cutting through complexity

IMPACT INVESTING IN AFRICA: PERFORMANCE INSIGHTS FROM THE KPMG IDAS AFRICA PORTFOLIO

DEVELOPMENT IN PRACTICE[1]
IMPACT PAPER 17

INTERNATIONAL DEVELOPMENT ADVISORY SERVICES AFRICA

kpmg.com/das
April 2015

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[1] This is one of a series of short pieces from KPMG IDAS Advisors designed to show forward thinking based on our extensive experience. It covers general development topics, as well as specific issues facing fragile states, private sector development, governance, assessment and organisational development, renewable energy and climate change. The series is edited by Julio Garrido-Mirapeix, Head of IDAS Africa. This paper was written by Rachel Keeler, Impact and Innovation Manager at KPMG IDAS.

Impact Investing in Africa: Performance Insights from the KPMG IDAS Africa Portfolio

Executive Summary

Impact investor interest in Africa is currently growing faster than the industry's ability to effectively deploy this capital. To overcome this challenge, investors need to better align their expectations, capabilities and strategies with market realities. Through management of various funds across Africa, KPMG's International Development Advisory Services (IDAS) has allocated capital to over 200 businesses working on projects that have a social impact, largely in agribusiness, renewable energy, climate change technologies and financial services, along with education, health and sanitation. In this paper, we draw on this experience to highlight practical lessons that may be useful to impact investors.

- The data shows that both commercial and impact performance vary significantly by sector:

Commercial Performance

- Agro-processing projects are the most profitable sub-sector group in the agribusiness portfolio
- Renewable energy projects grew 3x faster than agro-processing projects and had larger gross margins
- Input supply projects had more stable and larger gross margins than processors
- Time from inception to profitability varies greatly from one year up to an expected 10 years
- Agribusiness projects are slower to reach profitability than renewable energy projects
- Education, health and sanitation attract the least amount of non-concessional finance

Development Impact

- Agro-processing projects reach a lower number of households with higher benefits per household
- Financial services and renewable energy reach many households with smaller benefits per household
- Input supply projects occupy the middle ground, providing robust benefits to many households
- Within agribusiness, agro-processing projects create the most jobs, while across the sector projects tend to produce more income gains than new jobs
- Engaging with rural households as consumers reaches many people with low benefits, while engagement with them as suppliers results in the opposite

- Performance varies to a small degree by country: Input supply projects in Zimbabwe are larger and more profitable than in Kenya, while Kenyan projects had higher impact. Agro-processing in Tanzania outperforms Zimbabwe on scale of turnover, profitability and impact.

- Across the portfolio, commercial performance varies much more by sector than it does by level of impact, with no consistent correlation between impact and profit. However, many of the highest impact projects outperform the portfolio average commercially. Projects that combine strong commercial performance and high impact vary across sectors and business models, led by livestock projects and pay-as-you-go renewable energy distributors.

- Many companies cited low return on investment/commercial viability and partnerships with communities as top challenges to growth. This reflects the high cost of doing business in Africa, which is amplified for businesses that engage with poor communities and work in remote rural areas.

Lessons for Impact Investors:

- Investors can align their impact goals and investment strategies by considering that the level and type of impact vary significantly by sector and mode of engagement with poor people.
- Investors seeking to improve commercial performance can do so to some extent by carefully selecting sectors and business models, rather than by lowering impact goals. Although, this may not apply to portfolios that support companies for which impact motivations come before commercial motivations.
- Africa's challenging business environment makes market rates of return for impact portfolios more difficult to achieve in the near term. Grant and other kinds of soft funds and technical assistance facilities can play a key role in this environment to support early-stage ventures and cover high up-front costs.
- Soft funding is especially important to develop pipeline in agribusiness, which is inherently more risky than most other sectors in Africa (due to weather and commodity price variability) and often requires lead times to produce results that are longer than what a typical investment fund structure can accommodate.
- Early stage finance by experienced, on-the-ground fund managers can also play a key role in identifying and supporting the growth of more viable companies that have a social impact in the market, especially where they are able to blend funds from multiple investors and link seed finance to scale up.

Background

Africa currently attracts more impact investors by number than any other region in the world, as well as the greatest share of impact investors who planned to increase their allocations in 2014 to the region. As more capital crowds into Africa slated for social impact, investors are finding it increasingly difficult to deploy these funds effectively and earn positive financial returns on the capital already invested. Many impact investors target established companies that can provide a compelling business plan, meet robust accounting and reporting standards, and promise both hearty impact and commercial returns. The number of companies like this simply is not increasing at the same rate as the number of funds, while a select few strong companies are in high demand.

Impact investors are responding to this challenge in several ways. Fund managers focused on high-impact businesses are scouting the market and allocating more money to early-stage ventures. Others are softening their impact expectations in favor of commercial performance. (See Box 1 for a discussion of these various strategies.)

Box 1: What is Impact Investment?

"Impact investments are investments made into companies, organisations, and funds with the intention to generate social and environmental impact alongside a financial return." -the Global Impact Investing Network (GIIN)

This definition encompasses a vast range of investment strategies, which vary along four key points:

- Returns expectations: at minimum return of capital, up to below market returns or competitive market rate returns
- Asset classes: from private equity, debt and mezzanine capital to unique structures such as social impact bonds
- Forms of impact: environmental responsibility, seeking to address social problems, or creating opportunities for disadvantaged groups
- Target companies: companies for which impact goals come first (often called 'social enterprises); companies driven by commercial motivations that also produce significant impact; or responsible companies run according to commercial motivations with robust ESG standards.

Impact Investment in Africa

In Africa, high poverty rates mean that investors can have an impact by investing in a broad range of companies that:

- Engage the mass market as customers or suppliers
- Create quality jobs
- Are run by economically excluded people
- Have strong ESG or sustainability policies, or
- Are focused on high impact before commercial returns

But Africa's challenging business environment means that returns are more constrained in relation to impact goals:

- At the small-cap level and for many high-impact social enterprises, many investors are only able to return capital at cost
- Mid-cap companies, and those where impact is defined loosely as job creation, serving mass market customers or ESG standards, often produce market rates of return; but some would argue that this low level of impact is indistinct from traditional investing.

As the industry finds its footing, it will be helpful to understand more about the performance of current portfolios. Through management of various funds across Africa [2], KPMG's International Development Advisory Services (IDAS) has allocated capital to over 200 businesses working on projects that while aiming to be profitable are also expected to have a social impact. This portfolio can offer insights to impact investors experimenting with early-stage finance or seeking better balance between impact and commercial performance. In this paper we draw on performance data from the portfolio to examine:

- Commercial performance and development impact across key sectors and countries
- Key challenges to growth of high-impact businesses

In a later paper we will also look at performance spotlights for dairy, poultry and livestock, seed companies, pay-as-you-go renewable energy distribution, and contract farming

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[2] These funds include (with their sponsors): The Africa Enterprise Challenge Fund (DFID, DFAT, MFA, IFAD, CGAP, Danida, Sida); Food Trade East and Southern Africa (DFID); West Africa Food Markets (DFID); The Human Development Innovation Fund (DFID); The MasterCard Foundation's Fund for Rural Prosperity.

Data methodology

The data presented here is based on a portfolio of companies financed by challenge funds managed by KPMG IDAS Africa[3]. These are bilateral donor- and foundation-backed development funds that provide grants and repayable grants to businesses that can provide innovative, market-driven solutions to social problems. These funds typically support companies that are unable to raise commercial investment in order to develop new concepts and business models, usually because these projects are high risk and may require large up-front investment.

The companies are typically selected through competitions for funding: 'challenges'. Some challenge funds support a specific project to be carried out within a larger business. Others finance the entire business. This portfolio contains instances of both, and the performance data presented here is specific to the project. Many of these projects are carried out over six years, with results shown largely for the first four years of implementation for which a sufficient amount of comparable data is available. A large percentage of the companies are start-ups, which pose challenges relating to prior year comparisons, low returns on capital before breakeven, and nascent margin trend rates.

The projects come from a mix of sectors including: agribusiness (with the largest sub-sectors being agro-processing and input supply), financial services, renewable energy, health care, education, water and sanitation. All projects are located in sub-Saharan Africa. However, the sample operates across a range of environments – from Somalia to Sierra Leone, DRC and Mozambique. Other things being equal, in fragile states we would expect it to take longer to achieve strong impact and profit. Roughly 25% of the sample operates in such countries.

Most of the projects in this portfolio have been chosen with an investment strategy that seeks to support scalable projects driven by strong commercial motivations that achieve significant impact by default, rather than by design. This strategy hopes to not sacrifice commercial returns for impact. However, the early stage and innovative nature of these projects, along with the difficult African business environments in which they operate, can delay profitability in the near term.

[3] The majority of the data presented in this paper is aggregated from the performance of businesses supported by the Africa Enterprise Challenge Fund, which is hosted by the Alliance for a Green Revolution in Africa, funded by UKAID, Sida, Danida, IFAD, Australian Aid, and the Kingdom of Netherlands, and managed by KPMG IDAS Africa. Additional data from the Human Development Innovation Fund and the Food Trade East and Southern Africa fund, both funded by DFID and managed by KPMG IDAS Africa, has been included in the analysis on leverage presented on pages 9-10.

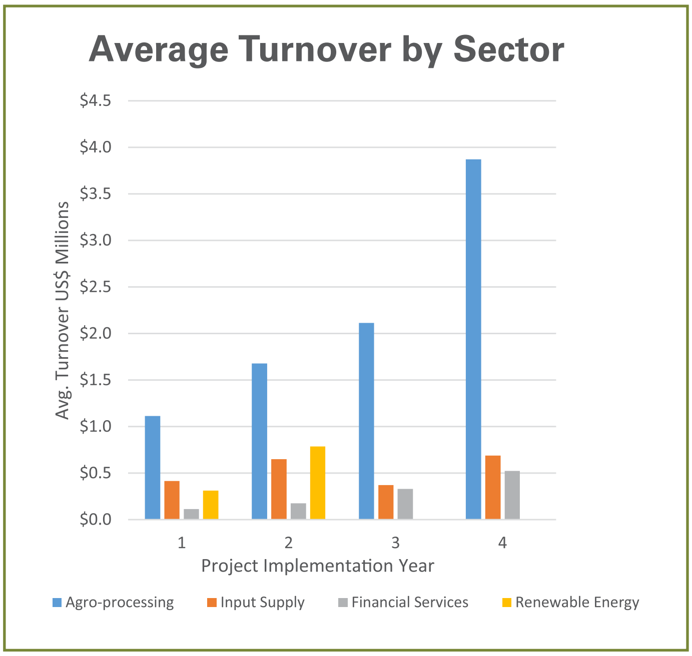
Portfolio performance by sector

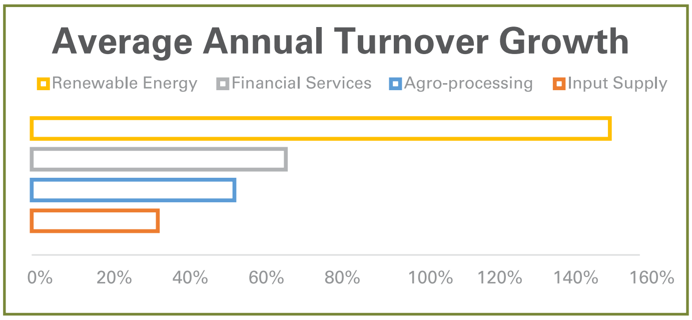
Commercial Performance

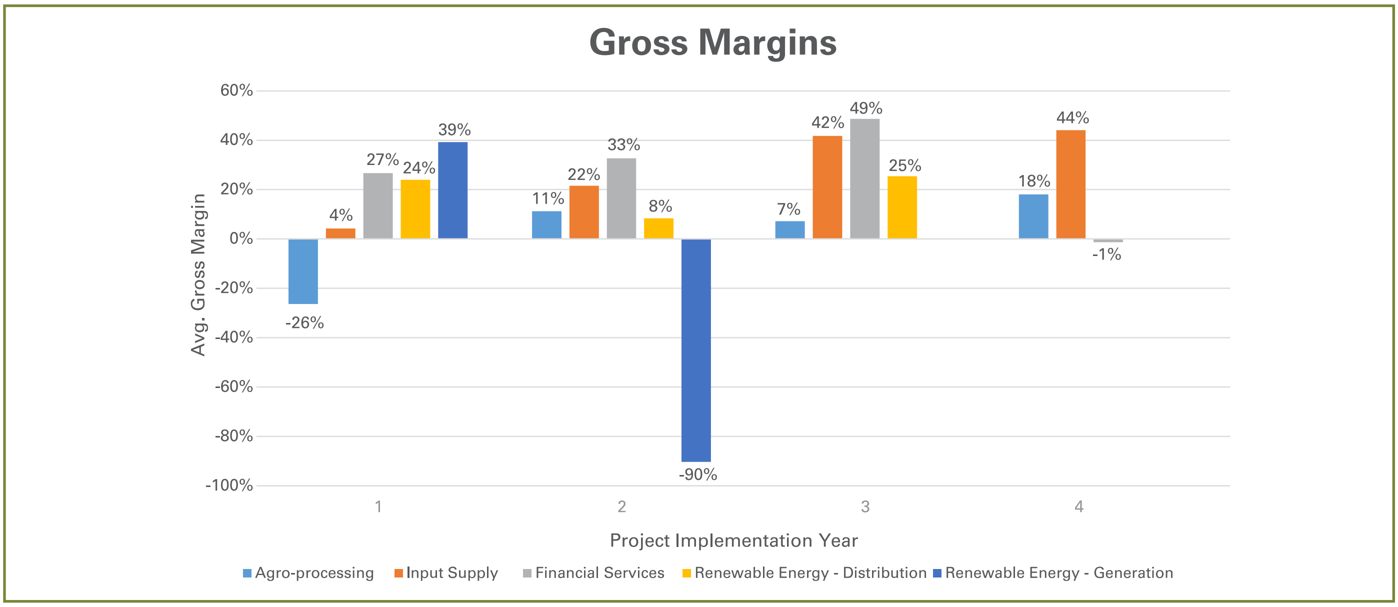
- Agro-processing projects are the most profitable sub-sector group in the portfolio
- Renewable energy projects grew turnover 3x faster than agro-processing projects and had larger gross margins
- Input supply projects had more stable and larger gross margins than processors
- Time from inception to profitability varies from one year to an expected 10 years
- Education, health and sanitation attract the least amount of non-concessional finance

All of the companies in the portfolio are operating innovative early-stage projects. Because of this, we would expect successful projects to become profitable only when they reach sufficient scale. Before that point, we look at turnover growth and gross margins as early predictors of future commercial viability.

The larger-scale turnover of projects in agro-processing reflects the predominance of this industry on the continent. Input supply companies can also reach similar scale. However, this portfolio is dominated by small input supply projects. Processing projects are much more profitable at an early stage. However, input supply projects have more stable and larger gross margins than processing. This is logical as inputs are sold before the quality of the agricultural season is known, and as such are price setters rather than price receivers. Processing margins appear to improve over time with efficiency gains.

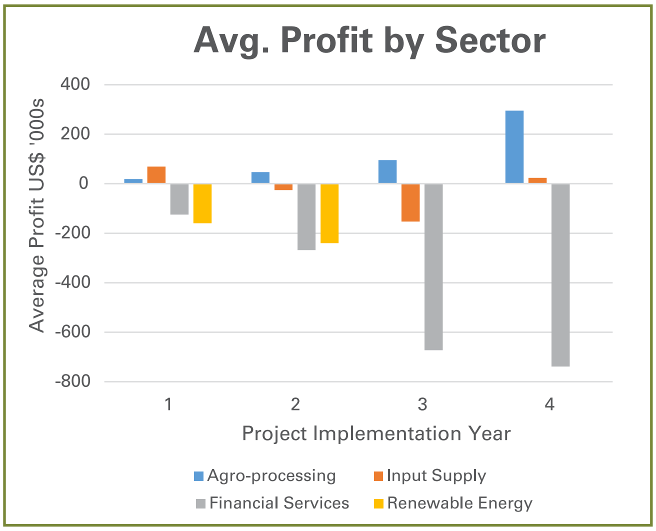


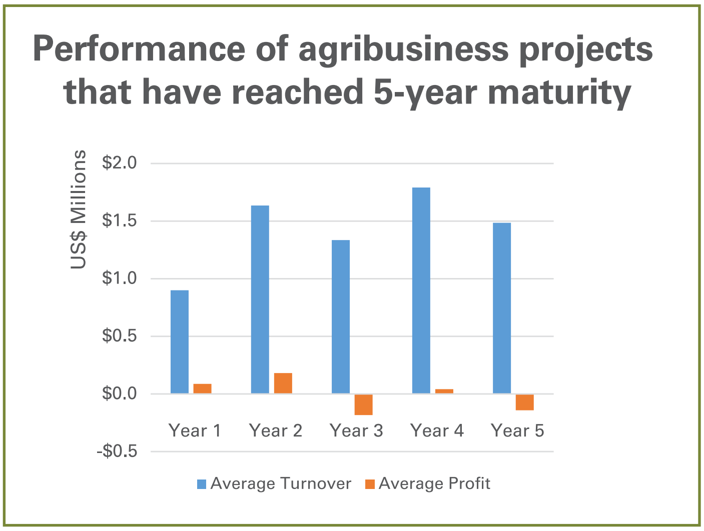




Small-scale renewable energy is a far less established industry in Africa than agribusiness. However, the sector shows significant promise via a variety of high-growth off-grid distribution projects. Many of these are start-ups with encouraging gross margins, despite some having negative profits. Energy generation projects tend to perform less well at this small scale and have longer lead times due to high up-front costs, which is reflected by their lower gross margins.

Rural financial services reflect the high gross margins associated with service sectors. However, many of the mobile money projects in the portfolio have struggled to perform commercially. This reflects experience more broadly in Africa, where companies not backed by a large telecom operator or bank and without regulatory support have been unable to replicate the success of Kenya's M-Pesa. Rural financial services remains a challenging sector. Promising models do exist, such as asset-based lending and leasing of common farm





Profit is relatively weak across most of the portfolio. This reflects the early-stage, high-risk financing space that challenge funds occupy. Broken down by sub-sector, we see the strongest performance by agro-processing projects – possibly driven by value addition as well as their relatively large scale. Looking more closely at performance by industry reveals that projects working with livestock, cash crop processing, and renewable energy distribution are some of the most profitable within the first four years.

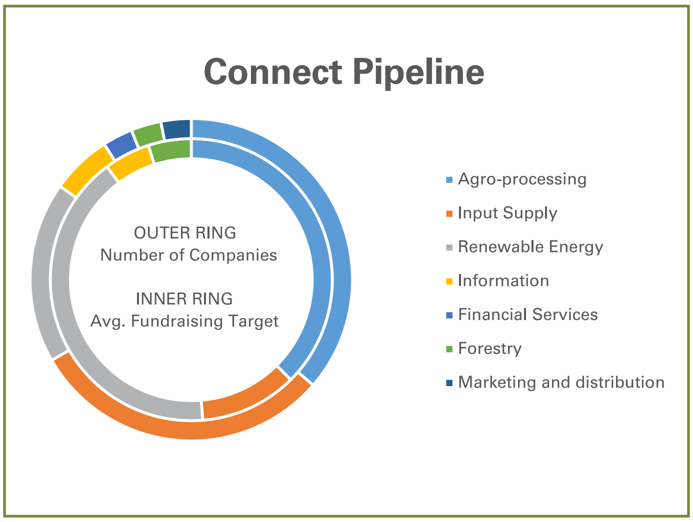
High year-on-year variance in performance of agribusinesses is reflected in the data for the projects that have reached their fifth year of implementation. This variance is driven by seasonal factors such as disease, weather and commodity prices. For agribusiness, time to profitability is also linked to the crop – e.g. for profitable tree crops such as avocado, macadamia or oil palm, it can take five to 10 years to see a return. And across the portfolio, time to profit can be significantly delayed by Africa's challenging business environments.

Leverage – the ratio of grant funding to funds provided by the grantee and other investors – can also indicate the commercial viability of a project. In many cases, commercial banks, development banks, and impact investors are willing to support a project once grant funds are in place. Concessional finance plays multiple roles here: identifying and demonstrating the potential of a range of new businesses, covering up front costs, and signaling confidence to other investors.

Agro-processing and renewable energy projects have had the most success in attracting additional finance. Low leverage ratios in education and sanitation are in line with investor feedback that suggests difficulty in finding as many commercially viable impact projects in these industries. Many of the education and health projects in the portfolio are focused on information dissemination, often using mobile technology. These projects have potential to improve many lives in significant ways. However, in this portfolio and in the African market more broadly, we have seen even large companies struggle with the ability to commercialise training and m-information services beyond reliance on donor and NGO clientele.

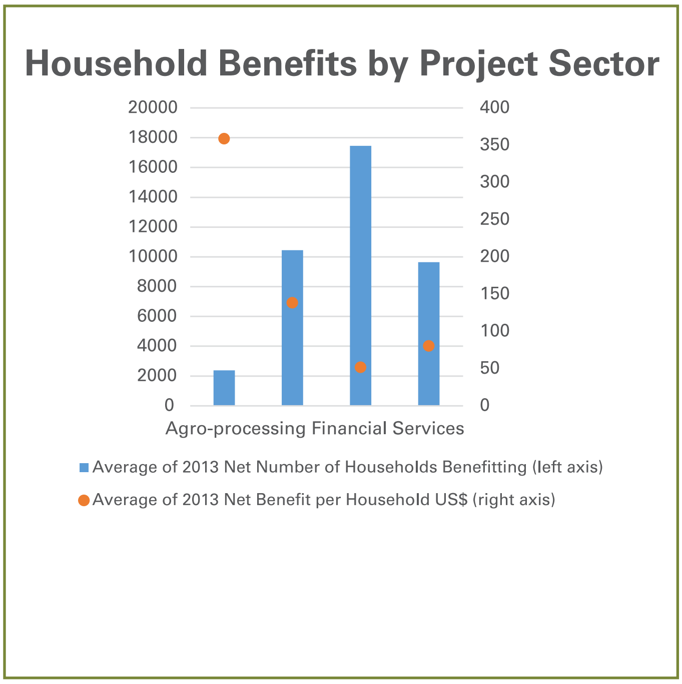
Sector	Leverage Ratio
Input Supply	2.64-2.80
Storage Solutions	1.29
Agro-processing	3.40
Financial Services	2.32
Renewable Energy	3.71
Education	0.37
Health	0.97
Sanitation	0.39
*Leverage Ratio = Matching Funds / Grant Funds	

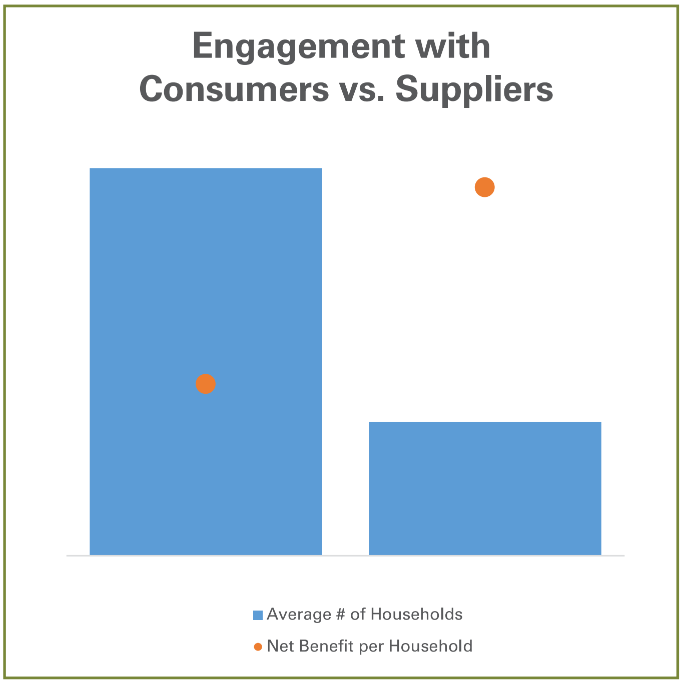
Data on fundraising by grantee companies suggests that agro-processing and renewable energy projects attract the most support from investors. Through the Africa Enterprise Challenge Fund, KPMG IDAS is piloting the 'Connect' service, which works with grantees to help them raise commercial and impact funding*. The team has helped two grantees raise US$3.5m, with a strong pipeline of roughly 30 companies seeking to raise US$90m. Renewable energy projects also have the highest average fundraising targets per company, reflecting the strong growth potential in this budding industry.



*In the case of the AECF, "Connect" is funded by Sida.

Development impact



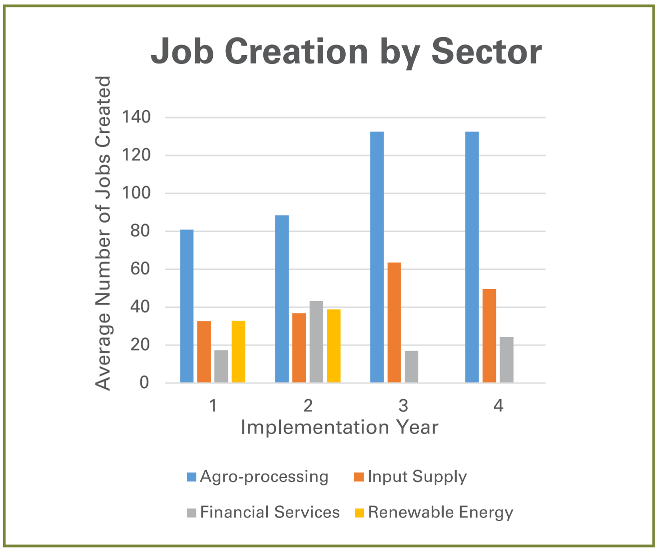


Impact for the majority of this portfolio is measured in two key areas: benefits to poor households and jobs created. Our data shows that impact varies significantly by sector and mode of engagement with poor people, tends to grow concurrently with turnover, and does not have a consistent relationship with profit.

The graph above shows that projects in different sectors produce different forms of impact:

- Agro-processing projects reach by comparison fewer households but provide the highest benefit per household – usually through sourcing produce from smallholder farmers.
- Conversely, financial services and renewable energy projects reach many people but with comparatively smaller benefits, e.g. through mobile money services and off-grid solar products. Both services take time to develop distribution networks and reach scale. The higher number of households reached by financial services in the portfolio reflects the longer operation of those projects, with one project achieving significant scale and impact in its fourth year.
- Input supply projects reach a moderate number of households with robust benefits – usually in the form of cost reduction and efficiency improvements for smallholder farmers. These companies can reach more farmers than agro-processers because their engagement with each farmer is limited.

Impact will also vary according to whether companies engage with poor people as consumers or suppliers, which can vary within and across sectors. Consumer engagement models are easier to scale to large numbers of people, but will almost always be limited in the benefit value per person. Of course, there are other forms of impact to consider, such as the social and psychological wellbeing that comes from financial inclusion, or the health benefits that arise when households replace kerosene and charcoal with clean solar lamps.

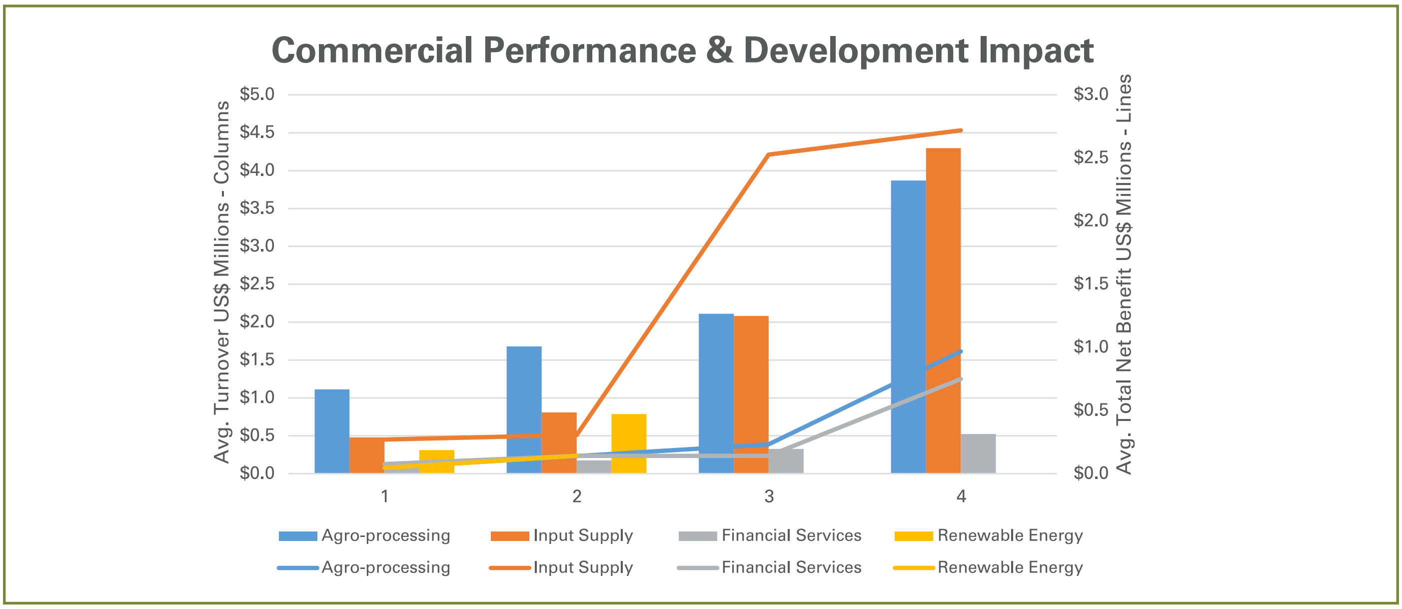


Job creation is not high across the portfolio, which largely reflects the way that impact is captured in the portfolio: many people in rural Africa are smallholder farmers, and for many of these projects, benefits to farmers are captured as household income rather than jobs created. In Africa, it is also easier and less capital intensive to create jobs in densely populated urban areas via the labor-intensive services and manufacturing sectors, while the emphasis of the IDAS portfolio is in rural areas.

The data shows that agro-processing projects create significantly more jobs than the other rural projects. Labor intensity in agro-processing is similar to the manufacturing sector, requiring many employees to staff processing facilities. Seasonal laborers are also employed at harvest time, while smallholder farmers experience the aforementioned income benefits as suppliers. Improving rural incomes through this kind of value addition may be just as important as creating new jobs in rural areas, where low labor productivity and the poverty perpetuated by it is often a bigger problem than official unemployment.

Aligning commercial performance and impact
As shown in the graph below, impact almost always grow along with turnover, with an average two to three-year delay before impact benefits take off. However, input supply projects stand out in this portfolio as punching above their weight: exhibiting moderate commercial performance while providing robust benefits to many households.

Portfolio projects that combine strong commercial potential alongside development impact vary across sectors. In this portfolio, these projects include dairy and poultry (falling across agro-processing and input supply sectors), seeds (input supply), and pay-as-you-go renewable energy distributors (renewable energy). All of these projects exhibit strong turnover growth, robust gross margins and high impact. However, not all of them are profitable in their first four years of implementation. This suggests that in Africa, even for commercially motivated companies, impact investors may need to sacrifice profit for impact in the near term, although this may not be the case over time. (Analysis of these projects will follow in a subsequent paper.)

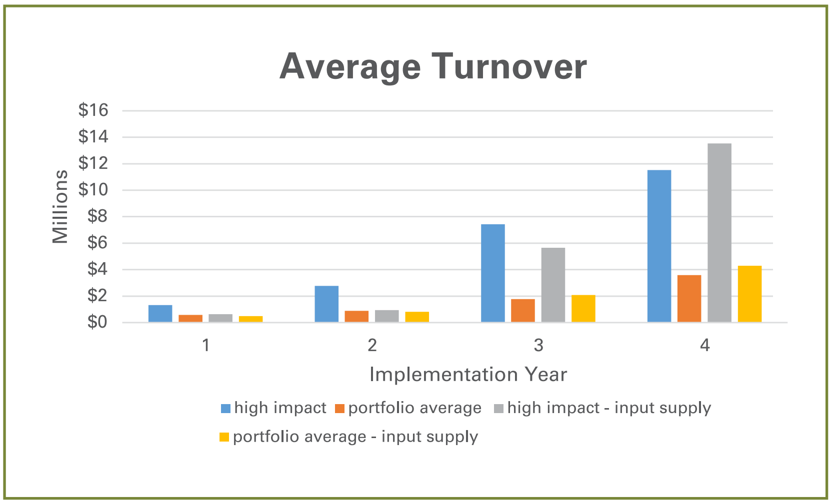


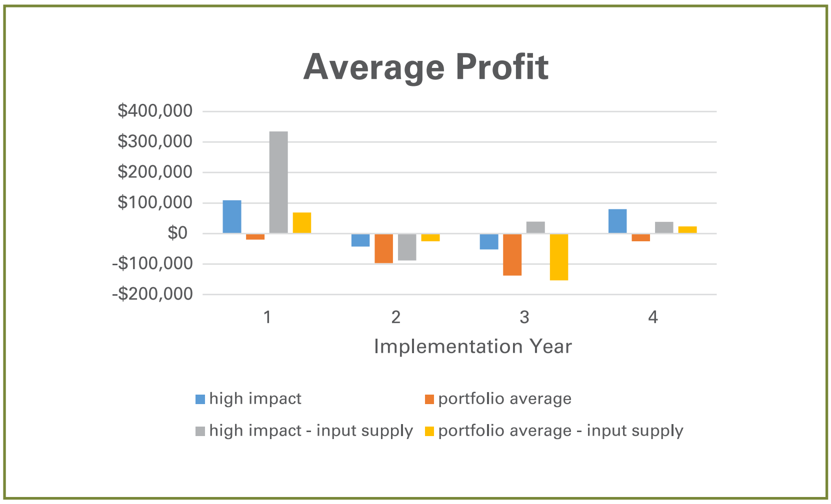
*Total net benefit is calculated as the number of households benefitting from a project multiplied by the average benefit per household

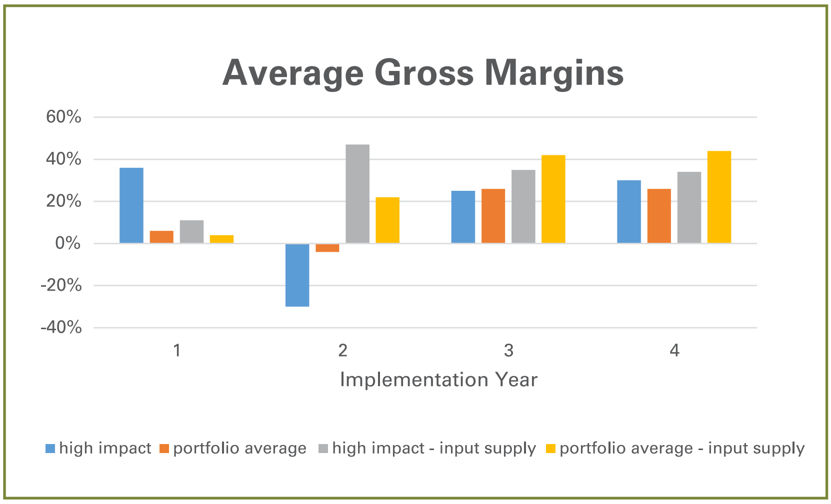
Sacrificing commercial performance for impact?

The charts below compare the commercial performance of the highest impact projects in this portfolio to the portfolio average. The data is compared both across sectors and holding sector constant by looking at a single sector (input supply). From this data, we can draw several conclusions:

- Projects with the highest impact perform roughly on par or better commercially than the rest of the portfolio. This is logical given the strategic focus of the portfolio: to support scalable projects driven by strong commercial motivations that achieve impact by default. For this portfolio, we would expect the strongest commercial performers to achieve the most impact.
- Comparing this with the data in previous sections, we find that commercial performance for this portfolio varies more by sector and business activity than by level of impact. This suggests that impact investors seeking to improve commercial performance could do so by carefully selecting business models rather than by sacrificing impact goals.
- However, the data here reiterates that even for commercially motivated projects, investors may need to sacrifice profit in the near term.
- Because this data compares projects within the portfolio, it does not reveal how these projects perform commercially relative to the general market.







*Data includes one large high-impact project in input supply that was previously excluded for greatly skewing the input supply average upwards. Here it is included because it is one of the high impact projects.

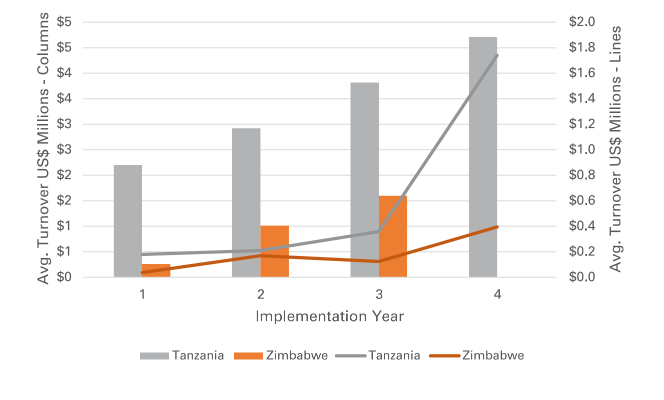
Portfolio performance by country

The portfolio is spread across more than 20 African countries. The high variance in type and number of projects across countries makes it difficult to draw performance comparisons between them. The charts here provide data cuts by sector and country where we have enough projects to produce robust averages. These are concentrated in Tanzania, Zimbabwe and Kenya. But we have found, qualitatively, that the trends noted above regarding performance by sector and mode of engagement with poor people tend to hold true across all regions. Projects from the Horn and West Africa tend to have more diaspora connections thanks to political economic dynamics in those countries.

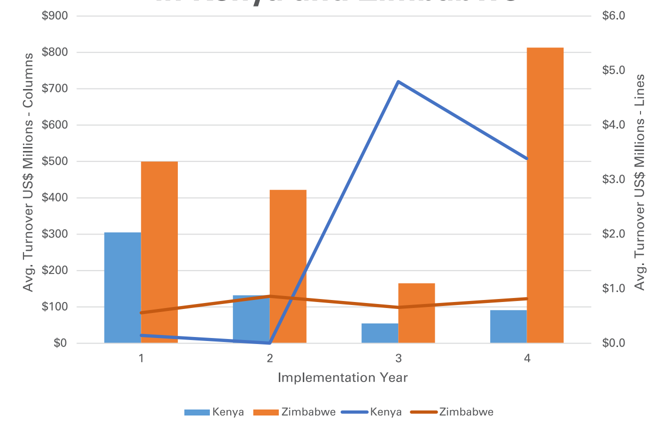
Referencing the specific data below, Tanzanian agro-processing projects performed strongly compared to those in Zimbabwe. Zimbabwe's historically well-developed agribusiness sector has resulted in the existence of many large-scale companies in that market. However, the country's business environment has also deteriorated significantly, with high levels of economic uncertainty marring market potential. Meanwhile, the business environment in Tanzania has been improving.

Input supply projects are larger in Zimbabwe than in Kenya, but had variable performance in both countries. The Kenyan business environment has also improved over time. However, the majority of input supply projects in this Kenyan portfolio are small. Development impact for Kenyan input supply was driven up significantly by one seed project in year three. This is an outlier, but also reflects the impact potential of even relatively small projects.

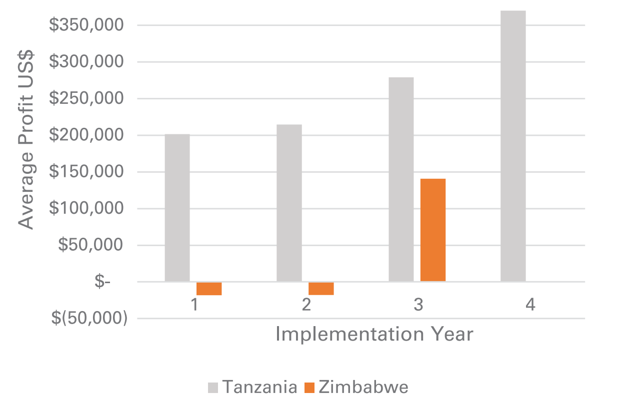
Agro-processing Performance in Tanzania and Zimbabwe



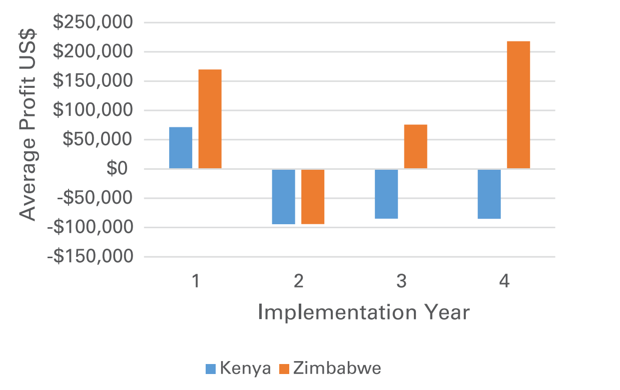
Input Supply Performance in Kenya and Zimbabwe



Agro-processing Profits in Tanzania and Zimbabwe

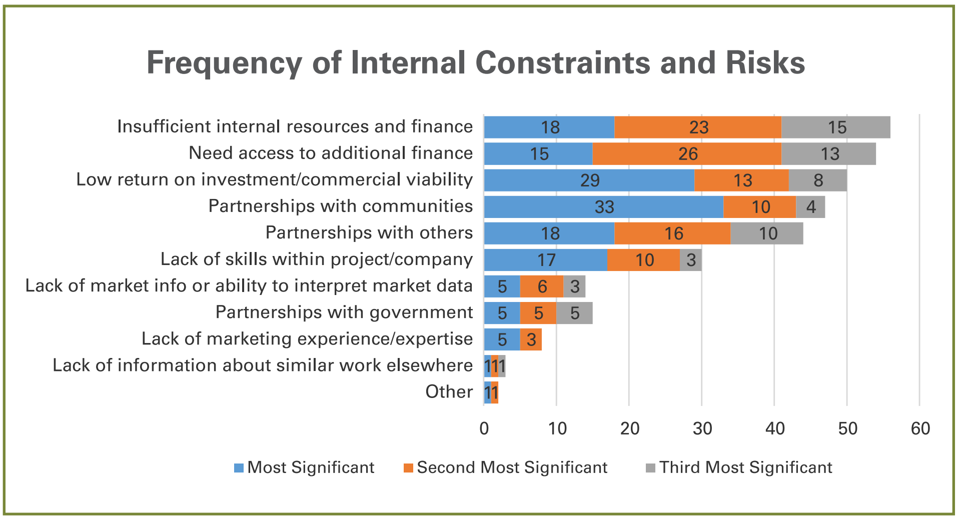


Input Supply Profits in Kenya and Zimbabwe



Challenges to business performance in Africa

Key challenges faced by grantees in the portfolio are shown here. Access to finance whether internal or external is nothing new for companies in Africa. What is interesting is the equally strong emphasis on commercial viability and partnerships with communities. These two challenges are in some ways interlinked, driven by the need for many inclusive enterprises to engage with remote consumers and suppliers. This engagement presents both social and cost challenges at the same time.



In Africa, inclusive enterprises face an uphill battle. They must contend with weak infrastructure, expensive inputs, opaque regulation, corruption and relatively low skilled labour at a relatively high cost, make doing business costly and inefficient for any company. To this, inclusive enterprises add further layers of difficulty – seeking to engage with low-income people often in remote areas, and developing innovative new products that require consumer education and new distribution networks and infrastructure, but must be sold at a low cost.

Many investors have noted that it is easier to finance inclusive and social enterprises in Asia, where lower costs of doing business provide a more workable baseline. Investors have observed improving corporate governance standards in Africa as new generations take over family businesses and market forces demand more responsible management. This management trend is encouraging, but it will take longer to change the cost of doing business fundamentals.

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Lessons for impact investors

The data presented here is limited to a single portfolio focused on innovative early-stage projects, largely operating in agribusiness and renewable energy. Much more research in this area is needed in order to comprehensively support more informed impact investment decisions in Africa. However, the data does reveal some interesting trends within its focus areas that suggest several conclusions:

- Investors can align their impact goals and investment strategies by considering that the level and type of impact vary significantly by sector and mode of engagement with poor people.
- Investors seeking to improve commercial performance can do so to some extent by carefully selecting sectors and business models, rather than by lowering impact goals. Although, this may not apply to portfolios that support companies for which impact motivations come before commercial motivations.
- Africa's challenging business environment makes market rates of return for impact portfolios more difficult to achieve in the near term. Grant and other kinds of soft funds and technical assistance facilities can play a key role in this environment to support early-stage ventures and cover high up-front costs.
- Soft funding is especially important to develop pipeline in agribusiness, which is inherently more risky than most other sectors in Africa (due to weather and commodity price variability) and often requires lead times to produce results that are longer than what a typical investment fund structure can accommodate.
- Early stage finance by experienced, on-the-ground fund managers can also play a key role in identifying and supporting the growth of more viable companies that have a social impact in the market, especially where they are able to blend funds from multiple investors and link seed finance to scale up.

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