IMPLEMENTING SCALE: SME FINANCE IN EMERGING MARKETS

A decade worth of lessons learnt from DGGF's community and the path to scale

DGGF Knowledge Sharing Event Report
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Ministry of Foreign Affairs
TripleJump
pwc

In light of its ten year anniversary, Triple Jump and PwC, on behalf of the Dutch Good Growth Fund (DGGF), hosted a knowledge sharing event titled "Implementing Scale: SME Finance in Emerging Markets." The event provided a platform to reflect on the past ten years of transforming the SME finance sector and to focus on developing effective strategies and collaborations for scaling.

Since its launch in 2014, DGGF has partnered with numerous organizations to co-create pioneering approaches for financing the "missing middle". A total of 160 diverse stakeholders, including DGGF's investees, co-investors, partners, and policymakers from 35 countries, gathered for a day full of inspirational keynotes, insightful panel discussions and interactive workshops.

The objective of this knowledge product is to share the outcomes and key takeaways from these exchanges, enabling the DGGF community to expand beyond its boundaries and attract like-minded stakeholders to scale SME finance in emerging markets.

"The DGGF has been able to build a strong tight community of entrepreneurs, financial intermediaries and investors over the past decade. But in order to scale, we need to reach out beyond the boundaries of our community. We need to shift from investing to influencing."

Steven Collet

Deputy Director General
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Ministry of Foreign Affairs of the Netherlands

The DGGF 2024 impact report can be accessed here.

Why continued investment in SME finance matters: lessons from the past ten years

The past decade has been synonymous with testing and validating SME finance innovations in emerging markets, building track records by doing things differently and learning from failures. The experiences and lessons learnt from the DGGF community over this period are vital for reframing the issues around access to finance for SMEs in emerging markets. With new narratives come new solutions. These insights and lessons can help investors and entrepreneurs navigate the challenges of investing and turn failures into opportunities for growth and impact.

Lesson #1 - There is not one "missing middle" but multiple segments of the SME sector that lack a convincing proposition to mainstream investors. This is often due to a combination of their small size and high risk, which justifies the need for a diverse financial ecosystem with a diversity of asset classes. **Tailored client segmentation and selection is a prerequisite to create an inclusive financial ecosystem but has also proven to enhance the outcomes of financial and non-financial support** by better addressing the specific characteristics and needs of different types of enterprises at various stages of development. **Identifying the right timing for intervention, adapting support as SMEs grow and mature, and showcasing the outcomes and impact** of both financial and non-financial support on the SMEs and the ecosystem as a whole demonstrates what can be achieved, rather than relying on assumptions and biases.

Lesson #2 - Preservation of capital in these challenging contexts happens because if companies are successful, they will generate return and impact, i.e. backing businesses with impact embedded in their model means there is no trade-off between financial returns and impact. **Comprehensive impact measurement** is essential: "data is gold" from a perspective of understanding and making clear the correlation between impact and financial performance, and on that basis drawing conclusions as to what works and what doesn't.

Lesson #3 - Taking risks is necessary. It is the role of mandates such as DGGF to take risks and consequently in some cases face financial underperformance, to allow SME finance providers to learn and reiterate on their models to become more successful. With a decade of experience and learning, we as a community are able to differentiate risk perception from actual risk management which needs to be customized across risk levels including country risks, sector risks, instrument risks, business model risks, etc.

Lesson #4 - Public funding, such as that provided by the Ministry of Foreign Affairs of the Netherlands behind DGGF, has been critical. It is not only important to take risks that others cannot take but also to invite other market players in funding SME finance in emerging markets. Co-investors have a similar risk appetite but can benefit from DGGF and its peers institutional support, while follow-on investors can benefit directly from the initial risk taken.

Lesson #5 - Partnerships are the way to go. SME finance is a "team sport" where different players have **complementary, additional and demonstrative roles** to play in innovating and building a diversified financial ecosystem. No entrepreneur or SME finance provider can shoulder the financial commitment, governance responsibility, and adaptation capacity required, alone. For example, reaching the minimum fund size requires to commit several founders. Equally it takes a whole ecosystem of financiers to fuel the growth of early-stage high growth businesses before they can reach their potential.

Key highlight #1 – Lessons from failures

Both SMEs and SME finance providers are led by entrepreneurs: they see a problem and look for a solution, constantly adapting to an evolving environment. Their first success factor is their **resilience and adaptability in the market they understand well.** Some of the hard-learned lessons include:

1. Strong co-founders with a good chemistry is the best insurance against key person risks: Solo founders rarely succeed; the chemistry between at least two founders is crucial. The strength of founding teams relies heavily on their complementarity. Poor co-founder relationships often lead to business and financial intermediary failures.

2. Solid knowledge and know-how are the basis to execution capacity: Talent availability is a significant issue for the diverse investment and business development roles that constitute the entrepreneurship development ecosystem. A lack of knowledge and know-how are often underlying cases of failure.

3. Clear governance is a must: The constant need to adapt and potentially pivot calls for well-informed decisions. Weak governance negatively impacts decision-making processes and poor decisions may lead to failures.

4. Managing failures: Failing is part and parcel of SME investing. Failing to integrate realistic failure probabilities for a given operating context and investment strategy hampers the team's ability to anticipate them. Anticipating failures allows for flexibility and learning opportunities, leading to greater agility in failing fast. This includes taking the loss as soon as it's clear an investment won't perform, cleaning portfolios of "zombie cases" (i.e. enterprises that are still officially in business but cannot sustain their operations) and doubling down on winners.

5. Embracing failure: Failure should not be defined purely in financial terms but should also consider long-term impact and the ability to provoke change in a given ecosystem. Sharing and learning from failures can help improve investment strategies and build a more resilient investment ecosystem. It is important to look at others' mistakes and improve collectively.

Exploring opportunities to accelerate SME finance deployment in emerging markets

The next 10 years should focus on refining and scaling approaches to SME finance as a means to sustainable development, realizing exits, financial returns and multi-dimension impact. It took DGGF 10 years to contribute to financing almost 12,000 SMEs and supporting 150,000 jobs. The pace needs to accelerate. To achieve this, we need to go beyond the boundaries of our community and engage meaningfully the different types of SME finance investors in emerging markets, especially local ones who are well aware of the local opportunities.

Insight #1 - Patient capital extends beyond 10 years:
Many SME investing approaches rely on a 12-year model. Realizing track records, outcomes, exits and sustainability requires adopting a longer time horizon than the commonly applied 10-year one. It also necessitates constantly adapting financial and impact assumptions and expectations based on what is actually feasible in nascent and challenging ecosystems.

Insight #2 - Innovation and flexibility remain key:
To layer risks, maximize cost effectiveness, and enhance impact efficiency, only adjusted models attuned to the diverse local conditions and incorporating lessons learnt from the sector can succeed. It is not about taking all of the risks at the same time (e.g. team, sector, geography, asset class) which would lead to failure, but managing risks by for instance backing an experienced teams in volatile geographies, versus supporting highly innovative and impactful models in more established geographies

Insight #3 - An explicit commitment to market creation.
To deliver a pipeline of bankable impactful opportunities to follow-on investors, notably private and local ones is actually about market creation. As the finance gap grows, addressing the complex challenge of solving the access to finance puzzle requires comprehensive and collaborative solutions that not only catalyze investors but also markets and sectors. Systems approaches leverage stakeholders' strengths to address barriers and build synergies while keeping transaction costs low. Collaborations can take many forms to create graduation pathways for the pioneers of SME finance provision operating in emerging markets. A core Key Performance Indicator (KPI) is to measure graduation of local SME finance providers to reach scale.

Key highlight #2 - Shifting from digitization and digital transformation towards effective predictive use of data

While the digitization of processes by SMEs and SME finance providers is becoming mainstream, the effective use of the data generated along the way has yet to materialize. Data is still largely applied for descriptive purposes only, rather than for predictive ones.

Predictive use of data is showing immense value in fostering financial inclusion. Monitoring and predicting cashflows of non-bankable clients can enable and improve credit assessments, reducing overall risk and increasing access to financing at better terms. Quantifying events, such as weather shocks, can facilitate offering insurance to underserved groups.

As we navigate this transition, **many challenges remain in data collection and management, including quality, governance and trust.** Data collection and disclosure are often not fully compensated or rewarded and can even be discouraged, for example, through higher taxation. It remains to be better established how to incentivize the collection of impact data and whether technical assistance can be productively used to foster it.

Key highlight #3 – The nexus of gender and climate

Climate change as well as gender diversity affect us all. A logical connection is that "women are disproportionately impacted by climate change"; "while they bring valuable experience and improve climate innovation"; and "women are benefit multipliers" – companies with women in lead tend to incorporate more climate action.

What should we be focusing on to move the needle?

Inclusive approaches: It is important to recognize that women are not a homogeneous group. Differences in background, characteristics, and needs must be considered when addressing climate issues with a gender lens. Inclusive approaches that consider the local context and cultural specifics are essential for successful interventions.
Gender-Smart climate investing: There are opportunities to improve both climate outcomes and business performance by applying a gender lens to climate change and a climate lens to gender finance.

Key highlight #4 - What about local capital mobilization?

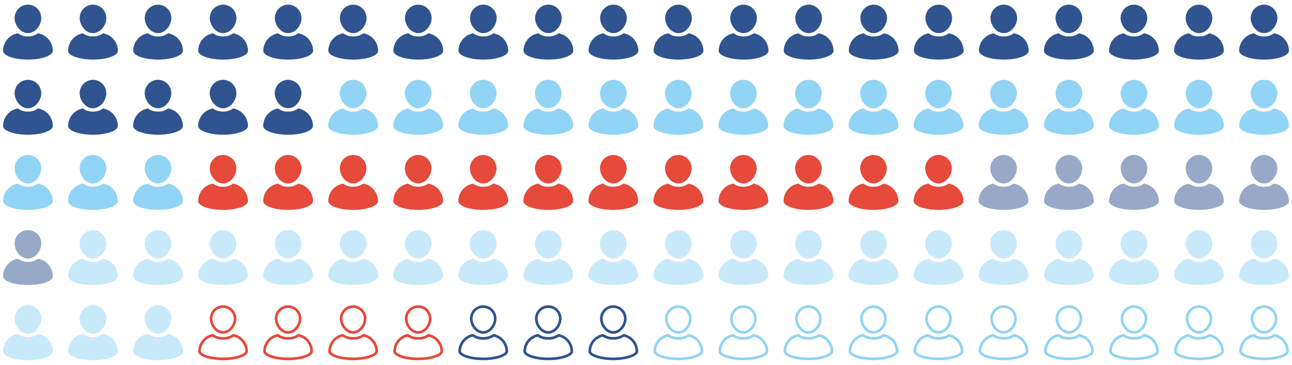
Mobilizing local capital involves **attracting resources from local development banks, pension funds, family offices, and corporate actors to create local impact.** This is crucial for local economic development, both within the country and the region.

Key challenges include the lack of knowledge and expertise that translate into the lack of incentives and track record. Additionally, the lack of financial depth and low local savings levels hamper the ability to mobilize local funding, and regulatory constraints further complicate the situation.

Mobilizing local capital is also about reducing actual risk. **Local solutions** include developing local bond markets, creating locally domiciled investment vehicles to engage local financial players, and exchanging knowledge and know-how among partners. This ensures that international capital plays its catalytic role in fostering solutions tailored to the unique local ecosystem. Examples from South Africa, India, and Ghana highlight the importance of collaboration and creating platforms to attract local capital.

Government incentives and regulatory support are essential to encourage local investments. Creating a safe and transparent investment environment, along with leveraging existing capital movers, can effectively mobilize local resources.

Organizations represented at the event:

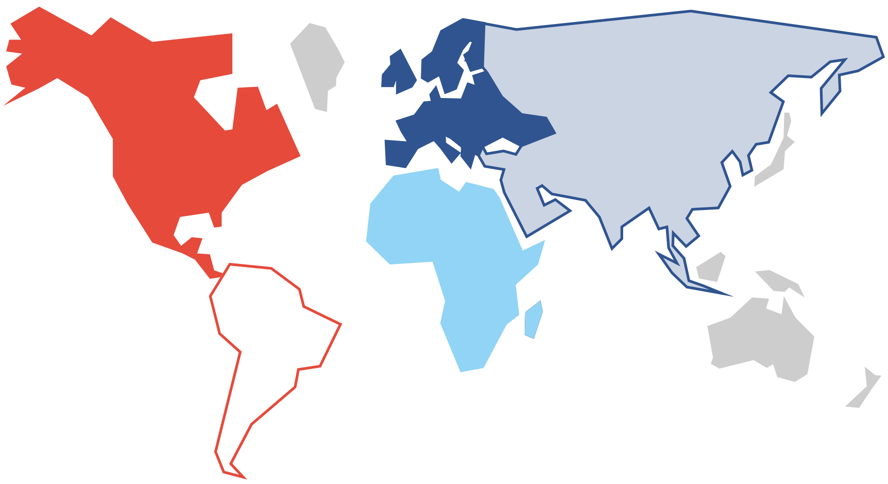


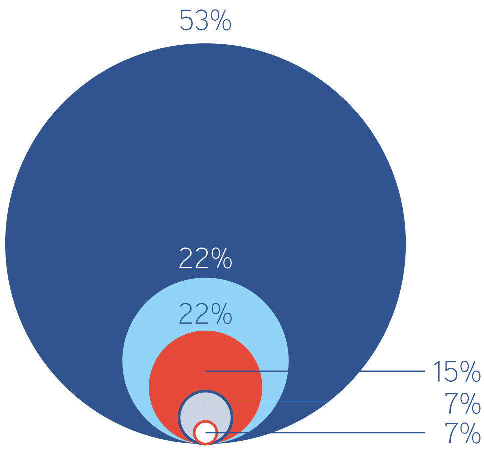
Local capital provider (debt, equity, mezz)
DFI (development finance institution)
Consultancy / advisory
Government / public funding agency
International investments manager (e.g. 'Fund of funds' manager)
Private institutional investor (e.g. foundation/ family office)
ESO (e.g. Accelerator/ incubator)
Other

= 1% of of total of event attendees

The geographical representation aligns with the DGGF portfolio exposure. The European overrepresentation is due to the presence of DGGF's co-investors, primarily European DFIs, and the DGGF implementation team, many of whom are centrally based in Amsterdam.

Geographical representation:





The depth of the discussions was certainly due to the diversity of perspectives.

Gender representation: