IMPACT INVESTING
WHOLESALE VEHICLE

Learning Outcomes Report
October 2021

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The Impact Investment Wholesale Vehicle is a project hosted by Tshikululu Social Investments, seeded by the Impact Investing South Africa, and funded through the Foreign and Commonwealth Office (FCDO) under the IMPACT Programme*. The technical work, represented in this report, was led by Dr Susan de Witt and Tracey Austin. The Project was prematurely ended, on account of funding cuts made by the FCDO.

Please note that this report is a summary of key findings, not a recommendation for investment and should not be used in isolation. The Project faced a cut to funding and all findings and research have been truncated to a tight time-line of a mere 4-months, unfortunately not allowing for the original full scope to be achieved and limiting the relevant components which require further research and interrogation.

* Former UK Department for International Development

Project motivation and the need for a South African Impact Investment Wholesale Vehicle (IIWV)

- SA Small and Growing Businesses (SGBs)[1] contribute ±30% of formal SA economy/GDP and create 50% of jobs, but cannot afford/don't qualify for bank/formal financing – often due to a lack of collateral.
- To get SGBs to contribute more to the economy in line with global norms of ±60% this funding gap has to be addressed by creating more intermediaries to facilitate investment
- Other alternative sources of funding in SA e.g. private equity, typically target mid-cap-sized companies, and GBs don't often fit with Venture Capital (VC) growth trajectories – thus little other SGB growth-stage funding is available
- Vast volumes of local currency (ZAR) remain tied-up in institutions (i.e. Insurance and Retirement Funds (RFs)/ banks etc.), due to investment mechanisms/processes and risk appetite, cannot easily be unlocked due to a lack of innovative funding structures
- To address the reluctance by SA Institutional Investors e.g. Asset Managers (AMs) and Asset Owners (AOs) the risk would need to be offset to encourage funding, citing a need for blended-intermediated structures
- There is also limited International DFI SA-specific funding available to anchor and seed innovative structures at scale (most International DFI funding in conditional upon a regional remit); and
- Little measurable impact is usually defined at the outset of investments made by the Wholesaler vehicles that do exist – and impact often limited to transformation at a fund manager level or anecdotal references to job creation, with some focus on gender of late

Wholesaler definition:

- An intermediated-vehicle, which pools funding (managed by a Manager),
- To be invested into other 3rd party intermediaries (or Funds), or for further investment via another fund/vehicle (per aligned impact mandate) into ultimate investees
- Technical Assistance (TA) & Working Capital (WC) is needed to support the IIWV

[1] SGBs make up a part of the Small Medium Sized Enterprise (SME) market segment

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1. INTERMEDIATION AND THEORY OF CHANGE

The need for intermediation despite prevailing global trends

Antithesis of intermediation

- In the private equity setting globally , institutional investors are increasingly shunning intermediaries in favour of direct investments[1]
- Arguments in favour of this incl. :
  - Single investments by institutions outperform co-investments and a wide range of benchmarks for traditional private equity partnership investments due to;
    - Outperformance driven by deals where informational asymmetry is not severe, e.g. close proximity institutional investor, and focus on later-stage deals; and
    - The poor performance of co-investments, on the other hand, appears to result from fund managers' selective offering of large deals to institutions for co-investing; AND
  - Additional layers of fees (and in the instance of a fund-of-funds model, arguably even more so)

Direct investing i.e. via a Fund – uneconomical & inefficient?

Reasons why SGB-funding in South Africa relies on a Wholesaler and thus intermediation:

Deal size, transaction cost and need for aggregation	Proximity and access	Asymmetry of data (incl. return data)	Time and replication
• The median funding need for SA SGBs (per the IIWV) is US$[2]300k, which is entirely outside of institutional ticket sizes • Thus there is a need to aggregate SGB financing at scale ±US$60m to focus on reducing management fees at a fund level and break away from PE conventions of carried interest	• Funders (incl. banks) don't directly connect with vast majority of SGBs (incl. remote access, varied sectors as well as genuine empathy for operating environment) • Strong disconnect between sources of funding needed vs. recipients' needs when seeking funding	• Existing intermediaries who already service SGBs have data, systems and human resources to reach SGBs & can avoid poor investment decisions at SGB-level – however they themselves struggle with efficient funding	• The duration and inefficiency to re/build systems/process to reach SGBs detracts from the socio-economic urgency • Rebuilding each time also reduces return expectations and allows current servicing intermediaries to focus on core activities

[1] Lily Fang & Victoria Ivashina & Josh Lerner, 2013. "The Disintermediation of Financial Markets: Direct Investing in Private Equity"
[2] ZAR equivalent, where US$1 = ZAR 15, range: ZAR 750-8,250k

Precursors to a 'Wholesaler' in South Africa

A few captive-type[1] type of wholesalers do exist in SA – according to diverse investment mandates linked to socio-economic upliftment (i.e. mainly job creation) and are often funded by single-source (captive) funding. The limitation of of these legacy wholesalers range from (i) very few blended financed structures, to that (ii) few (if any) target SGBs specifically with measurable outcomes, and (ii) very few which also have a market-building mandate, that makes them replicable (most are captive in nature, as from a captive/single source of funding – thus the focus is on the institution doing more as a proprietary offering)

Limited replicable Wholesalers exist in the SA

SGBs are part of SME segment but specifically commercially viable businesses between ±3-5 years, who require funding tickets between ±US$50k- 550k[6] for growth/expansion

However it is particularly necessary as the SA financial market does not promote financial inclusion and financial development collectively

A-type

Legacy wholesaler examples - captive, neutral mandate for SGBs and some blended financing

Wholesaler	Source of funding (blended)	Replicability (success?)
• SA SME Fund I	Combined SA corporate-CSR funding, pooled towards financing VC SMEs (SGBs), incl. pre-investment TA	Possible - raising Fund II
• PDP Fund (PIC[3])	Targeted 8 growth sectors with a focus on transformation and job creation – as source of funding i.e. SA Unemployment Insurance Fund	On hold - impacted by COVID
• Jobs Fund I & II Ashburton	SA National Treasury Jobs Fund (NTJF) and Ashburton Investments. Portion of NTJF investment formed guarantee mechanism for Ashburton	Replicable as long as a NTJF guarantee is available

B-type

Interesting SA trends – captive wholesaler who are building the market (outside of SGB funding for impact investing)

Wholesaler	Source of funding (blended)	SGB mandate?
• Thuso Partners[4]	Eskom Pension Fund[2] built a FoF to target fund manager at a diversity level but not targeting SGBs	N/A
• RisCura[5]	Built 3 impact funds for direct clients, targeting larger volumes of investing akin to infrastructure	N/A

The ideal scenario for a wholesaler is to combine focus and attributes of A-type initiatives with B-type market-building component

[1] Captive in the sense that it is a single corporate/investor mandate, specific to the source of funding's objectives
[2] AUM ±US$10bn
[3] Public Investment Corporation the asset manager for the Government Employees Pension Fund – ±US$125bn AUM
[4] https://www.thusopartners.co.za
[5] Like other international markets by and large the SA pension funds are advised by asset consultants
[6] US$1 = ZAR 15, range: ZAR 750k-8,250k)

South Africa Impact Fund-of-funds trends[1] (1/2)

Numerous fund of fund structures are attracting institutional funding alongside concessional capital each focusing on slightly different segment of the market (but incl. some SGB (aka. SME) focus) as shown here;

	SA SME Fund I	Third Way Investment Group	Ashburton ACEF funds	27four Black Business Growth Fund (BBGF)
Description	• Independent fund manager with a neutral mandate, and governed by a directive board (comprising key investor members). Unlikely inception story	• Independent and black-owned asset manager with: (i) infra-focused FoF AND (ii) (ii) partnered with Maia Capital Partners for Debt Impact Fund 2020	• Blended finance fund, leveraging a Jobs Fund (National Treasury (NT)) 50% guarantee to catalyse pension fund funding - targets unlisted credit in med-to-large corporates/on-lenders, investing in SMEs	• Blended finance project leveraging Jobs Fund (NT) first-loss capital to catalyse pension investments. BBGFs invest in Black Private Equity funds focused on investing into mid-sized SA businesses for growth/job creation
Size of assets	• ZAR1.4bln/GBP67m committed • >50 listed businesses & PIC have committed §ZAR1.4bn growth/ strengthening SA SME sector	• Core Plus Fund (CPF): ZAR2.5 bn/GBP119m, raising ZAR3 billion/ GBP142m; AND • Maia Impact Debt Fund (MIDF): Target ZAR3bln/ GBP142m	• ACEF I: ZAR785m/GBP37m (closed) • ACEF II: ZAR200m/GBP9.5m raised; target ZAR900m/GBP43m	• Target ZAR1.2bln/GBP57m, of which R200m Jobs Fund first-loss capital. ZAR710m/GBP34m raised (2nd close)
Asset allocation	• Venture capital funds: 57% • Growth funds / companies: 43% • ZAR925m/GBP44m deployed [2]	• CPF: Greenfield and brownfield renewable energy and other infra (large tickets) • MIDF: Blended mezzanine & senior debt focused on infrastructure in social sectors Appears to be direct investments	• Invest in diversified intermediaries that invest in SMEs	• Invest in private equity funds managed by black fund managers. Investing ZAR100m/GBP4.8m to ZAR200m/GBP9.5m in 5 to 7 funds. Diversified underlying mid-sized investees of ±50.
Regulatory landscape	• Operating as company - no clear reg. landscape for specialised NBFIs, but as part of the financial services industry it is expected they will be subject to the National Credit Act, FAIS Act, FICA, POPI & SA Co. Act etc.	• Falls under FSCA regulatory oversight* as Financial Services Provider in terms of the FAIS Act (*discussed below)	• Falls under FSCA regulatory oversight* as Financial Services Provider in terms of the FAIS Act, and the Collective Investments Scheme Control Act (45 of 2002) and is a full member of the Association for Savings and Investments (*discussed below)	• The 27four Group of companies includes a life insurer and as a result is considered an insurance group. It therefore falls under regulatory oversight of the FSCA and the Prudential Authority
Invest-ment process	• Independent Investment Committee, comprising leading SA business stakeholders	• Undisclosed	• Process not described - as AM, investment decisions likely depend on discretion of mandate and influence of AM	• Similar to Ashburton, provides platform services to AMs, ACs and financial advisors taking regulatory burden and admin

[1] Numbers correct based on time of interview or initial research – should not be relied upon – purely shown for illustrative purposes of how the market is evolving

[2] Time of interview

South Africa Impact Fund-of-funds trends[1] (2/2)

[1] Numbers correct based on time of interview or initial research – should not be relied upon – purely shown for illustrative purposes of how the market is evolving

	SA SME Fund	Third Way Investment Group	Ashburton ACEF funds	27four Black Business Growth Fund (BBGF)
Objectives – Financial	• Fund expects to return between 1- 3x despite 0% expectation; (expected to change for Fund II)	• CPF: CPI+ % target AND • MIDF: Variable returns; i.e. financial and impact. Targets not disclosed	• CPI+ % target AND • ACEF I delivered 10.65% as at 31 Dec 2019	• CPI + % net IRR; benchmarking returns above SA's listed market
Objectives – Impact	• Fund 1, SME, VC and fund manager market development agenda beyond impact objectives of transformation (B-BBEE) and job creation • Iterating under Fund II	• CPF: Renewable energy & infrastructure AND • MIDF: Impact-focused on social sector infrastructure	• Specific impact objectives combing job creation, training and development, capital leveraged, impact measurement and learning • ACEF I: Jobs created: (i) Jobs created 10,020 vs. target 9,635; AND (ii) Funds leveraged from guarantee: Target ±ZAR299m vs. fund size: ZAR785m	• A responsible investor, with defined Impact targets: • Transformation i.e. capacitating black private equity managers and at investee company level; • Creating > 3,500 jobs in these companies; and • Providing positive socio-economic outcomes
Observations	• CEO initiative capital was initially once-only opportunity, but is being repeated with new fundraising avenues are being explored (i.e. fund II) • Continued iteration and learnings form the SA SME Fund team is invaluable as neutral mandate	• A clear strategic direction by the Third Way Group to pursue impact-related opportunities in South Africa; renewable energy and social infrastructure, in particular • Limited information is available on the progress of capital raising and deployment of the initiatives. One transaction of ZAR225m /GBP10.7m announced in 2020 • Welcome a deeper dive to ascertain success factors and challenges	• Strong/transparent learnings • Successful in attracting PF; leveraging >2x funding • Positive shift in SME risk perception by PFs • Success of concessional guarantee as incentive for risk-averse retirement funders • Although positive PFs still require risk mitigation before investing in SGBs BUT replicability seen in similar funds (WIP) • Intermediaries with SGB experience is important link when PFs lack SGB expertise AND, wholesalers with impact investing experience - key to investor confidence • Managing impact investment portfolios is costly and may require subsidisation	• Positive feedback from retirement fund investors; i.e. strong indication of Pension Fund (PF) expectations – risk and return requirements remain unchanged, where these can be delivered, PFs will allocate capital to innovative, alternative investment initiatives; • "CRF seeks to achieve commercial returns for its members, limit downside risks and have a positive impact on South Africa and expects asset managers to create products that meet all three requirements. We are confident that the 27four BBGF II will achieve these requirements through the innovative Jobs Fund mechanism that has been negotiated."

Design considerations for designing a SA Impact Investing Wholesaler Vehicle

1. Collated research on Supply & Demand dynamics of SGB funding

Undertaken by various 3rd party researchers

2. Legal review of unclaimed assets & if/how this can be used by a Wholesaler

Approximates US$4.3trn of funding – unutilised
Review undertaken by Webber Wentzel (report to be shared in due course)

3. Legal and operational review of legal structure – flexible enough for various sources of funding

Understanding market preference for a limited vehicle structure
Undertaken by Bowmans and tested for practicality with Realfin

4. Building a strategy for Asset Owners' Forum of SA – incl. their impact mandate

Accounts for ±50% of SA's US$300bn retirement funds
Initial work with Asset Owners Forum SA[1]

5. Feedback from SA financial spectrum on funding requirements

Interviews with retirement funds, banks, SA & International DFIs[2], philanthropy, local empowerment foundations (incl. pricing/return expectations and mandate)

6. Designing to C–adaptable into an Impact Measurement and Management framework

Retained an impact expert to test ToC (& assumptions) at Project and vehicle level
Undertaken by IBIS

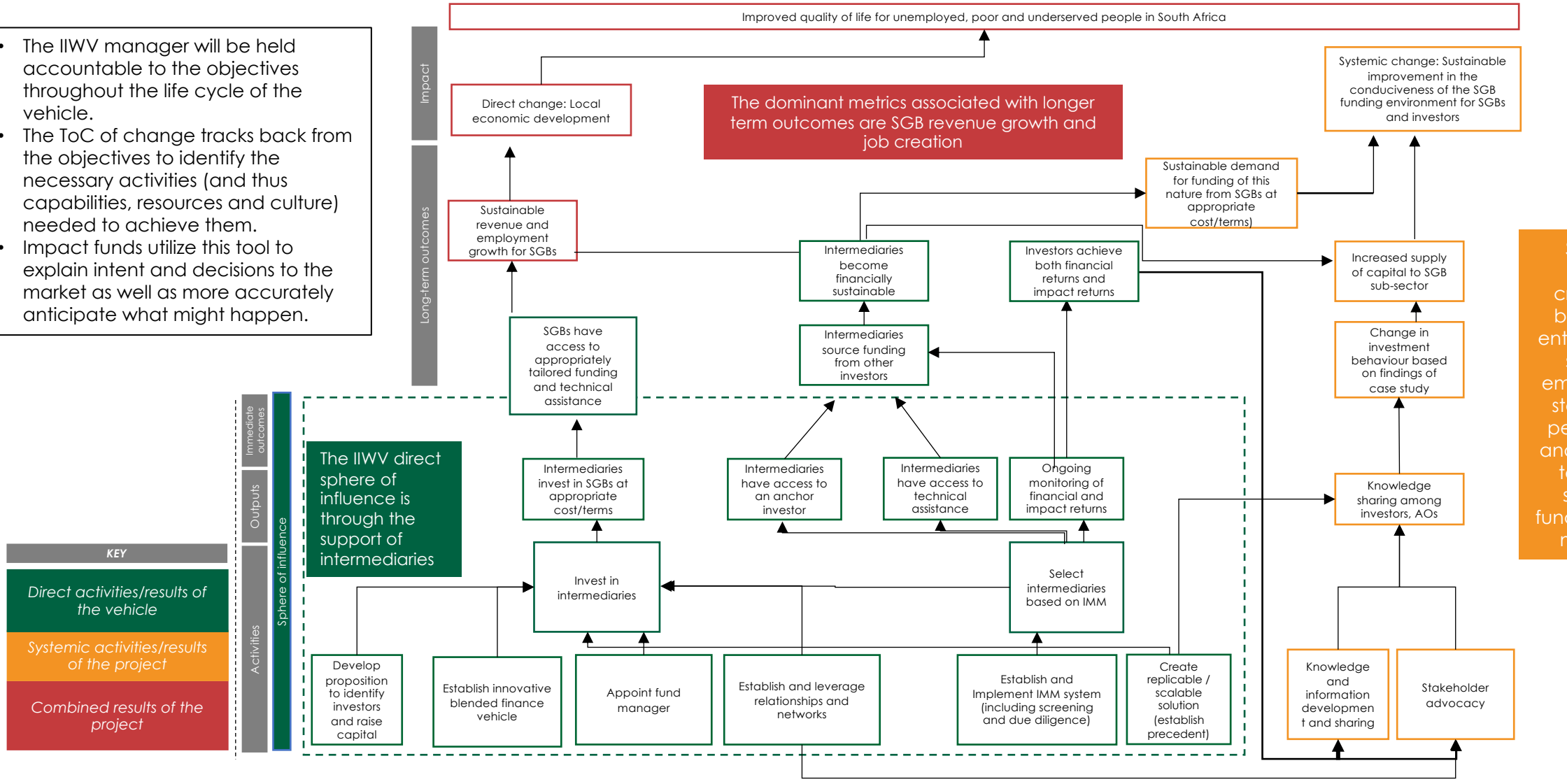
7. Designing a illustrative financial model (undertaken by Rebel Group)

On account of a reduction in funding of this Project[3], the findings/research have not been tested, however where possible select additional reports have been made available

[1] Not necessarily aligned with the IIWV's definition of impact or same target market
[2] DFIS including Canadian, European, UK, and US Development Finance Institutions
[3] In line with ODA cuts made by the UK in February 2021

The abridged Theory of Change presents a distinctive proposition in the South African market

- The IIWV manager will be held accountable to the objectives throughout the life cycle of the vehicle.
- The ToC of change tracks back from the objectives to identify the necessary activities (and thus capabilities, resources and culture) needed to achieve them.
- Impact funds utilize this tool to explain intent and decisions to the market as well as more accurately anticipate what might happen.



Systemic change created by building an entirely neutral structure embracing all stakeholder perspectives and not linked to a single source of funding or fund manager.

2. IIVW COMPONENTS AND COUNTERPARTS

The simplified structure the SA IIWV may take, considering market feedback

The IIWV has to be systematically[2] built, facilitating repetition at scale, to leverage significant ZAR-funding from funders (incl. institutions), to finance SGBs. Deliberately simplified here to demonstrate this

A **IIWV ("Fund-of-funds")**

Target Size[3]: ±ZAR 750m-1bn
Commination of debt and equity

B Senior-ranking funding (various)

C Concessional funding e.g. ***lower return-seeking*** funding

D Concessional funding i.e. ***returnable capital*** (on a deeply sub-ordinated basis to entice senior capital)

G **Secondary Intermediation**

H **Ultimate recipients**

3rd party intermediaries OR "Funds"[6]

SGBs

ZAR[3]

ZAR[3]

TARGET NO OF FUNDS ± 5

Should be conditional as is likely to be needed

Working Capital[4] ("WC")Facility

ZAR

E

F Technical Assistance[5] (TA) Facility

ZAR

[3]ZAR funding - can be debt, equity, mezz, or even a guarantee (tbd)

[4]WC should be mobilised for benefit of SGBs (but is not contemplated under the IIWV to avoid drag on vehicle returns and depends on source of funding)

[5]TA should be offered at the outset and/or during investment (source tbd)

[6] these should be established companies/that already have capacity and resources to reach SGBs with some replicable success

[1] Being refined as part of feasibility & design
[2] Blue-font components expected 1st to anchor vehicle
[3] Optimised modelling suggests fund size ZAR 900m to cover fund costs

IIWV – components and counterparties

	Definition in South African context (where applicable examples are shared)
A	**IIWV (Fund-of-funds)**; the legal structure review confirms the common use of the en commandite structure is likely to be used due to market familiarity and will support keeping establishment costs lower (the combination of funding will inform this at a fund-raising stage)
B	**Senior-ranking funding** incl.; • Potential Institutional funding; retirement funding (incl. pension and retirement funds), and potential collective investment schemes (subject to concessionary funding to reduce risk) for debt and/or equity structures; • SA big 4 banks[3], favouring debt structures, due to regulatory constraints and limited interest in participating in blended structures, off own balance sheet • DFIs, international (limited geographic for sole-SA remit, and would need to combine wider SADC region) and/or SA DFIs[1] (preference for debt vehicles)
C	**Concessional funding e.g. lower return-seeking funding;** international DFIs (traditionally however appetite vary since COVID-19), and other sources expected from global philanthropy, SA corporate empowerment trusts and other angel/UHNWI bespoke sources (often fragmented)
D	**Deeply sub-ordinated funding e.g. returnable capital** in SA most common local source is National Treasury's Jobs Fund, which has helped set up funds like Ashburton Jobs Funds I & II. Precedent for USAID who have provided direct first-loss to the SASME VC Fund II (±US$2 million). Regional government guarantees being tested on COVID Crisis Facility with Gauteng Province[2]
E	**Working Capital** – envisaged as (i) an imperative to the success of the IIWV on account of targeting SGBs. To avoid pressure on the IIVW itself (i.e. to avoid dragging down returns at a Fund-of-funds level) this should be pre-considered alongside fund structure, and pipeline building – the role of DFIs is important here to mobilise local currency capital as a potential stand-by facility to be used alongside the IIWV funding. Existing intermediaries focussed on the SGB sector frequently cite this need
F	**Technical Assistance Facility**; much like the Working Capital a captive source is key, and likely international donors, who are familiar with and run h capacity building and run such programmes are best placed to do this. The EU was found to be the most compelling this regard, already working on a related basis in SA[4]
G	**3rd party intermediaries (Recipients or "Funds")**; appears to be (i) credit/debt (+ mezzanine), (ii) equity (+ hybrids) 'funds' and Non-Banking Financial Institutions[2] (NBFIs), or leasing companies - all considered as these are all presently market-makers providing SGB-financing as they are are already set-up to do so
H	**Small Growth Businesses (SGBs)**; typically are businesses between ± 3-5 years, who require funding tickets between ZAR500- 5million/GBP25-250k for expansion and who are collectively a key contributor to the economy and employment. But often don't qualify for bank financing (due to lack of collateral), and are unable to access other alternative sources of funding

Not directly part of structure

[1] SA DFIs have revised mandates and need to be test on a case-by-case basis
[2] WIP at the time of writing
[3] Precedent for Fund managed by RMB with KfW support
[4] sefa's backing via a ± €50m facility from EU

A

Legal considerations resulting in three possible structures

Various considerations influencing the choice of legal structure[1]

SA regulatory considerations

These will influence the efficiency of the IIWV structure:

- The Collective Investment Schemes Control Act;
- The Financial Advisory and Intermediary Services Act;
- The National Credit Act;
- The Pension Funds Act and its Regulations;
- Relevant regulatory considerations under the South African Companies Act;
- The South African Income Tax Act; and
- Acknowledging the need for "robust governance" - apt governance for chosen structure

Well-known, good precedent and considered practical to implement (see next slide)

3 key structures	En commandite partnership(ECP) or Ltd partnership	SA private company (Pty Ltd)	Trust
Combination of the 3 is possible (costly/not much precedent)	• 2 categories of partners, i.e. general (GP) and the commanditarian partners (limited partners LP) • Partnership business is carried on in the name of the GP, who is fully liable to 3rd parties for the partnership debts, while the LP undertakes to contribute a fixed sum of money to the partnership on condition that they receive a fixed share of the profits and they will continue to enjoy their limited liability	• A private company whose memorandum of incorporation must prohibit it from offering any of its shares to the public and must restrict the transferability of its shares • Investors are issued with shares when they make an investment	• The trust structure enables the legal ownership of property to be separated from the enjoyment of the benefits that flow from that property. Trustees generally hold assets on trust for investors • A bewind trust is specifically recognised in the definition of a Private Equity fund (PE) under Regulation 28 to the Pension Fund Act and thus is a potential vehicle for PE structure

Overriding considerations

- ECP seemed to be most apt vehicle to meet the IIWV's objectives - where funds are raised and invested through equity/debt investments and grant-funding
- Due to investor risk profiles, a separate ECP is used for the equity, debt raises and for grants
- A South African private company as the most appropriate vehicle where funds are raised through debt
- Accordingly, a combination of vehicles may be ideal
- Ultimately the IIWV Manager could be appointed by each of the vehicles and potentially linked under an "umbrella" arrangement pulling the 2/3 entities together, optimising benefits of each vehicle

[1] Noting best practice, the choice of structure will invariably be determined by investors and their combined/ respective needs

A

Preferred legal structure: En Commandite Partnership

Advantages

- The investors will enjoy limited liability which means that the investors will be liable to their co-partners only to the extent of such investors' contributions to the partnership or to a fixed amount injected into the partnership. Therefore, the commanditarian partner is shielded from creditors and the limit of his/her partnership liability is predetermined
- It is flexible (can cater for investors specific needs)
- It is easy to establish and there are no formal establishment procedures
- Most commonly used legal vehicle for SA private equity funds and, as such, most equity investors should be familiar with how it works
- It is fiscally transparent and the partners each receive a pro rata share of the income, and each of them will incur a pro rata share of the expenditure:
    - If there is a profit/gain on the disposal of investments, such profit/gain is taxed in the hands of the partners; or
    - If partners suffer a loss on the disposal of investments, such loss should be available to be offset against the partners' other capital gains
- Any proceeds flowing through the partnership maintain its character
- The partnership is not a separate taxpayer. Donations made by the partners are thus made directly to the recipients. This means that this is a single donation and should only trigger donations tax once (if applicable).
- The Income Tax Act (**ITA**) provides for a South African partnership not to create a permanent establishment (**PE**) for a non-resident investor

From previous slide – preferred market feedback

Disadvantages

- LPs may not actively participate in the business of the partnership, as they will stand to jeopardise their limited liability status in the partnership

Fund regulation and licensing

- See Regulatory Considerations section for overview of regulatory and legislative requirements that may apply to a fund structured as an *ECP*, depending on how it is structured, raises funds and deploys capital

Suitability

- An *ECP* is not a separate taxpayer and thus 'see-through' from a tax perspective. This means that:
- Gains derived from equity investments retain their character and are taxed only in the partners' hands; and donations are made directly to the recipients, thus only triggering donations tax once (if applicable)
- The vehicle (or potentially two separate partnerships) is suitable for the equity of donation raising and investing
- Not ideal as a vehicle that borrows money or lends money to funds (as Borrowers)
- A loan from ECP constitutes a loan claim in the hands of each limited partners. Lending through a partnership causes unnecessary legal complexities due to the partnership not being a separate, distinct legal entity, since the lenders (being the limited partners) practically each owning only a pro rata loan claim
- E.g. securing a loan from a partnership would become unnecessarily complex as a result of each limited partner holding a separate loan claim
- Tax perspective, the considerations should be the same whether a loan is made directly by a partner to the borrower, or via a company:
- Repayment of loan capital is tax neutral irrespective of whether the loan is provided via a company or in a partnership context;
- If a loan is routed via a company, it should be done on a back-to-back basis, to ensure that there is no tax leakage in the company; and
- If interest withholding tax applies to a non-resident lender, should be the same both in a partnership or company structure

Expert inputs sourced from: Bowmans (legal guidance) and RealFin (practical application)

B

Senior ranking funders are becoming more familiar with alternative structures and are willing to evaluate impact deals on their own merits regardless of prior experience

- Asset Owners, (AO) primary motivator is alignment with fiduciary duty and thus they will assess risk and return on that basis. If there is adequate compensation for risk taken then they will evaluate impact deals on their own merits. A minority of well capacitated funds are proactively integrating impact alongside financial return.
- AOs have limited experience investing in SMEs outside of Private Equity. Nevertheless there is some precedent with blended products most utilising Jobs Fund guarantees (e.g. Ashburton Jobs Fund) and captive structures (e.g. Thuso Private Markets Fund). Hesitancy of double-fee layering permeates the resistance to fund of fund structures in general.
- Although there tends to be a shared focus on job creation and transformation, impact strategies are highly variable. Most investors would say they are are chasing diversity at fund level rather than impact specifically
- AOs are working within in a highly controlled, bureaucratic and inflexible environment, which would benefit from support from a peer group to encourage investment (albeit via co-investment mechanisms) – the debate of fiduciary duty beyond delivering returns prevails

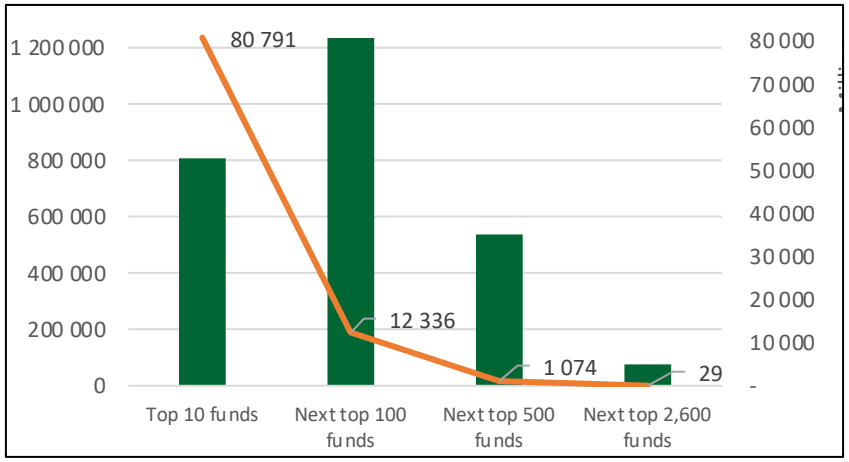
Criteria	Pension Funds	DFIs		Alternative: Fund of Funds
		International	South Africa (shown for comparability – don't fund F-o-Fs)	
Investment process (Direct/Advised)	Advised	Direct	Direct	Direct (but with strong-tiered oversight)
Precedent of funding into a F-o-F	As captive funder (e.g. Jobs Fund I & II, with guarantees)	Varied (depends on who vehicle is positioned)	No Direct	
Pricing	CPI +8-11%	Market-related Depends on where funding is from	Market-related	CPI + 10-15%
Funding duration (yrs.)	±10 -12 yrs.	10-plus yrs.	10-plus yrs.	Fund life 10yrs (plus 1yr x2 or 3)
Views on costs/fees				
Instrument	Debt/equity	Debt/equity/ mezz	Debt/equity	Debt/equity
Blended instruments	Yes – guarantees/tiered-ranking mechanisms (not first-loss)	Familiar-pioneers	Yes - guarantees	Yes – guarantees (but N/A)
Regulatory constraints	Reg 28		Internal mandate	
Impact focus	ESG	Full impact/ToC	ESG/Impact	ESG/Impact
Views on IIWV manager	Experienced only	Varies	Transformation NB	Experienced Equity
Views on structure	Ltd P/ship/ECP, some precedent for Permanent Funding Vehicle	Un/Limited/varied	N/A	Ltd P/ship/ECP

B

Pension Funds are looking to diversify into alternatives but champions and collective action is required to change traditionally risk averse behaviour

Criteria	Pension Funds
Volume	The SA pension industry is the 8th largest in world in AUM as % of GDP with ±ZAR4.6tr AUM. ±1600 active pension funds with a further push by regulator to consolidate to ±200 funds. 50% of Pension Fund AUM in 10 largest funds.
Motivation for involvement in FoF	Smallest ticket size in region of R150m and cannot take >20% of investment into asset so investing in larger fund works better A large proportion of pension funds (on a weighted basis, reflecting representation of assets under management) guided by the UNPRI (85%), CRISA (85%), SDGs (74%) and National Development Plan (53%) – growing commitment/allocation to ESG, impact (preferred thematics being job creation and transformation) RFs looking for uncorrelated assets to diversify portfolio and long dated assets to ensure Asset Liability Matching.
Constraints	The pension fund governance and investment processes are not conducive to making alternative investments Asset consultants are not incentivized to identify alternative investment opportunities and subsequently lack capacity to do so Asset Managers cite quality/bankability and regularity of pipeline as biggest constraint to investment There is significant mistrust and lack of knowledge around valuations and fee structures of alternative assets. There is a lack of diversity at the level of AC, AM and fund manager
Opportunity for IIWV	Regulation 28 allows pension funds to invest up up to 10% in PE (currently 0.3% for FSC- registered funds which excludes GEPF[1]). If these funds were to increase to GEPF level allocation (3%) this would mean an extra R48bn for unlisted assets. ±5-10 RFs with specific characteristics including (i) internal capabilities to assess risk (ii) value diversity and have outperformed the market as a result (iii) have a carve out for higher impact deals (iv) do not rely entirely on Asset Consultants to evaluate deals but rather work progressively to bring them along (v) have built captive structures to address developmental needs (vi) experience with blended structures Asset Owners Forum (set up by Batseta) whose 15 members represent ±ZAR2.2tr AUM with purpose of growing SA economy through co-investment into alternative assets including private equity and debt. Working to unlock investment through collective action.

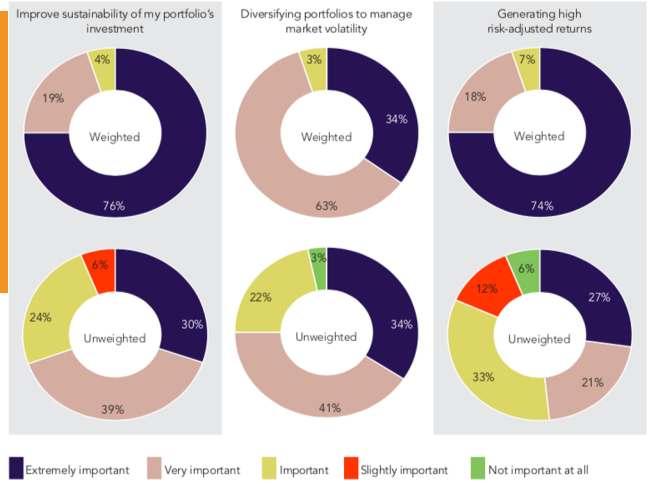
Figure: Allocation of AUM spread between Pension Funds



Pension Fund Assets concentrated in ±100 funds

Figure: Motivation of Pension Funds [2]

Sustainability and financial return considered on equal footing from sample of ±150 Pension Funds



[1] FSCA (2017). Registrar of Pension Funds Annual Report
[2] Intellidex (2020). Investing for Impact

B

Insurance companies and banks are showing little intent to overcome constraints in order to increase investment in SMEs. Banks could support working capital requirements of IIWV

Criteria	Insurance companies	Banks
Volume	Long-term life insurers ±ZAR3.1tr AUM, **tend to hold most conservative portfolios**. Concentrated in Investment Funds (53.9%) followed by Equity (15.5%), Government bonds (9.2%), Corporate bonds (7.8%), Cash (7.1%) with the remaining 6.5% across Structure Notes, Mortgages and Loans, Collateralised Securities, and Property. Of that ±2% in alternative funds (which includes hedge funds) and 0.6% in PE. Short term insurers even more conservative.	In South Africa, around $16 billion of funding is available for MSMEs of which banks provide $11 billion (±70%). **5 biggest banks hold 90% of these assets Nedbank, Std Bank, ABSA, FNB and Investec. 5% of this could cover R400bn funding gap.** DFIs/government have long recognised the potential of banks with existing infrastructure and systems to fill SME funding gap – thus the multiple guarantees or blended finance schemes that reduce the risk and cost inherent in the segment
Motivation	**Starting to engage SME market through fintech disruptors who have brought forward the pressure on insurers to become digitally-enabled, and already some major players in the non-life industry** (Santam, Old Mutual and Guardrisk) have partnered with insure-tech companies. National Sustainable Finance Initiative driving more stringent practice and reporting requirements on ESG which does not affect SME investing directly but is increasing awareness in impact.	**No evidence to suggest that this changes banks lending behaviour in the long term.** • ZAR200 billion loan guarantee scheme from the Government of South Africa to banks to provide relief in response to Covid-19. • sefa offers guarantee schemes to banks through its wholesale lending division, which was launched in 2018. As at the end of 2020, its guarantee facilities have growth to ZAR249m to a range of financial intermediaries, but including schemes with Absa, FNB, Standard Bank, Nedbank and Mercantile Bank • IFC's SME Push programme , AFD and Proparco's Choose Africa initiative., FMO has launched the NASIRA guarantee scheme all recently instituted in SA
Constraints	Covid causing cancellation of life insurance (discretionary purchase) and large scale claims for business interruption. The total gross-written-premium pool is forecasted to fall by 15 percent until 2022 and only return to pre-pandemic levels by 2024. **Most insurance companies will be forced to focus their efforts inward on a "survive and then thrive" strategy.** Only the top 5 life and general insurers are seen to have large enough capital buffers and less reliance on new business to weather the storm, while some 80 others are expected to be under severe pressure.	With Basel III capital adequacy rules assigning a risk weighting to each of a bank's assets proportionate to the credit and market risk of the respective assets. **For SMEs, this risk rating is relatively high compared to other bank assets and as a result, the bank has to hold more capital to, often twice as much, to fund SMEs**. Capital efficiency through leverage is paramount for bank performance and therefore they will allocate funding with the lowest capital requirements and consequently the lowest risk, leaving SMEs last in the queue of priority
Opportunity for IIWV	Insurance companies not meaningfully engaged in this study considering they are further behind in thinking than other institutional investors. Strained liquidity and solvency will likely result in close review of risk and **conservative capital allocations at portfolio and firm levels over the next two years.**	**SA Banks not geared to participate off own balance sheet – does not fit investment process** The opportunity may lie in partnering with banks to be able to **(i) provide working capital facility (possibly via a guarantee to provide the WC to the intermediary actors (i.e. 2nd level of intermediation) (**ii) support credit checks and (iii) provide decline data.

B

Unclaimed assets do not present an immediate source of funding for the IIWV although future legislation may open up the possibility

Pension Funds

- The Pension Funds Act contains a definition of "unclaimed benefit", circular PF 126 has addressed the treatment of unclaimed assets and the FSCA has established a portal to search for unclaimed benefits.
- The retirement fund owns the assets and the member merely has a personal right against the fund.
- All retirement funds (including unclaimed benefit funds) must comply with the asset spreading and investment restrictions contained in regulation 28.
- **ZAR 43 ,6 billion across ±1400 funds**

Collective Investment Schemes

- **There is no legal framework under the collective investment scheme that deals with unclaimed assets nor is there an agreed definition of what constitutes an unclaimed asset.**
- With unidentified deposits the original owner will always have the right to claim the return of the funds. Thus, a CIS must keep unclaimed deposits received from a customer and the assets of the portfolio separate from their own estates
- Managers of collective investment schemes who are members of ASISA are also subject to the ASISA Standard.
- **ZAR17.1 billion in unclaimed assets across ±150k insurance and CIS products**

Insurance companies and Banks

- **There is no legislative regime in South Africa dealing with unclaimed benefits payable by insurance companies or banks**
- The policyholder/depositor has a mere personal right to performance under the policy or contract and has no right and/or interest in the assets held by the insurer/bank. For this reason, insurers/banks can in law deal with unclaimed benefits in the manner appropriate.
- However, certain insurance companies are members of ASISA are contractually bound to comply the guidelines set out in the ASISA Standard dealing with unclaimed assets. There is a voluntary, non-binding, Banking Code that incidentally deals with unclaimed deposits.
- **No publicly available information on the value of unclaimed deposits in banks**

The newly proposed Conduct of Financial Institutions (COFI) Bill will have a material impact on the treatment of unclaimed assets. There are two scenarios contemplated below with regards to accessing funding for the IIWV

Scenario A: Financial Institution divests itself of all unclaimed assets (and potentially also any accompanying liabilities) for purposes of the impact investment through a central fund. Such benefits are, however, eroded if a Financial Institution cannot similarly transfer the liabilities relating to such unclaimed assets.

Based on the current regulatory environment as well as the revisions proposed by the COFI Bill, Scenario A may not be a viable structure for the IIWV absent further significant regulatory reforms, which must include that unclaimed assets are not treated as trust property under the COFI Bill.

Scenario B: Financial Institution is permitted to deploy unclaimed assets as an investor (i.e. make use of the unclaimed funds) in a central fund but retain the liability in respect of the unclaimed assets.

By contrast, Scenario B more easily aligns with the current and future regulatory regime in South Africa. Financial Institutions may, within certain limits, freely invest its assets. While the investment decisions may become more complicated if unclaimed assets are treated as trust property, there is no restriction on investment.

Concessional funding[1] is critical for success, particularly if senior institutional capital is sought

Sources	Select international DFIs[2], local DFIs, Angel Investor groups, International Donors[3]
Funding Volume[3]	• ± 40% level[3], relative to the total IIWV size (illustratively) is ZAR 360million/GBP 18million • Too large for single local (SA) DFI • Three or more possible sources of funding (likely international donors/DFIs) needed without crowding out senior funding to build the market principle. Fragmentation is expected for this source of funding (likely delays/greater costs) • Given the global nature of source of potential funding the regionality of connecting the wider SADC region – will be an imperative – but at the same time may need to be carved out of the structure to fit with pension fund restrictions
Market-building dimension	
Motivation	• To find senior funders (esp. Pension Funds (PFs)) for ± 40% participation will be challenging but not impossible(helped by both the Concessional and Sub-ordinated funding (slide 25). There is somewhat less absolute reliance on first-loss capital by some PFs at senior level – but likely necessary to support risk-compensation at a vehicle level • In the case of institutional investors, it is confirmed their their decision making process and 'trustees-asset consultant-advisor' relationship, will be binary i.e. facilitator or a detractor. There is still a need for this type of capital (priced at SA CPI (3.5.%)) to reduce cost of funding & speed-up first-close
Scale and reach	• The target is a factor of ± 1:2 (of Concessional Funding to Senior Funding, with residual being picked up by Sub-ordinated funding) to avoid diminishing optimum fund size (min ZAR900m – and managing fund costs), placing pressure on the senior funding and a circular effect i.e. which will ultimately require an even higher level of buffer funding • The circularity of this funding, facilitates the blended structure – without it, a first close will be near impossible, to address perceived risk
Benefit of neutral funding	• Adapting and adjusting attitudes to risk, has to start with relative positions – if the perceived risk of the IIWV (ultimately financing SGBs) is negated by proving such a 'risky structure' can at least return capital (with costs linked to SA CPI), then the risk must be less than originally assumed. This is the the most powerful demonstration to advocate for this structure on a replicable basis • The lack of DFI capital capable of participating in this capacity in SA is a fundamental gap that needs to be addressed – without the way being led by International DFIs – local funders will take a while to follow (many will not follow at all)

[1] Generally deemed to be lower-ranked funding, but not first-loss/guarantee-like in nature, assumed in SA context to attract return of CPI (3.5%) to cover costs
[2] Declining basis post COVID
[3] These numbers reflect the modelling exercise and shown in slides 31 & 32, 1GBP = 20 ZAR, and 1US$ = 15 ZAR
[4] Does usually require an off B/S or escrow-like structure – to avoid being seen to take money back, in the case of some donors

C

International DFIs are a much more likely source of concessional returnable capital than local DFIS. Even so Covid has changed the funding landscape significantly

Criteria	Local DFIs	International DFIs
Volume	3 DFIs in SA are making substantive SME investments – • Industrial Development Corporation (IDC) (ave ticket size ZAR82m), • Small Enterprise Finance Agency (sefa) (ave ticket size ZAR16k) and • National Empowerment Fund (NEF) (ave ticket size ZAR9m)	• Relative to their part of B/S or whether off B/S i.e. using Donor funds • Precedent is set by EU funding of sefa at €38m for sefa (plus €14m for TA • Expect average at GBP5m-8m/ZAR100-150m

Motivation	• As DFIs, these organisations are required by law to take on more risk than what banks or other private sector investors are willing to consider, as can be seen in the high levels of impairments (CEIC, 2020). IDC and NEF ±18 and sefa closer to 50%
	• Impact objectives reflect alignment to South Africa's triple challenge of unemployment, inequality and poverty, aiming to stimulate industry that can drive economic growth and create jobs
		• Until recent geological events and COVID-19 – the DFIs has sub-allocations;
		  • FMO – has Massif and Proparco- FISEA fund allocations – under €500m
		  • These funds have not readily been repleted and clarity is sought on whether this will fall to the Donor (via governments or EU) directly?
		• Returns are negotiated on a deal-by-deal basis but don't seek to distort market
		• And/or separate investment policies, e.g. CDC's on B/S consolidation of 2017-2021 policy indicated an IP2 policy with a published return of 0-3%

Constraints	• Anecdotally IDC and NEF moved to direct investments only, focus on black owned industrialists and mid cap preference • sefa the most aligned in terms of the size of businesses they are supporting with R250k-R5m cheque sizes (primarily ESD environment) but do not invest in FoF	• As referenced the change brought on by geological events and COVID-19 – does not provide a clear steer on who to approach these funds – hence the dual-tract of going via donors and DFIs together (always known for not being easy to access) • Challenge regionally and thematically will be key • Variable appetite for F-o-F (as arguably intermediaries themselves)
Opportunity for IIWV	• DFIs unlikely to participate in funding IIWV • Sefa recently received grant funding from EU (off balance sheet) – able to extend prime -5% to intermediaries and provides up to 10% business development support for SGBs through the fund manager. Require co-investment from intermediary/underlying loan book as collateral in return for such good rates – IIWV could potentially be a co-investor into those intermediaries	• To leverage relationships with those who have a clear SA-country focus, precedent and presence • Mandate aligns with EU/USAID/Proparco/Dutch Good Growth Fund as well as Mandate could align with KfW/SEDA/CDC/FCDO depending on thematic focus • Not in the mandate of DFC/Obviam/Norfund

C

Returnable capital funders

Terms	International Donors	DFIs		Philanthropy[1]
		International[1]	Local DFIs	
Examples (not incl.)	USAID/EU/Netherlands (evidenced by SA precedent)	Biggest group EDFI (via EDFI ManCo)	National Empowerment Fund, sefa and IDC	e.g. US-based Foundation/ endowments
Precedent of funding into a F-o-F	Likely yes	Limited, case-by-case	No Direct investment favoured	Yes
% cap (ticket size GBP m)	Precedent in SA ± £1.5m	± 10% (£10-15m)	N/A	Up to R1m Covid response
Net Return (%) i.e. 0% OR 0% + CPI	0%	CPI + inflation (or ± 3%)	CPI+	0%
Funding duration (yrs.)	Indefinite	Depends on instrument – 10yrs Avg	Depends on instrument – 10yrs Avg	>12 months
Instrument	Grant/guarantee	Debt/equity/ mezz	Debt/Equity	Debt/Equity
Familiarity with other instruments	Unfamiliar (willing to learn)	Familiar	Familiar – not aligned presently	Unfamiliar/open to learning
Recycling provisions vs. limits on returned funds	Cannot accept funding back	Flexible, co-investor led	N/A	Tbc – depends on what part of the organisation funds
Impact focus	Full impact/ToC	Full impact/ToC	ESG/Impact	Full impact/ToC
Views on IIWV manager's experience vs. capacity building	Open to capacity building	Some capacity for capacity building	Equity preferred	tbc
Source of TA funding	Yes (most likely source) – but procurement nuances	Yes – but own portfolio linked	N/A – possibly for transformation support	Yes – expect flexible – but challenge with theme alignment

[1] Distinction to be made for International Philanthropy with dual-investment pockets i.e. investment and grants

D

Subordinated capital[1] is required to provide downside protection due to prevailing attitudes to SGBs

Sources	Select international DFIs[2], SA Corporate trusts, International Foundations (eg MacArthur Catalytic Capital Consortium), potentially SA UHNWIs (COVID has set a positive precedent in this regard)
Funding Volume[2]	• ± 20% level[2], relative to the total IIWV size (illustratively) is ZAR 180 million/GBP 9 million • Three or more possible sources of funding on an aligned basis would suffice • A greater volume should only assumed fund size is increased counter-productive measure should be avoided i.e. the ratio 10%, did not decrease, from Ashburton Jobs Funds I to II (both backed by National Treasury guarantee)
Market-building dimension	
Motivation	• Senior investors require downside protection (particularly due to bias/prevailing attitudes towards SGBs), as a kind of insurance which aligns particularly with institutional investors' fiduciary duty. There has been a slight softening on this requirements, and some PFs will be approached as "lowest hanging fruits' • Regardless of the risk-adjusted pricing being market commensurate - this provides an additional layer of protection at ± 25c/1 ZAR • Over time and with replication, it is expected the need for a buffer will diminish • This is pivotal to entice senior funders and has worked well for UK PIDG- Emerging Infrastructure Fund, DFID (first loss), DFIs and Banks
Scale and reach	• This leverages the base capital as a buffer by ± 4 x, and is at the heart of blended finance • These structures are used with great effect in the rest of Africa, where DFI/Donor money most often underpins the buffer • Similarly a buffer, if from a foreign funder amplifies the reach in ZAR significantly e.g. USAID US$ 2 million (GBP1.5 million) equates to ±ZAR 30 million - at the IIWV vehicle size of ZAR900 million this would be 3% (of the 20% sought) of buffer funding
Benefit of blending	• On balance institutional investors and banks are arguably last to 'impact table' – and their learning curve, internal policies, tools and risk management systems are evolving to balance impact and financial returns, in a predetermined manner • The legal structure (limited life vehicle) is critical to allow blending. A permanent capital vehicle is considered unlikely for an unbranded vehicle (e.g. GrowthPoint has precedent of such vehicles backed by PFs regardless of exit-IPOs)

[1] Generally deemed to be lowest ranked funding, includes first loss/guarantee equivalent
[2] Declining basis post COVID
[3] These numbers reflect the modelling exercise and shown in slides 31 & 32, 1GBP = 20 ZAR, and 1US$ = 15 ZAR

D

Empowerment trusts are looking at innovative ways to leverage funds and create impact outside of traditional grant making

Criteria	Corporate empowerment trusts	UHNWI/Philanthropy
Volume	Ownership components of Broad Based black Economic Empowerment deals for 25 out of the Top 100 listed companies on the JSE indicated that R32.6 billion/GBP1.6 billion of value had been created by 2018 in endowments to foundations. They generate funding for philanthropic activities of about 10% per year, resulting in spending of over R3bn per year	The top 10 richest people in South Africa are worth close to $30 billion/GBP 21.6billion. Covid response has been noteworthy in terms of supporting small businesses Oppenheimer South African Future Trust ZAR1 billion /GBP47.6m to employees of MSMEs in South Africa against loss of income as a result of the pandemic. Administered by Absa, the relief is provided in the form of a repayable, interest free loan. Rupert Sukuma Relief Programme donated ZAR1 billion/GBP47.6m for Covid relief to MSME in form of patient loan with grant portion.. The facility is managed by Business Partners Limited (R2.8bn requested)
Motivation	The new foundations support a wide variety of objectives, but education stands out as a priority area. It is estimated that 67% of the financial resources the foundations command is focused on education-related funding objectives. This is followed by community development (10.6%) and entrepreneurship (8.4%). Mostly run semi-autonomously from company	In pre-pandemic times majority of funding goes into high level advocacy, grassroots community development and support, funding other non-profits, or specific sector or thematic initiatives, with education a high priority. Motsepe in partnership with associated companies also pledged ZAR1 billion/GBP47.6m in the response to Covid-19 focused with the primary objectives to save lives, curb the spread of the virus, education infrastructure to relief density In classrooms
Constraints	Bowmans currently undertaking research on behalf of Impact Investing South Africa on scope of activities, capacity to receive or distribute interest, capacity to transfer or receive property, and participate in outcomes-based funding (OBF) of these kinds of vehicles (so as not to loose PBO status)	Most philanthropists work in silos. Even the Independent Philanthropy Association of South Africa (IPSA) which has been set up to educate and support philanthropists does not drive collaboration. Giving is driven by personal preferences and mandates.
Opportunity for IIWV	Examples of trusts that have invested in blended structures e.g., Tutuwa Community Trust provided first loss in Bonds4Jobs OBF. Originally had floated idea of education/skills development side car in IIWV structure. SAB Foundation considering investment into FoF with focus on social enterprises specifically (set up as Small Business Funding Entity under section 10(1)(cQ) of the Income Tax Act – long history of investing in small businesses. Nedbank Eyethu Community Trust pivoted from education to climate in line with more investment friendly sectors Can distribute grants, loans or first loss capital	Both Covid relief funds set up systems whereby they could deploy capital over very fast period of time. Engage in order to understand tech used and to harvest data down the line from the loan book. Since HNWIs have engaged in force to support small businesses they may be interested in supporting not only liquidity but also solvency of businesses in this category. Have not yet explored the possibility of HNWI providing anchor concessionary funding into this vehicle as a flagship endeavour.

There is a need for Technical Assistance & Working Capital alongside the IIWV

The need for both, at the outset

- Needed to save time when inevitably needed – as unless pre-considered and a well-understood concept – success rates for procuring TA and or WC are limited
- Operational experts (and associated intermediaries that fund them) will always point out deficiencies in various sector/supply-chain models – funders invariably don't know this at the outset
- Delegating investment to an intermediary (e.g. via fund /other vehicle, doesn't dimmish the need, if anything puts more pressure, as the original funding source is often ranking as senior and set up in an inflexible manner so as to prevent additional 3rd party funding from being sourced
- For TA – finding this outside of DFIs for own portfolio is almost exclusively left to Donor/Philanthropic[2] pools raising issues of timing/ procurement/theme etc.

Evidence of need at scale specifically for intermediaries

Aside from the needs articulated in SA, precedents for wider emerging makers TA and WC is clearly defined by global emerging market precedents at scale:

- CDC is setting aside an additional GBP5m/ZAR 100m for its Financial Institutions) for its portfolio[1] to be managed by an expert 3rd party
- Thematic focus areas incl. gender, climate change, job quality, and skills and leadership
- This will take the shape of research, events, as well as conventional capacity and systems building which is provided to investees by CDC already
- Importantly 91% of their portfolio consists of intermediated investments, and yet there is still a need for more TA

Evidence of need in SA by reputable local intermediaries[3]

SA Banking market remains disengaged with SGBs and their funding needs – especially regarding pricing, also too slow

Small Operator-Owner Private Equity Fund

Growth always capped by the amount of funding available to on-lend to SMEs – consistently raising debt, equity, debt (circular)

Disruptive SA SME-lender

Need access to large amount of capital to scale a transformation model

Major SA Empowerment Fund

SA banks not geared for equity or highly structured small tickets

Sentiment testing	Parameters
• Likelihood of participating in blended finance structure?	• UNLIKELY: unless; to be off own B/S and if so most likely be a debt-instrument (exceptions via their own Corporate Empowerment Trusts and bespoke Foundation funds where matching principle applied i.e. for every ZAR[3] raised – matched by ZAR1[2]) HOWEVER • LIKELY; for infra funds (precedent for different tiered-participation), and when associated with recycling/syndication of infrastructure assets –to arguably free up B/S for green-infra assets
• Could SA bank provide a WC Facility?	• Initially considered unlikely – however possibly via a guarantee to provide the WC to the intermediary actors (i.e. 2nd level of intermediation)

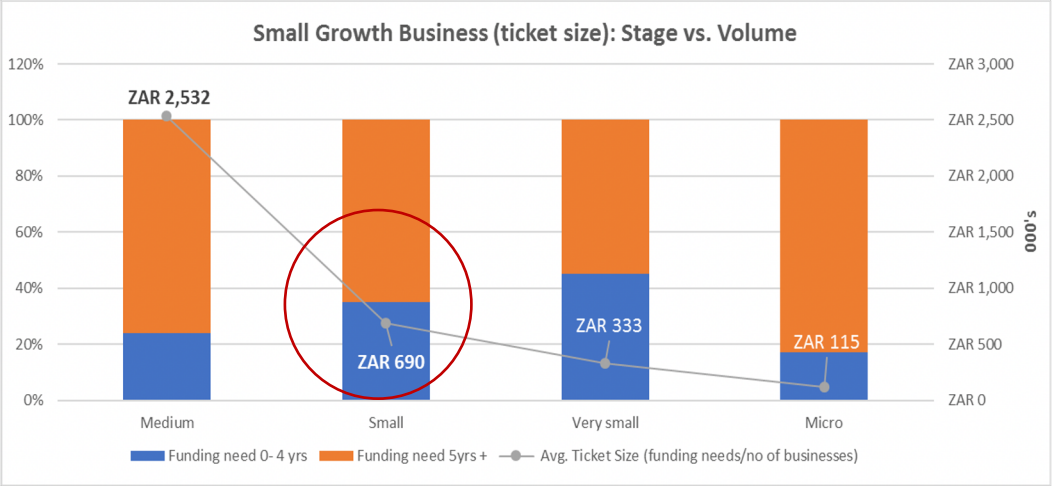
[1] May 2020, CDC had over 200 active investments in FIs, with total Assets Under Management of $1.6bn
[2] e.g. Ceniarth
[3] Institutional source withheld for purpose of publication

H

Small and Growing Businesses (SGBs) make up a distinct, under-served segment of the SME spectrum

Small and Growing Businesses is a term borrowed from ANDE where it is defined as commercially viable businesses with 5 to 250 employees that have significant potential, and ambition, for growth and typically seeking growth capital from $20,000 to $2 million. According to our analyses we have narrowed that definition for the purposes of the SA market to include commercially viable businesses in operation for 3-5 years looking for growth capital. These businesses are under-served by traditional funding options such as friends/fools/family, banks and VC/PE funds.

Figure: SGB finance need in terms of growth stage and ticket size (FinFind, 2017)



- ± 30k Enterprises in this category
- Funding gap of ±ZAR5-20bn (6% of total funding gap of ZAR86-344bn)
- Distinct from micro and medium sized enterprises who make up 59% and 35% of funding gap respectively
- Falls under the definition of small enterprises in use by by government with annual turnover ranging from ZAR15-50m
- Ticket sizes ranging between ZAR500k and ZAR5m with average of ZAR2m
- Preference for debt or hybrid instruments over equity
- 68% of SMEs are owned by men and 32% by women
- Lack of access to quantum and appropriate finance + lack of collateral and record keeping means access to finance key constraint to growth

South African market differs to other emerging markets in a number of ways.

- In most emerging markets SMEs contribute 35% to GDP and create 70% of jobs. In South Africa SMEs contribute 35% GDP and create a maximum of 50% of jobs.
- Only 7% of the South Africa's adult population is involved with running their own business – compared to the 45% average in emerging economies.
- South Africa also has one of the highest failure rates of small enterprises in the world where 5 out 7 fail in the first year, with the total early-stage entrepreneurial activity rate standing at 9.2%.. This below the average of 15% for efficiency-driven economies, and is half the Africa's regional average.

International Finance Corporation. (2018). *The unseen sector: A report on the MSME opportunity in South Africa.*
FinFind. (2017). *Inaugural South African SMME access to finance report.*
World Bank Group. (2017). *What's happening in the missing middle? Lessons from financing SMEs.*

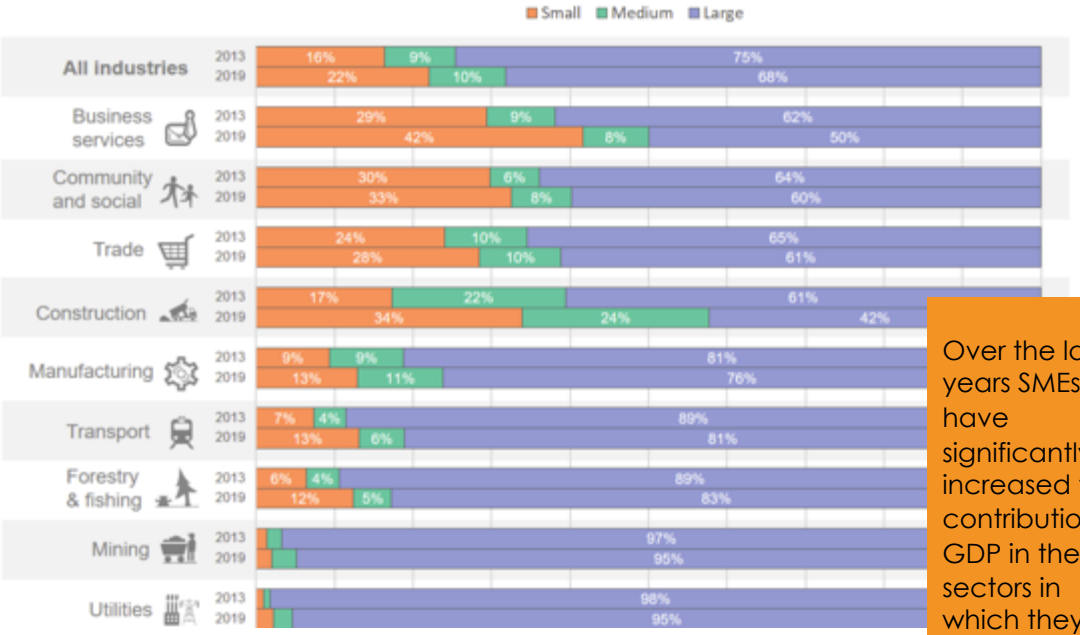
The South African SME market activity is weak compared to other developing countries yet those businesses that survive constitute a viable market segment

Historical data suggests this is a viable market segment despite current macro-economic environment. As a result of Covid 40% of SGBs expect to make a loss of more than 5% and there has been a 54% year-on-year increase in business liquidations[1]. Government stimulus has had mixed success with better uptake of salary support (ZAR60bn) than bank guaranteed loan (R10% of ZAR200bn utilised). Unlisted funds serving SMEs are not obliged to report performance data although some do so voluntary.

Table: SME financial performance data in SA and emerging markets

Nonperforming bank loans generally considered low compared to Sub-Saharan African peers (±2.5% in 2017) but worsening over Covid (±5.5% in 2019). The effect of the under-utilised Government Loan Guarantee Scheme has yet to be evaluated [2]
Local DFIs not obliged to report on non-performing loans, but three most relevant being NEF, sefa and IDC indicate impairment rate at 3x that of banks over past decade pointing to level of risk they are willing to assume as developmental funders
SAVCA members report voluntarily on annual basis with results of PE pooled IRR at 8.3% over 10 years dropping to -2.3% over 3 years (includes Covid effect). The equivalent ALSI result is at 7.7% and -2.1% respectively [3]
International DFI data shows that SME funds in emerging markets demonstrate a lower net IRR than venture capital/private equity (VC/PE) funds, likely due to high management fees, exchange risk and investee size. This improves over a 15-year time horizon (as opposed to the typical 10-year closed-fund period) and by 44% revenue growth if technical assistance is provided. SME funds are also reported to generate around 48 jobs per USD 1 million, with sector-agnostic funds outperforming sector-specific funds [4]

Figure: Small business contributions to turnover in South Africa (StatsSA, 2020)



Over the last 7 years SMEs have significantly increased their contribution to GDP in the sectors in which they are active.

1 *FinFind, 2020)*
2. CEIC. (2020). *South Africa Non Performing Loans Ratio*
3. RisCura (2020), *South African Private Equity performance report*
4. Shell Foundation. (2019). *Insights on SME fund performance:*

3. Modelling blended funding considerations

Blended funding combinations & considerations

A functional model is build on an illustrative basis, and would be adapted based on iterative discussions

*IIWV funding structure assumed to be a limited partnership

FM costs will feed into IIWV model

Cash flows of IIWV determined by investees & fund management costs. funding distributions to funders based on waterfall

Type of 3rd party recipients or Investees - funded by equivalent 'sub-funds':

Illustrative – not being tested on account funding terminated by FCDO

Private equity fund model

- Conventional minority private equity fund model

Private debt fund model (short term debt)

- Short term debt fund that will recycle funds throughout its life time.
- Redistribution of interest payments after deduction of management costs
- Repayment of principle during exit period,

Private debt fund model (long term debt)

- Long term debt fund that will solely recycle funds during the investment period (first 5-years).
- Redistribution of interest payments after deduction of management costs
- Repayment of principle during exit period,

Leasing company model

- Will provide specific assets to SGBs in return for lease payments.
- Asset will be liquidated at end of lease period

Illustrative model – designed to illustrate/test parameters

Private Equity Fund Model

- **Funding structure**: Private Equity Fund will be funded with equity.
- **Number of investments**: It is assumed the PE fund will invest in a diversified portfolio (12 – 15 companies).
- **Fund phases**:
  - Fund life: 10 years.
  - Investment period: 5 years, draw downs assumed to be linear.
  - Holding/exit period: 5 years, distributions linearly distributed after investment period.
- **Return projections**: are assumed based on a projected multiple, which is based on a mix of (fin)tech returns that should be achievable in developed and developing markets
- **Investment costs**:
  - Management fee: Assumed to be 2,5% p.a. over committed funding during investment period and 2,5% p.a. over invested funding during exit period. Assumed is that IIWV will invest in relatively small PE funds.
  - Carried Interest: Hurdle rate of 8% with 20% carried interest with catch-up.
  - Fund expenses: 0.5% p.a. over committed funding during investment period and 0,5% over invested funds during exit period.
  - Organisational expenses: 1%

- Size of fund i.e., ZAR ± 900 million
- Blending according to different return requirements of participating funding

IIWV fund manager

- **Level of effort:** fund management and fund expense cost assumptions are made are made based on an investment fund with size in the range of ZAR 750m – 1bn, that will make 5 commitments to sub-funds.
- **Management fee and fund expenses :** are based on a cost recovery basis. Overall management costs include cost on the management & monitoring of the fund & office expenses, fund expenses include deal specific costs. Total costs of both are depended on fund size, number of transactions & (impact) monitoring and mangement requirements.
- **Assumed management costs and fund expenses**:

Management costs		Fund expenses	
Salaries based on seniority	IC-expenses	Due diligence expenses	Audit costs
Office rent & expenses	Training	Legal & regulatory costs	Fund adminstration
Communications	Hardware	Investor relations	Establishment costs (once off)

- **Management costs & fund expenses**: during lifetime of fund costs are assumed on level of management effort and fund expenses during the investment period (higher effort) and the holding / exit phase of the fund (lower effort). Fund administration costs are assumed at 20bps of fund size (industry practise).
- **Pricing**: assumptions will be made based on SA prices/salaries. Inflation is not modelled.

- Serve and fund various recipients, including a leasing company
- Covers fundamental risk profile, and default rate etc.

Private Debt Fund Model – Short term debt

- **Funding**: Private Debt Fund will be funded with equity.
- **Fund phases**:
  - Fund life: 10 years.
  - Investment period: 5 years, draw downs assumed to be linear.
  - Holding/exit period: 5 years, redistributions will be made based on average loan tenor to ensure fund is fully exited after 10 years.
- **Return projections**: Will be based on interest rate income minus write-offs and investment costs. Assumptions will be made on a portfolio level.
- **Interest rate of outstanding loans:** 20% p.a.
- **Default Rate:** assumed that annually 4% of outstanding portfolio will default
- **Tenor & repayments:** assumed average loan tenor of 1yr for all loans. Repayments are assumed to be linear.
- **Recycling of funding:** to optimize outstanding amount of funding (average balance of outstanding loans) until year 9 of the fund life (based on av. tenor), whereafter the full fund will be redistributed in the final year.
- **Distributions to IIWV:** during fund life, annual distributions of interest (minus defaults) and repayment of principle in final year.
- **Investment costs**:
  - Management costs will have to be paid out of the interest rate margin and are assumed to be 2% p.a. over committed funding during investment period and 2% p.a. over invested funding during exit period.
  - Fund expenses: 0.5% p.a. over committed funding during investment period and 0,5% over invested funds during exit period.
  - Carried Interest: No carried interest.
  - Organisational expenses: 1%

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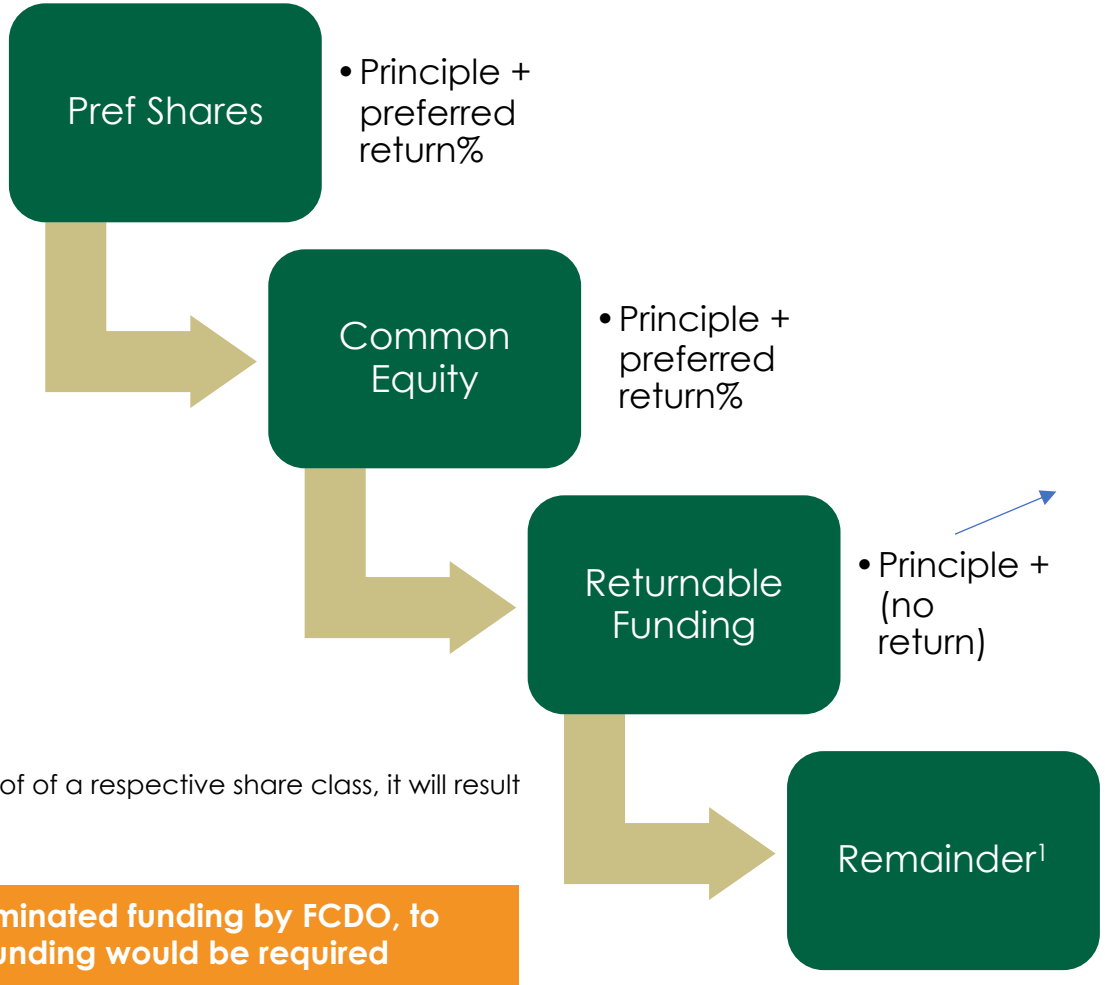
- **Distributions to IIWV:** during fund life, annual distributions of interest (minus defaults) and repayment of principle in final year.
- **Investment costs**:
  - Management costs will have to be paid out of the interest rate margin and are assumed to be 2% p.a. over committed funding during investment period and 2% p.a. over invested funding during exit period.
  - Fund expenses: 0.5% p.a. over committed funding during investment period and 0,5% over invested funds during exit period.
  - Carried Interest: No carried interest.
  - Organisational expenses: 1%

Financial Leasing Company

- **Funding**: leasing company will be funded with structured long term debt.
- **Fund phases**:
  - Fund life: 10 years.
  - Investment period: 5 years, draw downs assumed to be linear.
  - Holding/exit period: 5 years, redistributions will be made based on average loan tenor to ensure fund is fully exited after 10 years.
- **Return projections**: Will be based on interest rate income minus write-offs and investment costs. Assumptions will be made on a portfolio level.
- **Lease rate:** based on interest rate 15% and assumed residual value at end of lease period, assumed 50%
- **Default Rate:** assumed that annually 4% of outstanding portfolio will default
- **Tenor & repayments:** assumed average lease tenor of 5yr.
- **Liquidation of assets (after lease period):** assumed to be residual value + 10% (additional margin on liquidation)
- **Recycling of funding:** to optimize outstanding amount of funding (average balance of outstanding loans) until year 5 of the fund life.
- **Distributions to IIWV:** during fund life, annual distributions of interest (minus defaults) and repayment of principle in final 5 years.
- **Investment costs**:
  - Management costs will have to be paid out of the interest rate margin and are assumed to be 2% p.a. over committed funding during investment period and 2% p.a. over invested funding during exit period.
  - Fund expenses: 0.5% p.a. over committed funding during investment period and 0,5% over invested funds during exit period.
  - Carried Interest: No carried interest.
  - Organisational expenses: 1%

Emerging blended funding waterfall structure/ parameters

- **Waterfall structure:** Presented distribution waterfall would be used and is amended to accommodate a layered funding structure:
  - **Pref. shares** firstly will receive all distributions of IIWV until the full principle is repaid plus the preferred return
  - Subsequently **Common Equity** receives all distributions until principle and return is paid.
  - Thirdly, **Returnable funding** is repaid without return
  - Finally, in case any funding left this is shared between the pref. and common equity.



Key Source – at the crux of the challenge for a neutral wholesalers to succeed in South Africa, and to build principle of replicability at scale

- In case **insufficient funds** are available to repay the principles of of a respective share class, it will result in a loss for this share class(es).

Illustrative – not being tested on account of terminated funding by FCDO, to expand on these findings additional grant funding would be required

[1] Amended for a non-carried interest structure, while the identity of the Fund Manager (FM) has not been interrogated – the expectation is the IIWV (at least initially would rely on a cost-recovery basis, with a cash incentive for the FM (to be tested)

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THANK YOU