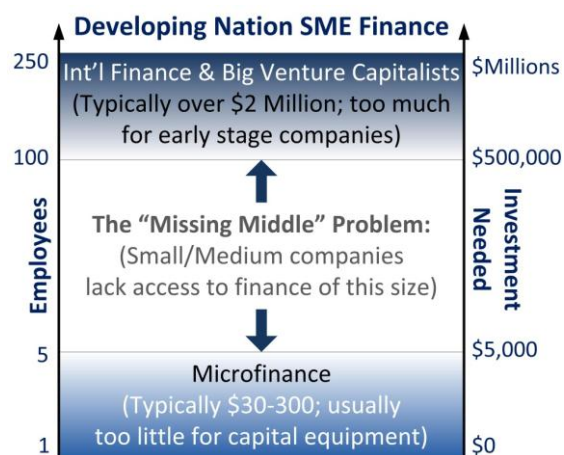


Micro-Venture Capital: Financing the “Missing Middle”

Introduction to the SME Finance Problem/Opportunity

Rightfully, Small and Mid-sized Enterprises (SMEs) are receiving much attention in the developing world:

1. Developing nations have a large number of very small and static businesses and handfuls of very large businesses.¹ This shortage in the middle plays out in society. For example, persistent malnutrition and hunger are not caused by a shortage of food. Instead, more than half of all crops are wasted.² This is due to post-harvest losses caused by a shortage of businesses: storage, processing, transportation, and distribution.
2. Moreover, SMEs account for the dominant form of employment, most job growth, and most innovation.^{3,4} Therefore, spurring SMEs growth is critical for both solving societal problems and creating economic growth. Financial empowerment of the poor, especially SMEs, has significant impact on poverty reduction.⁵
3. Many financial services have attempted to target SMEs in developing nations. Notable examples include microloans as pioneered by the Grameen Bank, voucher plans as used for crop inputs, cash flow financing as provided by Root Capital and large capital investments as by SEAF.
4. However, a careful mapping of available SME finance reveals a gaping hole known as “The Missing Middle”. At the bottom there is microfinance supporting micro-businesses such as farming, tailoring and retail shops. At the top there are large investments available to successful large entrepreneurs.^{6,7} This gap is demonstrated to be the most important factor limiting development in poor nations.^{8,9} (See diagram.) The Missing Middle is both a finance gap and a business gap.
5. Startup and early stage SMEs suffer from an 80% failure rate^{10,11} even in developed nations. Therefore, it is not appropriate for traditional bank finance to fill this gap. Banks don't have mechanisms to properly evaluate and manage such risks.
6. In Cheetah Development's survey of efforts to support SME finance in the Missing Middle gap, we have only found Agora Partnerships operating in Central America focused on this most needed space. There are a handful of other organizations that will occasionally provide finance in this range. However, they are usually exceptions to their standard investments or provided to large enterprises.



SMEs are central to development. They are in short supply in developing nations due to a lack of finance in the Missing Middle (about \$5,000 to \$500,000 USD). Efforts focused on resolving this gap are few.

Cheetah's Solution

Venture and Equity Capital Models

Beginning around 1980, venture capital and equity funds (VCs) began to grow. The USA saw the funds raised go from almost nothing to over \$500 billion¹² annually. This successfully institutionalized a model of using equity investments to fund startup, early stage and growth within SMEs. Indeed, VCs tend to outperform public stock markets¹³ – a remarkable achievement given that 80% of startups fail and public stocks are heavily weighted with large and successful companies. Success has created the extraordinary growth in funds. It is due to a relatively simple model:

- Investments carefully vetted: only about 1/200¹⁴ businesses seeking equity investments get them.
- They include an equity position granting rights to the investor like management oversight and preferred stock.
- Investors provide close assistance with development activities, staging in funds upon achieving milestones. Highly qualified personnel are assigned to work with investees to assure a focus on key issues and success.

If a business receiving investment is more carefully vetted and provided better support then it is more likely to succeed. This is expensive work, causing VCs to lean towards ever larger monetary investments so as to achieve high return on their resources. Thus the Missing Middle finance gap exists because VCs don't make the relatively small investments of that size. Nevertheless, venture and equity capital models can manage dozens of investments with a very small staff of 10-20 people.¹⁵ The model is demonstrated to be remarkably scalable.

The venture capital approach reverses the typical 80% business failure rate into an 80% success rate.¹⁶

Micro-Venture Capital

Cheetah Development proposes addressing the Missing Middle by lowering the cost of venture capital investments. There are three proven approaches that are being taken to do this:

1. Repeatable franchise/chain approach: VCs overcome failure through intensive assistance. Franchise operations provide assistance through pre-tested business plans and have been shown to work in developing nations.¹⁷ This repeatable form of support spreads the expense across many operations with the success of franchises exceeding 90%.¹⁸ This model can scale small investments into big impact. Therefore, Cheetah prefers investments where support provided is immediately repeatable.
2. Microfinance approach: microloans achieve high rates of repayment by creating a loan environment where a group of people are jointly and severally responsible.¹⁹ This creates group accountability and a built-in vetting mechanism. Therefore, Cheetah prefers investments placed in SMEs that have shared ownership.
3. Volunteers and internships: support costs are reduced by supplanting company expertise with specific technical or financial assistance provided by volunteers²⁰ or student interns. Student internships build the next generation of leaders.²¹ Therefore, Cheetah structures its operations to integrate such assistance.

By using these three primary approaches (and others) Cheetah can lower the cost of making venture-capital style investments, leveraging that demonstrated model of success.

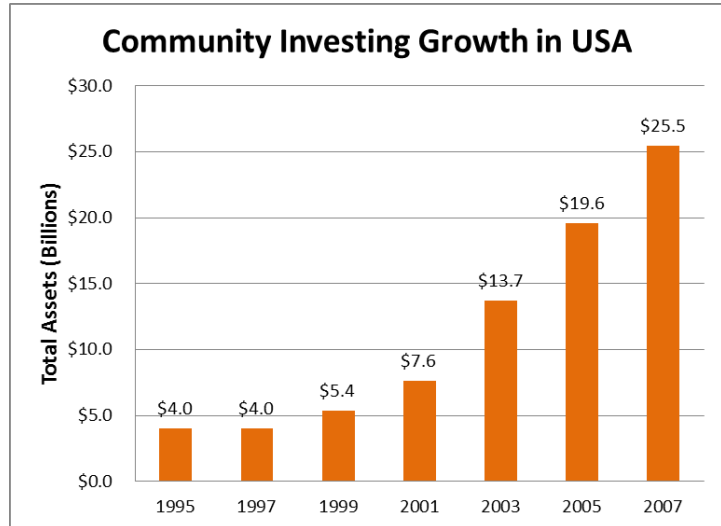
By lowering the cost of managing investments, Cheetah will apply the VC model to smaller investments in SMEs and directly address The Missing Middle. Cheetah calls this model, Micro-Venture Capital.

Building Capital Sources

By using an investment instead of a traditional aid model, problems are avoided²² and new opportunities are realized, including the ability to tap the different and larger investment fund pool.^{23 24} Cheetah is targeting three sources for funding the micro-venture capital model: Community Investing, Commercial Finance, and Local Investors.

Community Investing

Socially conscious investing is growing rapidly. Much of this is being placed in traditional businesses that have a socially positive impact, for example, solar energy. However, a significant and rapidly growing amount of money is in a narrower segment, termed “Community Investing,” which focuses on investments designed to change the lives of the poor. Investors seek both return on their monetary investment and a human impact. (See graph.²⁵)



Such funds are even attracting major firms like JP Morgan²⁶ and Charles Schwab. Cheetah has worked hard to clear legal and regulatory hurdles and is prepared to receive investments from private individuals, trust funds, and institutions. All investments are registered with a Fortune 500 bank having a trust relationship with Cheetah.

Commercial Finance

Cheetah has pioneered an agreement with the Tanzania Investment Bank²⁷ that calls for matching investment funds in Cheetah managed projects. This has major impacts: 1.) It leverages commercial money into SME Missing Middle finance; 2.) It provides a degree of accountability to all investments; 3.) It brings localized enforcement mechanisms.

Cheetah also works with microfinance providers leveraging their services to increase the participation of micro and small SMEs in its investment schemes and bulking up the total amount of finance delivered. For example, micro-franchisees can use microloans. This creates a virtuous feedback cycle between microfinance and micro-venture capital. All commercial financing requires Cheetah to raise the primary funds.

Local Investors

Cheetah’s model shifts equity back to local owners once the investment is recouped. There is a moral hazard when local investors don’t have a stake in a venture’s success. So Cheetah requires local people to raise a significant, albeit minority stake. Not everyone in a poor nation is poor but finding suitable local investors can be challenging.

The investment approach can tap a larger fund pool than traditional aid but it must do so with a new paradigm.

References and Notes

- ¹ Transatlantic Innovations in Affordable Capital for Small-and Medium-Sized Enterprises (Prospects for Market-Based Development Finance), 2007 The German Marshall Fund of the United States.
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- ³ "What makes affordable capital for SMEs so important? SMEs represent the dominant form of business organization worldwide, accounting for roughly 95 percent to 99 percent of enterprises depending on the country. They account for two-thirds of private sector employment and are the primary source of job creation in Organisation for Economic Co-operation and Development (OECD) countries. SMEs can have a multiplier effect on the economy by accelerating employment, raising incomes, spurring consumption, increasing locally-sourced inputs, and widening the tax base. They can lead to new products, services, and business models that fundamentally alter an industry and help launch a new one resulting in higher productivity. The agglomeration of SMEs helps to create new jobs, build supply chains, and forge dynamic business clusters linked to global markets through trade and investment." -Transatlantic Innovations in Affordable Capital for Small-and Medium-Sized Enterprises (Prospects for Market-Based Development Finance), 2007 The German Marshall Fund of the United States.
- ⁴ In the USA small businesses: Represent 99.7 percent of all employer firms; Employ just over half of all private sector employees; Pay 44 percent of total U.S. private payroll; Have generated 64 percent of net new jobs over the past 15 years; Create more than half of the nonfarm private gross domestic product (GDP); Hire 40 percent of high tech workers (such as scientists, engineers, and computer programmers); Are 52 percent home-based and 2 percent franchises; Made up 97.3 percent of all identified exporters and produced 30.2 percent of the known export value in FY 2007; Produce 13 times more patents per employee than large patenting firms; these patents are twice as likely as large firm patents to be among the one percent most cited. Sources: see the Office of Advocacy's [Research and Statistics page](#); U.S. Dept. of Commerce, Bureau of the Census and International Trade Admin., Advocacy-funded research by Kathryn Kobe, 2007; CHI Research, 2003; U.S. Dept. of Labor, Bureau of Labor Statistics.
- ⁵ This subject has much consensus. For example, Building Inclusive Financial Sectors: The Road to Growth and Poverty Reduction, Journal article by Kathryn Imboden; Journal of International Affairs, Vol. 58, 2005
- ⁶ According to the World Bank, access to investment for large enterprises in the developing world is not nearly the limiting factor that it is for SMEs. Source: Thorsten Beck. "Financing Constraints of SMEs in Developing Countries: Evidence, Determinants, and Solutions." Working Paper. World Bank, April 2007
- ⁷ According to Technoserve, there is more money at an investment size of \$500,000 and above looking for investment prospects in Tanzania than there are businesses to invest in. (Hilary Miller Wyse, conversation, 2009)
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- ¹⁰ US Small Business Administration Report, Businesses studied from 1992 to 2002
- ¹¹ <http://www.commfund.org/wp-content/themes/cff/assets/docs/SBA%20FAQ%20-%20Aug%2007.pdf>

- ¹² For a wide variety of data on VC and private equity funding see: <http://www.pegcc.org/pe-by-the-numbers-2008/>
- ¹³ Returns on venture capital (VC) investments continued to improve for the fourth quarter and all of 2010, for most time horizons stretching back to 1981, and in some cases exceeding the benchmark stock indexes. These data are contained in the latest Cambridge Associates U.S. Venture Capital Index, prepared for the National Venture Capital Association. For 2010, VC investments returned 13.5 percent to investors, with late- and expansion-stage funds returning 28.2 percent, well outperforming early stage (13.1%) and multi-stage (8.5%) funds. Over a five-year period, the 5.7 percent return for VC investors beat the Dow-Jones Industrial Average (4.3%), Standard & Poors 500 (2.3%), and NASDAQ Composite (3.8%) indexes.
- ¹⁴ Based on conversations over 20 years with numerous VCs by Raymond Menard.
- ¹⁵ Based on conversations over 20 years with numerous VCs by Raymond Menard.
- ¹⁶ Based on conversations over 20 years with numerous VCs by Raymond Menard.
- ¹⁷ Several replicable business models that have flourished in emerging markets. In particular, they studied a number of profitable traditional micro-franchises – very small-scale, often single person franchisees profitably distributing a standardized branded product or service. “The simplicity of the business model in meeting an underserved market need is the key to their success.” Franchising in Frontier Markets: What’s Working and What’s Not. A report by Dalberg Global Development Advisors with support from the John Templeton Foundation (JTF) and the International Finance Corporation (IFC). December 2009.
- ¹⁸ During the 2007 census in the United States, franchise businesses accounted for 10.5 percent of businesses with paid employees in the 295 industries that franchising data was collected for. Additionally, franchise businesses contribute \$1.3 trillion of the \$7.7 trillion in sales in these industries and is responsible for paying \$153.7 billion in total payroll to its 7.9 million workers. (http://www.census.gov/newsroom/releases/archives/economic_census/cb10-141.html) The franchise business model has exploded in popularity over the past few decades. One of the most attractive attributes of the model is that it’s shown success rates of more than 90 percent. (GERBER, M.E. 2001. The E-Myth Revisited: Why Most Small Businesses Don’t Work and What to Do About It. New York: Harper Collins)
- ¹⁹ The Economics of Microfinance, Second Edition by Beatriz Armendáriz and Jonathan Morduch (May 31, 2010) provides an excellent review of microfinance dynamics.
- ²⁰ Volunteering may be provided by people who are investors or have a humanitarian outlook.
- ²¹ Students are well equipped to work on accounting, surveys, communications, marketing, etc.
- ²² It is widely recognized (including such notable books as Dead Aid by Dambisa Moyo and The White Man’s Burden: Why the West’s Efforts to Aid the Rest Have Done So Much Ill and So Little Good by William Easterly that traditional aid is not measuring up to expectations. This mixed record is especially poor in creating economic success. Further, donor funds are waning and/or subject to severe swings with national economies. Sustainability is in question.
- ²³ Retail investors represent nearly ¾ of all dollars invested (\$17.1T in total in 2005) - “The Future of Advice” Tiburon Strategic Advisors 2005
- ²⁴ Median US household has \$1,000 to donate but \$50,000 to invest - Source: 2007 Report on SRI Trends in the US, Social Investment Forum
- ²⁵ Social Investment Forum Foundation
- ²⁶ For example, see JP Morgan study: Impact Investing, An emerging asset class, November 2010
- ²⁷ Details available upon request.