

## Capital Aggregation

### Briefing Paper for ANDE Conference Session

#### Introduction:

ANDE members have identified significant constraints along the ‘supply chain’ of capital that impede the flow of funds into the small and growing business (SGB) sector. While the supply, or volume, of capital available from interested investors – such as high net-worth individuals, foundations, private banks and other financial institutions – does not appear to limit the growth of the SGB sector, this ‘interested’ capital is not being deployed to intermediaries and beneficiaries in large quantities, nor within an efficient and effective system.

A number of reasons have been identified, including:

#### Investors:

- Highly diverse range of investors ‘interested’ in the small and growing business sector
  - High net-worth individuals
  - Private foundations
  - Private banks and family offices
  - Financial institutions
- Highly diverse and variable investor goals
  - Return and risk expectations
  - Sector focus – education, health, entrepreneurs
  - Geography focus – Africa, Latin America, or specific countries and regions within
  - Leadership and branding requirements
- High fund-search costs and information asymmetry on the models and return expectations
- Investment sophistication and knowledge of the challenges in the small and growing capital investment sector

#### Intermediaries:

- Highly-fragmented intermediary market,
- High transaction costs (term sheets, reporting requirements, etc)
- High due diligence costs relative to the size of the investment
- Variety of for-profit and non-profit models with unique goals, focus, returns and structures
- Minimal number of funds and realized returns across the sector
- Communication and targeting of investors
- Unknown number of intermediaries and financial institutions in developing countries

The diversity of investor interests is solved in other markets –such as microfinance or private equity– by the availability and diversity of fund vehicles from which investors can choose. When an investor wishes to enter microfinance, or private equity, or any other asset class, they can invest in a variety of financial products by sector, return, geography and beneficiary. The small and growing business sector has not yet established a structured and robust ‘market’ for financial products for investors.

Increasing the number of capital aggregation vehicles focused on the small and growing business segment, that aggregate investor interests and capital may be one solution. ANDE could play a catalytic role in facilitation or seeding of various vehicles according to investor needs.

A number of supply-side capital aggregation models that ANDE could facilitate can be considered:

- 1) Fund of Funds – aggregation of investor capital to invest in a portfolio of fund managers;
- 2) Investor Circle / Angel Investors Club – a formal or loose network of investors to identify and invest in small and growing businesses;
- 3) Pool of Funds – aggregation of investor capital to construct a pool of differing expectations, returns, stages and sectors or geographies;
- 4) Co-investment Vehicle and Network – allows investors who normally invest in a fund to directly invest in a business or project alongside the fund manager; and
- 5) Loan Guarantee Fund – loan guarantees provided to intermediaries to increase capital deployed and reduce default risk.

Each of these supply-side models is discussed in the following pages. While this list is not exhaustive, there may also be other approaches, or variations to these structures, that ANDE members could consider. For example, ANDE could facilitate opportunities for demand-side capital aggregation vehicles such as in supply chain finance. ANDE could identify industry value chains, or international companies working in developing nations, who source products and services from small and growing businesses. ANDE could work with these ‘sourcing’ companies to structure a fund or vehicle to provide capital to the small and growing businesses in its local supply chain.

Each model will be suitable under particular conditions and investor profiles. In selecting a model to facilitate, seed or promote, a number questions should be asked.

Does the capital aggregation model:

- Increase the pool of capital available to intermediaries and small and growing businesses?
- Meet investor return, risk, sector, and geography goals?
- Meet investor branding goals?
- Reduce transaction and due diligence costs?
- Facilitate the identification of quality investment opportunities?
- Minimize management fees, balanced against reducing information asymmetry?
- Educate investors on the small and growing business sector?
- Facilitate further capital aggregation through scale, replication or adaptation to new sectors, geographies or new investor classes?

Regardless of the model ultimately selected, ANDE should facilitate capital aggregation models that are efficient and effective at meeting investors’ needs, and that break down the constraints on capital aggregation for the wide variety of investors that have expressed interest in deploying capital into the small and growing business sector at both the intermediary and beneficiary level.

## Model 1: Fund of Funds

### Description of Model:

A model typically found in the Private Equity Community, Fund of Funds aggregate investor capital to invest in private equity or other asset-based fund managers. The Fund of Funds will hold a portfolio of fund managers (intermediaries) rather than businesses. The fund managers (intermediaries) in turn, make direct investments into businesses. A Fund of Funds in the private equity community will typically charge a fee of 1% of the funds invested for this service, plus take a small portion of the return from the fund manager's investments, known as 'carry'. There are many thousands of Fund of Funds globally, across all asset classes. The size of this segment is estimated by Private Equity Intelligence to constitute approximately 14% of capital invested into private equity.

The private equity Fund of Fund model could be highly relevant in encouraging capital aggregation in the small and growing business segment. Typical investors in Fund of Funds are smaller and more inexperienced institutional investors, often entering the private equity asset class for the first time. They often do not have knowledge of available fund managers, or the resources or expertise to search and invest directly with fund managers. The strength of the Fund of Funds model is in facilitating investor entry into a sector with high information asymmetry and in educating investors on the asset class. An example of such a Fund of Funds is the *World Ventures Network's* newly formed Micro Venture Fund of Fund, which seeks to aggregate \$50M of investor capital to invest in micro-venture funds investing between \$100-500k in businesses.

### Strengths of the Model:

- Allows new investors in private equity to enter the asset class and gain market experience.
- Allows investors to achieve a diversified portfolio of assets that they otherwise would not have the capacity, expertise or access to construct.
- Allows smaller investors access into high-performing, top-quartile fund managers.
- Provide expert fund manager selection for experienced investors.
- More likely to fund first-time fund managers<sup>1</sup>.

### Challenges of the Model:

- Investors are unable to 'cherry pick' individual investments, nor as the Fund of Fund makes an allocation for their total capital under management.
- High cost to investors from the double layer of fees: 1% of capital invested annually paid to Fund of Fund, plus 2% of capital invested annually paid to the Fund Manager.
- When some investors gain market experience, they will move to directly investing in the funds.
- The flow of new investors is crucial to Fund of Funds.

### Possible application to the Small and Growing Business Segment:

A Small and Growing Fund of Funds could be created that invests in a diverse portfolio of fund managers across the globe. These fund managers could consist of current players – such as ANDE participants – as well as developing emerging fund managers in the developing world. The Fund of Funds could be segmented by sector – rural, health, energy, Africa etc. Alternatively, existing Fund of Funds could place a small portion of their fund into the SGB sector through the ANDE Fund of Funds. Due diligence on the fund managers could be completed up front and the costs shared among investors.

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<sup>1</sup> Private Equity Intelligence Ltd 2008 Review of Fund of Funds

## Model 2: Investor Circle / Angel Network

### Description of Model:

Investor circles or angel networks are groups of high-net worth individuals who form a loose network or 'club' to identify and invest in businesses. Often providing seed capital for new businesses and ventures, the investors give an amount of capital to the network/club with various levels of commitment to invest. A network manager is paid a small fee to identify investment opportunities and present them to the group of angel investors. Each angel investor is free to invest or not, depending on their interest, sector focus, return expectation and amount of capital needed. In the US, angel investor networks successfully provide investment capital in technology and early stage investments.

Angel networks could be relevant in improving capital aggregation in the small and growing business segment. There are a diverse number of high-network individuals and institutions that are interested in deploying capital but appear to be unable to find quality deal flow, have specific sectors on which they wish to focus, or are new to the sector. A number of traditional angel networks in the US are expanding their operations internationally to emerging markets and seeding regional angel networks. For example, *The New Vantage Group*, a US-focused angel network based in Washington, DC is setting up a Latin America Angel Network for small and medium sized businesses, as well as seeding a global association of angel investors. Similarly, *Investors' Circle* is a well-known angel investor group that seeks financial, social and environmental returns on their investments in companies. Investors' Circle is made up of venture capitalists, individuals, foundations and family investment offices.

### Strengths of the Model:

- Low cost investment model for investors
- Allows investors to retain a flexible investment commitment and select investments that fit their profile of sector, return expectation and capital amount
- Strong source of capital for small businesses and technology or early stage investments

### Challenges of the Model:

- Format is appropriate for high-net worth individuals rather than institutional investors.
- Relies on abilities of angel network to identify deals in a more informal process.
- No certainty of investment as the manager of angel network offers businesses to investors which may or may not be invested in.

### Possible application to the Small and Growing Business Segment:

An ANDE Investor Circle/Angel Network may be an efficient central organizing group to provide access to direct and indirect investment opportunities. An ANDE Angel Network would target angel investors and other high-net worth individuals with a collection of specific and narrow investment or social goals. The investors could invest in either funds or the businesses themselves. In addition, there may be businesses that do not match the ANDE intermediary fund managers' criteria that could be passed onto the ANDE Angel Network. A success fee could be paid to the fund managers upon investment by an ANDE angel investor, and ANDE could pre-screen angel investors and funds, as well as broader deal network partners – regional venture capital associations, other angel networks, local financial institutions etc. ANDE would also provide the matching service and could devise a model of supporting due diligence, depending on the sophistication of the interested angel investor.

## **Model 3: Pool of Funds**

### **Description of Model:**

A Pool of Funds provides greater flexibility than a Fund of Funds for both investors and fund managers by allowing a more diverse portfolio of assets to be created. The Pool can be constructed with various investors' return expectations to create a 'blended pool' that results in a range of returns, rather than a single Fund return. The Pool allows investors to invest in specific stages or sectors, and it allows fund managers to focus more strongly on deal origination, knowing that capital can be drawn from the pool at any time. Therefore, a Pool of Funds can be constructed with structures and characteristics that suit the attributes of a varying group of investors, as well as the sector, return or stage focus of the fund managers.

A Pool of Funds may be applicable to the small and growing business sector in order to better segment investor expectations around return expectations, size of capital deployed, sector interests and branding interests. A uniquely constructed Pool of Funds, that blends return expectations, along a sector or geographic focus may be of interest to a collection of known investors interested in entering the space. A Pool of Funds allows more flexibility for investors, but is more difficult to construct than a Fund of Funds with collective returns and standard terms.

### **Strengths of the Model:**

- Due diligence costs are shared among investors and performed up-front on a pool of 'qualified funds'
- Allows a variety of investors with varying sector focus and return expectations to invest in a common, aggregated pool.
- Allows greater flexibility to construct a portfolio consisting of blended returns.
- Allows a focus on deal origination where capital can be called as needed.
- Increases ability to make risky investments.

### **Challenges of the Model:**

- More complex structure and time-consuming to set-up the Pool of Funds and match investors with fund managers.
- Difficult to scale because the Pool of Funds is constructed around unique investor or sector contexts.

### **Possible application to the Small and Growing Business Segment:**

An ANDE Pool of Funds could be structured to meet any gap in the SGB market. The unique structure allows ANDE to identify a number of classes of investors with varying return and sector expectations and construct a Pool of Funds to meet their needs. The applicability of the Pool of Funds structure as a vehicle to address capital aggregation in the SGB segment depends entirely on accurately targeting a range of investors and their needs.

## **Model 4: Co-investment Vehicle**

### **Description of Model:**

Co-investment allows private equity fund investors who normally invest in a fund manager to directly invest in a business or project alongside the fund manager. A co-investment is allowed by some fund managers from their investors once they have invested into their fund product. For example, an investor may allocate \$100M to a Fund, with a \$25M co-investment vehicle that can be drawn down on a selective basis to invest directly alongside the fund manager when they select investments for the Fund. The co-investment approach increases the capital deployed by the fund manager and spreads the investment risk across multiple investors. For the investor, it also increases their capital deployed, and allows them to invest additional capital into investments they find more attractive. Co-investment also occurs between different fund managers who invest together in a specific business to increase the capital, or because the fund manager brings special skills or relationships. Co-investment is usually on a case-by-case basis. For an investor, they must first invest in the fund, and then negotiate a co-investment relationship.

Co-investment vehicles or opportunities may be useful in the small and growing business segment, particularly among ANDE investor and intermediary members, in order to increase capital deployed, spread investment risk, and share transaction and due diligence costs. A variety of formal or informal structures could be set up depending on the interest and needs of ANDE investors and intermediaries.

### **Strengths of the Model:**

- Allows greater amounts of capital to be deployed by investors and/or fund managers.
- Spreads the transaction and due diligence costs between investors.
- Increases ability to make risky investments.

### **Challenges of the Model:**

- Difficult to scale, as the co-investment opportunity is based on a more informal and case-by-case basis.
- Opportunities are driven by strong existing relationships, which require fund managers and/or investors to be known and trusted.
- Sector, deal and return specific.
- Investor and fund manager interests in sector, deal size and return expectations must be matched.

### **Possible application to the Small and Growing Business Segment:**

ANDE may be able to establish co-investment opportunities or co-investment vehicles for its investor members based on a select number of funds. Fund managers would provide co-investment opportunities for their deals to ANDE investor members, whether or not those investors are in their specific funds. The ANDE network would also encourage co-investment opportunities between its intermediary fund manager members.

## **Model 5: Loan Guarantees**

### **Description of Model:**

Loan guarantees are provided by a range of development finance institutions to reduce the risk of loan making, particularly when there are minimal assets to provide collateral, or when cash-flow lending is needed. If a business defaults under a guaranteed loan, the guarantor will pay the lending institution up to the amount of the guaranteed loan. Usually, technical assistance training is provided in parallel to the loan guarantee to improve loan processes and train loan officers to assess growth and identify cash-flow lending opportunities.

Financial institutions will usually provide a partial loan guarantee from 20% - 50+% to encourage local banks to increase the amount of capital loaned to small and growing businesses. A number of large financial institutions provide loan guarantees, such as the Overseas Private Investment Corporation and the International Finance Corporation, among others. Loan guarantees are increasingly being used in emerging markets to fund downstream local content, supply chain and vendor finance, rural finance, and small businesses. In Kenya, Equity Bank has made use of loan guarantees in their small business and womens' lending programs.

### **Strengths of the Model:**

- Highly leveraged
- Strengthens local financial systems and increases their capital capacity
- Technical assistance often delivered in parallel
- Highly scaleable and able to target specific business sectors
- Available to any business, especially low-asset intensity

### **Challenges of the Model:**

- Relies on local financial institutions to make loans
- Provided for debt capital, not equity

### **Possible application to the Small and Growing Business Segment:**

ANDE may be able to facilitate a program to collate investors willing to leverage their capital by constructing loan guarantees for specific business sectors (agribusiness, farmers, energy, health etc) in specific countries. ANDE would market these sectors to investors, while identifying local financial institutions to provide loans. Technical assistance could be provided in parallel to train local lending officers. ANDE members could participate in referring opportunities to local financial institutions, or depending on the size of the loan, there may be co-investment opportunities with equity funds to support the provision of debt.