EXECUTIVE SUMMARY

How can African SME funds mobilise more capital? Data and lessons from pioneering LPs and GPs

Enriching current research with aggregated fund economics data and highlighting key lessons from GPs and LPs.

Despite its potential to deliver on the Sustainable Development Goals, particularly those targeting 'No poverty' (SDG 1), 'Decent work and economic growth' (SDG 8) and 'Industry, innovation, and infrastructure' (SDG 9), SME investing remains an overlooked segment of the private capital landscape in Africa. Decades after the term was coined, there is still a 'missing middle' in private capital finance on the continent and an unmet funding need estimated at a staggering $140bn*.

This report contributes to the learning agenda on improving access to finance for African SMEs, by highlighting solutions for SME funds to mobilise more capital. Pioneering practitioners and industry organisations, such as African Venture Capital Association (AVCA), Collaborative for Frontier Finance (CFF), Convergence, Dalberg, Dutch Good Growth Fund (DGGF), and Omidyar Network, among others, have done considerable work to segment SMEs and the funds that invest in them, document the challenges they face, and highlight the case for a more robust funding ecosystem.

However, there is still very limited aggregated and publicly available data when it comes to the fundraising performance and financial returns of African SME funds. This report documents the economics of SME funds; it provides data, often challenging existing preconceptions, to help ground current debates in the sector and generate new insights on the drivers of performance.

This report is only one step, and its conclusions need to be challenged and refined with an expanded sample of data, and in response to more direct input from GPs and LPs. We call for feedback on this first version from all players in the sector and envision a collaborative process leading to a subsequent report with more insight and data and with strengthened conclusions and recommendations.

* Convergences. 2024. R. Ivory., E. Pullela. How can blended finance help improve African SME's access to finance? [Consulted online]

Key findings

The past decade has seen the emergence of a growing and denser SME fund ecosystem.

The SME fund ecosystem has become geographically more diverse, now spans across asset classes, and above all is attracting more talent exponentially. In stark contrast to 15 years ago, it has become an African-led ecosystem: the vast majority of fund managers are now based in Africa, 80% are led by African GPs (66%) or mixed African-foreign GPs (13%), and 69% have raised capital from African public and private investors. This includes not only established SME funds (pioneers 15 to 20 years ago) who are mobilising more capital and diversifying their instruments for SMEs but also many first-time and emerging fund managers who are entering the space. The diversification of LPs has supported this growth with African sovereign and private capital, private foundations, international family offices, and other catalytic funders complementing the pioneering role of DFIs.

This SME fund ecosystem growth remains tenuous in relation to the needs of SMEs and their role in the development trajectory of the continent.

The unmet funding need for African SMEs remains estimated at $140bn*. SMEs are the fastest providers of decent formal jobs, and they drive value-adding economic growth and innovation. Most are neglected by the traditional financial sector, as they typically have little collateral, and innovative business models. SME funds can provide risk capital to these companies in the form of equity, quasi-equity, mezzanine, or straight debt, alongside management support and technical assistance; this support can unlock SME potential for developmental outcomes and financial returns.

Starting and running a SME fund is a journey plagued with challenges.

SME funds are most often pioneers in their market, operating with considerable additionality and being the first investors in the companies they target. They support SMEs with investment readiness (p.114), build investment talent from the ground up (p.132), and play a key advocacy role to attract African capital (p.114) and support enabling regulatory environments (p.127). In this context, they face numerous trade-offs.

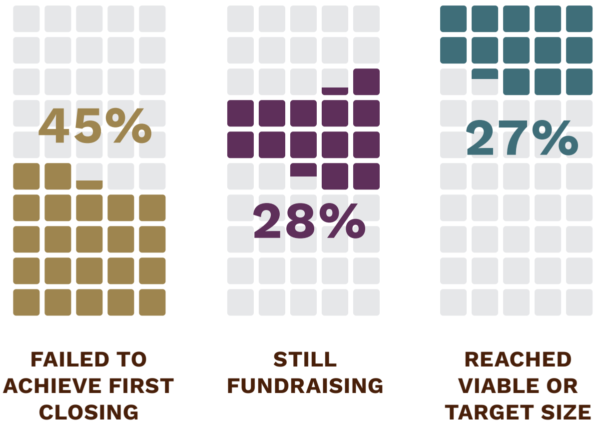
> It is structurally difficult for SME fund managers to deliver market-rate returns to LPs due to high relative transaction costs, lower liquidity, and exposure to country or macroeconomic risk (p.109). They must vastly outperform larger funds in terms of gross returns in order to deliver the same net returns. Most SME funds have historically delivered below-market returns for LPs (to Omidyar data) with challenging liquidity (link).

> It is structurally difficult for SME fund managers to sustain their own economics and retain a team. The very tight model of running a SME fund has forced most of the pioneering SME fund managers to abandon investment in SMEs as they increase their ticket size and fund size, with only a minority remaining focused on this space (p114). Today, most SME funds are led by first-time and emerging fund managers raising small fund sizes and struggling to attract and retain talent (p.20).

> Emerging fund managers face very challenging fundraising odds. Indeed, 45% fail to achieve first close, and those who do achieve it take two years on average and then additional time to reach their final target fund size.

GLOBAL SAMPLE

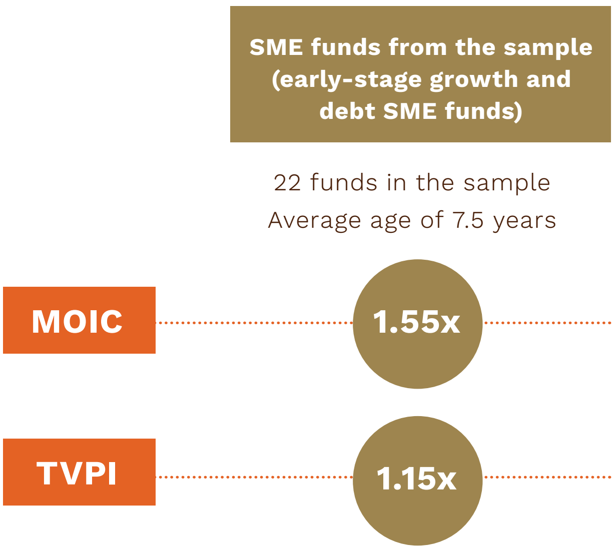
FIRST-TIME AND EMERGIGNG FUND MANAGERS



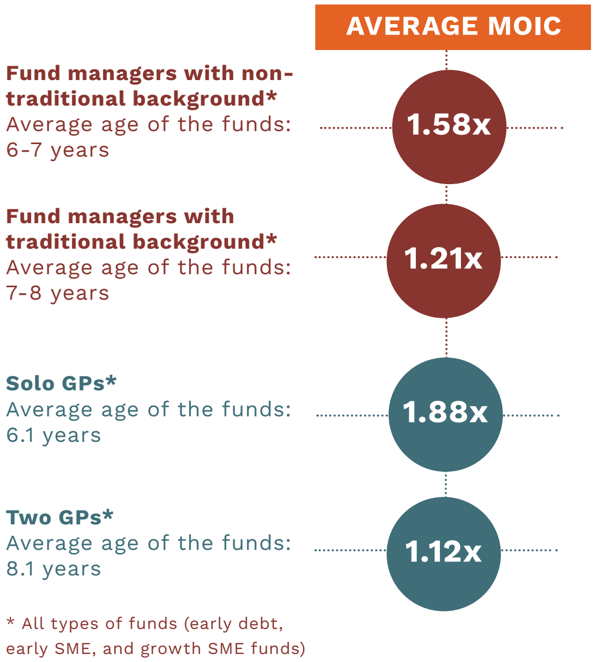
Historically, most LPs in the sector have built criteria that focus on reducing risk and end up excluding most emerging fund managers (p.38): these LPs typically do not back small fund sizes, first-time and emerging fund managers with non-traditional track records, solo GPs, country-specific funds, etc. These restrictions make it very difficult for first-time and emerging fund managers, where female and African fund managers are most highly represented, to raise capital from international investors.

SME fund managers are implementing solutions to these challenges.

> Their fund returns are improving: SME funds launched since 2015 have been delivering higher average gross returns than the previous generation of funds (p.109) thanks to a combination of an improving environment, strong market positioning, fast organic growth, and deep management support. These gross returns translate to positive net returns reached earlier than by the previous generation of funds (p.114).



Within our sample of SME funds, first-time and emerging fund managers with non-traditional backgrounds are performing very well (p.38), as are solo GPs (p.38). They are challenging conventional LP criteria and suggesting that a traditional track record is not a reliable proxy for fund performance.



> They better match liquidity with investor constraints by incorporating self-liquidating instruments in their strategy and by designing innovative fund structures such as longer-term closed-ended funds, permanent capital vehicles, and hybrid funds (p.99). They tailor their fund structure, currency, and country risk management to their fundraising strategy and investor base (p.88), including by domiciling their funds in new locations. Such strategies create a diverse panorama of fund structures with real success in raising capital.

> They design more robust fund management companies by challenging traditional fund terms on management fee and hurdle rates (p.109), building alternative models for investment readiness and portfolio support, reaching economies of scale via horizontal growth (p.116), and finding pragmatic ways to retain key talent (p.131).

In a difficult fundraising landscape, SME fund managers leverage new opportunities to mobilise more capital.

> Emerging fund managers triple the odds of achieving their target fund size by raising progressively or partnering with sponsors and platforms. Raising progressively (p.88) implies setting up pilot funds, mobilising personal, angel, and warehousing capital to build track record, and leveraging catalytic and philanthropic initiatives to design a fund and build a team.

	FAILED TO ACHIEVE FIRST CLOSING	STILL FUNDRAISING	REACHED VIABLE OR TARGET SIZE
EMERGING FUND MANAGERS WHO STARTED SMALL WITH A FUND SIZE < $5M	13%	35%	52%
EMERGING FUND MANAGERS WHO STARTED WITH A TARGET FUND SIZE > $5M	60%	24%	17%

Partnering with fund platforms and sponsors (p.88) accelerates the fundraise and triples the odds of reaching the target size.

	FAILED TO ACHIEVE FIRST CLOSING	STILL FUNDRAISING	REACHED VIABLE OR TARGET SIZE
EMERGING FUND MANAGERS **BACKED** BY A SPONSOR	22%	17%	61%
EMERGING FUND MANAGERS **NOT BACKED** BY A SPONSOR	50%	30%	20%

> They focus their fundraising efforts on specific pools of capital.

- Impact funding windows from international DFIs (p.55) have anchored several emerging managers; their investment criteria (fund size, terms, etc.) focus them on growth SME funds and VC funds.
- In order to reach first close, SME fund managers raise private capital from African corporates (p.60) and individual investors (p.60).
- African sovereign investors have grown to become a critical element of the funding space, with the example of VCTF in Ghana leading the way (p.67) and a multiplication of sovereign funds, public pension funds, and domestic and regional DFIs allocating capital to SME funds.
- Pan-African funds-of-funds (p.73) with a catalytic and/or impact mandate have become critical enablers of emerging fund managers, especially early-stage SME funds and SME debt funds, by playing an essential anchoring role and providing fundraising and fund design support. Some have also provided catalytic capital in the form of working capital, warehousing capital, and junior tranches.

There is **much more research to be done on the performance of African SME investing**, which can be achieved thanks to stronger collaboration in the sector, including:

- Expanding the understanding of African SME fund returns by including more funds and more asset classes and geographies.
- Exploring the trade-offs between impact performance and additionality on the one hand, and the profitability of SME fund models on the other by cross-analysing impact and returns data.
- Assessing how catalytic capital instruments influence fundraising performance and fund returns, as well as the additionality and impact of investment strategies, to determine how they can support the growth of the sector.
- Exploring the opportunities and constraints for African private and sovereign capital to unlock more allocation to the SME investing sector.
- Researching the mainstreaming of gender-lens investing within SME funds, including gender-diversity in fund management companies, representation of women in SME portfolios as owners, managers and employees, and adoption of gender-inclusive best practices in SMEs.

Key recommendations

Combining the lessons learned by practitioners in the space with recent data has helped identify the recommendations below for LPs, GPs, and ecosystem funders ("E").

PART 1

TREND #1: A multiplication and diversification of Africa-based funds over the past 30 years

The three segments of early-stage SME funds, growth SME funds, and SME debt funds remain under-researched; more data and sharing of lessons will build understanding of these segments for LPs and new GPs.

1. A data-sharing initiative will improve LPs' knowledge of fund performance in the sector and support new GPs in designing their fund; this requires collaboration. E

2. New LPs can be attracted to the asset class by receiveing more aggregated data and lessons on fund performance and fund models. LP

3. A particular research focus on funding models for early-stage SMEs is necessary to highlight how catalytic capital can solve some of the particular constraints faced in this segment. E

TREND #2: Raising a SME fund remains very challenging, especially for newcomers in the space

LPs can adjust their assessment criteria in order to back strong performing teams, including first-time and emerging fund managers with non-traditional backgrounds.

1. Assessing a first-time and emerging fund manager requires a more granular approach than looking at track record. LP

2. LPs can back lean teams, including solo GPs, to benefit from their advantages while mitigating some of the risks. LP

3. Creating equitable opportunities for women can take multiple approaches. E

4. There is a need for a flexible approach with respect to a GP's skin in the game. LP

TREND #3: International DFIs are still the leading players in SME fund investment – today, they invest mainly in larger funds

DFIs can continue building the market of African funds by complementing their existing range of instruments.

1. Increasing investments in SME funds and adapting terms is key. LP

2. Collaborating more closely with non-DFI investors could increase DFI allocation to SME funds. LP

3. Data shows that African private capital is more likely to invest in African SME funds than international commercial capital to; DFIs can find solutions to promote this trend. LP

4. DFIs can invest in funds-of-funds to target the smaller fund sizes that they are not able to fund directly, particularly SME debt funds and early-stage SME funds. LP

TREND #4: African private and sovereign capital is increasing its allocation to the sector, but there is still significant room to grow

Unlocking the pools of domestic capital will build a more resilient fundraising environment.

1. Engaging African/domestic capital in fundraising is a strategic priority for GPs. GP

2. Investing in African funds can be attractive for domestic investors. LP

3. Catalytic funders will be essential to unlock these domestic pools of capital. E

TREND #5: New catalytic capital funders have been decisive in building the market, but there is much more to be done

Increasing the amount of catalytic capital will speed up the mobilisation of capital for African SME funds.

1. A range of catalytic tools are key to empower a new generation of fund managers: working capital, warehousing capital, junior tranches, direct opex support. E

2. Funds-of-funds can scale with the right support. E

PART 2

Trend	Findings
TREND #1: Emerging fund managers are adapting their fundraising strategy to navigate LP dynamics	**Successful emerging fund managers have taken a progressive road to fundraising; an enabling environment is needed to facilitate the launch of new funds.** **1.** In the absence of a strong enabling environment, emerging fund managers should plan for a 2 to 4-year step-by-step fundraising sequence. GP **2.** There is a strong opportunity for new GPs to partner with other GPs or sponsors/ platforms and improve their odds on the fundraising market. GP **3.** Catalytic funders can facilitate the emergence of new SME funds by filling the most glaring gaps: availability of launch working capital, warehousing capital, anchor investment, and junior tranches. E
TREND #2: Better matching the liquidity profile of SME funds with the horizon of SME investments	**Fund structures can better match SME investment horizon constraints with LP liquidity objectives.** **1.** Raising open-ended hybrid funds or permanent capital vehicles can be the right option for raising a new SME fund. GP **2.** Adapting the liquidity requirements to the longer cycle of SME investing can improve fund returns while mitigating liquidity risk. LP **3.** Developing a secondary liquidity market for fund investments is an important next step for the ecosystem. E
TREND #3: The return profile of SME funds is showing improvement	**Recent data provides novel insights into SME fund performance.** **1.** Acknowledging the structural challenges of SME investing is a first step towards finding solutions to improve the returns of GPs and LPs. E **2.** Available data shows how certain LP perceptions (track record, first time manager risk, etc.) are not in line with the reality of returns achieved. LP **3.** SME investing is an impact choice; GPs must demonstrate how their approach and background enables them to overcome important structural challenges to provide returns; they can pursue alternative ways to grow as fund managers, in order to avoid creeping up and neglecting SMEs. GP
TREND #4: Options for fund domiciliation are multiplying but many markets are yet to design enabling environments	**Enabling environments are necessary to promote the growth of private equity and SME investment in key African markets.** **1.** GPs can adapt the domiciliation of their fund to their fundraising strategy, with an increasing number of options at their disposal. GP **2.** Advocacy from SME investors and LPs is necessary to promote enabling tax and regulatory environments across African markets and to develop domestic private equity markets. E
TREND #5: Currency and political risk cannot be overlooked by GPs	**Fund managers manage currency and country risks; ecosystem initiatives can help mitigate exogenous shocks.** **1.** Expanding access to and subsidizing currency hedging for SME fund managers will increase local currency financing. E **2.** Providing risk-sharing mechanisms for country and political risk will enable international investors to commit to emerging funds. E
TREND #6: Building and retaining talent against all odds is key	**Moving towards a new generation of African fund managers and investment teams.** **1.** Adequate support for new fund managers helps navigate the challenges of fund design and should be combined with working/warehousing capital. E **2.** Training investment teams and not only fund managers will grow the talent pool for SME funds. E