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Ministry of Foreign Affairs

'Demonstration Effect and Other Catalytic Effects' Learning Deep Dive

Dutch Good Growth Fund/Financing Local SMEs

May 2024

Acronyms and their meaning

ACF	Ankur Capital Fund
ALEG	Latin America Early Growth Fund
ALIVE	Acumen LatAm Impact Ventures
BDS	Business development services
BII	British International Investment
BoP	Bottom of the Pyramid
CDC	Commonwealth Development Corporation (now BII)
CFF	Collaborative for Frontier Finance
CPI	Climate Policy Initiative
DE	Demonstration Effect
DFI	Development Finance Institution
DGGF	Dutch Good Growth Fund
ESG	Environmental, social and governance
ESO	Enterprise Support Organisations
FCDO	Foreign, Commonwealth and Development Office
FI	Financial intermediary
FoF	Fund of Funds
HNWI	High-net worth individual
IDB	Interamerican Development Bank
IF	Investment Fund
KII	Key Informant Interview
LDC	Least Developed Country
MDB	Multilateral Development Bank
MENA	Middle East and North Africa
MFA	Ministry of Foreign Affairs
MSME	Micro, Small and Medium Enterprise
ODI	Overseas Development Institute
PE	Private equity
SCBD	Seed Capital & Business Development
SME	Small and Medium Enterprise
TA	Technical Assistance
TOC	Theory of Change
TOR	Terms of Reference
VC	Venture Capital

DGGF "Financing Local SMEs" is an impact-focused fund-of-funds (FoF) initiative working to increase access to finance for SMEs in frontier markets — the "missing middle". Funded by the Dutch Ministry of Foreign Affairs and managed by a consortium of private investment managers led by Triple Jump and PwC since 2014, it was established to shoulder greater risk than other market players. At the end of 2023, the Dutch Good Growth Fund (DGGF) amounted to almost €400m in committed capital across 51 investees which, in turn, have financed more than 13,000 SMEs — supporting over 110,000 jobs in more than 40 countries.

In 2023 DGGF commissioned a study to establish the demonstration and other catalytic effects it has achieved to attract further investment in the missing middle, and to provide DGGF with recommendations. This short paper summarises our findings, and provides lessons learned for DGGF, the Netherlands Ministry of Foreign Affairs and other market players, together with a series of recommendations to DGGF for the way forward.

Innovations to address the SME financing gap

Across the world, small and medium-sized enterprises (SMEs) account for the lion's share of employment, output and value added. Yet in developing countries, small businesses remain under-served by financial intermediaries. This is particularly the case for "missing middle" SMEs—firms that are have outgrown microfinance, are too small or risky for conventional financial market players or lack the growth or return on investment sought by traditional venture capital players.

According to World Bank estimates, SMEs face a finance gap that is equivalent to US$1trn.[1] This gap is driven by the perception that the missing middle is populated by firms with low investment readiness and a high-risk profile, and which have high transaction costs for investors. This results in a vicious cycle of limited demand for, and supply of capital.

Naturally, not all SMEs have the same needs. The financing gap is particularly acute in early-stage businesses that seek to grow, although it is seen across the four main segments of small and growing businesses (SGBs)—niche businesses, livelihood-sustaining enterprises, dynamic businesses and high-growth ventures.[2]

Recognising how each segment faces different challenges and has varying needs is at the heart of the DGGF's investment strategy. Established in 2014, "Financing Local SMEs" was among the first Fund of Funds (FoF) initiatives to deliver investment and technical support to a variety of financial intermediaries (FIs) serving different types of missing middle enterprises.

DGGF is an initiative of the Dutch Ministry of Foreign Affairs that aims to improve access to finance for the missing middle in target countries. Greater access to finance enables local SMEs to grow, thereby contributing to sustainable development in lower-income countries. DGGF is particularly keen to support young or female entrepreneurs and businesses in fragile states.

[1] World Bank (2017). MSME Finance Gap - Assessment of the shortfalls and opportunities in financing micro, small and medium enterprises in emerging markets.

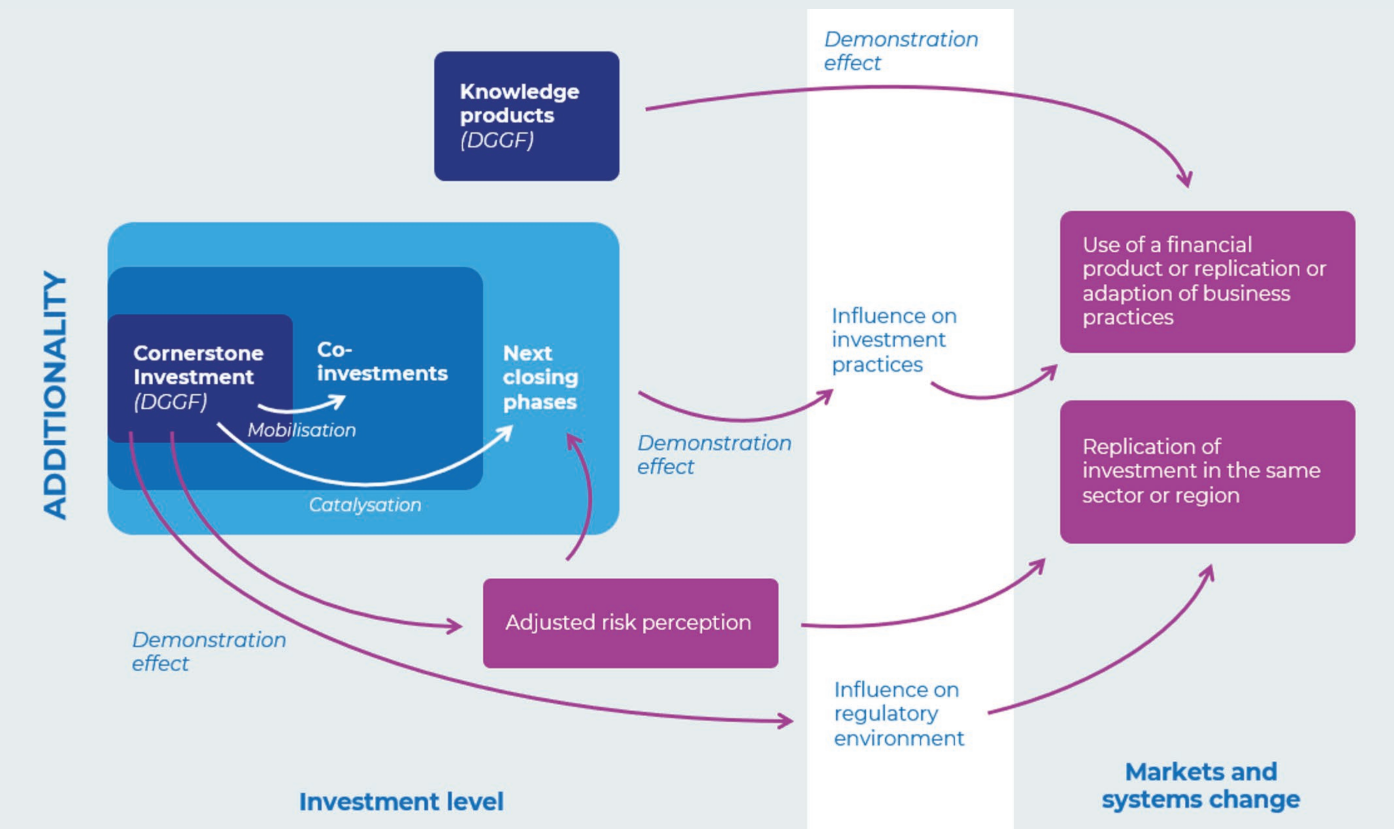
[2] See Dalberg Advisors. 2018. The Missing Middles: segmenting enterprises to better understand their financial needs. Commissioned on behalf of the Collaborative for Frontier Finance (Omidyar Network / Dutch Good Growth Fund).

Understanding DGGF's demonstration and its link to catalytic effects

From its inception, DGGF has sought to shoulder greater risk than traditional development finance institutions (DFIs) and other emerging market investors. This should, in principle, allow it to demonstrate that investing in the missing middle can generate both financial returns and a positive impact. DGGF was among the first investors to explicitly incorporate "demonstration effects" as part of its theory of change (ToC) and investment process, and it remains a reference for other players in this field. DGGF also prioritises investments that can support first-time ventures, contribute to scaling access to finance and to strengthening investment ecosystems in the countries in which it invests.

While the concept of demonstration effects is known and used by various investors, there is little consensus on its definition or its measurement. Based on an in-depth review of the existing literature and insights from interviews with DGGF and other market players, we propose the following framework to understand demonstration effects—and to link them to other catalytic effects.[3]

Figure 1. A simplified demonstration effect framework



Source: own elaboration

[3] In this regard, the paper combines what DGGF defines as "catalytic effects" at the level of specific investments on the one hand; with wider demonstration effects at the market and ecosystem level on the other.

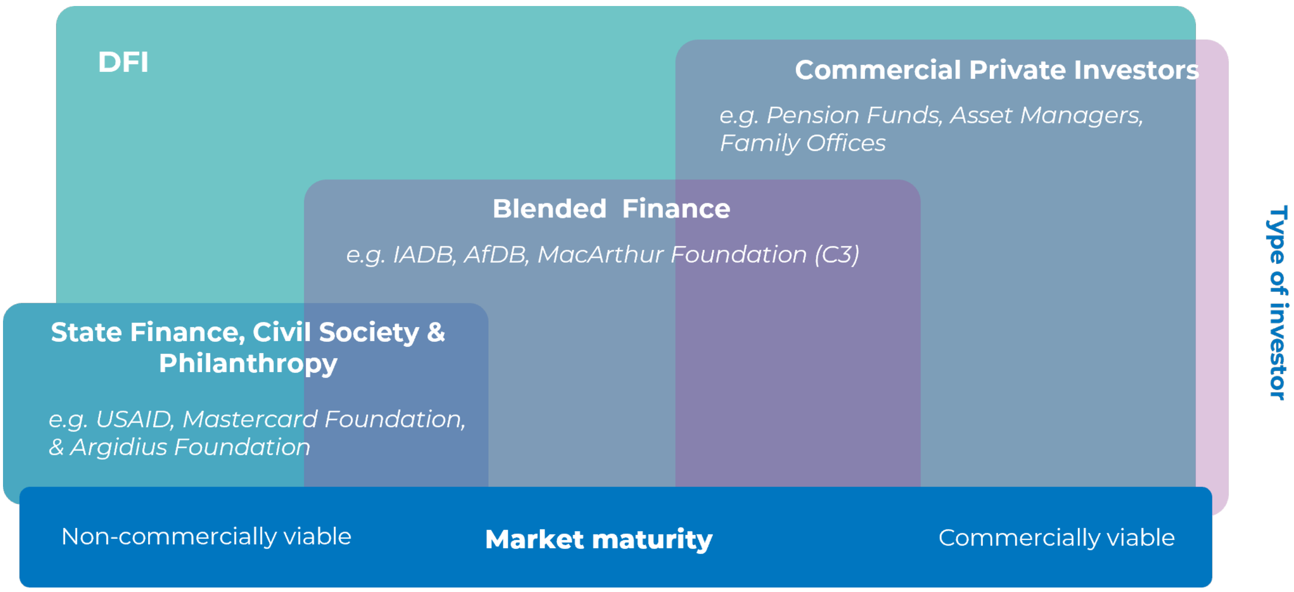
A demonstration effect can be understood as additional investment and/or improvements in the quality of investment triggered by DGGF's activities, which would not otherwise have happened. DGGF's activities include investment deals (represented in the larger box on the left-hand side of the figure), which are often supported by technical assistance (TA) and business development support (BDS), as well as its work on knowledge production and dissemination (represented by the smaller box).

One can differentiate between financial and non-financial demonstration effects.

Financial demonstration effects occur when investors realise that risk-adjusted returns are better than they had initially perceived. Here, the (potential) success of a given investment shifts the perceptions of the attractiveness of similar investments, increasing overall investment flows. Since success is likely to be serendipitous in high-risk environments, the key factor in shifting perceptions is that an investor has strong financial and impact results, and a credible track record.

Demonstration effects can target the whole spectrum of investors—from public to private. Depending on the commercial maturity of a market and fund—an evolutionary trajectory—different actors are likely to be influenced at different points of the journey. The next figure illustrates which type of investors will be influenced depending on an investment's trajectory.

Figure 2. Asset class used and type of investor most likely to be targeted by DE depending on the initial investment maturity



Source: own elaboration

Non-financial demonstration effects, which can be triggered by DGGF's TA and BDS activities, capture the influence of an investor on the behaviour of other investors through new business practices such as improved ESG performance or adopting a gender lens, for instance. When an investor invests in funds with strong ESG or impact management policies in place, or influences its investees' ESG standards, this can incentivise other investors to follow suit, either by de-risking and thereby improving performance; or by demonstrating that improved ESG performance is compatible with high financial returns.

In practice, effects are observed at ***three levels***

To find out more about DGGF's demonstration effects, we reviewed public and internal documentation and interviewed market participants as part of five in-depth case studies. We interviewed DGGF staff; the fund managers supported by DGGF's investment and seed capital and business developments (SCBD) portfolios; DGGF's co-investors, both present and past; staff at peer investors and other players, such as philanthropic foundations; and SMEs and entrepreneurs.

In the study, we have organised our findings across three levels: tracing demonstration effects for individual funds, the SMEs they support and the wider ecosystem (Table 1).

Table 1. Typology of effects per levels

DE1	Fund level	- Additional finance inflows to investees due to the investor's presence; - Additional funds emerging in the same market, replicating the model.
DE2	SME level	- Additional finance inflows to SMEs supported by investees, or to SMEs active in the same market; - New business practices adopted, leading to (inclusive) growth and impact.
DE3	Ecosystem level	**In specific markets:** - Greater involvement of local finance providers in missing middle investment; - Changes in regulation and investment practices and standards. **At the global level:** - Greater awareness of missing middle; - Set-up of new initiatives similar to DGGF's mandate.

Figure 3 below provides an overview of the case studies.

Figure 2. The case studies

Deep dive	Fund level	SME level	Ecosystem level
ALIVE Acumen LatAm Impact Ventures	✓	–	–
ankur capital	✓	✓	–
balloon VENTURES	–	–	✗
sawari ventures	✓	✓	✓
THE MISSING MIDDLES	N/A	N/A	✓

The fund level

At the level of funds, we found that DGGF is effective at supporting funds in their legal set-up, governance and strategy, contributing directly to de-risking. DGGF's presence sends a strong positive signal to other market players because it is known for having high standards, a skilled and knowledgeable team and for conducting strong due diligence.

DGGF provides a vote of confidence to its investees, in particular when acting as a cornerstone investor or coming in at first closing. This can prove to be a double-edged sword, however. Deciding not to support second or third-time funds launched by investees can be perceived negatively by co-investors and other market players.

Another form of demonstration effect is replication, with the emergence of funds employing similar models to those supported by DGGF. We found examples of this in both Egypt and Peru. In smaller and less well-established markets (e.g Uganda), DGGF's investees have a positive impact on access to finance, but the potential for replication by other investors will probably require more time and evidence.

The SME level

At the level of SMEs, DGGF's ability to demonstrate the benefit of investing in the missing middle is indirect. However, there is evidence of increased access to finance for entrepreneurs served by VC funds in Egypt, India and Colombia. Evidence is scarcer for non-VC funds. At the same time, DGGF directly supports SMEs through its TA and BDS facilities. This has the potential to increase the market readiness of SMEs, making them more broadly investable in the future. DGGF has commissioned another "deep dive" into catalytic effects at the SME level, which will shed more light on these issues.

The Ecosystem level

DGGF seeks to play a market-shaping role by investing in funds that can influence domestic practices and market regulations and in so doing help build business ecosystems. In Egypt and India the fund managers supported by DGGF are active ecosystem builders and contributors. While these efforts are independent of DGGF's support, the organisation's investment contributes to the continuation and maintenance of these activities.

DGGF is also increasingly effective in demonstrating to regional and domestic DFIs the potential returns and positive impact of investing in missing-middle SMEs. In terms of commercial investors, DGGF's mandate and choice to support early-stage funds and first-time fund managers does not typically align with the strategies of these market players. However, the growth of interest in impact investing among the institutional investment community is starting to generate interest in the markets in which DGGF invests.

At the global level, DGGF's influence remains understandably more limited, for reasons that are beyond its control. However, DFIs and donor organisations are showing increased interest in FoF models that can invest in smaller-ticket SME funds and serve the missing middle. Similar vehicles were either proposed or developed by FCDO, the Australian government and the Canadian government, among others. DGGF was an important reference point for donors, but we did not gather explicit evidence that DGGF was the sole inspiration behind these vehicles.

Finally, there is evidence that DGGF's knowledge work has inspired investors internationally, with large philanthropic foundations having adopted parts of the Missing Middles segmentation framework. There is a consensus among stakeholders that DGGF's knowledge work on the missing middle has contributed to the development of a common framework for market players. In addition, DGGF's collaborative approach to knowledge production is perceived as being useful to ensure wide dissemination and uptake.

Lessons learned

Key findings on DGGF's demonstration and other catalytic effects

At the time of its formation, DGGF was the only institution of its kind: a fund-of-funds targeting first-time fund managers serving the missing middle. Since then there has been an explosion of interest among DFIs, donors, the impact investing community and in many lower-income countries in the potential of investment funds to help support and grow the SME sector. It is evident that DGGF, both through its investing and its knowledge-sharing activities, has been a key contributor to this change.

Against this backdrop, DGGF's contributions to demonstration can be summarised as follows:

1. DGGF is able to demonstrate to other investors that fund managers in its portfolio are worth investing in;
2. In relevant target markets, such as Latin America (Peru) and North Africa (Egypt), funds that are not supported by DGGF use an investment strategy or thesis similar to that of DGGF-supported funds; and
3. The involvement of domestic and regional institutional investors in investing in DGGF-backed funds and therefore in the missing middle has increased since DGGF's inception.

Lesson 1: Demonstration effects take time to materialise

While a 2020 external evaluation report of DGGF's entire portfolio, carried out by ITAD, reported "few (...) demonstration effects",[4] we have found evidence of positive demonstration effects. The discrepancy is probably due to timing—our case studies suggest demonstration effects take time to materialise. This suggests that a long-time horizon—longer than the life-cycle of an average fund supported by DGGF—is required to evaluate the extent of demonstration effects in a given market.

Lesson 2: DGGF is effective at signalling

Among the reasons for DGGF's success at demonstrating the (potential) viability of its investees, all co-investors agree that DGGF's vote of confidence in a fund or fund manager provides a strong positive signal—particularly when it comes in at the first closing. In many of the markets in which it operates, DGGF is seen as a reference point. At the same time, where DGGF elects not to participate in second or third-time funds launched by its investees, DGGF may send a negative signal to other investors.

This may create a tension between signalling and additionality when DGGF is considering its support to second- or third-time funds launched by DGGF fund managers. We have included a recommendation on how DGGF might manage this tension in the following section.

Lesson 3: Investment alone is not enough

DGGF is among few institutional investors that actively seeks first-time fund managers. Its guidance on governance, management structure, legal set-up, and standardised fund documentation is recognised—by fund managers, as well as by co-investors—as important in raising the professionalism of fund managers, alignment with international standards and confidence in viability. This support is formalised when funds seek access to DGGF's TA and/or BDS facilities.

Lesson 4: Seed capital provision through the SCBD Facility opens up opportunities for learning and experimentation

DGGF's SCBD Facility is able to take on a higher level of risk than its main fund. As such, the SCBD Facility is able to help create opportunities for DGGF to invest in fund managers who have been enabled to develop an initial investment track record. During our deep dive into DGGF's provision of seed capital to Ankur via the SCBD facility contributed significantly

[4] ITAD (2020). Evaluation of the Dutch Good Growth Fund: Final Report. (See page 67 for the study's conclusions on demonstration effects).

to Ankur's first investment fund. Likewise, the SCBD's investment in Balloon Ventures in Uganda has enabled the company to grow to a stage where other investors are reportedly evaluating its potential for further growth and investment.

Lesson 5: Internal engagement with knowledge management could be improved

While key lead staff members are well versed in all DGGF's activities, some investment officers have limited awareness of the organisation's own knowledge production work; and of its ecosystem-building strategy. This reflects the team's prioritisation of deal making and portfolio monitoring. In addition, both investment officers and fund managers pointed to the need for knowledge products that are better adapted to the specific countries and markets in which they operate.

Lesson 6: The reach of DGGF's demonstration can be broadened

Owing to its mandate, which allows more risk-taking than traditional DFIs, DGGF is able to demonstrate and crowd-in a range of co-investors (international, regional and domestic DFIs; foundations; and, increasingly, family offices). However, findings suggest that across the markets in which it operates, DGGF tends to attract stakeholders that are already aware of the need of investing in the missing middle. At the same time, an increase in interest in this segment on the part of domestic and regional DFIs is an encouraging finding. There is scope for DGGF to continue building stronger relationships with these and other impact-focused private and institutional investors, including family offices, pension funds, local investors and angel investment networks to strengthen its demonstration effects. In addition, at the global level, there is an increased interest in FoF models to serve the missing middle. While this cannot be attributed directly to DGGF, it appears to have been the reference point for some of these efforts.

Lesson 7: There are trade-offs between the breadth of geographical scope and the depth of impact in individual markets

DGGF's portfolio is distributed across a broad geographical canvas, to ensure there is diversification in both investment risk and impact. However, there are trade-offs between the geographic breadth of DGGF's investing and the depth of impact and learning in individual markets, especially in relation to the ability to drive demonstration effects at the level of individual ecosystems.

Recommendations

Based on the findings and lessons learned presented in this deep dive, we present four recommendations for action. The first two are strategic recommendations; the last two are recommendations for process improvement.

Key questions for DGGF: a summary

1. **What should DGGF keep doing?** DGGF is highly effective at demonstrating to, and crowding-in like-minded partners. As domestic capital markets grow and deepen in institutional capacity, there is also an opportunity to continue targeting and engaging with local market players such as regional DFIs and institutional investors in order to help strengthen local financial ecosystems and help increase the amount of locally raised investment in DGGF's funds.
2. **What should DGGF stop doing?** DGGF can consider narrowing its portfolio: a more targeted investment strategy focused on prioritising additionality and social impact, together with a reduction in geographic coverage, may deepen DGGF's demonstration effects in the markets in which it operates.
3. **What can DGGF introduce as a novelty?** DGGF can consider communicating more openly and explicitly about its less successful experiences, to facilitate learning in the wider investment ecosystem.

Focus the ambition

To maximise demonstration effects and stimulate learning around what works and what does not, DGGF may consider tightening its strategy and narrowing its portfolio. The wide geographical scope of DGGF's portfolio is motivated by important considerations of risk and impact diversification. However, a more targeted investment strategy focused on prioritising additionality and social impact, together with a reduction in geographic coverage, may deepen DGGF's demonstration effects in the markets in which it operates.

Increase intentionality in outreach and engagement

DGGF is highly effective at demonstrating to, and crowding-in like-minded partners, in particular to the DFI community. In markets that are less mature, such as Sub-Saharan African economies, proving the viability of a given investment to DFIs should already count as evidence of demonstration. Even in these markets, however, DGGF is increasingly able to attract domestic and regional DFIs as well as more traditional investors such as banks. In more mature markets, such as Latin America, where private commercial investors are more active, DGGF has been able to attract family offices, high-net-worth individuals and, in the future, it may be possible to mobilise investment from traditional institutional investors such as local pension funds.

DFIs and private investors with a strong local presence have a comparative advantage relative to DGGF because they know the context. In addition, ensuring long-term sustainable access to financing depends on having a healthy interplay between local and international investment flows. Strategically targeting and actively engaging with these market players can help strengthen local financial ecosystems and help increase the amount of locally-raised follow-on investment in DGGF's funds.

To implement this recommendation, DGGF can:

- Leverage the connections of the fund managers it supports and, in some instances, of its own investment officers to identify and map relevant market players in specific countries and regions in which DGGF operates; and approach these players with targeted outreach and communication;
- Encourage (and support) its fund managers to participate in local and regional investment meetings, conferences and associations and help DGGF investment officers identify and meet with potential local and regional investment partners;
- Consider piloting a module for the newly-launched DGGF Academy for Fund Managers, focusing on the specific access to finance challenges of one country or region, drawing from the insights and expertise of a selected audience of investors that are not part of the DGGF portfolio but who might be able to bring deep contextual understanding of the relevant investment climate to DGGF and its partners.

Manage the tension between signalling and additionality

DGGF may consider implementing the following two process improvements:

First, align communication and learning. Demonstration effects and communication are inextricably linked. DGGF is already a learning-focused organisation, but there may be more that it can do to enable a wider dissemination of analysis, learnings and experience.

Secondly, invest further in continuous monitoring. This requires investing time and effort in adjusting monitoring system and templates to track funds' progress with demonstration effects at different levels. Doing so requires establishing a number of relevant quantitative and qualitative metrics that can complement the ex-ante scoring currently being used. It is worth noting that time horizons matter here (see recommendation 1 above).

To ensure industry uptake, tracking and measuring should be performed in close collaboration with other like-minded market players.

Annexes

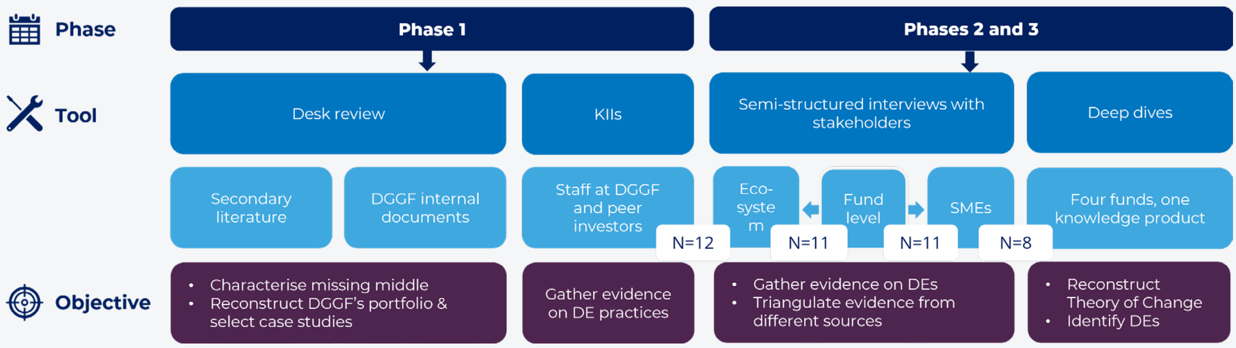
Methodology

This study was carried out in three phases, delineated in Figure 2.1. In Phase 1, we focussed on a comprehensive review of secondary literature and DGGF internal documentation. The objective of this desk review was to derive a definition and conceptual framework to study demonstration effects; and identify five case studies for in-depth analysis (see Annex I for an overview of the sampling approach).[5] We also conducted key informant interviews (KIIs) with staff at DGGF and peer investors to identify and gather evidence on practices that other investors use to track their demonstration effects.

In Phases 2 and 3, information was collected through semi-structured interviews with four groups of stakeholders: DGGF staff (and particularly investment officers); fund managers; co-investors; and entrepreneurs supported by DGGF's funds. We focussed our efforts at understanding the fund's position in its market; the rationale for investment, both for DGGF and its co-investors; the dynamics between investors; and the outcomes for entrepreneurs. Answers from one stakeholder group were validated and triangulated with those of the others, to ensure the findings reported here are as robust as possible. A draft interview guide features in Annex II.

These interviews fed into five case studies: Ankur Capital, ALIVE/ALEG, Balloon Ventures, Sawari Ventures and the knowledge product on The Missing Middles. In what follows, results are reported at three levels of aggregation: (1) the fund level; (2) the ecosystem level; and (3) the SME level.

Figure 2.1 Phased Approach



Limitations

Due to the timeline of the study, the methodological choices and the relative novelty of the study of demonstration effects, several limitations ought to be discussed.

Attribution vs. contribution

Demonstration effects are a qualitative attribute of an investment practice that involves multiple actors. Directly attributing a demonstration effect to a specific actor such as DGGF is a complex exercise that cannot yield firm conclusions. Therefore, the study assesses DGGF's contribution to generating demonstration effects in the markets in which it operates.

[5] The purposeful sampling aimed to ensure geographical representativeness, representativeness of DGGF's strategic blocks, coverage of both investment and influencing activities, the possibility of gauging DEs at different levels (SMEs, funds, and ecosystems), and coverage of DGGF's strategic priorities.

Evidence of demonstration effects cannot be found at the portfolio level

DGGF's portfolio has a wide geographical and thematic coverage, making it difficult to draw conclusions at the portfolio level. We focus on triangulating evidence to derive robust conclusions at the level of specific transactions and markets, and from these conclusions we derive general lessons.

Direct vs. indirect impacts

Given its structuring as a fund of funds, at the level of SMEs, DGGF's contribution to a demonstration effect is mostly indirect. Demonstration effects at the SME level occur through DGGF's investment in funds. Funds can also generate demonstration effects by sending positive market signals with their investments. It is worth noting that DGGF has commissioned a separate study on investment catalysation at the SME level, which will provide additional evidence.

DGGF weighs multiple factors in its decisions

DGGF's mandate requires it to take investment decisions based not only on risk-return considerations, but also based on positive social impact. There is a conscious willingness to accept trade-offs between the viability of investments and their impact.

'Demonstration Effect and Other Catalytic Effects' Learning Deep Dive

Commissioned on behalf of

The Dutch Good Growth Fund, part Investment funds for local Small and Medium Enterprises (SMEs), a "fund of funds" investment initiative from the Dutch Ministry of Foreign Affairs. The initiative aims to improve financing for the "missing middle" – i.e. entrepreneurs who have outgrown microfinance but do not yet have access to regular financial services. The Seed Capital and Business Development (SC&BD) program was established to increase the impact of the DGGF by providing technical assistance, seed capital and business support services to intermediary investment funds and local SMEs. The program incorporates a knowledge development and sharing component that supports research, tests assumptions and shares insights into financing SMEs in developing countries and emerging markets - fostering industry-wide knowledge exchange.

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Coordinated by

Triple Jump, fund manager of Dutch Good Growth Fund – Financing Local SMEs

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Acknowledgements

We wish to thank all the interviewees for this report at Triple Jump, the Dutch Ministry of Foreign Affairs, ALIVE Ventures, Ankur Capita, Balloon Ventures, and Sawari Ventures. We are also grateful to all other interviewees who took time to talk to us and share their insights.

Rotterdam, May 2024

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