CAPACITY CONSTRAINTS FACING RISK FUND MANAGERS

FINAL REPORT

AUGUST 2008

GrowthFin
financing for growth

FSD Kenya
Financial Sector Deepening

Prepared by

InvesteQ CAPITAL

Trade Finance • Asset Finance
Venture Capital

The report was commissioned by FSD Kenya. The findings, interpretations and conclusions are those of the authors and do not necessarily represent those of FSD Kenya, its Trustees and partner development agencies.

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Acronyms

AVCA	Africa Venture Capital Association
BDS	Business Development Services
BPI	Business Partners International
BPSA	Business Partners South Africa
DFI	Development Finance Institution
EVCA	European Private Equity & Venture Capital Association
FMO	Development Finance Company of the Netherlands
FSD	Financial Sector Deepening Trust
HR	Human resources
ICT	Information and Communication Technology
IDA	International Development Association
IFC	International Finance Corporation
IPO	Initial Public Offering
IRR	Internal Rate of Return
Ksh	Kenya shilling
M & A	Mergers & Acquisitions
MIS	Management Information System
MSME	Micro, Small and Medium Enterprise
MSE	Medium & Small Enterprise
NPV	Net Present Value
PE	Private Equity
PESTLE	Political, Economic, Social, Technological and Environment
SME	Small and Medium-sized Enterprises
SSC	(IFC's) SME Solutions Centre
SWOT	Strengths, Weaknesses, Opportunities and Threats
TA	Technical Assistance
TOR	Terms of Reference
US$	US dollar
USAID	United States Agency for International Development
VC	Venture Capital

Definition of terms

Angel Investor	A wealthy individual who provides backing to very early-stage businesses or business concepts.
Blue chip	A nationally recognized, well-established and financially sound company. In the capital markets, a blue-chip stock is considered a stable investment.
Carried Interest	The portion of any gains realized by the fund to which the risk fund managers are entitled, and given to create a significant economic incentive for venture capital fund managers to achieve capital gains.
Clean Technology	Encompasses energy, air and water treatment, industrial efficiency improvements, new materials and waste management.
Committed Capital	The total dollar amount of capital pledged to a private equity fund.
Deal Flow	The measure of the number of potential investments that a fund reviews in any given period.
Deal Directory	An information bank giving details of all business carried out with investee companies and relevant transaction details including due diligence processes, post monitoring, value addition as well as exit.
Debt Investment	An investment into a company whereby the company needs to repay the investment within a certain period of time, needs to pay interest over the debt amount within that time, and in many cases needs to provide some form of securities or guarantees towards the provider of the debt investment in case it could not repay the debt (in the form of a house for example).
Due Diligence	A process undertaken by potential investors, individuals or institutions, to analyze and assess the desirability, value, and potential of an investment opportunity.
Equity Investment	An investment into a company whereby the investor becomes shareholder of that company.
Exit	Exit (strategy) is the method by which a venture capitalist or business owner intends to get out of an investment made in the past. Examples include an initial public offering or being bought out by a larger player in the industry.
Fund Manager	The person(s) or management team responsible for implementing a fund's investing strategy and managing its portfolio trading activities.
Fund Size	The total amount of capital committed by the investors of a venture capital fund.
Initial Public Offering	The sale or distribution of a stock of a portfolio company to the public for the first time.
Investee Company	A company targeted for investment by a risk fund.
IRR	Internal Rate of Return - discount rate the makes the NPV of a project equal to zero, i.e. this rate defines the yield on a particular investment. Specific to venture capital, IRR is the compounded yearly rate of return on an investment that a fund manager receives on an investment at the time of sale or other exit.

Management Fee	A charge levied by a fund manager for managing a fund. The management fee covers the managers' time and expertise, investor relations expenses and the administration costs of the fund. Management fee structures are typically based on a percentage of assets under management.
Net Present Value	The difference between the present value of cash inflows and the present value of cash outflows. NPV is used to analyze the profitability of an investment or project and is sensitive to the reliability of future cash inflows that an investment or project will yield.
Private Equity	Equity capital that is made available to companies or investors, but not quoted on a stock market.
Private Placement	The sale of a security directly to a limited number of investors.
Quasi Equity	An investment into a company whereby the investor takes shares into the Investment company but agrees that the company will buy back/pay-off these shares after a certain period of time guaranteeing the investor a certain return on investment.
Venture Capital	Money provided by investors to startup firms and small businesses with perceived, long-term growth potential. It typically entails high risk for the Investor, but it has the potential for above-average returns. Venture capital is popular among new companies, or ventures, with limited operating history, who cannot raise funds through a debt issue.
Venture Capital Fund/ Risk Fund	An investment fund that manages money from investors targeting small- and medium-size enterprises with strong growth potential.
Exchange Rate	USD 1 = Ksh 67

EXECUTIVE SUMMARY

INTRODUCTION

InvesteQ Capital Ltd ("InvesteQ") was contracted by the Financial Sector Deepening (FSD) Trust to conduct a study on the capacity needs of risk fund managers in Kenya. The aim of the study was to:

- Identify capacity issues that if overcome would enable the funds to effectively serve the MSME market in Kenya.
- Identify potential interventions to overcome these capacity constraints.

Given the fragmented nature of the SME market in Kenya and the fact that the risk fund business in Kenya is relatively young, the consultant found the need to expand the scope of the study to include other relevant SME players as well as important contacts on the international front. In total, 20 firms serving the SME market in Kenya were surveyed.

This report presents recommendations from the research findings and the stakeholders input that may be considered in light of the proposed TA intervention.

FINDINGS FROM THE DESK STUDY

From the desk study the consultant came across the generally accepted characteristics of a good risk fund manager as outlined below:

- *Experience and Skills of the Management Team* – successful risk fund management is largely about the people who invest and their ability to add value to the investee companies. A more successful risk fund manager will generally have more than 10 years investment experience.
- *Fund Manager - Incentives* – The fund needs to have a minimum fund size and subsequently, sufficient management fees. The investors and management teams' interests should be aligned through proper incentive schemes by way of carried interest. Moreover, the investors should have a long term investment horizon, so that there is sufficient time to invest and divest the portfolio companies. An ideal outlook is in the range of at least 8 to 10 years.
- *Investment Strategy and Approach*– Successful risk fund managers focus on fast growing industries and invest in businesses that require a relatively small initial investment but which have very high potential for growth. These types of investments require a hands-on approach, where the senior partner would be involved from the beginning and at all stages of the due diligence process as well as taking a board seat until an exit is realized. Consequently, the number ofi nvestee companies one senior partner can handle is limited to around 6 or 7. One approach taken by individual risk fund managers to be able to handle more investments is by co-investing and sharing the risk and work load with other risk fund managers.
- I*nternal Rate of Return* – On average the top tier risk fund managers reach a net yearly IRR in the range of 25% or more over the lifetime of the fund. For a US$25M fund for instance, this would mean profits for the investors of US$207million after 10 years.

From the benchmark and desk study the consultant also found that recent trends in venture capital are changing the way the risk fund business has been traditionally conducted and points to some of the developments that local risk funds could expect in the near future. For instance, globalization has brought successful risk fund managers to, for example, India and China and some are eying the African continent. Two successful South African fund managers (BPSA and Grofin) have begun operations in Kenya.

Capacity constraints and best practice interventions from the desk study

The capacity constraints faced by risk funds across the globe are similar, especially for young fund managers, including:

- Poorly designed fund structures.
- High investor demands.
- Lack of skills specific to private equity and venture capital.
- Limited resources for efficient operation of the fund.

The lessons to be learnt from the experience of more established venture capital firms on how they have overcome some of their capacity constraints or the challenges are:

- Change in fund structures, through for instance higher management fees.
- Change in investment strategies, like co-investing.
- Support through venture capital associations like training, market data, deal flow and awareness creation through conferences.

- External support from development organizations and respective governments.

FINDINGS FROM THE FIELD WORK

The MSME Environment in Kenya

The MSME environment in Kenya faces many challenges, key being the lack of human resources, access to financing and the generally high cost of the financing that is available through short term debt capital from banks. This situation provides an opportunity for risk funds to work with SMEs in financing their requirements. However the fragmented and informal nature of the sector and the high risks associated with it still make it difficult and costly for risk fund managers to consider this group with certainty. A majority of the risk funds and SME finance providers surveyed cited the capacity constraints facing SMEs as being bottlenecks to their own anticipated business in the sector.

The risk fund environment in Kenya

The risk funds in Kenya that focus on SMEs are quite young, given that all of the funds surveyed are less than 3 years old (see table 1 below). None of these funds have seen any exits, save for those that have gone into short term contract financing, which would usually be for a period of less than one year. Among the risk fund managers surveyed, six of them have invested in businesses up to a total of about US$ 18.2 million. The consultant found the need to expand the scope of the field study to include a wider range of SME finance providers outside the pure risk fund managers.

Looking at the average deal sizes of the risk funds realized so far, i.e. BPI is US$200,000, US$300,000 for Bridgeworks, US$400,000 for Grofin, US $ 500,000 for Acumen and AAC, US$750,000 for TBL and US$ 700,000 for InvesteQ, it is clear that while some of the funds

Table I: Participants Surveyed – SME Risk Funds & Other Finance Providers

Locally Incorporated Risk Funds: This group comprises venture capital and quasi equity SME Funds.	7	Bridgeworks Africa, African Agricultural Capital (AAC), Acumen Fund, Grofin East Africa, BPI, TBL Mirror Fund, InvesteQ Capital
Banks	4	Fina, Equity, Standard Chartered, PTA
Private Equity Funds	3	Aureos EA Fund, ICDCI, TransCentury
Development Finance Institutions	1	Industrial Development Bank
Leasing Companies	1	Rentworks
Investment Clubs	2	ISoko Investments, Bridges Capital
Technical Assistance Funds	2	Enablis, Technoserve
Total	**20**	

Table II: Funds Committed & Invested – SME Risk Funds

Acumen Fund	45	2.3	11.5%	4
GroFin EA Fund	18	8	40%	20
African Agricultural Capital	10 (17 target)	17.4	22.5%	9
BPI	14 (15 target)	29.8	13%	12
TBL Mirror Fund	5	3.0	4%	1
Bridgeworks	15 (Target)	3.7	2%	1
InvestQ Capital	15 (Target)	1.4	7%	2
TOTAL	**93 (Target of 120)**	**19.6**	**100%**	**49**

could start providing as little as US$50,000, they all target more the larger of the "Small" enterprises within the MSME sector to minimize risk and increase potential returns. Furthermore, only 2 provide pure equity, with the other 4 providing quasi equity finance.

Table III: Average Deal Size of the 7 SME Risk Funds

	SME Risk Fund	Average Amount Invested (US $)
1	BPI	200,000
2	Bridgeworks	300,000
3	GroFin	400,000
4	Acumen	500,000
5	AAC	500,000
6	TBL	750,000
7	InvesteQ	700,000

Capacity constraints from the field work

The key capacity issues highlighted for all risk fund managers revolve around:

- Limited fund experience.
- Limited human capacity.
- Limited financial resources.
- Insufficient resources to do proper post investment monitoring.
- Challenge to get good deal flow creation.
- Challenges around exit management.

As noted, similar issues were encountered in the desk study by the now more developed risk funds. Some of the capacity issues are tied to the fact that the funds are young thus overcoming these issues is a matter of experience, which will result in the ability to raise more funds and have more resources. Other capacity issues can be solved by partnering with experienced fund managers and with TA providers.

The challenges resulting from limited available resources that come with doing small deals or managing small funds could be resolved by changing the fund structure or investment model. Funds focusing on pure equity investments, which need dedicated post investment monitoring to maximize returns and exit potential, choose to increase the deal sizes and/or focus on investments in fast growing industries. Funds focusing on quasi equity and debt either increase deal sizes, or manage many small investments through an efficient, system driven, post investment approach which is focused on debt collection. Table IV below highlights some of the specific solutions used solve the capacity issues raised. The solutions given here are from the entire group of SME finance providers surveyed.

CASE STUDY

The case study looked at Business Partners International, Kenya (BPI). This provides a good reference point for the possible interventions sought in this study given that the risk fund was the first beneficiary of a US$ 2.5 million technical assistance from the World Bank through the Government of Kenya's Ministry of Trade and Industry. The expectation is that a similar intervention will be made available to other risk funds.

It remains to be seen what the success of the BPI model in Kenya is given the fund was only launched in early 2007. The deal flow sourcing through IFC's SSC seems successful, and the investment process efficient. BPI has so far closed 12 investments, since the fund's inception early this year.

Risk fund managers that would like to reach BPI's level, and wish to qualify for the next disbursement of TA, can learn a number ofl essons from the BPI model. Most importantly:

1 BPI has a subsidiary relation with BPSA from South Africa, where it can tap into the knowledge and experience of BPSA.

2 BPI has adopted the BPSA due diligence processes and investment model that enables to do many small investments through investment structures that combine debt with equity or royalties, thereby minimizing the risk and optimizing the anticipated returns.

3 The staffs' interests are aligned with those of the investors through appropriate incentive schemes.

However, there are certain components of the BPI model that are difficult to copy. Looking at the BPI organization, its scope and the level of business, the fund's cost structure must be relatively high compared to other local risk funds, which means the need for access to additional support from an organisation like the IFC or a grant to provide "free" resources. Furthermore, the access to SSC services is quite exclusive, and building an organisation the size of the SSC to operate alongside each fund requires significant financing which would only be achieved through a grant. Moreover, the cost of services provided by the SSC as described are not reflected in the returns of the fund thus giving it an unequal advantage. A solution to this could be that SSC considers providing its services on a wider scale and on a neutral basis to other funds as well.

PROPOSALS & RECOMMENDATIONS FROM THE STAKEHOLDERS' WORKSHOP.

A stakeholders workshop was held in Nairobi on 13 November 2007, with the aim of having the stakeholders validate the findings of the study. The key proposals and recommendations raised in light of the capacity issues identified from the field work are highlighted in Table V.

Table IV: Participants Solutions to Capacity Issues

Lack of Qualified & Experienced Management and staff.	- Have TA funds in place to train staffon critical skills of SME lending. - Investment officers receive mentoring from experienced consultant, bankers, investors and entrepreneurs from abroad. - Partnering with experienced fund managers to get VC experience.
Limited financial and human resources for Due Diligence and Post investment Monitoring	- Have good post investment monitoring systems. - Focus on fast growing industries with high upside potential. - Some of the risk funds have taken the options of a board seat to add value through the fund's network - Some funds have investors that agree to lower returns. - Some of the SME finance providers have TA for legal process and negotiation of deals. - Others have TA to provide business advisory services to portfolio companies. - Some risk funds have found the need to increase the average deal size to more than US $ 500,000.
Absence of reliable market Sector Studies	- Partnering with experienced fund managers to get market data. - Working with graduate trainees on contract on the ground, who work closely with people in the areas or sectors off ocus. - Contracting firms such as Consumer Insight to carry out market sector studies.
Constraints associated with deal Sourcing/ Marketing of the Fund and Networking	- For some SME providers, by working closely with the government, there is a greater likelihood to be aware of prospective projects in the public sector - Creating a networking platform for entrepreneurs who meet regularly. - Partnering with an organization that provides and assures a consistent deals.
Limited exit management opportunities and experience	- Instead of providing pure equity, which has the greater exit challenges, risk funds provide quasi equity, where the main investment is disbursed as a loan which needs to be repaid, and the upside come from interest and a small portion of equity. - Key focus is on efficient mobilization and delivery channels to drive business.
Demanding reporting requirements by investors and shareholders	- Some risk funds receive TA funding for reporting on specific items that investors request, e.g., social impact. - Alignment ofi nvestor interest with fund manager interest through incentive schemes like carried interest
ICT & MIS systems wanting	- Some of the funds have partnered with experienced fund managers who have a sophisticated ICT and information management systems. - Some funds have TA funding which provides interest free loans to investees for specific requirements, e.g. for investment in proper ICT systems.

Conclusions: Proposals for intervention through technical assistance

The study reveals that some of the capacity constraints experienced by local risk fund managers have been resolved by the risk fund managers and MSME finance providers themselves by for example changing their fund structures or investment models. Some of the constraints could also be overcome through interventions such as Technical Assistance, the government and different forms of grant funding. Recommendations on the possible TA interventions that could be adopted, based on findings from the desk study, field work, lessons from the case study and stakeholders' workshop are highlighted in Table V.

Table V: Proposals & Recommendations from the Stakeholders' Workshop

Capacity Issue	Participants' Comments/ Proposed Solutions
Limited experience and skills of the fund and the respective fund managers.	- Setting up a Venture Capital Association (VCA) will provide support towards risk fund managers in many ways, e.g., building capacity through training. - The capacity building to be provided should be focused on training risk fund managers on understanding MSMEs and MSME finance. - Need for interventions that will provide TA to support experienced fund managers to work with a risk fund lacking in experience. - Kenyans in Diaspora with the relevant experience and skills could be approached to act as mentors to local risk funds. - In the long term, see how university curriculum can include private equity/ venture capital courses. - The individual risk funds should provide a platform through the proposed VCA, to share information and skills among themselves up to the levels that are allowable, i.e. without the risk ofl osing their competitive edge. - Local risk funds should share information and skills by co-financing
Limited resources for efficient operation of the funds	- Set up of a VCA to promote best practice, research and set standards to instill confidence in the market, promote policy building and lobbying for members, e.g. for tax incentives
Limited human and due diligence experience	- Provide TA at both pre and post investment level to cover the expenses incurred in the due diligence process. - The proposed VCA could provide a pool ofi ndustry experts to act as an advisory board to the local risk fund managers. - Pool synergies from the different local risk funds. - Have a mentorship program through the VCA to encourage professionals in this market to work with risk funds. - Consolidation of small funds to enhance their capabilities - Have a mentorship program through the VCA, e.g. retired professionals
Inadequate and unreliable market sector studies.	- The studies could be provided by the proposed VCA, against a subsidized fee. The VCA could also influence other organizations like the Kenya Institute of Manufacturers, Kenya National Central Bureau of Statistics and the Chamber of Commerce to collect market data and carry out relevant studies. - The risk fund managers should assist these organizations in developing the required questionnaires to gather the relevant information. - In addition, the VCA could carry out studies in certain sectors.
Demanding shareholders/ Investors	- The proposed VCA could develop appropriate reporting standards. - The risk funds should provide detailed/ comprehensive reporting to their respective shareholders where all issues are adequately addressed. This would include providing different reporting variables as required. - The risk funds should educate their respective investors about what to expect from this market in terms of return and limitations. - For guidelines on reporting and content, risk funds could refer to the IFC SME toolkit or the EMPEA toolkit
Inadequate/ unreliable management information systems	- Through the VCA, create standards that can be adopted by all the players.
Exit management – market underdeveloped thus providing few exit options	- The risk funds should look into proper exit management strategies before investing and implement the exit strategy well.
Challenge of deal flow sourcing	Each risk fund manager should implement their own marketing strategy and communicate their investment parameters well towards MSMEs and towards other fund managers. - Through the proposed VCA, promote networking in the industry such that specific applications and requests for venture capital funding are channeled to the appropriate risk fund. - The risk funds should take the initiative to educate the market, the business community and relevant stakeholders on the working of private equity and venture capital. This could be done through conferences or other forums. - Develop an SME deal depository – the risk fund managers could team up and approach an independent organization which has the capacity and interest to provide this kind of service. Such an organization would likely be financed through grants.

1. *TA Services:*

- Provide deal flow assistance.
- Sponsor access to professional services.
- Provide funding for specific post investment interventions.
- Sponsor the set-up of a VC Association.
- Sponsor reliable market sector studies.
- Sponsor the set-up or access to credit reference bureau services.
- The scope of services possible with the anticipated US $ 4 million TA Fund are those that would enhance the investees' business processes as opposed to issues that would be fundamental to the deal process with the risk fund manager. Risk fund managers feel that there is need for flexibility by the TA administrator to cater for the different and unique needs of their investee companies.
- Proposals from the workshop are to immediately include a training component for risk fund managers for specific modules on private equity and venture capital training.

2. *TA Structure:*

There were various suggestions to this end as highlighted below.

- A proposal that the TA funding be channelled through one, revolving, TA fund. Most of the services provided would be through interest free or minimal interest loans, thus ensuring the revolving nature of the facility, sustainability of the fund and accountability by the SMEs. Each risk fund manager or MSME finance provider would on-lend the funds to its investee company, be responsible for the collections and be required to repay the full amount taken from the TA fund. In case of defaulting investees the repayment would come from the profits made on the funds' other investments. The reason for payback by the investee is to ensure :
- A suggestion that the TA be disbursed as a grant, as there would be a good number of organizations, who would be willing to support the TA funding.
- A mechanism for insurance should be worked into the loan provision to ensure loan recovery.
- The decision about whether or not to lend to an investee company should be left to the fund manager.
- The issue as to whether the fund manager could also be the BDS provider should be at the discretion of the fund manager if they are managing the TA themselves.
- A precedent where a TA fund is given as a debt would help as a reference point to draw conclusions on an appropriate structure.
- Risk funds could share costs and risks of return of the TA with the investee.
- A proposal to charge the TA at the same interest as the respective funds' costs.

3. *TA Amount*

Drawing from the example of the case study, BPI provides TA funding to its investees up to an amount of about 30% of the investment size. The US $ 2.5 million TA fund available to BPI is approximately 17% of its fund size. This fund is also of a revolving nature.

Thus, applying the example of BPI to the local risk fund industry and other MSME providers, the resulting TA amount would be quite substantial as shown below, i.e., suppose the 17% is applied to fund sizes of up US$ 15 million and in addition, have a maximum TA sum per fund of around US$ 2.5 million. The resulting TA amount would be as follows:

Table VI: Estimated TA Funding Requirements for SME Risk Fund Managers

NAME OF FUND	FUND SIZE US$ M	TA AMOUNT (US$ M) 17% OF FUND SIZE, MAX 2.5 M
Acumen Fund	45	25
GroFin EA Fund	18	2.5
African agricultural Capial	10	1.7
BPI	15	2.5
TBL Mirror Fund	5	0.9
Bridgeworks	15 (target)	2.5
InvesteQ capital	14 (Target)	2.4
TOTAL	**120**	**15**

Looking at the local MSME finance industry, this would work out to a TA fund in the range of US$ 10-20 million.

From the stakeholders' workshop, participants felt that to determine a sufficient amount of TA, the actual figure should be based on a realistic amount based on the different fund sizes. Whereas the feeling is that the TA fund available (US$ 4M) may not be sufficient for all the needs and capacity constraints highlighted, it is possible to grow the amount. Another suggestion is for the threshold to be for investments below US $ 50,000 as this is where there is greater need for investees to streamline various aspects of their businesses.

Chapter 1

INTRODUCTION

1.1. BACKGROUND

The Financial Sector Deepening (FSD) Trust was established in early 2005 to support the development of financial markets in Kenya as a means to stimulate wealth creation and reduce poverty. GrowthFin, a programme of the FSD works in partnership with the financial services industry to increase the ease with which SMEs access financial products and services. Together, GrowthFin and FSD's primary focus is developing the capacity of the financial services industry, working directly with a diverse range offi nancial institutions as well as business service providers.

On another front, the Government of Kenya is implementing the World Bank funded MSME Competitiveness Project whose main goal is to enhance the competitiveness of Kenya's micro, small and medium enterprises ("MSMEs"). The project has more recently found the need to build the capacity off und managers as well so as to provide greater impact to the success of the MSME sector. It is in this regard that GrowthFin is partnering with the MSME Competitiveness Project to carry out a capacity needs assessment of risk capital fund managers in Kenya. The information gathered will be useful in helping FSD design possible interventions for the identified constraints as well as provide a basis for the use of a technical assistance fund for these fund managers made available by the MSME Competitiveness Project.

It is in this regard that INVESTQ CAPITAL LTD, through a competitive bidding process, was contracted to carry out the study. The objectives and deliverables of the assignment are highlighted below.

Objectives of the Assignment:

(i) To carry out a study of any existing and potential risk capital fund managers in Kenya in order to identify any capacity constraints that these fund managers are facing in effectively serving the SME market in Kenya

(ii) To determine how current and prospective fund managers have built their current capacity and what steps they intend to take to build it further

(iii) Get a feel for best practices off und management capacities internationally; and

(iv) To recommend possible interventions to solve the identified constraints.

Deliverables

1. Inception Report
2. Draft Report
3. Final Report

The detailed TOR is attached in appendix A.

1.2. METHODOLOGY

The Consultant designed this assignment to be executed in four phases, namely:

1 Design and Work plan

2 Field work and Assessment

3 Meetings to validate results and generate input and

4 Reporting

Design and work plan

The Consultant held a preliminary meeting on 18 June 2007 with the Head of GrowthFin and a representative from the IFC SME Solutions Centre (IFC-SSC). The purpose of the meeting was to obtain a common understanding of the Terms of Reference and to receive input and critical issues and concerns that needed to be addresses in the study assignment.

The issues that emerged which required special attention in the performance of the assignment included:

(i) That the Consultant provides a working definition for Small and Medium Enterprises for purposes of this study. Also provide an overview of the SME environment in Kenya.

(ii) Interview a broader range offi nancial service providers, aside from purely risk capital funds, i.e. look at the whole chain of finance providers towards SMEs, including asset finance managers and various working capital providers

(iii) Classify the finance providers based on the specific instruments that they provide to SMEs.

(iv) Consider the Business Partners International model as a case study when considering interventions for capacity constraints that will be identified.

(v) Look into the broader elements of capacity focusing not only on the human aspect but also on systems, and processes.

(vi) Consider the final proposed interventions from two broad perspectives, i.e.

a What is the risk that financial service providers, even if the capacity constraints are overcome, would end up focusing on bigger investments as these are more lucrative?

b What is the risk of building the human resource capacity of the fund, after which they leave the financial service provider for better paid options?

(vii) Provide recommendations on how the proposed Technical Assistance could be structured.

The Consultant proceeded to prepare a work plan, identify the list of participants to be interviewed as well as design the study questionnaire which would be used in discussion with key participants in the risk fund and SME finance environment. The inception report that has details on the project scope and the design and work plan is attached in appendix G.

Fieldwork and assessment

Desk Review of Literature

The Consultant referred to local sources of information, namely the Ministry of Trade and Industry documents, the Central Bureau of Statistics, Central Bank of Kenya and country location of the World Bank and IFC offices for information about the SME environment including sectoral and industrial distribution of SMEs in the country. The consultant also studied best practice of risk fund management from previous studies that have been prepared on venture capital and referred to various Internet sources.

The list of sources for the desk review is attached in appendix B.

Interviews

The Consultant made appointments and interviewed key management and staff of the different classes of SME finance providers in the country as well as telephone calls with participants from international locations where risk fund management is more developed. The list of participants is attached in appendix C.

Meetings to validate results and generate input

The Consultant met with the Head of GrowthFin and representative from the IFC-SSC on July 12, 2007 to discuss the research findings and the emerging solutions as at that date. The Consultant received further inputs on October 18, 2007 following meetings held by the Head of GrowthFin, the IFC and representatives from the Ministry of Trade. The draft report was subjected to further discussions by stakeholders in a workshop held on 13 November of this year. This final report is therefore the product of a consultative process as required in the assignment Terms of Reference.

Reporting

This report presents recommendations from the research findings and the stakeholders input that may be considered in light of the proposed TA intervention.

The rest of the report is divided into the following sections:

- Section 2 – contains a summary of the research findings comprising the desk research, participant interviews and the case study. This section also includes details of risk fund management best practices, cross cutting capacity issues and proposed or existing solutions to the capacity issues.

- Section 3 - looks at the emerging proposals for the technical assistance fund (TA) intervention as a solution to the capacity issues mentioned as well as other proposed solutions outside the TA fund framework.

- Section 4 – captures the main points of the report and provides the final conclusions.

Chapter 2

CHARACTERISTICS AND CAPACITY ISSUES OF RISK FUND MANAGERS

2.1 INTRODUCTION

This section gives a summary of the findings from both the desk study and the field work.

The aim of carrying out the desk study was to identify benchmarks from already established funds in developed countries, concerning how they overcame their capacity issues at the point of setting up their respective funds and what the capacity issues actually were. In addition, the study looked at available documented research on the risk fund environment and present capacity issues facing other developing countries in general. The desk study was also meant to help get pointers as to how a technical assistance program or similar intervention can most effectively be employed. The Desk study summary is provided in section 2.1 below.

The purpose of carrying out the field work was to identify the key capacity issues facing risk fund managers in Kenya. The consultant found the need to expand the scope of the target audience given the fragmented nature of the risk fund environment in Kenya. Thus the study also looked at other players involved in the financing of SMEs in the country, e.g. banks, investment companies, asset managers, development finance institutions and working capital providers. The summary of findings fromthe different players is presented here in section 2.2.This section also provides an overview of the SME environment in Kenya to give an indication of the kind of market that the risk fund managers are operating in.

In addition, one of the aims of the field work was to seek benchmarks by looking at successful risk fund operations. In this case, the consultant spoke to representatives from more established funds in Europe and key players involved in private equity to see how they have resolved certain capacity issues as well as how they resolved issues at the start of their funds or their risk business.

Finally, the consultant singled out a newly established risk fund manager as a case study, to look at how they have resolved their capacity issues and what other funds can learn from their model. Most importantly for this study and given that the institution is a beneficiary of a technical assistance program for its investee companies, it is interesting to see how this has impacted their current business and therefore use this as a reference point for the proposed technical assistance intervention. The consultant was keen to see whether the TA has been effective in resolving some of the capacity issues faced, how best such an intervention can work or what more needs to be done for the industry, aside from a technical assistance intervention. The case study review is presented in section 2.3.

2.2. DESK STUDY

The desk study looked at documented research on capacity issues facing risk fund managers at a global level and how these issues have been resolved. The consultant also sought benchmarks for a good risk fund business and looked at how the venture capital business is changing and the implications of this on the business. This section is divided into:

- Characteristics of a good risk fund manager;
- Recent trends in Venture Capital;
- Cross cutting capacity issues and other challenges;
- Interventions to resolve these capacity issues.

2.2.1. Characteristics of a good risk fund manager

Experience and Skills of the Management Team

The success of risk funds depends largely upon the skills, competence and network of their managers and their ability to add value to their investee companies. Key is that the professionals are able to assess the growth potential of a new business and ensure that the 'new idea' is transformed into a success story. Usually, the more appropriate skills base revolves around professionals who have management experience in specific industries and have outstanding business building and financial skills . However, these people still require retraining on basic fundamentals of risk fund management, which is mostly learnt by 'doing' on the job.

Research shows that a more successful risk fund manager will have more than 10 years investment experience, with the focus being on having the same people in the management team over those 10 years. In this period, the management team will have taken the portfolio of an average of 10 to 30 investee companies through the full cycle offi rst investment and follow-on financing to exit. This gives the manager the added value of having seen the 10 to 30 companies grow, whereas an entrepreneur would generally only be able to see the growth of about only 1 to 3 companies.

Fund Incentives

A good fund structure helps define incentives for managers to perform and align the interest with those of the fund shareholders. Important structural elements that need to be considered include:

- Minimum fund size and thus sufficient management fees. Fund sizes range between US$15 million for first time funds charging 3-5% in management fees and US$200 million for the more experienced risk funds, charging 2-3% in management fees .
- A two-tier structure to separate the funds from the management company, where the management company is able to manage more than one fund.
- A limited fund life gives managers the incentive to divest and be exit oriented.
- A longer fund life gives managers the ability to fully invest and divest the whole portfolio ofi nvestee companies. Investments in later stage businesses usually are divested after 5 years. Investments in the higher risk/higher upside early stage businesses usually are divested after 7 to 10 years . The Private Equity Performance Index for US VC companies shows that the 10 and 20 year horizons remained the strongest benchmark for the venture industry and were returning 25.8% and 16.0% respectively for the period ending 30 June 2006. Five year performance for venture capital was posting a negative return of -6.3% for the period ending 30 June 2005.
- Mechanisms to prevent conflicts ofi nterest between fund managers and the fund. Benchmarks show that incentive schemes of risk fund managers are most successfully based on a significant participation in the profits derived from the deals under the managers' responsibility (called carried interest) . A fund must return the capital given to it by limited partners plus any preferential rate of return (called hurdle rate, which is usually around 8%) before the risk fund managers can share in the profits of the fund.

The managers would then receive a 20% carried interest, although some successful fund managers receive between 25% and 30% .

Investment Strategy and Approach

The success of venture capital business is a function of finding projects that require a relatively small initial investment but have very high potential for growth, where the total investment of the fund can increase over the lifetime of the investment through follow-on financing . Such companies are usually early stage and in the high growth segments of the economy. Similarly, venture capital investments in high growth segments are likely to have more reliable exit opportunities .

Early stage companies in high growth segments usually require hands-on-post investment monitoring, so that maximum value can be added. Ideally, the same senior partner of the risk fund is involved from due diligence, identifying the strategy for growth, until exit. The post investment monitoring and value addition is better achieved mostly through a position as non-executive director on the board of the investee company, advising on all matters arising during the growth of the business such as expansion strategies, finding partners, looking for additional finance, staffing, marketing, product development and distribution .

The needed close supervision and monitoring of the activities of the investee firms requires the risk fund manager to be located closely to the investee. It also significantly limits the number of projects that each fund manager can manage to around 6 to 7 at a time. This impacts and increases the average deal size. Co-investing with other risk funds is one of the ways to increase the human capital resources required to effectively manage the portfolio ofi nvestee companies .

Internal Rate of Return

The average IRR for experienced funds is 25%. For instance, from the EVCA Final Performance and Activity Figures 2006 , the private equity performance benchmarks showed the industry returning on the long-term a 10.8% net IRR since inception, and on the short-term a 36.1% one-year horizon net IRR, with top quarter private equity funds producing a 23.3%long term net return.

A study undertaken in 2000 in Germany showed that the average required IRR for German VC firms was 28.4% per annum. The average required IRR for early-stage firms was 32% per annum and 24.7% for late-stage firms . For a US$ 25 million fund with a 10 year lifetime a 25% average IRR would mean that the fund would make a cash profit of US$207 million.

2.2.2. Recent trends in venture capital

Ernst and Young conducted a benchmark study in 2007 on how the venture capital business is developing and changing at a global level and what developments local risk funds could expect in the near future. They highlight the following trends in the VC industry at a global level:

- Continuing globalization of venture capital – This stems from the fact that prospective portfolio companies are investing and operating all over the world. Emerging markets are accounting for more dollars invested as well as a large portion of portfolio companies' revenue streams. This calls for the need for the VC firms to act globally and manage a distributed organization, a phenomenon that affects both the activities of the VC firm and that ofi ts portfolio companies. Several VC funds have started operations in India and China and are now eying the Africa continent. For instance, South African funds have started operations in Kenya through BPI and Grofin.
- Emergence of mergers and acquisitions as the primary exit path for venture capital investors. This has several implications both

on funding requirements and the returns that can be expected. While traditionally, VC has focused on high profile acquisitions, the average M&A deals tend to be small and medium sized transactions, resulting in more but lower value exits.

- The industry is also seeing a blurring of the distinctions between venture capital, private equity and hedge funds. This may be due to the fact that in order to take a company public today, it needs to be backed for a longer period to bring it to higher levels or revenue. All three groups of funds are finding themselves beginning to fund these types of transactions thus presenting various opportunities for collaboration.

- Another interesting development is the growing contribution of angel investors (private high net worth individuals) in the growth of a healthy VC ecosystem. In the Swiss and UK markets for instance, angel investors fill a niche, bringing companies from early stage to a maturity level at which they are attractive for venture capital.

- The global VC industry is now focusing mostly on the growth sectors of ICT, media, medical sciences and clean technology.

For Kenyan risk fund managers these trends could have the following implications:

- International VC firms and angel investors starting to gain interest in investing in Kenya, either directly or through partnering with Kenyan risk fund managers.

- Potential exit of portfolio company investments through sale to companies outside of Kenya and/or Africa.

- The specialization of risk fund managers to invest in specific industries (ICT, energy, healthcare, media).

2.2.3. Cross Cutting Capacity Issues and Best Practice Interventions

The cross cutting capacity issues and aligned best practice interventions from the desk study as experienced in both developed and developing markets are highlighted in the following table.

Table 1: Capacity issues and existing solutions

	Capacity Issue	Description	Existing Solutions to Capacity Issues
1	Lack of Qualified & Experienced Management	■ One of the biggest challenges in the VC industry continues to be the search for good management teams that are required to develop great companies[18]. In emerging markets, it takes time for teams to develop the required skills and in the meantime this could lead to sub-standard returns. In China for example, a large number of venture capital practitioners do not yet have sufficient experience in either operations or investing. In 2006 this led to price increases as the VC firms were bidding for deals at any price.	■ Co-investing (see point 3 below) with experienced risk fund managers. ■ Many risk fund management industries have a national or regional venture capital association. Appendix F provides a summary of the structure and services provided by a selection of these associations. These associations provide several services required by risk funds, like Training of the members, to address the issue of lack of qualified experts, Conferences and publishing of Market data on the VC industry through information provided by the members on fundraising, investments and exits. Such information is also relevant for potential foreign investors who are keen to invest in the region. For instance, AVCA has organized 2 training courses in Nigeria and Tunisia in partnership with the Private Equity Institute of the London Business School. Such a course would normally cost between EUR 2,000 – 3,000 per person, AVCA subsidizes the costs to EUR 500 per person, through membership fees and grants[19].
2	Poorly Designed Fund Structures	■ IFC[20] and USAID[21] through their experience in venture capital funds in emerging markets identified several factors that threaten the viability of venture capital investment in developing countries. Chief among these were poorly designed fund structures where the investors would interfere in the managers'decisions to divest and poorly defined incentives for managers to perform. ■ A good number of foreign investors investing in funds in developing countries fear the political and economic risks associated with investing in these countries. They therefore require very high returns on investment and also have high reporting demands[22].	■ Having a check and balance process in place with real accountability and goal alignment is fundamental to grow a sustainable and quality large venture capital firm. A good amount of time should be spent in refining the process. In addition, it is important to keep the decision making process straight forward, with clearly defined roles for all stakeholders in order to save time for both the VC firm and the investee company[23].

[18] Ernst and Young, 2007.
[19] James, B. CEO, AVCA. Personal communication, July 17, 2007.
[20] Sagari & Guidotti.
[21] USAID, 1995
[22] UNIDO 2001
[23] Ernst & Young, 2007

	Capacity Issue	Description	Existing Solutions To Capacity Issues
3	Limited Resources	■ Doing smaller deals e.g., less than US$ 1 M takes as much if not more time, effort and resources as bigger deals, forcing many risk fund managers to increase their deal size range in order to get a decent IRR. This is because risk fund managers need a certain level of management fees in order to properly manage the fund, attract and retain good people. When managing 25 investments, at least 5 investment professionals are needed, i.e. 3 senior professionals and 2 junior assistants. In this case, approximately US$ 750,000 in management fees per year is required. Typically, the average rate for management fees is 3% of fund size per year. Thus in order to get to US$750,000 the fund size needs to be US$ 25 million with an average investment size of US$1M. However, for SME financing, the average investment size is lower than US$500,000 thus requiring the fund manager to either manage a double amount of investments, e.g. more than 50 investments with the same team, or manage a smaller fund and ask for higher managing fees[24].	■ When the VC industry was in its infancy in Europe and funds were smaller than US$25M, management fees were increased by either increasing the charges to around 10%, or by doubling the fund sizes through interest free loans from the government (Germany, the Netherlands). Another example[25] is the case of Nigeria where all commercial banks are obliged by the government to commit 10% of their pre-tax profits to invest in SMEs with the intention of growing the sector. ■ Through co-investing fund managers can leverage on each others knowledge, share the risk, increase the shareholder base of the investee companies and potential for follow-on investing and share the costs and workload of due diligence and post-investment monitoring[26]. Such relationships also provide greater possibilities for further portfolio diversification and an easier way to gather relevant market/sector information for decision making.
4	Awareness and Deal flow Creation takes time	■ In countries where VC is a new concept, relatively much time needs to be spent on awareness creation, i.e. some small closely held firms are not used to sharing project ideas with outsiders, or ceding some ownership and control[27]. Similarly, there is the lack of overall understanding by the general public of the value that VC can bring to society.	■ Conferences organized by VC associations bring together members to share and strategize on different aspects relevant to the risk fund business and create an enabling environment for the risk fund business. In Russia for instance, the Russian Venture Capital Association has an annual conference that brings together fund managers and their clients. The last one held in 2006 had a forum of 700 entrepreneurs to learn what the VC funds are looking for in investments[28].
5	Challenges associated with Fast Growing & New Industries	■ For risk fund managers investing in businesses that operate in new industries (like ICT), the challenge is to be able to properly assess the market opportunity, where there often is a lack of good market sector studies and where market experts are expensive[29].	■ Through co-investing the due diligence costs and the costs spent on market sector studies are spread over more risk fund managers.
6	Unfavorable Exit Environment	■ An unfavorable exit environment, e.g., an underdeveloped local stock market, limits the exit opportunities of VC firms. On a global scale, it is unlikely that the public markets will be able to accommodate anything but a smaller fraction of the mature companies, especially since capital market conditions and the regulatory environments have raised the bar for IPOs[30]. For VC firms with many portfolio companies under management, this could cause a scalability issue on the VC model where in some cases back logs are experienced.	■ See paragraph below on government interventions.
7	Laws & Regulations	■ The challenge with government regulation in developing countries has always been that the regulations are too restrictive where the implementation of them is oftentimes fairly lax so it makes it difficult for people to follow or not to follow[31].	■ See paragraph on government interventions.

[24]Heijer
[25]www.avca.com.
[26]HBR, 1998.
[27]IFC, 1996.
[28]James, B. 2007.
[29]HBR, 1998.
[30]Ernst & Young, 2007.
[31]Ernst & Young, 2007.

Some of the capacity constraints mentioned in table 1 can be overcome through the change in fund structures and investment strategies of the risk fund managers. Some however need to be solved through outside support. The fact that risk fund management is working to increase growth in a sector that is critical to the success of the economy (SME), calls for increased support. For the majority of the countries surveyed, such support has come from development organizations and the respective governments.

Government Interventions:
The UK government supports the risk fund industry through a venture capital trust to promote tax relief and incentives for risk fund managers. For instance, those funds that invest in SMEs that are in their early stage of growth, disadvantaged areas and/or create innovation receive a tax relief of up to 30%. France also adopted incentives and policies aimed improving the competitiveness and innovative performance of French firms, hence addressing the quality of demand.

In the two countries, it has been shown conclusively that tax incentives have been successful in attracting additional funding to the private equity sector. Furthermore, research in the UK has shown that companies receiving backing from investors through venture capital create jobs and grow at rates well ahead of national averages.

2.2.4. CONCLUSIONS ON THE DESK STUDY

1. The desk study showed several characteristics of a good risk fund manager. These include:

- The required considerable experience of the fund, its staffand its management.
- A fund structure that aligns the interest of the manager and the investors.
- Focus on fast growing industries.
- Sufficient resources to be able to have a hands-on post investment monitoring approach.
- The above characteristics resulting in IRRs of above 25% for a one year horizon for good risk fund managers.

2. The capacity constraints faced by risk funds, especially when the risk fund management industry is still developing, are similar across the globe. These capacity constraints include:

- Poorly designed fund structures.
- High investor demands.
- Lack of skills specific to private equity and venture capital.
- Limited resources for efficient operation of the fund.

3. Established venture capital firms have overcome their capacity constraints in several ways:

- Through a change in fund structures.
- Through higher management fees.
- Change in investment strategies, like co-investing.
- Through support from venture capital associations in terms of training, providing market data and deal flow and awareness creation through conferences.
- Through external support which has largely come from development organizations and respective governments.

2.3. FIELD WORK

The field work is the core component of this study. It presents the findings of the capacity issues faced by risk fund managers in Kenya and as noted, other SME finance providers. Many of the recommendations and the final interventions proposed will stem from the findings and recommendations highlighted in this section.

The first sub section of this chapter focuses on the MSME environment in Kenya, highlighting the special characteristics of a sector that calls for special financing arrangements.

Next, we have a general overview of the risk fund environment and MSME finance industry in Kenya. Appendix E ii provides details on the respective firms' focus and funding strategies.

Thirdly, the following section highlights the cross cutting capacity issues and challenges across the risk fund environment in Kenya and looks at how the firms have been able to resolve some of these challenges.

In the last section we review a case study on BPI, a risk fund manager that presently has an opportunity to utilize a TA fund facility through the government of Kenya. This section examines the BPI model to see how TA funds could be administered and efficiently utilized. Important is also to assess whether such an intervention will be able to resolve some of the capacity issues raised by both the risk fund managers and their investee companies.

In summary, this section is divided into the following sub sections:

- The MSME environment in Kenya
- Overview of the risk fund environment in Kenya
- Cross cutting capacity issues and challenges and existing solutions to these issues
- Case study

2.3.1. The SME environment in Kenya

MSME Definition

From the study the Consultant found that most of the finance providers/ risk fund managers surveyed have adopted their own working definitions of SMEs based on the financing requirements of SMEs in their target group. Some have sought to go by the definition used by the IFC and the SSC. According to a Study commissioned by the IFC, there are an estimated 22,000 SMEs in Kenya, representing 66% of all formally registered private enterprises. The study defined SMEs as formally registered businesses, with 5 - 100 employees and with an annual turnover of between Ksh 6 million (US $ 89,000) and Ksh 100 million (US $ 1.5 million). The consultant came across other SME definitions as shown below.

Table 2: SME Definition I (World Bank Group)

Category	Employees	Turnover – US $
Micro	Up to 10	Up to 100,000
Small	Up to 50	3 M
Medium	Up to 300	15M

Table 3: SME Definition II (Kenya, Uganda & Tanzania Institutes of Bankers)

Category of enterprise	No. of employees	Capital Investments – US $
Micro	0 - 5	Less than 5,000
Small	6 - 49	5,000 – 200,000
Medium	50 – 100	200,000 – 800,000
Large	100+	800,000+

See appendix C (interviews summary) for the various definitions by the respondents.

MSME Distribution

According to the Central Bureau of Statistics 56% of all formal businesses registered in Kenya are within Nairobi. Informal sector enterprises are more widely distributed with the majority found in rural areas.

Table 6:

Sector	Urban			Rural			Total	
	No.	Col%	Row%	No.	Col%	Row%	No	Row%
Manufacturing	45,019	10.2	26.1	127,745	15.1	73.9	172,764	13.4
Trade	273,738	61.5	33.1	552,410	65.0	66.9	826,149	64.1
Bars/Hotels	24,888	5.9	32.5	51,789	6.5	67.5	76,677	6.0
Restaurants Services	92,937	21.0	32.5	98,398	11.6	51.4	191,335	14.8
Construction	6,551	1.5	29.7	15,537	1.8	70.3	22,087	1.7
Total	**443,133**	**100**	**34.4**	**845,879**	**100.0**	**65.6**	**1,289,012**	**100.0**

Table 4: MSME Distribution)

Region	No. of Enterprises (Formal Sector)	%
Nairobi and environs	19,600	56%
Coastal region	7,000	20%
Other towns	8,400	24%
Total	**35,000**	**100%**

Distribution of SMEs – Sectoral

According to an IFC survey conducted in 2004 on the SME environment in Kenya, the majority of enterprises are in the informal service and trade sectors.

Table 5: Sectoral Distribution of SMEs

Sector	Formal sector		Informal sector	
	Est. No. of Enterprises	%	Est. No. of Enterprises	%
Manufacturing	4,900	13	218,382	13
Services	14,000	40	369,569	22
Trade	11,550	33	1,075,110	65
Other	4,900	14		
Total	**35,350**	**100**	**1,663,061**	**100**

Sectoral and Urban-Rural Distribution of MSEs

Close to two-thirds of all rural and urban MSEs are in the trade sector. This means that a large proportion of MSEs are involved in buying and selling of commodities.

The Baseline Survey suggested that the dominance of the trade sector over the other sectors is not uncommon in many developing countries; though in some other countries manufacturing sometimes dominates the scene due to relatively easier access to raw materials, particularly in the rural areas. The dominance of the trade sector can be explained by the fact that these businesses require less investment capital and prior training compared to activities in manufacturing. Businesses in the trade sectors can therefore access finance available for MSEs, like short term microfinance. Trade involves a quick turn around from purchase of goods to sales revenue.

The study findings consistently showed that as the size of enterprise increases, the dominance of trade decreases .

Sectoral Performance of the Kenya Economy

Real Gross Domestic Product (GDP) expanded by 6.1% in 2006 compared to a revised growth of 5.7% in 2005. Key sectors supporting this growth:-

Table 7: Sectoral Performance of the Kenya Economy

Sector	% Contribution to GDP '06
Hotels and Restaurants	14.9
Wholesale & Retail Trade	10.9
Transport and Communication	10.8
Manufacturing	6.9
Building & Construction	6.3
Financial Intermediation	5.5
Agriculture and Forestry	5.4

Source: Economic Survey 2007

Challenges for MSMEs in Kenya

The MSME finance providers interviewed in this study highlighted several challenges for MSMEs in Kenya, which are all related to the shortage of resources:

- HR resources and training – due to lower budgets for paying salaries and for training, there is a lack of proper management and technical skills required for business management or for sound corporate governance. Good managers tend to opt for the larger and better paying companies. This often results in the several business functions not being performed, like marketing, business development and quality assurance thus making the MSME less competitive in the global markets.

- Management Information Systems ("MIS") – often, the financial systems are not up to standard. The necessary ICT platforms and implementation thereofi s quite costly. Many SMEs are only just beginning to comply with accounting and reporting requirements of their businesses as well as tax regulations.

- Access to finance – Kenyan entrepreneurs cite access to and cost offi nance as a major constraint to growth. The banks require significant collateral and charge high interest rates, which is a heavy burden on the companies' cash flows and limits the amount of debt that can be serviced. Moreover, there is hardly any longer term financing, like equity finance, available for MSMEs.

- Shift of outlook from the informal to formal sector – this is a challenge for many SMEs, a good number of which are at the 'next step' after microfinance. The shift into the formal sector demands more advanced business practices and generally more resources (fiscal, accounting) so that they can effectively compete in the marketplace.

2.3.2 Overview of the risk fund environment in Kenya

The Key MSME finance providers in Kenya comprise Risk Fund Managers, Venture Capital Funds and Private Equity funds, Banks, Investment clubs, DFIs, leasing companies and TA funds. The two private equity funds with operating licenses from the Capital Markets Authority are Acacia Fund and Aureos East Africa Fund (both managed by the same fund manager, Aureos). There are also 16 registered fund managers. The other venture capital/ risk funds operating in Kenya are incorporated in their countries of origin but have a legal structure that allows them to carry on the business locally.

The total number of Kenyan firms surveyed in the study was 21 with the relevant classification as follows:

Table 8: Risk Fund & SME Finance Providers Summary Tables

Type of Firm Surveyed	No.	Actual Firms Surveyed
Locally Incorporated Risk Funds. This group comprises venture capital and quasi equity SME Funds.	7	Bridgeworks Africa, AAC , Acumen Fund , Grofin East Africa, BPI, TBL Mirror Fund, InvesteQ Capital20%
Banks	4	Fina, Equity, Standard Chartered, PTA
Private Equity Funds	3	Aureos EA Fund , ICDCI, TransCentury
Development Finance Institutions	1	Industrial Development Bank
Leasing Companies	1	Rentworks
Investment Clubs/ Investment Companies	2	Soko Investments, Bridges Capital
Technical Assistance Funds	2	Enablis, Technoserve
Total	**20**	

The risk fund environment in Kenya, comprising the seven locally incorporated risk funds above, is quite young given that all of the funds surveyed are less than 3 years old. None of these funds have managed a portfolio ofi nvestment companies through the full life cycle (from first investment to exit or divestment), save for those that have gone into short term contract financing, which would usually be for a period ofl ess than one year.

Among the 7 funds surveyed, 6 of them have invested in businesses up to a total of about US$ 18.2 million. The following tables give more detail on the risk funds surveyed.

Looking at the amounts invested by the risk fund managers so far and the number ofi nvestments, the average deal size per fund is as follows: BPI is US$200,000, US$300,000 for Bridgeworks, US$400,000 for Grofin, US $ 500,000 for Acumen and AAC US$750,000 for TBL and US$ 700,000 for InvesteQ. This shows that while some of the funds could start providing as little as US$50, they all target more the upper "Small" portion of the MSME sector to minimize risk and increase potential returns. Furthermore most funds provide short to mid-term capital (the quasi equity providers), with only 2 funds providing long-term 5 to 10 year finance (the pure equity providers).

Table 9: Funds Committed and Invested SME Risk Funds in Kenya

Name of Fund	Amount Committed (US$M)	Amount Invested (US$M)	%	No. of Companies in Portfolio
Acumen Fund	45	2.25	11.5	4
Grofin EA Fund	18	8	40	20
African Agricultural Capital	10 (17 Target)	4.4	22.5	9
BPI	14.1 (15 Target)	2.5	13	12
TBL Mirror Fund	5	0.75	4	1
Bridgeworks	15 (Target)	0.3	2	1
InvestQ Capital	14 (Target)	1.4	7	2
Total	**93 (Target of 120)**	**19.6**	**100**	**49**

Table 10: Average Life Time of Investments – SME Risk Funds

Maximum Period of Investment	No. of Funds
3-5 years	4
5-10 years	2
Information Not Available	1
Total	**7**

Table 11: Typical Investment Instruments – SME Risk Funds

Investment Instrument	No. of Funds
Equity	4
Quasi Equity	2
N/A	1
Total	**7**

The following table gives detail on the typical deal sizes for the 7 funds and loan sizes for the banks surveyed.

Table 12: Average Deal Size of the 7 SME Risk Funds

	SME Risk Fund	Average Amount Invested (US $)
8	BPI	200,000
9	Bridgeworks	300,000
10	GroFin	400,000
11	Acumen	500,000
12	AAC	500,000
13	TBL	750,000
14	InvesteQ	700,000

A summary of the responses from the Risk Fund Managers and SME Finance Providers surveyed is attached in appendix C and D. The summary includes: the funds/ institution profiles, their focus and investment strategy, firm specific capacity issues and how the same have been resolved as well as their proposals on the application and structure of a TA Fund as an intervention to the capacity issues raised.

2.3.3 Cross Cutting Capacity Issues & Existing Solutions

Table 13: Typical Loan Size – Banks

Sizes SME Loans	Amount
Fina Bank	US$ 4,200-142,000
Equity Bank	US$ 7,200-72,000
PTA Bank	US$ 500,000-2,000,000
Standard Chartered Bank	Up to US$ 3,000,000

The study found that the capacity issues faced by funds in Kenya are quite typical of the situation in other developing markets and similar to what the more advanced markets experienced when they were starting off. These include:

- Lack of qualified & experienced management
- Limited resources for due diligence and post investment monitoring
- Lack of market sector studies
- Lack of Industry awareness
- Deal flow creation takes time
- Exit management challenges
- Demanding investors and shareholders
- Wanting systems and infrastructure

The following table lists the issues raised by the study participants, and describes the existing solutions to these issues. More detail on the issues specific to each fund are given in appendix E.

Table 14: Cross Cutting Capacity Issues & Existing Solutions - Local Risk Funds and SME Finance Providers

	Capacity Issue	Description	Existing Solutions To Capacity Issues
1	Lack of Qualified & Experienced Management	■ Getting the right staff with the relevant skills, qualifications and track record especially with respect to experience in private equity, venture capital, MSME financing and successfully completing deals. ■ Some funds have limited budgets and end up with limited human resources. The only available solutions to provide additional assistance towards the investees are TA funds to hire outside consultants, which does not build the capacity of the team. ■ The required training for staff to upgrade their skills to fit the required caliber of private equity/ venture capital/SME finance professionals is expensive and not available in the region. ■ The institutions that provide training on the job face the threat of staff leaving for	■ PTA bank, Equity bank, Fina bank & IDB - Have TA funds in place to train staff on critical skills of SME lending. ■ Technoserve - Have a mentorship program for their officers where leading management consultants and investment banks (McKinsey, Bain , Goldman Sachs) who are on holiday volunteer their time to work with the officers (shadow the teams) for periods of 3-6 months. ■ TBL Mirror Fund – Partnership in place with Bain that send their consultants to Kenya to work with the TBL investees on strategic issues. Furthermore the group of private investors provides strategic guidance and networks to the investees. ■ BPI, TBL, Grofin, Acumen – partner with their more experienced counterparts to get VC experience.
2	Limited resources for Due Diligence and Post investment Monitoring	■ Small funds doing small deals do not have sufficient management fees to build a team that can provide sufficient time on due diligence and post investment monitoring. Management fees tend to be 3% of fund size, irrespective of whether the fund small or large. Smaller and early stage deals also take more management time than larger later stage deals. Spending a lot of time on deals only makes sense if the business has large growth potential. Investors however are still quite risk averse when it comes to high risk type VC investments. ■ Due diligence costs for smaller deals are as high as or higher than for larger deals. For instance, absence of proper audited accounts in a transaction is a major hurdle to completing a deal. ■ The local legal fraternity does not have a good understanding as to how the venture capital environment works and needs hands-on guidance in drafting the legal documents.	■ Fina Bank, Equity Bank – dedicated officers that work with the clients combined with good monitoring systems. ■ TBL - focus on fast growing industries with high upside potential. Take a board seat and work with 2 dedicated investors per deal who can add value through their experience and network ■ Acumen Fund – Some investors may on occasion agree to lower returns. Also have a grant for legal process and negotiation of deals. ■ BPI – take advantage of the due diligence process refined by their subsidiary relationship with BPSA. Have a TA fund and are partnering with the SSC to provide business advisory services to its portfolio companies. Have their own internal legal department for main part of legal due diligence. ■ Fina Bank - holds various seminars and workshops for their entrepreneurs for e.g. book keeping training. ■ Aureos, PTA – increased average deal size to more than US $ 500,000. ■ Enablis –members (entrepreneurs) pay a membership fee which goes towards a mentorship program aimed at building their overall capacity.

	Capacity Issue	Description	Existing Solutions To Capacity Issues
3	Market Sector Studies	■ Market sector studies are not current, reliable or available. What is readily available is macroeconomic data (instead of concrete market figures on market size, growth and key players) which may not focus on the industries where most MSMEs operate in, e.g., retail trade, transportation, hotels & restaurants, ICT, manufacturing, construction and agribusiness. ■ Comprehensive and reliable studies are costly, require much effort, are time consuming and would almost always require the services of experts outside the risk funds.	■ BPI, TBL, Grofin – partner with their more experienced counterparts to get market data. ■ Acumen Fund has graduate trainees on contract on the ground who work closely with people in the areas or sectors of focus. ■ BPI – concerted daily effort to build market data for use in future deals. ■ IDB - on occasion contract firms such as Consumer Insight to carry out market sector studies for them.
4	Deal Sourcing/ Marketing of the Fund and Networking	■ The need to spend a lot of time on awareness creation in the market where the MSMEs themselves are not familiar with the operations of risk fund managers. For instance shifting the outlook of MSMEs that have been financed through a microfinance program in the past into the working of a commercial/profit outfit financed through equity may be challenging. ■ Many enterprises are family owned and/or in the informal sector and the owners are wary of relinquishing control. ■ Actively identifying deals in certain industries that fit the risk fund manager's investment criteria is time consuming.	■ IDB – since they work closely with the government, more likely to be aware of prospective projects in the public sector. ■ Enablis - provides a networking platform for their members with their peer groups – meet twice yearly. ■ BPI – works with IFC's SSC to secure deals. ■ Technoserve – assists entrepreneurs in certain industries (e.g. dairy) to find investors.
5	Exit Management	■ This is a great challenge in Kenya as there are not many buyers in case of a trade sale. For an IPO, companies need to meet certain criteria and high costs before a public listing can be allowed.	■ BPI, Grofin – instead of providing pure equity, which has the greater exit challenges, these funds provide quasi equity, where the main investment is disbursed as a loan which needs to be repaid, and the upside come from interest and a small piece of equity. ■ Equity Bank - the bank's key focus is on efficient mobilization and delivery channels to drive its business; has one of the highest loan recovery rates in the industry.
6	Demanding Investors & Shareholders	■ Reporting requirements for MSME funding are very high and challenging where for instance every investor requires reporting in their own format. Furthermore a good number of the investors, e.g. foundations and philanthropic investors need reporting on additional items like social impact.	■ PTA Bank – receives TA funding for reporting on specific items investors request (like social impact). ■ BPI, TBL, Aureos, TransCentury – align investor interest with fund manager interest through incentive schemes like carried interest.
7	Systems	■ The acquisition costs associated with a reliable ICT system for fund managers (e.g. one that would support reporting, financial, operations, deal flow and portfolio management components) are enormously high. ■ The Funds are also faced with the challenge of working with SMEs with imperfect MIS. ■ For the more established Funds that have a regional focus, they are faced with the challenge of managing remote offices in a number of countries with poor telecommunications infrastructure.	■ BPI - has a sophisticated ISO certified intranet system linked with their South African office. They also have a US$ 2.5M TA fund which provides interest free loans to their investees for specific requirements, e.g. for investment in proper ICT systems.

In addition, there are certain specific challenges for certain type of providers of SME finance as highlighted below:

	Capacity Issue	Description	Existing Solutions To Capacity Issues
8	Specific Challenges for Asset Managers – Leasing Business	■ Those in the leasing business are "Residual Value Investors" so the Assets have to be returned to them in good working condition at the end of the primary Lease term. This means they need to inculcate a Maintenance culture as a necessity in Managing Productivity Assets and not an after-thought when a technical break-down occurs. This has proven to be a challenge with most asset users who are not keen on maintenance.	■ The core business revolves around the Leasing of Moveable Assets. Since the Asset is the sole collateral then they usually need to take certain measures e.g. Asset Tracing technology to ensure that their interests are protected.
9	Specific Challenges for DFIs	■ Most of challenges are tied to the fact that the institutions have been parastatals now shifting their way of working into commercial enterprises and facing competition from other players in the industry.	■ No solutions seen
10	Specific Challenges for Banks	■ For banks lending to the MSME sector, the mismatch of short term savings from clients(savers) with long term lending requirements limits the loans (amount and period) that the institutions are able to on lend to MSMEs. ■ Definition of an "SME" in this environment is misunderstood.	■ Fina Bank - has a subsidized loan from FMO to on-lend to SMEs; In addition, the bank has a guaranteed line of credit from USAID to act as security for various trade finance products.

2.3.4 Technical assistance arrangements in place

- Enablis - Have a seed grant for overall local operational expenses although the amount disbursed has to be matched locally
- BPI – Dedicated TA fund of US$2.5M provided as interest free loans to investees of up to 30% of deal size to resolve specific capacity issues.
- Aureos – Has a TA facility from the IFC such that they can access TA on a need basis on behalf of their investee companies, e.g., to assist portfolio companies on environmental compliance.

2.4 CASE STUDY

2.4.1 Overview

The consultant selected Business Partners International, Kenya ("BPI") as a case study for this research given the institution was the first beneficiary of a technical assistance fund (US$ 2.5 million) from the World Bank through the Government of Kenya's Ministry of Trade and Industry, to assist in its risk fund business focussing on the SME sector. Thus the risk fund fraternity in Kenya as well as prospective funds could draw some from lessons from the BPI model as well as how the risk fund has been able to utilize the TA fund for its investee clients.

The BPI fund is co-sponsored by IFC and is a subsidiary of Business Partners Ltd (BPSA), a South African based SME investment specialist. BPSA has been successfully financing SMEs for the last 26 years. The fund in Kenya is the second replication of their model after Madagascar and there are plans to establish a similar fund in Ghana.

2.4.2 Fund description

The fund was created to provide financial services to Kenyan SMEs on a commercially sustainable basis, investing between US$ 50,000 and US$ 500,000 per company.

The fund has US$ 14.1 million under management and was set up as a finite life venture to last 8 years, with an option of two 1-year extensions. The first 5 years will constitute the "Investment Period" during which the fund will invest the capital contributions and re-invest all loan collections and proceeds from equity investments. The next 3 years will constitute the "Harvest Period" during which the outstanding loan and equity portfolio will be cashed in, and cash distributions made out to the investors. Optionally, the fund may be extended twice for a duration of 1 year each, thus providing a potential maximum life of 10 years. The fund aims to invest in 180 businesses over 5 years in the country.

As a further boost to the fund, the World Bank through the Government of Kenya (Ministry of Trade and Industry) provided US$ 2.5 million as Technical Assistance. BPI provides the technical assistance to investees for specific issues as an interest free loan where the investee is expected to repay the capital cost of the technical assistance. The amount of TA provided by BPI is around 30% of the investment size.

The fund is registered in Kenya as a Limited Partnership, with Business Partners International Kenya ("BPI") as the General Partner and the other investors listed below as the Limited Partners. The structure is governed by The Limited Partnerships Act (Chapter 30,

Table 15: BPI's List of Fund Investors

Institution	Category	Contribution (US$ million)	Stake (%)
Business Partners International Kenya Limited	General Partner	None	-
International Finance Corporation	Limited Partner	5.0	33.3
East African Development Bank	Limited Partner	1.0	6.7
European Investment Bank	Limited Partner	5.0	33.7
CDC	Limited Partner	1.6	10.7
TransCentury Group	Limited Partner	1.5	10.0
	Commitment	14.1	94.0
	Funding gap	0.9	6.0
	Total	**15.0**	**100**

Source: EADB

Laws of Kenya) and The Partnership Act (Chapter 29, Laws of Kenya) and the rules of equity and common law applicable to partnerships.

2.4.3. Model description

BPI has adopted the proven investment model of BPSA that has the following characteristics:

1 Core of the investment model is that the fund can provide capital to companies based on future cash flows and not on the current assets (security) or revenues available. The fund's investment products comprise a combination of:

- Pure Equity
- Risk based loan investments (receive interest plus an equity kicker)
- Royalty based loan investment (interest plus royalty)
- Property investment transactions

2 BPI can tap into BPSA's large expert database of different SME sectors, providing industry information as well as access to a deal directory[39]. Again, this enables BPI to structure investments based on profitability of the business and not on collateral.

3 The deal flow and due diligence review processes are well structured and system supported. The due diligence process includes the evaluation of documents and task lists. Furthermore there are in-house implementation and legal teams as well as standardized legal documents. Operational teams have clearly defined targets which include the approval and advance of 0.74 deals per month per operational staff member. For a risk fund to achieve and manage this target, it is only possible through efficient processing and systems. Moreover, the fund's post investment monitoring process is not very time consuming where the focus is largely on loan repayment. The post investment monitoring process is also system driven. BPI rarely will take a board seat.

4 All investee companies are evaluated for business and technical skills. The investee companies can access mentors through the local IFC's SSC, where the aim is to improve value-added and profitability. The cost of mentorship is shared with the investee company. The investees can access interest free loans through the TA fund for specific capacity building issues like putting in place efficient systems and good reporting formats. The investee will receive funding from the Technical assistance Fund to cover the cost of this mentorship, with the loan being interest free and having a delayed date of commencement of repayment, i.e. upwards from of 18 months.

5 Individual remuneration is tied to Company Performance and merit incentives in place include annual bonuses and direct carried interest scheme participation. All operational staffof BPI is assessed by way of a performance scorecard which is aligned to certain critical success factors of the investee companies.

2.4.4 Solutions and strengths to specific capacity constraints

Business Partners has taken various initiatives to resolve capacity issues common to first time as well as existing fund managers. Also, the fact that it employs an already successful model sets a solid foundation for its risk fund business. The solutions to various capacity issues are outlined below.

[39]An information bank giving details of all business carried out with investee companies on relevant transaction details including due diligence processes, post monitoring, value addition as well as exit.

Table 16: BPI's Solutions to Specific Capacity Constraints

Capacity Issue	Solution
Lack of adequate Fund Experience/ Human Capital/ Necessary skills and quali!cations	■ The local team draws a lot of investment experience from their counterparts in South Africa. The team gets ongoing training from the South African o!ce on the critical capacity components of pre -investment analysis, deal structuring and due diligence.
Due Diligence	■ The IFC's SSC provides business advisory services support to BPI clients. ■ Most due diligence like legal process is done in house.
Post Investment Monitoring	■ TA to investees is available through a TA Fund. ■ Limited post investment monitoring required through the type of investment with large focus on loan repayment thus no need to take a board seat.
Market sector studies	■ The fund has access to a large data base, from the South African office, for sector studies that have been carried out in previous projects. ■ In addition, gathering data and information relevant to the local situation is done in house by the team as opposed to outsourcing to consultants. There is a dedicated daily effort to collect market data and build a relevant database as applies to the Kenyan economy.
Deal Sourcing	■ BPI works closely with the SSC for deal $ow and to create awareness of its services. This significantly decreases time and resources spent on prospective deals.
Exit Management	■ BPSA achieved a total of 27 investment exits in 2007 thus the local fund can draw a lot of experience on exit management from the parent company.
Demanding Investors	■ Interests are aligned through appropriate incentive schemes.
Systems and Infrastructure	■ The fund has a well developed Intranet system, linked with the South African o!ce that provides a reliable source of market and deal data. ■ The fund's processes have also been approved as ISO compliant. ■ The TA fund provides interes t free loans towards investees to help them acquire e!cient systems as approved by BPI.

2.4.5. TA Intervention.

As noted, the Government of Kenya and the World Bank provided US$ 2.5 million in Technical Assistance to BPI meant to enhance service delivery to its investee companies. Furthermore BPI closely works with the SSC which also provides additional support.

1. Business Partners Mentors – SSC has agreements with Independent Mentors as service providers. The mentors are business / professional people available to SME entrepreneurs. SSC manages the mentoring process.

2. Technical Assistance - BPI's assessment of the investees during due diligence determines the type of TA they require.

2.4.6. Appraisal of the BPI Model

It remains to be seen what the success of the BPI model in Kenya is given the fund was only launched in early 2007. The deal flow sourcing through SSC seems successful, and the investment process efficient. This is seen the number ofi nvestments (12) that have been achieved to date, since the fund's inception early this year. A more comprehensive appraisal of the effectiveness of the TA could be achieved by interviewing the investees, which unfortunately falls outside of the scope of this study.

For risk fund managers that would like to reach BPI's level, and wish to qualify for the next disbursement of TA, can borrow a number of lessons from the BPI model: For one, they could look for a partner with a good track record in SME finance, preferably in Africa, for training and mentoring of the risk fund managers, to be able to align their investment strategies together, adopt efficient and effective processes, and have in place attractive incentive schemes as well as efficient management information and ICT systems.

However, there are certain components of the BPI model that are difficult to copy. Looking at the BPI organization, its scope and the level of business, the cost structure must be relatively high compared to other local risk funds, which means the need for access to additional support from an organisation like the IFC or a grant to provide "free" resources.

Furthermore, the access to SSC services is quite exclusive, and building an organisation the size of the SSC to operate alongside each fund requires significant financing which would only be achieved through a grant. Moreover, the cost of services provided by the SSC as described are not reflected in the returns of the fund thus giving it an unequal advantage. A solution to this could be that SSC considers providing its services on a wider scale and on a neutral basis, not exclusively to BPI, but to other funds as well.

2.5 STAKEHOLDERS' WORKSHOP

A stakeholders workshop was held in Nairobi on 13 November 2007, with the aim of having the stakeholders validate the findings of the study as presented in a draft report.

Following is a summary of the proposals and recommendations gathered from the feedback and comments of participants at the work shop. The detailed workshop report is attached in appendix H.

2.5.1 Comments on Characteristics of Good Risk Fund Managers Identified from the Desk Study

See table 17 below.

2.5.2 Comments on MSME Definition

- The MSME definition adopted by the risk funds should be flexible enough to allow for instance, a company with few employees but with significantly high turnover. Thus absolute definitions restrict potential players.
- The difficulty to define the MSME sector is also reflected by the fact that local risk fund managers themselves do not understand the MSME industry. There is need for capacity building specifically to MSME finance as it relates to risk funds, just like the required capacity in microfinance provision has been built over the last 20 years, through grants and soft loans. Thus local risk funds could look into funding and the necessary support from organizations such as USAid and the Ford Foundation
- There is a need, for the study purposes, to define the type of MSME finance that should be targeted with the anticipated TA funding. It was agreed that this is longer term, risk finance, through a mix of equity and debt.
- There is also the need to define "TA", which should be targeted at mitigating the above mentioned risk (long term nature of the finance).

Table 17: Comments on Characteristics of Good Risk Fund Managers Identified from the Desk Study

Characteristics/Benchmarks	Participants' Comments
Fund structure – structures that a lign the interest of manager and investors to address the following: ■ Sufficient management fees. ■ Carried interest. ■ Fund/ Investment horizon in the range of 8 -10 years	■ Fund structure must be aligned with the funds' investment strategies and respective deal types.
Returns - IRRs (gross average) above 25%.	■ When comparing with bench marks from more developed markets, there is need to take into account that one first needs to understand the specific local SME environment. ■ In the case of required benchmark returns at an average IRR of 25%, there is need to caution the investors coming into this market that the higher perceived risk is not necessarily offset against higher return.

2.5.3. Table 18: Proposed Solutions to capacity issues identified in the Field Work

Capacity Issue	Participants' Comments/Proposed Solutions
Limited experience and skills of the fund and the respective fund managers.	■ Overall, it was agreed that setting up a Venture Capital Association ("VCA") is a very good idea in providing support towards risk fund managers in many ways, e.g., building capacity through training. ■ The capacit y building to be provided should be really focused on training risk fund managers on understanding MSMEs and MSME finance. ■ Need for interventions that will provide TA to support experienced fund managers to work with a risk fund lacking in experience. ■ Kenyans in the Diaspora with the relevant experience and skills could be approached to act as mentors to local risk funds. ■ In the long term, see how university curriculum can include private equity/ venture capital courses. ■ The individual risk funds should provide a platform (through the proposed VCA) to share information and skills among themselves up to the levels that are allowable, i.e. without the risk of losing their competitive edge. ■ Local risk funds should share information and skills by co-financing.
Limited resources for efficient operation of the funds	■ Set up of a Venture Capital Association (VCA) to promote best practice, research and set standards to instill confidence in the market, promote policy building and lobbying for members, e.g. for tax incentives.
Limited human and due diligence experience	■ Provide TA at both pre and post investment level to cover the expenses incurred in the due diligence process. ■ Advisory board - for example the proposed VCA could provide a pool o f industry experts to act as an advisory board to the local risk fund managers. ■ Pool synergies from the different local risk funds. ■ Have a mentorship program through the VCA to encourage professionals in this market to work with risk funds. ■ Consolidation of small funds to enhance their capabilities. ■ Have amentorship program through the VCA, e.g. retired professionals.
Inadequate and unreliable market sector studies.	■ The studies could be provided by the proposed VCA, against a subsidized fee. The VCA could also influence other organizations like the Kenya Institute of Manufacturers, Kenya National Central Bureau of Statistics and the Chamber of Commerce to collect market data and carry out studies. The information collated in this case should include relev ant business information and data. ■ It was proposed that the risk fund managers should assist these organizations in developing the required questionnaires to gather the relevant information. ■ In addition, the VCA could carry out studies in certain sectors.
Demanding shareholders/Investors	■ The proposed VCA could develop appropriate reporting standards. ■ The risk funds should provide detailed/comprehensive reporting to their respective shareholders where all issues are adequately addressed. This would include providing different reporting variables as required. ■ The risk funds should educate their respective investors about what to expect from this market in terms of return and limitations. ■ For guidelines on reporting and content, risk funds could refer to the IFC SME toolkit (www.ssc.co.ke) or the EMPEA toolkit (www.emepeatoolkit.org).

Capacity Issue	Participants' Comments/Proposed Solutions
Inadequate/unreliable management information systems	■ Through the VCA, create standards that can be adopted by all the players.
Challenge of deal flow sourcing	■ Each risk fund manager should implement their own marketing strategy and communicate their investment parameters well towards MSMEs and towards other fund managers. ■ Through the proposed VCA, promote networking in the industry such that specific applications and requests for venture capital funding are channeled to the appropriate risk fund. ■ The risk funds should take the initiat ive to educate the market, the business community and relevant stakeholders on the working of private equity and venture capital. This could be done through conferences or other forums. ■ Develop an SME deal depository – the risk fund managers could team up and approach an independent organization which has the capacity and interest to provide this kind of service, has an adequate budget for advertising, does the screening of prospective investees and templating with respect to the varying investment strategi es of the risk funds. Such an organization would likely be financed through grants.
Exit management – market underdeveloped thus providing few exit options	■ "A good exit starts with a good start:" i.e. it is more likely that good investments will always be able to be exited: The risk funds should look into proper exit management strategies before investing and implement the exit strategy well.

2.5.4 Comments and proposals on the anticipated technical assistance

Structure

There were different thoughts and proposals as to the structure of the fund as highlighted below:

- One suggestion was that it should be disbursed as a grant, as there would be a good number of organizations, e.g. the Bill Gates Foundation who would be willing to support the TA funding. A good point of reference is the local microfinance industry that has come a long way but is now well established.
- A mechanism for insurance should be worked into the loan provision to ensure recovery of the loan.
- The role of fund manager in disbursing the funds to investees creates a conflict ofi nterest because the fund is also the one evaluating which investee is eligible for TA. This was also raised as an ethical issue. However, participants resolved that the decision about whether or not to lend to an investee company should be left to the fund manager.
- There is need to find out whether there is a precedent where a TA fund is given as a debt and draw conclusions from such a structure.
- A proposal was put forth for the fund manager to "go Dutch", i.e., share costs of the TA with the investee. In addition, the risk of return should be borne by both investees and risk funds since the TA is beneficial to all parties concerned.
- It was mentioned that the reason for payback by the investee is to ensure :
  - sustainability of the fund and making sure the SMEs are accountable
  - the funds are used as intended,
  - a revolving facility
  - accountability by the SMEs.
- There was a proposal to charge the TA at the same interest as the respective funds' costs.
- The issue was raised as to whether the fund manager could also be the BDS provider This would also be at the discretion of the fund manager if they are managing the TA themselves.

Services

- The scope that the proposed TA could be used for might be limiting thus need for flexibility by the administrator/ manager to cater for the different and unique SME needs.
- To cater for an immediate need, include a training component for risk fund managers for specific modules on private equity and venture capital training.

Amount

- The actual figure should be based on a realistic amount based on the different fund sizes.
- The TA fund available to BPI (US$ 2.5 million) provides TA up to a maximum of 30% of the investment in a particular SME or investee.

Participants agreed that the TA fund available (US$ 4M) may not be sufficient for all the needs and capacity constraints highlighted in the study and during the workshop, but it is possible to grow the amount.

One suggestion was for the threshold to be for investments below US $ 50,000.

Other Pertinent Issues

- Participants concurred that any recommendations proposed on the TA Fund should not be rushed
- The participants expressed the need to understand the use and scope of services possible with the anticipated US $ 4 million TA Fund. The IFC representative explained that the components to be considered for funding are those that would enhance the investees' business processes as opposed to issues that would be fundamental to the deal process with the risk fund manager. Appendix J provides this information as detailed in the Request for Applications to the Pool of Fund Managers for TA Fund.
- Risk fund managers were encouraged by the Ministry of Trade and Industry representatives to apply for the fund when the advertisement comes up again.

2.5.5 Comments on the Case Study:

- There was a proposal to consider having more than one case study for comparison purposes.
- Participants greed that there were certain components of the BPI model that are difficult for other funds to copy, specifically the issue of deal flow where BPI has the advantage of working with the SSC on this component. There were various proposals to this end:
    - That the SSC could work with other fund managers as well to provide deal flow.
    - A body should be set up suited to source deals specifically for the risk fund fraternity
    - Work with existing institutions that can do this as part of their business.
    - A call to fund managers should be more open to their peers and allow for among other issues, cross referencing of deals.

2.5.6. Other comments, proposals and recommendations

- There is need to identify issues that prevent other groups ofl ocal investors from investing in the local risk funds.
- There is need for stakeholders to determine the real constraint, i.e. the weakest link in understanding the unique nature of the MSME market from both qualitative and quantitative aspects and provide solutions on this basis. For instance, the risk fund industry is one where a very specific skill set is required.
- Given the fact that it is difficult to use commercial funding (from the fund profits) to resolve most of the constraints as identified, grant funding plays an important role in bridging this gap.
- Risk funds should have a "minimalist" approach, i.e. by cherry picking the right SMEs to invest in and focus on their venture capital business. Other, specialized business development, organization(s) will provide the much needed BDS services. Again, a point of reference is the lessons learnt in microfinance industry.
- Overall, significant public funding is needed to develop and scale the risk fund market in Kenya and greater effort by the risk funds should go into sourcing for these funds.
- A proposal for tax incentives for risk funds will play a big role in reducing the costs for risk funds. In this respect, the risk fund managers together need to determine the threshold that would be applied.
- Risk funds could also work with other specific funds to provide venture capital to various initiatives, e.g., consolidating the interests and strategies of different small funds like, youth funds and women's' funds.
- Leasing – stakeholders should educate the government on how this can be introduced to provide the benefit to SMEs.
- The risk fund managers could also act as a voice for the SMEs on various fronts as applicable, for instance, where various policy issues affect the SME players.

2.5.7 Next steps and follow-up actions

- A meeting will be organized in early 2008 for all SME risk funds to meet with FSD Kenya to review the proposal for the establishment of a local venture capital association and see how this can be instituted.
- The participants that attended the workshop will be invited to take part in another stakeholders' workshop following a study on the Local Long Term Fund Availability that has been commissioned by FSD Kenya. The dates will be communicated to participants in due course.
- The advertisement by the Ministry of Trade and Industry for Request for Applications to the Pool of Fund Managers for TA Fund will be re-worked and sent out to fund managers to invite them to apply for the US $ 4 million TA Fund.

2.6. CONCLUSIONS

1. MSMEs in Kenya face many challenges:

- Lack of resources.
- Access to financing.
- High cost of the finance that is available, mostly through short term debt capital from banks.

2. There is an opportunity for risk funds to work with MSMEs in financing their requirements. However the fragmented and informal nature of MSME sector and the high risks associated with it still make it difficult and costly for risk fund managers. A majority of the risk funds and MSME providers surveyed cited the capacity constraints facing MSMEs as being bottlenecks to their own anticipated business in the sector.

3. The risk fund environment is quite new in Kenya. Debt finance is available but only for those companies that are able to provide the traditional forms of collateral. The seven risk funds surveyed have invested between them a total of about US$ 18.2 million which leaves a lot of scope for development in this sector. The average deal size of the risk fund managers is between US$ 250,000 and US$ 750,000. This gives an indication of the target and size of SMEs that the risk funds are ready to work with. Furthermore the majority of the surveyed risk fund managers provide quasi equity as opposed to pure equity.

4. The key capacity issues highlighted for all risk fund managers revolve around:

- Fund experience.
- Human capacity.
- Limited resources.
- Post investment monitoring.
- Deal flow creation.
- Exit management.

5. The capacity issues can be overcome by:

- The investors giving young funds time to develop and become more stable.
- Partnering with experienced fund managers.
- Partnering with TA providers.
- The challenges resulting from limited available resources that come with doing small deals or managing small funds could more likely be resolved by changing the fund structure or investment model. Typically, funds focusing on pure equity investments, which need dedicated post investment monitoring to maximize returns and exit potential, choose to increase the deal sizes and/or focus on investments in fast growing industries. Funds focusing on quasi equity and debt either increase deal sizes, or manage many small investments through an efficient, system driven, post investment approach which is focused on debt collection.

6. The main factors that contribute to BPI's success and which could be copied are:

- BPI has a subsidiary relation with BPSA from South Africa, where it can tap into the knowledge and experience of BPSA.
- The fund has adopted the BPSA due diligence processes and investment model that enables to do many small investments through investment structures that combine debt with equity or royalties, thereby minimizing the risk and optimizing the anticipated returns.
- The staff's interests are aligned with those of the investors through appropriate incentive schemes.

7. The components of the BPI model that are difficult to copy are:

- To run an organization like BPI, the cost structure is be relatively high compared to other local risk funds, which means the need for access to additional support from an organization like the IFC or a grant to provide "free" resources.
- The access to SSC services is quite exclusive, and building an organization the size of the SSC to operate alongside each fund requires significant financing which would only be achieved through a grant. Moreover, the cost of services provided by the SSC as described are not reflected in the returns of the fund thus giving it an unequal advantage. A solution to this could be that SSC considers providing its services on a wider scale and on a neutral basis, not exclusively to BPI, but to other funds as well.

8. Proposals and recommendations raised by participants at the stakeholders workshop:

- Benchmarking – when comparing bench marks from more developed markets, there is need to understand the specific local SME environment. There is also need to caution foreign investors that the higher perceived risk is not necessarily offset against higher return in this market.

The following were proposed as solutions to the capacity issues facing local risk funds and their investee companies:

- Set up of a Venture Capital Association will provide support towards risk fund managers in various ways, e.g.,
    - Building capacity through relevant and specific training
    - provide a platform to share information and skills among the risk funds
    - Promote best practice, research and set standards to instill confidence in the market, promote policy building and lobbying for members,

  - Provide a pool ofi ndustry experts to act as an advisory board to the local risk fund managers.
  - A mentorship program to encourage professionals in this market to work with risk funds.
  - Providing reliable market sector studies
  - Develop appropriate reporting standards required by investors
  - Promote networking in the industry such that specific applications and requests for venture capital funding are channeled to the appropriate risk fund.
- To resolve the issue ofl imited resources for risk funds, the following solutions could be applied:
  - Liaise with Kenyans in Diaspora to act as mentors to local risk funds.
  - See how university curriculum can include private equity/ venture capital courses.
  - TA to support experienced fund managers to work with funds lacking in experience.
  - TA at both pre and post investment level to cover the expenses incurred in the due diligence process
- Co-financing and pooling synergies among the local risk funds; consolidation of small funds to enhance their capabilities
- Develop an SME deal depository independent organization to serve risk funds
- Focus on proper exit management strategies at pre-investment to ensure good exits
- Encourage networking among the risk funds as well as educating the industry on the working of private equity and venture capital.
- Risk funds could refer to the IFC SME toolkit or the EMPEA toolkit for guidelines on reporting
- Risk funds should have a "minimalist" approach, i.e. by cherry picking the right SMEs to invest in and focus on their venture capital business. Other, specialized business development, organization(s) will provide the much needed BDS services.
- Overall, significant public funding is needed to develop and scale the risk fund market in Kenya and greater effort by the risk funds should go into sourcing for these funds.
- Tax incentives by the government for risk funds will play a big role in reducing their costs.
- Risk funds could also work with other specific funds to provide venture capital to various initiatives, e.g., consolidating the interests and strategies of different small funds like, youth funds and women's' funds.
- Leasing – stakeholders should educate the government on how this can be introduced to provide the benefit to SMEs.
- The risk fund managers could also act as a voice for the SMEs on various fronts as applicable, e.g. on policy issues.

Chapter 3

PROPOSALS TOWARDS AN APPROPRIATE INTERVENTION

3.1 INTRODUCTION

The first part of this section summarizes the various possible interventions towards solving the capacity constraints faced by the local risk fund managers, including:

- The setup of a venture capital association.
- Provide access to market data or industry information.
- Assistance with deal flow sourcing.
- Subsidize Payment for professional services.
- Support access to credit reference bureau services.
- Assistance in investor reporting and.
- Support the restructuring of the informal sector.
- Sourcing for grant funding
- Tax incentives to risk funds
- Increase potential pool of potential investors
- Consolidate other small funds
- Lobbying on behalf of SMEs

The end of the chapter provides recommendations on interventions that could be resolved specifically through TA funding and how these interventions could be structured.

3.2 POSSIBLE INTERVENTIONS

The previous chapter shows that some of the capacity constraints experienced by local risk fund managers have been resolved by the risk fund managers and MSME finance providers themselves by for example changing their fund structures or investment models. Some of the constraints could also be overcome through interventions such as TA, the government and different forms of grant funding. The various suggestions put forth are highlighted below.

1 Set up a venture capital association:
Many capacity constraints could be addressed by a national or regional venture capital association. The services of such an association would be paid for by membership fees and in the early stages of the association and through grants. The VC association would create a platform for a one-stop shop for various solutions sought by its members, namely:

- Build capacity through relevant and specific training for its members.
- Collect data on the risk fund management industry that can be used by the fund managers
- Create a networking platform:
    - For all fund managers through e.g., conferences so that they might start co-investing more often and to encourage the sharing ofi nformation and skills among them
    - So that specific applications and requests for venture capital funding are channeled to the appropriate risk fund.
    - Create awareness about how local risk funds work.
- Provide valuation and reporting guidelines as well as develop appropriate reporting standards required by fund investors
- Provide affordable fund management information systems.
- Assist with fundraising so that institutional investors, e.g. pension funds and investment clubs can start investing in the industry.
- Lobbying with the government to consider providing tax incentives, to encourage funds to invest in risky sectors or in investee firms that encourage innovation; lobby for other forms of grant financing like development organisations and donors.
- Promote best practice, research and set standards to instill confidence in the market.
- Provide a pool ofi ndustry experts to act as an advisory board to the local risk fund managers.
- A mentorship program to encourage various professionals to work with risk funds.
- Provide reliable market sector studies

2 Provide access to market data/ industry information:
Stimulate third party providers to carry out and document good market research, build their capacity to get quality, current and comprehensive research that can be used by the fund managers for investment decision making. The provision of reliable market sector studies would significantly lower the due diligence costs as well as

provide a consistent basis to cross check the various risks associated with MSMEs.

3. Assist with deal flow sourcing

Set up an organization that actively assists the various MSME finance providers in sourcing for deals that fit their investment criteria, i.e., channel the right businesses to the right finance providers and assist the entrepreneurs in writing good business plans.

4. Subsidize payment for professional services

Support fund managers to be able to hire specialists and professionals for due diligence and other related key services at a reduced rate. In addition, support the risk funds to be able to pay dedicated advisors for post-monitoring who are not on their payroll but who can offer the required service to portfolio companies. This is especially crucial for funds which have low staffnumbers and therefore cannot adequately support their portfolio companies.

5. Support access to credit reference bureau services

Sponsor the set-up of a Credit Reference Bureau entity that also has the support of all local financial institutions.

6. Back investor reporting expenses

Assist to finance specific reporting requests that investors might have.

7. Interventions in the informal sector

At a broader macro-economic level and perhaps indirectly, support the restructuring/ formalizing of the informal sector.

8. Source for grant funding

Overall, significant public funding is needed to develop and scale the risk fund market in Kenya and greater effort by the risk funds should go into sourcing for these funds. Also, given the fact that it is difficult to use commercial funding (from the fund profits) to resolve most of the constraints as identified, grant funding plays an important role in bridging this gap.

9. Adopt a minimalist approach

Risk funds should have a "minimalist" approach, i.e. by cherry picking the right SMEs to invest in and focus on their venture capital business. Other, specialized business development, organization(s) will provide the much needed BDS services.

10. increase potential pool ofi nvestors

There is need to identify issues that prevent other groups ofl ocal investors from investing in the local risk funds.

11. Tax Incentives

Tax incentives for risk funds will play a big role in reducing the costs for risk funds.

12. Consolidate other small funds

Risk funds could also work with other specific funds to provide venture capital to various initiatives, e.g., consolidating the interests and strategies of different small funds like, youth funds and women's' funds.

13. Leasing

Leasing – stakeholders should educate the government on how this can be introduced to provide the benefit to SMEs.

14. Lobbying on behalf of SMEs/ investee companies

The risk fund managers could also act as a voice for the SMEs on various fronts as applicable, for instance, where various policy issues affect the SME players.

3.3 TECHNICAL ASSISTANCE FUNDING

If Technical Assistance funding would be made available for the local risk fund fraternity, a number of questions arise, for instance, which of the proposed interventions described above could this TA address? How should the TA funding be structured? In this section we provide our recommendations on the possible TA interventions that could be adopted, based on our findings in the desk study, field work and lessons from the case study.

3.3.1 TA Services

The following services could be provided by a TA Fund or sponsored through TA funding:

- Provide deal flow, assistance with business plan writing and formalizing the deal process for potential investees. This could be a service where over time, once the value-add is proven, the risk fund managers pay a subsidized membership fee for this service.
- Sponsor the professional services required for due diligence and post investment monitoring, through for example an interest free loan advanced to the risk fund manager.
- These sponsored professional services could either be provided by individuals identified by the risk fund manager and/or by consultants/ network instituted by the TA Fund.
- Provide funding for specific post investment interventions required by the investees, e.g., being able to pay a reasonably good calibre of board members, mentoring on certain management issues or acquisition of good systems. This could be achieved through an interest free loan advanced to the risk fund manager, which can be channelled to the investee.

- Sponsor the set-up of a VC Association, which then takes care of among other issues, the provision of training of the risk fund managers, lobbying, awareness creation and provision of good risk fund management systems. This could be through a grant or interest free loan advanced to the association and paid back to the fund through membership fees.

- Sponsor good market sector studies provided by third party providers, which then can be provided to the risk fund managers for a fee.

- Sponsor, through an interest free loan, the set-up of a credit reference bureau, which provides its services to the risk fund managers and investees for a fee.

- The scope that the anticipated TA could be used for might be limiting thus need for flexibility by the administrator/ manager to cater for the different and unique SME needs.

- To cater for an immediate need, the anticipated US $ 4 million TA fund could include a training component for risk fund managers for specific modules on private equity and venture capital training.

3.3.2 Structure of the TA Fund

The TA funding could be provided along the following lines:

- Have one dedicated TA fund that is available to all fund managers, so that fund managers do not have to source for the funds themselves. The fund manager is responsible for managing its allocation. The TA Fund would be governed by a body that represents both the risk fund management industry and independent individuals from the business community.

- The instruments provided by the TA fund could be structured as follows:

The TA fund would be financed through grants but have these grants provide interest free loans or at minimal interest to the applicants to ensure:

- that the TA funding is a revolving facility.
- accountability by the SMEs.
- sustainability of the fund and making sure the SMEs are accountable
- the funds are used as intended,

There was also a proposal to charge the TA at the same interest as the respective funds' costs.

On receipt of qualifying proposals from approved fund managers, the TA fund would provide financing based on a percent of the intended investment size, up to a certain amount. This would be in the form of a loan (as above) that would be repaid over the fund lifetime, say 5 to 10 years. The fund manager would then on lend this to the investee and act as a collection agent for the funds disbursed. If the investee defaults, the risk remains with the fund manager. The fund manager could finance defaulting loans through the profit made on its other investments. If the fund manager defaults, it would no longer be able to access the TA fund, unless the fund's investors can guarantee the repayment.

To resolve the issue ofl oan recovery, participants proposed a mechanism for insurance to be worked into the disbursement of the funds. In addition, the risk fund manager could share costs of the TA with the investee and the risk of return should be borne by both investees and risk funds since the TA is beneficial to all parties concerned.

The role off und manager in disbursing the funds to investees creates a conflict ofi nterest because the fund is also the one evaluating which investee is eligible for TA. However, participants resolved that the decision of whether or not to lend to an investee company should be left to the fund manager.

Disbursement to the investees would be in the form ofi nterest free loans or discounted lines of credit, e.g. instead of paying back to the fund at 10% interest, pay back up to 9% and use the balance of 1% for TA.

TA fund could also provide grants or loans to other organizations that provide services to the risk fund management industry.

- Overall, the methods of disbursement would be transparent to the entire fraternity and would employ an efficient accounting system able to track the various uses of the fund by the fund managers. In addition, the proposed fund would be well managed and monitored. This would mean the set up of a separate body to administer the Fund.

3.3.3 TA fund amount

Drawing from the example of the case study, BPI provides TA funding to its investees up to an amount of about 30% of the investment size. The US $ 2.5 million TA fund available to BPI is approximately 17% of its fund size. This fund is also of a revolving nature.

Thus, applying the example of BPI to the local risk fund industry and other MSME providers, the resulting TA amount would be quite substantial as shown below, i.e., suppose the 17% is applied to fund sizes of up US$ 15 million and in addition, have a maximum TA sum per fund of around US$ 2.5 million. The resulting TA amount would be as follows:

Table 19: Estimated TA Funding Requirements for SME Risk Fund Managers

NAME OF FUND	Fund Size (US$ M)	TA Amount (US$ M) 17% of Fund Size; Max 2.5 M
Acumen Fund	45	2.5
Grofin EA fund	18	2.5
African Agricultural Capital	10	1.7
BPI	15	2.5
TBL Mirror Fund	5	0.9
Bridgeworks	15 (Target)	2.5
InvesteQ Capital	14 (Target)	2.4
Total	**120**	**15**

Looking at the local MSME finance industry, this would work out to a TA fund in the range of US$ 10-20 million.

From the stakeholders' workshop, participants felt that to determine a sufficient amount of TA, the actual figure should be based on a realistic amount based on the different fund sizes. Whereas the feeling is that the TA fund available (US$ 4M) may not be sufficient for all the needs and capacity constraints highlighted, it is possible to grow the amount. Another suggestion is for the threshold to be for investments below US $ 50,000 as this is where there is greater need for investees to streamline various aspects of their businesses.

34. CONCLUSIONS

The previous chapter shows that some of the capacity constraints experienced by local risk fund managers have been resolved by the risk fund managers and MSME finance providers themselves by for example changing their fund structures or investment models. Some of the constraints could also be overcome through interventions such as TA, the government and different forms of grant funding.

In conclusion, recommendations on the possible TA interventions that could be adopted, based on findings in the desk study, field work and lessons from the case study are highlighted below.

1. TA Services

The following services could be provided by a TA Fund or sponsored through TA funding:

- Provide deal flow, assistance.
- Sponsor access to professional services.
- Provide funding for specific post investment interventions.
- Sponsor the set-up of a VC Association.
- Sponsor good market sector studies.
- Sponsor the set-up or access to credit reference bureau services.
- For the anticipated US $ 4 million TA Fund, the components to be considered for funding are those that would enhance the investees' business processes as opposed to issues that would be fundamental to the deal process with the risk fund manager.
- Local risk fund managers will apply to the Ministry of Trade and Industry to be considered as beneficiaries of the TA Fund on behalf of their investee companies.

2. TA Structure

The recommendation is that the TA funding is channelled through one, revolving, TA fund. The proposal is that most of the services provided would be through interest free or minimal interest loans, thus ensuring the revolving nature of the facility.

Each risk fund manager or MSME finance provider would on-lend the interest free loan to its investee company and be responsible for the collections.

3. TA Amount

- To determine a sufficient amount of TA, the actual figure should be based on a realistic amount based on the different fund sizes. Whereas the feeling is that the TA fund available (US$ 4M) may not be sufficient for all the needs and capacity constraints highlighted in the study and during the workshop, it is possible to grow the amount. One suggestion is for the threshold to be for investments below US $ 50,000 as this is where there is greater need for investees to streamline various aspects of their businesses.

Chapter 4

CONCLUSIONS

This final section summarizes:

(i) The study findings – desk study and field work

(ii) Proposals and recommendations from the stakeholders' workshop

(iii) The proposed interventions that may be considered in light of the anticipated TA funding towards risk fund managers.

DESK STUDY

1. The desk study showed several characteristics of a good risk fund manager. These include:

- The required considerable experience of the fund, its staffand its management.
- A fund structure that aligns the interest of the manager and the investors.
- Focus on fast growing industries.
- Sufficient resources to be able to have a hands-on post investment monitoring approach.
- The characteristics above resulting in IRRs of above 25% for a one year horizon for good risk fund managers.

2. The capacity constraints faced by risk funds, especially when the risk fund management industry is still developing, are similar across the globe. These capacity constraints include:

- Poorly designed fund structures.
- High investor demands.
- Lack of skills specific to private equity and venture capital.
- Limited resources for efficient operation of the fund.

3. Established venture capital firms have overcome their capacity constraints in several ways:

- Through a change in fund structures.
- Through higher management fees.
- Change in investment strategies, like co-investing.
- Through support from venture capital associations in terms of training, providing market data and deal flow and awareness creation through conferences.
- Through external support which has largely come from development organizations and respective governments.

FIELD WORK

1. MSMEs in Kenya face many challenges including:

- Lack of resources.
- Access to financing.
- High cost of the finance that is available, mostly through short term debt capital from banks.

2. There is an opportunity for risk funds to work with MSMEs in financing their requirements. However the fragmented and informal nature of MSME sector and the high risks associated with it still make it difficult and costly for risk fund managers. A majority of the risk funds and MSME providers surveyed cited the capacity constraints facing MSMEs as being bottlenecks to their own anticipated business in the sector.

3. The risk fund environment is quite new in Kenya. Debt finance is available but only for those companies that are able to provide the traditional forms of collateral.

The seven risk funds surveyed have invested between them a total of about US$ 18.2 million which leaves a lot of scope for development in this sector. The average deal size of the risk fund managers is between US$ 250,000 and US$ 750,000. This gives an indication of the target and size of SMEs that the risk funds are ready to work with. In addition, the majority of the risk fund managers surveyed provide quasi equity as opposed to pure equity.

4. The key capacity issues highlighted for all risk fund managers revolve around:

- Fund experience.
- Human capacity.
- Limited resources.•Post investment monitoring.
- Deal flow creation.
- Exit management.

5. The capacity issues can be overcome by:

- The investors giving young funds time to develop and become more stable.
- Partnering with experienced fund managers.
- Partnering with TA providers.
- The challenges resulting from limited available resources that

come with doing small deals or managing small funds could more likely be resolved by changing the fund structure or investment model. Typically, funds focusing on pure equity investments, which need dedicated post investment monitoring to maximize returns and exit potential, choose to increase the deal sizes and/or focus on investments in fast growing industries. Funds focusing on quasi equity and debt either increase deal sizes, or manage many small investments through an efficient, system driven, post investment approach which is focused on debt collection.

CASE STUDY

1. The main factors that contribute to BPI's success and which could be copied are:

- BPI has a subsidiary relation with BPSA from South Africa, where it can tap into the knowledge and experience of BPSA.
- The fund has adopted the BPSA due diligence processes and investment model that enables to do many small investments through investment structures that combine debt with equity or royalties, thereby minimizing the risk and optimizing the anticipated returns.
- The staff's interests are aligned with those of the investors through appropriate incentive schemes.

2. The components of the BPI model that are difficult to copy are:

- To run an organization like BPI, the cost structure is be relatively high compared to other local risk funds, which means the need for access to additional support from an organization like the IFC or a grant to provide "free" resources.
- The access to SSC services is quite exclusive, and building an organization the size of the SSC to operate alongside each fund requires significant financing which would only be achieved through a grant. Moreover, the cost of services provided by the SSC as described are not reflected in the returns of the fund thus giving it an unequal advantage. A solution to this could be that SSC considers providing its services on a wider scale and on a neutral basis, not exclusively to BPI, but to other funds as well.

STAKEHOLDERS WORKSHOP

1. Benchmarking – when comparing bench marks from more developed markets, there is need to understand the local SME environment including its limitations. There is also need to caution foreign investors that the higher perceived risk is not necessarily offset against higher return in this market.

2. Stakeholders need to determine the real constraint, i.e. the weakest link in understanding the unique nature of the MSME market from both qualitative and quantitative aspects and provide solutions on this basis.

3. There is need to identify issues that prevent other groups ofl ocal investors from investing in the local risk funds.

4. Comments on the case study - on the issue of deal flow where BPI has the advantage of working with the SSC, there were various proposals to this end:

- That the SSC could work with other fund managers as well to provide deal flow.
- A body should be set up suited to source deals specifically for the risk fund fraternity
- Work with existing institutions that can do this as part of their business.
- A call to fund managers should be more open to their peers and allow for among other issues, cross referencing of deals.

5. Below are proposals to resolve some of the capacity issues facing risk funds and SMEs in this market.

- Set up of a Venture Capital Association will provide support towards risk fund managers in various ways, e.g.,
    - Building capacity through relevant and specific training
    - provide a platform to share information and skills among the risk funds
    - Promote best practice, research and set standards to instill confidence in the market, promote policy building and lobbying for members,
    - Provide a pool ofi ndustry experts to act as an advisory board to the local risk fund managers.
    - A mentorship program to encourage professionals in this market to work with risk funds.
    - Providing reliable market sector studies
    - Develop appropriate reporting standards required by investors
    - Promote networking in the industry such that specific applications and requests for venture capital funding are channeled to the appropriate risk fund.
    - diligence process
- To resolve the issue ofl imited resources, the following solutions could be applied:
    - Liaise with Kenyans in Diaspora to act as mentors to local risk funds.
    - See how university curriculum can include private equity/ venture capital courses.

    - TA to support experienced fund managers to work with funds lacking in experience.
    - TA at both pre and post investment level to cover the expenses incurred in the due
- Co-financing and pooling synergies among the local risk funds; consolidation of small funds to enhance their capabilities
- Encourage networking among the risk funds as well as educating the industry on the working of private equity and venture capital.
- Risk funds could refer to the IFC SME toolkit or the EMPEA toolkit for guidelines on reporting
- Develop an SME deal depository independent organization to serve risk funds
- Focus on proper exit management strategies at pre-investment to ensure good exits
- Risk funds should have a "minimalist" approach, i.e. by cherry picking the right SMEs to invest in and focus on their venture capital business. Other, specialized business development, organization(s) will provide the much needed BDS services.
- Overall, significant public funding is needed to develop and scale the risk fund market in Kenya and greater effort by the risk funds should go into sourcing for these funds.
- A proposal for tax incentives for risk funds will play a big role in reducing the costs for risk funds.
- Risk funds could also work with other specific funds to provide venture capital to various initiatives, e.g., consolidating the interests and strategies of different small funds like, youth funds and women's' funds.
- Leasing – stakeholders should educate the government on how this can be introduced to provide the benefit to SMEs.
- The risk fund managers could also act as a voice for the SMEs on various fronts as applicable, e.g. on policy issues.

6. Next steps and follow up actions:

- Representatives of SME risk funds will meet with FSD Kenya in early 2008 to review the proposal for the establishment of a local venture capital association .
- The workshop participants will be invited to a stakeholders' workshop following a study on the Local Long Term Fund Availability, commissioned by FSD Kenya.
- The Ministry of Trade and Industry will re-work the request for applications to the US $ 4 million TA fund and sent out to fund managers to apply.

Recommendations on proposed interventions for Consideration

Previous sections shows that some of the capacity constraints experienced by local risk fund managers have been resolved by the risk fund managers and MSME finance providers themselves by for example, changing their fund structures or investment models. Some of the constraints could also be overcome through interventions such as TA, the government and different forms of grant funding.

In conclusion, the possible TA interventions that could be adopted, based on findings in the desk study, field work, lessons from the case study and stakeholders' workshop are highlighted below.

TA Services:

- Provide deal flow assistance.
- Sponsor access to professional services.
- Provide funding for specific post investment interventions.
- Sponsor the set-up of a VC Association.
- Sponsor reliable market sector studies.
- Sponsor the set-up or access to credit reference bureau services.
- Need for flexibility by the TA administrator to cater for the different and unique SME needs.
- Immediately include a training component for risk fund managers for specific modules on private equity and venture capital training.

TA Structure:

There were various suggestions to this end as highlighted below.

- A proposal that the TA funding be channelled through one, revolving, TA fund. Most of the services provided would be through interest free or minimal interest loans. This will ensure the revolving nature of the facility, sustainability of the fund and accountability by the SMEs. Each risk fund manager or MSME finance provider would on-lend the funds to its investee company and be responsible for the collections.
- A suggestion that part of the TA be disbursed as a grant, as there would be a good number of organizations, who would be willing to support the TA funding.
- A mechanism for insurance should be worked into the loan provision to ensure loan recovery.
- The decision about whether or not to lend to an investee company should be left to the fund manager.
- The issue as to whether the fund manager could also be the BDS provider should be at the discretion of the fund manager if they are managing the TA themselves.

- A precedent where a TA fund is given as a debt would help as a reference point to draw conclusions on an appropriate structure.
- Risk funds could share costs and risks of return of the TA with the investee.
- A proposal to charge the TA at the same interest as the respective funds' costs.

TA Amount

- Drawing from the example of the case study, BPI provides TA funding to its investees up to an amount of about 30% of the investment size. The US $ 2.5 million TA fund available to BPI is approximately 17% ofi ts fund size. This fund is also of a revolving nature. However the actual figure should be based on a realistic amount based on the different fund sizes.
- Whereas the feeling is that the TA fund available (US$ 4M) may not be sufficient for all the needs and capacity constraints highlighted in the study and during the workshop, it is possible to grow the amount.
- One suggestion is for the threshold to be for investments below US $ 50,000.

Other pertinent issues

- The components to be considered for funding through the anticipated US $ 4 million TA fund are those that would enhance the investees' business processes as opposed to issues that would be fundamental to the deal process with the risk fund manager.
- Local risk fund managers will apply to the Ministry of Trade and Industry to be considered as beneficiaries of the TA Fund on behalf of their investee companies.

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Appendix A

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2	African Agricultural Capital	Mr. Tom Adlam Managing Director
3	Business Partners International	Ms. Sally Gitonga Chief Investment Officer
4	Grofin	Mr. Fred Kiteng'e – Country Manager Guido Boysen – Regional Dircetor Mr. Kenneth Onyando – Investment Manager
5	Acumen Fund	Ms. Nthenya Mule Country Manager
6	PTA Bank	Mr. James Kabuga Project Finance Officer (Credit Facilities & Business Development)
7	Aureos Fund	Mr. Kiriga Kunyiha Associate, East Africa
8	IDB	Mr. Amos Aketch Manager, Strategy & Business Development
9	Fina Bank	Jared Aimba Head of Business Banking
10	Technoserve	Fred Ogana - Country Director Moses Kimani Business Advisor Josfynne Miingi - Consultant (Prg Manager)
11	Equity Bank	Ms. Mary Wamae Company Secretary/ Investment Manager
12	Bridges Capital	Ms. Catherine Gitonga Operations Manager
13	Rentworks	Baisama D. Awori Business Development Manager
14	Trans Century	James Mworia – Senior Investment Officer Elenor Kibet – Investment Analyst
15	Gilde Investment Management	Mr. Toon den Heijer
16	TBL Mirror Fund	Ms. Eline Blaauboer Investment Director
17	Investeq Capital Ltd	Mr. Dan Awendo Chief Executive Officer
18	Africa Venture Capital Association	Ms. Barbara James Managing Director
19	Enablis	Brian Longwe Implementation Manager, Eastern Africa
20	Standard Chartered	Mr. Ben Muchina Head of SME Banking
21	ICDCI	Mr. Peter Mwangi Investment Manager
22	Soko Investments	Mr. James Kabuga, Director.

Appendix B

STUDY QUESTIONNAIRE

InvesteQ CAPITAL

Trade Finance • Asset Finance
Venture Capital

Introduction

INVESTEQ has been contracted by FSD Kenya to carry out a study on The Capacity Constraints Facing Risk Fund Managers in Kenya.

We invite you to take part in this study to help us gather relevant data as pertains to the risk and SME financing environment in Kenya. This information will be useful in helping FSD design possible interventions relevant to any identified constraints from the study as well as provide a basis for a proposed Technical Assistance programme targeted at fund managers by the MSME Competitiveness Project.

We do appreciate you taking the time to fill out this questionnaire. If you have any questions, please feel free to contact us on 2730980/81 or send an email to mnyambura@investeqcapital.com and info@investeqcapital.com.

Name of your organization	
Name and position of interviewee	

1. Fund Profile - Please fill in as applicable

Fund size – committed (USD)	
Fund size – Invested (USD)	
Legal structure of the fund	
Core investors in the fund	
What were the main considerations of your investors to invest in your fund? i.e. - experience of the team - proven returns in the past - your investment model - other	
Fund term (years)	

Fund Focus & Investment Strategy

1. Deal size (range/ USD)	
2. Sector/ Industry focus	
3. Geographical focus	
4. Typical financing instruments: ▪ Straight Equity ▪ Quasi Equity ▪ Senior, long term Debt ▪ Working capital ▪ Subordinated debt ▪ Convertible loans	
5. Stage of investment: ▪ Seed ▪ Start-up/First stage ▪ Early growth ▪ Expansion ▪ Other, being:	
6. What are your investment considerations/ criteria for investing in portfolio companies?	
7. Target lifetime of the investments	
8. Number of companies in portfolio	
9. Names and type of portfolio companies (stage, industry, geography, investment instrument used, size of investment)	
10.Target return of the fund	
11.Management fee (% of committed capital)	
12.Does the management team receive carried interest?	
13.Other fees and possible grants/loans (please specify)	

2. Capacity Scope

a) Below is a list of work components that are essential for a risk fund manager to either perform in -house or outsource to specialists. Based on your experience as a risk fund manager working in Kenya, please place a relative value on each item with regard to constraints faced by your organisation (column A) and those you consider as cutting across the industry (column B) . Please use a scale of 1 -10 with 10 being the most challenging area. Furthermore indicate if you perform these functions in -house or outsource them. A column has also been provided for you to expound on the specific nature of how these components of your work are preformed and what the capacity constraints are faced by your organisation regarding this specif ic component.

		A In-house or outsourced?	B Rating (1 -10) Firm Specific	C Rating (1-10) Crosscutting	D Remarks
(i)	Deal sourcing				
(ii)	Marketing of the fund and networking				
(iii)	Market sector studies				
(iv)	Pre-investment analysis				
(v)	Legal structuring, negotiation & documentation				
(vi)	Due diligence, market, management, legal				
(vii)	Post investment monitoring and synergy creation				
(viii)	Advisory – Business Development Services				
(ix)	Exit management				
(x)	Fundraising, approaching new and existing investors to expand existing fund or start a new fund				
(xi)	Investor relation management				
(xii)	Other areas				

b) Systems & Infrastructure

- Which systems are used?
- What challenges, if any, with regard to systems and infrastructure is your firm currently facing?

c) Key Management & Staff/ Advisory Team

Kindly provide a summary profile of your key management team below.

	Position/ Role	Age	Nationality	Years with the team	Years in fund mgt/ MSME financing	Key Qualifications & Experience
1.						
2.						
3.						
4.						
5.						

What kind of training have your management received: in house training, training by previous employer, training provided by external parties? If not, what king of training would you like to receive as management?

d) Investment Process & Decision Making

Describe the investment process: the steps needed to be taken before investing.	
Who takes the investment decision and what is the basis?	
Please describe your portfolio valuation procedure	
Do you follow any valuation guidelines?	
Who does the valuation & who reviews it?	

3. Technical Assistance

Do you currently utilize the services of (outside? technical assistance providers? (Yes/ No)

If No:

(i) Why not?

If Yes:

(i) What % of fund size goes to TA?

(ii) How much should that ideally be?

(iii) What functional services does the TA cater for:

(iv) To whom are the services targeted: the fund or the portfolio companies?

(v) Does your fund pay for these services (yes/no). If not, how are the TA services paid for?

(vi) Do the portfolio companies pay for the services or are the services donor funded?

(vii) What would be the ideal mix?

4. Proposed Solutions

Do you consider appropriate, a technical assistance programme or fund as one of the solutions to the constraints faced by fund managers in Kenya?

a) If not, why?

b) If so:

What size of funding (USD) would be most appropriate to your organisation? Please justify	
What type of TA funding (instrument) would be most appropriate?	
Which type of risk fund managers should be targeted?	
What specific services would you most highly value from such a programme/ fund?	
Do you have any suggestions as to how such a programme/ fund should be structured?	
What other solutions may be considered aside from a TA programme/fund?	
What, if anything, is your organization doing to take these solutions forward?	

5. Definition of SME

Please provide your definition of "SME":

Appendix C

SUMMARY OF INTERVIEW/ QUESTIONNAIRE RESPONSES

	Institution	No of Cost in Portfolio	Fund term (yrs)	Target lifetime of investments (Yrs)	Key Mgt Experience –in fund mgt/MSME financing (Yrs)	TA Fund in Place	Challenges/ capacity Issues	Participants TA Recommendation
1.	Bridgeworks Africa	Target 15-20 portfolio compani es	10	**	1.6 years – average for 6 members of staff & management	Applying for funds with FSD.	■ Deal sourcing, Marketing & networking of the fund: spend a lot of time on this, but no real challenge. ■ Due diligence component – lack of reliable market / sector information & high costs for due diligence process ■ Post-monitoring to some extent: looking for TA funding for this from FSD, to pay advisors (prefer to pay own staff from TA funding b ut mostly not possible, solving this by working with venture partners, i.e. dedicated advisors who are not on the payroll). ■ Reliable ICT system –acquisition costs ■ Fundraising: being a first time fund and having little VC experience (done 3 deals so far) this is a challenge, therefore they're looking for a partner with VC experience, also to tap into deal structuring knowledge ■ Reporting requirements for SME funding very high and challenging, every investor wants reporting in own format.	■ Instrumen ts: grants/ interest free loans ■ Ideal would be $ 1 M dedicated TA fund s, part of the Bridgeworks fund with a dedicated TA investor, managed by the fund manager. In addition to a regional VC association. ■ Target should be for early stage funds & funds tar geting small and medium sized businesses ■ Objectives of TA: Access to a robust network of professional service providers, risk mitigation in fundraising, market studies, ■ Form a national/regional VC association with valuation and reporting guidelines, training, market studies. ■ Need a fund off unds (EADB?)
2.	African Agricultural Capital	9 with a further 3 under negotiati on	Open	**	4 years – average for 3 team members	N/A	■ BDS – no finance available for this component ■ SMEs with imperfect MIS	■ Aiming to raise a minimum TA fund equivalent to 5% of their committed capital (US $ 10M)Should target genuine SME financiers ■ Access to a d ata base of specialist consultants ■ a grant -financed fund which, on receipt of qualifying proposals from approved fund managers, can provide up to 50% of the funds required to provide post - investment TA to investees.

	Institution	No of Cos in Portfolio	Fund term (yrs)	Target lifetime of investments (Yrs)	Key Mgt Experience –in fund mgt/MSME financing (Average/Yrs)	TA Fund in Place	Challenges/ capacity Issues	Participants TA Recommendation
3.	PTA Bank	**	N/A	**	■ Senior management with the relevant experience have been with the bank on average more than 8 yrs ■ Close to 60% are professional staff	- receive grant funds from ADB for training & consultancy (being provided in-house, for reporting. About $200k per year but applies for specific funds where required	- market sector studies take a lot of time and need outside experts - post investment monitoring takes time, therefore only invest above $500k.	■ have one dedicated TA fund, so that fund managers don't have to source the funds themselves ■ best towards in-house capacity building ofi nvestment managers and ofi nvestee companies (who have manpower constraints and need training) ■ Target DFIs, VCs, PE, investee companies. Not banks ■ In the form of grants , line of credit (instead of paying 10% interest pay 9%, use 1 % for TA) , equity .
4.	Acumen Fund	4	**	5-7 years	Key management has an average of 4 years in fund and SME management	■ Usually for legal purposes ■ They also have fellows in Leadership programs from graduate schools in developed countries whom they attach to investee companies for 1yr ■ Lower returns accepted	■ Fact that they have a social impact dimension may sometim es compromise the financial/ profit component with some of their clients. ■ Clients systems – reporting, financial, operations and feedback – wanting ■ Human capacity – in some cases need more human resources and also how to get them committed and question abo ut their track record ■ Marketing of the fund	■ Support a Credit Reference Bureau platform ■ Platform to formalize the informal sector ■ The TA fund should support investments that have innovative business models that are opening up the market for new ways of doing business and targeting niches that are currently underserved, have the potential of creating employment, and demonstrate potential for scalability. Target risk fund managers working with SMEs that have innovative business models that are new in the ma rket. Also fund managers keen to invest in sectors not traditionally served by investors, e.g., PPPs.
5.	Equity Bank	Current focus on SME financing is 6% of portfolio, plans to grow this to 40%	N/A	0-3 years (SME loans)	**	DFID (FSD) Banal Consultants – 70% funded through the TA fund to build HR capacity	■ Market sector studies ■ Ongoing training for staff ■ Mismatch of ST savings with clients LT lending requirements where currently can only give loans up to 3 years ■ Clients' reporting structures & systems	■ Should be a grant ■ TA Fund should be targeted at the retail SME lending sector as this has the greater impact to the SME environment/ economy in general

	Institution	No of Cost in Portfolio	Fund term (yrs)	Target lifetime of investments (Yrs)	Key Mgt Exper ience – in fund mgt/MSME financing (Average/Yrs)	TA Fund in Place	Challenges/ capacity Issues	Participants TA Recommendation
6.	Trans Century	5 funds, 3 private equity Cos, 11 listed Cos	N/A	ST: 0 -3 yrs LT: 5 -7 yrs		N/A	■ Market sector studies ■ Structuring the debt financing as a fundraising instrument is a challenge ■ Lack of cost effective MIS systems for portfolio management ■ Difficult to undertake courses that require critical personnel numbers	A. Support third party institutions to off technical training B. A TA fund may be inconsistent with their values & mission because they a a private entreprise C. Finance third party providers of research(possibly academic institutions)/ build their capacity to g quality research D. Partner with leading institutions/ firm to bring in expert trainers in technica issues – e.g. valuation training
7.	Technoserve	E. women entreprises = 24 F. Up scaling entreprises = 17	N/A	3-5 years	To be provided	Mentorship programme by leading consultants to 'shadow' their teams of officers and c onsultants; usually come in for periods of about 3 - 6 months. (Consultants from Mckinsey, Bain, Goldman, E &Y)	■ Up scaling the clients from micro to small ■ Deal sourcing: Many SMEs needing the services are in the informal sector working outside tax and may not appreciate letting third parties in ■ Identifying growing businesses	■ Resource centre – one stop shop ide the grassroots level for knowledge transfer and technical know -how ■ Establish a network platform for all fund managers ■ Part of the fund to be for experts fro more developed markets to come in and help to enhance skills ■ Help restructure /formalize the informal sector ■ Due diligence service providers ■ Refinancing certain management aspects of the business
8.	Fina Bank	**	N/A	3-5 years (SME Loans)	**	■ DFID – for consultant from Shorebank (USA) to provide expert training in SME lending ■ FMO – US $ 3M To on lend ■ USAID _ US $ 5 M Guaranteed line	■ SME/ clients Reporting systems wanting	■ Market sector studies ■ Expert training for officers – SME knowledge and r elevant transfer lacking ■ To beef up systems ■ Instrument should be a grant ■ May need to increase the proposed amount to effectively reach all funds requirements

	Institution	No of Cost in Portfolio	Fund term (yrs)	Target lifetime of investments (Yrs)	Key Mgt Experience – in fund mgt/MSME financing (Average/Yrs)	TA Fund in Place	Challenges/ capacity Issues	Participants TA Recommendation
9.	Aureos Fund	13 entreprises	**	3-5 years	13 years – average for 3 team members	■ IFC US $ 400, 000 – targeted at the in vestee companies to upgrade their environmental components to world standards ■ Other – on project by project basis or e.g. ICT upgrades ■ Have DFID TA on upgrading of system for one of their portfolio companies in Uganda	■ Clients reporting and ICT systems ■ Mar ket sector studies	1. Need to set up a system/ body to administer the Fund 2. Probably more appropriate for funds trying to set up 3. Uses would be to upgrade the portfolio co. systems and their depth of management 4. Fund Managers' personnel training to shift their m indset from "lending" to "equity" management
10	ICDCI	** - Examples include K -Rep, Rift Valley Railways Corp, General Motors, UAP Insurance	N/A	N/A		N/A	**	**
11	IDB	Approx 250	N/A	6 years – typical of a DFI	**	■ Government sponsored staff trainings ■ Antici pated TA assistance from partnership with Exim Bank, Romania	■ Most of challenges are tied to the fact that the institution is a parastatals now trying to shift way of working into a commercial entreprise ■ Pricing of interest rates – specifically a challenge for DFIs; cannot compete with banks or institutions that have no cost for finance for lending instruments	■ Support structured market sector research that is current and comprehensive ■ More of the TA fund should be targeted at SMEs

	Institution	No of Cos t in Portfolio	Fund term (yrs)	Target lifetime of investments (Yrs)	Key Mgt Experience –in fund mgt/MSME financing (Average/Yrs)	TA Fund in Place	Challenges/ capacity Issues	Participants TA Recommendation
12	Business Partners	9	8-10	3-5 years	▪ 12 years in banking 4 in SME fina ncing – Chiefi nvestment officer. ▪ 25 years investing experience provided by the back office in Johannesburg	▪ US $ 2.5 M in place – uses and services on a case by case basis for portfolio companies, e.g. for systems upgrade ▪ TA pays for technical assistance services to TA service providers only. SSC also provides consultants and experts during the post investment monitoring process	▪ Challenges in educating the fund clients on how VC works ▪ The local legal fraternity does not have a clear und erstanding as to how the VC environment works. ▪ Fundraising – challenge because of the nature of this market; not clear whether the environment is ready for such a fund	▪ The purpose and objective of the TA should be a support enhancement clients (funds) who are not well developed The proposed fund shou be well managed and monitored ▪ Should not be a grant so that other entrepreneurs can benefit. ▪ Proposal for a structure where each fund has its own allocation ▪ Should provide a platform for a poo of skille d people in the market ▪ Have bodies like AVCA come in to train the fund managers and addre the problem of skills gap
13	Grofin East Africa	20	7	3-5 years	8 years average for 3 team members	N/A	▪ Market sector studies ▪ Pre -investment analysis because privat e equity experience in this market is scarce ▪ Due diligence – depends on market/ industry information which is a challenge ▪ Legal structuring – fact that it is outsourced ▪ Systems challenge – managing remote offices in 9 countries with poor telecommunications infrastructure.	▪ A Fund of US $ 150,000 pa (US $ 450,000 over 3 years) most ideal for Grofin. This is for training for 15 investment professionals @ US 15,0 pa. ▪ Most appropriate instrument is a grant ▪ Private equity fund managers sho be targeted ▪ Most b eneficial services are private equity training and SME consulting Using facilitators such as Euromone at subsidized fees

	Institution	No of Cost in Portfolio	Fund term (yrs)	Target lifetime of investments (Yrs)	Key Mgt Experience –in fund mgt/MSME financing (Average/Yrs)	TA Fund in Place	Challenges/ capacity Issues	Participants TA Recommendation
14	TBL Mirror Fund	1	10 (+ 2 optional)	5-10 years	3.5 years average for 5 team members	No TA Fund, but get assistance from the investors, where for each investment two investors provide dedicated support. Furthermore have a partnership with Bain where consultants come to Kenya for 3 months to work with investees on strategic issues.	■ Market sector studies – no reliable data available ■ Due diligence – DD with established companies can be time consuming. Challenge is also to keep DD costs low in comparison to the deal sizes ■ Post invest monitoring and business advisory first because they are key aspects to the success of VC ■ Exit - great challenge in Kenya. For instance not many buyers if a trade ale is considered and for IPOs, companies need to meet certain criteria ■ Fundraising – due to risk aversion by the DFIs and Institutional investors ■ Anticipated system specific to the VC business is costly.	■ Requires an int ervention of US $ 1 M to manage the fund properly, i.e. pay managers, cover monitoring and due diligence costs ■ Proposed instrument: a grant of US $ 1M or an interest free loan that doubles the fund size, i.e. US $ 4 M ■ Structure: - Provide grants/ loans dir ectly to fund managers on a one off basis at the start of the fund. ■ Fund should target fund managers with fund sizes less than US $ 10 M and deal sizes less than US $ 1 M Proposed services: ■ Training, market sector studies, networking, setting VC industry standards and keeping data
15	Enablis	N/A	* *	Variable	**	■ For the mentorship program for entrepreneurs – this is key to their unique model that seeks to focus on the entrepreneur. Pays for e.g. coaches for the entrepreneur and for various skills enhancement ■ Members pay fees of US $ 150 pa ■ Seed grant for overall local operations – but has a matching requirement	■ Investor relation management. A good number of the investors are also interested in the social return or impact of the investments ■ Market sector st udies	■ To assist in their matching requirements by the fund investors ■ Method of disbursement should be transparent to the entire fraternity and have an efficient accounting system ■ Support an entity that has a large array of specialists on a retainer program who can provide their services to the fund managers as and when required, e.g. for due diligence services. ■ Pay for expert trainers specific to fund management and private equity skills.

	Institution	No of Cost in Portfolio	Fund term (yrs)	Target lif etime of investments (Yrs)	Key Mgt Experience –in fund mgt/MSME financing (Average/Yrs)	TA Fund in Place	Challenges/ capacity Issues	Participants TA Recommendation
16	Investeq Capital	N/A	To be decided	3-5 yrs	13 – average for 3 team members	N/A	▪ Licensin g by the relevant authorities has proved to be lengthy thereby curtailing fundraising efforts or allowing the fund to be fully operational ▪ Human capacity – experience and training in venture capital not sufficient with current team. Require specific skill s and understanding of VC management ▪ Lengthy due diligence processes ▪ Market sector studies not current or reliable for investment decision making	▪ Training/ upgrade skills in VC/ private equity and mentorship program for staff ▪ Sponsor the establishment of an association to create an opening for a one-stop shop idea for various solutions sought by its members
17	Standard Chartered Bank (SME banking)	**	N/A	Up to 15 years (loans + mortgages)	15 years experience for team leader; over 10 years average expe rience for key management	N/A	▪ Charging security a challenge because most SMEs do not have any collateral to secure their loan applications ▪ Problem of defining an 'SME' given the fragmented nature of the market. Tied to this is how to separate 'micro' from 'small.' Also the challenge of pricing ofl oans for the SMEs - differentiating this sector with the 'corporate clients' product ▪ Key challenge for banks in the SME market is the 'cost to serve' the SME sector.	▪ Sound framework required to determine how the private and public sectors can efficiently work together. ▪ A significant amount of funding is required to be able to serve the entire SME sector as the needs for both SMEs and the fund managers are numerous ▪ Banks would welcome technical assistance to on lend to SMEs which is a highly risky sector and given that banks can only utilize depositors' funds. As such a legislation should be put in place for lending to SMEs to assure the lenders and risks funds that their money will 'come back.'

18	Rentworks	Key issues raised: ■ The core business revolves around the Leasing of Moveable Assets. Since the Asset is the sole collateral then they usually need to take certain measures(e.g. Asset Tracing technology) to ensure that their interests are protected. ■ Main ele ments of risk within their program. 1. Credit Risk - their Funding Partner Bank(s) have to vet and make a judgement call as to whether a potential Lessee is a good credit risk. 2. Asset risk - the Asset being leased is to be maintained in good working order so that it is rentable to a new Lessee at the end of the Primary Lease period. ■ Rent Works is a "Residual Value Investor" so the Assets have to be returned to them in good working condition at the end of the primary Lease term. Related to this and specific to the SME sector, they need to inculcate a Maintenance culture as a necessity in Managing Productivity Assets and not an after-thought whena technica lbreak-down occurs.

Key:
** = Information missing/ not available

Appendix D

FUND FOCUS AND STRATEGY

	Institution	Fund Size – If applicable (US $)	Legal Structure	Key Investors	Year of Start	Financing Instruments/ Stage of Investment	Av. Range of Deals (US $)	Target Return/ Fees	Sector Focus	Geographical focus	SME definition
1.	Bridgeworks Africa	Target: 15M Invested: 300,000 E, 30,000 L	Not yet structured – structure adopted should take advantage of tax incentives in the region	N/A	2005	▪ Straight equity, quasi equity. Looking to go into venture leasing as well with a partner. ▪ Seed, start-up and early growth	50,000 – 500,000; exceptionally up to 1M	2-3.5% mgt fees	Life sciences, agriculture, environment, health, nutrition	East Africa – Ethiopia, Kenya, Rwanda, Tanzania, Uganda	Small: turnover <US$2m, 5–10 employees Medium: turnover US$10m, 40+ employees
2.	PTA Bank	Committed: 250M Invested: 50% of portfolio	Bank	Member countries; Non African, e.g. China; Institutions, e.g. ADB	1997	▪ All stages ▪ Debt	500,000 – 2M; have done contract financing of lower deals but strictly on a case basis	1-3 % Mgt fees	Infrastructure, Manufacturing, Tourism, Mining, Agribusiness, 'others'	17 countries in the COMESA region	Any investment with financing requirements of less than US$2m
3.	African Agricultural Capital	Committed: 10M with a further 7 M being raised	Ltd liability company registered in Uganda	Kilimo Trust (Gatsby Charitable Foundation & Rockefeller Foundation); Volksvermogen NV	**	▪ All stages of investment with a focus on early stage and expansion ▪ Quasi-equity	100,000 – 1M; plans to increase to 1.5 M	4-5% of committed capital; fixed interest rate for loans	Agriculture	Kenya, Tanzania, Uganda	Has to satisfy at least two out of these three conditions Net assets <US$1m (equivalent) Turnover < US$5m (equivalent) Employees < 500
4.	Acumen Fund	Committed: 100 M Invested: 21.2 M	Company ltd by guarantee, registered in Kenya	Individuals, Philanthropic orgns, Institutions & Foundations	2006	▪ Early growth and expansion ▪ Straight equity + quasi equity	250,000 – 1M	Equity coupons, interest for loans	Health, housing, water + sanitation, energy	Kenya, Tanzania, Uganda	Business with an annual t/o of up to US$2m and up to 200 employees
5.	Trans Century	Committed: Open	Ltd liability company	individuals	**	▪ Straight equity + quasi equity	(private equity) 500 000 10M	**	Various	8 countries in sub-Saharan Africa	Commercial definition (IFC)

	Institution	Fund Size – If applicable (US $)	Legal Structure	Key Investors	Year of Start	Financing Instruments/ Stage of Investment	Av. Range of Deals (US $)	Target Return/ Fees	Sector Focus	Geographical focus	SME definition
6.	TransCentury	Committed: Open invested: 14m	Limited liability company	Individuals	**	Straight equity + quasi-equity, listed equity investments	Private equity 500,000–10m	**	Various	Sub-Saharan Africa	**
7.	Aureos EA Fund	Committed: 40M Invested: 35.8 M		CDC, Norfund, EIB,	2003	▪ All financing instruments expect WC ▪ Early growth and expansion	500,000 – 4 M	Target: 15% net of expenses (US $) Mgt fees: 3% of committed capital	Open-transaction type focussed	Kenya, Uganda, Tanzania	Turn over of US$0.45 –75m High-quality management Business has been in operation for 5 years
8.	ICDCI	N/A – entity is an investment company	Ltd liability company	Individuals Institutional, e.g. ICDC		Straight & quasi equity	USD 400,000	**	Open – focus is on growth sectors based on a 5-year strategic plan	Kenya	N/A – focus is not the SME market
9.	Equity Bank	N/A Currently commits 6% of portfolio to SME financing, plans to grow this to 40%	Bank	Principally a savings bank – only 35% accounts for credit		Business should have been consistently trading for 6 months	7,200 – 72,000; Anticipate to grow the volumes	Loans: 16% on reducing balance	Open	Kenya – 53 branches	Based on financing requirements: US$7,200–72,000
10.	Fina Bank	N/A	Bank	Account holders	SME scheme: 2 years	Early growth – business should have been consistently trading for 12 months	4,200 – 142,000	Loans: 19%	Open	Kenya: Nairobi, Mombasa, Nakuru, Eldoret. Looking to expand into Rwanda in 2008	Turnover of up to US$720,000 Fewer than 100 employees US$4,200–142,000 in borrowing requirements
11.	Standard Chartered (SME banking)	N/A	Bank	Account holders	5 years (SME banking)	Generally business should be at least 3 yrs. If younger, transaction has to be strongly justified	Up to 3 M	Base is about 14%; actual cost is higher	Open – growth sectors	Kenya	Turnover of up to US$10m Borrowing requirements of up to US$3m

	Institution	Fund Size – If applicable (US $)	Legal Structure	Key Investors	Year of Start	Financing Instruments/ Stage of I nvestment	Av. Range of Deals (US $)	Target Return/ Fees	Sector Focus	Geographical Focus	SME Definition
12.	Grofin East Africa	Committed: 18M, co financed Invested: 8M	**	Shell Foundation, FMO, CDC, Finfund	**	■ 'All' financing instruments – focussed on 'appropriate' finance for the SME ■ Stages of financing: All, except Seed	50,000 – 1 M	**	All except primary agriculture	East Africa	Guidelines: ■ Total assets – less than 3 million ■ Turnover/ sales – less than 5 million Employees – less than 50
13.	Business Partners	Committed: 14.1M Invested: 2M	Ltd partnership incorporated in Kenya	IFC, EIB, EADB, CDC, TransCentury	2007	Straight equity, quasi equity; can take collateral	50,000 – 500,000	Target IRR: 25%; due diligence fees by client; interest on loans is at commercial rates	Open	Kenya	Definition by funding size: (US $ 50,000 – 500,000)
14.	IDB	N/A	Ltd company;	Treasury: 58.2% shareholding, the rest: Kenya Re, ICDC, National Bank	1973	Quasi equity, long term debt, contract financing WC (trade and bridging finance)	50,000 – 1.5 M	2% mgt fees; other facility fees: 1.5-2%	Various	Kenya	Has adopted commercial definition by the EA institute of Bankers: Small: 6-49 employees; capital investments of US $ 5,000 – 200,000 Medium: 50-100 employees; capital investments of 200,000 – 800,000

	Institution	Fund Size – If applicable (US $)	Legal Structure	Key Investors	Year of Start	Financing Instruments/ Stage of Investment	Av. Range of Deals (US $)	Target Return/ Fees	Sector Focus	Geographical Focus	SME Definition
15.	Enablis	Committed: 19 M Invested: N/A	Trust Corporation	CIDA, Ministry of Youth Affairs, Accenture, Microsoft	2007	▪ Stage of investment is variable ▪ Loan guarantees (local bank), straight equity, quasi equity, convertible loans	14,000 – 380,000	Target: variab le – 8-10% on debt	Open	East Africa	Based on funding requirements
16.	TBL Mirror Fund	Committed: 5M Invested: 750,000	Dutch entity managed by TBL Invest (Dutch)'; owned by the partners	40 private investors		▪ Instrument: straight equity, quasi equity, converti ble loans	100,000 – 1 M	Target 25+% Mgt fees, 3% Carried interest 20%	Open	East Africa, mainly Kenya	Based on financing requirements: US 100,000 – 1M
17.	Investeq Capital	Target: : 14M Invested: N/A	Limited Liability Company, Registered in Nairobi, Kenya. Th e Venture Capital Fund will be registered in Kenya as a Trust Corporation.	N/A	N/A – VC firm Yet to be registered	▪ Stages: Acquisition , Expansion , MBI/MBO, Pre - IPO, Private Placements, Restructure, Start-up ▪ Instruments: straight equity, quasi equity	50,000 – 500,000		Services, Agric, Agricultural commodity trading and commodity - value adding sectors, Manufacturing Transportation & Logistics	Kenya	Based on financing requirements

Key:

- E = Equity
- L = Loan

** = Information missing/ not available

CIDA – Canadian International Development Agency

COMESA – Common Market for Eastern and Southern Africa

EIB – European Investment Bank

MBI – management buy-in

MBO – management buy-out

WC – Working capital

Appendix E

PROFILE OF VENTURE CAPITAL ASSOCIATIONS

ASSOCIATION	ABOUT THE ASSOCIATION	STRUCTURE	NO. OF MEMBERS	SERVICE TO MEMBERS	CRITERIA FOR MEMBERSHIP/ RESPONSIBILITIES OF MEMBERS
European Private Equity and Venture Capital Association (EVCA)	Established in 1983, Based in Brussels	■ 15% of members are part of the Association's governing and operating bodies ranging from Board of Directors, to operating committees working on such issues a professional standards ■ Management of the Association is handled by a Brussels based secretariat staff of over 25 people.	Over 900	■ Regular networking meetings, symposia, conferences and workshops ■ Provides management training and courses to members to enhance their skills ■ Availing to members latest research and publications eg. in partnership with PWC, quarterly and annual industry averages ■ represents members in public policy activities, ■ Raises professional standards by promoting understanding of members' role in the economy of Europe; ■ Research assistance	■ Full membership open toorganizations actively participating in private equity and venture capital whose main business is carried out in Europe ■ Associate membership open to private equities outside Europe; organizations investing in private equity such as banks and insurance firms; and organizations providing services to private equity sector such as law firms, investment banks; ■ Network membership - open to subsidiary, branches and associates of member firms
National Venture Capital Association (NVCA)	A trade association representing the U.S. venture capital industry.	■ Has a secretariat with a staff of 15 ■ Has BOD consisting of 5 Board Officers and 21 Directors all of whom are drawn from member organizations.	Over 600	■ Member representation and public relations ■ Training ■ Management Liability Insurance Program offers its members a suite of comprehensive insurance covers and risk management services designed to protect venture capitalists and their investments at competitive prices ■ Networking ■ Research & Publications - information on issues relevant to the venture capital process and industry ■ Technology Services	■ Members must be actively engaged in private equity investing on a cash-for-equity basis and must invest from a dedicated pool of capital that has been allocated for the purpose of venture capital or private equity investments. ■ The Member firm must have at least $5 million under management for the sole purpose of private equity investing.
Canada's Venture Capital & Private Equity Association (CVCA)		■ 7 officers and 30 Directors all of whom are drawn from member organizations ■ Several committees to oversee different functions and requirements of members	Over 1200	■ Annual Conference ■ Organizes two annual awards 'Entrepreneur of the Year' Award and the 'Deal of the Year' Award ■ Industry Research ■ Public Policy ■ Networking ■ Professional Development Series ■ Web Site - The CVCA web site is a primary resource for many professionals looking for statistical data, industry events, news, and information on the key players of Canada's venture capital and private equity industry.	Applicants are actively involved in venture capital and / or private equity, are of good standing in the risk capital community, and are usually proposed by two full members who have themselves been members for a minimum of one year. a) Full Members Applicants are involved inas a principal business, the provision of equity finance to unquoted companies and have risk capital funds under management in Canada. b) Advisory Members Applicants are actively involved in the venture capital industry and fall into one of four categories:
China Venture Capital Association (CVCA)	A member-based trade organization	Has a Board of Governors of 10 members	Over 100	■ Representation of industry interests through active lobbying ■ Annual conferences, seminar and training programs ■ Publications and research reports ■ Networking ■ Initiatives for increased visibility for members	

ASSOCIATION	ABOUT THE ASSOCIATION	STRUCTURE	NO. OF MEMBERS	SERVICE TO MEMBERS	CRITERIA FOR MEMBERSHIP/ RESPONSIBILITIES OF MEMBERS
South African venture Capitalists Association (SAVCA)	A non-profit company set up to promote the venture capital and private equity profession in Southern Africa	There exists an 11-member executive committee drawn from member firms.	Over 50 full members and over 25 associate members.	▪ Represents the profession at the national and international level ▪ Develop and stimulate professional and transactional venture capital and private equity investments throughout Southern Africa ▪ Collect information from markets and from members and carry out various researches in the VC and PE industry ▪ Circulate information to members and the outside world including the public ▪ Stimulate and maintain contacts within the membership ▪ Overall development ofi nvestors and investees ▪ Provide the relevant authorities with proposals for improvement in the corporate, fiscal and legal environment for venture capital and private equity in Southern Africa ▪ Maintain ethical and professional standards in the profession ▪ Promote selfregulation ▪ Lobbying on behalfof the VC industry ▪ Organize training for its members ▪ Special privileges enjoyed by Full members include: o Option to participate in an annual Salary Survey of the SAVCA members; o Participation in the Annual KPMG/SAVCA Venture Capital/Private Equity Survey; o Preferential rates on SAVCA sanctioned training Courses; o References from SAVCA from potential capital seekers and employment candidates.	Full Membership - provides a high level of endorsement from the industry and denotes a high level of professionalism and integrity for the member firm. Membership criteria: ▪ be actively involved in venture capital or private equity investment ▪ be of good standing in the industry. ▪ have, as its principal business, the provision of equity finance to unquoted comapnies and make its returns mainly through medium to long term capital gain. ▪ have experienced executives engaged full-time in venture capital and private equity investment; ▪ have venture capital and private equity funds under management having made at least one investment in Southern Africa and be actively making investments; and take an active role in helping to build and develop the companies in which it invests. Associate Membership - Open to persons and companies representing a special interest group that can influence the development of venture capital and private equity in Southern Africa.

Annexe: Workshop Report

1. Introduction

This report encapsulates the stakeholders workshop held in Nairobi at the Lenana House Conference Centre on 13 November 2007.

The aim of the workshop was to have the stakeholders validate the findings of the study , Capacity Constraints Facing Risk Fund Managers in Kenya, as presented in the consultant's draft report.

Study Objectives

The objectives of the completed research are highlighted below.

i. Identify capacity constraints faced by risk fund managers in effectively serving the MSME market.
ii. Identify how fund managers have built their current capacity and steps they intend to take to build it further.
iii. Identify global best practices of risk fund management.
iv. Identify interventions to overcome the constraints.
v. Recommendations on how the proposed TA fund could be structured.

The rest of the report is divided into the following sections:

2. Workshop Facilitation
3. Participants
4. Workshop Program
5. Participants Proposals & Recommendations
6. Next Steps & Follow -up Actions

2. Workshop Facilitation

The workshop was facilitated by the Ministry of Trade and Industry, GrowthFin (FSD Kenya) and InvesteQ Capital Ltd. The presentation of the findings was done by InvesteQ Capital Ltd.

3. Workshop Participants

The workshop had 27 participants , all stakeholders in the SME finance industry in the country. The participating individuals and their respective organisations are listed below.

	Participant	Organization
1.	James Kashangaki	GrowthFin (FSD Kenya)
2.	Milton Lore	Bridgeworks
3.	Edi Theiler	Bridgeworks
4.	Josiah Mwangi	Apex Communications Ltd
5.	Cecilia Mwende	Apex Communications Ltd
6.	Diana Onguso	Apex Co mmunications Ltd
7.	Sally Gitonga	Business Partners International Kenya Ltd
8.	Fred Kiteng'e	GroFin Kenya
9.	Tom Adlam	African Agricultural Capital
10.	Anthony N. Gichini	IFC SME Solutions Centre -Kenya
11.	Dan Awendo	InvesteQ CAPITAL Ltd
12.	Melissa Nyambura	Inves teQ CAPITAL Ltd
13.	Eline Blaauboer	TBL Mirror Fund
14.	Tom Okumu	I & M Bank Ltd
15.	Patrick N. Kariuki	Genesis Kenya Investment Management Limited
16.	Kiriga Kunyiha	Aureos Kenya Managers Limited
17.	Patrick Kariuki	Kenya Association of Investment Groups
18.	George Odo	Entrepreneurs Unite
19.	Sam Odhiambo	Equity Bank Limited
20.	Michael Mithika	J.M. Mantle & Co. Ltd
21.	Peter Kegode	Technoserve Kenya
22.	Salma Mazrui	Trans Union
23.	Lydia Olesi Ojiambo	Ministry of Trade and Industry
24.	Stephen Odua	Ministry of Trade and Indu stry
25.	Robert A. Ng'onga	MSME Competitiveness Project (Ministry of Trade and Industry)
26.	Sammy Muvelah	Zimele Asset Management Company Limited
27.	John Kashangaki	Strategic Business Advisor

4. Workshop Program

The main items for discussion comprised:

- Remarks FSD, IFC and MoTI representatives
- Presentation of research findings from the study
- Feedback & comments on the presentation by the participants
- Final proposals & recommendations with input from the Ministry of Trade and Industry, the IFC's SME Solutions Centre and GrowthFin.
- Proposed Next Steps – immediate steps to be taken as a follow-up to the workshop and the study.

The detailed workshop agenda is attached in appendix A.

5. Remarks GrowthFin, IFC and MoTI representatives

The representatives of GrowthFin, IFC and the Ministry of Trade and Industry (MoTI) provided introductory remarks, giving some more background on the purposes of the study.

In 2004 the World Bank provided a 5 year credit line of US$ 22 million to the Kenyan government to be used towards the MSME competitiveness project. The Ministry of Trade and Industry (MoTI) oversees the project, which has the following aims:

i. Increase access to finance for MSMEs:
    a. GrowthFin through FSD looks into sustainable interventions that increase financing to MSME s, e.g., longer term capital and possibilities of "downscaling" by existing finance providers like banks.
    b. Support to SME risk capital funds for both local fund managers and the new established BPI which adopted a successful model from South Africa.

ii. Capacity building :
    a. US$ 2.5 million TA fund towards investees of BPI
    b. US$ 4 million general TA fund (see below), managed by IFC's SSC

iii. Encourage linkages

iv. Improve entrepreneurial environment.

Before disbursing the US$ 4 million TA fund, IFC, MoTI and GrowthFin wanted to determine through a study, the capacity constraints facing local risk fund managers in effectively Financing MSME. MoTI had also advertised in the local dailies for expressions of interest in the US$4 million TA fund, but received very low response. This workshop would also serve to address this issue and underst and better how to deal with the various challenges faced by local risk fund managers.

6. Participants Proposals and Recommendations

The following proposals and recommendations were gathered from the feedback and comments on the presentation by the different groups during the breakout session.

6.1 Comments on Characteristics of Good Risk Fund Management identified from the Desk Study

Characteristics/Benchmarks	Participants' Comments
Fund structure – structures that align the interest of manager and investors to address the following: ▪ Sufficient management fees. ▪ Carried interest. ▪ Fund/ Investment horizon in the range of 8-10 years	▪ Fund structure must be aligned with the funds' investment strategies and respective deal types.
Returns - IRRs (gross average) above 25%.	▪ When comparing with bench marks from more developed markets, there is need to take into account that one first needs to understand the specific local SME environment. ▪ In the case of required benchmark returns at an average IRR of 25% , there is need to caution the investors coming in to this market that the higher perceived risk is not necessarily offset against higher return.

6.2 Comments on MSME Definition

- The MSME definition adopted by the risk funds should be flexible enough to allow for instance, a company with few employees but with significantly high turnover . Thus absolute definitions restrict potential players.
- The difficulty to define the MSME sector is also reflected by the fact that local risk fund managers themselves do not understand the MSME industry. There is need for capacity building specifically to MSME finance as it relates to risk funds, just like the required capacity in microfinance provision has been built over the last 20 years, through grants and soft loans . Thus local risk funds could look into funding and the necessary support from organizations such as USAid and the Ford Foundation
- There is a need, for the study purposes, to define the type of MSME finance that should be targeted with the anticipated TA funding. It was agreed that this is longer term, risk finance, through a mix of equity and debt .
- There is also the need to define "TA", which should be targeted at mitigating the above mentioned risk (long term nature of the finance).

6.3 Proposed Solutions to Capacity Issues Identified from the Field Work

Capacity Issue	Participants' Comments/ Proposed Solutions
Limited experience and skills of the fund and the respective fund managers.	▪ Overall, it was agreed that setting up a Venture Capital Association ("VCA") is a very good idea in providing support towards risk fund managers in many ways, e.g., building capacity through training. ▪ The capacity building to be provided should be really focused on training risk fund managers on understanding MSMEs and MSME finance. ▪ Need for interventions that will provide TA to support experienced fund manager s to work with a risk fund lacking in experience . ▪ Kenyans in Diaspora with the relevant experience and skills could be approached to act as mentors to local risk funds . ▪ In the long term, see how university curriculum can include private equity/ venture capital courses . ▪ The individual risk funds should provide a platform (through the pro posed VCA) to share info rmation and skills among themselves up to the levels that are allowable, i.e. without the risk of losing their competitive edge. ▪ Local risk funds should share information and skills by co-financing
Limited resources for efficient operation of the funds	▪ Set up of a venture capital association (VCA) to promote best practice, research and set standards to instill confidence in the market, promote policy building and lobbying for members, e.g. for tax incentives
Limited human and due d iligence experience	▪ Provide TA at both pre and p ost investment level to cover the expenses incurred in the due diligence process. ▪ Advisory board - for example the proposed venture capital association (VCA) could provide a pool of industry experts to act as an a dvisory board to the local risk fund managers. ▪ Pool synergies from the different local risk funds. ▪ Have a mentorship program through the VCA to encourage professionals in this market to work with risk funds. ▪ Consolidation of small funds to enhance th eir capabilities ▪ Have a mentorship program through the VCA, e.g. retired professionals.
Inadequate and unreliable market sector studies .	▪ The studies could be provided by the proposed VCA, against a subsidized fee. The VCA could also influence other organ izations like the Kenya Institute of Manufacturers, Kenya National Central Bureau of Statistics and the Chamber of Commerce to collect market data and carry out studies . The information collated in this case should include relevant business information and data. ▪ It was proposed that the risk fund managers should assist these organizations in developing the required questionnaires to gather the relevant information. ▪ In addition, the VCA could carry out studies in certain sectors.
Demanding shareholders/ Inv estors	▪ The proposed VCA could develop appropriate reporting standards. ▪ The risk funds should provide detailed/ comprehensive reporting to their respective shareholders where all issues are adequately addressed. This would include providing different reporting variables as required. ▪ The risk funds should educate their respective investors about what to expect from this market in terms of return and limitations. ▪ For guidelines on reporting and content, risk funds could refer to the IFC SME toolkit (www.ssc.co.ke) or the EMPEA toolkit (www.emepeatoolkit.org).

Capacity Issue	Participants' Comments/ Proposed Solutions
Inadequate/ unreliable management information systems	▪ Through the V CA, create standards that can be adopted by all the players.
Challenge of deal flow sourcing	▪ Each risk fund manager should implement their own marketing strategy and communicate their investment parameters well towards MSMEs and towards other fun d managers. ▪ Through the proposed VCA, promote networking in the industry such that specific applications and requests for venture capital funding are channeled to the appropriate risk fund . ▪ The risk funds should take the initiative to educate the market , the business community and relevant stakeholders on the working of private equity and venture capital. This could be done through conferences or other forums. ▪ Develop an SME deal depository – the risk fund managers could team up and approach an independen t organization which has the capacity and interest to provide this kind of service , has an adequate budget for advertising, does the screening of prospective investees and templating with respect to the varying investment strategies of the risk funds. Such an organization would likely be financed through grants.
Exit management – market underdeveloped thus providing few exit options	▪ " A good exit starts with a good start: " i.e. it is more likely that good investments will always be able to be exited: The risk funds should look into proper exit management strategies before investing and implement the exit strategy well.

6.4. Comments & Proposals on the Anticipated Technical Assistance

Structure

There were different thoughts and proposals as to the structure of the fund as highlighted below:

- One suggestion was that it should be disbursed as a grant , as there will be sufficient organizations , e.g. the Bill Gates Foundation who would be will ing to support the TA funding. A good point of reference is the local microfinance industry that has come a long way but is now well established.
- A mechanism for insurance should be worked into the loan provision to ensure recovery of the loan.
- The r ole of fund manager in disbursing the funds to investees creates a conflict of interest because the fund is also the one evaluating which investee is eligible for TA. This was also raised as an ethical issue. However, participants resolved that the decision of whether or not to lend to an investee company should be left to the fund manager.
- There is n eed to find out whether there is a precedent where a TA fund is given as a debt and draw conclusions from such a structure
- A proposal was put forth for the fund manager to "go Dutch", i.e., share cost s of the TA with the investee. In addition, the risk of return should be borne by both investees and risk funds since the TA is beneficial to all parties concerned.

- It was mentioned that the reason for payback by the investee is to ensure :
  – sustainability of the fund and making sure the SMEs are accountable.
  – the funds are used as intended.
  – a revolving facility.
  – accountability by the SMEs.

- There was a proposal to charge the TA at the same interest as the respective funds' costs.
- The issue was raised as to whether the fund manager could also be the BDS provider. This would also be at the discretion of the fund manager if they are managing the TA themselves.

<u>Services</u>

- The s cope that the proposed TA could be used for might be limiting thus need for flexibility by the administrator/ manager to cater for the different and unique SME needs.
- To cater for an immediate need, include a training component for risk fund managers for specific modules on private equity and venture capital training.

<u>Amount</u>

- The actual figure should be based on a realistic amount based on the different fund sizes .
- The TA fund available to BPI (US$ 2.5 million) provides TA up to a maximum of 30% of the investment in a particular SME or investee.
- Participants agreed that the TA fund available (US $ 4M) may not be suffcient for all the needs and capacity constraints highlighted in the study and during the workshop, but it is possible to grow the amount.
- One suggestion was for the threshold to be for investments below US $ 50,000.

<u>Other Pertinent Issues</u>

- Participants concurred th at any recommendations proposed on the TA Fund should not be rushed.
- The participants expressed the need to understand the use and scope of services possible with the anticipated US $ 4 million TA Fund. The IFC representative explained that the components to be considered for funding were those that would enhance the investees' business processes as opposed to issues that would be fundamental to the deal process with the risk fund manager. Appendix J of the main report provides this information as detailed in the Request for Applications to the Pool of Fund Managers for TA Fund.
- Risk fund managers were encouraged by the Ministry of Trade and Industry representatives to apply for the fund when the advertisement comes up again.

<u>6.5. Comments on the Case Study:</u>

- There was a proposal to consider having more than one case study for comparison purposes.
- Participants greed that there were certain components of the BPI model that are difficult for other funds to copy, specifically the issue of deal flow where BPI has the advantage of working with the SSC on this component. There were various proposals to this end:
  - That the SSC could work with other fund managers as well to provide deal flow.
  - A body should be set up suited to source deals specifically for the risk fund fraternity.
  - Work with existing institutions that can do this as part of their business.
  - A call to fund managers should be more open to their peers and allow for among other issues, cross referencing of deals.

6.6. Other Comments , Proposals and Recommendations

- There is need to i dentify issues that prevent other groups of local investors from investing in the local risk funds.
- There is need for stakeholders to determine the real constraint , i.e. the weakest link in understanding the unique nature of the MSME market from both qualitative and quantitative aspects and provide solutions on this basis. For instance, the risk fund industry is one where a very specific skill set is required.
- Given the fact that it is difficult to use commercial funding (from the fund profits) to resolve most of the constraints as identified, grant funding plays an important role in bridging this gap .
- Risk funds should have a "minimalist" approach, i.e. by cherry picking the right SMEs to invest in and focus on their venture capital bus iness. Other specialized business development, organization(s) will provide the much needed BDS services . Again, a point of reference is the lessons learnt in microfinance industry.
- Overall, s ignificant public funding is needed to develop and scale the risk fund market in Kenya and greater effort by the risk funds should go into sourcing for these funds.
- A proposal for tax incentives for risk funds will play a big role in reducing the costs for risk funds. In this respect, the risk fund managers together need to determine the threshold that would be applied.
- Risk funds could also work with other speci!c f unds to provide venture capital to various initiatives, e.g., consolidating the interests and strategies of different small funds like, youth funds and womens' funds.
- Leasing – stakeholders should educate the government on how this can be introduced to provide the benefit to SMEs.
- The risk fund managers could also act as a voice for the SMEs on various fronts as applicable, for instance, where various poli cy issues affect the SME players.

7. Next Steps and Follow-up Actions

Participants agreed that the following steps should be taken up immediately:

- A meeting will be organized in early 2008 for all SME risk funds to meet with FSD Kenya to review the proposal for the establishment of a local venture capital association and see how this can be instituted.
- The participants that attended the workshop will be invited to take part in another stakeholders' workshop following a study on the Local Long Term Fund Availability that has been commissioned by FSD Kenya. The dates will be communicated to participants in due course.
- The advertisement by the Ministry of Trade and Industry for Request for Applications to the Pool of Fund Managers for TA Fund will be re -worked and sent out to fund managers to invite them to apply for the US $ 4 million TA Fund .

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Financial Sector Deepening

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