

IFC SME Ventures

Investing in Private Equity in Sub-Saharan African
Fragile and Conflict-Affected Situations

IN PARTNERSHIP WITH



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Cover Image: SCS Malienne de Cartonnerie, a cardboard and packaging manufacturing plant backed by regional and international investors. (Allen Nahounou, Mali, 2018)

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Foreword

Invitation to the world's most underserved markets

Small and medium-sized enterprises (SMEs) are important drivers of growth in economies across Sub-Saharan Africa, accounting for about 90% of all businesses in these markets. IFC's research shows that more than 17 million SMEs in developing countries have unmet financing needs. Young, growing businesses lack the track record on which banks base their lending criteria. SMEs are often too large to be served by microfinance institutions, yet too small for commercial banks. They require 'risk capital' – forms of finance that have a higher risk tolerance than bank loans.

Risk capital is particularly scarce in fragile and conflict-affected countries. Investors are wary of these markets for good reason – weak governance, poor infrastructure, unreliable energy supply, and physical safety concerns pose significant challenges. Yet the need for risk capital is most dire in fragile and frontier countries where SMEs can have an enormous impact on job creation and economic growth. With access to the right kind of capital, local entrepreneurs in fragile countries would be able to expand their businesses, create a significant number of jobs, and provide essential goods and services.

It is for this reason that IFC, together with other development partners, created SME Ventures in 2008, an innovative program that provides risk capital in the form of debt instruments, quasi equity, and equity alongside technical assistance to entrepreneurs and fund managers in the world's most challenging markets. IFC believes that supporting such Funds provides a cost-effective, results-oriented, and sustainable complement to other initiatives that support these markets.

This report provides lessons from IFC's decade of experience with SME Ventures, including the insights of fund managers who grapple with endless challenges. We intend for it to serve as a guide to investors and fund managers operating in difficult environments.

We invite you to push the boundaries, explore the potential of underserved markets and support Africa's resilient entrepreneurs.



Kevin Warui Njiraini

Director, Southern Africa and Nigeria, IFC

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Solar company employee installing a panel (Stefan Freeman, Mozambique, 2018)

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Acronyms

ANDE	Aspen Network of Development Entrepreneurs
AVCA	African Private Equity and Venture Capital Association
AUM	Assets Under Management
AWA	Amethis West Africa
BRVM	Bourse Régionale des Valeurs Mobilières
CAR	Central African Republic
CPIA	Country Policy and Institutional Assessment
DFI	Development Finance Institution
DOI	Digital Object Identifier
DRC	Democratic Republic of the Congo
EAC	East African Community
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortization
EMPEA	Emerging Markets Private Equity Association
ERP	Enterprise Resource Planning
ESG	Environmental, Social, and Governance
FCS	Fragile and Conflict-affected Situations
FDI	Foreign Direct Investment
FSI	Fragile State Index
FFP	Fund for Peace
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GIIN	Global Impact Investing Network
GIIRS	Global Impact Investment Rating System
GNI	Gross National Income
GP	General Partner
I&P	Investisseurs et Partenaires
IDA	International Development Association
IDP	Internally Displaced Person
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IPO	Initial Public Offering
IRIS	Impact Reporting and Investment Standards
IRR	Internal Rate of Return
LP	Limited Partner
MDB	Multilateral Development Bank
MFI	Microfinance Institution
MNC	Multinational Company
MWh	Megawatt hour
NBFI	Non-bank Financial Institution
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
OPIC	Overseas Private Investment Corporation
PCV	Permanent Capital Vehicle
PE	Private Equity
SADC	Southern African Development Community
SDG	Sustainable Development Goal
SME	Small and Medium-sized Enterprise
SSA	Sub-Saharan Africa
TA	Technical Assistance
TAF	Technical Assistance Facility
UN	United Nations
UNDP	United Nations Development Programme
WAEMU	West African Economic and Monetary Union
WBG	World Bank Group



Macrowaste is providing private waste management services in Bamako. Non-tradable services represent investment opportunities for investors in FCS. (Kelley Gasper, Mali, 2018)

Executive summary

1

Foreign direct investment (FDI) in fragile and conflict-affected situations (FCS)¹ represents just 1% of global FDI flows, more than five times less per capita than the world average.² However, to grow businesses beyond the micro level, most entrepreneurs need financing. In fragile states, risk capital investments can have a significant catalytic impact, even with relatively low commercial returns.³ Funds in frontier markets often help spur the emergence of new sector leaders and domestic challengers and/or partners to multinational firms. New jobs are created, providing training and formal sector social protections such as health insurance. The impact through potential spillover effects of FDI is also enhanced by local sourcing.⁴ **The International Finance Corporation's (IFC's) Small and Medium-sized Enterprise (SME) Ventures program is one of very few initiatives supporting entrepreneurs and high growth companies through investing in private equity funds that deploy risk capital in fragile states.**

This report, researched in partnership with CrossBoundary LLC, highlights the critical success factors when investing in fragile states, as well as existing innovations being developed by current investors.⁵ While the challenges of investing in FCS are well known, the most effective approaches and factors required for success are still being explored. New financial instruments, fund structures, and types of technical assistance are constantly being designed and tested. The lack of shared information, including results and best practices for developing and delivering mechanisms to invest in FCS can lead to missed opportunities for limited partners (LPs) and general partners (GPs).

Companies operating in fragile states face challenges that are often more severe and sometimes unique compared to those in emerging markets or developed markets. In this operating and investment context, average risk-adjusted returns are lower. **Reasonable net returns (5%-10%) are more difficult to achieve in fragile states and require a tailored approach.** Investors need to adopt context-specific methodologies, adjusting to market/population size and growth, currency risk, and political uncertainty, among other factors.

However, several observed patterns and best practices have led to more successful funds. First, funds with better net financial returns have the tendency to either be highly active and in control positions on a small set of investments, or deploy standardized (but flexible) debt-like instruments to a larger group of investments. Additionally, certain types of sectors appear to be more favorable to investments: (i) companies with revenues in hard currency, (ii) companies with insulation from international competition (basic goods and

¹ For the purpose of this report, the IFC definition of FCS is used. FCS are countries or territories with (i) a harmonized country policy and institutional assessment (CPIA) rating of 3.2 or less, and/or (ii) the presence of a UN and/or regional peacekeeping or political/peacebuilding mission during the last three years. Throughout the report, the countries considered are referred to as either fragile or FCS, and can also be categorized as frontier markets – although the latter is not always associated with a post-conflict or fragile situation.

² Alexandros Ragoussis and Heba Shams, "FDI in Fragile and Conflict-Affected Situations", Global Investment Competitiveness, Chapter 5 of Global Investment Competitiveness Report 2017/2018, Digital Object Identifier (DOI): 10.1596/978-1-4648-1175-3., 2017.

³ Dr. Josh Lerner, Ann Leamon, Andrew Speen, and Chris Allen, "Risk Capital in Emerging Markets and the SME-Ventures Model", Bella Research Group for IFC, 2015.

⁴ Thomas Farole and Deborah Winkler, "Making Foreign Direct Investment Work for Sub-Saharan Africa – Local Spillovers and Competitiveness in Global Value Chains", International Bank for Reconstruction and Development / The World Bank, International Trade Unit, 2014, p87-114.

⁵ CrossBoundary LLC is a frontier market investment advisory firm with offices in Nairobi, Johannesburg, Bamako, Lagos, Dubai, New York City, and Washington, D.C. The research for this report was primarily conducted from October 2017 to March 2018, and included extensive interviews in Côte d'Ivoire, the Democratic Republic of the Congo (DRC), Liberia, Mali, Mozambique, Sierra Leone, and Madagascar. The primary authors of this summary report are Jake Cusack and Soline Minière, with support from Bryan Epps, Nathan Kelly, and Marcos Sampablo.

essential services), (iii) companies with restricted domestic competition (a monopoly/oligopoly/first mover), and (iv) opportunistic comparative advantage companies (country specific). However, while financial returns are important, the potential social or environmental impact should be considered with similar weight, as measured through metrics such as whether alternative sources of financing were available, jobs were created after investment, employee benefits and training flowed from the investment, taxes/government revenue was generated, or improvements were effected in the overall value chain or ecosystem. The optimal investment from a net return perspective may differ from the optimal development impact investment, as transaction/monitoring costs are often higher with earlier-stage, entrepreneur-led businesses in more fragile economies.

Even with a customized approach, **GPs and companies in FCS still face challenges in originating and closing transactions, running businesses, and exiting investments**. Specific mitigation strategies at each step of the investment process can improve the risk/return profile. For instance, during the origination process, investment opportunities will be earlier stage than typical private equity, facing higher risk of failure than those available in more mature enterprises.⁶ Several GPs end up partially incubating greenfield projects in-house to improve control and results. During the structuring of the investment, GPs need to adapt and innovate in terms of investment instruments and can also often leverage donor/concessional capital. Lastly, GPs and LPs have highlighted the lack of flexibility in the timing of exits in countries with limited or no secondary market. Exit opportunities are primarily limited to management buy-outs or trade sales, while initial public offerings (IPOs) are very rare.⁷ Beyond the self-liquidating type of instruments that many funds employ, several funds also seek to mitigate this challenge by identifying the exit opportunity pathway before investing, or by adopting a holding company structure with no fixed time requirements for exit. At all steps of the investment process, GPs face challenges specific to fragile states that require tailored mitigation strategies.

More broadly, **the standard features of a typical private equity structure (generally incorporating a 2/20 compensation structure over a 10-year life cycle) can also create difficulties in implementation for some GPs in FCS**. For instance, in a large fund a 2% management fee may adequately cover the costs of the needed investment professionals. But in other contexts, the GP's choice of strategy, ticket size, and fund size may create very different requirements for management time and the number of investment professionals required. Management fees for FCS funds should not only be based on a simple percentage benchmark but should also consider the strategy and desired impact of the fund. Additionally, other incentives are often not aligned. Fund personnel in FCS may never see carry (performance compensation) due to low net commercial returns (although they may potentially still deliver high development impact) and a too high hurdle rate. If carry is low or unlikely, salary and bonus are the only incentives on which GPs can recruit skilled professionals. Lower hurdle rates (e.g. 5%) or hybrid incentive schemes should therefore be considered in FCS.

In this challenging context, **additional support to risk capital providers is highly valued and sometimes critical to success**. Technical assistance (TA) should be used to pay for expertise that directly increases revenue/earnings before interest, taxes, depreciation and amortization (EBITDA) or reduces costs and other challenges such as environmental, social, and governance (ESG) issues of the investment. GPs in FCS have mentioned the effectiveness of hiring specialized industry experts, providing assistance with marketing and setting/achieving key performance indicators, as well as supporting the development of accounting, management, and other enterprise resource planning (ERP) systems. Separately, TA can also be used for direct support of the set-up of the GP in first-time funds and for crosscutting macro support (for example, for private equity regulatory environment reform).

IFCSME Ventures has played a crucial role in developing the investment landscape in fragile states in Sub-Saharan Africa (SSA). IFC SME Ventures was catalytic in developing first-time funds and supporting them in building an initial track record. In this report, to build on that success, **three complementary angles are suggested to spur additional risk capital into FCS**: first, methods for attracting additional LPs and innovating on fund structure; second, providing a suite of shared services and toolboxes to support FCS GPs; and finally, country- or region-centric platforms to facilitate investment from a broad range of risk capital sources into a variety of FCS companies.

⁶ "IPDEV, a pioneering initiative to promote African SMEs", Investisseurs et Partenaires (I&P), May 2018.

⁷ "Due Diligence in Emerging Markets", IFC, World Bank Group (WBG) and Overseas Private Investment Corporation (OPIC), Vancouver Conference – Institutional Limited Partners Association, October 2011.

Investors should adopt a context-specific approach

The strategy to approaching fragile states must be tailored to the local context, with the country-level environment presenting different challenges and opportunities depending on a number of factors.

First, while this report refers to the IFC framework for FCS, there is no single internationally recognized definition of fragility (see Appendix A), with FCS often characterized by different political, social, and security metrics. FCS factors, including political conflict, criminality, institutional fragility, and lack of government legitimacy will all influence how investors prioritize countries based on their tolerance for uncertainty and perceived return potential. For example, in the Fragile State Index of 2017, Côte d'Ivoire is considered as more fragile in terms of violence than Mali and identical in terms of institutional fragility. Yet Côte d'Ivoire has still been able to attract significant investment, thanks to a legacy of past economic opportunity, a supportive ecosystem, and strong economic fundamentals. Some businesses even gain revenue in fragile situations – for example, hotels, airport logistics, and vehicle rental companies in Liberia and Sierra Leone did better during the Ebola outbreak, as they provided housing and transportation for the influx of aid agencies. However, ensuring that growth driven by such a temporary market dynamic is sustainable can present a subsequent challenge.

Poor hard infrastructure (such as transport and energy) and soft infrastructure (such as education and legal systems), informality, and limited export capacity (including satisfying quality assurance) affect operating costs in emerging markets generally but are more severe in FCS:

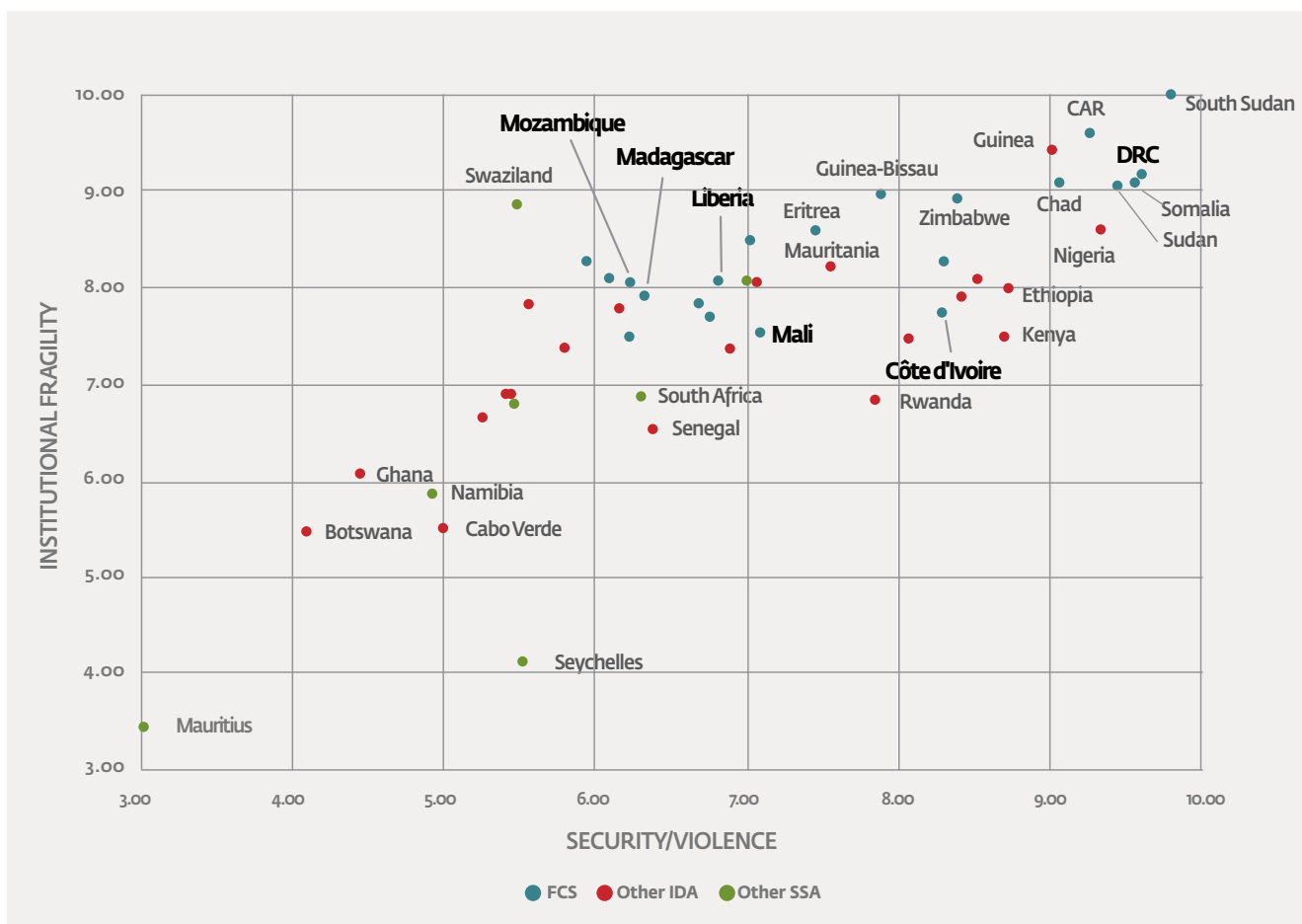
- The cost and reliability of electricity are often considered to be the most significant challenges for businesses operating in fragile states.⁸ Whether light manufacturing, hotels, or healthcare clinics – power outages and the subsequent use of generators lead to a high cost of production and operation for local companies.
- In order to export consumable and/or perishable goods such as mangoes or shea butter internationally, the supply chain must operate to an international standard of quality control. Fragile states have difficulties reaching the required levels, with both public investment and technical assistance being critical.

The most specific risks for fragile states are (a) security challenges arising from political conflict and/or (b) institutional fragility or lack of government capabilities.⁹ Figure 1 illustrates how countries in SSA compare on a select set of dimensions, especially in FCS.

⁸ Alexandros Ragoussis and Heba Shams, "FDI in Fragile and Conflict-Affected Situations", Global Investment Competitiveness, Chapter 5 of Global Investment Competitiveness Report 2017/2018, DOI: 10.1596/978-1-4648-1175-3., 2017.

⁹ Ibid

FIGURE 1: DIMENSIONS OF STATE FRAGILITY IN SSA¹⁰



Macroeconomic data and financing needs help to understand the country context

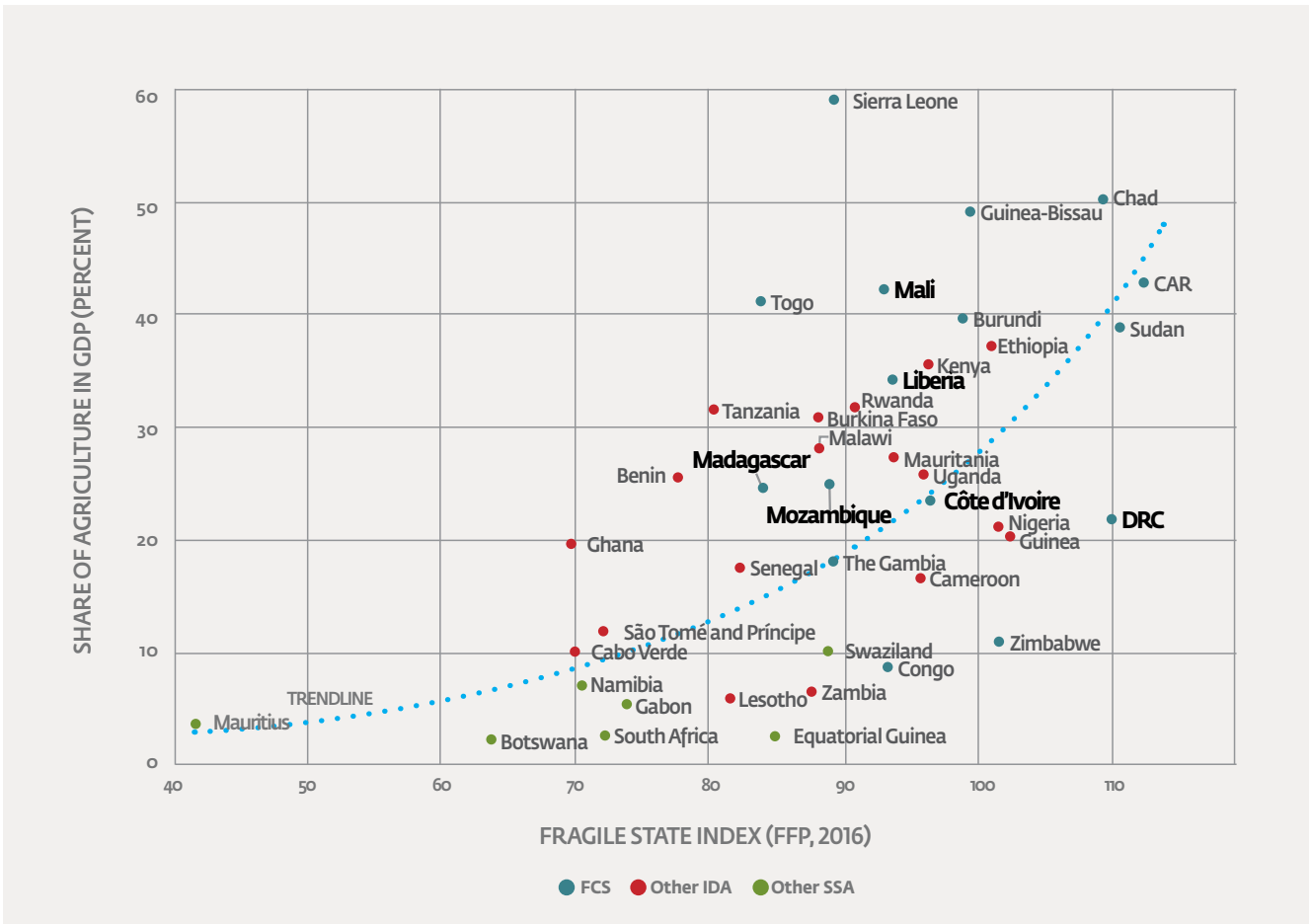
Comparing gross domestic product (GDP), population size, purchasing power, and growth can give an investor an indication of the potential size of a market. While fragile countries vary in population and market size, most of them experience market access challenges due to disruptions in trade routes and enabling infrastructure. But even in countries with low accessible local demand, there can still be opportunity for investors with a regional or export-led investment strategy.

In the context of variable GDP and GDP growth for most fragile countries, several sectors will be more resilient to shocks. As per the 2017/2018 Global Investment Competitiveness report, labor-intensive activities such as agriculture dominate highly fragile economies. *“The bulk of employment in FCS is in the small farmer and household enterprise sectors, driven by necessity and resilience rather than growth.”* In FCS in SSA, the same trend is apparent. The share of agriculture in GDP is higher, on average, in FCS countries (33%) than in overall International Development Association (IDA) (27%) or SSA countries (24%). Agriculture, as a necessary basic good and labor-intensive activity, is relatively resilient (albeit fragmented) and typically contributes a higher share of GDP in fragile states compared to services and industry.¹¹

¹⁰ Derived from the Fund for Peace (FFP) Failed State index (FSI): <http://fundforpeace.org/fsi/>. Security and violence values were computed using the average of security apparatus (C1), factionalized elites (C2), and group grievance (C3). Institutional fragility values were computed using the average of state legitimacy (P1), public services (P2), and economic decline (E1).

¹¹ Alexandros Ragoussis and Heba Shams, “FDI in Fragile and Conflict-Affected Situations”, Global Investment Competitiveness, Chapter 5 of Global Investment Competitiveness Report 2017/2018, DOI: 10.1596/978-1-4648-1175-3., 2017.

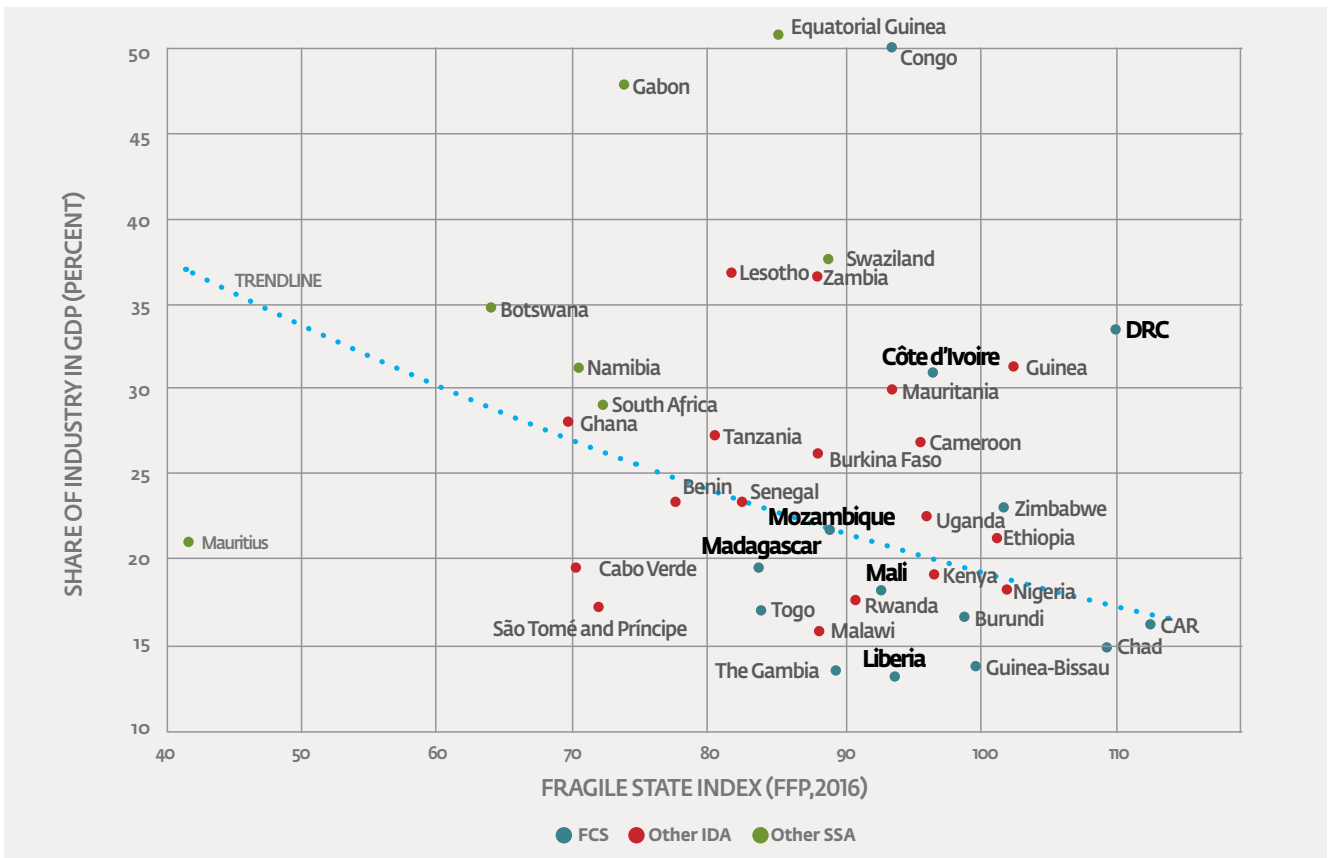
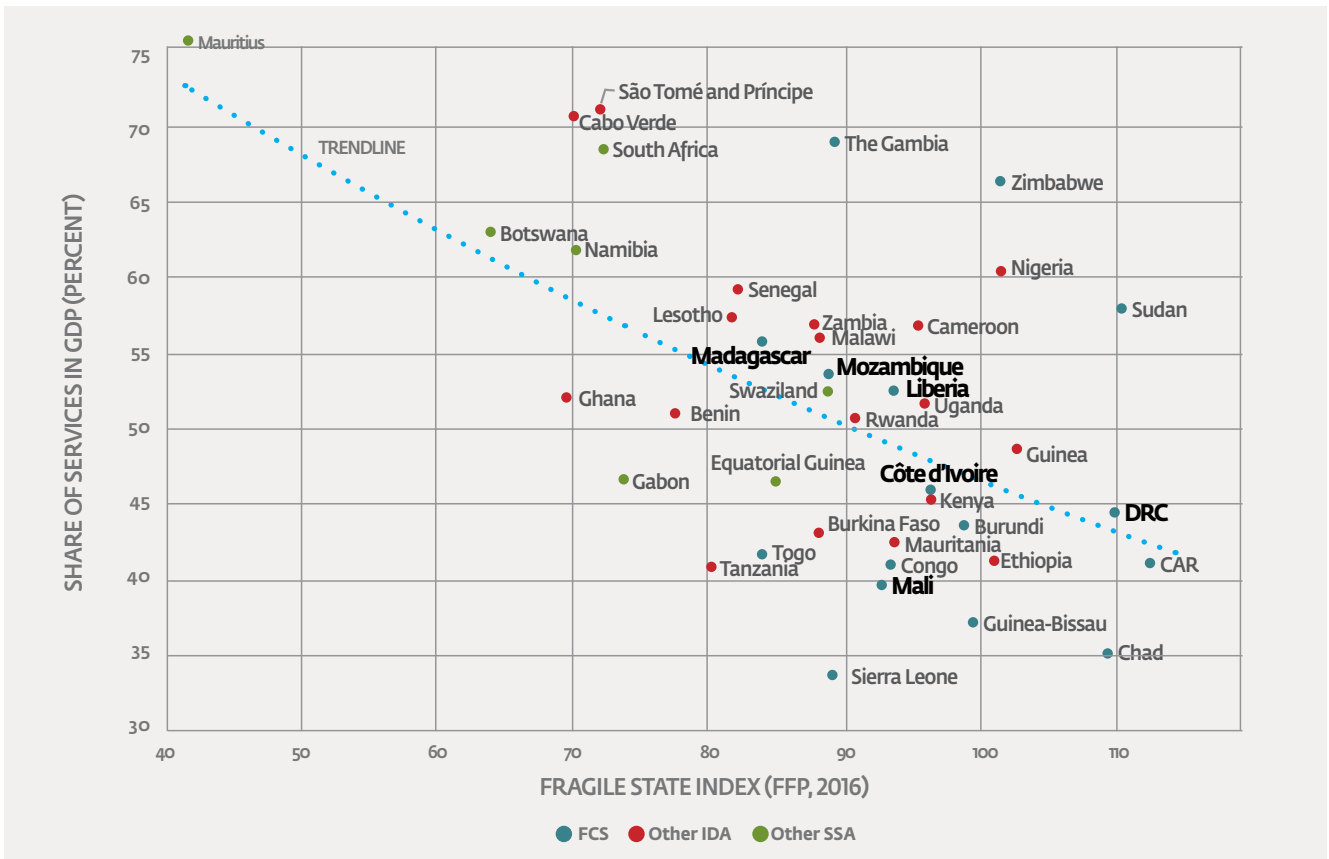
FIGURE 2: SHARE OF AGRICULTURE IN GDP OF SSA, 2016 (ANNUAL % GDP)¹²



Services and industrial activities, on the other hand, are less prevalent in FCS countries. The share of industrial activity in GDP is defined as value-added mining, manufacturing, construction, electricity, water, and gas. As such, countries with strong mining sectors such as the Democratic Republic of the Congo (DRC) will have a higher concentration of these activities. General services include value-added wholesale and retail trade (including hotels and restaurants), transport, and other services such as education, health care, and real estate services.

¹² FSI Indicator: <http://fundforpeace.org/fsi/>; World Bank data: <https://data.worldbank.org/indicator/NV.AGR.TOTL.CD>.

FIGURE 3: SHARE OF SERVICES AND INDUSTRY IN GDP IN SSA, 2016 (ANNUAL % GDP)¹³



¹³ FSI Indicator: <http://fundforpeace.org/fsi/>; World Bank data: <https://data.worldbank.org/indicator/NV.IND.TOTL.ZS>, <https://data.worldbank.org/indicator/NV.SRV.TETC.ZS>.

Risk capital has a strong development impact and is desperately needed in fragile states

There is a substantial body of research showing that capital investments in SMEs drive job creation. As noted in the 2015 Bella Research Group report commissioned by the IFC,¹⁴ “SMEs are the primary engines of job creation in low income countries, and employ about 78% of permanent, full-time employees in the formal sector of these countries.”¹⁵ In addition, SMEs can provide alternative employment opportunities for skilled but unemployed workers.¹⁶ A study of 200 private equity funds conducted by the African Private Equity and Venture Capital Association (AVCA) in Africa between 2009 and 2015, found that private equity backed companies generated a net increase of 10,990 jobs.¹⁷ Firms without access to finance are not able to grow as fast, as they are capped by the company’s ability to generate cash. A 2013 IFC study found that firms having even just a loan or overdraft facility had a 3.1% higher rate of growth in permanent employees than firms without access to finance.¹⁸ Beyond simply creating new jobs, additional benefits include training and formal sector social protections such as health insurance. Impact through the potential spillover effects of FDI has been measured in recent World Bank research and is enhanced by local sourcing.¹⁹

According to multiple researchers, financing also reduces inequality: “Financial development, measured by growth in private credit, disproportionately boosts incomes of the poorest quintile of the population and reduces income inequality.”²⁰ This has been reinforced by studies at the individual level, such as Christopher Blattman’s work in Uganda, which found that: “After four years, the treatment group [individuals with access to capital] had 57% greater capital stocks, 38% higher earnings, and 17% more hours of work than did the control group. Treatment group members also became more ‘firm-like’ in that they were 40%–50% more likely to keep records, register their business, and pay taxes.”²¹

Supporting the entry of new risk capital providers can create the well-functioning financial intermediaries that are frequently absent from these markets. Such intermediaries are an effective tool to improve corporate governance, boosting productivity and growth.²² Additionally, increased risk capital provision spurs the development of the business ecosystem (lawyers, accountants, and consultants) and an appropriate regulatory environment. Development finance institutions (DFIs) should seek to back locally based GPs in FCS, as they can be particularly beneficial in this regard. As Ross Levine has noted, “Legal and accounting reforms that strengthen creditor rights, contract enforcement, and accounting practices can boost development and accelerate economic growth.”²³

More specifically, GPs in frontier markets often lead to the emergence of new sector leaders and domestic challengers and/or partners to multinational firms. Yet the risk capital gap is most significant in fragile

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- ¹⁴ Dr. Josh Lerner, Ann Leamon, Andrew Speen, and Chris Allen, “Risk Capital in Emerging Markets and the SME-Ventures Model”, Bella Research Group for IFC, 2015.
- ¹⁵ Mighana Ayyagari, Asli Demircuc-Kunt, and Vojislav Maksimovic, “Small Vs. Young Firms Across the World: Contribution to Employment, Job Creation, and Growth”, World Bank Policy Research Working Paper no. 5631 (2011), p. 37 (table 1). The 78% figure is for the median low-income countries. The paper uses the World Bank’s Enterprise Surveys between 2006 and 2010, and supplements them with data from 44 other countries drawn from other comparable sources that were taken mostly from 2008 but ranges from 1997 to 2009.
- ¹⁶ “Transition Report”, European Bank for Reconstruction and Development, London, 1995, cited in Aidis, 2005.
- ¹⁷ Aubrey Hruby, “The developmental difference of African private equity”, Financial Times, 25 January 2017, <https://on.ft.com/2FXgeml>.
- ¹⁸ “IFC Jobs Study: Assessing Private Sector Contributions to Job Creation and Poverty Reduction”, IFC, January 2013.
- ¹⁹ Thomas Farole and Deborah Winkler, “Making Foreign Direct Investment Work for Sub-Saharan Africa – Local Spillovers and Competitiveness in Global Value Chains”, International Bank for Reconstruction and Development/The World Bank, International Trade Unit, 2014, p87-114.
- ²⁰ Independent Evaluation Group, “The World Bank Group’s support to capital market development”, 2016, <https://bit.ly/2rzKm3d>.
- ²¹ Christopher Blattman, Nathan Fiala, and Sebastian Martinez, “Generating skilled self-employment in developing countries: experimental evidence from Uganda”, The Quarterly Journal of Economics (2014), p697-752. DOI: 10.1093/qje/qjt057, 2014, <https://chrisblattman.com/documents/research/2014.GeneratingSkilledEmployment.QJE.pdf>.
- ²² Valerie Bencivenga and Bruce Smith, “Some consequences of credit rationing in an endogenous growth model”, Journal of Economic Dynamics and Control, 1993, vol. 17, issue 1-2, p97-122.
- ²³ Ross Levine, Norman Loayza, and Thorsten Beck, “Financial Intermediation and Growth: Causality and Causes”, World Bank Policy Research Working Paper No. 2059, February 1999.

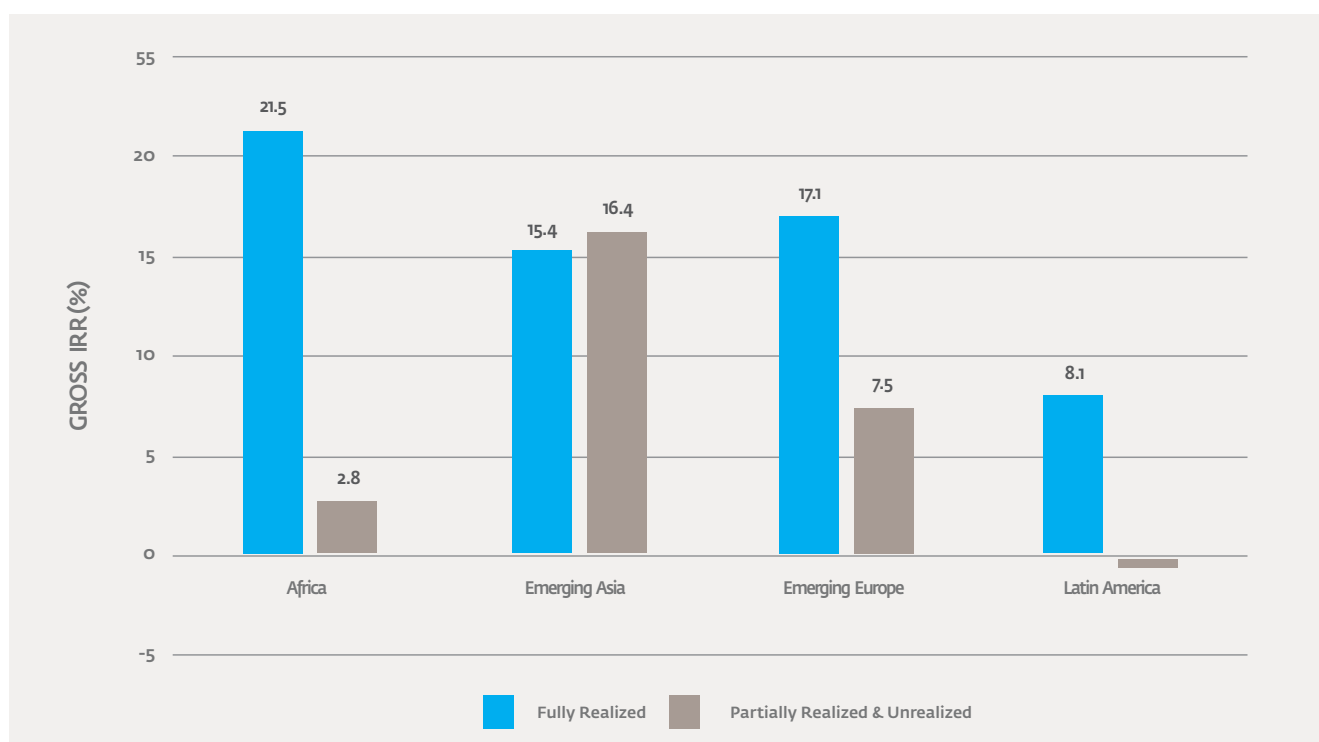
states. For instance, a survey of finance providers in one country found that the IFC SME Ventures fund (managed by XSML) was one of the sole providers of flexible risk capital (including loans with tailored and flexible repayment schedules, royalty-based lending, convertible loans, and equity), while others that existed primarily deployed more standard debt instruments. In Liberia, before the IFC SME Ventures fund, very few small/mid-size risk capital investments had recently occurred (today, several private equity funds are exploring entry).²⁴ In judging the development impact of such funds, not just the explicit outcomes achieved should be considered, but also the 'missed opportunities' if nothing had been attempted. Many investees of FCS funds state that they had no other viable options for financing.

Finally, inflows of capital from DFIs and foreign investors typically encourage fund managers and their companies to follow ESG best practices. Although the long-term role of DFIs and multilateral development banks (MDBs) is to push for more private LPs in these funds over time, these anchor organizations put in place high expectations and "continue to influence the setting of high environmental, social, and governance standards".²⁵

FCS gross return expectations must be appropriate

In Africa, the gross internal rate of return (IRR) on fully realized investments has demonstrated good returns compared to other emerging markets. However, as of yet the gross returns on partially realized and unrealized investments are lower than in emerging Asia and Europe (see figure 4; note that this chart's data are for all markets, not just FCS).

FIGURE 4: AFRICA VERSUS OTHER EMERGING MARKETS' INVESTMENT-LEVEL RETURNS AS OF JUNE 30, 2017 (VINTAGE YEARS 1995-2015)²⁶



²⁴ As of January 2018, several funds, including Pan African Capital and Gemini Capital, were being raised in Liberia with the purpose of investing in the country or in the larger Mano River Union area.

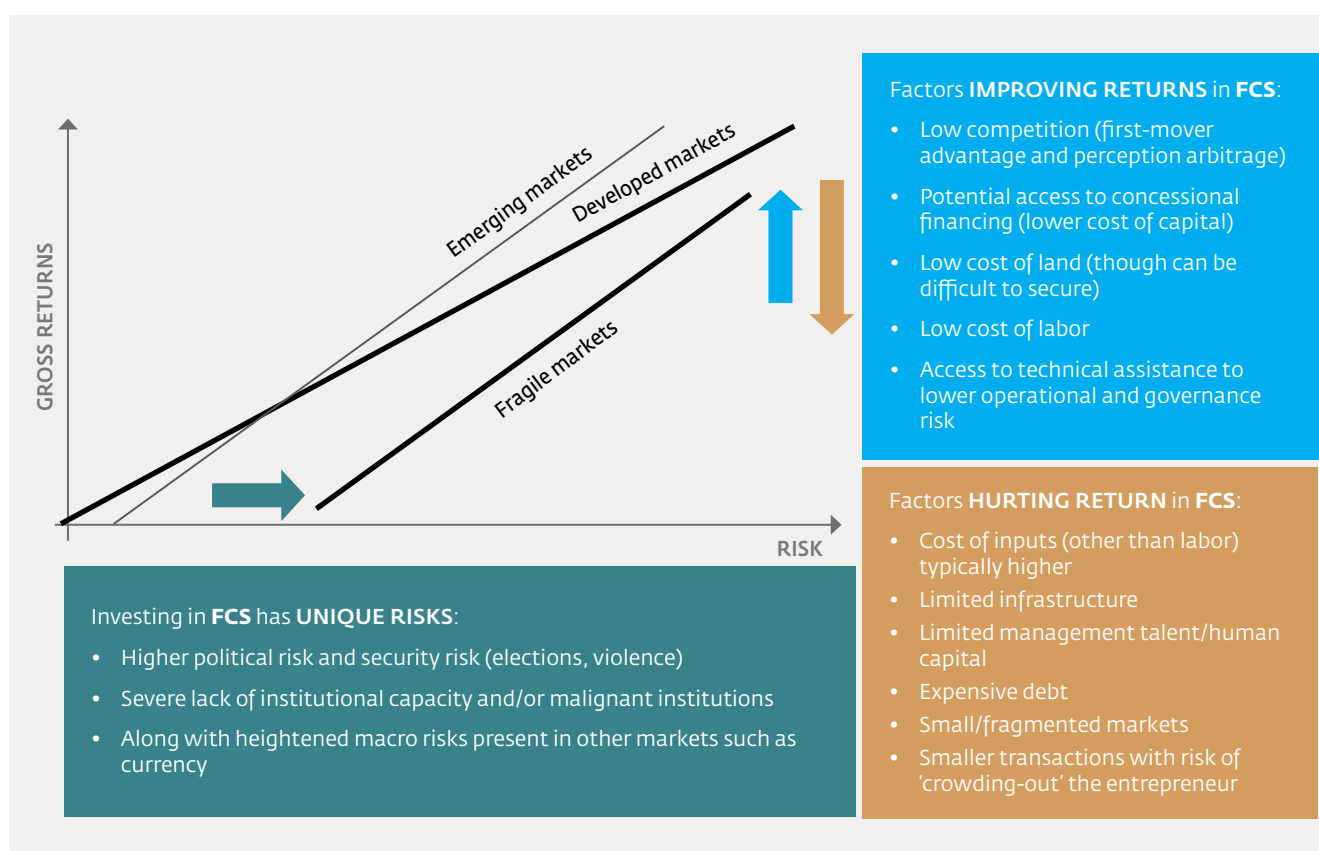
²⁵ "The World Bank Group's Support to Capital Market Development", WBG, 2016.

²⁶ "Cambridge Associates LLC Private Investments Database; AVCA Focus Series 2018 Private Benchmarks for Africa". The database includes 24 participating fund managers, 51 institutional quality Africa-focused private equity and venture capital funds, and over 450 unique portfolio investments in nearly 400 companies. Vintage year coverage: 1995 to 2015; total fund capitalization: US\$12.6 billion of commitments; average fund size: US\$248 million, ranging from <US\$50 million to >US\$800 million. Geographic strategies of funds: South African (13 funds), pan-African (34 funds), other regional (four funds). Individual investments headquartered in 33 different African countries.

Investing in FCS presents significant challenges, and gross returns are, in general, lower than in other markets. GPs can, and should, still seek 15%-20% returns on individual investments, as their portfolio companies should be experiencing sustainable growth even within the complexities of a fragile state. In general, if targeting lower gross returns, the fund is not sustainable and/or investments are not in sufficiently high growth and job-creating companies, and thus the GP is likely not adding particular value to the investment ecosystem. However, LPs must be realistic in grading their GPs given the challenges of a tougher environment. Additionally, when appropriate to the sector of the investment, performance should be judged in local currency terms before hard currency.

“No trade-offs on a deal by deal basis... we have to target gross IRRs around 20% in hard currency.”
Chief Investment Officer of SME Fund

FIGURE 5: STYLIZED FRAMEWORK OF GROSS RETURNS FOR INDIVIDUAL INVESTMENTS IN FCS²⁷

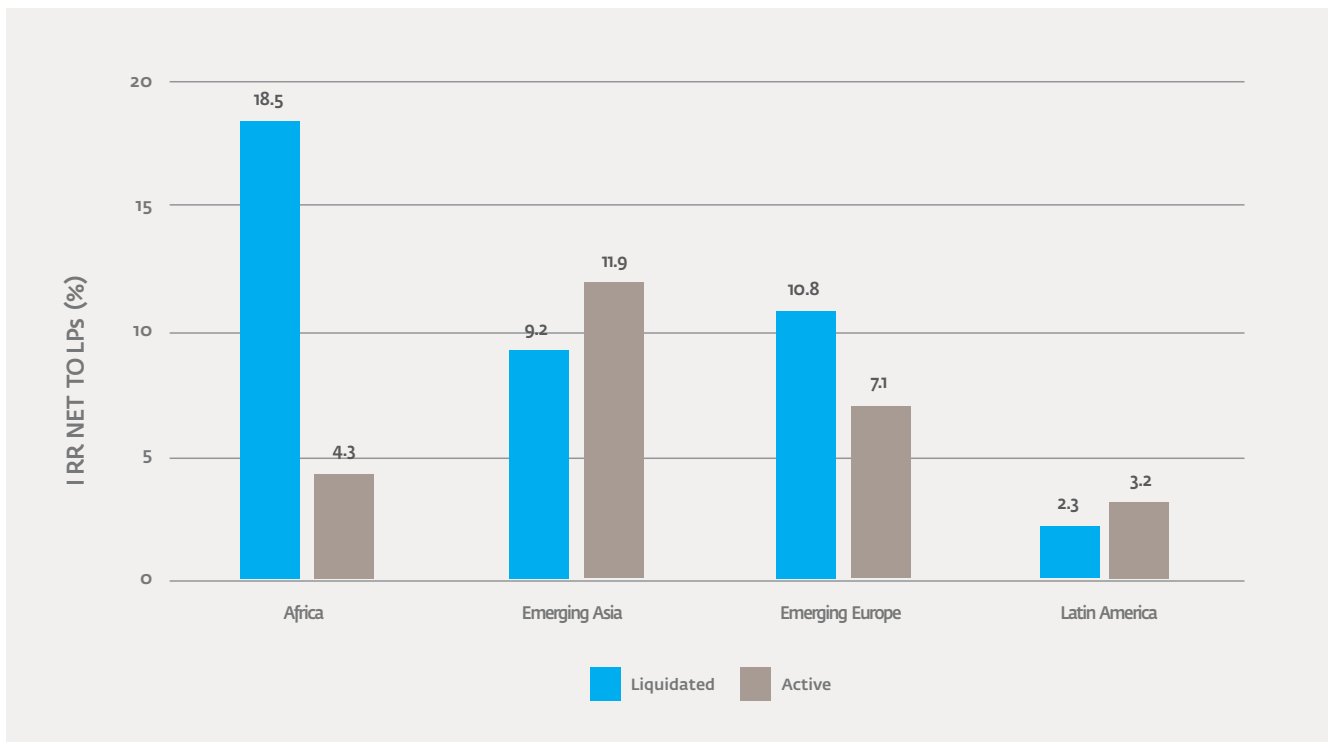


A net return environment is particularly difficult

Net return is reduced by management fees due to high costs of operation and small fund sizes. For funds that have fully distributed, net IRR to LPs in Africa has been relatively high compared to other emerging markets. However, active funds currently in Africa have not yet achieved net IRRs as high as in other emerging markets.

²⁷ CrossBoundary analysis based on a literature review and field interviews with GPs and LPs investing in eight SSA fragile states.

FIGURE 6: AFRICA VERSUS OTHER EMERGING MARKETS' FUND LEVEL STATUS: LIQUIDATED VERSUS ACTIVE FUNDS AS OF JUNE 30, 2017²⁸



In SSA fragile states particularly, the gap between the net and gross IRR is higher than in other emerging markets. In the specific context of FCS, a ~5%-10% return net of management costs should be considered good performance, expecting improvement from a first-time fund to subsequent funds raised. As funds mature and raise additional capital in a given market, the increased knowledge of the market and stakeholders

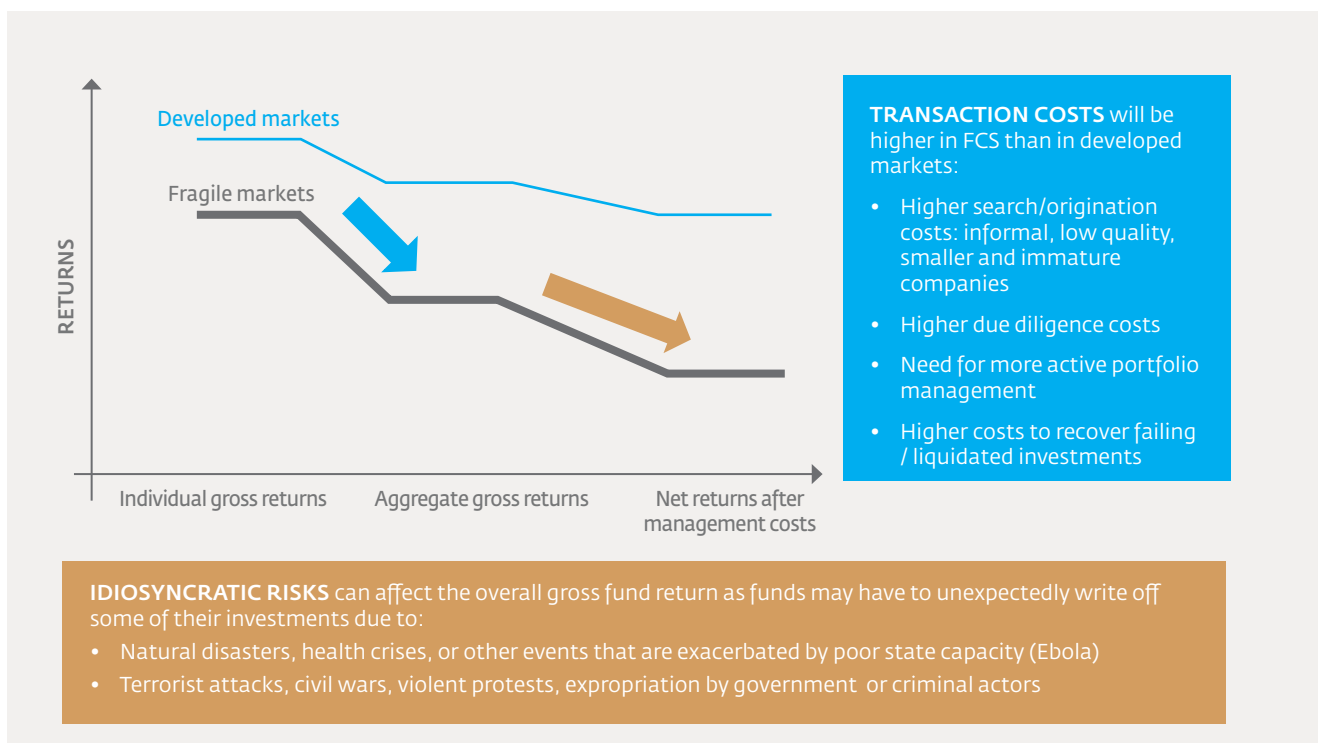
should decrease the transaction costs (cost of origination, investment, and management), as well as bring economies of scale. As a consequence, this gap should shrink over time, but the gross-net gap may stay higher than in other emerging markets because of the additional idiosyncratic risks.

“Several single-country funds have failed because of a major crisis in the region (Ebola, oil embargo, commodity crisis, earthquake...)”

FCS development professional

²⁸ “Cambridge Associates LLC Private Investments Database; AVCA Focus Series 2018 Private Benchmarks For Africa”. All returns are net of fees, expenses, and carried interest. Number of liquidated funds: Africa (8), Emerging Asia (77), Emerging Europe (23), and Latin America (17). Number of active funds: Africa (43), Emerging Asia (303), Emerging Europe (39), and Latin America (49).

FIGURE 7: FROM GROSS RETURNS TO NET FUND PERFORMANCE



Impact metrics and incentive structure are important to demonstrate investment value beyond financial returns

While return on investment is an important metric to weight the success of a fund, LPs often invest in frontier market SME funds to have a lasting impact on the economy. Private equity is an important asset class to achieve economic growth and drive towards fulfilling the Sustainable Development Goals (SDGs). A recent Emerging Markets Private Equity Association (EMPEA) report highlighted that, “*The private sector has a critical role to play in achieving the SDGs, and private equity investors are in a unique position to invest in and influence businesses in a manner that creates positive change.*”²⁹ In a context of challenging net returns, the outsize development impact of fragile state funds is important to measure and showcase — in both quantifiable and qualitative ways.

Frameworks and indicators to measure impact are becoming more standardized but are still diverse

Underlying financial performance is of course relevant to demonstrating that the investment is sustainable and profitable. However, monitoring and evaluating funds’ social and environmental impact is critical to ensure fund managers put in place a pro-active approach to achieving development results.

While SDG indicators are often linked to national-level statistics and therefore not suited to fund managers, aligning with well-known and understood impact frameworks helps funds communicate more easily. Currently, two tools are often used to measure the impact of an investment: IRIS and GIIRS. IRIS (Impact Reporting and Investment Standards), housed at the GIIN (Global Impact Investing Network) is a “*catalog of generally accepted performance metrics that leading impact investors use to measure social, environmental, and*

²⁹ “Private Equity’s Role In Delivering the SDGs: Current Approaches and Good Practice”, EMPEA, 2018.

financial success”.³⁰ IRIS provides benchmarks and best practices updated regularly, in a similar way to GAAP/ IFRS (Generally Accepted Accounting Principles/International Financial Reporting Standards) accounting standards for financial metrics. Building on IRIS, GIIRS (Global Impact Investment Rating System) is an impact ratings platform that rates funds and companies based on their impact performance.

Sometimes in alignment with, but also often independently of those tools, most funds design their own frameworks to report impact. Several indicators are very commonly used, such as the number of jobs created, additional taxes collected, tons of carbon dioxide reduced, percentage of women on the board of companies, access to healthcare/insurance for employees, and training and new certification achieved. The indirect effects of the portfolio company on its clients, suppliers, customers, and competitors are more difficult to report and are often described through narrative case studies.

FIGURE 8: EXAMPLE OF FUND PERFORMANCE FRAMEWORKS³¹

	CATEGORY A	CATEGORY B	CATEGORY C	CATEGORY D
MEDICAL CREDIT FUND	Finance: risk, return, impact on portfolio risk	Developmental: impact of value chain, leverage created, impact on quality of service delivered, impact on scale/ efficiency	Social: population reached, improving access, access for low-income group	N/A
MARIS LTD	People: number of current jobs, number of jobs post-investment, % of national employees	Community: taxes, royalties, community program spending	Environment: trees planted, environmental incidents, solar installations	N/A
SOLON CAPITAL PARTNERS	Level of impact: government service delivery, tax collection, legal compliance and business ethics enforcement, market productivity	Sectors of impact: human capital development through jobs and skills, supply chain benefits and reduced barriers to entry, new technologies, upscaling of service delivery, SDGs addressed	Quantified returns from invested capital: local tax paid, incomes, goods and services purchased locally	N/A
INVESTISSEURS ET PARTENAIRES (I&P)	Impact on staff: job creation, job patterns (gender, wages, etc.), employee training and other advantages	Impact on clients: quantity of goods/ services provided (company-specific metrics), number of clients (company-specific)	Impact on suppliers & distributors: number and share of local suppliers and distributors	National value added: contribution to state revenues, GDP and exports
INSPIRED EVOLUTION	Financial: cost-effective financial management, IRR, multiple on investment	Environmental: MWh clean energy produced, tons of carbon dioxide-equivalent emissions reduced, tons of sustainably produced product, resource savings	Social: employment created, labor spend, training person-hours, local procurement, SMEs spend, socio-economic development spend, corporate social investment spend	Governance & transformation: local ownership, inclusion of women, policy, systems and reporting

³⁰ Definition of IRIS: <https://iris.thegiin.org/guide/getting-started-guide>

³¹ CrossBoundary analysis

Quantitative metrics are generally easier and often already recorded in some form as part of standard business governance. For instance, Solon Capital Partners, a fund in Sierra Leone, estimated that for each dollar invested today, four dollars of quantifiable benefits would be created (calculated as additional income, goods and services purchased, and taxes paid). Similarly, Maris Ltd, a holding company investing in South Sudan and other fragile states, collected data on taxes, duties, and royalties provided to the relevant government bodies, as well as local salaries, contractor payments, and community contributions.

At the same time, fund investment in fragile states create value in the overall ecosystem – and such impacts are more difficult to quantify, including improving a specific value chain, decreasing costs of doing business for other funds/companies, and raising ESG and compliance standards in the market. Though difficult to easily measure and compare, these include visible changes with lasting impact on the local economy. For instance, in Sierra Leone, the growth of Solon’s company in the vehicle leasing sector led to the emergence of several competitors as well as the market-wide introduction of technologies such as global positioning system (GPS) tracking and Iridium satellite phones for remote areas.

Throughout, the cost of measuring impact, in both time and money, should be taken into consideration. Impact funds must allocate resources to the evaluation of the developmental effect of their portfolio companies. If LPs expect significantly more data than simple-to-collect metrics (such as jobs created), it will come at a management cost – a cost which is often most burdensome on smaller funds in more fragile states.

Impact and return performances should be evaluated/incentivized in parallel

In some cases, fully commercial risk-adjusted net returns may be achievable, but in many high-impact fragile state investments they are not. As I&P has argued: *“In practice, it is often necessary to make trade-offs between profit and impact.”*³² In a recent lessons learned report, I&P noted that to achieve significant and sustainable measurable impact, fund managers need to provide intense support in setting up and influencing tailored structures, governance, supply chains, policies, etc.³³ LPs expecting to have a meaningful impact on those companies and ecosystems may need to compromise on (net) returns or liquidity, particularly in the early years of more flexible equity-like capital entering a specific FCS market. In interviews, I&P highlighted that small ticket equity capital is rare and creates the ‘missing middle’ – in an analysis of about 80 equity investments they had made, they found that only three of them were in competition with other equity providers.

Job creation and domestic linkages are arguably of particular importance in FCS where unemployment is often higher and access to basic services is difficult, potentially driving extremism and violence.³⁴ I&P’s reporting highlighted an outsize employment impact in its markets, many of which are FCS. *“I&P’s partner companies have average employment growth of 50% over the investment period, which is three times higher than that observed in companies supported by traditional private equity players in Africa.”*³⁵ Of course, higher percentage changes come with lower absolute starting points, and this result was accordingly driven primarily by service companies, early stage ventures, and microfinance institutions (MFIs).

Job quality is an indicator often tracked in parallel with job creation. For the company, formalized jobs can decrease turnover and increase sustainability. For the employee, a formal job provides direct benefits such as healthcare benefits as well as indirect benefits such as access to loans and financial stability. However, of

“Balancing the types of impact is important – often the more profitable and job-creating opportunities in fragile states are in mining and large-scale agriculture/forestry, sectors which certain LPs may not allow because of perception concerns or environmental impact.”

Investor in multiple FCS countries

³² Elodie Nocquet, Clémence Bourrin, and Emilie Debled, “There is no impact but only proof of impact!”, I&P, p6.

³³ “Fifteen Years, Fifteen Lessons from Africa”, I&P, 2017, p45.

³⁴ “Plan of action to prevent violent extremism”, UNDP, https://www.un.org/counterterrorism/ctitf/sites/www.un.org/counterterrorism.ctitf/files/plan_action.pdf.

³⁵ “Fifteen Years, Fifteen Lessons from Africa”, I&P, 2017, p63.

note, in some contexts where most employees have several jobs and prefer the ability to easily change, the formalization of jobs could also lead to departures.

Impact performance indicators can be used to incentivize fund managers appropriately, for example the compensation structure could include a 'social carried interest' component (see the text box below).

When net returns are particularly difficult to achieve due to a fund's desired impact model – for example, for funds investing small ticket sizes for minority stakes (and therefore usually investing more time and expense in helping a local early-stage entrepreneur) – tailored incentive structures can help ensure that GPs and LPs are aligned in achieving the stated impact.

Lastly, there are crossover indicators that drive both returns and development, even though they are not

typically mentioned in the context of fund performance frameworks. These include governance metrics such as delivering accurate, timely reports, accounts, and audits; having regular and appropriately documented board meetings; and being in good financial standing and compliance with external entities/stakeholders – all of which are relatively easy to monitor without creating new reporting burdens. Additionally, tracking the successful mobilization of commercial capital and concessionary funding for each dollar invested by an LP in fund capital and advisory services is a way to gauge the investee's success and sustainability from a high-level perspective.

"The base carry is 15% for achieving the financial hurdle and is adjusted upward according to the achievement of one or more of the three impact targets. Assuming that the financial hurdle is met: if impact target A is met, then the GP carry increases by 5% from a base of 15% to a total of 20%, the standard carry for private equity fund managers. The carry increases to 30% if impact targets A, B, and C are met."

Social carried interest as described in a Global Impact Investing Network report



Young girl fetching water. The lack of water infrastructure limits agriculture efficiency. (Stefan Freeman, Mozambique, 2018)

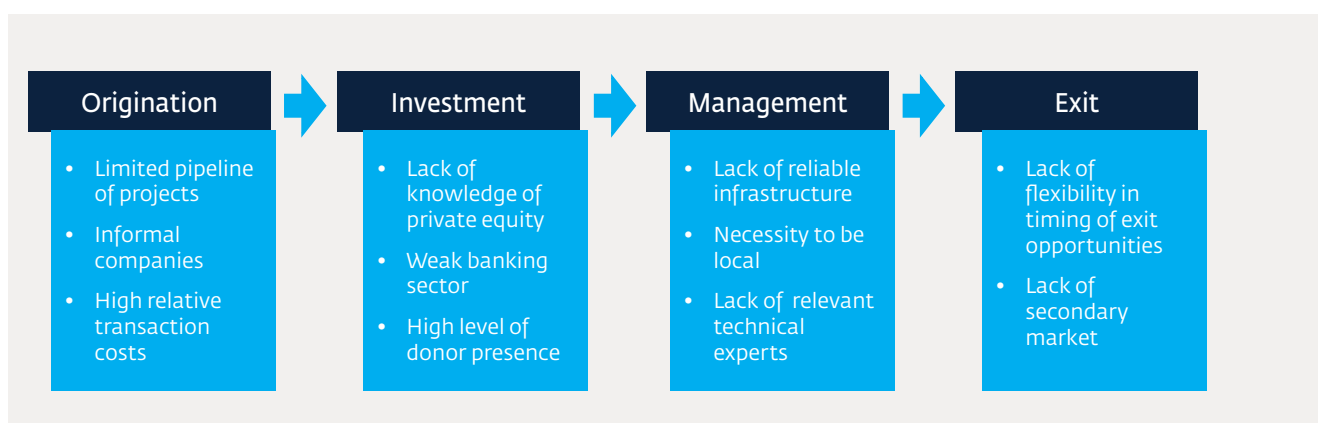
Challenges in investing in SMEs in fragile states

Several challenges, although not exclusive to FCS, are particularly severe in these contexts. For most frontier markets, there are a number of common challenges: poor infrastructure quality, a scarcity of skilled labor, difficulty to establish the creditworthiness of firms, a limited volume of business activity due to high poverty levels, the low quality and availability of lawyers, consultants, and accountants, and volatile exchange rates.³⁶ However, the distinctive political, security, and related economic characteristics compound a number of these challenges in frontier markets. For example, while poor infrastructure is common across frontier markets, this challenge may be especially apparent in a context where key infrastructure has been damaged or severely neglected due to political unrest and/or violent conflict.

Additionally, there are distinctive risks that are more unique to fragile states and create a particularly difficult investment environment.³⁷ For instance, lenders may have to finance companies with high inefficiencies in their funding and operating cost structures due to structural issues in fragile states.³⁸ More generally, differences between emerging/developed markets and frontier markets include the fund's strategy, the type of opportunities available, and the nature of the investment process.³⁹

The challenges discussed in this report are experienced in frontier markets, whether specific to those markets or not. The sets of challenges encountered at different stages of the investment process are represented in the figure below.

FIGURE 9: REPRESENTATIVE SETS OF CHALLENGES AT DIFFERENT STAGES OF THE INVESTMENT PROCESS⁴⁰



³⁶ "Private Enterprises in Conflict-related Situations", IFC WBG, May 2017.

³⁷ Dr. Josh Lerner, Ann Leamon, Andrew Speen, and Chris Allen, "Risk Capital in Emerging Markets and the SME-Ventures Model", Bella Research Group for IFC, 2015.

³⁸ "IPDEV, a pioneering initiative to promote African SMEs", I&P, May 2017.

³⁹ "Due Diligence in Emerging Markets", IFC WBG and OPIC, Vancouver Conference – Institutional Limited Partners Association, October 2011.

⁴⁰ CrossBoundary analysis

Funds prioritize countries based on the attractiveness of the investment environment

The first step to attract investors in fragile states is to put fragile states on the map of potential investors. GPs will build their strategy based on both their knowledge of the investment climate in the countries and on demand from LPs. LPs can partially influence the country of interest, but most GPs will already have a set of countries where they plan to invest as a first-time fund or expand as an experienced fund. The list of countries chosen by the GP will ultimately be influenced by the size of the opportunity alongside political, security, and currency risks, as well as the regulatory framework. Thereafter, fundraising challenges will orient the strategy as LPs push for additional conditions.

Security risks arising from political conflict or criminal violence as a result of diminished rule of law are challenges particularly relevant in fragile states

When a country is at war, investors have to weigh business opportunities against threats to their operations, staff, and the general effect on the business outlook. In that context, countries with high security risk will not be prioritized. In some context, the perception of security risk is inaccurate, especially if the narrative of the country is focused on war or fragility. For instance, Cameroon and Nigeria have high security risks with Boko Haram attacks in the north of both countries. However, neither country is limited to this single narrative. On the other hand, the war in Mali is seen as violent, spreading across the country. The reality is that, thanks to peacekeeping security operations led by international stakeholders (the United Nations [UN] and France), Mali is relatively peaceful and stable in the south, while the north remains mired in conflict.

The fragile state indicators often confirm this divergence between perception and reality where a country can rank high risk on the 'security apparatus' indicator, which often leads to a negative image of the country. On that indicator, Mali is ranked among the 8th most at risk countries in SSA. However, Mali ranks as low risk on the fragile state indicators of 'cohesion' or 'factionalized elites' (indicators considering the fragmentation of state institutions along ethnic, class, clan, racial or religious lines, and the use of nationalistic political rhetoric by ruling elites, often in terms of nationalism, xenophobia, and communal irredentism [e.g. 'a greater Serbia'], or of communal solidarity [e.g. 'ethnic cleansing' or 'defending the faith']), and therefore can be on average more stable and safe than what investors perceive. Then, the 'group grievance' indicator focuses on divisions and schisms between different groups in society – particularly divisions based on social or political characteristics – and their role in access to services or resources, and inclusion in the political process. Adding those two indicators to the 'security apparatus' indicator, Mali is now ranked 21st, after the DRC and Côte d'Ivoire. From an outside perspective, Mali may seem like a bleak investment destination. However, investors who have a more nuanced perception of the differentiation between the north and south have invested in opportunities in the southern half of the country. Despite the government's efforts to attract more FDI, the perception of Mali as a high-risk business environment lowers its chances of being on investors' radars. The 5% steady GDP growth and the government's efforts to attract more FDIs represent an opportunity for investors.

The perception of a country as a high-risk business environment lowers its chances of being on the initial map of investors. From their initial map, investors will dig deeper and look into the macroeconomic environment of the country.

Macroeconomic factors, including currency risk, GDP growth, and population size will be used to generate a list of priority countries

In private equity, return drivers are leverage, valuation multiples, revenue growth, or efficiency gains. In fragile states, the most common driver of returns is revenue growth, with deals rarely focused on leverage or improved

efficiency.⁴¹ In that context, investors are looking into the size and potential growth of each country and economic region. Macroeconomic data will provide a sense of the country's potential: GDP and GDP growth, FDI trends, population size and growth, consumer purchasing power, currency fluctuation, etc. LPs' strategy will also be influenced by countries' macroeconomic data. The AVCA LP survey states that 61% of LPs note currency risk as the greatest challenge to GPs over the next three years in emerging markets.⁴²

For instance, the DRC represents an attractive market because of its large population size (79 million people). Fast-moving consumer goods and service sectors are deemed high-growth potential sectors in the DRC. At the same time, the depreciation of the Congolese Franc has decreased the buying power of the population working and living in the DRC, decreasing the revenues of SMEs. The DRC's macroeconomic data get it onto the watch list of investors but have not yet led to many investments.

*"The population size drives the entrance of companies. You can't ignore a big market."
Investor based in Kinshasa*

Private investors consider the country's currency fluctuation before moving forward in a country. After the depreciation of the Nigerian Naira post-commodity crisis, several investors noted that Francophone West Africa was becoming more attractive, considering the safety represented by the CFA Franc. With the CFA Franc pegged to the Euro, low currency fluctuation is a positive aspect of investing in the West African Economic and Monetary Union (WAEMU), especially as several investors encountered difficulties with the Nigerian Naira and the Ghanaian Cedi. Local currencies of fragile states are often depreciating when they are not pegged. Volatility and depreciation of the Malagasy Ariary, the Congolese Franc (although the DRC economy is largely dollarized), and the Mozambican Metical negatively impacted local GP IRRs despite the positive fundamentals of their portfolio companies. One LP investing in Africa noted that they generally modeled a ~5% annual depreciation in currency for a typical SME or FCS fund projection. Meanwhile, direct currency hedging is expensive and often unavailable. In this context, proxy hedging can be considered alongside other options such as donor-backed insurance or expanding the availability of direct hedging products for certain currencies. As presented in a report supported by USAID's Office of Private Capital entitled "Expanding Institutional Investment into Emerging Markets via Currency Risk Mitigation", proxy hedging involves creating a shadow portfolio of marketable, liquid options in instruments (commodities such as oil or wheat, interest rates and equity indices, etc.) that are predicted to have likely gains if there is material currency depreciation.⁴³ While clearly complex and potentially difficult to implement under standard fund governance, such innovative mechanisms should be explored, as currency concerns are perhaps the most common impediment to GPs and LPs entering new FCS markets.

WAEMU is also very well integrated economically, more so than the East African Community (EAC) or the Southern African Development Community (SADC), with free movement of people and capital. Côte d'Ivoire, the economic hub of the region, is experiencing equity market crowding. Twenty-two private equity funds in the country are doing similar types of deals (minority, ~US\$10 million ticket) while there were only five funds in Côte d'Ivoire in 2012. This influx is becoming an issue, as funds are lacking differentiation and are competing for the same deals.

On the other hand, Madagascar has a similar population size (25 million people) as Côte d'Ivoire (24 million) and Mozambique (29 million), but a higher level of poverty, which has consistently increased over the past 50 years.⁴⁴ Investors have also seen a sustained trend of currency depreciation alongside unpredictable fluctuations driven by a lack of political stability. As an insular economy, with only a few families controlling the major sectors of the country (telecoms, the auto industry, fuel, energy, and construction), Madagascar's macroeconomic data are not positive and do not encourage investments.

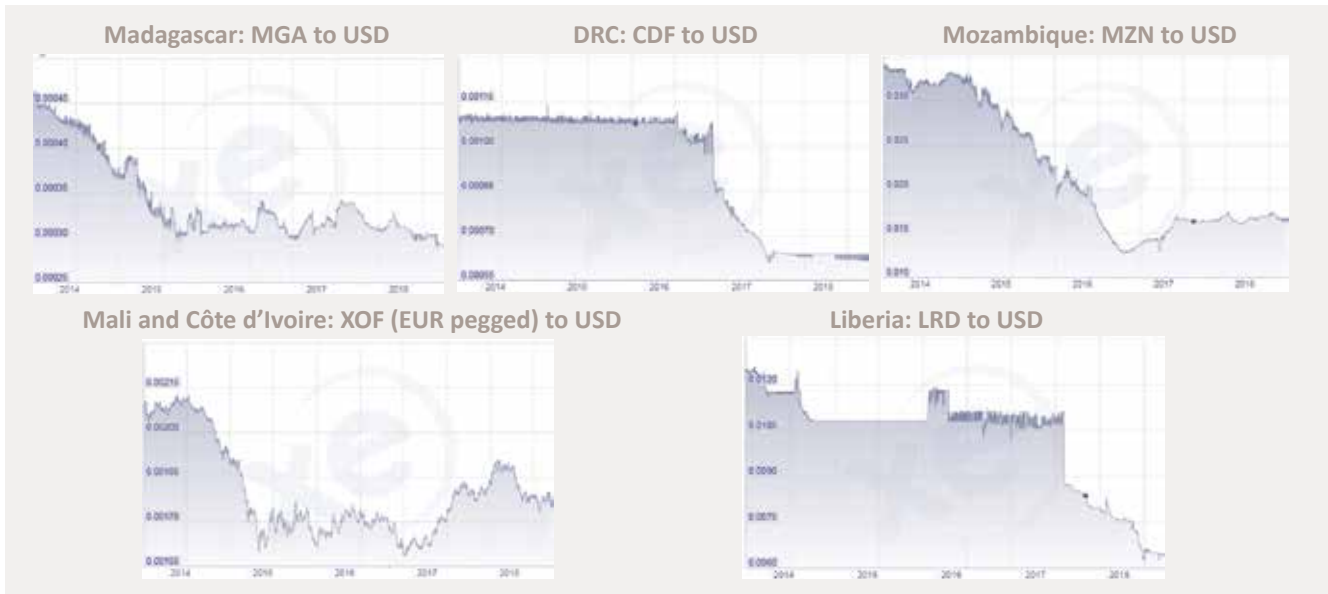
⁴¹ "Due Diligence in Emerging Markets", IFC WBG and OPIC, Vancouver Conference – Institutional Limited Partners Association, October 2011.

⁴² "Annual Limited Partner Survey Institutional – investor views and expectations about private equity in Africa", AVCA – Limited Partner Survey, 2016.

⁴³ "Expanding Institutional Investment into Emerging Markets via Currency Risk Mitigation", Sarona Asset Management, EMPEA, Crystalus, and USAID's Office of Private Capital and Microenterprise, January 2018.

⁴⁴ Poverty gap at US\$1.90 a day (2011 PPP) (%): Madagascar: 39% in 2012; Côte d'Ivoire: 9% in 2015.

FIGURE 10: CURRENCY FLUCTUATION, 2008-2018⁴⁵



Political risks arising from institutional fragility and lack of government legitimacy diminish the attractiveness of fragile states

GPs seeking to launch a fund in a country or region will look for some type of certainty on the returns of their investments. Countries with uncertain political stability will often be rejected as a result. Often, in frontier markets, a change of government can lead to changes in taxation, customs rights, trade treaties, and land rights, among others. When GPs prioritize countries, they will also take into account the ability to disburse funds in a timely manner. In contexts where the stability of a country depends on the next election, several investors mentioned that they would wait before considering the country as a potential investment location. Since money needs to be disbursed quickly, countries with stronger institutions and high legitimacy of their government will be prioritized.

The regulatory framework will influence investor confidence in a market

Before prioritizing a country, investors will look thoroughly at its legal system, including the ability to repatriate dividends and profits, the level of taxation, and perceptions of corruption. The regulatory framework of FCS is often nascent or disconnected between the letter of the law and reality. The reputational risks and political exposure of some companies in fragile states, particularly where corruption is high, can contribute to a lower investor interest.⁴⁶ Additionally, investors in FCS are often minority investors, which often have weak protections in fragile states.

However, companies operating in FCS rank the burden of government regulations below average in terms of severity compared to other frontier markets. The 2017/2018 Global Investment Competitiveness Report

⁴⁵ www.xe.com

⁴⁶ "Due Diligence in Emerging Markets", IFCWBG and OPIC, Vancouver Conference – Institutional Limited Partners Association, October 2011.

suggests that the problem in FCS may be less one of regulatory burden and more the absence of needed market regulation.⁴⁷

The absence of clear and transparent public and private regulation, the opacity of the tax system, the lack of stability in fiscal norms, interpretation of the fiscal law, high levels of corruption, lengthy and complicated governmental processes, and the inability to enforce regulation are among the factors that will significantly decrease the willingness of GPs to invest in a country. The lack of rule of law creates an uncertain business environment where businesses have to adapt to unpredictable changes in the regulatory landscape. In most fragile states, the regulatory framework for funds is also nascent. Countries without an existing legal framework for private equity investments nor with precedent to rely on are considered riskier.

For funds located in countries with more developed legal systems, such as Côte d'Ivoire, investors still express frustrations, but these are centered on the type of regulations rather than the lack thereof. For instance, capital gains arising from the disposal of fixed assets and shares are often included in taxable income and the level of taxation on capital gains can be high compared to Ghana (15%), Kenya (5% on the net gain), Cameroon (17%), Gabon (20% or exempted), Madagascar (20%), or Nigeria (10%). Partly due to this, several funds with their headquarters in Côte d'Ivoire are registered in Mauritius.

Between stable emerging markets and frontier markets, deal flow differs in quality, maturity, and size of companies

In frontier markets, out of a hundred deals reviewed, only two to three deals will be selected.⁴⁸ Additionally, the investment opportunities will be closer to venture capital than private equity, as many companies are greenfield and face a higher risk of failure than more mature enterprises.⁴⁹ For example, investors interviewed in Mozambique mentioned that the lack of investable companies is often a significant challenge faced in the market. As a result, investors end up launching a significant proportion of investments as greenfield projects, often playing an initial role as advisor, which provides them with the option to invest over time.

Finally, customer demand is often low. High levels of poverty limit the volume of business activity that the local population can support. At the same time, foreign markets often remain out of reach because of the poor quality of transport infrastructure and the high-level export requirements (such as traceability). The small size of certain markets (both in terms of a small population and low individual purchasing power) makes it challenging to gain economies of scale. Many businesses in small fragile states simply do not have enough of a local market to grow much larger than they already are. This constraint may force funds to take on smaller investments, which increases the percentage cost of sourcing, TA or operational oversight. Many funds will not have the luxury to afford smaller ticket sizes and might decide not to enter the market. The alternative is for funds to invest in companies that take more of a regional approach, but typically these are more formal and developed enterprises.

Companies targeted by impact investors tend to be informal

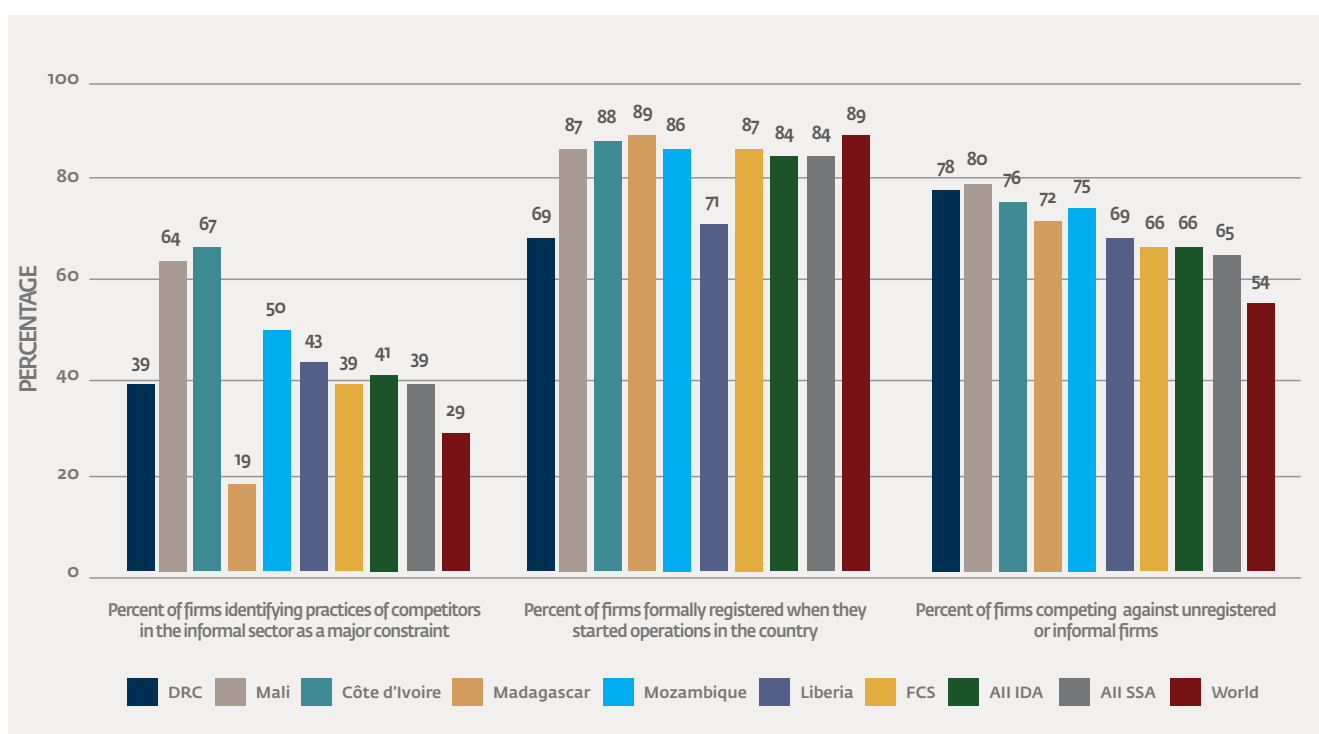
In most countries, the level of formalization of companies has been mentioned as a barrier to investment. However, based on an enterprise survey on the level of formalization, the six case study countries and the average in FCS, IDA, and SSA are not very different. If lack of formalization is an issue in fragile states, it is not specific to fragile economies. It is noticeable that Côte d'Ivoire and Mali are countries where the practices of competitors in the informal sector are the most salient. Liberia and the DRC are countries where firms are more likely, on average, to start operations informally compared to SSA.

⁴⁷ Alexandros Ragoussis and Heba Shams, "FDI in Fragile and Conflict-Affected Situations", Global Investment Competitiveness, Chapter 5 of Global Investment Competitiveness Report 2017/2018, DOI: 10.1596/978-1-4648-1175-3., 2017.

⁴⁸ "Due Diligence in Emerging Markets", IFC WBG, and OPIC, Vancouver Conference – Institutional Limited Partners Association, October 2011.

⁴⁹ "IPDEV, a pioneering initiative to promote African SMEs", I&P, May 2017.

FIGURE 11: LEVEL OF FORMALIZATION BY COUNTRY CATEGORY⁵⁰



In frontier markets, entrepreneurs know that to get capital they need to provide accounts to banks. As an example, several companies will refer to their three 'books' (tax, bank, owner). The accounts are rarely audited by the banks. GPs must work hand-in-hand with entrepreneurs to ensure transparency. Entrepreneurs that are used to working with banks need to be convinced to increase their level of formalization, which includes ensuring that there are regular board meetings, inventory tracking, and usage of employees rather than contractors, among other changes. For many SME owners, the benefits of transitioning from informal to more formal business practices are not necessarily obvious, as it often leads to higher costs (including accounting, human resources, or ESG costs). For instance, in a fragile state, an entrepreneur formalized his processes and found that he was facing strikes from employees. According to him, this issue would not have occurred had the company stayed informal. This mindset requires investors to continually demonstrate the value of formalization.

SMEs are receptive to several arguments. For a company to grow past being a lifestyle business, it will need to implement systems that are costly at first but ultimately lead to higher returns. Without governance structures, key post-investment activities such as monitoring, strategy guidance, and investor assistance become the most challenging and time-consuming aspect of an investment. The smaller the investee, the more challenging this becomes. Arguments to formalize companies lie in the significant positive externalities: jobs in the formal sector provide access to training and social security; those jobs are also more secure and pay significantly higher wages than jobs in the informal sector. To quote I&P's report *Investing in Africa's Small and Growing Businesses*: "Formal SMEs create good quality jobs. These jobs, with higher wages than in the informal sector (50% to 60% higher according to data from Ghana and Tanzania) are more secure and give access to training and social security." Having employees instead of contractors, and being able to provide some type of social security, among other benefits, should lead to lower employee turnover, which benefits the company in the long run.⁵¹ Additionally, the regularity of formal wages enables employees to gain greater access to credit, to save money for their children's education, and to plan for the future.⁵² Nevertheless, the transition from informal to formal takes time and increases transaction costs.

⁵⁰ World Bank data – enterprise survey: <http://www.enterprisesurveys.org/data/exploretopics/informality>

⁵¹ "Investing in Africa's Small and Growing Businesses", I&P, ANDE, EY, INSEAD, Tony Elumelu Foundation, 2016.

⁵² "IPDEV, a pioneering initiative to promote African SMEs", I&P, May 2017.

High relative transaction costs decrease net IRR

Small deal sizes lead to relatively high transaction costs. The size of the investment needs to be in line with the burden of completing and managing the investment, but the average cost of due diligence will remain similar whether the deal is US\$1 million or US\$10 million in size. In fact, costs may be higher for smaller deals, where companies often have less robust accounting, governance, and other systems in place.

Furthermore, the importance of trust to close a transaction with a new investor means funds must spend time proving their ability to add value to company owners. Deals relying heavily on relationships and requiring significant face-to-face time will decrease overall net IRRs due to management costs. Face-to-face meetings with companies outside of a fund's locale office can significantly increase due diligence costs. While each fund, country context, and deal are unique, one GP investing in an FCS market found that a deal with a gross IRR of 20% resulted in a net IRR of only 7% once its transaction costs had been included.

During the investment process, risk capital investors will need to overcome the lack of knowledge of entrepreneurs, a weak banking system, and free donor money

The investor has an educating role to play to increase the knowledge of entrepreneurs on equity investment

Equity investments are not well known in frontier markets. The entrepreneurs are more comfortable working with debt and are less familiar with equity, especially in countries with low currency volatility where debt can be relatively affordable. As a result, investors will often have to educate the entrepreneur on the value of an equity investment.

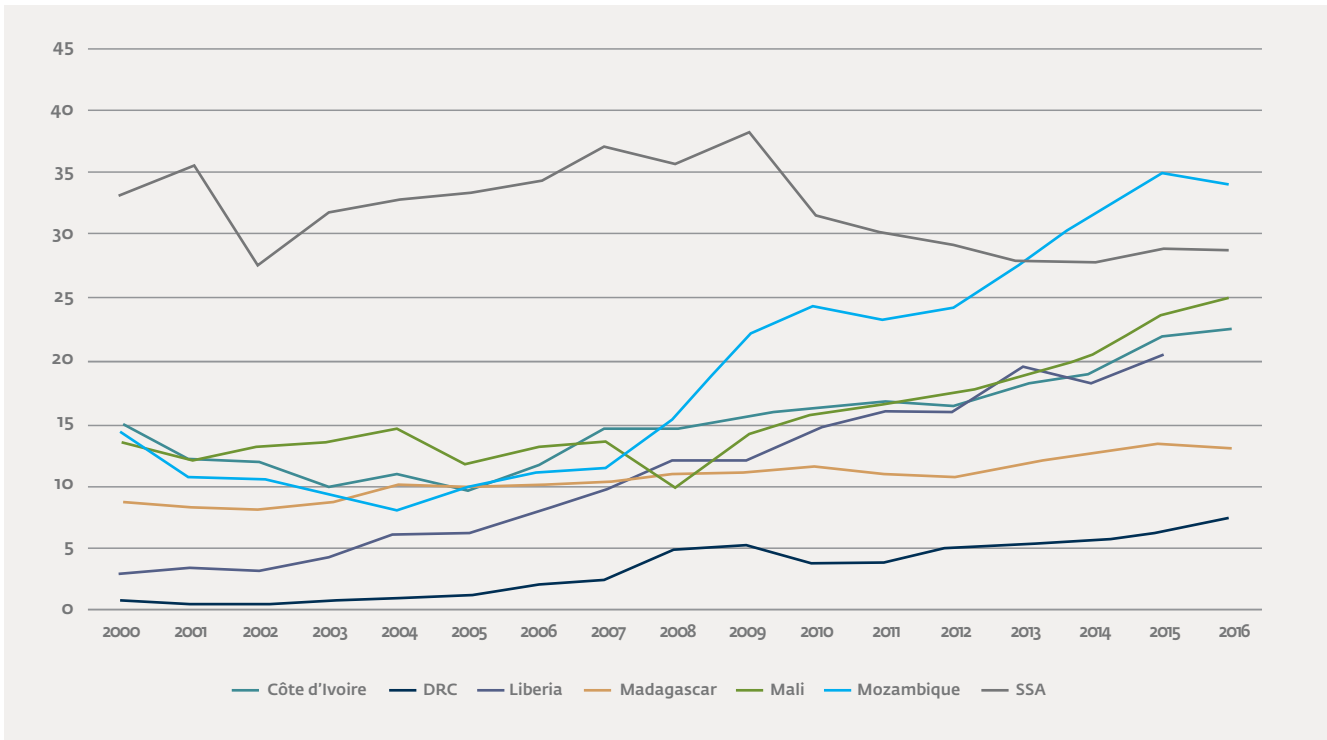
Often entrepreneurs in fragile states who own family-run businesses will be reluctant to cede ownership to external investors. This environment, centered upon a family approach to owning a company and a strong sense of legacy from one generation to the next, creates an additional barrier to the negotiation. Because companies are uncomfortable with equity, investors have developed several other instruments ('mezzanine products') to mitigate those challenges, but it can be confusing to entrepreneurs who are already unfamiliar with equity structures.

"Even after months of negotiation, we are asked 'what's the interest rate?', which reflects the difficulties of understanding private equity."
Equity investor in Abidjan

A weak banking sector can be both a barrier and an opportunity for risk capital investors

The banking sector is important to investors, as it is often complementary to an equity investment (especially for working capital, trade finance, etc.) The maturity of the banking sector and the affordability of loans will influence investors' confidence in the ability of banks to participate in the financing needs of companies. The value of domestic credit to the private sector by banks as a percentage of GDP is low in the DRC (8%) and Madagascar (13%), especially when compared to the SSA average of 29%. Liberia (at 20%), Côte d'Ivoire (at 22%), and Mali (at 25%) are catching up with SSA, while Mozambique (at 34%) is above the SSA average (at least as of the time of these statistics). However, at the same time the difficulty experienced in obtaining credit in Madagascar and the DRC can represent an opportunity for risk capital investors. If the banks are not providing credit, other investors can step in and play a similar role to banks by providing self-liquidating debt-like instruments.

FIGURE 12: DOMESTIC CREDIT TO PRIVATE SECTOR BY BANKS, 2000-2016 (% OF GDP)⁵³



For SMEs, access to finance is a major constraint. Providing funding to SMEs is a challenge that is especially acute in frontier markets, despite the important role that SMEs play in job creation in FCS. Over 40% of the SMEs in SSA mention access to finance as a major constraint to growth, which is almost 1.5 times more often than SMEs elsewhere.⁵⁴

Globally, beyond friends and family sources of capital, SMEs most frequently access credit through bank loans – with SME bank loans estimated at about 13% of GDP.⁵⁵ Banks are trained to assess traditional risk and preserve capital, which may result in deferring several categories of borrowers. For instance, a greenfield project does not appear likely to preserve capital, nor can it guarantee to make regular loan repayments. Additionally, in both frontier and fragile states, only a few SMEs will have the necessary collateral to qualify for loans. In FCS, SME bank loans are estimated at about 3% of GDP.⁵⁶ FCS SMEs are left with very few options to fund business expansion.

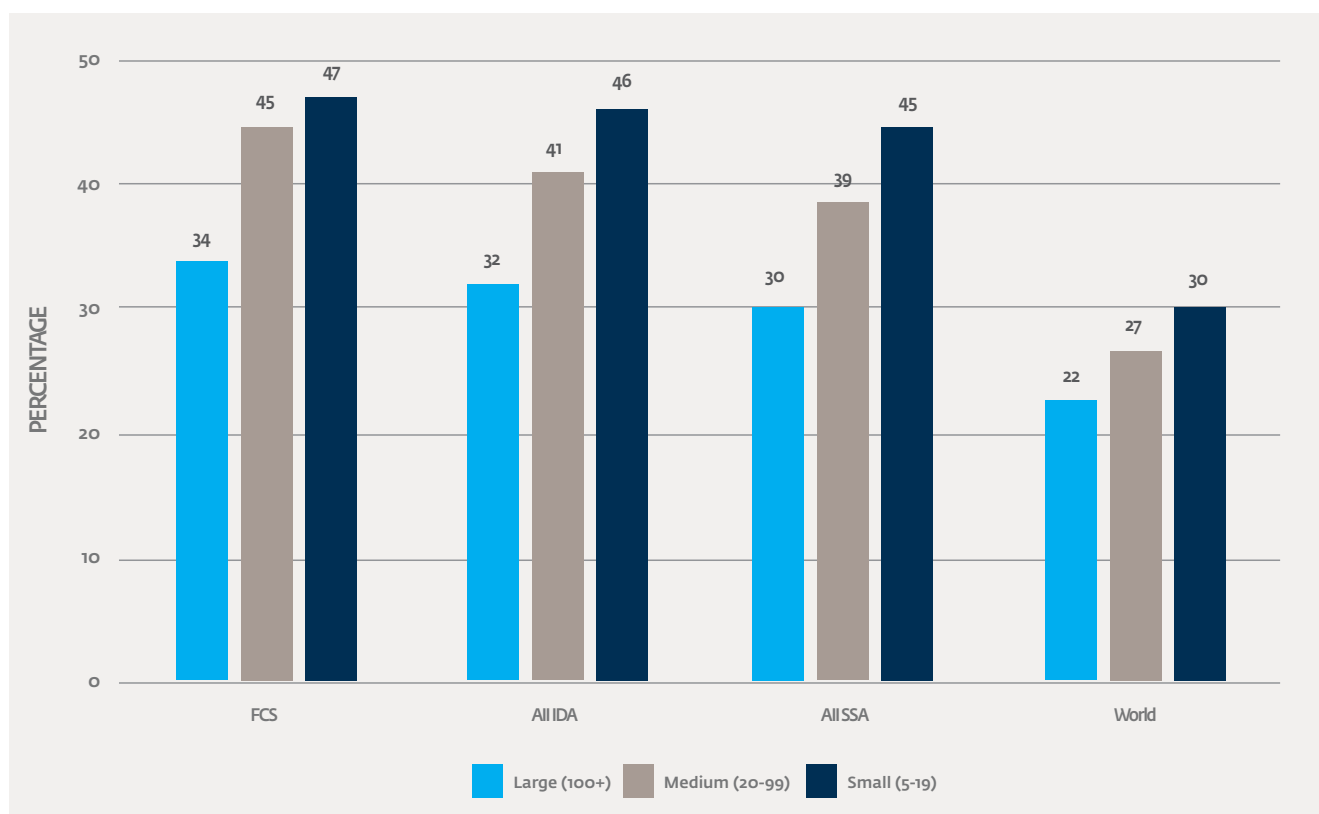
⁵³ World Bank data: <https://data.worldbank.org/indicator/FD.AST.PRVT.GD.ZS?end=2016&locations=CD-ML-MG-CI-LR-MZ-ZG&start=2000>.

⁵⁴ Data from World Bank Enterprise Surveys (database), 2016.

⁵⁵ Dr. Josh Lerner, Ann Leamon, Andrew Speen, and Chris Allen, "Risk Capital in Emerging Markets and the SME-Ventures Model", Bella Research Group for IFC, 2015.

⁵⁶ Ibid

FIGURE 13: PERCENTAGE OF FIRMS IDENTIFYING ACCESS TO FINANCE AS A MAJOR CONSTRAINT (BY FIRM SIZE)⁵⁷



Debt lending for SMEs in FCS is based on risk/return dynamics that can be understood through an analysis of two key drivers:⁵⁸

- Probability of default:** Lenders can find it difficult to differentiate between high and low risk credits and suffer from bad selection of borrowers. The creditworthiness of firms is established based on information asymmetry and a lack of available data. Banks will protect their losses by asking for high collateral requirements.
 - Often, entrepreneurs will be working with several banks to which they have already provided collateral, guarantees, pledges, or mortgages. Companies can end up being short of available collateral to take on a new credit.
 - In Mozambique, national land laws preventing the ownership of land remove a major source of collateral. Since the government owns all the land, firms are often unable to meet their collateral requirements, which are typically around 150% of the loan value. This leads to significant challenges, especially for agriculture companies that can only use existing equipment as collateral.
- Loss given default:** Lenders may suffer from high loss rates in the event of borrower default. The share of non-performing loans for small businesses in Africa is 14.5% as opposed to an average of 5.5% in developing countries,⁵⁹ and the inability to recover on collaterals adds on to the risk.

⁵⁷ Ease of Doing Business, World Bank data.

⁵⁸ "SME Finance Policy Guide", IFC, October 2011.

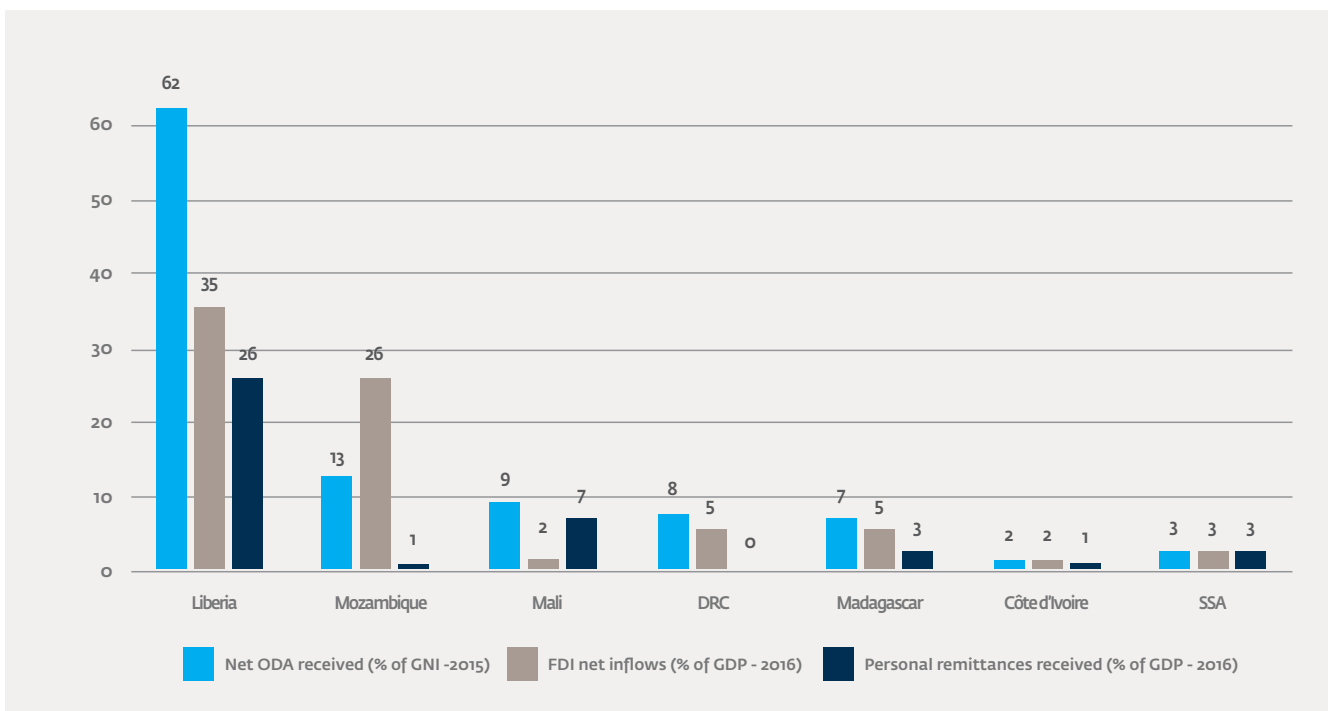
⁵⁹ "Investing in Africa's Small and Growing Businesses", I&P, ANDE, EY, INSEAD, Tony Elumelu Foundation, 2016.

Finally, risk capital investors will look to interest rates to define the complementarity of debt lending and equity investment. On the one hand, in some FCS, funds are also in competition with banks. Interest rates in Francophone West Africa can be below 4% FCFA. Cost of debt is lower than in other fragile states, which means equity might become relatively too expensive for companies, and equity investors will need to actively prove their added value. On the other hand, in countries where interest rates to SMEs range between 20% and 35% per year, investors can have equity-like returns by using debt-like instruments. Equity instruments become extremely rare and focused on start-ups.

A high level of donor presence can provide unfair competition and hinder the potential of risk capital investors

Donor interventions alongside subsidies, grants, or 'free money' from aid agencies, often as part of a post-crisis recovery effort, can lead to misaligned or unrealistic expectations of the terms of investment.⁶⁰ The Fragile State Index (FSI) 'external intervention' indicator considers the influence and impact of external actors in the functioning of a state. Liberia, Mali, the DRC, and Côte d'Ivoire are four of eight countries ranked highest in this regard. Liberia has received 62% of gross national income (GNI) from net Official Development Assistance (ODA). ODA consists of either disbursement of loans made on concessional terms, or grants by multilateral institutions to promote development outcomes. Additionally, Liberia is the country with the highest remittances as a percentage of GDP, and among the highest in terms of FDI net inflows as a percentage of GDP.

FIGURE 14: NET ODA RECEIVED AS % OF GNI, FDI NET INFLOWS AS % OF GDP, REMITTANCES AS % OF GDP⁶¹



⁶⁰ "Private Enterprises in Conflict-related Situations", IFC WBG, May 2017.

⁶¹ World Bank data

Companies that are positioned to serve the sudden influx of development and aid organizations pouring into a region after a crisis can fare well. For example, a company in Liberia focused on logistics services performed well through the Ebola crisis and thereafter. Many of their foreign competitors left the country in a period of unprecedented demand for logistics services spurred by the increased donor presence, enabling them to increase market share. In contrast, another Liberian company was disproportionately affected by Ebola, as its production activity was located close to the epicenter of the outbreak. While these disparate outcomes illustrate that crises do not always negatively damage companies, investors must be very knowledgeable of market dynamics to benefit from the 'opportunities' for both financial return and impact created by shock events.

Finally, risk capital investors can take advantage of an inflow of aid money by financing Technical Assistance or encouraging their companies to secure contracts with international organizations (such as NGOs, the UN, and embassies). However, aid money can also become disruptive and risk capital investors can end up competing with grant money. If donor money is necessary to answer acute humanitarian needs, the 'aid versus trade' debate remains relevant when countries move from crisis to post-crisis.⁶²

During the managing period, risk capital investors must support growth to ensure high returns on investment

The lack of reliable infrastructure is a challenge limits returns on investment

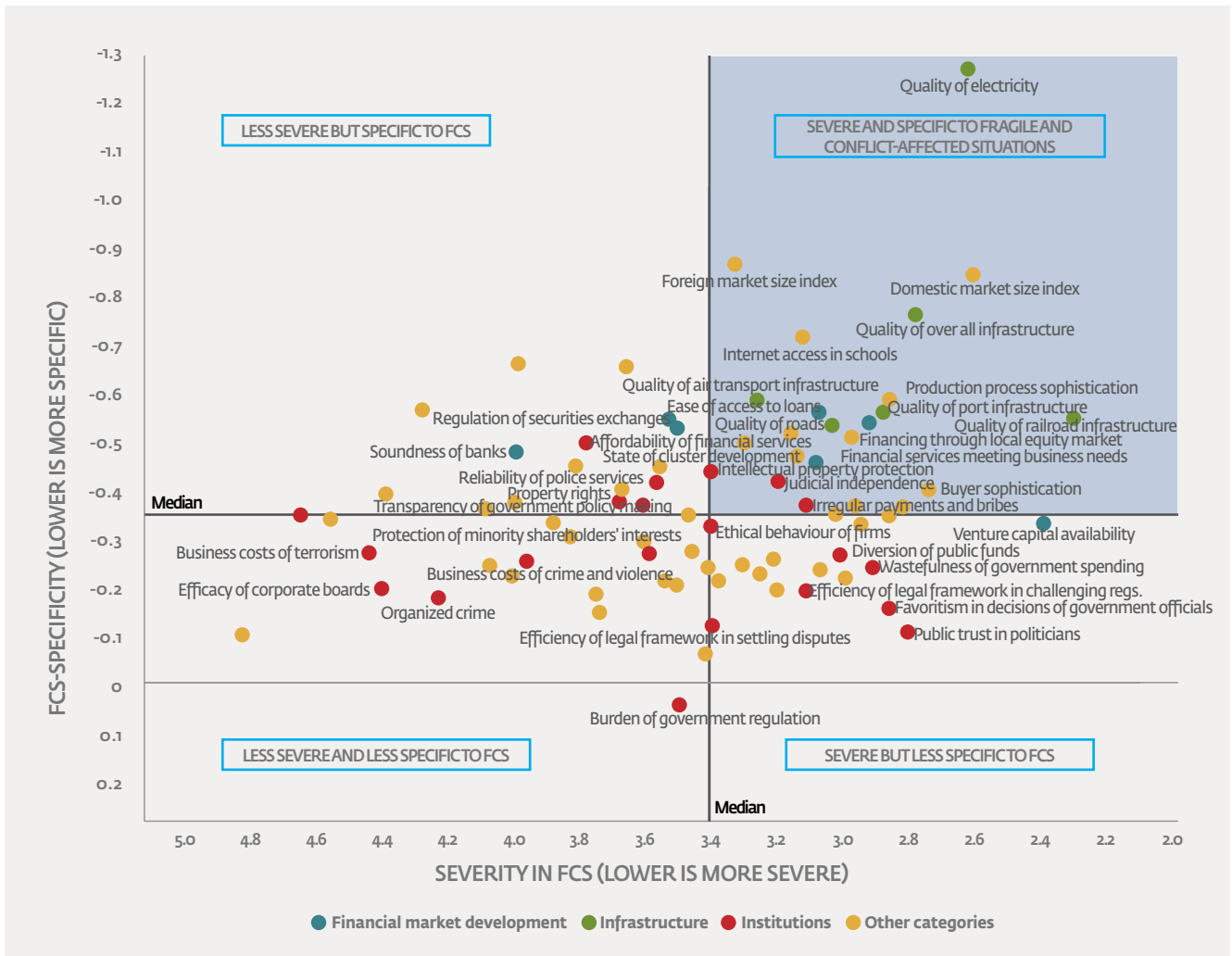
In fragile states, the poor quality and availability of energy, water, roads, and ports will lead to lower returns on investment, as the cost of operations and transportation will be higher than in stable countries and more developed markets. The lack of both hard and soft infrastructure can lead to higher costs of electricity and higher costs of skilled labor relative to comparable markets, which reduce returns.⁶³ A recent World Bank survey of multinational company (MNC) executives highlighted the severity in FCS of issues of electricity supply and other constraints related to poor infrastructure.⁶⁴

⁶² Ibrahim H. Yassin, "When is trade more valuable than aid?", *World Development*, Volume 10, Issue 2, February 1982, p161-166, [https://doi.org/10.1016/0305-750X\(82\)90045-6](https://doi.org/10.1016/0305-750X(82)90045-6).

⁶³ "IPDEV, a pioneering initiative to promote African SMEs", I&P, May 2017.

⁶⁴ Alexandros Ragoussis and Heba Shams, "FDI in Fragile and Conflict-Affected Situations", *Global Investment Competitiveness*, Chapter 5 of *Global Investment Competitiveness Report 2017/2018*, DOI: 10.1596/978-1-4648-1175-3., 2017.

FIGURE 15: PERCEPTIONS ON SEVERITY AND FCS-SPECIFICITY OF CHALLENGES, 2016⁶⁵



In Mali, Niger, Burkina Faso, and other landlocked countries, the lack of reliable infrastructure is diminishing the potential returns of companies that need access to roads, ports, and other transportation infrastructure to be able to export and trade. For instance, Mali imports goods through the ports of Dakar and Abidjan before such goods get transported over land to the country. Freight must be transported thousands of miles by road to the ports before being loaded into shipping containers for export to distant markets. The lack of adequate road and rail transport infrastructure makes this a very onerous process for importers and exporters. For instance, a slaughtering house located 600 km from Mali's capital Bamako is facing significant transport and logistics costs to move its products from the slaughterhouse to its vendors. A Mali-based fruit exporter, which exports mangoes to Europe, faces even more exorbitant transportation costs as its products must use other West African countries' roads and the crowded Abidjan port, cutting into the company's profitability.

If the need for high quality transport infrastructure is more striking in landlocked countries, other countries are also suffering from the lack of infrastructure that is required to accommodate and support business growth. With poor road connections, companies are relying heavily on local airports for transportation. In several FCS, it can be cheaper to import low-margin agricultural products from the US and Brazil rather than move local products from the north to the south of the country.

⁶⁵ Alexandros Ragoussis and Heba Shams, "FDI in Fragile and Conflict-Affected Situations", Global Investment Competitiveness, Chapter 5 of Global Investment Competitiveness Report 2017/2018, DOI: 10.1596/978-1-4648-1175-3., 2017.

Monitoring a company will be facilitated by being local, and finding relevant technical experts

Most deals need hands-on management, which involves local presence and time spent with entrepreneurs. The cost of monitoring deals can be high if the fund is far from its entrepreneurs. An investor can easily be 'disconnected' from the local challenges of its investees if he or she does not monitor the company and the entrepreneur closely.

Additionally, to ensure growth and added value, funds must provide access to technical support to the company. Often, investment team members are generalists. For more technical assistance, investors will need to find experts that can support the company's growth challenges. Those technical experts need to have the technical knowledge, the ability to travel and provide recommendations to local companies, and the language skills to communicate with the entrepreneurs and teams. Such experts are rare and difficult to find. In Madagascar, for instance, an investor was describing the lengthy process to find a technical expert who was knowledgeable in sea cucumber fertilization, could speak French, and was able to travel to Madagascar for a few weeks.

There are limited exit opportunities

Funds complain about the lack of flexibility in the timing of exits

Based on the AVCA LPs survey, half of LPs note that the relatively slow pace of exits will be a challenge for GPs over the next three years in emerging markets (second after currency risks).⁶⁶ In frontier markets, compared to developed markets, the exit opportunities are limited to management buy-outs or trade sales. IPOs are very rare and the secondary market is not as developed.^{67,68}

Exiting companies requires patience and substantial preparation, as SMEs need to 'graduate' and become 'big-investor ready'.⁶⁹ GPs are pushed to disburse funds quite quickly, but the time to negotiate an equity stake with an entrepreneur can be very long. At the same time, the exit timing is often a short window of opportunity and the fund must prepare the entrepreneur in advance.

In the context of fragile states and regular crises, one of the main challenges funds face is deciding whether to continue supporting a struggling company, and for how long. Recognizing and accepting failure is not easy for FCS investors that are closely engaged and committed.⁷⁰ For instance, when Côte d'Ivoire went through the 2011 crisis, investors had to face the difficult decision of writing off the investment, investing more, or waiting. During this period, an investor's reputation is at stake, as funds need to demonstrate their ability to work with entrepreneurs during crises as long-term investors. Exiting an investment in periods of crisis is highly challenging, especially in FCS countries that are relatively untouched markets.

The lack of a secondary market is a characteristic of frontier markets

Countries moving from fragile states to more stable markets will look into developing a secondary market. A smoother path to IPO on a regional stock exchange for a mid-size company is one stage towards becoming an emerging market. In FCS today, doing an IPO is an unlikely option for investors to exit an investment.

⁶⁶ "Annual Limited Partner Survey Institutional – investor views and expectations about private equity in Africa", AVCA – Limited Partner Survey, 2016.

⁶⁷ "Due Diligence in Emerging Markets", IFC WBG and OPIC, Vancouver Conference – Institutional Limited Partners Association, October 2011.

⁶⁸ "IPDEV, a pioneering initiative to promote African SMEs", I&P, May 2017.

⁶⁹ "Investing in Africa's Small and Growing Businesses", I&P, ANDE, EY, INSEAD, Tony Elumelu Foundation, 2016.

⁷⁰ "IPDEV, a pioneering initiative to promote African SMEs", I&P, May 2017.

For instance, in Côte d'Ivoire, investors commented on the development of the Bourse Régionale des Valeurs Mobilières (BRVM), the regional stock exchange in Francophone West Africa:

- The IPO process is too complex and costly to be attractive for SMEs. To respond to this challenge, the BRVM has put in place a third 'compartment' that would allow the trade of shares of SMEs. It has not yet been tested but GPs are following its progress closely.
- The stock exchange is relatively small. There are few transactions and low liquidity compared to other stock exchanges. Investors buy shares in a listed company and expect dividends. As a consequence, the company's dividends will be the main factor defining its market value. For companies that are in an expansion process, those dividends can be irregular, leading to low valuation.
- The average market valuation of a company is high compared to valuation through a potential trade sale or management buy-out. Valuations are going up to 12 to 13 times earnings, providing strong exit opportunities for the right companies.
- The head of BRVM is working closely with GPs to design better processes and systems. The goal is to answer the needs of the investors and shareholders using successful models, such as the Casablanca stock exchange, as examples.

The development of regional stock exchanges or mechanisms to sell shares will ease the exit process.

Several challenges are cross-cutting in the investment process

The lack of data and general information hinders the fund's strategy development, pipeline creation, and monitoring of its investments

There is a significant information asymmetry between investors entering frontier markets for the first time and companies seeking outside capital. In fragile states, 'normal' tasks such as evaluating a market size become cumbersome. Gathering data, finding experts in the field, and ensuring the reliability of the information represent significant barriers to investment.

The valuation of companies in FCS is complex, as comparable companies and the data required to support assumptions are rarely available. Valuation is uncertain in markets where the density of existing deals is low and there is no history of multiples. Additionally, discounted cash flow analyses are based on a variety of hypotheses and assumptions that are difficult to test.

Given low access to data, due diligence takes longer and is more difficult in frontier markets. Investors in the DRC and Côte d'Ivoire noted that the collection of financial information and the unreliability of any data provided directly by potential investors lead to long due diligence processes. Several banks also complained of the lack of shared information on creditors between banks. The low capacity of existing credit bureaus, sitting within central banks, compounds this problem further.

The lack of local skills needs to be overcome by risk capital investors

In fragile states, the scarcity of skills is due to poor education, high rates of emigration and brain drain, and improper labor standards, among others. Based on the AVCA LPs survey, about half of LPs note that scarcity of talent is a challenge to GPs over the next three years in emerging markets (third after currency risks and pace of exits).⁷¹

⁷¹ "Annual Limited Partner Survey Institutional – investor views and expectations about private equity in Africa", AVCA – Limited Partner Survey, 2016.

A general absence of sophisticated companies poses concerns about management abilities in terms of business expansion. Managers of small businesses are often not well positioned or appropriately prepared to manage businesses that are substantially larger. A gap in local talent makes finding good management difficult. For instance, in Liberia, a weak educational system and years of brain drain (due to civil unrest, migration to the US, and other causes) left a labor pool that may not often be able to provide the middle management layer necessary for businesses to expand beyond their current sizes.

In Mozambique, the lack of skilled human capital is a constantly cited problem. There are not many “business-minded” people – investors have pointed to the history of communism in the country as a contributing factor to the lack of business knowledge or culture of entrepreneurship. Additionally, according to the UN Development Programme’s (UNDP’s) human development index, Mozambique ranks 171st in terms of expected years of schooling, with 9.1 years as the national average (well below the average among all countries of 13 years).

In the DRC, investors state that employees lacked expertise and that senior management was difficult to find and recruit. Entrepreneurs, bank staff, and company employees rarely have the tools to anticipate complications. This constraint is especially relevant in venture capital. Investors in start-ups mentioned that funds can identify good business ideas but that the skills of the entrepreneurs are lacking, and entrepreneurs can be unreliable. One entrepreneur noted that if you provide training to employees, it is highly likely that they will leave once trained or formally qualified. A common assumption among interviewees is that skilled Congolese will look to leave the country as soon as they find a job elsewhere.

The lack of a conducive and enabling business environment also contributes to low IRRs

In fragile states, the business ecosystem is weak, with low quality and poor availability of lawyers, consultants, and accountants. The chronic shortage of an enabling business environment weighs heavily on businesses. This shortage is especially acute for the development of start-ups that suffer from a lack of basic support systems to entrepreneurs. The lack of incubators and an enabling cultural environment for entrepreneurs will lower the returns on investment in start-ups.

In some FCS, the lack of reliable SME accounting firms will decrease investors’ confidence in an investment. Accountants might only do yearly accounts, almost never provide day-to-day accounts, and create accounts mostly based on bank statements (not accounting for cash transactions). Additionally, lawyers are not knowledgeable about how to support start-ups and are too expensive for SMEs.

In another FCS country, an interviewee recounts that for two years, the lack of adequate controls by accountants, consultants, and lawyers within certain organizations led to a microfinance crisis that threatened the industry as a whole. The third largest and the fifth largest MFIs both went bankrupt. Fearing the risk of contagion, other MFIs and investors had to partner with government and other foreign lenders to support the banks and help prevent the crisis from becoming systemic.

Several funds described the challenges of raising a fund to invest in FCS

More than half of LPs cited a lack of established GPs targeting Africa as a potential barrier to LP investment in Africa. When evaluating African private equity firms, LPs’ first criterion is the GP’s track record. As FCS are mostly ‘private equity untouched markets’, LPs must invest in first-time funds. Two thirds of LPs (66%) would consider investing in a GP’s first fund in Africa.⁷² Then, funds must have teams on the ground, particularly considering the high need for follow-up, and advisory and ongoing support. LPs find that track record does

⁷² “Annual Limited Partner Survey Institutional – investor views and expectations about private equity in Africa”, AVCA – Limited Partner Survey, 2016.

not necessarily travel well outside of the location, and a 'fly-in fly-out' strategy does not work.⁷³ Funds must also offer a unique investment strategy and provide market analysis showing that their strategy is backed by research, first-hand investment experience, and a relevant pipeline of potential investments. The budget of the fund needs to be well thought through and the GP must make sure its internal financials are sustainable (integrating seed funding, management fees, etc.).⁷⁴

A relevant track record is critical for fundraising and presents a significant challenge in FCS

A fund in Côte d'Ivoire mentioned that, as a first time fund without track record and in a crowded market, the real challenge is to build trust with its LPs. Francophone Africa is especially difficult as the industry is new to the region. LPs are searching for comparable metrics to evaluate GPs, but see a low number of deals in the region compared to East Africa or Southern Africa. Fundraising is becoming harder as the market for Africa funds gets more competitive. An LP mentioned that, in 2017, the team received about 200 propositions from first-time fund managers interested in launching a fund in Africa. Most demands are from investment bankers or lawyers who see the opportunity to make money. The fundraising for a second fund can be even more difficult, as the team needs to demonstrate, through a good track record, that the investment thesis and strategy are working.

Additionally, most GPs in FCS are new and have been led by a small team of two to three people. There are only a few larger GPs in FCS. Existing funds need to become institutionalized to build on the experience. Currently, new funds come in every two to five years. Some GPs disappear, as they are not profitable. Other GPs raise new, often bigger, funds and increase their ticket size, playing in a new market without taking advantage of built experience. Few GPs will continue to work in the same market with the same ticket size, using their experience and relationships to decrease origination, transaction, and monitoring costs.

Investor perception is sometimes that higher risks should lead to higher returns

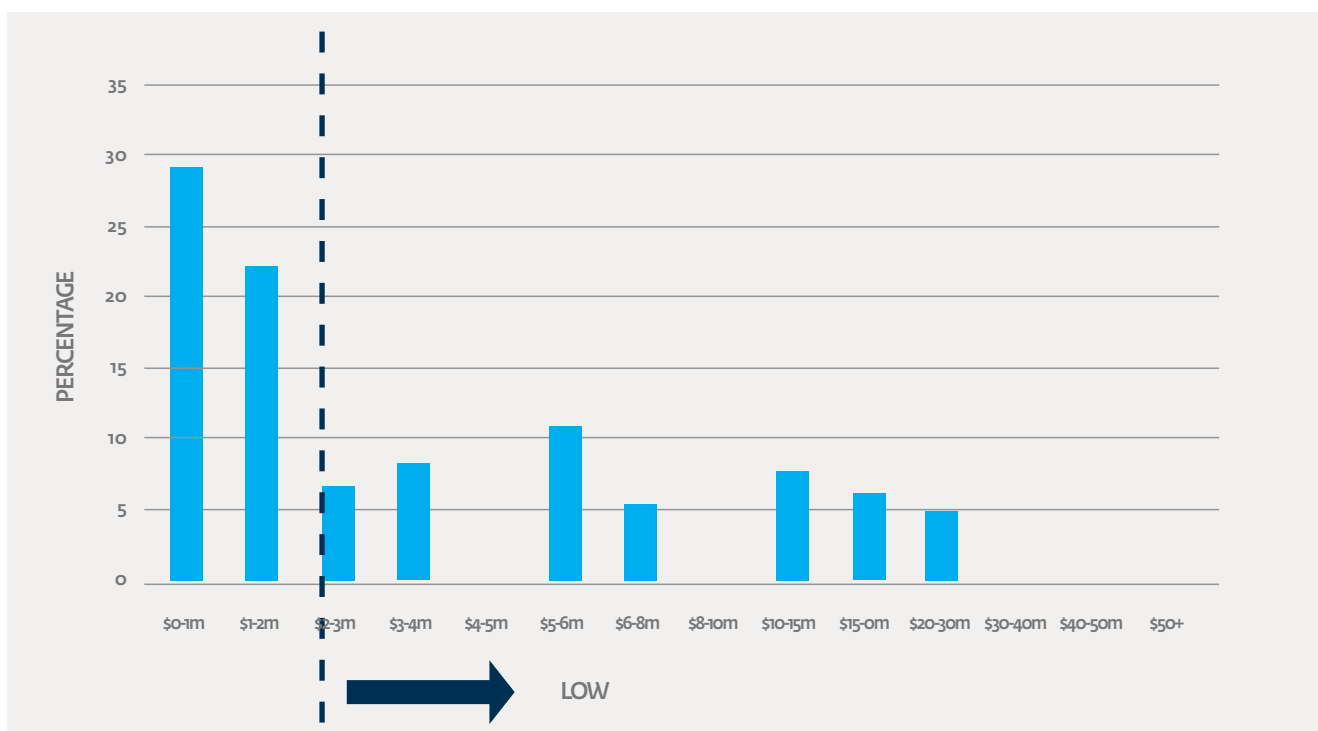
Investors may expect gross returns in frontier markets to compensate for the higher risk, and the risk-adjusted returns in FCS are expected to be comparable to stable markets. But the risks are higher due to the inherent idiosyncratic and catastrophic dangers of doing business in these markets. Funds are searching for market returns in a context where even banks struggle to avoid default. Additionally, based on 323 exits from IFC-invested funds, the share of write-offs for investment above US\$2 million is 5% - 10%, while the share of write-offs for investments lower than US\$2 million goes up to 20%-30%, suggesting that the risks of write-offs are higher with smaller deals.⁷⁵

⁷³ "Due Diligence in Emerging Markets", IFC WBG and OPIC, Vancouver Conference – Institutional Limited Partners Association, October 2011.

⁷⁴ "Investing in Africa's Small and Growing Businesses", I&P, ANDE, EY, INSEAD, Tony Elumelu Foundation, 2016.

⁷⁵ "What are the Risks in Frontier Markets Private Equity & How do You Mitigate Them?", IFC WBG, Super Return presentation, 2012.

FIGURE 16: SHARE OF WRITE-OFFS BY INVESTMENT SIZE BASED ON 323 EXITS FROM IFC-INVESTED FUNDS⁷⁶



As a consequence, several funds will focus on the social purpose of the investment strategy, searching for LPs motivated to work in fragile states for reasons other than financial returns, as market rate returns are hard to achieve. These LPs are largely DFIs or family offices (supported by diaspora funding in particular). Trust that the GP can achieve impact will be a key component of the LP's investment. Unfortunately, an LP mentioned that some fund managers can be great at sales but might have difficulty delivering. Fund managers now understand what DFIs 'want to hear' ('multi-country', 'small ticket size', 'hands-on', 'minority', 'local'). It leads to difficult conversations when the DFI due diligence becomes more advanced and GPs fail to demonstrate the right capabilities to deliver their strategy.

Fund location will influence its level of impact

The research paper *Making Foreign Direct Investment Work for Sub-Saharan Africa – Local Spillovers and Competitiveness in Global Value Chains* states that foreign-based investment firms likely have less inherent potential impact for productivity-enhancing spillovers than domestic-based firms. Thus DFIs have good reason to hope to back more locally based GPs from a development perspective. This is further evidenced from recent research, showing that local sourcing is instrumental to obtaining FDI spillovers, and local domestic GPs are more inclined to use local services.⁷⁷

⁷⁶ "What are the Risks in Frontier Markets Private Equity & How do You Mitigate Them?", IFCWBG, Super Return presentation, 2012.

⁷⁷ Thomas Farole and Deborah Winkler, "Making Foreign Direct Investment Work for Sub-Saharan Africa – Local Spillovers and Competitiveness in Global Value Chains", International Bank for Reconstruction and Development/The World Bank, International Trade Unit, 2014, p87-114.

4

Observed patterns and best practices for successful funds in fragile states

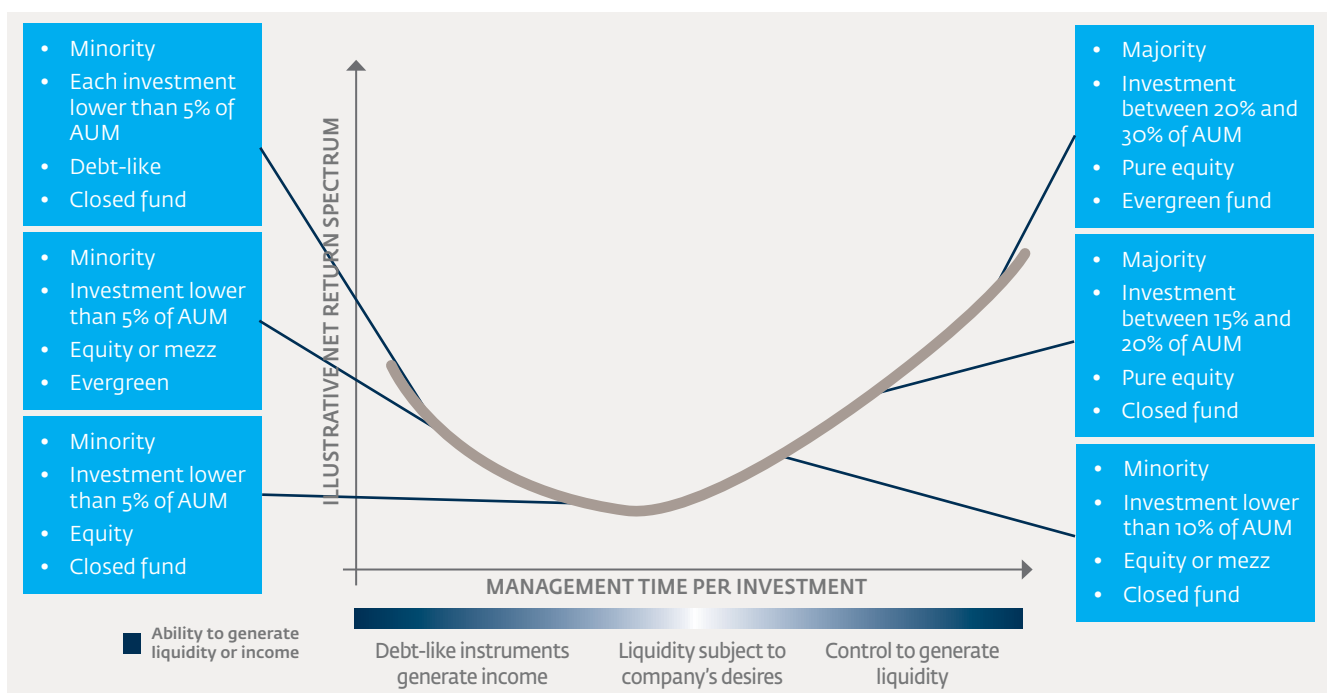
“In a control investment context, we have much more freedom because: 1) when things go sour, we can make a decision for the company; 2) we have a choice in the timing of exit. [...] I’m still an entrepreneur, and an entrepreneur can’t be a minority investor.”

A majority/control investor in SSA, panel remarks at 2018 AVCA Conference

Funds investing in FCS with better net returns often tend towards two ends of the strategy spectrum

Based on research, FCS funds with better net returns tend to either be highly active and in control positions on select investments or deploy standardized (but flexible) debt-like instruments to a larger group of investments. One hypothesis is that this is due to balancing management time per investment with potential returns, as well as the ability of the investor to generate income/liquidity from investments. Small funds with a large array of minority equity positions can struggle to both realize liquidity and adequately manage their investments.

FIGURE 17: FCS FUNDS WITH BETTER NET REALIZED RETURNS OFTEN TEND TOWARDS TWO ENDS OF THE SPECTRUM: STANDARDIZED FLEXIBLE DEBT-TYPE INVESTMENTS OR MAJORITY CONTROL POSITIONS⁷⁸



⁷⁸ CrossBoundary analysis. CrossBoundary did not have consistent access to formal net return information. The graph is a combination of formal reporting and self-reported results.

Nonetheless, investors operating in this mid-spectrum, with a philosophy of 'backing entrepreneurs, not companies' (i.e. not replacing management or otherwise taking control), also have a distinct positive development impact.

Separately, otherwise potentially viable majority investment opportunities were sometimes not feasible due to political exposure risks in the context of particularly corrupt environments.

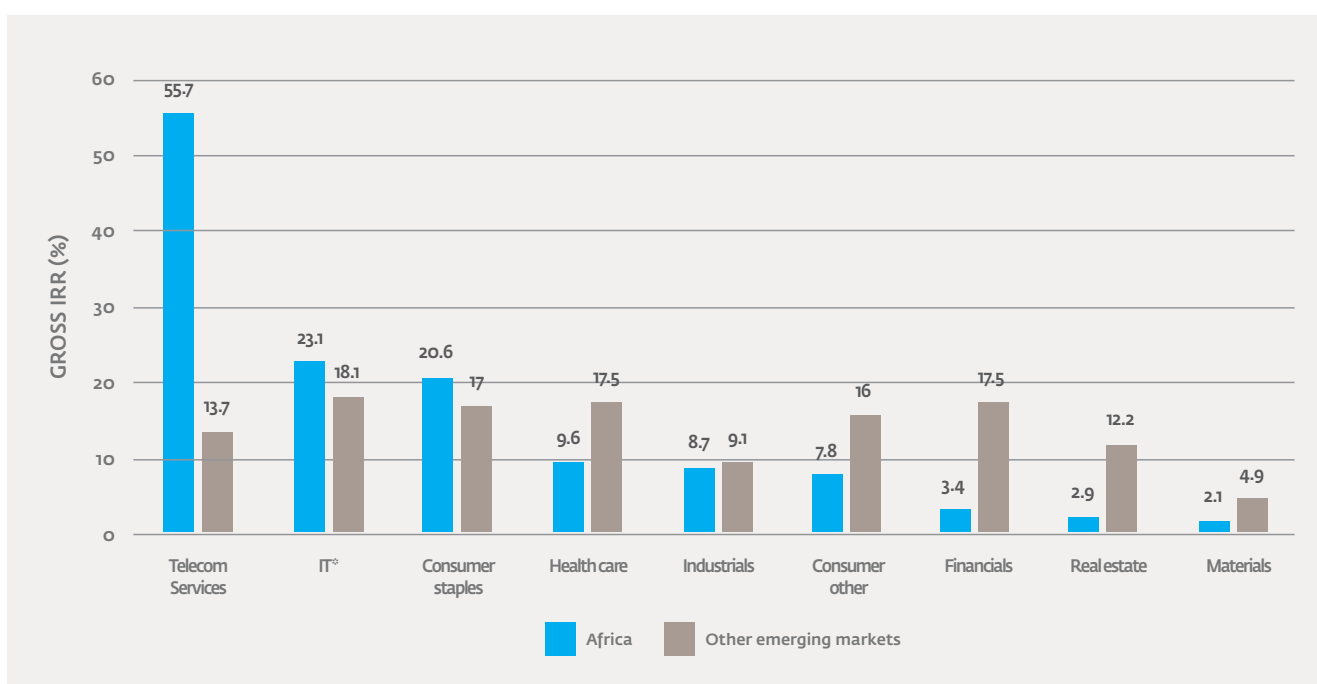
"Being a majority shareholder in countries where tax harassment is extremely high would present a risk for the overall fund. Debt-like instruments are more adapted to those markets."

Private equity investor in FCS

Sectors can be selected based on observed patterns of success in comparable environments, nuanced by unique local context

Returns per investment in Africa vary significantly per sector. Portfolio companies in the telecom services, information technology, and consumer staples sectors have proven to be high gross return investments compared to other emerging markets. Real estate, materials, and financial sectors have led to lower returns on investments in Africa. Comparing Africa to other emerging markets can assist GPs in selecting companies operating in profitable sectors. However, for each fragile state, some sectors are more relevant than others and investors should adapt their strategy to the local context, including leveraging government or donor priorities that can help complement their investments through incentives or concessional capital (while still being careful to not 'chase' donor dollars into unprofitable strategies).

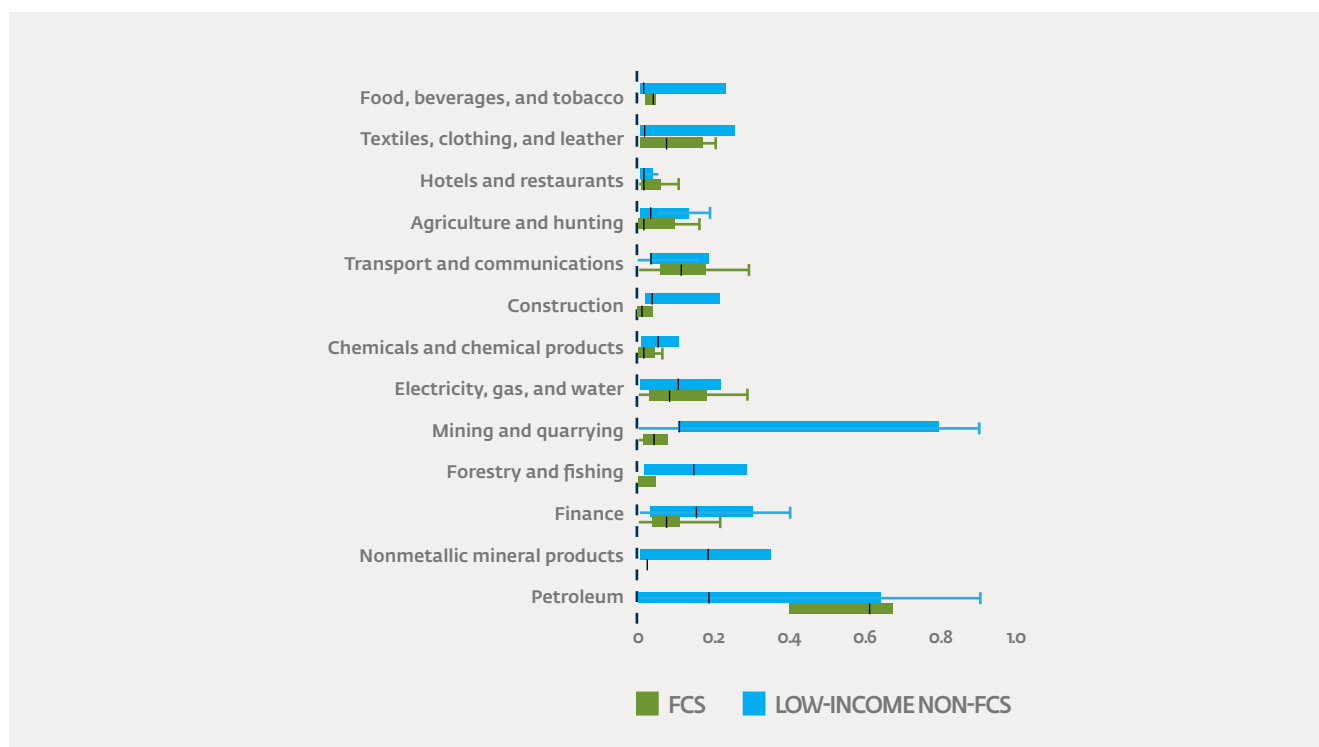
FIGURE 18: INVESTMENT-LEVEL GROSS IRR BY SECTOR⁷⁹



⁷⁹ "Cambridge Associates LLC Private Investments Database". Returns are gross of fees, based on the funds' cash flows to and from portfolio companies. Data as of June 30, 2017. Includes all investments in African and other emerging markets countries made by ex-US private equity and venture capital funds (i.e., not solely Africa- or emerging markets-focused funds) formed since 1995. African sample includes 463 company investments. Ex-African emerging markets sample includes 5,958 company investments. Note: *Return for African Information Technology industry focus group excludes one small investment that distorts the overall return.

More generally, when looking at the landscape of FDI flows across FCS, it appears that foreign investors are mainly investing in capital-intensive activities, including natural resources. FDI include investments by funds as well as by companies expanding into new countries (as in most extractive activities). As per the 2017/2018 Global Investment Competitiveness report: "FCS exhibit systematically different shares in four broad industries: extractives, construction, forestry and fishing, and food and beverages. Of those, only construction, and food and beverages rely largely on local demand, supplemented in some cases by foreign aid."

FIGURE 19: DISTRIBUTION OF SECTOR SHARES IN INWARD FDI FLOWS ACROSS FCS, 2008-2014⁸⁰



GPs also look at sectors providing an import substitution arbitrage — sectors facing high relative costs of transport (high volume/low weight) or services that inherently need to be provided locally:

- GPs in FCS have successfully invested in food and beverage companies such as bottling companies or biscuit companies, as well as business hotels and transport companies (car and truck leasing). In the aftermath of conflict, sectors relevant for reconstruction, such as construction and associated locally produced materials, can see good returns.
- Countries with extractive sectors attracting foreign investors can provide sets of products and services along the supply chain. For instance, in the DRC and Mali, the mining industry brings a set of local companies to supply the needs of the sector (food, transport, and housing). Other adjacent opportunities to existing businesses could include producing packaging or printing materials for locally produced goods, ranging from bags for cement to labels for foodstuffs.

Additionally, several GPs concentrate their origination process on export-led businesses and sectors, though typically outside of extractives. Those GPs are using the country's comparative advantage, either regionally or

⁸⁰ Alexandros Ragoussis and Heba Shams, "FDI in Fragile and Conflict-Affected Situations", Global Investment Competitiveness, Chapter 5 of Global Investment Competitiveness Report 2017/2018, DOI: 10.1596/978-1-4648-1175-3., 2017. Computation based on Investment Map Database, International Trade Centre; World Development Indicators, World Bank. Note: The distribution of shares of sectors in total FDI inflows across all FCS (in blue) is compared with the same distribution across all low-income and lower-middle-income non-FCS countries (in green) for which data exist after 2008. Each horizontal box illustrates the median of the distribution across the two groups with a black line, the box delimits the 25th percentile (left) and the 75th percentile (right) of each distribution – i.e. the top and bottom quartile, and the lines extending from the box illustrate the full range of shares.

globally, to increase the probability of good returns. Investments in these sectors lower the currency risk and may take advantage of the low cost of labor often found in frontier markets.

- Differentiated weather conditions and seasonality can result in niche export opportunities. In Madagascar, the lychee industry (two weeks of harvest per year) can provide a living to farmers for a year. Seasonal conditions are also favorable in Mali where, in November and December, it is among the few countries able to harvest and export fresh mangoes.
- Shared language can also support investment in tradable services. Call centers, computer programming, and other back-office services represent unique opportunities to take advantage of the low cost of labor.

FIGURE 20: FUNDS IN FCS TEND TO INVEST IN COMPANIES WITH THE FOLLOWING CHARACTERISTICS

	Companies with revenues in hard currency	Companies with insulation from international competition (basic goods & essential services)	Companies with restricted domestic competition (monopoly/oligopoly/first mover)	Opportunistic comparative advantage companies
Description	Focus on exports or providing goods / services to international customers in-country. Illustrative sectors include tourism, export oriented agriculture, and mining/oilfield services.	Produce essential non-tradeable goods or produce goods with high transportation costs. Illustrative sectors include logistics, construction, FMCG retail, business services, hospitality, and healthcare.	Provide services that have a restricted license to operate or provide infrastructure that has high capital costs/barriers to entry. Illustrative sectors include telecoms, toll roads, energy, and any other sole licensee businesses.	Leverage a comparative advantage of the country to build an enterprise with unique advantages. Illustrative sectors include extractives or unusual crops native to the region.
Examples	<p>Maris Capital invested in separate housing and warehouse companies for multinationals in Mozambique.</p> <p>Adenia Partners invested in a beach hotel in Madagascar.</p> <p>Solon Capital invested in Flash Vehicles, a vehicle rental company in Sierra Leone.</p> <p>African Century invested in an equipment leasing company in Mozambique and Tanzania.</p>	<p>XSML invested in a digital printing company in the DRC.</p> <p>TLG invested in a healthcare provider in Liberia.</p> <p>WAVF invested in a bakery providing products to locals.</p> <p>XSML invested in a clinic in the DRC.</p> <p>Beverage investments include WAVF in Sierra Leone, SABMiller in South Sudan, Heineken in Sierra Leone, and Coca-Cola in Somaliland.</p>	<p>ManoCap invested in the largest fishing company in Sierra Leone.</p> <p>Whatana Investments invested in a major telecom provider in Mozambique.</p> <p>Kinyeti Capital invested in an airport logistics company in South Sudan.</p> <p>WAVF invested in a company providing logistics services to the airport in Monrovia.</p>	<p>AgDevCo invested in tree crops (like cashews) in Mozambique that have comparative advantages for export markets.</p> <p>Maris Capital invested in a teak company exporting from South Sudan.</p> <p>I&P invested in a lychee exporter in Madagascar.</p>

Vertical integration can potentially enhance any investment by reducing risk along uncertain supply/value chain

Higher velocity and recycling of capital improve IRR

Because the common metric for fund performance is IRR rather than multiple of money (cash on cash return), it is useful to consider both current and potential ways to enhance IRR for a similar gross performance. By increasing the velocity by which capital is deployed and returned, and/or recycling capital, IRR can be improved, and the chances of a second fund increased.

A fund can increase velocity of capital through:

- **Deploying capital quickly:** Through a previously developed pipeline of opportunities or providing the ability to warehouse deals pre-close, fund managers can execute transactions earlier in the fund lifecycle. Pipeline development can be optimized through formal and informal partnerships with other ecosystem actors, including accelerators or other donor programs that seek to facilitate investment. For the average negotiation with a company in FCS, debt-like instruments are more understandable and therefore quicker to deploy than equity.
- **Bridging capital calls:** By using a bridge capital call facility, which is not typically used in FCS contexts, funds could boost IRR by first drawing debt at a rate of 6% (for example) before bringing in the more 'expensive' LP capital six to even nine months later.⁸¹ This both enhances IRR and potentially eases administrative burdens by allowing GPs to proceed with transactions quickly in advance of LP draws. Larger funds that can access such facilities typically have terms of 12 months and a LIBOR +1% to +2% rate,

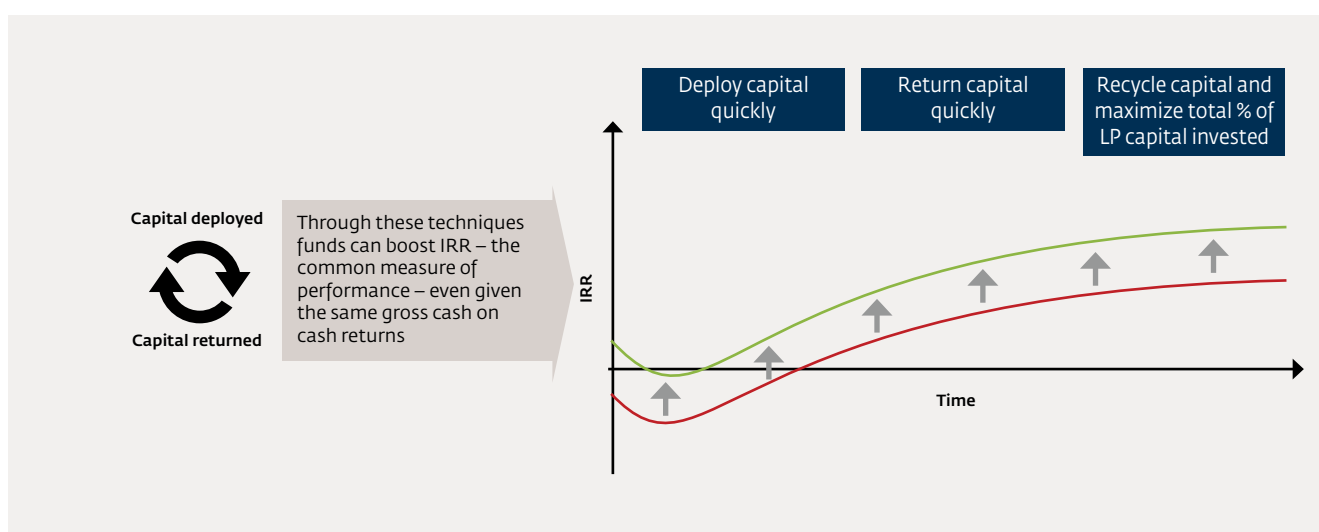
"GPs in America are getting bridge facilities. They are drawing for deals at the right time rather than sitting on cash or facing liquidity management challenges. It can have a big effect on net IRR... 100-200 basis points or more."

US institutional investor

with their total draw capped at 15% of fund size. However, some argue that such subscription capital call lines are tools of 'financial engineering' and a distraction for developmentally minded funds. LPs also express a lack of comfort with such facilities, as they result in less direct LP oversight of fund investments and their timing of disbursements, which could raise governance concerns. But such subscription capital call lines are being more frequently used elsewhere to boost IRRs. If SME funds are deprived of this tool, net IRRs should arguably be adjusted upwards by 1% to 2% when being compared with global funds.

- **Returning capital quickly:** By using debt-like income-generating instruments or exiting investments quickly, funds can shorten the capital return period and boost IRR.
- **Recycling returned capital:** Without recycling, a 10-year fund with a 3% annual management fee will only put 70% of its capital to work, with the remaining 30% covering management costs. More generous recycling provisions (such as an 18-month recycling window) can allow a fund to effectively invest 100% or more of its capital. In discussions, one fund-of-funds investor identified the inability of African funds to fully invest 80% of their capital as a major challenge, resulting in too much or disproportionate fee drag.

FIGURE 21: VELOCITY OF CAPITAL... DRIVES FUND PERFORMANCE J-CURVE



⁸¹ Also called a subscription credit facility – it "provides short-term funding on a revolving basis to private equity funds to bridge the time between when an investment is made by the fund and when capital contributions are received from investors to finance that investment. Loans are repaid with capital contributions once received from investors."

Specific mitigation strategies at all stages of the investment process can also improve the risk/return profile

GPs encounter challenges at different stages of the investment process and mitigate through different strategies. Initially, to launch a fund and attract competent LPs, GPs must build a track record. GPs can do so by making small investments in one or two companies before beginning fundraising. For example, in Liberia, a GP mentioned having made three personal investments in Liberian companies. Those investments established a track record of investment and demonstrated that he is willing to put his own capital into the market, signaling his level of commitment. Additionally, part of the attraction of FCS to first-time GPs can be the easier differentiation from generalist pan-African GPs as well as working with DFIs that are incentivized to put capital to work in these countries.

Once a fund is raised, a number of challenges and appropriate mitigations can be observed across the investment process (see the appendix for further details on key challenges facing GPs).

GPs need to create innovative origination mechanisms

In many cases, the investment opportunities will be earlier stage than typical private equity, facing higher risk of failure than in more mature enterprises.⁸² To address this, GPs can continue to back an entrepreneur into related businesses, once trust has been built and performance demonstrated. GPs can also diversify their initial sources of revenue to allow patience in sourcing investments, for instance by providing advisory services in addition to their investment activities. In Mozambique, Dominio Capital began as an advisor to gain experience that could be used to build a pipeline of companies.

When facing a lack of investible deal flow, GPs can launch greenfield businesses. For example, a GP provides the initial equity investment and then capitalizes the business with shareholder loans after that. While most GPs look to acquire/invest in existing business, some GPs, seeing critical business opportunities without existing companies that have reasonable value expectations, can decide to move forward with greenfield investments. In Mozambique, Maris chosen strategy has been primarily greenfield companies, as the fund faced a lack of investable deal flow from the beginning.

In many cases, before risk capital can be deployed, an investor needs to educate the prospective investee on both the value and characteristics of equity or mezzanine instruments, given that most businesses are used to working with debt to meet capital needs. To close better transactions, GPs can work with the diaspora and 'second generation' to explain the value of equity investment to family-owned companies. For instance, in Côte d'Ivoire, while business founders often have a negative view of equity, the next generation tends to have more technical knowledge than their parents. This generation can act as intermediaries, understanding and communicating the value of bringing a fund into their family company's capital structure.

GPs working in FCS must adapt their investment strategy to the local context

GPs in fragile states should adapt the investment instrument to the political context, the regulatory system, the valuation of the company, and its positioning in the market. For instance, in a context of high uncertainty and markets that lack secondary buyers – whether strategic (industry players) or financial (other funds or investors) – GPs can consider mezzanine instruments, mixing debt and equity (kickers). These instruments are more aligned with the needs of SMEs and help a GP to get reimbursed, limit downside risk, and get a good return. GPs can also use royalty-based lending, including potentially marking a specific revenue line from a

⁸² "IPDEV, a pioneering initiative to promote African SMEs", I&P, May 2017.

buyer to reimburse the investment.⁸³ GPs can also use debt-like instruments and self-liquidating instruments when:

- Interest rates are high, as the fund will be able to get equity-like returns while using a self-liquidating instrument. For instance, XSML in the DRC has been able to meet investor return expectations while providing debt-like instruments.
- The regulatory system is risky for the investor. For instance, in some fragile states, companies can end up with high levels of tax harassment or other regulatory burdens. By using debt instruments, GPs will not be liable for the company's taxes and other debts.

The decision to become a majority or minority shareholder should also be based on the desired impact and investment strategy. From an IFC study on 312 exits (61 majority and 251 minority), it appears that minority positions have performed almost as well as majority positions in terms of median gross IRR.⁸⁴ It indicates that the risks associated with minority positions can sometimes be managed effectively.⁸⁵ At the same time, most GPs put in place drag-along rights and other protective mechanisms in the shareholder agreement, knowing that it may be hard to enforce and that building trust with the entrepreneur will be key.

If companies desire to grow in the long term, becoming formal is essential. GPs in FCS highlighted that companies might lose money in the short and even medium term while formalizing or improving governance. For instance, one investor noted it could take more than five years for new ESG measures to fully demonstrate added value. It may sometimes be necessary to incentivize the company to formalize by stages. GPs can do a first investment in the company and tranche the total investment to the achievement of milestones in terms of formalization. For example, a bank in the DRC described making a second extension of credit conditional on formalized accounting.

GPs investing in one sector can share resources and leverage shared learnings. For instance, with a specific strategy of focusing on small ticket deals in agriculture in West Africa, Injaro differentiates itself from other investors and brings a specific sector knowledge and network. GPs can also invest in clusters, either alongside a supply chain, or in a specific region, or in the same industry. It potentially can build synergies by pushing portfolio companies to trade between one another. It can also create effective vertical integration of different businesses, limiting the supply risk and contracting risk for their portfolio companies (though such strategies also bring governance challenges that must be carefully monitored).

GPs should follow best practices in management and tailor monitoring tools to the portfolio company

Monitoring costs can be high if the fund management is far from its entrepreneurs, and if the portfolio is widely disbursed geographically. Funds must be hands-on to ensure returns on investment, and there are other benefits to being local. As an example, in Abidjan, Amethis recognized the potential to fundraise with local insurance companies and created Amethis West Africa (AWA), a CFA Franc-denominated investment vehicle and the first private equity fund domiciled in Francophone Africa. This initiative was created by the GP as it realized that AWA could offer attractive investment opportunities for insurance companies while effectively mobilizing local savings.

Through quarterly reporting and more frequent monitoring of companies, the fund manager can also closely engage with its portfolio companies. Monitoring tools should be tailored to each company and include milestones, tasks, deliverables, etc. For instance, in the DRC, for each portfolio company, Konnect (providing venture capital and advisory services) uses an online platform to track that tasks are being done.

⁸³ For instance, if the company is selling a service or product to a reliable buyer every month (a big company such as Vodacom, Shell, or Caterpillar), then the investor will use that line of revenue to be reimbursed.

⁸⁴ "What are the Risks in Frontier Markets Private Equity & How Do You Mitigate Them?", IFC WBG, Super Return presentation, 2012.

⁸⁵ "IPDEV, a pioneering initiative to promote African SMEs", I&P, May 2017.

If not completed, after a few reminders/warnings, the entrepreneur can lose shares in his/her company. The case rarely presents itself with the CEO but has happened sometimes with the shares of other senior leadership (typically with the CEO's concurrence). Konnect believes the structure allowed it to incentivize all members of a company.

GPs mentioned the need for both pre-investment support (due diligence and assistance to meet conditions precedent) and support after the investment (installing back-office accounting/ management information systems [MIS], sector-specific expertise, etc.). In that regard, TA have been tremendously helpful to GPs investing in SMEs in FCS, though the basic governance responsibilities must remain firmly in the remit of the GP rather than outsourced. (See the following section for more detail.)

GPs have found few mitigation mechanisms to the challenges of exiting investments

GPs and LPs mention the lack of flexibility in the timing of exits as among the biggest challenges faced in countries with limited or no secondary market. Exit opportunities are limited to management buy-outs or trade sales, and IPOs are very rare.⁸⁶

Beyond the self-liquidating type of instruments that many employ, several funds seek to mitigate this challenge by (i) identifying the exit opportunity pathway before investing, (ii) working towards that exit strategy while being flexible on opportunistic chances to sell, or (iii) adopting a permanent capital vehicle structure with no fixed time requirements for exit. Sometimes funds sell assets into subsequent funds of the same group, but this approach is not considered best practice. Some LPs mention that a holding company is problematic, as it can be illiquid. However, in markets where exits are difficult and costly, a holding company with periodic dividends and redemption windows can be considered more liquid than a standard 10+1+1 structure where the GP cannot sell its investments and may not be able to efficiently exit the fund.

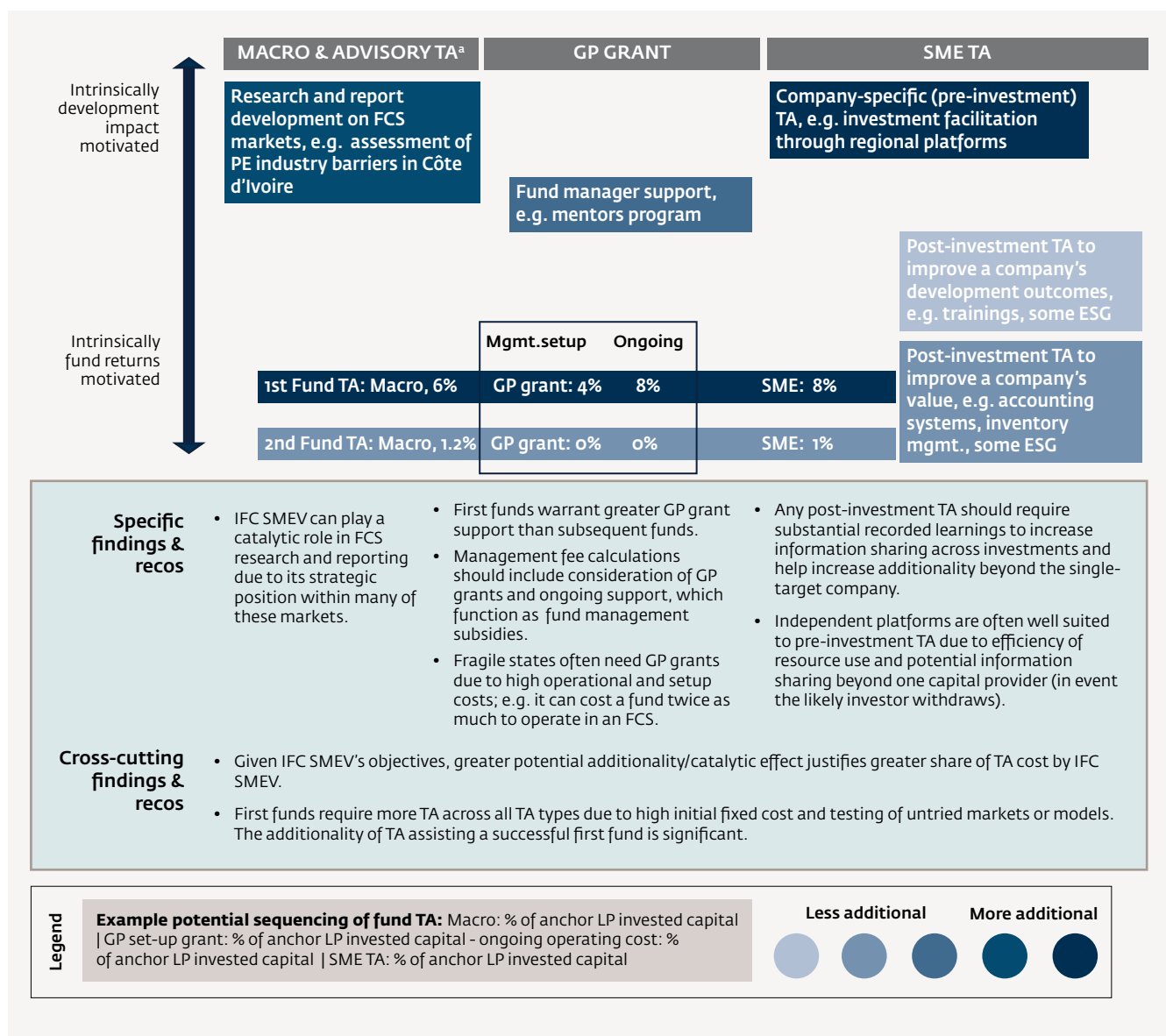
For example, a GP working in a frontier market mentioned that it considered the exit strategy carefully before investing in a company. Given that in fragile states, strategic sales constitute most exit opportunities, this GP decided to invest in companies that could adapt their growth strategy to attract strategic buyers. The challenges of the exit strategy will not be fully solved by planning ahead but it can lead to some strategic decisions (around quality standards, human resource recruitment, and investment instruments) that can ease the exit.

Technical assistance is an important tool that requires a nuanced approach

TA should be used to pay for expertise that directly increases revenue/EBITDA or reduces costs/other challenges like ESG issues of the investment. TA can be in the form of grants through the GPs and channeled as concessional loans, often zero interest and/or cost-share arrangements to the portfolio companies. TA is often highly dependent on the presence of DFIs as LPs of the fund. Funds with no DFIs as LPs will be less likely to hear about potential TA opportunities and will have more difficulty receiving TA. Separately, TA can also be used for direct support of the set-up of the GP in first-time funds and for cross-cutting macro support (for example, private equity regulatory environment reform). LPs providing significant TA directly to a fund can reasonably expect to have slightly expanded rights in fund governance and oversight, commensurate with their increased support (and also the likely riskier country/operating environment).

⁸⁶ "Due Diligence in Emerging Markets", IFC WBG and OPIC, Vancouver Conference – Institutional Limited Partners Association, October 2011.

FIGURE 22: FRAMEWORK FOR DEPLOYING TECHNICAL ASSISTANCE⁸⁷



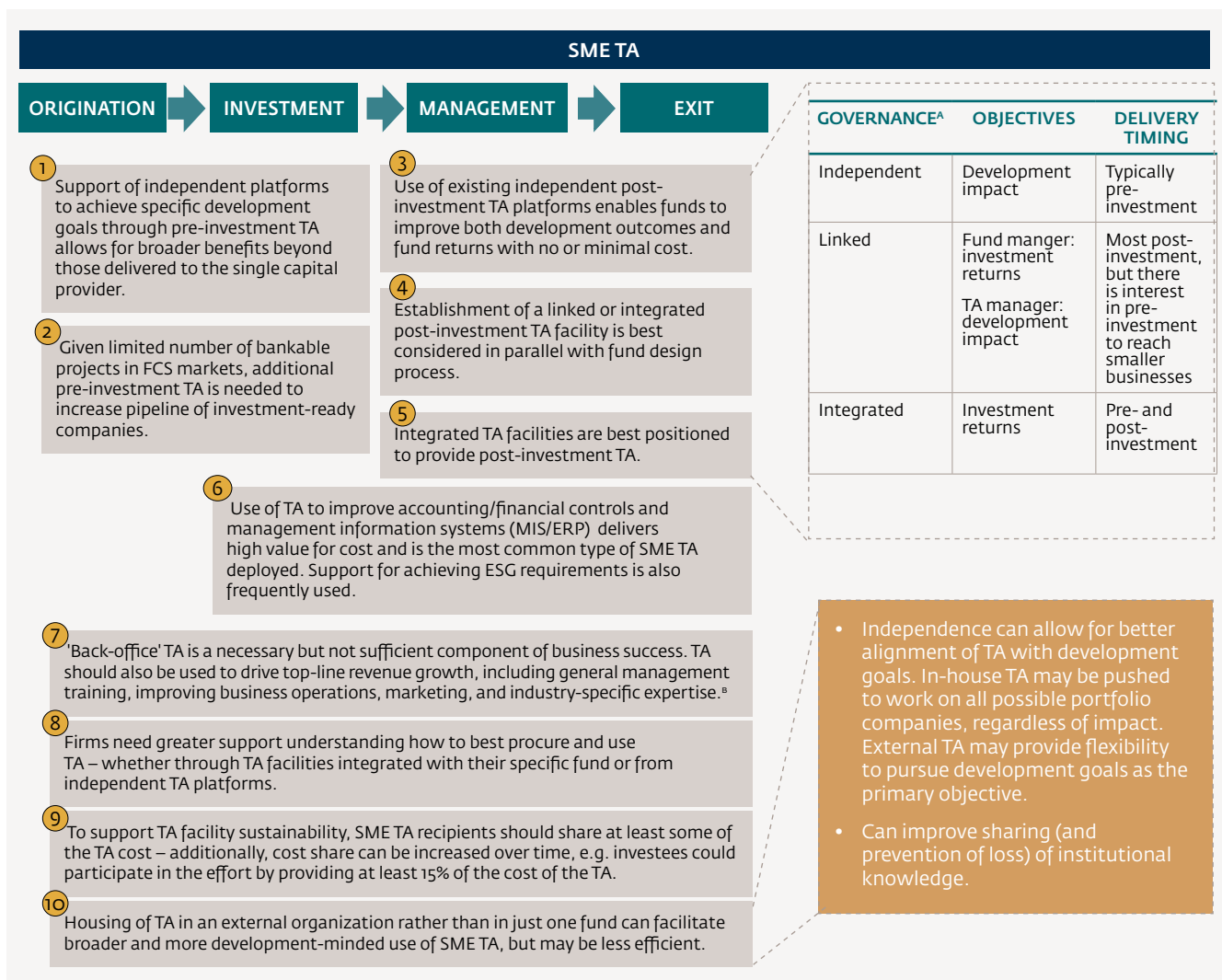
GPs investing in SMEs in FCS note the crucial role of TA in supporting their portfolio companies. In terms of TA use, these GPs mentioned the effectiveness of this resource in hiring specialized industry experts as well as supporting the development of accounting, management, and other ERP systems. Additionally, it appears that marketing assistance and key performance indicator management systems are useful tools to drive top-line revenue growth, typically the most important determinant of investment performance. TA is also often used for ESG improvements, which have both operational and developmental benefits.

In both investment decisions and TA allocation, GPs often get mixed messages from DFIs, without clarity on whether investing in underserved/harder to reach companies (impact) or achieving returns that are closer to emerging markets (financial performance) was the primary priority. As an example, a GP mentioned that due to its LPs' influence (mostly DFIs), the fund was seeking bigger ticket sizes. Bigger ticket size could mean more job creation, but less of other types of impact, as these companies may be more likely to receive investment

⁸⁷ Notes: The spectrum of TA activities from development impact-motivated to fund returns-motivated can be correlated to Enclude and Technoserve's TA governance model spectrum (from independent to linked to integrated) where independent facilities are intrinsically development impact-motivated and integrated facilities are intrinsically fund returns-motivated.
^a Adopted from: IFC Private Equity – SME Ventures, "Interim Report", February 2018.

through other providers or have less need for mentorship. In general, it was clear that LPs did not have a robust or consistent set of 'impact metrics' for funds that capture performance beyond IRR and job creation.

FIGURE 23: FINDINGS ON TA FOR SMES IN FCS COUNTRIES⁸⁸



According to fund managers interviewed, TA to investees is vital. Most funds have limited resources because of their small fund size and correspondingly limited management budgets, which also mean they have primarily generalist rather than highly specialized investment professionals. Some companies may need extremely niche support that only TA can answer. Other, more back-office-type TA (e.g. governance, IT, and accounting) is often needed as well; SME funds can run into bandwidth and cost-efficiency limitations when installing and implementing such systems themselves with multiple companies. Finally, TA can be an important way to drive revenue growth and ultimate fund success.

⁸⁸ Notes: ^a Adapted from Enclude's framework, "Transforming Agriculture by Linking Technical Assistance to Blended Finance: Trends and Lessons", August 2017; ^b GIIN, "Beyond Investment: The Power of Capacity-Building Support", October 2017. Additional sources: Stakeholder interviews; AAF TAF, "Reflection on the effectiveness of TA Facilities linked with investment funds"; The World Bank, "Private Equity and Venture Capital in SMEs in Developing Countries: The Role for Technical Assistance", April 2014.

More broadly, the standard fund model is not well adapted to investing in SMEs in FCS

Fund structures should be adapted to the local context and vary depending on strategy, sectors, and instruments identified by the investment strategy. Currency, cyclical, the level of local demand, and the secondary market, among others, must be considered when developing the fund structure. For example, LPs who might advocate for a low maximum limit on investment size or constrain their focus to a single fragile country could hinder the ability of a fund to identify suitable investments or diversify its risks. Several GPs mentioned that a multi-country fund is preferable, as FCS countries often suffer from a few months/years of uncertainty (especially around the election calendar). It allows for the fund managers to prioritize countries differently depending on the current level of uncertainty. Because of this, several DFI LPs are now in favor of GPs having a split of FCS and non-FCS countries, but this approach must be managed to prevent the GP simply focusing on the more developed markets in its remit. For example, LPs could require the main office or key personnel to be based in an FCS market, and put limits on maximum non-FCS investment. Regarding sector specialization, there are few great private equity opportunities in FCS, so 'externally imposed' specialization could reduce the pipeline of companies and hurt the fund in its origination process. However, there are advantages to 'cluster investing', which include potential vertical or horizontal integration between investee companies (though it also brings potential governance challenges) which can help with reliability of inputs/offtakes.

The standard features of a 2/20 fund model with a 10-year life cycle are not optimized for private equity investment in FCS and are not well adapted to the needs of local companies. For instance, in a large fund, a 2% management fee may adequately cover the costs of the needed investment professionals. In other contexts, strategy, ticket, and fund size may create very different requirements for management time and number of investment professionals. As an example, our research showed the average large cap (~US\$1 billion) fund has a ratio of 0.3 to 0.8 investments per investment professional, whereas the typical SME fund (<US\$100 million) has more than three investments per professional. Put differently, large cap funds may have 10 times more investment professionals per portfolio company than small funds. Some SME funds seek more efficient monitoring through rigorously standardizing and enforcing reporting, or using debt-like instruments. Debt-like instruments also decrease the time and effort required to search for exit opportunities.

As management fees are easily measured and compared with funds in more developed markets, they can be a source of tension between LPs and GPs. One manager noted that a 0.25% increase in fee could be a major sticking point, even though they believed the need for additional staff to drive fund performance was clear. The management fee for small and fragile funds should not only be based on a simple percentage benchmark but also consider the strategy and desired impact of the fund.

The number of investment professionals is fixed by the management fees and the size of the fund. If the fund is small and management fees are low, the number of investment professionals will also be low. Additionally, in fragile states, the average ticket size has the tendency to be small. As a consequence, the number of deals per investment professional is high. For instance, I&P is typically expecting its investment professionals to close one deal and exit one deal every year, while also managing two to three portfolio companies.

FIGURE 24: NUMBER OF INVESTMENT PROFESSIONALS AND INVESTMENTS FOR SELECTED FUNDS⁸⁹

	FUND 1	FUND 2	FUND 3	FUND 4	FUND 5	FUND 6	FUND 7	FUND 8
AUM	8bn+	5-8bn	2-4bn	400-500m	100-200m	50-100m	50-100m	10-20m
INVESTMENT PROFESSIONALS (IP)	180	100	33	12	18	19	13	9
# OF OFFICES	20	10	3	4	1	7	2	3
PROXY FOR # OF INVESTMENTS ^A	54	51	26	19	10	56	47	36
TICKET SIZE	50m-250m	50m-250m	30m-200m	10m-35m	5m-20m	0.3m-2m	0.5m-2m	0.1m-0.5m
\$ PER IP ^B	45.0	76.0	90.9	35.4	6.9	4.4	5.4	2.0
INVESTMENT SIZE AS % OF AUM ^C	1.9%	2.0%	3.8%	5.3%	10.0%	1.8%	2.1%	2.8%
# OF INVESTMENTS PER IP ^D	0.3	0.5	0.8	1.6	0.6	3.0	3.6	4.0

The number of investments per staff is significantly higher for smaller funds and ticket size

Additionally, other incentives are often not aligned. Fund personnel in FCS may never see carry due to low net commercial returns (though potentially high development impact) and too high a hurdle rate. If carry is low or unlikely, salary is the only incentive for GPs to recruit skilled professionals. Lower hurdle rates (i.e. 5%) or hybrid incentive schemes should be considered in FCS. Another possible solution would be to allow GP/management team members to co-invest on a deal-by-deal basis (though, of course, this process must be managed to avoid 'cherry-picking'). In general, LPs and GPs should work together to ensure human resource compensation policies are appropriate and incentivize personnel meaningfully, rather than being seen as promises that are unlikely to come to fruition.

⁸⁹ Assets under management (AUM), the number of IPs, the number of offices, and ticket size as per the EMPEA database and the funds' websites. Notes: ^A This proxy for number of investments is calculated by dividing the AUM by the average ticket size; ^B US\$ per investment professional is calculated by dividing the AUM by the number of investment professionals; ^C The Investment size as percentage of AUM is calculated by dividing the AUM by the average ticket size; ^D The number of investments per Investment Professionals is calculated by dividing the number of investments by the number of Investment Professionals

FIGURE 25: FUNDS AND LPS SHOULD ADAPT FUND STRUCTURE TO THE LOCATION AND COMPANY NEEDS

	STANDARD VEHICLE	EXAMPLE OF HYBRID FUNDS	PCV, EVERGREEN
DESCRIPTION	<ul style="list-style-type: none"> • 10+1+1 or 12+2+1, blind pool, closed-end funds • Fixed-term life investment: 2yr • Holding: 5-7yr to 7-9yr • Exit: 1-2yr 	<ul style="list-style-type: none"> • Closed-end funds with flexible periods and possibilities for follow-ups and renegotiation (FF) such as 10+1+1+1+1+1 or 5+5+5 • Deal-by-deal funds (DbD) or pledge funds 	<ul style="list-style-type: none"> • Indefinite periods – LPs have exit windows to leave the fund or can sell their shares
ADVANTAGES	<ul style="list-style-type: none"> • Provide LPs with certainty on exit period • Knowledge of best practices to run and monitor such funds – they are preferred vehicles for most large LPs 	<ul style="list-style-type: none"> • FF: Do follow-ons, hold for longer • DbD: Mobilize capital for single opportunities, reduce time spent fundraising, and build a track record while giving possibility to LPs to pass on deals 	<ul style="list-style-type: none"> • LPs can exit, for instance when DFIs change priorities • Funds can make better returns • Bring private capital to the most frontier
CHALLENGES	<ul style="list-style-type: none"> • Pressure to disburse can lead to sub-optimal choices • Small secondary markets lead to lower returns than possibilities 	<ul style="list-style-type: none"> • For LPs, lack of knowledge of best practices to run and monitor funds • Need for strong relationships and ensure alignment with LPs 	<ul style="list-style-type: none"> • Requires strong active, hand-holding investing • LPs are reluctant as they lose power of not investing in next fund • No vintage year (no fund track record)
EXAMPLES	<ul style="list-style-type: none"> • Amethis, Adenia 	<ul style="list-style-type: none"> • Lateral Capital (currently not investing in FCS) 	<ul style="list-style-type: none"> • Solon Capital, Maris Capital, IPDEV2, Africa Capitalworks, Tana Africa Capital II

It is possible, and advisable, to tailor the lifetime, economics, instruments, and strategy of a fund to suit the specific FCS context. Potential adaptations of the standard private equity model to fragile states include:

- Increase the fund's lifetime, on a conditional basis, to lower the pressure to disburse money and exit companies on artificial timelines (examples could include closed-end funds with more flexible periods such as 10+1+1+1+1+1 or 5+5+5, as well as permanent capital vehicles [PCVs]).
- Increase the spectrum of funds and consider being the anchor or sole LP (on a temporary basis) for unique fund strategies/structures.
- For 'evergreen' type vehicles, consider incentivizing through bonuses linked to portfolio valuation or other metrics (instead of, or as a complement to, carry).
- Encourage funds to use some portion of self-liquidating instruments, especially closed-end funds in countries with a limited secondary market.
- Invest in funds and/or non-bank financial institutions (NBFIs) with smaller tickets and shorter holding periods (one to two years), with the possibility to revolve several times to support working capital or trade finance.
- Explore funds that seek similar advantages to typical holding companies and PCVs: mutualizing services for portfolio companies, finding economies of scale along a value chain, and encouraging portfolio companies to contract with one another.
- Adapt governance and supervision to FCS, which would likely include more involvement/oversight of the LPs. In the wake of Dubai private equity firm Abraaj's governance challenges, additional oversight is on the minds of many LPs.

- There are several examples of funds that either started as 10+1+1 funds and switched towards different structures, or decided to create long-life funds:
 - In 2013, Maris started to discuss with its LPs the potential of switching the fund to a holding company via a simultaneous capital raise and transformation, which was completed in 2014. Maris gave all LPs the opportunity to exit at transformation, and those that exited received a 24% net IRR on their investment. The net value of funds raised was almost exactly equal to the original fund raised, and the total value of exiting LPs was broadly matched by existing LPs investing further funds. Since transformation to a holding company, Maris has been investing and operating its companies from that structure. Currently, Maris has a bi-annual trading window for its shareholders where they can buy and sell among themselves or to new investors.
 - I&P decided to move towards evergreen funds for IPDEV2, which is a platform for local country vehicles. The ability to create open-ended local funds in FCS allows local GPs to potentially create more added value and long-term flexibility.
 - Oikocredit is a social investor incorporated in the Netherlands as a cooperative society with an investor base of around 50,000 individuals and 6,000 institutions. Oikocredit provides loans, equity, and capacity-building support to financial institutions and social enterprises. As of 2017, the loan portfolio made up the largest part (86%) of Oikocredit's close to €1 billion financing portfolio (equity comprised 14%). This broad-based investor structure allows Oikocredit to offer patient capital for its equity investments (seven to 10 years) and still manage to provide annual dividends to its investors.



Fabrar rice. Procuring appropriate packaging locally was a challenge. (Soline Miniere, Liberia, 2018).

5

Interventions to support risk capital entering in fragile states

IFC SME Ventures has played a crucial role in developing the investment landscape in fragile states in SSA. The SME Ventures pilot programs established four funds between 2010 and 2015: two funds (the West African Venture Fund and the Central Africa SME Fund) in four SSA fragile states and two funds in Asian fragile states. IFC SME Ventures was often the sole initial investor. FMO, Lundin Foundation, and Cordaid joined the Africa funds later with smaller, but still important, commitments. IFC SME Ventures was catalytic in developing these first-time funds and supporting them in building a track record. The IFC SME Ventures team also demonstrated the need for pioneer risk capital in FCS to develop the investment ecosystem. IFC SME Ventures is now entering the next phase of mobilizing other LPs to join IFC in follow-on investments. Funds such as the African River Fund (XSML's follow-on fund), Oasis Africa Fund, and I&P Afrique Entrepreneurs 2 (IPAÉ 2) have already mobilized the majority of their capital from LPs beyond IFC.

To go beyond the specific GP best practices and recommendations already discussed, below we briefly explore three different but complementary angles to spur additional risk capital into FCS: first, methods for attracting additional LPs and innovating on fund structure, second, a suite of shared services and toolboxes to support FCS GPs, and finally, country- or region-centric platforms to facilitate investment from a broad range of risk capital sources into a variety of FCS companies.

Exploring new ways to accommodate and attract other LPs into FCS

Several investors have expressed interest in the private equity asset class in FCS, along with an increasing general interest in private equity from a range of capital sources. In recent research on the state of private equity (not specific to FCS), EY noted: *"The search for higher returns has led family offices, sovereign wealth funds, endowments, insurance companies and high-net-worth individuals to significantly increase their allocations to private equity. According to an SEI survey of 200 PE firms, 70% of them expect to see an additional investment from family offices over the next few years. For sovereign wealth funds and endowments, this figure was 50%, and for high-net-worth individuals, 58%."*⁹⁰ New types of LPs are becoming more interested in fragile states. For instance, a GP in Côte d'Ivoire has been backed by several family offices and high-net-worth individuals. Other family offices mentioned that they are seeking to support private equity funds and in the long run are planning to create their own funds. Lastly, local pension funds and insurance companies have begun to invest more in local GPs in a range of countries such as Kenya and Madagascar, and in the French CFA zone.

⁹⁰ "How can private equity transform into positive equity? Perspectives on the future of private equity from industry pioneers", EY and Roubini ThoughtLab, based on high-level interviews with industry pioneers and top executives, including David Rubenstein of Carlyle, Stephen Schwarzman of Blackstone, David Bonderman of TPG, Charles (Chip) Kaye of Warburg Pincus, Glenn Hutchins of North Island, and John Canning of Madison Dearborn (among others), 2017.



New Brookfields Hotel in Monrovia (WAVF, Liberia, 2018).

In this context, it is worth exploring the best ways to support fragile state investors. In FCS, the closed-end fund model has limitations due to the longer time it can take to generate returns. The challenge of exiting during a certain time period can be overcome through alternative capital structures.⁹¹ Alternatives of the traditional capital aggregation have emerged, such as open-ended funds and holding companies.⁹² These models should be tested by LPs able to learn from such structures. For instance, CDC invested in Solon, a holding company with an existing track record. This approach should not always translate into an incentive to postpone exits but can give some companies the time to reach a targeted stage of development.⁹³

In terms of impact, the time horizons of investors matter, as firms that are investing for the long term are more focused on developing domestic linkages. In a relevant example, research has shown that the use of defined-term contracts by foreign investors rather than undefined long-term contracts significantly restricts the likelihood of positive spillovers from FDI.⁹⁴

Further, the development of secondary markets should be prioritized, through strengthening linkages between investors and improving information availability. Regional stock exchanges are emerging, such as

⁹¹ Andrea Armeni with Miguel Ferreyra de Bone, "Innovations in Financing Structures for Impact Enterprises: Spotlight on Latin America", Multilateral Investment Fund, Rockefeller Foundation, Transform Finance, 2017. Available at <http://transformfinance.org/briefings/2017/9/1/innovations-in-financing-structures>.

⁹² Open-ended funds, permanent capital vehicles, or evergreen funds do not have a fixed life. There is no time limit for fundraising or for when the fund must be liquidated. Without such limits, open-ended funds are able to keep enterprises in their portfolios for longer periods, avoiding either an unrealistic growth trajectory or sale to a misaligned acquirer. An open-ended fund may maintain enterprises in its portfolio indefinitely; value is returned to investors in the form of dividends and appreciation. Open-ended funds are often called 'evergreen funds', though some practitioners distinguish between the two and favor the use of 'evergreen' for open-ended funds where the proceeds are re-invested into the fund, rather than distributed. Holding companies are not funds, but a parent company that owns a portfolio of subsidiaries, often within the same geography or sector to promote synergies among the enterprises. The structure as a company, rather than a fund, means that capital invested in a holding company is more liquid than that in a closed-end fund – to the extent that there is a market for investors to enter and exit the holding company. Like open-ended funds, holding companies do not have a forced exit, providing similarly favorable conditions for impact enterprises. Holding companies can be particularly attractive where the underlying enterprises have a clear but longer path to cash flow due to a longer business cycle where they operated in illiquid markets, or where there are strong synergies across the portfolio.

⁹³ "IPDEV, a pioneering initiative to promote African SMEs", I&P, May 2017.

⁹⁴ Thomas Farole and Deborah Winkler, "Making Foreign Direct Investment Work for Sub-Saharan Africa Local Spillovers and Competitiveness in Global Value Chains", International Bank for Reconstruction and Development/The World Bank, International Trade Unit, 2014.

the BRVM in Francophone West Africa. New stock exchanges are not always necessary to provide a secondary market. For instance, in Madagascar, a team is exploring the possibility of a new secondary market for small equity investors. Individuals would sell their shares to other individuals through an online platform. This exchange of shares would be done with approval of the company but without the company necessarily becoming a public entity. This platform (similar in some ways to a crowd funding platform) could solve the issue of exiting investments for individuals. Another method for creating a secondary market (a version of which was also proposed by Enclude and the MacArthur Foundation) is to create a managed buy-out vehicle that would buy out LP stakes at the end of the hold period, allowing the GP to stay in with its share, and managing and controlling the company for exit after that.⁹⁵

Finally, there is a need for more structures that leverage both commercial financing and concessional capital for blended finance vehicles. For instance, by taking first-loss or subordinated capital positions (the Medical Credit Fund is a recent successful example of this), the appeal to risk-averse LPs can increase, growing the fund size, increasing economies of scale for the manager, and increasing fund impact.

Creating comprehensive shared services and tailored toolboxes for GPs

The primary difficulty of LPs investing in fragile states is finding the right GP team. Most GPs in FCS are first-time managers, which, because of their limited or no track record, implies an additional risk. Anecdotally, there is increasing demand and interest from investors to back FCS funds, but the supply of talented and experienced management teams has not yet risen commensurately.

More specifically, to ease the entry of GPs into fragile states, providing a set of tools like the 'fund set up in a box' model could be catalytic. This model is akin to some of what the firm Capria already seeks to do as a GP incubator/seed vehicle. The goal should be to provide GPs with a ready-to-use toolbox that can lower the costs of setting up a fund in fragile regions. The toolbox can include detailed recommendations on the legal structure, accounting systems, governance/reporting tools, pre-identified local service providers (including consultants, lawyers, and accountants), lists of likely interested LPs, initial sector/pipeline information, potential to access bridge/warehouse financing, and/or capital call (subscription) lines of credit to optimize liquidity management. After set-up of several GPs in a specific country (perhaps differentiated by sector or type of investment focus), an investment center can facilitate shared services across GPs and long-term mentorship. Often, common services are required across multiple funds, such as access to international counsel for fund structuring, or sub-sector-specific expertise for similar companies (multiple FCS GPs have beverage companies, business hotels, and printing companies in their portfolios, for example). Funds could negotiate shared service agreements at a lower price.

While a full suite of shared services might not always be needed, coordination among GPs is also critical for shared knowledge, a united voice to push for appropriate regulations, and relevant relationships. For example, in Côte d'Ivoire, investors decided to organize themselves and created the Association of Investors in Côte d'Ivoire (A2IC). In other countries/regions, a space/hub would allow GPs to share their experience and learnings. As a first step, organizing regular local events among investment stakeholders (investors, entrepreneurs, lawyers, and consultants) would benefit the industry as a whole. Several existing organizations already seek to do this in related ways, including Aspen Network of Development Entrepreneurs (ANDE) and the African Private Equity and Venture Capital Association (AVCA). Interested anchor LPs can support those organizations to be more present in FCS, for instance by providing a space for events, proposing themes, and sharing knowledge.

⁹⁵ Andrea Armeni with Miguel Ferreyra de Bone, "Innovations in Financing Structures for Impact Enterprises: Spotlight on Latin America", Multilateral Investment Fund, Rockefeller Foundation, Transform Finance, 2017. Available at <http://transformfinance.org/briefings/2017/9/1/innovations-in-financing-structures>.

Country or regional investment facilitation platforms can catalyze risk capital provision

While the 'fund set up in a box' model and associated services are GP-centric (and likely limited to a select set of funds), there is also an opportunity for interventions oriented around a specific country or region, and working with a broader range of potential investees and sources of risk capital. Across FCS, there are information asymmetries between investors entering the market for the first time and companies seeking their first outside capital, as well as large initial fixed transaction costs to overcome. Gathering data, bringing relevant experts to the field, and verifying information create barriers to investment, with relatively routine tasks such as market sizing becoming difficult. Valuations are problematic, as comparables or data required to support assumptions are rarely available, and there is a lack of trust between new investors and new investees. The low capacity of credit bureaus/ratings agencies (if they exist) compounds this problem further.

To support the origination process and provide regional risk capital providers with local knowledge and shared learnings, local investment facilitation platforms could be established. These platforms are local or regional technical assistance hubs that, rather than just being linked to one fund, are neutral intermediaries to connect transactions to multiple potential capital sources. The Country Investment Facilitation Platform (entry, origination, and transaction support) can provide a set of tools to pool the costs of identifying and due diligencing transactions for local, regional, and international investors. These transactions can be 'shopped' to multiple risk capital providers, lowering their transaction costs and addressing the inherent information asymmetries between companies that have never taken outside capital and investors that may have never invested in the country.^{96, 97}

This service will decrease the cost of origination, decreasing the gap between gross and net IRR by limiting the transaction costs, and also provide a clear understanding and analysis of a country and relevant sector, legal, or structural consideration. This tool could be most applicable in countries that have yet to have substantive risk capital providers based locally. In particular, by drawing in existing regional providers of capital, the hub could surmount the 'attractive to first-time managers only' dynamic that seems to be the case in many FCS. A recent Organisation for Economic Cooperation and Development (OECD) report described a solution along similar lines where the platform would involve several stakeholders at a global level (World Bank Group [WBG] and DFIs): *Identification: setting up an appropriate labelling scheme and mechanisms to screen and label 'investment-worthy' companies and investment intermediaries (financial institutions) that operate in FCS; Information and Networking-and-Oversight Hubs: one-stop shops for facilitating the generation and dissemination of tailored sector- and country-specific information, networking between investors and would-be investees at country level.*⁹⁸

Such a platform, based locally, could serve as a temporary catalyst to a more robust risk capital ecosystem and provide assistance to multiple GPs interested in the country. Ultimately, it would serve to change the perceived narrative of certain countries and demonstrate the possibilities for a varied range of risk capital investors and investees. The screening and selection process for support could be publicly shared and transparent. In general, the providers of risk capital are limited in FCS, and co-investment/collaboration is more likely than competition. Incubators could be a complement to or part of investment facilitation platforms by helping launch/guide start-ups and early-stage companies. A broader facilitation platform would still be useful to help companies in need of later stage growth capital or which do not fit the incubator model (which is typically focused on more venture capital-type opportunities).

⁹⁶ "Investing in Africa's Small and Growing Businesses", I&P, ANDE, EY, INSEAD, Tony Elumelu Foundation, 2016.

⁹⁷ Jake Cusack and Matt Tilleard, "Investment Facilitation in Transitional and Fragile States", CSIS, December 2013.

⁹⁸ "How to Scale up Responsible Investment and Promote Sustainable Peace in Fragile Environments", OECD, January 2018.

Conclusion

The need for risk capital in fragile states is stark — not just to finance potential high growth companies and drive inclusive economic expansion, but to increase resilience and buttress nascent state stability to benefit the country and the region. A skeptic might point to the mixed track record of fragile state funds and other intermediaries, and argue that private investment is impossible and that support activities should rather remain the preserve of pure donors. This conclusion would be short sighted. Many of the ultimately financed companies in fragile markets repeatedly noted they would have had 'no other financing' option and point to the jobs they have created, the social/consumer goods and services they have provided, and the benefits that have been created for the local economic ecosystem. While net returns that are fully commercial and risk adjusted may take a few iterations to achieve, supporting these funds provides an accountable, cost-effective, results-oriented, and inherently sustainable alternative to the purely grant-based initiatives that tend to dominate fragile state interventions. Moreover, the lessons learned and the incipient strategies discussed above form the foundation for a more adaptive risk capital approach to FCS that will continue to drive longer-term and more flexible investment into some of the world's most underserved markets.



A textile manufacturing plant providing employment to women and youth groups (Bobby Patel, Madagascar, 2018)

Appendix A:

Definitional clusters of fragile states

The IDA is an international financial institution that offers concessional loans and grants as part of the WBG.

Using the WBG's Country Policy and Institutional Assessment (CPIA) scoring mechanism, the IDA identified 75 of the world's poorest developing countries, 39 of which are on the African continent. The CPIA assesses the effectiveness of the country's policy and institutional framework in reducing poverty, creating sustainable growth, and optimizing development assistance. It rates countries against a set of 16 criteria grouped in four clusters:

- Economic management: the indicator evaluates macroeconomic management, fiscal policy, and debt policy.
- Structural policies: the indicator evaluates trade, the financial sector, and the business regulatory environment.
- Policies for social inclusion and equity: the indicator evaluates gender equality, equity of public resource use, human resources, social protection and labor, and policies and institutions for environmental sustainability.
- Public sector management and institutions: the indicator evaluates property rights and rule-based governance, the quality of budgetary and financial management, the efficiency of revenue mobilization, the quality of public administration, and transparency, accountability, and corruption in the public sector.

Cluster assessments are rated on a scale of 1-6, where a level 1 score signifies high risk and a level 6 score signifies low risk.

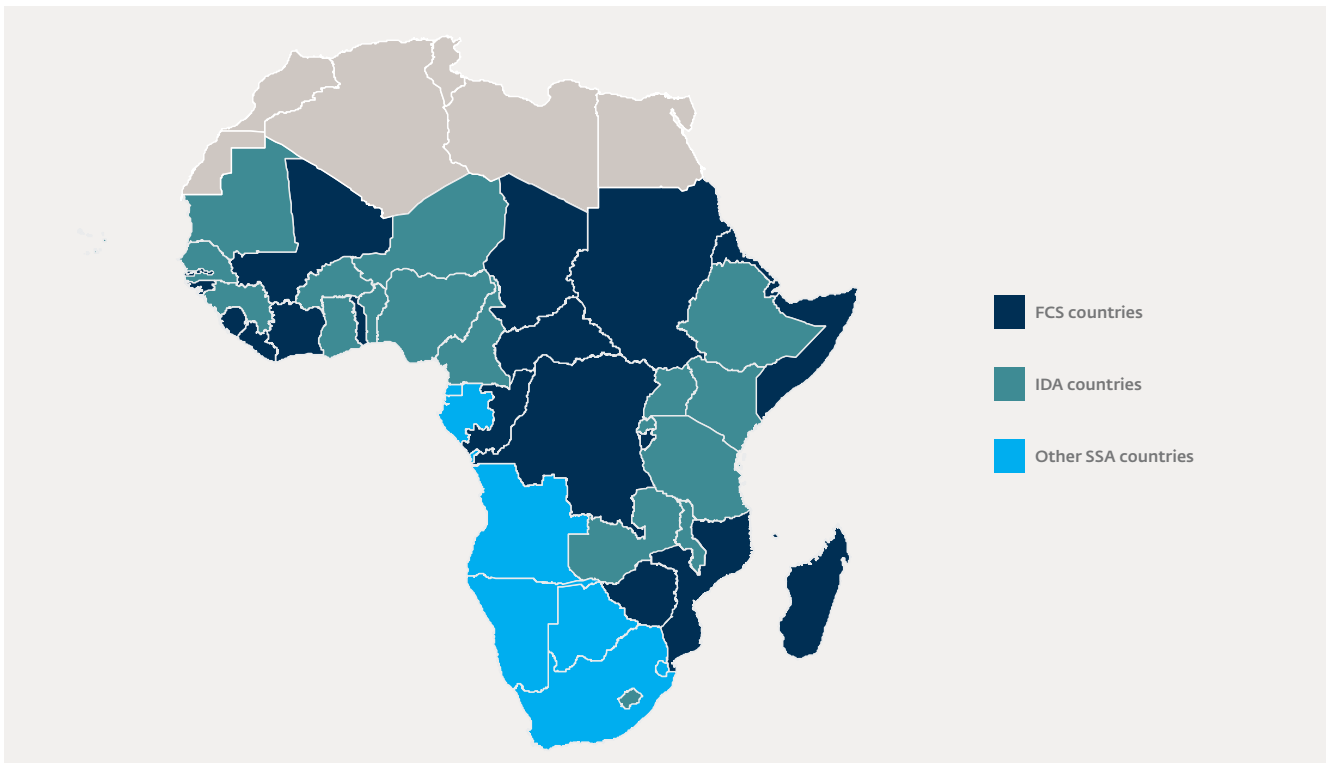
Countries with a CPIA score below the average of IDA countries and/or with a current UN peacebuilding or peacekeeping mission will be included in the WBG list of FCS. The list changes regularly when countries 'graduate' to a higher CPIA, or if the political peacebuilding or peacekeeping mission closes.

IFC has built a similar list to the WBG, which includes countries that graduated from the WBG list less than three years ago. Both IFC and the WBG's FCS lists consist of 21 SSA countries.

The three clusters of SSA countries are:

- Countries classified as IFC FCS (21): Burundi, Central African Republic (CAR), Chad, Comoros, Congo, Côte d'Ivoire, the DRC, Djibouti, Eritrea, the Gambia, Guinea-Bissau, Liberia, Madagascar, Mali, Mozambique, Sierra Leone, Somalia, South Sudan, Sudan, Togo, and Zimbabwe.
- Countries classified as IDA (40): IFC FCS, and Benin, Burkina Faso, Cabo Verde, Cameroon, Ethiopia, Ghana, Guinea, Kenya, Lesotho, Malawi, Mauritania, Niger, Nigeria, Rwanda, São Tomé and Príncipe, Senegal, Tanzania, Uganda, and Zambia.
- SSA countries (49): IDA, and Angola, Botswana, Equatorial Guinea, Gabon, Mauritius, Namibia, Seychelles, South Africa, and Swaziland.

FIGURE 26: FCS (21) AND OTHER IDA AND SSA COUNTRIES⁹⁹



Countries can also be compared using the FSI.¹⁰⁰ The FSI is based on a conflict assessment framework that was developed by Fund for Peace (FFP), which evaluates the vulnerability of states to collapse, and in pre-conflict, active conflict and post-conflict situations. The FSI's methodology incorporates 12 conflict risk indicators, both qualitative and quantitative, and relies on public source data to produce quantifiable results measured on a scale where 0 equals low risk and 10 equals high risk.

- Cohesion indicators: security apparatus (C1); factionalized elites (C2); group grievance (C3).
- Economic indicators: economic decline (E1); uneven economic development (E2); human flight and brain drain (E3).
- Political indicators: state legitimacy (P1); public services (P2); human rights and rule of law (P3).
- Social and cross-cutting indicators: demographic pressures (S1); refugees and internally displaced persons (IDPs) (S2); external intervention (X1).

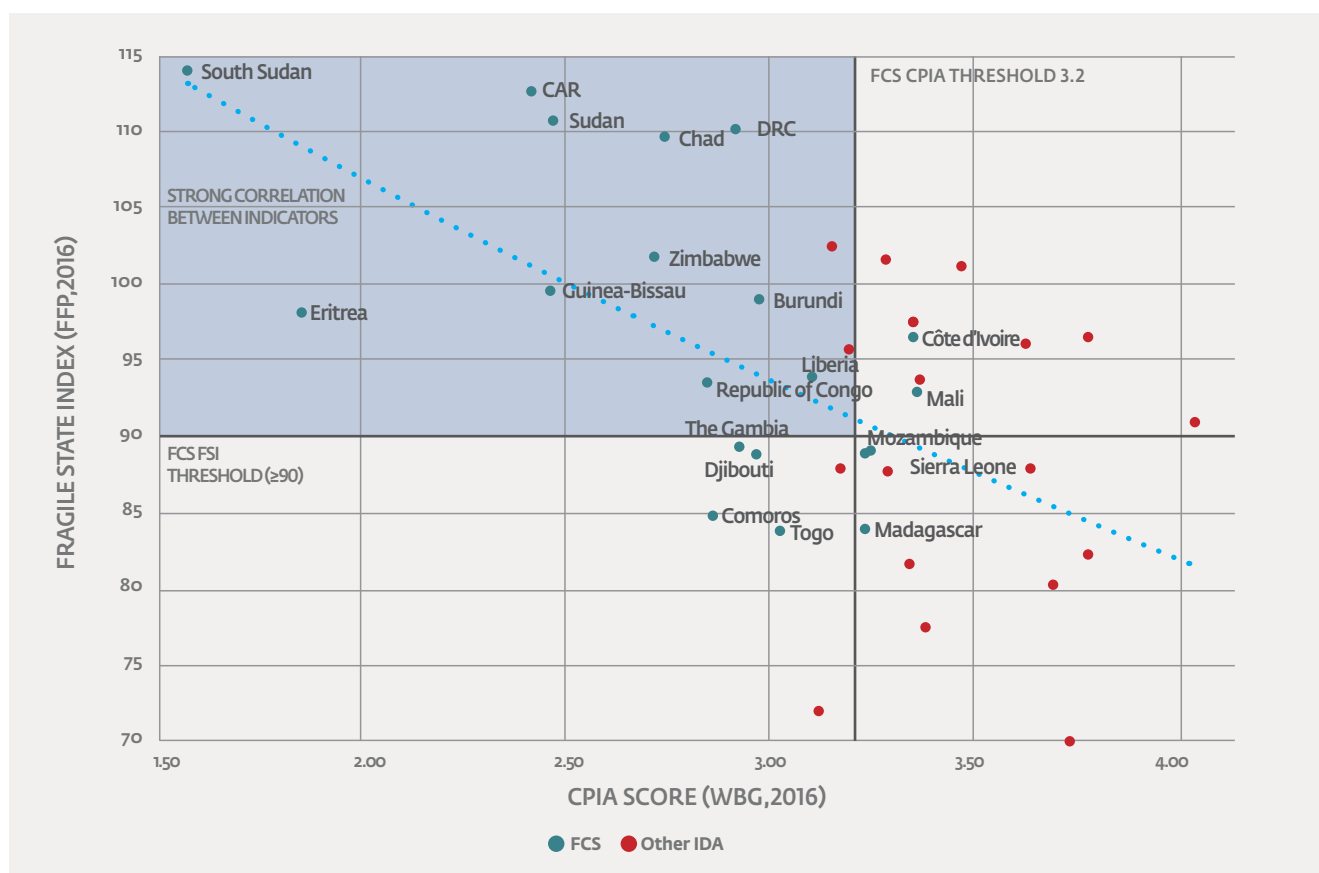
The case studies that served as the research focuses underlying this larger report were based on six FCS: Côte d'Ivoire, the DRC, Liberia, Madagascar, Mali, and Mozambique.

The CPIA and the FSI databases are complementary in certain aspects. The CPIA score (where 1 equals fragile and 6 equals developed) captures the quality of a country's policies and institutional arrangements, focusing on key elements that are within the country's control, rather than on outcomes. The FSI indicators (where 1 equals developed and 113 equals fragile) highlight the pressures that states experience, and identify a state's capacity to manage those pressures. One dataset (the FSI) displays the pertinent vulnerabilities contributing to the risk of state fragility to assess political risks, while the other dataset (the CPIA) measures the extent to which a country's policy and institutional framework supports sustainable growth and poverty reduction.

⁹⁹ IFC FCS Africa Program Factsheet: <https://www.ifc.org/wps/wcm/connect/179b107c-ec5c-416c-8cce-d4eb52a8b165/IFC-FCS-Africa-Program-Factsheet.pdf?MOD=AJPERES>

¹⁰⁰ Fund for Peace: <http://fundforpeace.org/fsi/>

FIGURE 27: FCS AND OTHER IDA COUNTRIES PER CPIA AND FSI INDICATORS¹⁰¹



The two sets of indicators have a relatively strong correlation, as a state's vulnerability partially depends on the quality of its policies and institutions. However, each indicator sheds light on a different set of country characteristics.

The 2017/2018 Global Investment Competitiveness report, a document that evaluates foreign investor perspectives and policy implications, states that the security risks arising from political conflict or private criminal violence, and the political risks arising from institutional fragility and a lack of government legitimacy are specific to fragile states.¹⁰² In that context, to compare countries selected for case studies, the chart below was developed using specific data for each country:

- Security and violence values (from 0 to 10) were computed using the weighted average of security apparatus (C1), factionalized elites (C2), and group grievance (C3).
- Institutional fragility values (from 0 to 10) were computed using the weighted average of state legitimacy (P1), public services (P2), and economic decline (E1).

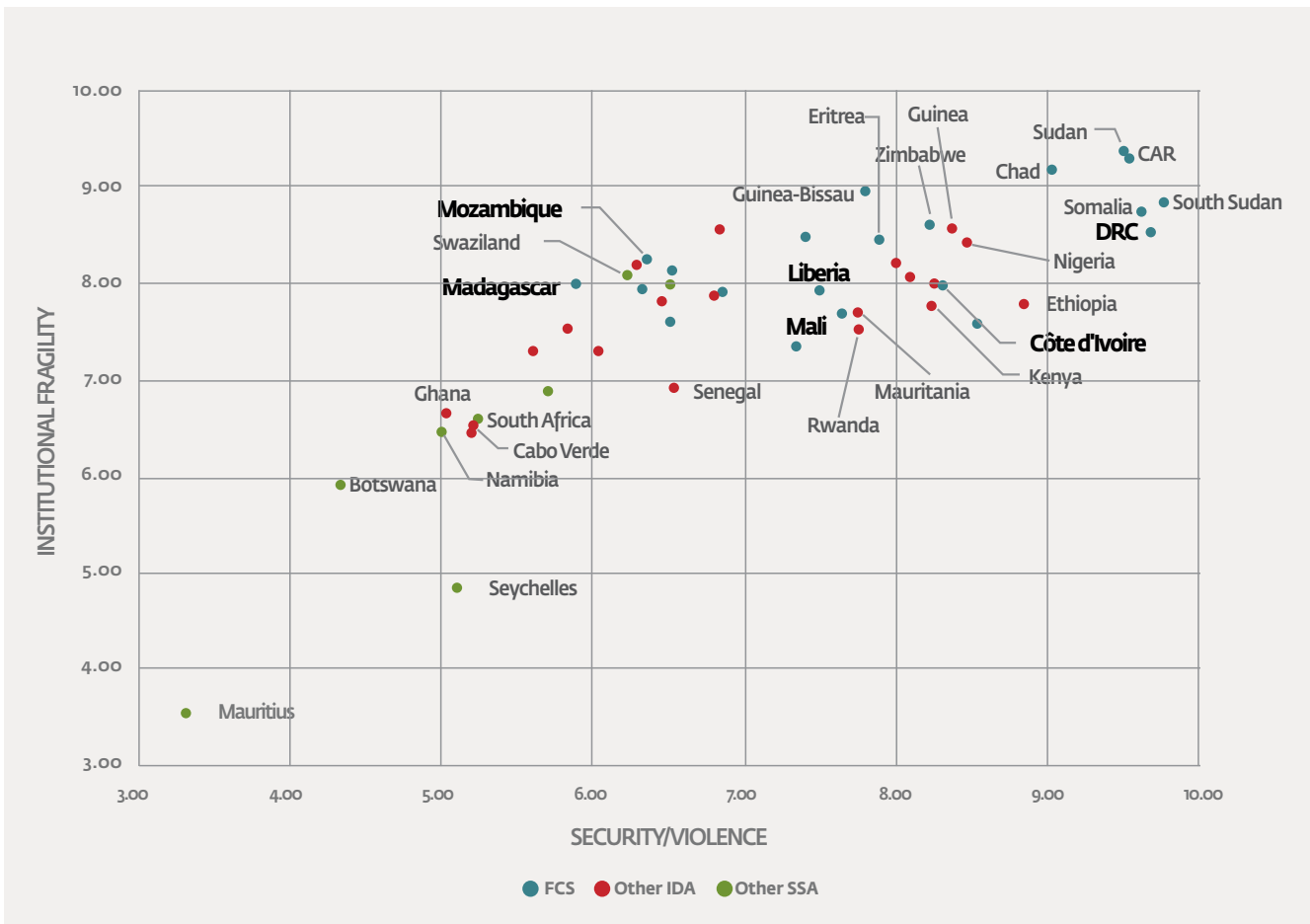
Based on this chart, a comparison between the chosen case study countries can be made:

- The DRC is the most fragile state on both institutional fragility and security risks.
- Madagascar, Mozambique, and Liberia are comparable in terms of both institutional fragility and security risks.
- The currently attractive investment destination of Côte d'Ivoire has a higher security risk than Mali.

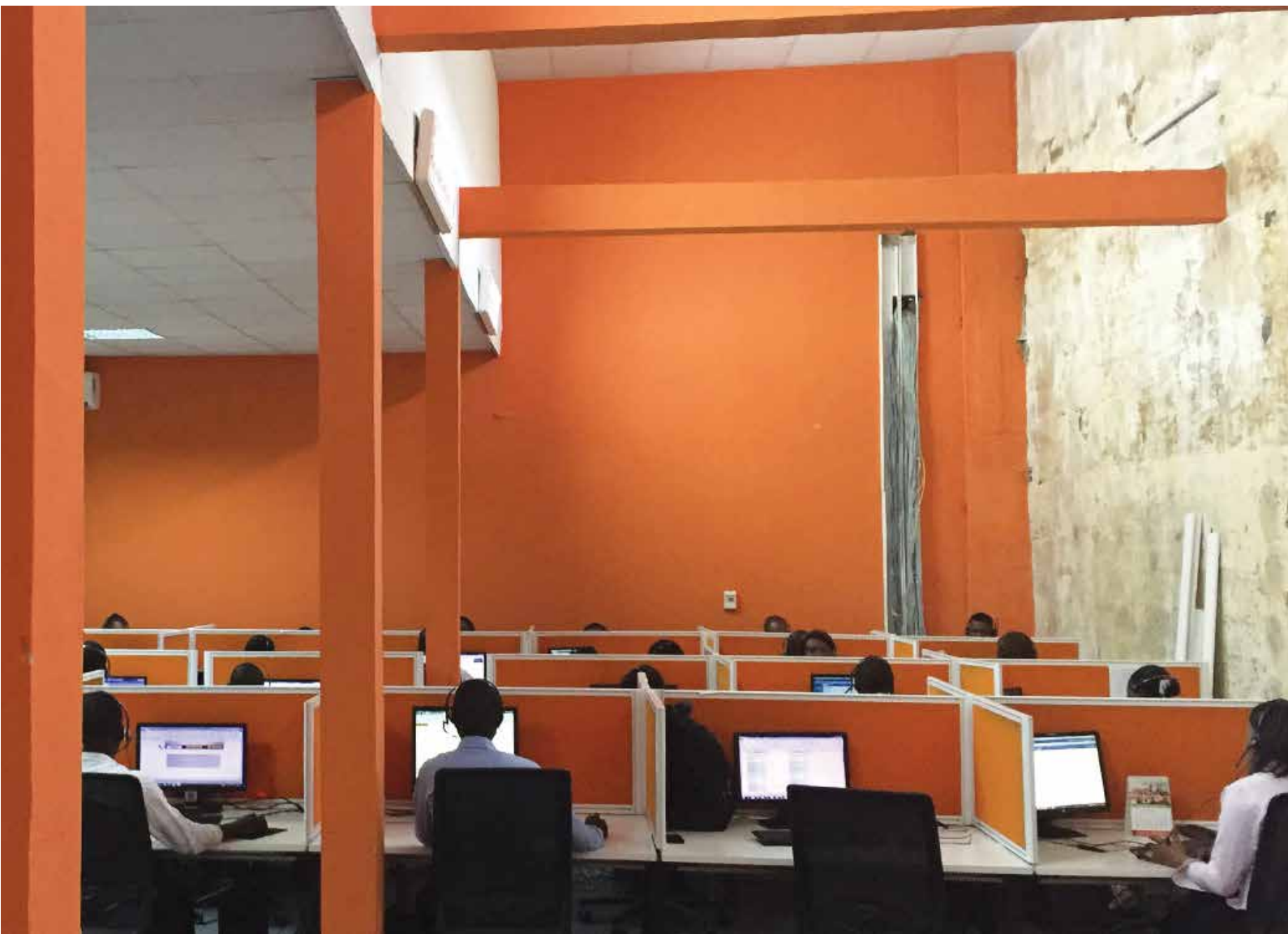
¹⁰¹ FSI Indicator: <http://fundforpeace.org/fsi/>; CPIA indicator: <https://data.worldbank.org/data-catalog/CPIA>

¹⁰² Alexandros Ragoussis and Heba Shams, "FDI in Fragile and Conflict-Affected Situations", Global Investment Competitiveness, Chapter 5 of Global Investment Competitiveness Report 2017/2018, DOI: 10.1596/978-1-4648-1175-3., 2017.

FIGURE 28: FSI IN 2017 FOR COUNTRIES IN SSA¹⁰³



¹⁰³ Fund for Peace: <http://fundforpeace.org/fsi/>



Call Centre in Kinshasa, financed by the Central Africa SME Fund (XSML, DRC)



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