IN BRIEF:
A thriving SME sector is crucial to spurring growth and reducing poverty in developing and transition economies. But financial institutions often avoid SMEs, sensing—that transaction costs of financing them will be excessively high. What SMEs need is not to be left without access to capital, but approached on a new model that combines early-stage equity investment and performance-enhancing technical assistance, writes Bert van der Vaart, CEO of Small Enterprise Assistance Funds (SEAF). This US- and Dutch-based NGO manages a network of 14 commercially driven investment funds worldwide with total assets of $140 million, and has developed a unique “equity plus assistance” approach to SME investing.

Small and medium sized enterprises (SMEs) are widely credited with generating the highest rates of revenue and employment growth in virtually all economies. In transition and developing countries open to foreign direct investment, they also tend to pay disproportionately more in taxes and social security contributions than either their larger and smaller counterparts. Larger enterprises, especially multinationals, often find a way to reduce their tax obligations through transfer pricing, royalty payments, and negotiated tax holidays. Microenterprises, on the other hand, often fall in the informal sector, neither paying taxes nor making social security contributions.

Yet if SMEs constitute a critical dimension of growth and development and are often well positioned to achieve high revenue and profit growth, why have private and public financing institutions alike tended to avoid investing in them?

The reasons are multiple and, for the most part, understandable.

For private investors, the amount of work required to invest relatively small sums into several SMEs seems unattractive compared to the work needed to support fewer investments in larger companies. Moreover, investing in local SMEs also often involves working with entrepreneurs who are less familiar with conventional financing relationships, business practices, and the English language than principals of larger firms. There are broader issues to be considered as well, including the lack of transparency in local
legal systems and governments that make investing in these countries difficult at best. Accordingly, most private capital would much prefer to invest in a few large-asset enterprises in fields such as pharmaceuticals, telecommunications or privatized industry rather than in smaller companies with relatively few assets, low capitalization and a perceived greater vulnerability to market conditions.

Public development institutions can also encounter high administrative costs in making SME investments. These can be coupled with perceptions that local SME entrepreneurs may not be trustworthy, and that working with them might bring fewer visibly “developmental” benefits than targeting more poverty-focused fields such as microfinance.

Local commercial banks too are often biased in favor of large corporate borrowers with considerable assets. This has meant that even the lines of credit local banks receive from development institutions for on-lending to SMEs are often under-utilized. SME entrepreneurs’ lack of experience in accounting and other areas of financial documentation makes it difficult for banks or other potential sources to assess their creditworthiness and cash flows, again hindering the provision of financing.

Combined, these factors have largely left what should be the most dynamic sector of the economy in developing countries lacking the capital it needs to realize its potential.

Small Enterprise Assistance Funds (SEAF)

In 1989 the international relief and development organization CARE sought to do something about this situation, sensing huge but largely unfilled demand for effective SME finance. CARE noticed that technical assistance and other business support services were readily available to local enterprises in developing countries, but tangible results were not. Visiting foreign businesses experts were spending time with SMEs and developing clear recommendations for improvement. But local entrepreneurs were generally unable to raise the financing necessary to put these plans into practice. Once the experts had left the country, their advice frequently turned out to be harder to implement than originally thought. Entrepreneurs, lacking trust or perhaps full comprehension, frequently failed to act on the good advice. As a result nothing was achieved in addressing the gap between SME performance and potential.

Hoping to act on these missed opportunities, CARE project officer Tom Gibson began developing a new model for sustainably financing SMEs. He worked with Louis Boorstin, an independent consultant at the time who is now with IFC, and Bert van der Vaart, a pro bono lawyer at the US firm Gibson, Dunn & Crutcher. The result was a concept that would later become SEAF’s business model. CARE used this model as the basis for forming a new independent
subsidiary, the CARE Small Business Assistance Corporation (CARESBAC), which in 1989 received an initial $300,000 start-up grant from the US Agency for International Development (USAID).

SEAF’s founders had observed many local entrepreneurs in developing countries having access to business support but not to longer-term risk capital. Any model focusing on investing in local SMEs, they reasoned, required that capital be integrated with business support. To ensure the trust necessary to implement business changes and create transparency, a strong local presence would also be required. Consequently, the founders developed a model involving a disproportionately strong local fund presence, backed up by administrative and strategic support from headquarters in Washington. As it has evolved today, more than 10 years later, the SEAF model is best represented as shown by the diagram on page 2, which shows how SEAF provides:

- an initial equity participation
- technical assistance improving the investee’s cost accounting and financial controls, thus making it possible to obtain additional bank financing
- other sources of direct business support.

Raising Capital

It is essential that direct business support be provided to the investee. Why? Because it helps the investee come to trust SEAF as a source of valuable business advice and also builds enterprise value, ultimately providing an acceptable equity-like return to SEAF’s investors.

While the model appeared logical, raising the funds needed to execute it proved difficult. At CARE, Tom Gibson executed sovereign-debt equity swaps to fund various projects in Uganda and Ecuador. Working with Bert van der Vaart, he obtained a commitment on the part of Bankers Trust in 1989 for $15 million in past due Costa Rican debt that was to be swapped into local currency to fund the first SEAF investment fund in Costa Rica. But before this transaction could be completed, the Brady Plan debt relief initiative was announced and governments were no longer willing to engage in sovereign debt-equity swaps of this kind.

Fortunately, at almost exactly the time that this disappointing news came in, the Berlin Wall fell, sparking great interest in private enterprise development in Central and Eastern Europe. Former Minnesota Governor Orville Freeman, SEAF’s chairman at the time, helped SEAF work with the US Department of Agriculture to obtain various counterpart funds to provide SEAF’s first round of investment capital. Through the participation of the Polish Cooperation Fund and the Foundation for the Development of Polish Agriculture and a commitment from the Oversees Private Investment Corporation (OPIC) to lend $2.3 million, SEAF formed its Poland fund (CARESBAC-Polska) in 1992 with investment capital of $2.435 million.
Starting with this small amount and a small office in downtown Warsaw that shook and rumbled with the passing of each streetcar, the new fund gradually began making investments. In 1993, the European Bank for Reconstruction and Development (EBRD) made an additional $2.5 million investment in CARESBAC-Polska. In 1994, Bert van der Vaart took over as Director General. CARESBAC-Polska’s assets under management eventually reached $16.9 million. It has now made 43 SME investments, including a bookstore chain, an agribusiness equipment manufacturer, an Internet service provider, and others.

Meanwhile Tom Gibson also raised money for funds in Russia and Bulgaria through the sale of surplus butter—activities requiring him to brave exposure to corruption and organized crime. Nonetheless, he was able to raise $2 million in St. Petersburg and $1.4 million in Bulgaria, which then led to additional capital from USAID and the EBRD. A process was underway that by 2000 had led to the management of 14 different funds.

**From Developmental to Commercial**

The initial goal was simply to test the proposition that the SEAF investment model could succeed in helping local SMEs achieve high growth rates, and the experience of its first four years proved to be very positive. The combination of direct local business support and equity capital, together with a focus on leveraging additional financing from banks and other sources, resulted in strong growth in each of SEAF’s funds. As of the end of 2000, the average annual increase in revenues in portfolio companies within the SEAF network was 80 percent. Employment growth was also strong, with 7,000 jobs resulting from the funds’ investments. As a result, SEAF has grown able to attract capital from other international finance institutions. Today it manages more than $140 million and has made more than 160 investments.

It is important to realize that while SEAF is a development organization with a nonprofit structure at the headquarters level, it manages its investment funds as separate, for-profit entities. Early in SEAF’s existence it became clear that the model would not work unless the investees themselves saw that they were receiving investment on a commercial basis. As many investments began to perform well, CARESBAC-Polska became profitable, achieving its first exits in 1995 and making a modest distribution to its shareholders. Last year, on a total of almost $50 million invested and an average holding period of less than three years, SEAF was able to distribute $1.5 million to its investors. SEAF has now achieved more than 15 exits with at weighted average internal rate of return in excess of 35 percent.

As SEAF has expanded, the organization has faced pressure both from investees to become more professional with respect to business strategy and contacts with Western corporations, and from investors to reduce its management costs. In response its most recent fund charged a management fee of 3 percent on investment capital of approximately $24 million—a considerable drop from the 8 percent fee charged in the original Poland fund. It now also charges investees annual consulting fees, covering much of the costs of SEAF’s business support activities. This model is proving to be attractive to more commercially minded international financial institutions, and, in some cases, private sector entities. New York Life International, the Pension Fund of the German Lutheran Church, Calvert World Ventures, LAI Capital N.V., Fundapro, and Merifin Capital N.V. are all private sector investors that have recently participated in SEAF’s funds. IFC has played an important part in SEAF’s development in this regard.

**Exits**

SEAF believes that the investment levels it takes, coupled with its focused efforts on increase value after investments, allows it to invest at relatively attractive multiples. This offers an array of potential exit possibilities. By contrast, many conventional emerging market private equity investors have had disappointing records in achieving exits over the last four years. SEAF’s approach to early-stage investing in SMEs thus may one day be seen as one of the more appropriate means of investing in developing countries. In the meantime, SEAF is achieving its developmental objectives by rapidly increasing the revenues, productivity, and employment growth of its investee SMEs.

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