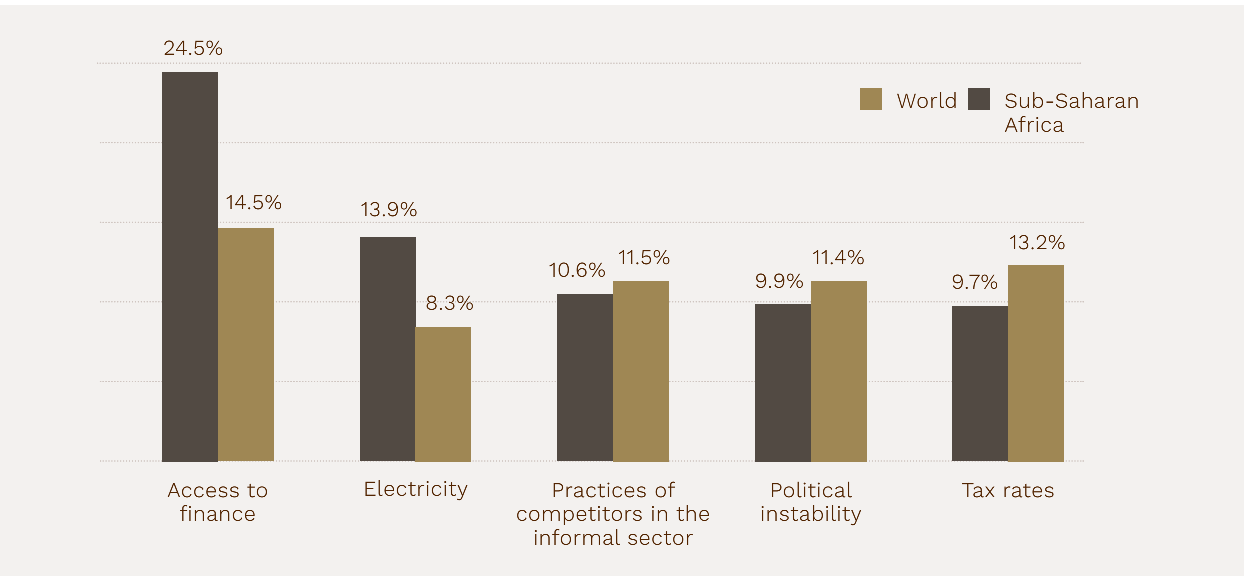
African firms report that **unreliable electricity** is the second biggest obstacle they face. About 48% of Sub-Saharan African lacks proper access to electricity, and every sector suffers from shortages[14].

66% of Sub-Saharan African firms declare that they compete against **unregistered or informal firms** that benefit from more flexible practices. In addition, it is estimated that 89% of jobs are informal.

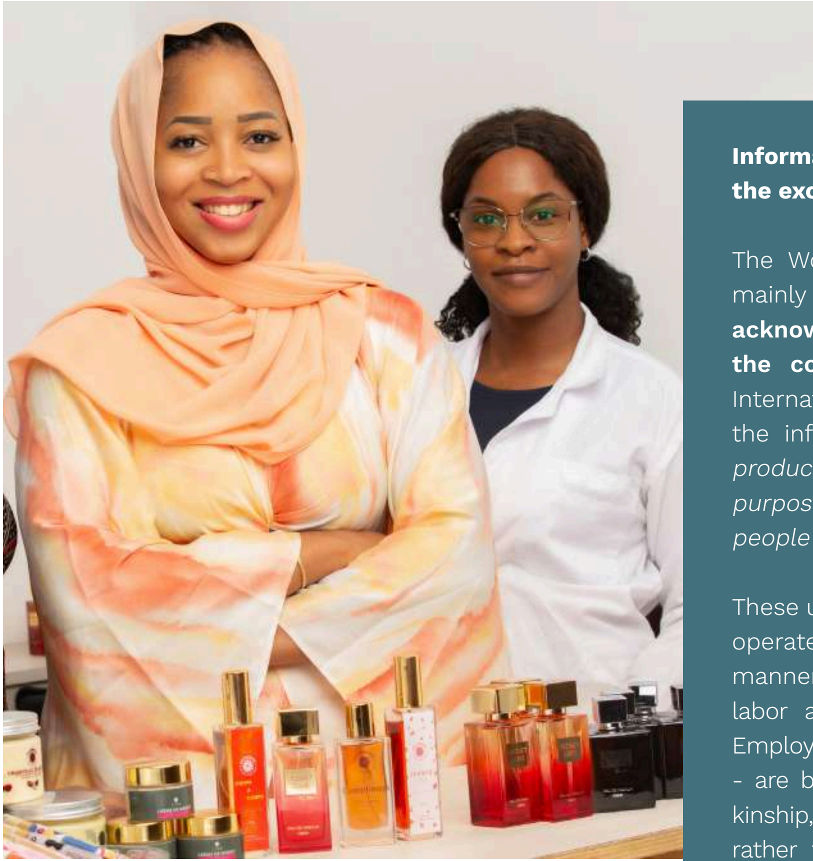
Political instability is an entrenched problem in Sub-Saharan Africa and the numerous crises, such as the 2022 political and security crisis in Burkina Faso and Mali or the 2016 Nigerian economic crisis, have prevented SMEs from growing.

35.7% of firms identify **tax rates** as a major constraint. In addition to being costly, these issues require time: 8% of senior management's time is spent dealing with the requirements of government regulations.

Top 5 obstacles in Sub-Saharan Africa and in the world



13. https://www.enterprisesurveys.org/en/custom-query. - 14. McKinsey & Company, 2015



The overall trends are similar for SMEs and large companies. Nevertheless, ***SMEs quote access to land, practices of informal sector competitors,*** *and* ***access to finance*** *as major obstacles whereas larger firms mention difficulties with the justice system, lack of skilled labor, and trade regulations.*

Expanding access to finance

The challenge most often quoted as the biggest obstacle for companies is "**Access to finance**". In Sub-Saharan Africa, **the current lack of financing for SMEs is estimated at $330 billion**[17], **while the current offering is only $70bn**. Consequently, according to the International Finance Corporation, Africa has the highest rate of underfunded SMEs (51%[18] - Figure on page 14). The available financing is not only insufficient but also not well-suited to SMEs, which are considered by the various financial operators as too risky and are often unable to provide the necessary guarantees or financial history required by these operators.

Informality: the norm rather than the exception

The World Bank Enterprise Survey focuses mainly on registered companies. However, **acknowledging informality is essential in the context of Sub-Saharan Africa**. The International Labour Organization defines the informal economy as « *a set of units producing goods or services with the main purpose of creating jobs and income for the people concerned* ».

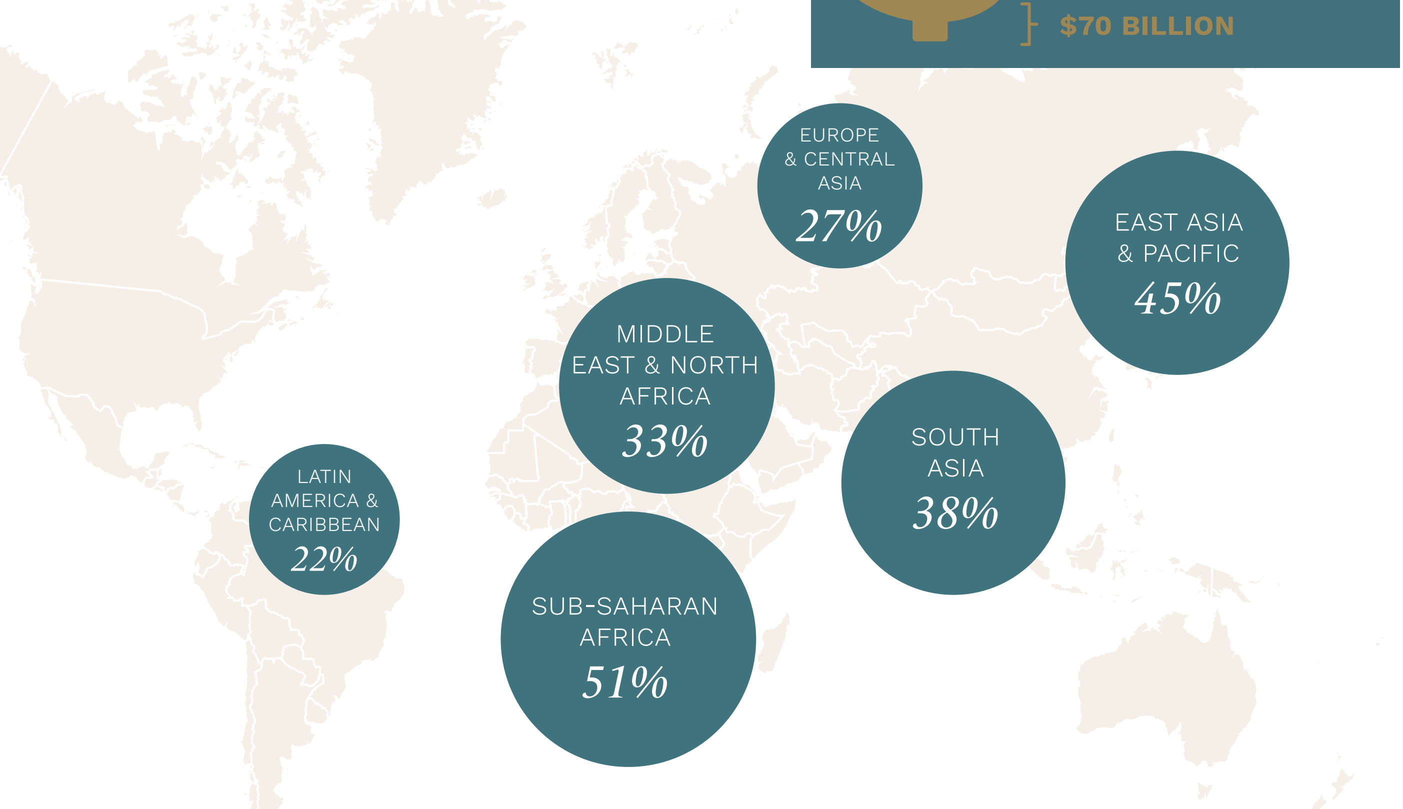
These units, having a low level of organization, operate on a small scale and in a specific manner, with little or no division between labor and capital as factors of production. Employment relationships - where they exist - are based primarily on casual employment, kinship, or personal and social relationships, rather than on contractual agreements with formal guarantees. It is estimated that **89% of jobs are informal** [15]. This proportion varies greatly across the continent, rising to 95% in West Africa, but falling to around 35% in South Africa[16].

Informality offers flexibility, allows companies to adapt to economical fluctuations and is a way to avoid administrative constraints (taxes, regulations, administrative requirements...). Nevertheless, **informality is often not a conscious choice** (formalization is expensive by also complicated and time-consuming). In addition, the lack of information and functional structures for rapid registration do not encourage entrepreneurs to formalize. Informality can be identified at different degrees. Businesses can be registered and provide informal jobs or can pay flat taxes unrelated with their turnover and not own or rent the land they use, etc. Informality excludes entrepreneurs from public tenders, but also from the financing system. In another hand, it reduces the States' fiscal resources to invest in infrastructure, health, education, etc. At the macroeconomic level, supporting small companies in their formalization process represents increased fiscal revenues to fund national policies.

15. International Labour Organization , 2018 - 16. International Labour Organization, 2018 - 17. International Labour Organization, 2018
18. International Finance Corporation, 2018

Demand for financing is estimated at $330 billion when offering is only of **$70bn (17.5%)**

Share of financially constrained SMEs in total SMEs by region



Who are the different financial operators?

◆ **African commercial banks** exist, but they mainly offer long-term loans targeting infrastructure sector, machinery and other tangible assets but rarely working capital or factoring needs. These loans are often reserved for banks' top customers, have relatively high interest rates (often in the double digits, sometimes higher than 20–25 percent[19]), rapid maturity and high guarantee requirements. They are mostly concentrated in urban areas and finance in priority low-risk activities (trade, equipment). The absence of local bond markets and long-term interbank lending systems lead to a dependency on customer deposits for financing. Moreover, in 2019, there were only 4,4 commercial bank branches for 100,000 adults in Sub-Saharan Africa, while there was 10,6 for East Asia and Pacific, and 13,2 for Latin America & Caribbean[20]. As they are seen as riskier and the credit supply is inadequate, the average SME seeking to scale-up suffers from a tight credit offer and high interest rates. In one hand, they cannot provide the guarantees required and reliable financial statements. On the other hand, African banks face significant set-up costs due to issues related to infrastructure, for example. All in all, long-term financing is unaffordable. They could find opportunities to fund equipment but should ensure that the rate and terms are consistent with the material's capacity to outperform those conditions. These financial obstacles are even more constraining when businesses are women-owned. Indeed, they tend to have a smaller enterprise, and face more difficulty to scale-up because of lack of collateral (land property or assets not in their name as well as gender stereotypes) or credit history.

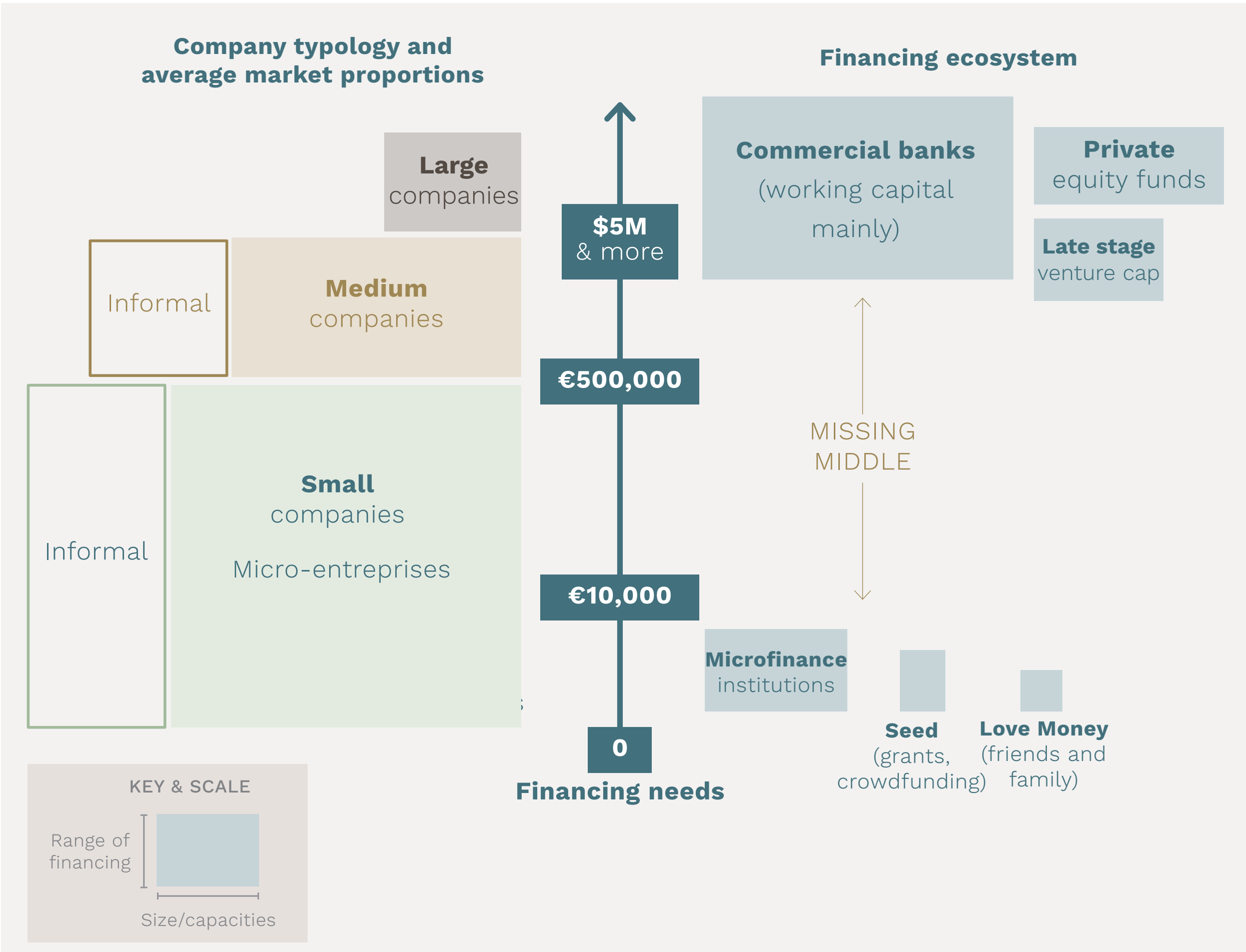
◆ **Private equity funds and international investors** traditionally require investor-ready metrics and track records, but also provide high ticket sizes compared to SMEs' needs.

◆ On the other extremity of the scope, **microfinance institutions (MFIs)** offer diverse services from deposit collection to credit facilities and savings mobilization. Mutual benefit MFIs only serve their shareholders. Their credit capacities are limited by the amount of savings collected and are therefore more dedicated to local cooperatives or households. Incorporated MFIs have greater access to refinancing and can serve a greater variety of customers. However, they provide loans with at near-usurious rates, short deadlines, and focus on low-risk sectors such as trade and retail for instance.

- Some SMEs may turn to **crowdfunding**[21] or **business angels**[22], but the availability of these financing methods is still extremely limited compared to the continent's potential.

The lack of relevant financing products mixed to a less conducive economic environment has led to the well-known conclusion of a **missing middle** in Africa, illustrated in the figure below. **The term missing middle reflects the gap faced by SMEs when it comes to financing, due to the lack of a financing continuum in the region.** They struggle to find financing at both ends, being either too risky for some, too small or too large.

Financing the ecosystem and the missing middle in Africa



To generate the long-term impacts previously described, African SMEs must be economically sustainable. They therefore need access to long-term financing, governance, and management skills. It is from this perspective that I&P began its business as an impact investor, with the objective of addressing this underserved segment. Indeed, concessionary financial tools can address this financing gap by answering a two-fold strategy: finance projects that have positive social and environmental impacts, i.e., those SMEs considered as less profitable, while maintaining positive returns.

In the following section, we will analyse how I&P's financing tools and methodology address the needs of African SMEs while creating firm-level and market-level impacts.

19. CSIS, 2021 - 20. International Monetary Fund , 2019 - 21. The practice of funding a project or venture by raising money from a large number of people who each contribute a relatively small amount- 22. A business angel is an individual who decides to invest part of his or her financial assets in innovative companies with high potential

02

Tackling challenges of the missing middle with catalytic capital

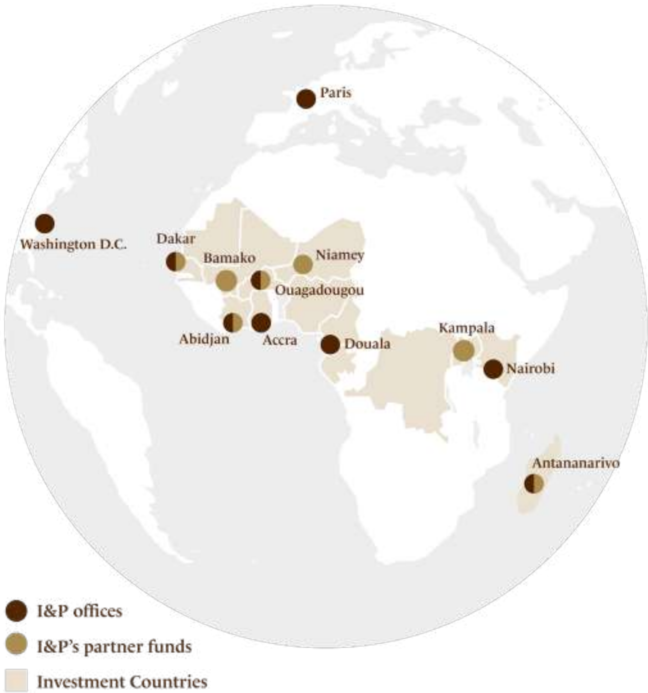
The use-case of I&P impact funds

I&P deploys catalytic financing tools to meet the needs of SMEs in the missing middle

Overview of I&P's activities and experience

Since 2002, I&P has gradually extended its scope of intervention **to provide financing to this so-called missing middle** and now offers a **continuum of funding mechanisms**. Indeed, I&P provides a variety of tools and services to sustain the growth of businesses at all development stages: equity; quasi-equity, and other instruments (such as reimbursable advances or convertible notes), which are all suitable for the time and development needs of SMEs and offer flexible and adaptable conditions. I&P has created a financing continuum ranging from several thousand euros to 5 million euros, filling a critical financing gap in geographies where the perception of risk is usually high.

In addition, I&P manages and advises several funds and programs entirely dedicated to African startups and SMEs, which are mainly distinguished by the size and maturity of the targeted companies. They bring a strong additionality and fill a critical financing gap in Sub-Saharan Africa (especially in Francophone Africa), where the perception of risks is usually high, but where impact creation can be very important.



I&P Intervention countries

This section describes how I&P uses concessional financing to meet the needs of SMEs, financing that can be considered as catalytic capital investments.

I&P has gradually extended its scope of intervention and now offers a continuum of investment ranging from several thousand euros to 3 million euros, through four complementary lines of businesses:

I&P ACCELERATION

Scaling-up young businesses through seed funding and/or training programs

I&P Acceleration programs rely on a proven methodology based on seed-funding, trainings that combine skill-building and individualized mentoring, strategic support, and technical assistance missions. One of its key programs is **"I&P Acceleration in the Sahel" (IPAS)**, a €19 million program funded by the European Union. IPAS supports **early-stage companies** with pre-investment financing, provides financial support and technical assistance to young SMEs, as well as capacity building and training to the overall SME ecosystem. It offers reimbursable advances. The recycling objective is at 70% and requires high standards in the selection of the companies. So far, every dollar disbursed in these SMEs led to a fundraising of $0,5.

I&P DEVELOPMENT

Sponsoring a network of African funds to finance small companies with high potential in amounts ranging between €50,000 and €500,000

I&P Development (IPDEV 2) is an **evergreen financial company** which was conceived as an incubator and **sponsor of 10 African country-focused investment funds**. These 10 impact funds are deeply rooted in their local context and can efficiently and sustainably support start-ups and very small businesses with minority equity and quasi equity financing between **€50,000 and €500,000.**

This project was made possible by its shareholders, who accepted to take **a significant level of risk with low return expectations (capital preservation)**, based on the impact of the program. 7 local investment funds were launched to date (5 of which are mature enough for financial analysis (cf. part 3), completing successful **fundraisings toward national investors**. For every dollar invested by IPDEV 2 into these funds, $4 were raised on local investors. These teams supported and financed **50 SMEs** to date, generating significant impact and allowing SMEs to raise additional funds from local African investors ($0,76 was raised for every dollar invested by IPDEV 2 fund).

In addition to equity investments, I&P Development raised grants to finance the **launching phase** of national investment vehicles, making each project **sustainable** and enabling third-party investment that otherwise would not be possible. Last but not least, IPDEV 2 benefited from a **concessionary loan** which had complementary roles of de-risking the whole project by acting as a first-loss mechanism after 10 years and improving the risk profile and impact of IPDEV 2 investments by financing the portfolio SMEs through debt instruments.

The 7 first investment funds, mature enough for financial analysis are based in: Côte d'Ivoire, Niger, Burkina Faso, Madagascar, Senegal, Mali and Uganda (the last fund that was launched).

I&P EXPANSION

Supporting and providing equity financing to mature SMEs and start-ups in amounts ranging between €500,000 and €5 million

I&P Afrique Entrepreneurs 1 and its successor fund I&P Afrique Entrepreneurs 2 are Pan-African SME funds dedicated to support entrepreneurs seeking economic growth and societal impact. They provide equity and quasi-equity investments **between €500,000 and €5 million** as a minority shareholder but with an active involvement in the governance. At this day, they are present in 12 different countries, half of which are ranked Least Developed Countries. The funds seek co-investors in most cases, among its LPS but also other players and has a **strong leverage effect** on debt providers, especially local ones ($0,6 was raised for every dollar invested by IPAE). Both funds operate in various business sectors (health, agriculture, construction, microfinance, services).

IPAE 1 and 2 are one of the only generalist SME funds operating with such ticket size in Francophone Africa, especially in LDCs.

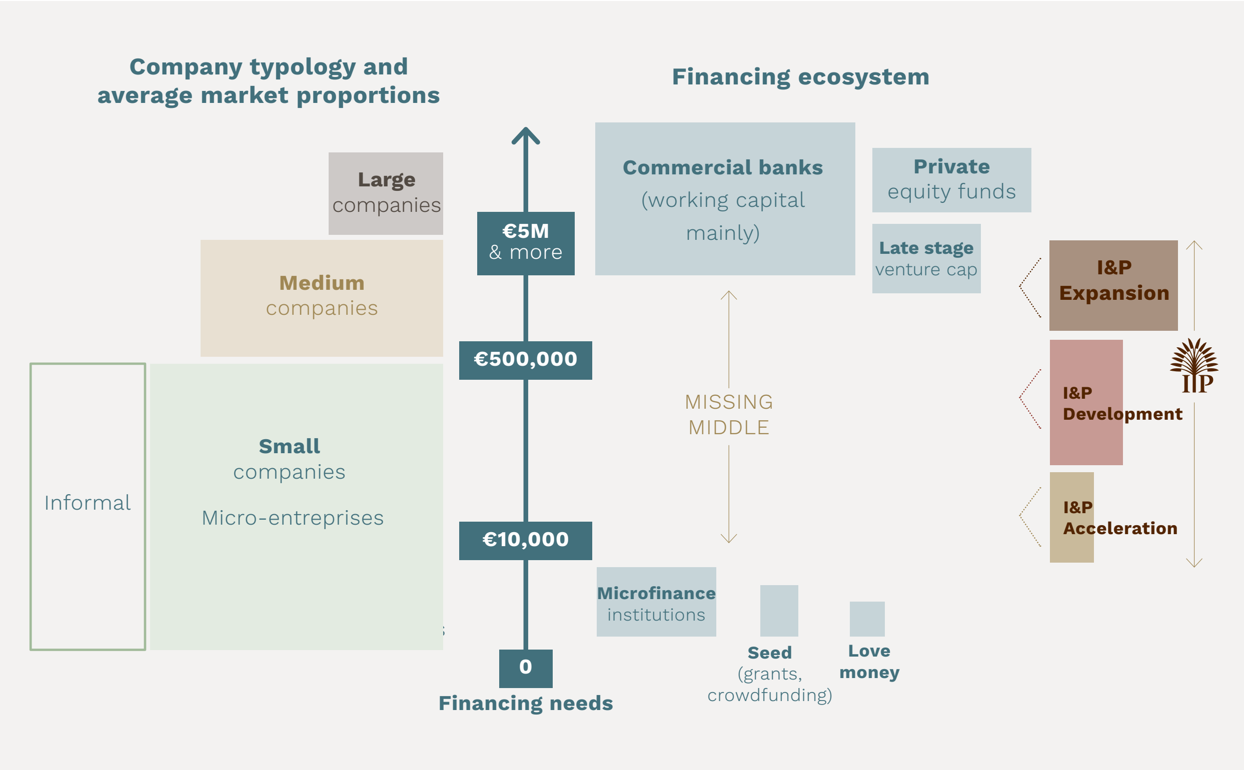
Their sizes are respectively of €54 and €92 million. The funds target an IRR above capital preservation but **below market rate returns**. considering the small size of the investments and risk related to its geographies.

I&P ECOSYSTEMS

Promoting the emergence of entrepreneurs and investors in Africa and fostering the development of a business environment conductive to their prosperity

Capitalizing on I&P's expertise as an investor, I&P Ecosystems increases the impact of the Group's activities by providing structuring, advice, training and support to the public and private intermediaries that make up the ecosystem supporting entrepreneurship in Africa. ***I&P Conseil***, the consulting branch of I&P, encourages the emergence of entrepreneurship in Africa and prepares ecosystems for a better partnership with investment funds by designing courses, carrying out strategic studies, partnering with local players and designing new programs and funds. I&P Ecosystems has also been chosen as the fund manager of the ***Mastercard Foundation Africa Growth Fund***, a new initiative financed by the Mastercard Foundation and led by MEDA: a $200 million fund of funds which, through African investment vehicles, supports SMEs and start-ups in the start-up and growth phase on the continent.

I&P's range of funds within the ecosystem



With the creation of local added value in 16 African countries, a significant positive impact and more than 255 portfolio companies supported by a variety of dedicated instruments, I&P has a significant track record in supporting and financing the private sector. Catalytic capital has been essential to make I&P's model work, along with other partnerships and tools that increase the ecosystem's efficiency. Raising such funds rely on the capacity to generate and account for financial and non-financial impacts. In the following chapter, we will analyse how I&P's policy encourages and ensures that investments generate non-financial impact for firms, their employees, and their relatives. Then we will evaluate the financial outcomes and costs related to investments and therefore the role catalytic capital played in balancing the model, and what other success factors have been identified.

Defining catalytic capital

The expectations of SMEs in terms of flexibility, accessibility and conditions call for a new type of capital and investors. As defined in Tideline's 2019 research report on impact management verification, catalytic capital addresses a significant part of the growth needs of SMEs:

« We define catalytic capital as debt, equity, guarantees, and other investments that accept disproportionate risk and/or concessionary returns relative to a conventional investment in order to generate positive impact and enable third-party investment that otherwise would not be possible »

Tideline – Catalytic Capital: Unlocking More Investment and Impact, 2019

Moreover, catalytic capital provides essential leverage for impact funds economic model, as it addresses some of the above-mentioned challenges faced by African SMEs while ensuring the viability of the funds. We identified a number of concessionary criteria, specific to catalytic capital, that allow to best address the financing challenges of African SMEs:

◆ PATIENCE: Long-term financing is much-needed. As these SMEs are not yet fully structured, they need time to set up actual processes and scale up their business, especially in rural environments and agribusiness sectors where the duality of seasons and climate variations can additionally affect their performance. Repayment delays (for debt) or too short a holding period (for equity) can put the company at risk while not allowing investors enough time to make the most of their contribution. **I&P's acceptance of a longer or uncertain time period before exit** (in equity) **or flexible debt repayment schedules** are forms of concession and give SMEs the opportunity to build-up on a more sustainable basis.

◆ RISK-TOLERANCE: A major obstacle to access to credit for African SMEs lies in their incapacity to provide commercial banks the required guarantees, which are often equal to or greater than the loan amount. By financing companies in the missing middle, **I&P's vehicles undertake stronger risks** that would not be considered by traditional investors. In addition, **I&P does not usually require collateral**, which increases the level of risk. The return on investment expected by I&P's vehicles does not compensate for the high risks involved; the approach is thus **concessionary** and **risk-tolerant**.

◆ CONCESSIONARY PRICES: Market rates in Sub-Saharan Africa are high, usually in the double digits. Lending at affordable rates is essential to providing young SMEs with affordable capital. I&P Acceleration in Sahel program addresses the financial needs of SMEs during their incubation or acceleration phase with **seed financing**, in particular with **reimbursable advances at a zero-interest rate**.

The Catalytic Capital Consortium has identified the need for catalytic capital as urgent and made it its mission to increasing shared knowledge about, establishing best practices for and, importantly, encouraging the use of such flexible capital within the impact investing community - with the objective to expanding and deepening impact. I&P is aligned with the consortium's ambition and shares its objectives with a focus on its target region and activities.

I&P's investments also have a strong leverage effect: for €1 invested by an I&P fund, €2 are invested by other investors in average. Most of those additional investments would not have been realized without I&P initial investment and lead taken among investors.

« Catalytic capital is an essential tool to bridge capital gaps and achieve both breadth and depth of impact, while complementing conventional investing »

Catalytic Capital Consortium - Catalytic Capital at Work, 2019

I&P has been deploying catalytic capital and engaging in accompanying grant-supported activities for twenty years in order to overcome the challenge of balancing frontier-market SME funds

Since its creation, I&P has gradually extended its scope of intervention and now offers a continuum of investment activities that answer the needs of companies, from the seed stage to the growth stage. One of the key success factors of its model has been **the progressive development of catalytic capital tools and accompanying grant-funded support mechanisms that jointly have enabled the scaling up of I&P's impact investment activity.** Indeed, catalytic mechanisms have been progressively integrated to meet the needs of balancing risk and to conciliate the return expectations of its different shareholders:

◆ As a novice and pioneer in the impact investment sector in Africa, I&P's launch was done with an intuitive **and "experimental" use of catalytic capital, quite different from the blended finance models of today**. I&P's first pilot fund (IPDEV1), with a final size of €11 million, was indeed launched essentially with its founder Patrice Hoppenot's own funds and those of a pool of business angels. We can consider these funds as catalytic funds as they share the characteristics of patience, higher risk, and low or no return. However, these funds were subsidized by private individuals rather than by institutions. IPDEV 1 was a pilot experience essential to developing I&P's model. However, this pilot activity was carried out on an extremely small scale, and only the entry of the first landing partners made it possible to scale up this business.

◆ I&P's historical line of business is to support African entrepreneurs through the pan African investment funds **I&P Expansion** (IPAE1, IPAE2 and its future successor fund IPAE3). The shareholders of these funds accept an **unbalanced risk/profitability profile** compared to conventional funding, justified by the impact intentionality of I&P's strategy. Together with their investments in the funds, some investors have also brought technical assistance facilities to the SMEs as an additional grant funding package. In terms of capital structure at the fund level, blended structures including, for instance, a junior or first loss tranche, were not applied in IPAE1, where all shareholders were being pari passu.

◆ In order to continue financing lower tickets at an affordable cost, I&P launched a second line of business, **I&P Développement** (IPDEV2), a holding company that sponsors national African fund management teams. Investors of the holding company aim to contribute to the leverage effect of IPDEV2 (anchor investor), allowing national funds to raise capital from local investors willing to invest in smaller SMEs. Through this program, I&P also raised grant support, both to provide technical assistance to the supported SMEs and to finance fund launch phases before their closing. A first-loss loan mechanism[42] provided by AFD through a junior loan has also been set up, both to provide a first-loss cushion to investors in the local funds and to provide low interest loans to the underlying investee SMEs of the funds.

◆ I&P has recently created a new range of activities, **I&P Acceleration**, which aims to provide close support to companies with promising impact and local value creation that are still too informal, poorly structured, and insufficiently mature to access conventional financing. I&P Acceleration programs, such as *I&P Acceleration in Sahel*, prepare these SMEs to be **investment ready** while **reducing the pre-investment time and costs**. For all I&P Acceleration programs, the main financing tool used is repayable advances, i.e., a debt without interest or guarantee. The potential losses, costs of implementation, and technical assistance are grant funded.

42. The first loss guarantee is a mechanism whereby a third party compensates investors/lenders if the company defaults. As the third party pays for the losses, the mechanism gives investors/lenders more confidence to give out capital, acting as insurance against a loss.

Progressive deployment of catalytic mechanisms within the I&P group's funds

2002 — IPDEV
PILOT FUND

Fund's launch subsdized by private individuals:

- Founder's personal funds + business angels
- Volunteer Fund Director
- Evergreen investment company
- Patience, higher risk, and low or no return

2015 — IPDEV2
SPONSOR FUND

- Evergreen structure
- First-loss mechanism (junior loan from AFD)
- Subsides to finance fund-launch phases beofre closing
- Subsides to finance TA for SMEs
- IPDEV2 acts as anchor investor provides leverage on national investors

2012 — 2017 — IPAE 1 & IPAE 2
SCALING UP

First entry of institutional investors:

- Unbalanced risk/profitability ratio
- Grant funding for Technical Assistance

At SME level, the investments made by I&P are catalytic: I&P funds take a high level of risk compared to modest return expectations, with more patience on repayment terms, a search for leverage etc.

I&P has demonstrated the long-term impacts of financing SMEs through catalytic capital

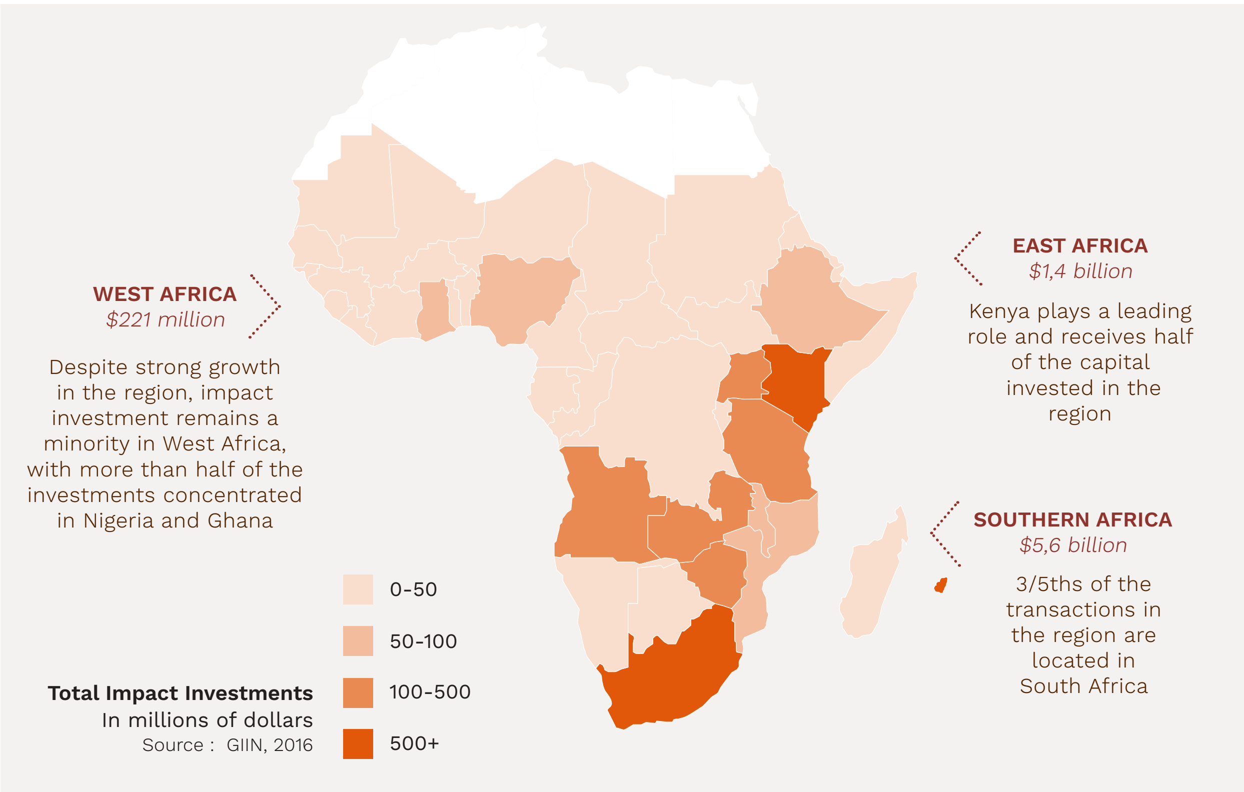
One of **I&P's additionality commitments** is to support SMEs that are not supported by others actors and to use catalytic capital to bring resources to underserved geographies. According to the latest GIIN Impact Investor Survey (2020)[23], **Sub-Saharan Africa is the 4th most popular region for impact investors** and is attracting more and more funds. In 2019, $12,800 million were allocated to the region, representing 33% more than in 2015. However, these encouraging results conceal a less positive reality. Yes, the region is attracting significant asset flows but these flows are not evolving much compared to the global trend. In 2019, Sub-Saharan Africa impact investments represented 11% of the world's total impact investments. In addition, there are large regional disparities; only 14% of impact capital is disbursed in African Least Developed Countries (LDCs), and there is a low availability of funding in West Africa, with more than half of the investments concentrated in Nigeria and Ghana.

This concentration can be explained as follows:

◆ Nigeria accounted for 80% of the region's GDP, and has received the largest amount of impact capital (29%) because investors seek to service a large and growing addressable market.

◆ Ghana has received a nearly similar share of impact investment (25%) despite only accounting for 5% of West Africa's GDP. The political stability and business-friendly regulations explain this attractivity.[24]

Impact investment, capital invested from 2005 to 2015 (in billion)



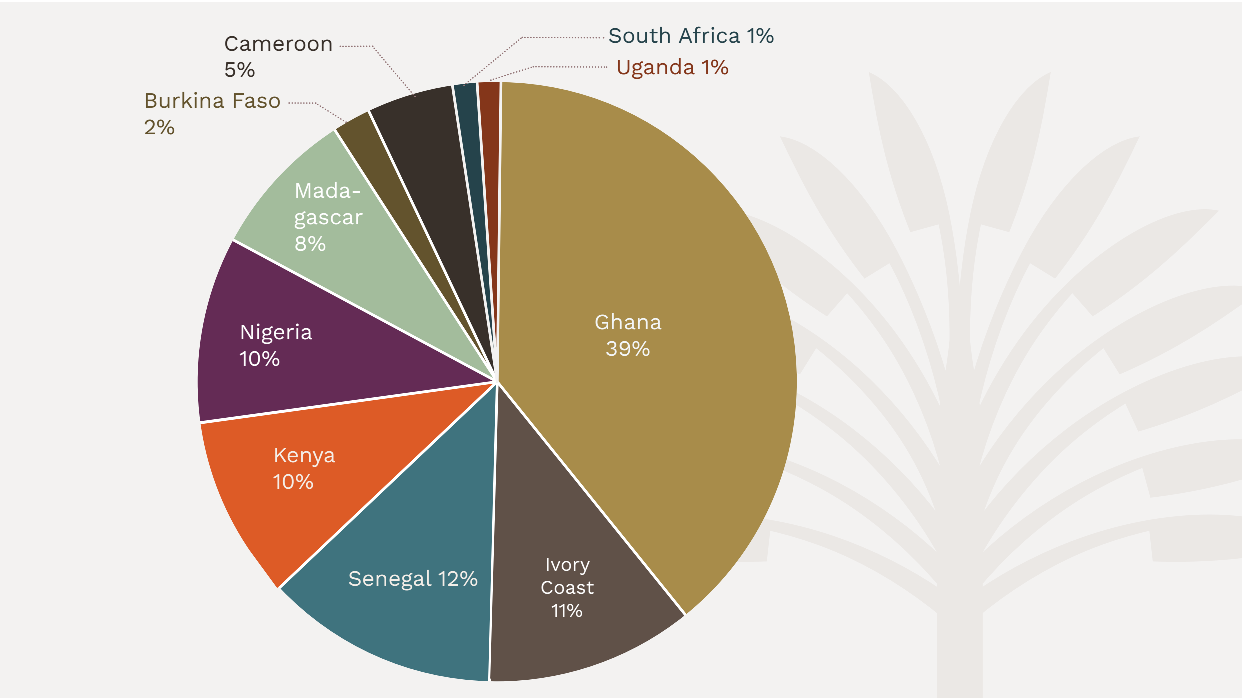
23. To avoid confusion, it is important to note that the Global Impact Investor Network 2020 only describes the assets of a respondent sample of 294 investors and therefore does not represent the full market size. - 24. I&P, FERDI

Among the 46 Impact Investors that are active in West Africa, 32 of them were non-DFIs. These non-DFIs investors surveyed by the GIIN study had closed around 250 deals and disbursed $221 million in West Africa. Among those 250 deals, only 32 used quasi-equity or equity, the rest operated with debt.

I&P strives for the emergence of private equity as a reliable solution for SMEs and to create additionally, especially in Francophone Africa. I&P thus chooses to target underserved markets to maximize its impact: among the 260 million invested in equity or quasi-debt by I&P investment vehicles, 78% of the investments have been made in the least developed or fragile countries.

In June 2021, the IPAE fund allocation per country was the following:

IPAE breakdown per country (% of total invested), 2021



As we can see on the figures above, Ghana and Nigeria attract a big share of I&P impact investments: almost 50%. This can be explained by the fact that the amounts invested in anglophone countries are greater because the companies are more structured and developed. Nevertheless, if we consider the number of deals, these two countries are less present in I&P's portfolio.

Focus - IPDEV2: Strengthen local investment structures

In 2020, only 5% of the surveyed impact investment organizations' headquarters were in Sub-Saharan Africa. I&P contributed to modify this trend with the launch of I&P Development. This investment vehicle, acting as a fund of fund, seeks to develop local private equity funds and national partners. It aims at providing a leverage effect: for every dollar invested by IPDEV 2 into these funds, $3 were raised by the local funds through local investors. In 2022, the funds supported and financed 50 SMEs, generating significant impact and allowing SMEs to raise additional funds from local African investors.

In addition to financing particular SMEs, each intervention generates **useful learning for the entire ecosystem**. Indeed, **I&P acts as a market builder: impact lies both at the company and market levels**, as supporting pioneering impact firms proves the viability of new models that foster competition, spark innovation, provide industry infrastructure, and influence policies[25].

25. Omidyar Network, 2020

The effects of I&P's financing are reflected in its impact thesis through 6 key impact pillars

The I&P impact strategy focuses on 6 fundamental pillars:

1. Accompanying the emergence of a new generation of African Entrepreneurs in fragile and Least Developed Countries
2. Creating decent jobs and training opportunities
3. Densifying the local economic fabric
4. Easing access to essential goods and services
5. Promoting Gender equality and women's empowerment
6. Fostering sustainable growth

1. Accompanying the emergence of a new generation of African Entrepreneurs in fragile and Least Developed Countries

I&P's core mission is to **support the emergence of a new generation of responsible entrepreneurs'**, making a difference in their community. The targeted companies often lack access to financial services or development support, preventing them to grow. I&P has thus developed different approaches to meet the needs of underserved African SMEs, according to their maturity, size and financing requirements. This is done partly through the **formalization of the private sector**, which results in more sustainability and higher fiscal performance for local states.

Transitioning to formality has indirect impacts:

◆ Transversal to the benefits for the workers, a formalized business helps to **structure the market**: by adopting standards and disseminating good practices, it turns the firm into an active game changer of the local economy.

◆ The **respect of fiscal rules** is a precondition for long-term growth within a formal framework and key to establishing strong relationships with banks, authorities and international partners.
In 2019, I&P's partners companies paid €51 million in taxes to local authorities.

◆ Moreover, **formalization often means enhanced performances for companies**. For example, a World Bank and French Development Agency study[26] shows a 20% increase in profits for formalized companies in West Africa.

◆ Respecting standards pushes SME to improve the quality of their products and to consider certifications.

◆ By offering formal employment contracts that facilitate access to certain benefits for the employee, they ensure that they **attract a better-quality workforce** and become more attractive to potential candidates.

◆ In addition, they benefit from a **better connection to the public infrastructure network**: in Dakar, 80% of formal companies are connected to the water distribution network compared to 55% of informal companies.[27]

◆ A company has **easier access to financing from investors or banks** by becoming formalized in terms of taxation and accounting. It also creates new opportunities with clients who require formalized partners.

◆ Finally, the **guarantees of legal contracts** provide protection against fraud and legal disputes.

26. French Development Agency & World Bank, 2012 - 27. I&P, 2019

2. Creating decent jobs and training opportunities

Decent jobs go beyond work availability by ensuring that employees have the ability to support themselves and their close ones, develop their potential and participate in the development of their country (definition of the French Agency of Development[28]). In addition, they result in higher-paying, better conditions and more secure jobs, providing access to training, social security, social protections and a "regular salary". In Africa, the number of young working poor is declining every year, but not as fast as in other regions. In 2019, the number of working people over the age of 15 living below the poverty line was still by far the highest.

Informality is strongly related to the issue of decent work. The significancy of the topic has been highlighted in the table beyond (Proportion of employed population living below the poverty line, 2019).

Proportion of employed population living below the poverty line, 2019					
Africa	Americas	Arab States	Asia and the Pacific	Europe and Central Asia	World
34	2,5	9	4	0,8	7,5

Creating decent jobs and training opportunities, improving HR skills and providing formal jobs results with higher incomes for the employees and their households, as well as higher living standards (health, education, etc.) is one of I&P's target.

28. French Development Agency, s.d.

Focus – Minimum wage vs. Living wage

The minimum wage is defined as a legal construct that is required by law, whereas living wage estimates are established outside of a political process and are normative based. The living wage represents the remuneration received for a standard workweek by a worker in a particular place, sufficient to afford a decent standard of living for the worker and her or his family. Elements of a decent standard of living include food, water, housing, education, health care, transportation, clothing, and other essential needs including provision for unexpected events. A living wage is particularly important because it prevent workers from working excessive overtime hours or multiple jobs, putting their children into work instead of school, being unable to withstand crises such as ill health or being denied their basic human rights to food, shelter, nutrition, health, housing and education and suffer social deprivations such as being unable to take part in cultural events.

Minimum wages in Africa are far from being living wages. This is holding people in poverty and constraining development. Initiatives by employees are thus underway to demand an increase in minimum wages, such as the "100% Africa: Dignity, Value and Wages" campaign. Unions are calling on their governments to set minimum wage floors that allow African workers and their families to live in dignity.

The average minimum wage paid by I&P's partner companies is 53% higher than the average minimum legal wage in their respective countries.

Focus - Health insurance

Health care is a major concern: only a few people have access to health coverage and many have to give up treatment due to the inability to pay. I&P and the FERDI (Foundation for Studies and Research on International Development) carried out a study in 2018 (Formalizing SMEs in Sub-Saharan Africa", 2019), interviewing 204 employees in six of I&Ps portfolio companies. Thanks to health insurance, the burden of health expenses has decreased from 23% to 13% of these employees' income. That amounts to 10% of their budget that could thus be used to satisfy other needs.

IMPACT BY FUND - Creating Decent Jobs

IPAE1

Since 2012, **more than 6,000 jobs have been created or maintained,** indirectly impacting around 37,000 people in total. The average minimum wage is currently higher by 70% than the national one.

IPDEV2

More than 1,400 jobs have been created, formalized or maintained. In 2020, minimum wages in invested companies comparing to the national minimum wages were:

Senegal	Burkina Faso	Niger	Madagascar	Côte d'Ivoire
83% Higher	91 % Higher	7% Higher	42% Higher	74% Higher

IPAS

473 permanent jobs have been supported, including 104 which were created. Altogether, they provide incomes for 3,235 family members.

BUSINESS CASE: Impact study in Madagascar

In 2018, I&P led two 360° studies in Madagascar and Senegal in order to **assess the economic and social impact of formalized jobs on employees and their families**.
In Madagascar, more than 280 employees and 5 enterprises were surveyed. Those companies were all I&P investees. Madagascar is classified by the United Nations as Least Developed Countries (LDCs) and it is a central country of operation for I&P. Indeed, it has a very low Human Development Indicator (158th on 188 Countries) and 76% of the population lives below the poverty line. The studies showed that:

Formalized jobs have significant positive impacts on employees:

- Better quality jobs: They are protected against dismissal and have a stable and higher wage. Indeed, the median wage was increased by 76% since employment and is higher than national average by 116%.
- Better protection: Retirement plans were contracted by 88% of employees. Half of them had never contributed in a formal plan before.
- Better access to credit: 96 % of the employees that asked for credit obtained it. For 88% of them, it was their first contracted credit ever.

Formalized jobs also had significant positive impacts on the employees' families. Unsurprisingly, higher revenues resulted in better living standards for their household through extra spendings.

The extra spending breakdown outlined a direct spending in everyday improvement:

1. 51% of the extra money is spent on food.

2. 17% is invested on education. 82% of employees in Madagascar have at least one child in private school. Private schools are known to be of higher quality and therefore more expensive. This has several possible effects, but the main and most obvious one is the decongestion of public schools.

3. 16% is spent on housing as 85% of respondents moved or improved their homes. However, only 40% had a consistent access to running water and electricity in their homes.

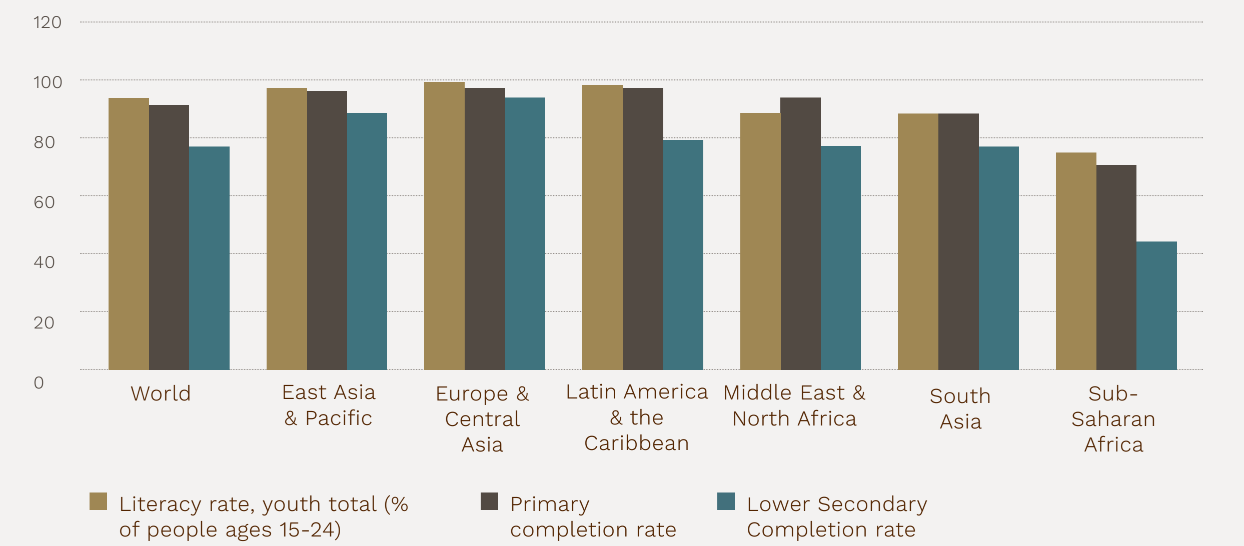
4. 1% only is spent on health. More than half of the employees benefit from a health insurance for the first time. This social protection policy has a multiplier effect since the other members of the family benefit from it. On average, for one worker, three people in the household are covered.

5. 7% is used for savings. Respectively 78% of the employees possess a formal bank account, while 70% among them never had one before. This is a first step that can help building savings. Nevertheless, savings are still limited, only half of the employees surveyed could save a part of their incomes. The other half save less or the same amount as compared to their previous work. A formal job, coming with more « safety » can also lead to a reduction of precautionary savings.

The need of training programs and a more structured educational landscape

The continent needs a structural shift in its economy, moving capital and labor from low-productivity sectors to high-productivity sectors. In order to achieve this shift towards a value-added economy and to create decent jobs, countries must focus on **developing training and skills development programs to enhance the employability of workers**. But the prerequisite for **technical skills** development cannot be achieved without basic education strategies first. Despite a strong improvement in recent years in primary school enrollment and literacy rates, Sub-Saharan Africa still lags behind other continents in basic education (Figure below), and this has a strong impact on the upgrading of its workforce.

Basic education in the world, 2019



Source: UNESCO UIS 2020 Database

As a key driver of human capital growth, limited access to quality education and inadequate skills can explain the low impact of human capital on productivity growth in Africa. A better-quality education and research are still reserved for a rather urban, male elite from high-income households, or at least for a very small part of the population. In a large majority of Sub-Saharan African countries, the enrollment rate in higher education remains below 20%. **Since the first I&P inception, there was a strong commitment to increase of skills on the continent**.

IMPACT BY FUND

IPAE1

IPAE supports for example Enko Education, a Pan-African Education Group, one of the largest networks of African private schools. In 2020 only, 3,100 students were enrolled, including 49% of women, in high quality education establishements. 29 of them received scholarchips.

IPDEV2

Through 4 local funds and 10 education entreprises supported, 27,400 students benefited from a quality secondary or higher education in Senegal, Burkina, Madagascar and Côte d'Ivoire. In burkina Faso, a technical school supported started to expand and build new school. In Côte d'Ivoire, a learning management platform online provided teaching to more than 17,000 students. Also in Côte d'Ivoire, a publishing house produced and distributed more than 1 million Schoolbooks since inception.

IP2E

I&P Education and Employment is an access fund program dedicated to education. It aims to improve access to relevant, quality education and strengthen job training to better meet employers' needs. The programfincances and supports private institutions or companies producing education-related goods, services and technologies.

3. Densifying the local economic fabric

Africa lacks of manufacturing and processing industries and, hence, has seen a skyrocketing import dependency in many sectors: automobiles, pharmaceuticals, IT products, and, most importantly, food.

As seen previously, in the coming years, the challenge of structural transformation of African countries will be central to the resilience and independence of the countries. In order to encourage SMEs as well as bigger companies to innovate and increase their value, the integration of small and medium-sized companies into local value chains is essential. I&P believes that creating businesses for local suppliers and distributors generates virtuous circles through reinforced value chains and can make local economic ecosystems more interconnected and strengthened.

IMPACT BY FUND

IPAE1

Over 1,500 suppliers have contracted with IPAE's companies in 2022. Among them, 77% were local. Over 6,900 small producers were reached to purchase 2,722 tons of fruits and vegetables.

IPDEV2

Over 2,000 suppliers have contracted with IPDEV2's companies, of which 81% are local. In total, 15,300 small producers were involved in business activities.

IPAS

106 suppliers are involved with IPAS companies (among two seeding programs), of which 87% are local.

4. Easing access to essential goods and services

Meeting unsatisfied demand for goods and services contribute to the SDGs. Producing goods and services in-country for the local market should create better access to such products, at better conditions, and will contribute to reducing imports and the related carbon footprints. Therefore, higher economic self-reliance will be fostered. **73% of SMEs in I&Ps portfolio supplies goods and services that directly contribute to Sustainable Development Goals**. *For example, before 2020*:

11 SMEs are dedicated to achieve food security and improve nutrition and 11,628 tons of agricultural products have been purchased in 2020.

10 SMEs ensure inclusive and equitable quality education to 27,400 Students.

2 SMEs are dedicated to ensure healthy lives and promote well-being for all at all ages. One of it being a dental clinic that provide 1,077 treatments in 2020.

In Burkina Faso, a company providing soap and cosmetic products is committed to spread sanitation norms.

In Senegal, GOGELEC installed 161 Km of electric lines.

5. Promoting Gender equality and women's empowerment

Labor market, health, political representation, education...multiple discriminations based on gender are still current around the world, and Sub-Saharan Africa is not an exception. **Gender inequality is costing Sub-Saharan Africa $95 billion a year on average – or 6% of the region's GDP** – jeopardizing the continent's efforts for inclusive human development and economic growth. It is estimated that a 1% increase in gender inequality reduces a country's human development index by 0,75%.[29]

IMPACT BY FUND

IPAE1

Before 2020, the portfolio companies produced 466 tons of fruits and vegetables, 503,811 hl of water and juices, 21,268 solar kits, 52,644 loans and generated 11,200 visits into a care center as well as the enrollment of 3,100 students, including 49% of women, in high quality education. All companies addressed local needs and 67% of them improve local access to goods or services that address essential needs as defined by the SDGs.

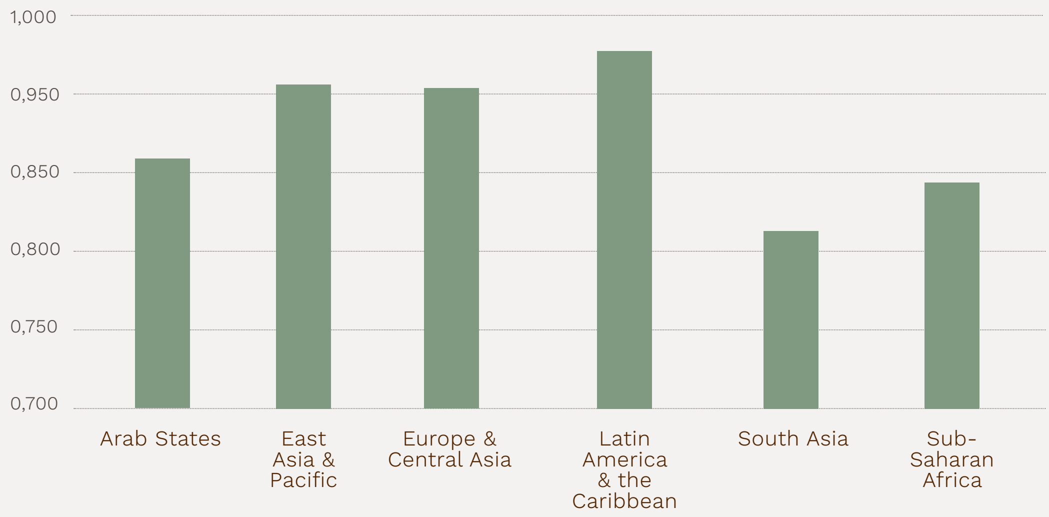
IPDEV2

The fund pursues two client-related objectives:

1. Meet unsatisfied demand for products and services
2. Provide basic products and services to the base-of-the-pyramid customers

76% of partner companies are offering essential product or service directly addressing the SDGs.

Gender development index, 2019



Source: *UNDP Database, 2020*[30]

Estimated Gross national income per capita (2018 PPP $)		
Continent	**Female**	**Male**
Arab States	5,092	23,923
South Asia	2,393	10,416
Sub-Saharan Africa	2,937	4,434

Source: *UNDP Database, 2020*

Sub-Saharan Africa has a higher gender development index than South Asia and the Arab States. This can be explained by the fact that the gap in gross national income per capita between men and women is less important, as illustrated by the table above.

In Africa, women's economic inclusion is hindered by a reduced access to a range of financial and productive assets. If women are impacted by discriminating land tenures and land rights, they are also less likely to have access to credit, digital payment methods and savings. Unsurprisingly, women have less access to formal bank accounts compared to men (22 versus 27% in Sub-Saharan Africa).[31] This reduces their capacity to be entrepreneurial and invest, limiting them to subsistence activities.

Women empowerment and gender equality are recognized as major factors of inclusion and development. I&P funds encourages these dynamics by supporting women-owned businesses, encouraging permanent jobs for the female workforce and targeting sectors, products and services that benefit women's specific needs (microfinance, medical centers, etc.). According to the 2X Challenge criteria, 71% of I&P investments are gender inclusive.

Concerning the previously cited 360° study on the impact of formal jobs in Madagascar, I&P's impact team and the FERDI surveyed portfolio companies[32] and outlined the following numbers:

57% of employees are women.
54% asked for a credit loan since their employment (vs 36% of men).
90% have an unlimited duration contract (vs 83% of men).
80% think that wages differentiation among sex doesn't exist in their companies.

29. UNDP, 2016 - 30. The Gender Development Index measures gender inequalities in achievement in three basic dimensions of human development (health, education and command over economic resources). The index results from a ratio of female HDI over male HDI. - 31. The World Bank, 2021 - 32. 5 companies and more than 300 employees

IMPACT BY FUND

IPAE1

Women lead 16% of the portfolio's companies (5% in average in Africa), they represent 21% of board members and 30% of senior leadership positions. Additionally, 67% of the portfolio satisfy the 2X challenge criteria*.

IPDEV2

35% of business supported are led by women and 40% of board members are women. 41 % of women among highly skilled employees and 52% of IPDEV 2 team employees are women. 79% of the portfolio satisfy the 2X challenge criteria.

**The 2X Challenge was launched at the G7 Summit 2018 as a bold commitment to inspire DFIs/IFIs and the broader private sector to invest in the world's women. All commitments to achieve 2X Challenge criteria must include clear objectives and be monitorable.*

Moreover, the fact that the ticket size decreases while the proportion of companies led by woman increases underlines the fact that their limited access to economic assets hamper them to scale-up or even to formalize their businesses. The share of women leading very small enterprises (correlated to the entrepreneurship by necessity) is clearly higher than the one of man.

I&P is proud to seek to pave the way to fully support women's labor capabilities. IPDEV2 as well as IPAE pursues I&P's gender strategy, in addition to its own gender objectives:

- **SME leaders**: empowering women in decision-making processes as shareholders, board members and CEOs;

- **Employees**: developing women's access to decent jobs and training opportunities;

- **Clients and suppliers**: focus on women's inclusion - providing essential goods and services for women and/or implementing specific support programs for women employees and small-scale suppliers/distributors.

6. Fostering Sustainable Growth

Africa is the continent that is experiencing the **most adverse consequences of climate change**: severe droughts, floods and storms, rising temperatures, etc. Climate change effects are already visible across the continent. It translates in different phenomena such as an erosion of biodiversity, a decrease in agricultural yields, the degradation of infrastructures and important population movements. Rural populations are in the front line, but urban and peri-urban populations are not spared either.

Climate instability and natural disasters create increasing food, energy and water insecurities. The vulnerability is particularly high, with an increase in poverty and a rise in conflicts expected. Indeed, according to the 2018 SEforALL report[33], Sub-Saharan Africa's GDP could be impacted by up to 2% per year over the next 30 years, suggesting a 50% reduction in its overall per capita growth. This will directly and indirectly cause a decline in job creation, but also, according to Burke (2015), an increase of already existing inequalities. To maintain sustainable economic and social development, it is essential to create resilient ecosystems and infrastructures. The private sector needs to anticipate future climate events, as well as future regulations (in terms of waste, emissions, etc.).

Sustainable growth can be achieved by investing in resource-efficient companies and by reducing carbon footprints through local production, mitigation of environmental impact and adaptation to climate change for companies.

40% of I&P's portfolio companies implement green projects

33. Sustainable Energy for All , 2018

IMPACT BY FUND

IPAE1

The carbon footprint of the portfolio is estimated at 31,000 tCO2eq with 2 companies weighing 60% of that figure. Major categories include freight, energy and other transportation directly related to the companies' activities. It is nevertheless important to note that the positive impacts are not valued (for example, the decrease in CO2 emissions resulting from the shift of imports to local productions). 28% of IPAE's partner companies provide products and services with positive environmental impact and another 52% implement green projects to mitigate their impact (targeting mainly energy, waste and effluent issues).

IPDEV2

The fund pursues two environmental objectives: foster Biodiversity and soil preservation and encourage energy-efficiency and renewable energy initiatives. 22% of the investees have a product/service or have put in place initiatives that contribute to reducing negative impact on the local ecosystem, including a waste management system, making soil more resilient, protecting biodiversity, reducing pressure on natural resources, etc.

I&P has been working since 2020 on its Environmental strategy. Not published yet and still in design, it presents different topics:

- An **Environmental Scorecard** to rate the companies in which I&P has taken an equity stake. A grade is given to the company depending on its sector of activities and the potential impacts generated. This allows to take into account the «physical» risk associated with the investments.

- An Improvement of data collected in terms of macroeconomic regulations to prevent legal risks.

- An **Adhesion to the Task Force on Climate-Related Financial Disclosures** (TFCD) to increase the reporting of climate related financial information.

How does I&P measure its impact?

I&P's impact methodologies and frameworks are tailored differently for each fund and program. Each impact methodology integrates an **ESG (Environmental, Social and Governance) risk management dimension and a positive impact creation lens**. ESG and Impact dimensions are integrated throughout the investment process from screening to exit.

Defining ESG performances and Impact for an impact investor such as I&P

EGS (DO NO HARM)

Understand and minimize esg risks

- Refers mainly to the functioning of a company and its production
- ESG risks are evaluated through standards

EGS (DO GOOD)

Enhance positive impact to achieve broader devlepment outcome

- Refers mainly to the functioning of a company and its production
- Impact is assessed against intentional objectives, in relation with specific thematic (access to education, electricity, job quality, etc.
- Impact objectives are supported by robust ESG analysis

How does I&P integrate ESG and Impact matters throughout the investment process?

I&P integrates ESG performances and impact metrics throughout the investment process, from screening to exist. It uses tools and processes to ensure that this integration is anchored in the investment activity to the fullest.

SCREENING

Building an impact-oriented portfolio **before the investment (screening)**: I&P evaluates the potential impacts of an opportunity, as well as its ESG risks and opportunities. The investment team uses I&P's **Impact Screening Scorecard to screen investment projects** aligned with I&P's core **impact thesis** and identifies ways to **improve the overall impact on**:

- Employees: creation of decent jobs and training opportunities.
- Clients: meeting of local and essential needs (SDGs).
- Local suppliers and subcontractors: fortify the local economic fabric.
- Environment: foster environmentally-friendly development, whether through "green" products and services or through mitigation of environmental impact.
- Women empowerment: integrate a gender-lens perspective and promote women leadership, women employees, and women-oriented products and services.
- Local entrepreneurship: develop responsible African entrepreneurship, particularly in fragile and least developed countries.

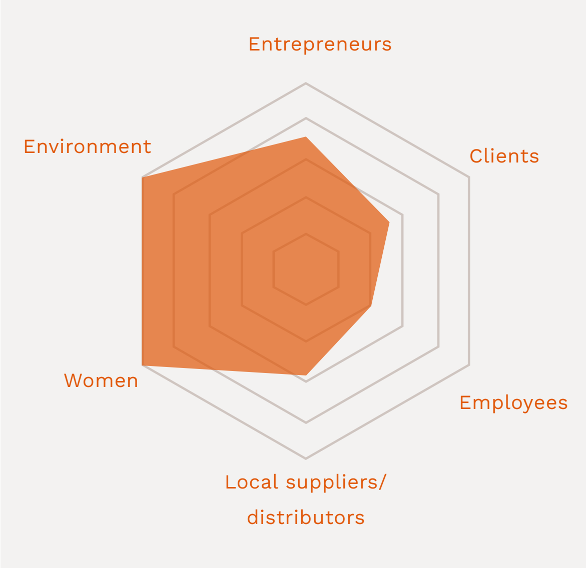
MONITORING

I&P sets up with entrepreneurs **a tailor-made ESG/ impact action plan, reviewed annually**, for each company. I&P also implements ESG measures across the portfolio, such as social security and energy efficiency measures. Bi-annual meetings with the investment team are set up to assess progress made and to update the action plan.

EXIT

Together with the entrepreneurs, I&P implements actions that are deeply anchored in the business of the companies. **Impact management issues are included in exit discussions with the selected purchaser(s)**. I&P selects buyers who will allow for the **sustainability of the company's impacts and ensure good ESG practices**.

I&P's impact screening scorecard output



I&P's ESG and impat methodology throughout the investment process

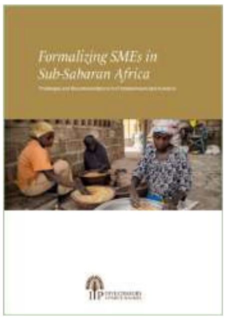
SCREENING	MONITORING	EXIT
◆ Evaluation of potential impacts ◆ Evaluation of ESG risks and opportunities Main tool: I&P's Impact Screening Scorecard	◆ Set up of a tailor-made ESG and impact action plan for each company of the portfolio ◆ Bi-annual meeting are planned to assess ESG and Impact progress and update the action plan with the investment team	◆ Inclusion of ESG matters in exit disscussions ◆ Selection of buyers who will allow for the sustainability of the company's impacts and ensure good ESG practices

I&P goes beyond ESG and impact integration in the investment processes

As said before, one important criterion in impact investing is to share practices and experiences. I&P is committed to a proactive advocacy policy for the recognition of SMEs as vectors of change and to the promotion of adapted financing solutions in Africa. The primary objective of I&P's advocacy mission is to go beyond its impacts alone and to have a multiplier effect on its contribution to Africa's development agenda. Therefore, I&P works on disseminating its experience and expertise through its advocacy tools (for example, the report on the formalization of SMEs in Sub-Saharan Africa).

Impact reporting
To report its impacts, I&P publishes an annual ESG & Impact report for each fund under management, as well as a global impact report. Once a year, I&P reviews the impact and ESG performance of its portfolio companies, thanks to an in-house information management tool (40 indicators) based on IRIS metrics. The gathered information enables I&P to define areas for improvement across the investment portfolio.


HORTI VERT SARL
Construction de Serre
07 07 76 12 64 / 07 59 92 07 75
AGRICULTURE TROPICALE
GROUPE
2IFE / 2IAE
2IAE
ATV
L'ECOLE DES ENTREPENEURS



360° Impact studies

I&P also conducts in-depth impact studies every year on one or several companies, or on a specific topic. These 360° impact studies gather a 3- to 4-member team which conducts a field survey among local stakeholders to evaluate each company's impacts. In 2018, *two studies* were published on the impacts of formal employment in Madagascar and Senegal, respectively (The results can be seen beyond: *1. Promote a more inclusive growth and a new generation of formalized entrepreneur).*

Raising awareness among investors and entrepreneurs

I&P follows a proactive approach regarding impact, seeking to do better and better in this area. The ESG Impact team continuously builds measurement tools on issues such as climate change and the measurement of living wages for entrepreneurs and investment teams. This approach makes sense for many entrepreneurs willing to ensure the viability of their companies in the long run. Most entrepreneurs are strongly committed to improving their business practices, such as ensuring better working conditions for their employees or setting up projects that benefit small-scale suppliers or local communities.

Raising awareness among I&P's team

I&P's ESG and impact team tries to raise among teams on specific sustainable development dimensions (climate, gender, waste...) during training sessions or internal communication. As an impact investor, it is essential to keep strengthening the commitment of our teams to sustainable development.

FOCUS ON DECENT WAGES

To contribute to the achievement of SDG 8 – Decent work and economic growth – I&P works on the creation of a tool to measure decent wage. This tool follows the Anker methodology. For each country where I&P invests, the tool aims to calculate the decent wage by taking into account the prices of a complete basket, balanced and adapted to national preferences, and of non-food expenses. Each company of the portfolio will be able to see where it stands regarding this development goal.

FOCUS ON THE ENVIRONMENTAL SCORECARD

As part of I&P's environmental strategy, the ESG and Impact team is developing an environmental scorecard based on a questionnaire for companies. This scorecard will allow to measure the impacts of the activity of each company on the environment (climate, biodiversity, transition...), the environmental risks on the activity of each company, and to see to what extent these stakes are acknowledged and managed at the level of the company. This scorecard will allow companies and investors to take into account the importance of climate issues and the negative impacts they can have on their business.

Private equity ranks among the most effective tool to finance SMEs from the private sector as it goes beyond the limits of philanthropic subsidies, which are necessary but can hinder the demonstration of a reliable business model over the long-term. In this context, private equity is also more suited than debt instruments, which can put high pressure on SMEs balance sheets under certain conditions (e.g., when used at initial stages). Through impact investing, private equity allows SMEs to be financially sustainable and thus to ensure the sustainability of their impacts. Good financial performance, when sustainable, is therefore at the root of qualitative and long-term impact results. It also allows for investment amounts to be recycled. In this third section, we will look at the financial value creation stages of impact investments using examples of I&P vehicles.

03

The business model behind I&P's impact

The previous sections have demonstrated that SMEs are a major development lever for African countries, creating conditions for endogenous and sustainable growth. When SMEs meet their financial needs, they foster local productions, diminish imports, create a greater economical resilience, etc. In addition, they generate a better redistribution of wealth for populations, at different levels, through employment and by developing markets for local goods and services. The largest SMEs also generate important driving effects for national value chains, participating in turn in the emergence of a dynamic entrepreneurial fabric.

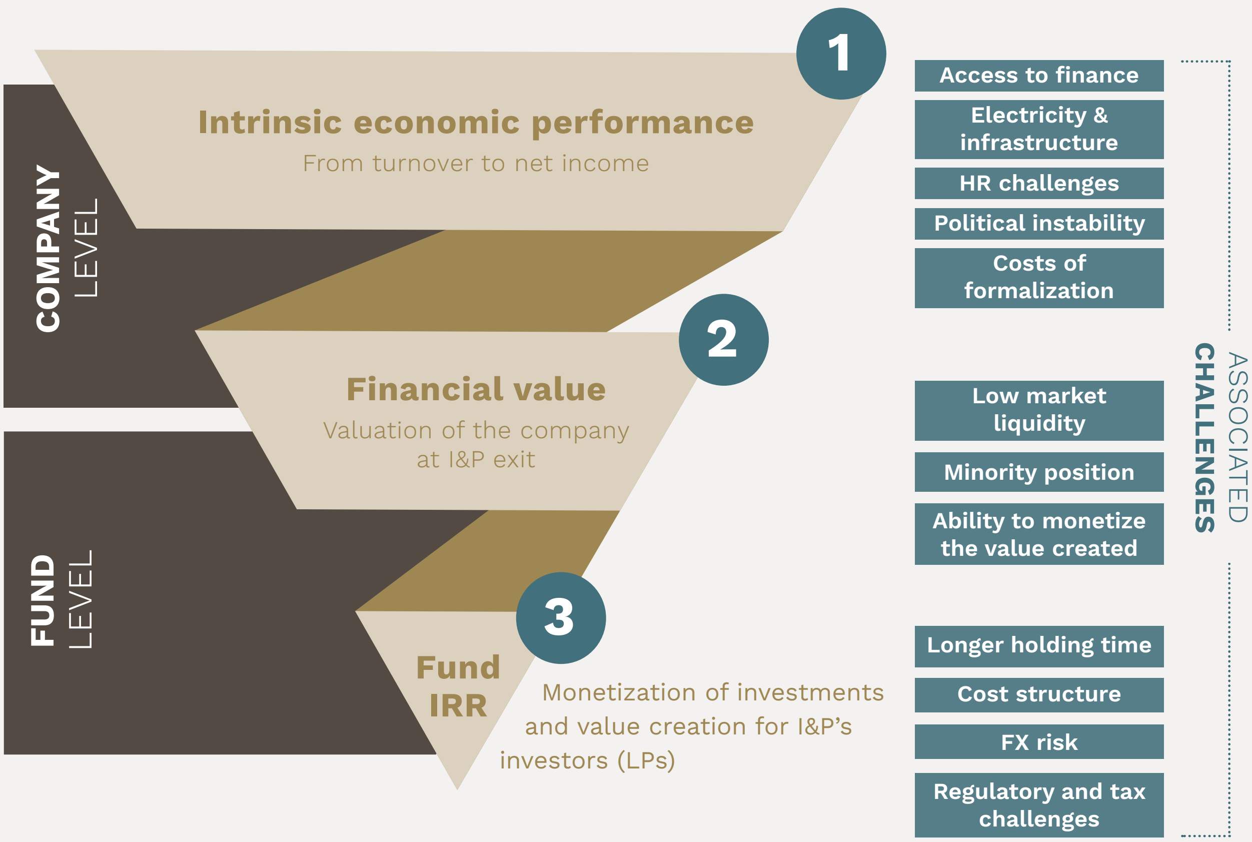
From a financial player's point of view, **addressing the «missing middle» requires tailored targeting and intervention methods**. The weak structuring of certain sectors and a complex business framework impose very local approaches and strategies that are sometimes riskier in terms of ticket size or company maturity. Aiming for impact thus entails (over)costs specific to this investment segment.

This section aims to illustrate the impact of catalytic capital financing through the consolidated results of I&P portfolio companies.

We will look at how I&P funding generates intrinsic economic performance at the firm-level despite a challenging environment. We will also study how this concessionary capital can be deployed, dissecting all stages of the value creation process, from the performance of portfolio companies to that of the fund's investors. Finally, we will demonstrate that catalytic capital plays a significant role in balancing the higher risks and costs supported by frontier market SME funds and allows them to overcome the obstacle of the incremental cost of impact

The analysis conducted in this chapter follows the methodology presented in the full report: Appendix 1 "Methodology used for the calculations on I&P portfolio performance".

Waterfall of the value creation of an investment

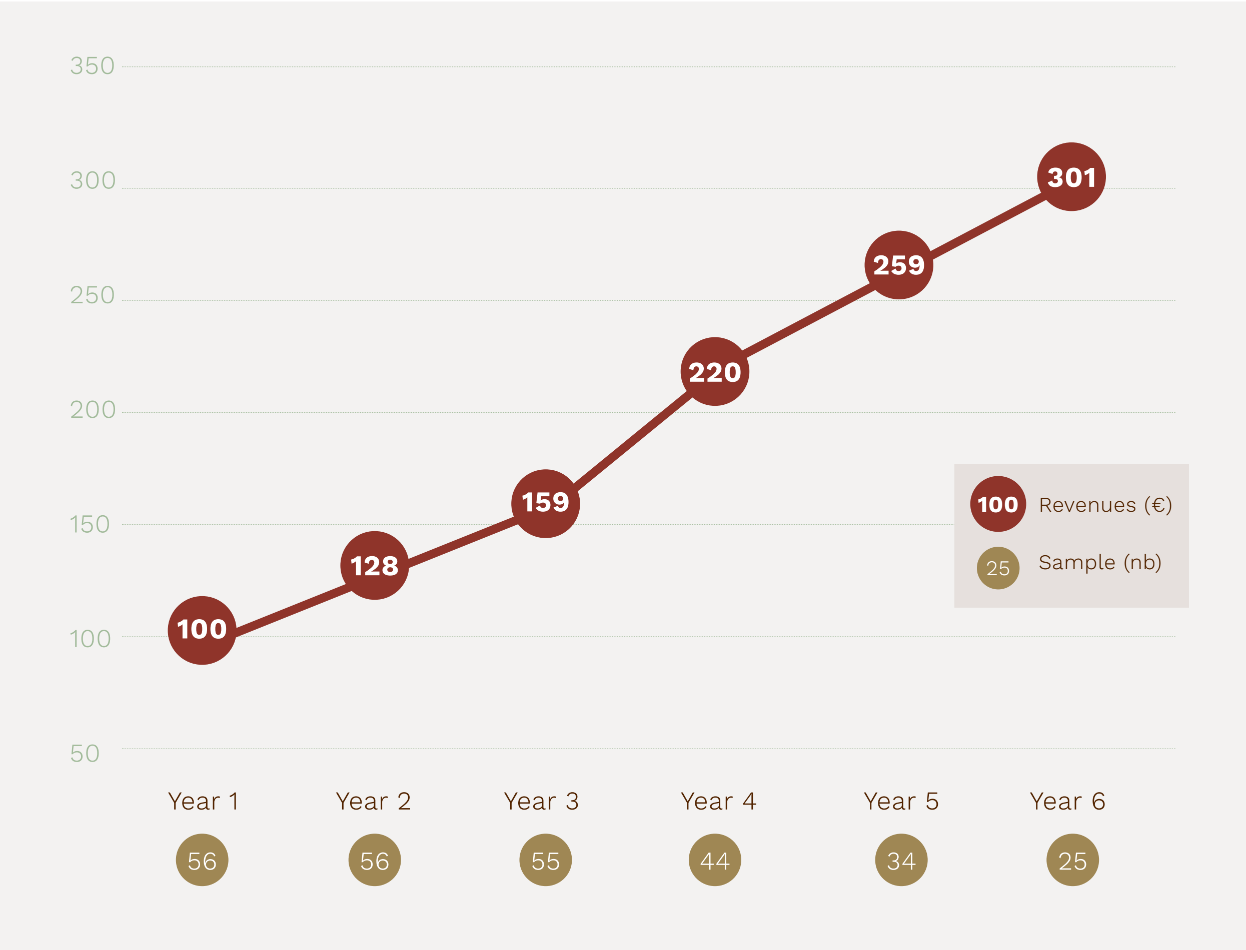


Portfolio companies are succeeding and generating economic value, despite external and structural challenges

Investments lead to an increase in the companies' turnovers[34]

Since their year of investment, I&P's portfolio companies have recorded an **average growth in sales of +22% per year** and 81% of them have increased their turnover. As the graph bellow shows, this growth is quite linear. The aggregated revenues of I&P's portfolio **double before the 4th** year of investment and **triple after the 6th year**.

Revenue growth of I&P's portfolio



34. **Turnover**: number of sales of products and / or services made during an accounting period. It is therefore the total revenue during the yearn regardless of the costs generated.
35. **Value-added**: intermediate management balance corresponding to the gross wealth created by the company, i.e., its capacity to generate wealth through its production cycle. This ratio represents the difference between the final value of a company's products and services and the cost incurred for its production process. The value-added is also macroeconomic data: the sum of the value-added of the companies of the same country constitutes its gross domestic product (GDP).
36. Deloitte, Omidyar Network, Shell Foundation, "Insights on SME Fund Performance – Generating learnings with the potential to catalyze interest and action in SME investing", December 2019.

This economic performance is even more remarkable as African SMEs grow in constraining and unfavourable business environments: they are nested in tight value chains and exposed to numerous hazards, both upstream for supply, affecting production phases, and downstream for distribution. In addition, many factors, such as those listed above, can impact their business: they face high production costs, recruitment difficulties, a lack of solid public infrastructure and of adequate facilities. Moreover, many I&P portfolio companies have recorded turnover growth even while Sub Saharan economies have undergone multiple crises (political, monetary, health...).

Value-added insert [35]

This economic performance directly generates economic impact at a macroeconomic level: an internal study conducted on IPAE portfolio company data demonstrated that **value-added growth of IPAE 1's portfolio (+60%)** is **significantly higher** than the **average growth of the respective countries' GDP (+27%)**. This result demonstrates the strong economic performance of the companies within IPAE1's portfolio that are making a **very dynamic contribution** to the development and growth of their countries of intervention.

The revenue growth leads to job creation

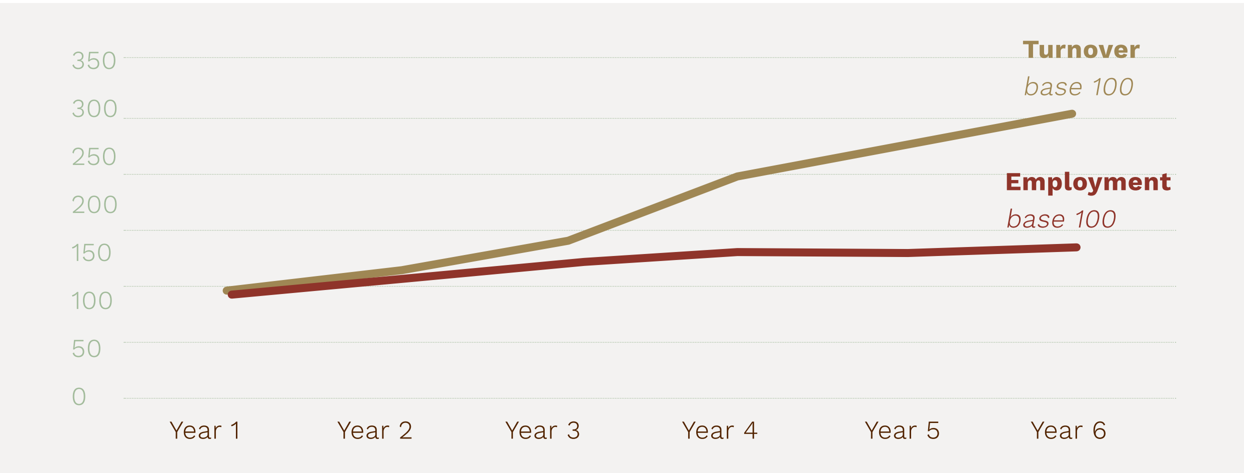
According to the study "Insights on SME Fund Performance"[36], **African SME funds are creating an average of 47,9 jobs for $1 million invested**. The African Private Equity and Venture Capital Association also carried out a study that highlights the link between private equity and job creation in Africa. The analysis indicated that of 200 PE-backed companies, the numbers of jobs registered an overall growth of 15%.

Instead of downsizing to make equity investment profitable, or invest in low value-added sectors creating very few jobs, I&P income growth of SMEs companies is not at the expense of employment.

For IPAE, on the studied period, the employment increased by **50%** (considering job creations and job destructions) in an equally continuous manner. The growth gains thus seem to be linked to both endogenous (increase in the number of employees) and exogenous factors (increased competitiveness). This increase is particularly pronounced for small businesses (x2), which nevertheless represent only 19% of jobs in year 1 (and 26% in year 6).

The largest companies see their employment grow by 40% over 4 years before stabilizing until year 6.

Evolution of the turnover and the total number of jobs overs 6 years [IPAE 1]



The structuring phase implies direct and indirect costs, affecting the EBITDA figure[37]

I&P's experience also highlights that its intervention leads to a **more cost-efficient operating cycle** after 5 years of intensive work alongside entrepreneurs. During first years of inception, impact investors along with the entrepreneurs conduct an important in-depth work. This structuring phase requires considerable time and resources, which explains an initial **decline in EBITDA**: growth is postponed for the time it takes to absorb new employees and upgrade the production system.

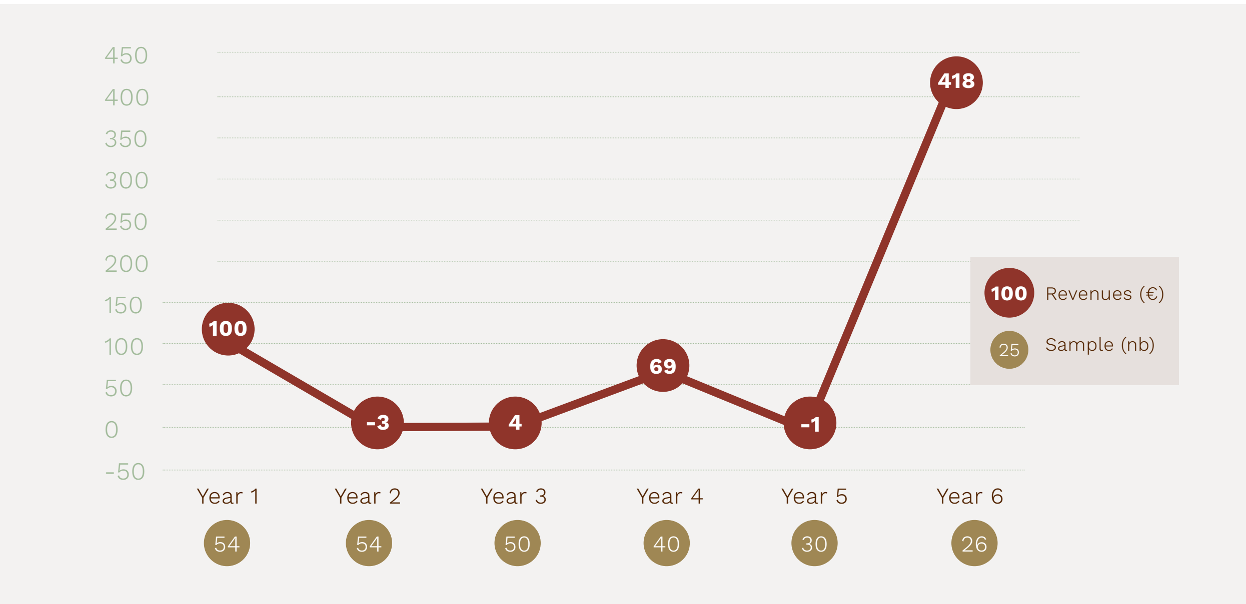
Then, investors will encourage entrepreneurs to build a solid foundation to prepare for growth, which increases the expense structure and the operating charges. This structuring phase requires resources and time to:

- Recruit new employees;
- Purchase larger inputs and enable investments that imply higher current expenses;
- Formalize the company or the processes and comply with fiscal or social requirements;
- Transform the legal structure of the company, to a SA for example;
- Set up a reporting and a better financial, fiscal, legal follow-up.
- The investor often requires an asset and liability guarantee that will allow the company to have a "fresh start". The guarantee will allow the investor to be protected from the risks of a decrease in assets or an increase in liabilities that originate before the investment.

In a second stage, the efficient **technical assistance** provided generates learnings that can allow EBITDA to recover and grow. Once the profitability has been set up and new volumes of production absorbed, the productivity gains of operational cycles are ready to takeoff. The time spent by the management and the investment team is compensated.

This trend is reflected in the portfolio's results: **we can observe an initial downward trend and a subsequent rebound after about 5 years. In total, on average the EBITDA of SMEs supported by I&P gains 4 times its absolute value over 6 years.**

EBITDA growth of I&P portfolio companies



37. EBITDA: The amount of a company's operating resources (turnover (-) personnel expenses (-) miscellaneous purchases) before subtracting financial expenses, taxes, depreciation and amortization and provisions for fixed assets. EBITDA thus measures the profitability of a company's operating cycle (capacity to generate revenues from its operational activity) but not its overall profitability (which depends on its financing and investment strategy and tax pressure).
38. Net Result or Net Income: The difference between a company's revenues and expenses (operating, financing, etc.) in a given year. Net income is the measure of a company's profitability.

Net revenue growth vs. Net income [38]

Despite this encouraging performance, portfolio companies have **difficulty reflecting their revenue growth in their net income**. Profitability can indeed be affected by:

◆ The **weight of investments** made thanks to I&P financing. A large part of the investment projects of the SMEs supported by I&P are in fact transformational investments (production line, factory, etc.), with a significant weight in relation to the size of the companies concerned. The high weight of depreciation & amortization expenses in relation to the size of the company can thus weigh heavily on the net result. Indeed, many investments may be made in one year but depreciated over several years and only recorded in the income statement.

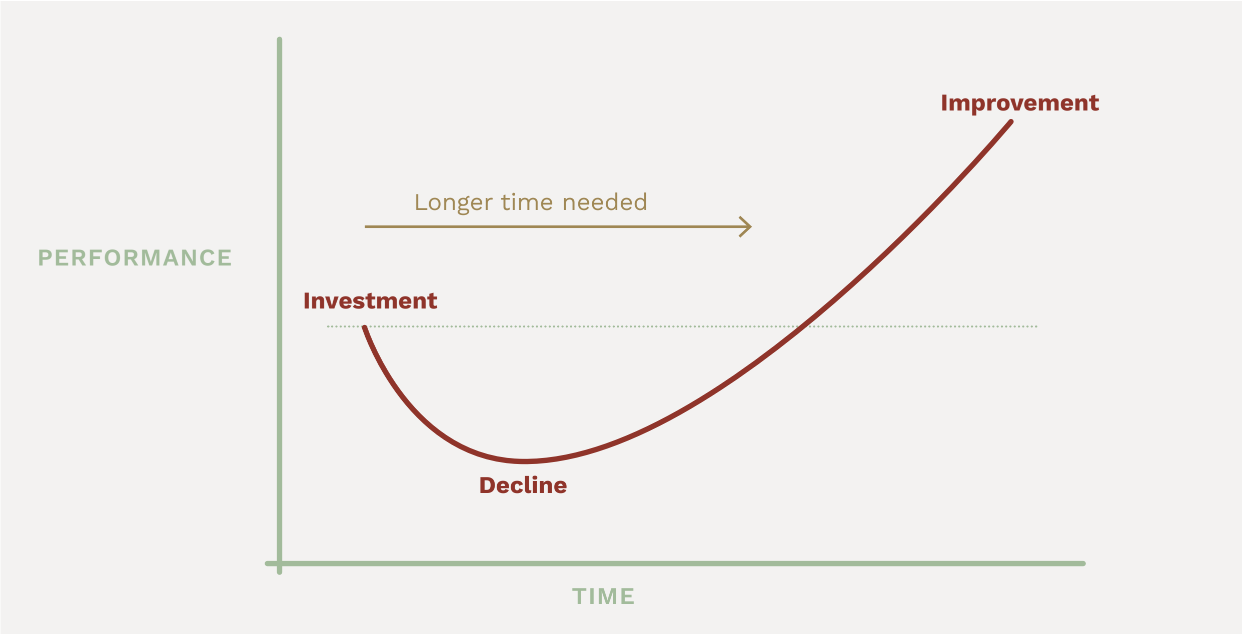
◆ The **cost of debt** and the associated variable interest charges (in some cases) can impact the net income and self-financing capacity of the companies. The strong growth in revenue also means a strong increase in working capital needs that need to be financed through debt. Africa's private debt is excessively expensive, and, moreover, maturities tend to be short, which partially explains why good EBITDAs can still translate into disappointing net revenues and cash-flow. The need in cash is more important for a given level of activity as the payment delays or the deliveries can be longer, which increases the working capital requirements.

◆ The **cost of formalization** can also explain the EBITDA/net income gap. I&P's intervention leads to changes in the methods of calculating certain results, to increased formalization of employees, etc., which leads to a tax revaluation spread over several years. The cost of this formalization is necessary for the professionalization of the company, but impacts its results (for the induced higher fiscality) until it is compensated by the increase in revenue.

◆ Lastly, "**exceptional expenses**" often linked to the pre-investment audit conducted by I&P can affect a company's results. These costs are, for example, related to accounting or tax adjustments linked to the entry of the investor («cleaning up» of the accounts) or even to a change in the currency used, which can lead to exchange losses.

Vallesse: Created in 2005, Vallesse is an Ivorian publishing house operating in the sectors of general literature, children's literature and extracurriculars. To date, VALLESSE has a publishing collection composed of five collections and about eighty books, of which thirty-three are approved for the scholar program. EIF, the fund dedicated to education managed by Comoé Capital, invested FCFA 130 million in the company in 2017 to strengthen the editorial fund, identify new distribution channels and support the formalization and structuring of the company. This investment has enabled the company to grow from **FCFA 137 million** in 2016 to 960 million in 2019, recording an increase of **700%**.

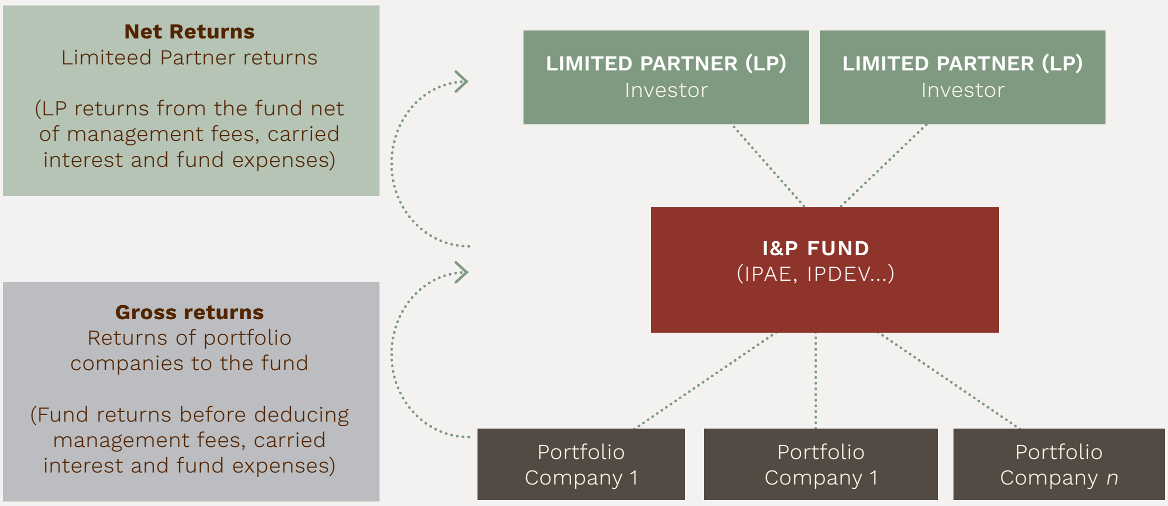
In conclusion, despite the many challenges they face, SMEs can achieve great economic performance and high turnover if they are properly supported and funded by investors aware of the obstacles. It is common that the entry of a capital investor temporarily degrades the financial ratios (EBIDTA and net income in particular), because of the increase in operating costs necessary to carry out the growth plans. Indeed, investors most often finance projects aiming to scale up the company. Negative performance at the beginning of investment will then decrease until a level of stability is reached. I&P's experience has shown that the initial pre-investment net income level takes longer to recover than for traditional markets: long-term financing is thus necessary to adapt to the development time and needs of African SMEs. Next, the company usually enters a phase of profitability, where performance exceeds the initial profitability level. This is known as the **«J-curve».**


Improvement
Longer time needed
PERFORMANCE
Investment
Decline
TIME

Good economic performance does not necessarily translate into maximized financial value at exit or into shareholder value (IRR) at the fund level.

Financing African SMEs often involves **higher costs and longer investment periods than in other geographies** because of high levels of human capital and financial investment, associated with significant risk. These costs are inherent to both I&P's impact investor model and to the segment of targeted companies and they are thus necessary to serve the missing middle SMEs. However, the financial equilibrium of this type of fund is fragile, and there is no systematic guarantee to generate the expected internal rate of return (IRR).

Internal Rate of Return (IRR): the IRR is the annual rate of growth that an investment is expected to generate. It refers to the profitability expected by the providers of capital (creditors and shareholders) for a given investment.
We can distinguish the **net IRR** and the **gross IRR**.



In this section, we propose to study what we can call «***the cost of impact***», **i.e. the model of an impact fund**. We will thus analyze how the financial performance of a fund is constructed, from the beginning (the economic and intrinsic performance of companies) to the value creation for investors (the net financial performance of the fund). We will concentrate on the financial value of the companies and on the value creatin for LPs.

1. Financial value creation at the SME level (gross performance)

As previously demonstrated, the starting point for a balanced impact fund model is to have SMEs that perform well. **However, from an investor's perspective, intrinsically well-performing companies do not necessarily translate into a profitable portfolio**, as there is no systematic and proportional link between a company's economic growth and its valuation. Indeed, despite good development trajectories, a company's financial value can be structurally limited. External and internal factors can explain this "glass ceiling". The fund performance will indeed come from a relevant investment structure, i.e., a financial package capable of creating value for investors:

◆ Negotiate entry and exit valuations that are in line with the fair value of the company an allow the investor to realize gains on the exit;

◆ Set up a structure that will not slow down the company's growth, and provide sufficient safeguards for the investor;

◆ Provide variable components to the potential loan that allow a certain IRR to be achieved;

◆ Set up a structure that is as «liquid» as possible (easy to sell and quickly).

As an impact investor focusing on early-stage African SME, I&P is facing several limitations compared to the classic private equity model. These constraints are both internal (resulting from deliberate impact choices) and external (resulting from the economies in which we operate and the structure of the African private equity market).

Constraints linked to I&P's model:
I&P's position as a **minority shareholder** entails constraints that a majority investor would not have. Nevertheless, this positioning is the result of a deliberate impact choice: remaining the minority investor in order to **encourage the emergence of African entrepreneurship**. Indeed, I&P is convinced that the entrepreneur must remain in the driver's seat and have sufficient incentive to successfully carry out the development project that has led to his partnership with I&P. There are also many entrepreneurs that are willing to share a portion of their capital, but would refuse to "loose the control" of its founded company. This position leads to some implications for the investor:

◆ As a minority shareholder, the funds have less control over the company and therefore take more risks in case of crises or dealignment with the promoter.

◆ I&P often provides the majority of the funds to companies that are not sufficiently capitalized. This sometimes leads to a capital structuring with a large proportion of debt compared to equity (not to exceed 50%), weighting more heavily on the company's performance (debt effect): the liquidity and the profitability expected by the investor need to be made from the company cash flows. Being both a shareholder and a lender can also raise some dilemmas because the money used to reimburse the loan could have been injected in the company's growth. Moreover, in this configuration, the remuneration of the loan is uncertain. In order not to undermine the company's performance, the loans include a large variable component, calculated according to forecasts that are ambitious. In consequence, I&P takes almost as much risk as with equity with a potential return that has not been not so important historically.

◆ **The fund's holding period is necessarily higher** when dealing with young African SMEs that are market builders. Selling as quickly as possible maximizes IRR, but a short holding period does not always allow companies to develop as they should. The financial performance of the SME showed earlier that waiting more than 5 or 6 years before selling a company could increase its financial performance (and its valuation). However, the main financial performance indicator used is IRR, that includes the time of holding. Indicators like ROI or multiples are sometime more relevant to assess the gross performance in our markets, but holding a company for a longer period also implies higher management fees for the fund. According to the "Insights on the SME fund performance "study[39], returns are maximized when the investment period is of 15 years. Indeed, an investment period of 8 years in average is the minimum needed to reach a net IRR of zero. This varies dependent on the funds type and is of more than 14 years for SME funds.

Focus: IPAE - the need for long-term financing

As seen before, IPAE is not an evergreen fund and its investment period is supposed to last 5 years. Nevertheless, as the valuation is made with the EBITDA; the 5 years equity investment is not enough to correctly valuate the SMEs as solids and productive as they really are. Therefore, the valuation is often made downward and I&P does not benefit it. **This explains the low IRR reached by I&P.**

Constraints related to the markets

◆ From an exit point of view, **I&P operates in a weakly liquid market**, with few buyers and limited willingness to pay. AVCA Report[40] shows that according to 76% of LPs, the limited exit opportunities in Africa are the biggest challenge faced by PE fund managers. Moreover, in 2019, only one out of 44 exits in African PE went through an IPO. To maximize the profitability of the exit for the investor, the fund manager theoretically needs to maximize the resale price of the shares the fund holds in the company. To do this, it needs a sufficiently structured, formalized and attractive company and to set up competition to drive up prices and to be in a strong negotiating position with potential buyers. This is where impact funds fall short the most, mostly for structural reason.

◆ This is even more the case for I&P, which supports smaller SMEs in frontier countries. The market is not very buoyant, making it difficult to attract conventional investors. There are several reasons for that:

- Few buyers are interested in this level of investment ticket: the companies, even if they have grown strongly during the investment period, remain small companies for traditional players.
- The geography and investment targets are considered as too risky.
- The promoters may want to keep control of the company and are not ready to sell enough shares to strategic/financial players.

The willingness to maintain African entrepreneurs at the head of their companies, combined with the reality of the markets (limited exit opportunities) can lead to favor a buy-out of the company by its founder/manager at the end of I&P investment period. To make sure the promoters can buy I&P out, arrangements must be set up, sometimes limiting the return on investment (IRR).

◆ **The investments are made in regulatory, foreign exchange, and fiscal frameworks that also affect the profitability of the exits**. Lastly, some sectors present regulatory burdens when exiting a company: approvals are needed from slow and bureaucratic administrations.

- I&P's equity investments are made in the local currency, which triggers vulnerability to currency effects and foreign exchange losses. Indeed, the money is brought up to the LPs in euros or dollars while the investments are made in CFA (fixed exchange rate), ariary, or Ghanaian cedis (currencies highly exposed to fluctuations). This configuration makes it possible to sell a high-impact, high-performing business at a loss because the local currency has depreciated too much.
- In addition, in most of the countries in which I&P operates, there are **no fiscal incentives to support SMEs**. The interests invoiced, dividends received or added-values realized are heavily taxed when compared to other jurisdictions. The withholding taxes lower the profitability of the investments.
- Lastly, **some sectors present regulatory burdens when exiting a company**: approvals are needed from slow and bureaucratic administrations. This, in the best case, represent a time loss (couple of months), and in the worst case a deal cancellation.

39. Deloitte, Omidyar Network, Shell Foundation, 2019 - 40. "Addressing the exit challenge in Africa", African Private Equity and Venture Capital Association, 2022

Focus: IPAE - the need for long-term financing

As seen before, IPAE is not an evergreen fund and its investment period is supposed to last 5 years. Nevertheless, as the valuation is made with the EBITDA; the 5 years equity investment is not enough to correctly valuate the SMEs as solids and productive as they really are. Therefore, the valuation is often made downward and I&P does not benefit it. This explains the low IRR reached by I&P.

Illustration of the exchange rate effect with Eden Tree case: *Using local currency, we see an accentuation effect due to the appreciation of the euro, both upwards and downwards. The case of the Ghanaian company Eden Tree illustrates this well: when the company is doing well, its gains are partly erased by the exchange rate effect. Overall, even if data for all companies are not available, the appreciation of the Euro over the years 2010-2020 has certainly been rather unfavorable to I&P in the valuation of its companies.*

Opportunities

Even though the above constraints are frequently encountered, the markets in which I&P operates also offer opportunities:
- When investing in companies, I&P can benefit from strong negotiating positions. As very few other actors are active in our sectors, SMEs have little alternatives during the fundraising stages.
- The investing environment is positively improving. More and more governments, if not all, are now promoting SME support politics as well as the private equity sector to finance SMEs. The legal, fiscal, regulatory environment should improve as well.

2. The fund's expense structure (net IRR)

The business model of the funds managed by I&P and, by extension, private equity funds targeting African SMEs, is made complex by two factors: a smaller ticket size than most investment funds, which mechanically increases transaction costs, and a workload for the team that is more important than a classic fund.

◆ **Increased transaction costs:** SME impact funds often feature management fee rates that are higher than those of larger, more commercial funds (doing larger transactions), when expressed in percentage of assets under management. Indeed, by definition, impact funds manage assets that are small in volume. However, the amount of work per transaction is huge, as targeted companies are often experiencing their first capital raise. It therefore takes teams staffed with high-level professionals, in numbers consistent with the number of portfolio lines, as well as external service providers for some parts of the due diligence, leading to a high percentage in transaction costs.

The following tab illustrates, in a voluntarily simplified way, that the gross return needed during the exit stages is higher for small funds than for larger ones. In other words, for a given gross return, the net return will be much higher for large funds. This is due to higher management fees in smaller funds than in larger ones, representing a significant part of the use of funds. However, this higher percentage does not mean that the absolute amount is higher but it reflects that the team will need to make more deals, for a lower salary.

	Large private equity fund	**"Finance First" Impact Fund (IPAE-like)**	**"Impact first" Impact Fund (IPDEV II-like)**
Total commitments	€300 million	€60 million	€20 million
Management fees (%)	2%	3%	5%
Amount remaining for investments (%)	85%	77%	62%
Gross multiple needed to reach 0% IRR	**1,17**	**1,30**	**1,61**
Management fees	€6 million	€1,8 million	€1 million
Team	15	15	15
Deals / employee	1,5	2	2
Management fees / employee	**€400,000**	**€120,000**	**€66,000**

◆ **A significant workload for a team of market-builders:** I&P plays a market-builder role in a private equity market that is still immature and underdeveloped for these targeted investments. In addition to the day-to-day work of sourcing and monitoring investments, I&P's teams conduct necessary market-building tasks such as raising awareness and improving the skills of its stakeholders (lawyers, banks, solicitors...), building and training a pan-African investment team "from scratch", and preparing both these investment teams and SMEs to work with institutional investors. In addition, the management teams often have to deal with ongoing external crises: geopolitical context, a lack of aid from governments in case of disasters, failing public sectors that do not support SMEs when suppliers fail, tax harassment from administrations, etc. Every time we fail in identifying the right person (entrepreneur, layer, investment officer, co-investor, etc.), this is time we will have lost in a context of a high pressure for productivity.

◆ **Few "kickers" to increase the profitability of performing deals**: When compared to funds operating in more mature markets, we have very few options to propose innovative structures that strongly contribute to the performance of other funds: leverage on banks, recycling funds, benefits from public initiatives (tax incentives for investors, public related entities to invest back our investment, etc.). Very high performing/ successful/profitable companies cannot enjoy the same level of profitability as they could in another context.

I&P's activity also involves time-consuming activities due to the following constraints:

◆ A Pan-African strategy is needed for large deals (given the size of the economies) and allows diversification of risk. Nevertheless, it involves HR issues and high costs: having teams that operate in different locations and countries create management difficulties, necessary additional travel costs, problems to retain people who are far from their managers or colleagues, etc. In addition, each countries have different legal systems and laws. In consequence, the teams have to master a lot of different regulations and be aware of the local contexts.

◆ After the investments, the management teams often have to deal with successive crises during which they have to support entrepreneurs. For example, the companies can be affected by complicated geopolitical context, little help from


LIBERTY
PRESSING

governments in case of disasters, failing public sectors that do not support SMEs when suppliers fail, tax harassment from administrations, infrastructural issues that can block imports or constrain the arrival of new machines, etc. If this affects the financial performance of the SMEs, it also increases the time spent by the investment team on the different cases.

◆ As an impact investor, dedicated expertise and missions are needed. ESG, impact or Advocacy functions are necessary to demonstrate what I&P does and to convince entrepreneurs and investors.

We might have assumed that investors' lack of interest in African SMEs derives from their lower profitability compared with that of larger corporations. However, the structural profitability of the companies is not what differentiates the performance levels of instruments dedicated to large corporations or to SMEs[41], as illustrated by the present study that was conducted using data from several I&P funds.

To I&P, what makes the difference is a combination of: (i) premature exits forced by the legal structures of the "closed-end fund" model, derived from the practice of more mature markets and companies but unfit for structural investments in small companies and fragile countries (ii) market features which lead to lower multiples than in mature markets and a perceived attractiveness that does not always allow for an increase of the EBITDA between the investment and the exit (iii) currency depreciations that weigh excessively on domestic market oriented companies, and finally (iv) fund management costs related to the small size of the investments.

We have previously seen that in Africa; front-end and management costs are exceptionally high compared with the unit values of the transactions in an industry where fixed costs are the rule. This has, therefore, an automatic knock-on effect on net profitability for investors. Moreover, when investment objectives are innovative, profitability may be limited, resulting in extended investment periods or higher losses than the portfolio average. These considerations explain the relative disinterest of investors in this target category – and, as a consequence, the low number of management teams dedicated to this sector.
Achieving impact outcomes therefore implies a specific economic model that can generate successful businesses but does not deliver the net performance of conventional finance or standard market returns, making catalytic tools more necessary than ever to balance impact funds.
The last part of this study will developp how Capital Catalytic tools can address this constraint.

41. Severino, 2011

04

Conclusion: How to better balance the equation

SME impact fund strategy, along with the nature of frontier markets, make this financial model more costly than conventional investments. Thus, catalytic capital remains one of the most effective tools to address this under-served market.

As seen before, **impact investment funds targeting SMEs** face **economic constraints** that do not allow them to reach the same level of profitability as does conventional funding, mainly for the following reasons:

1. The choice of small tickets: SME funds feature a bigger gap between gross and net IRR than other funds. Among other reasons, the size of the deal compared to the time (and therefore human resources) needed to support SMEs, has a big impact on their performance.

2. The choice of operating in frontier markets: choosing SMEs operating in frontier markets implies compromising on the risk/return trade-off in favour of social performance. Returns also appear to increase with the country income group, whereas SME impact funds tend to invest mostly in lower income countries where financing gaps are greatest.

By doing **small transactions** in **frontier markets**, impact investors reduce their profitability. Impact funds typically demonstrate **economic growth in the underlying businesses** but **lower financial returns** than other fund types (VC, large PE funds...), taking more time to become profitable and suggesting it will continue to be a challenge to attract conventional capital to this sector.
However, this choice seems to us essential for the impact considerations seen previously, and scaling impact investing in Africa requires attracting capital with terms adapted to this particularly set of constraints (duration, return expectations, etc.). Catalytic capital remains the most effective tool to address this under-served market and create firm-level and market-level impacts while balancing the higher risks and costs involved in operating in underserved markets. Through various mechanisms (subordinated debt, junior equity, guarantees, grant support, etc.) catalytic capital acts as a yield enhancer and/or risk reducer for commercial capital, unlocking conventional funding with market return expectations. By financing SMEs on a long-term horizon, it also ensures the sustainability of both their business model and their positive impact (especially in terms of job creation).

Access to catalytic capital remains limited for frontier market SME funds, and structural constraints limit their expansion

Even if impact investing is growing and is increasingly enabling SMEs and startups to respond to Africa's environmental and social challenges, it is still not sufficiently widespread on the continent: a GIIN report from 2019 reveals that, while 52% of impact investors plan to increase their allocations to Sub-Saharan Africa, only 11% of the total assets under management (AUM) has actually been disbursed in these geographies[43].

1. SME impact funds are still struggling to access available catalytic capital.

While catalytic capital is being deployed, it continues to fail to reach frontier market SME funds because, while being flexible, it is often still not flexible enough. The leading investors in frontier markets are mainly DFIs, which usually do not have the means or mission to directly target SMEs. They are incentivized to invest in conventional fund structures and negotiate financial terms that can be counter-productive for SME funds. Indeed, it is common for some investors to accept an unbalanced risk/return trade-off (by asking for «only» 7% IRR) but at the same time imposing other structural constraints such as a short fund lifespan or a low level of management fees. Paradoxically, **private foundations** are often the ones who end up providing the tools that unlock DFI investments (such as first-loss risk capital, grant support, long-term financing...). Even when **public structures** can bring grant funding (for instance, to cover technical assistance projects), the constraints make them very difficult to cost-efficiently implement (a heavy and inadequate tendering process for SMEs, impossibility to cover human resource costs...).

As a result, too few SME funds manage to raise this type of capital, even though the leverage effect on private capital is substantial, resulting in low catalytic capital flows towards African SMEs. These constraints weigh on the financial models of investment funds but also have repercussions for the SMEs they support: impact investors are perceived by SMEs as very demanding, elitist, and sometimes even inacessible (often asking for high returns and short tenors).
There is, therefore, a double need, both quantitative (unlocking of more catalytic capital) and qualitative (improving the terms of the deployed capital) in order to develop mechanisms that are better adapted to our ecosystem's stakeholders (risk/return ratio and intervention geographies).

2. Average lifespan of SME funds in frontier markets still remains too closely linked with developed market standards.

By adopting the standards of developed markets, funder expectations are not aligned with frontier market fund managers' constraints. Moreover, the investment tools that are expected by most of the investors are not suited for financing SMEs in these markets: fund durations are often too short (and usually postponed) and financial expectations are too high. The main performance indicator, the IRR, should be reviewed, as it pushes investment teams to exit early from portfolio companies even though a longer investment period would maximize t impact creation and financial returns.

We can illustrate this observation through I&P's experience: by being a closed-end fund rather

43. GIIN, Annual Impact Investor Survey, 2019.

than an evergreen structure, I&P Afrique Entrepreneurs I (IPAE) must observe limited investment and disinvestment periods, both supposed to last 5 years. As the valuation of companies is done using the EBITDA, the 5-year equity investment may not be sufficient to correctly valuate SMEs as solid and productive as they really are (we have demonstrated that the EBITDA significantly increases after 6 years of investment). At the time of exit, the valuation is often made downward and I&P does not benefit from it.

Funds comparable to I&P funds take 15 years to break even a net positive IRR

Emerging markets funds take approximately 15 years to reach their full potential
Based on a fund segmentation, SME funds are expected to reach a Net IRR after:

- PE Funds: 5,1 years
- PE Funds (with SME Exposure) 3,4 years
- SME Funds: 14,6 years

For SME funds, on average it takes:

- Between 10 and 14 years to reach a positive gross IRR
- Between 15 and 20 years to reach a net IRR

Source: Insights on SME funds performances, Shell, Omidyar Network, Deloitte (2019); Across the Returns Continuum, Omidyar Network (2020)

Solutions exist and ecosystem actors should co-operate with new approaches to deepen the reach of catalytic financing

Ensuring that catalytic capital is better directed toward African SMEs is a collective effort, to be carried out by the entire SME-support value chain, from institutional and private investors to fund managers, as well as professional networks and advocacy actors such as the C3 Consortium. Through its 20 years of experience in impact investing and the raising of nearly 15 financial vehicles, I&P seeks to share here some reflections on how to move further towards more flexibility in the terms of catalytic capital providers. The objective of the following section is to participate in the collective learning process and encourage investors to unlock further catalytic capital to support impact investing initiatives in Africa.

1. By integrating more flexibility into their financial and legal frameworks, catalytic capital providers could better reach SME funds and generate significant impacts in frontier markets.

◆ **FUND LIFETIME AND EVERGREEN STRUCTURE:** Long-term financing is much-needed, especially in rural environments and the agribusiness sector, where the duality of seasons and climate variations can affect SME performance. Allowing for longer or flexible timelines before exit or debt repayments provides SMEs the chance to grow sustainably. Changing the legal structure of financial vehicles from closed-end funds to open-ended or permanent vehicles would help them reach higher financial returns at the expense of liquidity. This is a constraint which most DFIs, foundations, and impact-oriented investors could potentially manage with sufficient political or leadership will.

Focus on IPDEV2's evergreen structure: quick disbursements, long reimbursements

Launched in 2015, IPDEV2 is the first I&P's "fund of funds" and the largest incubation platform dedicated to the creation of national investment vehicles in Sub-Saharan Africa that supports microenterprises excluded from long-term financing sources. The project aims to create a network of 10 vehicles in 10 countries by structuring and training 10 local investment teams thanks to a total capitalization of €20m. Each vehicle finances needs ranging between €50,000 and €500,000, in the form of participatory loans, convertible bonds, and minority equity investments.

IPDEV2's very specific governance and disbursement processes have allowed it to be very responsive when SMEs have faced financial needs. In addition, some investments need longer maturity than usual investors are accustomed to, and patient capital is also a key aspect of IPDEV's model. This should not translate into an incentive to postpone exits but can give some companies the time to reach a targeted stage of development. In the case of IPDEV, this strategy was made possible because of an active commitment of its shareholders to IPDEV's mission.

By favoring a long-term perspective, IPDEV2's evergreen structure has enabled local partner funds to maximize the financial performance of their exits while avoiding having to exit within strictly 5 years. Six years prior, Sinergi Burkina, one of IPDEV2's local fund managers, invested in Agroserv. Since then, sales have increased tenfold, while Agroserv has grown and increased its impact. Sinergi Burkina provided strategic and technical support and helped structure the company and has recently exited their investment with a multiple of 7x on its equity stake.

◆ **ACCOMPANYING GRANT SUPPORT:** as seen before, the «cost of impact» may ultimately affect the profitability of SME impact funds. Covering some of the fund's operating costs through donor funding is a way to overcome the impact/return dilemma, as we have seen previously with I&P Development's use-case, through which I&P raised grant support, notably to finance the launch phase of the funds before their closing.

At the fund level, the use of grant funding can indeed allow for a reduction in the costs incurred by traditional investors either by:

- Subsidizing some of the general partner costs implied by the "cost of impact" such as implementation and monitoring of ESG & Impact activities, internalization of some resources to better support portfolio companies on topics such as work health and security, and QHSE (Quality, Health, Safety & Environment), conducting pre-investment technical assistance and support, etc.
- Having catalytic capital pay for a higher management fee.

At company level, the fixed costs of implementing these social and environmental measures are high. Technical assistance is insufficient, not entirely dedicated to ESG & Impact issues, and must be partly paid by the company. Impact investors could partner with DFIs and donors to secure grants for ESG and Impact issues such as the environment (and thus cover for corporate energy audits, feasibility studies for solar panels or other renewable energy installations, pre-financing of environmental equipment, etc.)

◆ **PRE- AND POST-FINANCING TECHNICAL ASSISTANCE:** Most entrepreneurs need support to meet investors' standards. Investment readiness is a prerequisite for any investment fund and can consume a lot of time and resources before the first investment is made. To ensure objectives will be met and impact will be generated after investment, a recurrent technical assistance and monitoring process is necessary. This assistance is often funded by grants awarded by DFIs.

◆ **GUARANTEE:** Due to an insecure environment, most lenders require significant guarantees and collateral. Lower loss-coverage ratios or innovations in terms of mortgage guarantees (cooperatives, grouped guarantees) would make more SMEs eligible. First-loss coverage guarantees are one of the most popular de-risking mechanisms, in particular for DFI's. Guarantee funds currently exist but are not sufficiently oriented towards SMEs due to a substantial cost of the guarantee and complex and heavy administrative procedures to follow.

◆ **CO-FINANCING:** Risk can be shared within members of the SME funding ecosystem by matching their investments with specific types of needs. Banks may be willing to fund equipment when less risk-averse institutions, such as impact funds, can finance working capital or highest perceived risk operations in combination with a financial institution.

2. Frontier-market SME funds also find ways to better demonstrate and value the impact they generate

In order to convince more investors and institutional stakeholders to support the impact investment sector and, importantly, catalytic capital, we are also convinced that fund managers such as I&P could strengthen their advocacy efforts toward concrete impact outcomes by providing innovative tools to better measure and illustrate impact results. We suggest a few ideas on which a follow-up study could be considered:

Improve the impact measurement of investment funds and increase the resources devoted to measuring it

Many social benefits are generated by investing in SMEs: education, health, environment, job creation…. Yet, the direct impacts are seldomly captured by the impact measurement systems of the impact funds, and even less when they are indirect. This may be related to capacity limitations but is often related to the costs associated with the measurement and reporting of those impacts. Impact funds face significant and legitimate pressure from their investors to diminish management fees. Nevertheless, a contradiction persists with the necessity to invest in impact measurement and reporting in order to justify the social costs incurred by investors.

We suggest that philanthropic investors and DFIs agree to subsidize the costs of impact measurement and reporting, at least partially, through mechanisms similar to those of technical assistance, a move which would help decrease management costs and bring them closer to commercial terms.

Propose innovative metrics to assess social performance

Overall, impact metrics have to be improved and regenerated. This could be made via a move by the impact community, through, for instance, shared work within institutions and networks like ANDE, and supported by willing donors, setting ambitious though realistic impact frameworks based on improved economic science and associated to training and capacity building within the impact community.

The impact community could work on **standards to capture key "internalities"** such as the direct and indirect benefits (although also sometimes costs) brought to staff, suppliers, and clients on health, education, environment… The community could also work on **innovative standards** which could capture **key positive and negative, direct, and indirect externalities.** These are mostly related to environmental costs (carbon, pollution, resource depletion, biodiversity). Finally, standard **"Leontieff matrixes"** could be created and shared among impact funds in order to facilitate the measurement of indirect added value. These are very important to complement job creation indicators, which have many limitations: job creation reported by impact funds rarely include measurement for job destruction, for instance. They don't encompass the fact that productivity increases should lead to lower job numbers related to the dollars invested as companies grow and become more sophisticated and target the formal job market more closely. Therefore, if ratios like jobs created reported to the dollar invested are interesting to provide an idea of a certain dimension of the social impact achieved, one cannot rely on them to describe the full scope.

We suggest that impact funds set a target Economic Rate of Return (ERR), which would capture the direct and indirect added value of the investments. This approach could also take into account specific negative externalities, such as carbon emissions and workplace accidents. The ERR could be compared against the economic cost of subsidizing the fund, while the fiscal

return generated by the invested companies could be compared against the fiscal cost of the concessional financing. Hence the social benefit of the concessionality would be made clear. These benefits could be compared with those of other public policies, and the acceptable level of direct or implied subsidization could be discussed on rational grounds.

Value-added vs GDP

One way to point out the contribution of our SMEs to economic development at the country level could be to demonstrate their contribution to national GDP growth. The best (although not perfect) financial indicator to carry out this demonstration would be the value-added. I&P began conducting this analysis on IPAE's portfolio and showed that the value-added growth of this fund's SMEs was higher than the GDP growth in the same regions. This work could be expanded at I&P's portfolio level, or even more broadly.

However, the notion of GDP is widely criticized for not integrating more qualitative aspects of development and the question of inequalities. Hence, considering a way of measuring a social IRR in order to overcome its purely financial logic and highlight the positive externalities brought to the economy (decrease of the carbon footprint) is an interesting approach that is in line with the Economic Rate of Return (ERR) concept discussed above.

It is critical that the "true" impact community remain **ahead of the curve of impact measurement** as impact washing makes progress and thus demonstrates how legitimate it is to consider the engage high social cost carried by taxpayers and philanthropic stakeholders. Finally, we could also mention the question of the impact's durability: unlike philanthropy, where many projects stop when a grant's funding ends, the impact investment model makes it possible to generate longer-lasting impacts. An interesting avenue of study for impact funds would be to demonstrate this sustainability through long-term studies of exited companies.

Appendices

1. Methodology used for the calculations on I&P portfolio performance

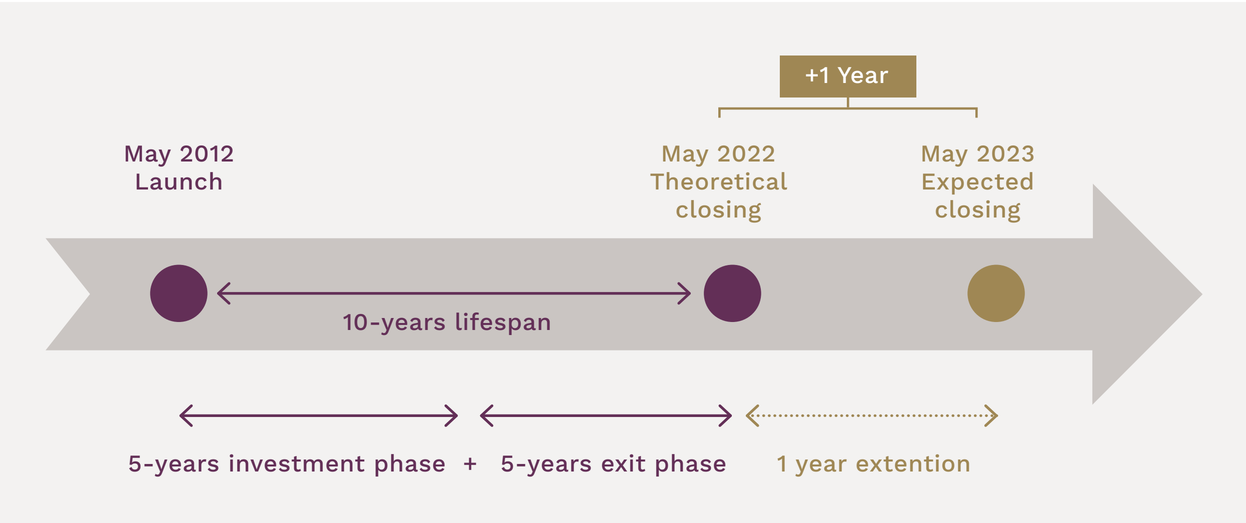
Sampling: not all of I&P's funds currently have the same maturity. However, analyzing the performance of a fund requires a minimum of hindsight, especially as we have just gone through a major health and economic crisis. The data used therefore comes from the IPAE1, IPAE 2 and IPDEV 2 funds. The sample therefore decreased over the years.

Methodology:
Our method is based on three principles:

◆ Bringing all companies to the same time scale: we considered the number of years of investment (year 1, year n, etc.) rather than calendar years (2012, 2013, etc.), as the equity investments in the different companies were made in a staggered manner from 2012 to 2021. We therefore considered year 1 as the year of the fund's entry into the company, and then reconciled all the data to have the same starting point before proceeding with the calculations. This has the effect of smoothing out the effect of crises and context on company performance at the portfolio level. This choice is deliberate in order to discern underlying trends independently of external influences.

◆ Reasoning at the portfolio level: The indicators for turnover and EBIDTA and employment were added up year by year, at the portfolio level. They present a consolidated "portfolio" vision as they correspond to the annual sum of the companies'

EBITDA growth of I&P portfolio companies



figures before calculating the evolution from one year to the the year of investment. The alternative would have been to calculate the evolution of companies annually before averaging them - this method overvalued, with significant percentages, the smallest companies and greenfield investments, which distorted the reading. Conversely, our method is more influenced by the results of larger companies, which is also representative of the portfolio's exposure to these larger investments.

◆ Maximizing the sample size: In order not to measure a constant sample, which would have been very limited or over a limited time, we took into account all the available data for evey years, and compared it to year 1. This allowed us to make our sample evolve (and decrease) over the years, using as much data was available.

Display: For the sake of readability, we have decided to present the results in base 100 index: the starting value, even if negative, is brought back to 100 to better visualize and compare the trends.

In summary, the graphs presented in this section represent the annual sum of the indicators of I&P's funds companies, brought back to their first year of investment, with a sample that evolve over time.

2. Statistical limits

COVID crisis: The choice of a harmonized time scale means that some firms experienced the COVID period during the holding period and others did not (exit before 2020). Thus, we cannot isolate the effect of the health crisis within these statistics, which was also partly the intended effect.

Sub-samples: Not all sub-categories, by sector or by geographical area, could be studied. The samples thus composed would have been insufficiently representative (uneven distribution and/or too small a number of companies).

References

ACBF - Union Africaine. (2016). Compétences techniques essentielles pour l'Afrique.

African Private Equity and Venture Capital Association. (2022). Addressing the exit challenge in Africa.

BAD. (2020). Perspectives économiques en Afrique.
Bygrave, C. a. (2003).

CSIS. (2021). Supporting Small and Medium Enterprises through Blended Finance.

Deloitte, Omidyar Network, Shell Foundation. (2019). Insights on SME Fund Performance – Generating
learnings with the potential to catalyze interest and action in SME investing.

French Development Agency & World Bank. (2012). Francophone West African Informal Companies.

French Development Agency. (2021). The African Economy 2021, .

French Development Agency. (s.d.). Decent Work. Récupéré sur https://www.afd.fr/en/page-thematique-axe/decent-work

I&P. (2019). Formalizing SMEs in Sub-Saharan Africa.

I&P, FERDI. (s.d.). Investing in Development.
International Labour Organization. (2018). Women and men in the informal economy: a statistical picture.

International Monetary Fund . (2019). Financial Access Survey.

Kappel, R. (2022). Afrique : Les défis de l'emploi.

McKinsey & Company. (2015). Brighter Africa.

MSME Finance Gap database. (2018).

Private Sector and Development. (2019). Private Sector Magazine.

Rouanet, F. D. (2021). Female entrepreneurship, key ingredient for Africa's growth . iD4D Sustainable Development News .

Runde, S. a. (2021). Supporting Small and medium enterprises in SubSaharan Africa through Blended Finance.

Shapero. (2015).

SME Finance in Africa: Whats's new ? (2019). Private Sector and Development n°32.

Sustainable Energy for All . (2018). Annual Report 2018 .

The World Bank. (2021). The Global Findex Database .

UNDP. (2016). Africa Human Development Report 2016: Advancing Gender Equality and Women's Empowerment in Africa.

World Bank Enterprise Survey. (2019).

Contributions
Special thanks to the team of R.M.D.A.(Red Mangrove Development Advisors) for their contribution to this report (data analysis).

Photo credits
Cover: CIFOP © Tévin Lima, Agence Fën p1: © Inua Capital - p6: Gona Maroquinerie © Atchioua Photography - p13: Lika Cosmétiques © Label Foto - p16: Xpress Gaz © Michael Dakwa- p 19: Citrine © Atchioua Photography - p 25: © Afroto - p30: Hi Tech Solution © Afroto - p 33: Design Institute Africa © Michael Dakwa - p36: © Afroto - p38: Yam Agro © Olympia de Maismont - p44: CDS © Béchir Malum - p50: Liberty pressing © Afroto - p52: CIFOP © Tévin Lima, Agence Fënt - p55: Heri Madagascar © Riana Annette - p57: © Afroto - p61: © Afroto

To find out more on the report:

https://www.ietp.com/en/content/IP-C3-report-catalytic-capital

INVESTISSEURS & PARTENAIRES