# INSIGHTS ON SME FUND PERFORMANCE

## Generating learnings with the potential to catalyse interest and action in SME investing

December 2019

Shell Foundation

OMIDYAR NETWORK

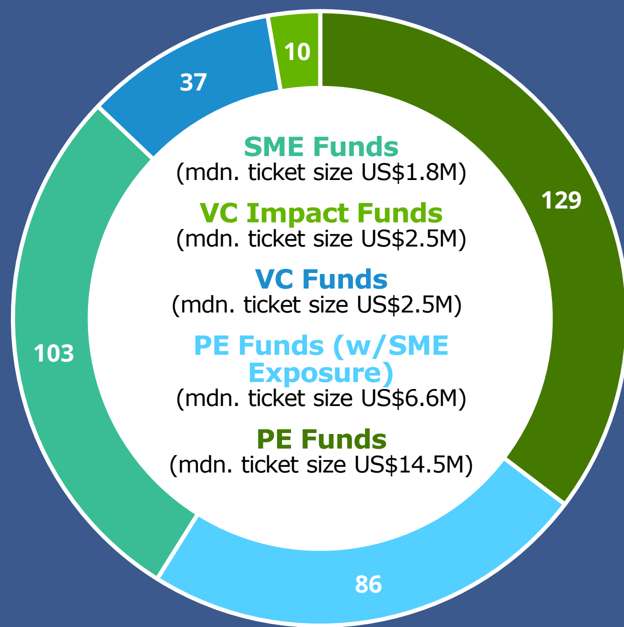
Deloitte.

# Highlights from the analysis of SME fund performance

Small and medium sized enterprises (SMEs) in emerging markets are critical to driving economic growth, creating jobs and working toward the Sustainable Development Goals, contributing up to 60 percent of employment and 40 percent of national income.

These businesses face a significant financing gap, and increasing access to finance can unleash their potential to deliver financial and development returns. However, a lack of data on the risk, return and impact of investments has held back additional capital from flowing into SME segments in emerging markets.

Shell Foundation and Omidyar Network consider SME investing to play a pivotal role in driving job creation and economic development. This executive summary highlights several key findings of a study of SME fund performance, the purpose of which was to **establish realistic expectations for development outcomes and financial returns, to encourage the flow of capital into SME segments**.




Five development finance institutions (DFIs), the largest class of investors in emerging market funds that invest partially or fully in SMEs, provided historic fund data related to financial and development performance. **Financial returns and development outcomes were analyzed for 365 funds**.

### *The analysis revealed five key findings…*

1. SME funds typically demonstrate growth in the underlying businesses but lower returns than other fund types, suggesting it will continue to be a challenge to attract capital to this segment
2. SME fund returns appear to improve up to a 15-year time horizon, suggesting the typical 10-year closed-ended fund structure may not provide the time needed to maximize financial returns and impact in certain contexts
3. Due to the longer horizon of value creation, TVPI and DPI are useful to compare fund types
4. The number of jobs created is the most common impact indicator tracked by DFIs for their SME fund investments, but is insufficient as an indicator of development value
5. Generalist funds show evidence of strong job creation outcomes relative to sector-specific funds, but have demonstrated lower returns on average

### *…with three considerations for investors.*

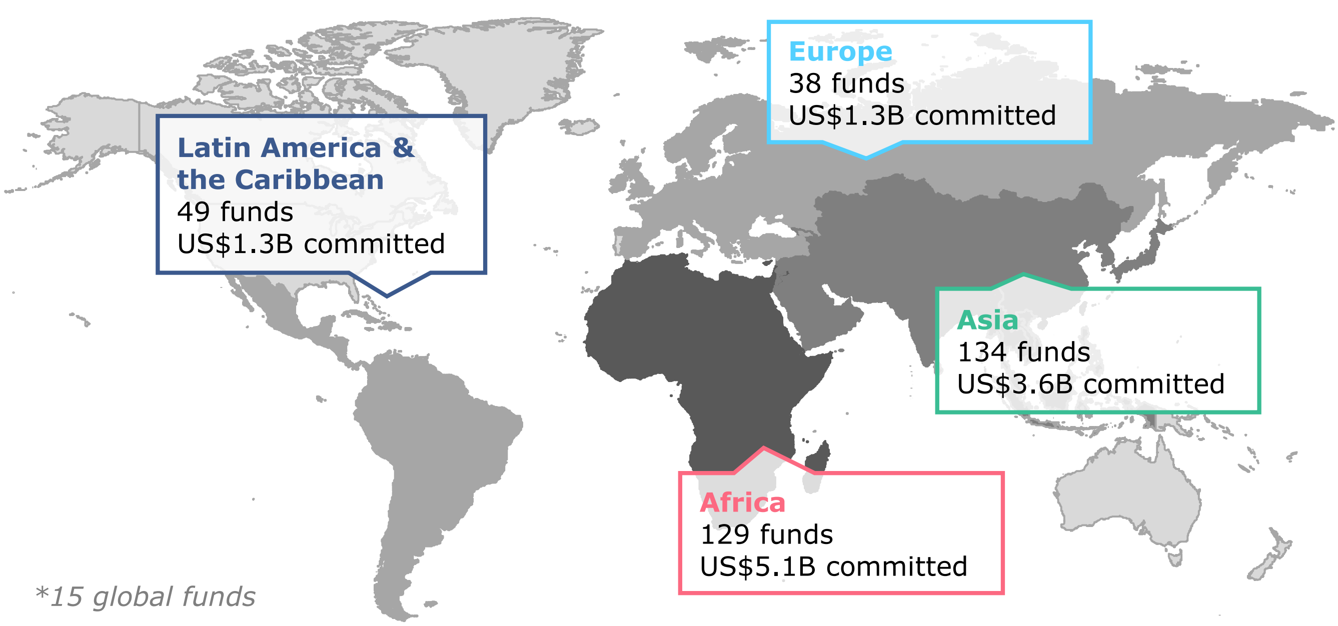
1. Monitor development outcomes beyond jobs created
2. Monitor performance of the underlying portfolio of SMEs
3. Seek fund structures and terms that accommodate the longer horizon to value creation

# Fund performance was analyzed according to fund type and region of investment

In order to compare financial and development outcome performance across fund types, DFIs were asked to classify each fund according to the following segmentation.

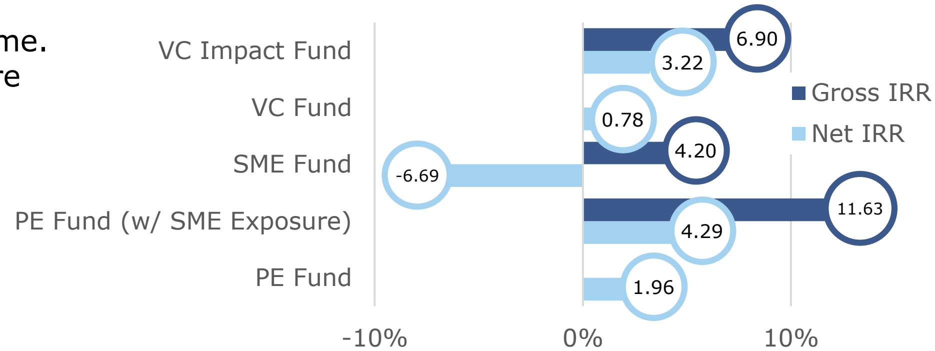
| Fund Type | Strategy | Investment Thesis | Investment Size |
|---|---|---|---|
| **Venture Capital (VC) Funds** | Target **early stage, high-growth, innovation-driven companies.** | **Commercial orientation** seeking returns in line with VC benchmarks; returns often driven by a small number of high performers | Seed, Series A, Series B, generally **$500k to $2M** |
| **VC Impact Funds** | Target **early stage, high-growth, innovation-driven companies aligned to impact.** | **Commercial orientation with a clear impact thesis;** typically seeking VC level returns and exits. | Seed, Series A, Series B, generally **$500k to $2M** |
| **SME Funds** | Target **smaller and/or earlier-stage SMEs** with growth potential, with smaller ticket size debt, mezzanine, or equity. | Often have **strong impact** and additionality orientation regarding SME and financial market development. May have more moderate returns expectations than VC or PE. | Generally **$100k to $2M** |
| **Private Equity (PE) Funds (SME Exposure)** | Target a combination of **medium sized growth-oriented SMEs and larger, later stage companies.** | **Commercial orientation seeking risk-adjusted market rate returns** in line with PE benchmarks. | Generally **$2M to $10M** |
| **PE Funds** | Target **later stage, growth-oriented companies** (typically larger than what is defined as a SME). | **Commercial orientation seeking risk-adjusted market rate returns** in line with PE benchmarks. | Generally **$10M+** |

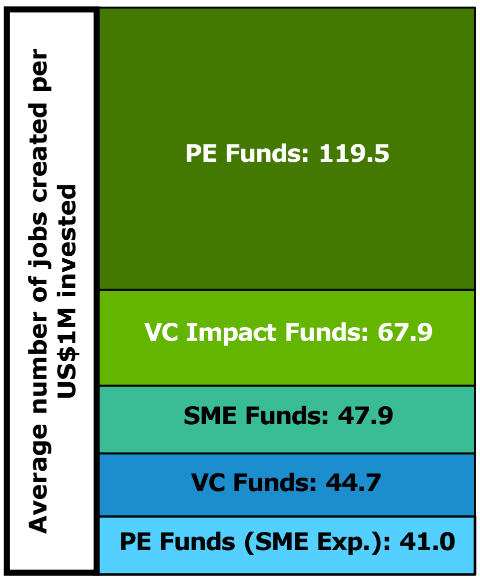
**Financial performance and jobs created varies between region of investment**, likely due to factors including uneven distribution of fund type and size, and country characteristics. For example, Africa is the region with the greatest number of SME funds and investment in low income countries (LICs) in this dataset. While funds investing in lower income countries may achieve smaller returns on average, they are more likely to **bridge financing gaps for SMEs operating in more challenging markets**, thereby maximizing funds' potential impact.



# Benchmarking reveals that typical financial returns and development outcomes vary by fund type

Analysis of the internal rate of return (IRR) and investment multiples shows that **underlying businesses are growing but may take longer to be profitable**. This is evident in the gap between Gross and Net IRR, which indicates firm level growth across fund types, but that factors such as high management fees and FX risk may hamper performance. Investee company size also likely influences fund-level performance. This could attract investors to funds investing in later stage companies with higher chances to provide shorter-term returns. However, investment in small or early stage companies can help SMEs to overcome access to finance challenges, with the potential to achieve similar returns over a longer period of time. SME funds are also investing more in lower income countries, where this financing gap is greatest.




The number of jobs created is the main development outcome indicator monitored by DFIs. **Funds are creating an average of 80 jobs per US$1M invested**. The available data show that PE funds are the most productive fund type in terms of creating jobs. However, funds operate in diverse macroeconomic, political and business environments in countries at varying stages of development, affecting jobs creation potential.

Funds are also working with different types of businesses. PE funds appear to target later stage companies (median ticket size US$14.5M), while SME funds, VC funds and PE funds with SME exposure target smaller or earlier stage SMEs (median ticket size US$1.8 to 6.6M) that must grow before they can generate similar jobs creation results.

Providing technical assistance (TA) may also improve the financial performance of investees. The small fraction of funds that reported providing TA achieved **44 percent greater SME revenue growth** and a higher average IRR. If maximizing development outcomes is a fund's primary objective, providing TA could be an important strategy to maximize investee growth and their potential to create jobs as companies grow.

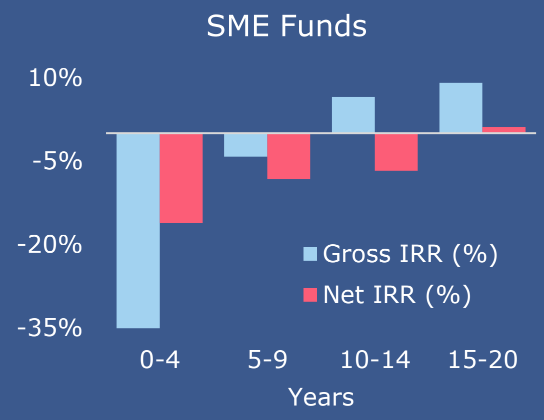
Compared to Net IRR, fund performance appears more favourable when considering investment multiples, Net DPI and TVPI, with the potential to provide positive returns. TVPI and DPI are also more evenly distributed across fund types.

| | Total value to paid-in ratio (TVPI) | Distributed value to paid-in ratio (DPI) |
|---|---|---|
| **VC Impact Fund** | 1.08 | -- |
| **VC Fund** | 1.11 | 0.52 |
| **SME Fund** | 0.84 | 0.26 |
| **PE Fund (w/ SME Exposure)** | 1.15 | 0.55 |
| **PE Fund** | 1.19 | 0.66 |

***Returns are typically maximized with a fund investment horizon of 15 years. SME funds may therefore not be optimized to reach their full potential.***

Based on the available data, **funds are expected to reach a Net IRR of zero after an average of 8 years**. The time needed to reach this point varies by fund type, as PE funds typically require 5.1 years and SME funds 14.6 years.

Funds in the sample have a median fund life of 10 years. However, for select funds with a horizon greater than 10 years, **returns were maximized in the 15-20 year range**, complementing the average of 15 years needed for funds in the Africa PE & VC Index to reach their full value. This indicates a mismatch between the typical fund structure and time needed to realize post-investment value.




# Factors affecting performance

## A number of factors were found to affect financial returns and development outcomes, including country characteristics and sector.

Sector-specific data was limited, and more data is needed to understand variation in performance by sector of investment. However, **fund performance appears to reflect projected sector growth and labour intensity in emerging markets**. Financial returns varied by sector of investment. Funds investing in transportation & infrastructure, agriculture, and health sectors demonstrated the greatest financial returns, while generalist funds (investing in two or more sectors) demonstrated a negative Net IRR on average. Interestingly, generalist funds have made significant investments in the ICT sector, and are the preferred investment type in fragile and conflict-affected situations.

**Sector of investment also appears to affect typical development outcomes**. Funds investing in ICT and transportation & infrastructure, and generalist funds created the greatest number of jobs per US$1M invested. Conversely, financial and energy & extractives sector funds created the fewest jobs. These results reflect IFC modelling of the socio-economic impacts of investments by sector.

| Country income group | Net IRR (%) | TVPI | DPI | Jobs created per US$1M invested | Capital allocated (US$ billions) SME Funds | PE Funds* |
|---|---|---|---|---|---|---|
| Upper middle income countries (UMIC) | 4.69 | 1.24 | 0.65 | 92 | 0.76 | 4.15 |
| Lower middle income countries (LMIC) | - 2.06 | 1.00 | 0.29 | 90 | 1.61 | 4.93 |
| Low income countries (LIC) | - 3.62 | 0.99 | 0.13 | 36 | 0.35 | 1.43 |

**Includes PE funds with SME exposure*

**When funds are categorized according to the income group (based on gross national income per capita) of the country of investment, financial returns and jobs creation are clearly affected**. A significant positive relationship between Net IRR and the World Bank Group's Ease of Doing Business Score, which reflects an economy's position to the regulatory environment most conducive to starting and operating a local firm, was also noted.

**Returns appear to increase with country income group**. Thus, results are maximized in UMICs, possibly due to a more commercial orientation of funds and investment in labour-intensive sectors.

Although there is less investment in LICs, the average TVPI of 0.99 and DPI of 0.13 demonstrate that investments have the potential to provide returns, but may require more time. Likewise, funds in LMICs demonstrate the potential to provide returns to investors, and hold a significant share of the total dollars invested by DFIs.

## The study revealed several findings which have implications for SME fund investing

While this benchmarking exercise is just a first step in generating the evidence needed to evaluate SME fund investing, the study yielded several findings with implications for the field:

1. SME funds demonstrate lower average returns than other fund types, suggesting it will continue to be a challenge to attract capital to this segment
2. SME funds typically achieve positive Gross IRR indicating firm-level growth, but negative Net IRR which may be due to greater investment in lower income countries with higher management fees and FX risk
3. The benchmarking data suggest that SME fund returns continue to improve up to a 15-year time horizon, suggesting that the typical 10-year closed-ended fund structure may not provide the time needed to maximize both financial returns and development outcomes
4. Due to the longer horizon of value creation, TVPI and DPI are useful to compare fund types
5. The number of jobs created is the most common impact indicator tracked by DFIs for their SME fund investments, but is insufficient as an indicator of development value due to factors including stage of the company or market and labour intensity
6. Only a small fraction of funds report providing TA, but those that do appear to generate greater increases to SME revenue
7. Generalist funds show evidence of strong job creation outcomes relative to sector-specific funds, but have achieved lower financial returns on average

## A concerted effort is needed to respond to challenges

Recognizing the financial returns and development outcomes that can realistically be achieved by SME funds, investors must now consider how to drive capital to SMEs in emerging markets. To respond to the challenges identified, investors could consider working to:

1. Monitor development outcomes beyond jobs created
2. Monitor performance of the underlying portfolio of SMEs
3. Seek fund structures and terms that accommodate the longer horizon to value creation
4. Continue to pursue generalist funds, which are well suited if jobs creation is the primary objective, but lower financial returns should be expected

***Overcoming limitations of current monitoring practices to illustrate development outcomes will require standardized monitoring of new indicators. For example:***

**Market development**

a. Local ownership (%)
b. Women in ownership (#, %)
c. Non-DFI capital invested ($)
d. Increase in SME revenues (%)
e. EBITDA (%)

**Employment**

a. Direct jobs (in the company) created (#)
b. Women employed (#, %)
c. Annual average salary per local employee ($)

■ = Already monitored by some or all DFIs

## Acknowledgments

Shell Foundation, Omidyar Network and Deloitte would like to express their gratitude to the DFIs and their representatives that participated in this study. Special thanks to CDC Group, GroFin, the International Finance Corporation, Obviam, and Triple Jump for their participation.

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