KPMG

Private sector grants

Holding their own in an impact investing world

Development in practice
Impact paper 19

International Development Advisory Services(IDAS)

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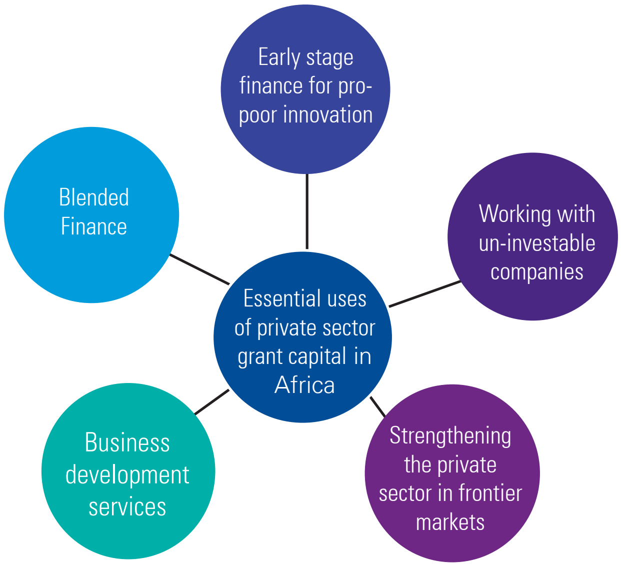
KPMG's International Development Advisory Services (IDAS) Africa manages philanthropic funding for private sector-led development across Africa. Headquartered in Nairobi, Kenya, IDAS has managed hundreds of private sector grants in 30 African countries over the last decade.

In the eyes of their critics, private sector grants are to impact investing what the Tesla is to an old station wagon --the sleek and efficient future overriding a wasteful and sluggish past. Impact investment and innovative finance are exciting right now and understandably so. Aid budgets are shrinking, recycling capital makes sense for sustainability, and there is no doubt that investment capital can do great things in Africa-- from building infrastructure, to scaling responsible companies that create jobs and provide social services.

But in Africa, impact investors are limited in their reach and scope. The trade-off between profit and impact is felt more harshly here than in other regions. A huge number of poor people remain persistently excluded from markets where investors can operate. They have very low incomes and live in high risk countries, small markets or remote areas with low population densities and weak infrastructure where it is hard to make money. Many of the companies that hold much of Africa's wealth also continue to resist, or fail to attract, third party investment. For these reasons, impact investment has been limited in its reach across the continent.

We think grant funding to the private sector remains essential to reach marginalised people and places. In our work, we have seen five areas where grant capital is key to achieving impact in Africa where investment capital falls short:



- Early stage finance for pro-poor innovation;
- Driving development through un-investable companies;
- Strengthening the private sector in frontier markets;
- Catalysing the nascent business development services market; and
- Leveraging blended finance solutions.

In this paper, we share our insights regarding how the philanthropic community can use grants wisely for maximum impact. The first section outlines the five essential uses for grants that we have seen in our work. Section 2 offers recommendations for how foundations, corporates, donors and other philanthropists can use private sector grant capital well in Africa.

This is one of a series of short pieces from KPMG IDAS Advisors based on our extensive experience. The series is edited by Julio Garrido-Mirapeix, Head of IDAS Africa and Twebese Mugisha, Communications Director. This paper was written by Rachel Keeler, Manager IMPACT Unit, with inputs from Hugh Scott, Director.

What can grants do in Africa that investment capital cannot?

1. Early stage finance for pro-poor innovation

- Endure long timelines to profit
- Cover the high up-front costs associated with innovation and market building
- Take a broad view of market systems change

Major success stories have come out of early-stage grant support that incentivizes companies to test new products and business models to benefit the poor. Most noted amongst these are mobile money and off-grid solar. But for many businesses in essential sectors such as agribusiness, the road to success has been extremely long. As of 2016, the average profit for five and six-year-old innovation projects across one of the large agribusiness portfolios that we managed was negative, and we have seen companies take the better part of a decade to reach scale.

Grants can provide the early stage capital to endure these long timelines and cover other very high up-front costs associated with things like developing new technology, establishing distribution networks, or consumer education. Arguably, more patient investment capital could perform these same roles, while also demanding better discipline from investors and companies to prevent wasting capital on commercially unsustainable businesses. We agree that much more patient capital is needed in Africa, but we also see distinct limitations.

Repaying debt on steep start-up costs can cripple a business and prevent growth, while equity is hard to negotiate and value at this stage. Many entrepreneurs here are unwilling to give up equity stakes or may offer no path to exit. Grants can also be more effective in leveraging in commercial capital at an early stage. It is difficult for example, to leverage in debt on top of debt.

Even with longer time horizons, patient capital investors are also bound to the performance of individual companies and limited in scale by the high management costs associated with structuring and recovering investment capital. Grant portfolios can take on a much larger number of deals and higher failure rates to experiment more broadly. Discipline in this case, comes from a clear focus on changing market systems, by promoting competition and learning openly from failure. We think this flexibility is essential to meet the scale of social challenges in Africa and to overcome the unique difficulties posed by operating environments here.

Financing science for smallholder farmers

Two agribusiness companies that we managed had been working since 2008/9 to develop new eco-friendly bio pesticides for smallholder farmers in East Africa. These companies trialled natural viruses to control pests and weed resistant seed treatments that took the better part of a decade to get right thanks to lengthy local regulatory approvals and unexpected results. During that time, grant capital supported the businesses. And just this year, both companies received significant international investment that will fund expansion and distribution of their products across the region.

2. Forging partnerships with companies that cannot or will not take on third party investment

- Provide innovation pilot grants for established corporates
- Leverage private sector wealth in under-served markets for pro-poor activities
- Assume risks that would otherwise prevent investment from happening

We have often found that with innovation grants, the best impact comes from established businesses. Whereas an impact investor might not easily take a debt or equity position in a large corporation, a grant can drive an innovative pilot project there. M-Pesa was born like that. Working with start-ups is expensive because of capacity development needs and the high risk of failure. Established companies have the experience and infrastructure upon which to innovate, and the resources to carry on successful projects even where follow-on investment isn't available.

Partnering with established local companies is also a good way to penetrate under-served markets. But in Africa, these businesses are often difficult to invest in--especially for foreign investors. They might be highly leveraged, resistant to equity investment because of family interests, operating in a high risk market, too big or too small for impact investor budgets, or not eager to exit. This type of business accounts for a huge amount of the private sector wealth in Africa. While they do not work out of innovation hubs, grab headlines or rely on high-tech solutions, they do know how to make money here. The openness of these businesses to outside investment will change over time. But until that happens, grants are an essential tool with which to direct their resources toward more pro-poor activities.

3. Strengthening the private sector in frontier markets

- Early stage and growth capital for local companies with no access to finance
- Market entry for regional expansion into frontier markets
- Encourage diaspora investment at home

As part of our ongoing efforts to support companies looking to raise follow-on investment, we reviewed our grant portfolio. In conclusion, our analysts pointed out that much of the portfolio was "nearly un-investable." What was essentially a mismatch between company profiles and what impact investors want, reflected

various things: small company or market size, early stage, low margins, long working capital cycles, very long payback periods, insufficient returns on capital or operations in high risk and post-conflict states. Critics might suggest this is a sign that grant portfolios need to be more rigorously selected.

We think the problem is that investor expectations do not match much of the reality across the continent. Recent studies found that roughly 90% of non-Development Finance Institute (DFI) impact investment capital deployed across sub-Saharan Africa has gone to eight countries: Kenya, Tanzania, Uganda, Nigeria, Ghana, South Africa, Angola and Zambia[1]. Investments have also been concentrated in urban and peri-urban segments within those states.

In trying to reach the poor in under-served countries and markets, companies we work with have faced extreme challenges, for example in developing profitable last mile distribution models, something also reported by impact investors[2]. Some companies have begun to pivot away from social causes to more profitable pursuits that can draw commercial interests[3]. In frontier environments, there is a case for supporting private companies that are not capable of raising impact or commercial investment. Our "un-investable" portfolio of businesses benefited 10 million people in 2015 across 25 countries in many markets where investors simply won't go.

Grants can also encourage the Diaspora to invest more at home, in high risk places like Somalia, Zimbabwe, South Sudan or DRC. Some of the companies here may never scale. But they all use private sector resources alongside grants to benefit people unreachable by investors, thereby offering a unique social impact return on grant capital.

Driving regional expansion through market entry grants is another option to reach marginalised communities. This is working in many cases. But there is also a real and observed danger of diverting companies and their management resources to markets where their natural growth would not take them, that are not in line with their core business model, and where investment capital will not sustain their operations when the grant is done. In those cases, working with local businesses is a better option.

[1] "The Landscape for Impact Investing in Southern Africa," The Global Impact Investing Network, with Open Capital Advisors. (February 2016); "The Landscape for Impact Investing in West Africa," GIIN, with OCA (December 2015); "The Landscape for Impact Investing in East Africa," GIIN, with Dalberg (July 2015).
[2] "An Impact Investor Urges Caution on the 'Energy Access Hype Cycle'," Next Billion (27 March 2017). Available at: http://nextbillion.net/an-impact-investor-urges-caution-on-the-energy-access-hype-cycle/
[3] "Kenya's Tech Hub Gets a Makeover: 'Silicon Savannah' is refocusing on profits and revenues, going beyond social activism." The Wall Street Journal (11 April 2017). Available at: https://www.wsj.com/articles/kenyas-tech-hub-gets-a-makeover-1491903007?mod=e2tw

Credit: Kate Holt

4.Building Capacity Through Business Development Services

- Build investable companies to drive pipeline for impact investors
- Strengthen and professionalise companies to encourage inclusive growth

Many impact investors have concluded that a lack of capital is not the main challenge in Africa – rather a widespread lack of business capacity and formality is limiting the investable pipeline. This calls for more investment in business development services (BDS) and technical assistance, paid for by grant capital. The preferred approach is to use grant capital to demonstrate the value of these services and catalyse a long-term market where companies and investors will be willing to pay for them.

This is a great direction for the market. But, the length of this play should not be underestimated. Successful providers of BDS are expanding in East Africa. However, companies we work with in West, Central and Southern Africa, and even in East African countries like Tanzania, still have a very hard time finding qualified and affordable service providers. Grant capital will play a role in building up these markets for a long time to come.

The need for BDS also takes us back to the basics of economic development – where it is important to carry on with classic styles of grant making like early stage finance for SMEs to create jobs and make companies effective competitors in their own markets. This basic market development creates the bedrock upon which new innovative and blended finance solutions can work.

5. Paving the way for blended finance

- Provide guarantees and first loss capital to reduce risk and drive commercial investment into under-served markets
- Establish institutional standards of corporate governance and risk management to allow grantees to raise commercial investment

Blended finance is an exciting new way to use grants to drive commercial investment into under-served markets. For this to work, we need to distinguish better between cases of perceived vs. actual risk to determine the best role for grants to play. In the first case, to demonstrate the viability of a market to potential investors; in the latter, to cover the high cost of actual risk.

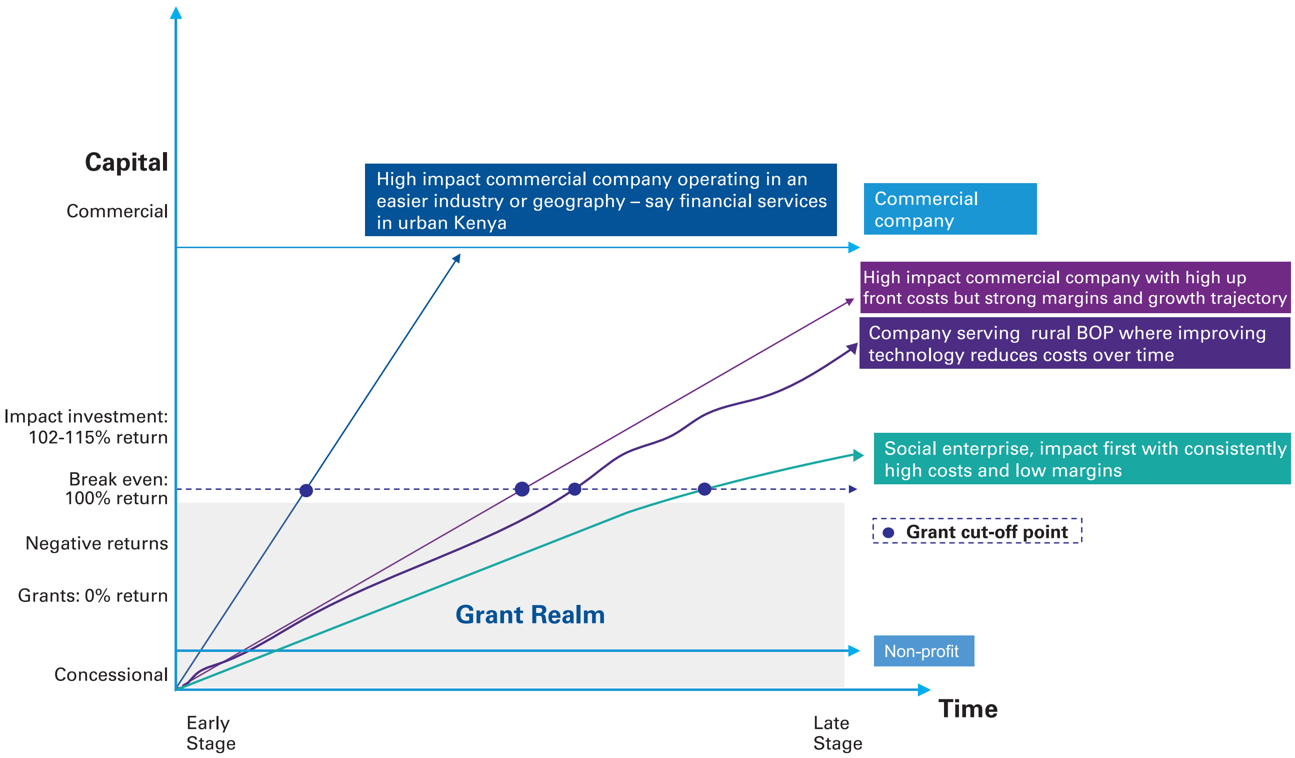
On their own, early stage grants are also capable of establishing track records that improve understanding of new industries before innovative finance solutions can be tailored to the specific needs of those industries. We've seen this with development of unique working capital solutions for pay-as-you-go solar. Grants that come with the condition of high standards of corporate governance and strong risk management can also lay the groundwork to identify and promote companies that can later attract blended finance investors.

How to use grants well - some recommendations

1. **Know the purpose of your fund.** Is this an impact first fund, an impact investment fund with a target rate of return, a business development fund for SMEs, a fund focused on improving market systems or a fund focused on a particular development challenge? The purpose will decide how grants should be used – on their own or blended with other instruments – not vice-versa.

2. **Understand perceived vs. actual risk.** Cases of perceived risk can often be overcome with innovative structures or blended finance that crowds in commercial investors with first loss guarantees. With a better understanding of the company and its market you can structure an investment facility to effectively meet those needs and demonstrate viability to risk averse investors. In cases of actual risk where, even though you understand the market, the risk of failure is actually high or the up-front costs cannot be born commercially, grants are appropriate to cover those costs. If a company cannot access commercial capital because of actual risk, repayment capability will be much lower than in cases of perceived risk. In these cases, grants can help leverage in commercial finance, rather than distort it out.

3. **Instil discipline.** Financial discipline and rigour is a common argument against grants. There are ways to ensure similar discipline for grants: requiring matching funds, taking a venture philanthropy approach, or payment by results. Shared risk is determined by various things including the size of the business and its capital mix, how much the business is already leveraged, against what, etc. – understand the whole picture.



4. **Know when to stop grants.** Know where your grantee is on the chart above, on page 7. Use phased and flexible grants to match the dynamic nature of an innovative company's growth. Understand profit margins, market constraints, industry potential and common timelines to profit, and what models have already failed – does your company need time to reach commercial sustainability, or is it a social enterprise that will never get there?

5. **Understand leverage.** One sustainability goal is to leverage in maximum private or commercial capital for each grant dollar spent. But the higher the leverage, the lower the additionality – the less essential the grant. A key issue is whether a grant can change an investment decision from a "no-go" to a "go", when investment capital cannot.

6. **Use competitions to diversify portfolios.** Pipeline development is expensive and often limits investors to close networks and urban areas. Using a public competitions approach can surface unexpected partners. With the right local outreach and support for application development, this model can move beyond 'donor darlings' to work with companies in under-served markets. Designing and managing competitions is not a mechanical process. It is more of an art that requires amongst other things in-depth country and sectoral knowledge and a real feeling for a social impact portfolio.

7. **Pay for business development services.** There is growing recognition that this is one of the missing pieces to create pipeline for the immense amount of impact capital moving into Africa. However, BDS is difficult and expensive to provide to a large portfolio across many countries, and quality local providers are often not available – in such cases it is better to carefully select only those businesses with the capacity to deliver.

8. **Understand the life cycle support landscape.** Know what kind of follow-on investment is available in the market and industry before giving a grant. If follow-on investment for scale is important to your model, build it into your grant-making criteria. Have a plan for sustainability. Know what might happen post grant. Discuss this with the grantee to make sure you are aligned in your expectations.

9. **Think more broadly about impact.** Impact is not just about the income benefit or jobs created or the financial performance of individual businesses. It's not just about finding one winner that you can pass on to an impact investor. How do you measure changing attitudes toward poor people as consumers or employees? Replication of business models or tactics even as the pioneer business fails? How entrepreneurs learn over time – failing multiple businesses, enduring a million iterations before something hits? We have established a series of metrics to track progress on systemic change, and are working on how to better quantify the value of learning from failure. Learning from failure needs to happen for the entrepreneur, their competitors, donors and investors. The better we get at measuring and standardizing the value of these things, the easier it will be to justify grant finance and attract as well as retain capital in this space.

Grants, debt, equity, innovative finance – these all have a place in achieving social impact via the private sector in Africa. We see grants as the essential building blocks to open up truly frontier markets, reach the unreachable and set the stage for broader and deeper investment heydays to come.

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