Fifteen years Fifteen lessons from Africa

IP INVESTISSEURS & PARTENAIRES

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8 Lesson n°8:
A small investment requires an impact choice and specific support on the structuring of the company

I&P's choice to focus on small investments led by African entrepreneurs in fragile states is clearly rooted in an impact choice. I&P began investing in the Sahel region in 2002 and continues to invest almost exclusively in fragile countries (85% of IPAE1 investments, 100% of IPDEV2 investments, as of today). These countries are very particular in that they have a fabric of SMEs that are still young (some are even still in the development stages), small in size, and largely operating in the informal sector. These SMEs often have a strong growth potential and, as such, a strong impact potential in terms of job creation and knock-on effect on their local ecosystems. Their environmental, social and governance impacts are colossal. Nonetheless, they are hindered in their development by lack of access to long-term finance and equity. They are all the more fragile as they have to face major local challenges beyond the usual (and substantial) internal and sectoral challenges faced by SMEs. There is, therefore, a real consistency in I&P's impact thesis, the small size of the investments it targets, and its preference for companies with a "fragile country" footprint.

SMEs often have a strong growth potential but are hindered in their development by lack of access to long-term finance and equity.

Since 2002, I&P has progressively learned first-hand about the constraints of the economic model inherent in these choices, which were very well known in theory, but had not yet been fully put into practice. How to identify the right thresholds, know the real costs of investing in a start-up or an SME from sourcing to exit, and assess the legal fees and tax issues ... All of this was a mystery to us.

These past fifteen years have allowed us to answer, however provisionally, two essential questions: are profitability and impact mutually exclusive in our business? Why is providing support to the entrepreneurs so costly, and what should be our primary support priorities, in order to maximize our effectiveness ?

Profitability or Impact? Primarily a question of ticket size!

At the risk of disappointing, our answer is categorical: an impact fund dedicated to start-ups and SMEs, whose gross returns can approach or compare with the performance of traditional private equity funds, cannot meet the same level of net returns .

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Private Equity professionals know this perfectly well: the smaller the investment, the higher the transaction and monitoring costs, which, in fact, heavily reduces the investor's net profitability. In other words, if an investment of 300,000 euros has been made in a small company that outperforms over the investment period, the margin generated is only likely to cover external and follow-up costs, which are often very high for these poorly structured companies. As a consequence, investors' net profitability will be lower than what they can expect for large investments in more mature and less risky companies. This size criterion determines the economic model of an impact fund and represents a strong impact choice on the part of all investors who have opted to support I&P since 2002.

This impact choice comes with a series of consequences that have considerably changed the way I&P has operated since its creation in 2002. Based on the pioneering experience of I&P Development 1, I&P has changed its business model to offer a wide continuum of equity financing ranging from €30,000 to €3 million for start-ups and small and medium-sized enterprises (SMEs) in Africa. The purpose is to meet the financing needs of companies that are too large to access microfinance institutions and too small to access traditional financing channels, while adapting the financial vehicles' business models to different return profiles for different categories of investors.

In 2015, I&P launched the IPDEV 2 program, which consists of incubating and sponsoring ten impact funds dedicated to very small businesses in ten African countries over the next decade. They are led by local teams and funded up to two-thirds by African investors, in addition to IPDEV2's contribution as a minority stakeholder. These funds are deeply rooted in the fabric of local economies and offer comprehensive and unprecedented support to firms in Africa, relying on a wide range of financial tools (equity, small no-interest, no-collateral loans, grants, coaching, etc.).

The intermediary set up provided by IPDEV2 offers two levels of returns : the holding company gathers investors primarily motivated by development objectives and whose expectations for returns are close to venture philanthropy. Although IPDEV2 needs to be financially sustainable in the long run, the fund does cover the costs of incubation and technical assistance provided to early stage local investment funds. These locally rooted funds gather local investors together to assist IPDEV2 and target higher returns, in the local currency, consistent with local risk/return profiles. IPDEV 2 contributes to financing very small companies, building local capacities and fostering a new generation of African private equity investors.

In line with the investment continuum, impact funds promoted by IPDEV 2 stop where the pan-African IPAE fund begins. Indeed, IPAE invests in companies whose financing needs are greater than €300,000 and go up to €1.5 million. It targets growing companies, but a quarter of the companies in its portfolio are start-ups. The launch of the IPAE fund in 2012 gave I&P the opportunity to create six offices in Africa, including four in West Africa, (historically the most densely operational region), one in Central Africa and one in the Indian Ocean region. These offices are mainly led by African teams who work over the entire investment cycle and support the entrepreneur to meet his needs on the ground. While remaining below the intervention thresholds of typical for-profit investors, the slightly larger size of the companies funded by IPAE1 and 2 allows their investors to hope for better returns, ranging between market returns and the preservation of capital

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Why are the support costs of investee companies so great and what areas should they target in order to get the best return on investment?

Indeed small businesses that need only small investments also need intense, multidimensional and long-term support. With I&P coming on board, they must formalize and structure their company, set up reliable management tools and an efficient information system, improve their HR policies, etc. Time spent is also much greater than for higher investment tickets and requires the mobilization of patient and sometimes poorly remunerated capital. Today, investors ready to make a trade-off between performance and impact and compromise their expectations of return and liquidity to promote this category of small companies remain very few. Thus we still face a huge deficit of finance that can allow us to assume the triptych of patient capital / below market-rate returns / high risks, which is key to the growth and success of promising, early stage businesses in Africa and which form the so-called "missing middle".

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Steering the company, a more technical mission than it seems

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Challenges in supporting I&P's investees begin even before the investment. For all of the entrepreneurs we have worked with, their partnership with I&P is their first with an investment fund, and in most cases, I&P is also the company's first private shareholder aside from the entrepreneur and his or her friends or family. The negotiation of the entry of the capital therefore very slow because entrepreneurs need to be educated on 4 topics: (i) the relationship with a private equity investor (including financial and legal discussions, which are often new to the entrepreneur), (ii) the company's formalization, (iii) implementation of new governance (the company often has no board we invest), (iv) definition of a new ESG policy.

Once the investment has been made, supporting the company is tough in many cases. The shareholders' agreement must be implemented, as well as the action plan and the new ESG practices. The company's finances need to be restructured and often call for additional debt financing. Building new facilities, such as a plant or offices, requires close on-site monitoring. A number of technological problems may arise. Strategic and commercial management of the business is time consuming in a context of weak support coming from middle management and a fast evolving environment. Many events happen and require strategic intervention/support on the part of I&P.

Nevertheless, our experience has progressively driven us to focus on the information and management systems of the business, as soon as in the due diligence phase is completed. We continue to devote an increasing number of resources to these business systems, although this weighs ever more heavily on our operational budget, because our experience has proven that this focus is critical to the success of our partners.

The vast majority of companies funded by I&P have experienced major problems with their management and information systems. Accounting is often deficient or inexact and auditors inconsistently competent. Cost accounting often does not exist. Physically rudimentary information systems and a low level of computerization of the company are very common. Yet confronted our partners' immense daily operational challenges in sales, purchasing, production, and HR . Unfortunately, we have frequently been slow to prioritize the set-up of a well-functioning information system to run strategic operations because of the cost , ERP (Enterprise Resource Planning) or not. Indeed, it is not possible to think strategically when the costs and margins of the company's products are not known, or only slightly and approximately, and the economic model is not under control. Nor is it possible to manage production and distribution, monitor the commercial policy and billing process and identify potential fraud in the absence of an effective information system.

In recent years, analysis of the company's management information system (MIS) has become a prerequisite for an investment by I&P. In the vast majority of cases this analysis has led to the definition of an action plan, including audits and new administrative, accounting and financial procedures, software and hardware investments and trainings on how to use business management software tools... These simple action steps should not hide the fact that this is a very complex activity: the engagement of business leaders and employees is not always in place and must be built; suitable software and hardware may be difficult to identify and obtain; good international or African consultants familiar with SMEs are scarce and sometimes difficult to mobilize; the costs of information systems are high compared to the turnover of SMEs and their cash flow problems can make a regular investment process difficult; the use of spreadsheets and their rigorous implementation in the field must be promoted by shareholders. All this means that failures exist and can be expensive. **The translation from intention to reality requires strong determination, as well as the construction of a qualified and specific network to transfer skills and know-how to African SMEs**.

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Nevertheless, investing in management and information systems is extremely rewarding and satisfying. Having permanent access to the business margins, costs, economic model, and cash flow and being able to quickly establish solid business plans, etc. represents an invaluable asset for the company. It prevents the entrepreneur and his shareholders from making bad choices or from losing management control, as too often happens in start-ups and SMEs.

This is our eighth lesson from Africa. Choosing to finance small businesses, early stage businesses and start-ups is first and foremost an impact choice. In essence, the lower the investment ticket, the more constrained the economic model of an investment fund, which weighs on the net profitability delivered to investors by over-allocating management costs in relation to the size of the ticket. This is why today, most private equity funds invest more than €5 million per deal where, in reality, there are fewer investment opportunities, perpetuating the phenomenon of the missing middle. For small businesses, and even more so for start-ups, there are very few financing solutions available, even though financing is at the heart of the demand of the African entrepreneurial makeup. At the same time, making an impact choice is not always easy for investors, who have an increasingly wide range of options in the world of "impact" that lead some to believe, often wrongly, that no trade-off between profitability and impact must be made. The impact choice and its consequences on the business model depend on the monitoring costs, which are high for these SMEs. It is possible to reduce costs and make these companies more profitable, thanks to a good information and management system, which does not always appear to be a top priority for the entrepreneurs.