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FROM: **Tom Gibson**
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DATE: **November 30, 2003**

SUBJECT: **Final Report of Sub-Grantee, Institute for SME Finance, for USAID Grant #PER-G-00-00-00019-00**

In accordance with Grant Agreement #PER-G-00-00-00019-00 (the "Grant") between USAID and Small Enterprise Assistance Funds (SEAF), the Institute for SME Finance (the "Institute") herewith provides to the Grantee, SEAF, a Final Program Report for the three-year period of the Grant (September 18, 2000 through September 17, 2003).

Summary:

The Institute was formed in July 2000 as a non-profit organization under the laws of the District of Columbia and subsequently received tax-exempt status under Section 501-c-3 of the U.S. Internal Revenue Code. The Institute's stated mission was then and remains to promote the greater availability and more effective use of risk capital finance for small and medium enterprises (SMEs) in developing and transitional economies.

The purpose of the Grant was primarily to help to establish the Institute and build its capacity to serve its mission, particularly, but not exclusively, in the countries served by the Europe and Eurasia (E&E) Bureau of USAID. The Grant Agreement did not require implementation of specific individual projects having quantitative benchmarks.

During the period of the Grant the Institute has worked on five continents, has interviewed or worked with more than 50 SME risk capital funds, has provided training to more than 250 professionals, and has directly presented its findings to aggregate audiences worldwide totaling more than 3,000 individuals related to the field of SME finance.

Among the Institute's activities in the E&E region were two one-day workshops on SME equity investing in Almaty, Kazakhstan and Tashkent,Uzbekistan in April 2001, sponsored by the Eurasia Foundation and USAID. The Institute also produced two case studies on risk capital investments in SMEs in the region. The first addressed the challenges of raising long-term capital for SMEs in Uzbekistan and was utilized in the above-referenced workshop in Tashkent. The second case study addressed the challenges associated with the exit from an investment in Bulgaria. These case studies have been used in a number f seminars and workshops worldwide and were supported by Grant proceeds.

The major strengths in the Institutes performance under the Grant include:

- establishment of the Institute as a globally recognized and innovative participant in the field of SME development and finance;
- development of a new SME fund strategy combining best practices in "leveraged funds", quasi-equity investment, and technical assistance and currently under consideration or establishment in several countries of Asia and Africa;
- provision of non-remunerating advice and information to a wide variety of U.S. and international development institutions, NGOs, and SME investment funds; and
- achievement of financial sustainability, including total revenues equal to more than five times the amount of USAID grant funding (total other USAID-sourced contracts constituting less than 10% of total revenues).

Weaknesses in performance under the Grant include:

- revenues were less than projected,
- the level of activity in the E&E region was less than in other regions, and
- the Institute opted not to serve as a member-based association of SME risk capital funds.

All proceeds of the Grant were expended during the period of the Grant and in accordance with the line-item budget projections submitted in the Institute's unsolicited proposal for the Grant.

Below are elaborations and explanations of the strengths and weaknesses listed above as well as summaries of the current status of the Institute and its future plans.

Strengths in performance under the Grant:

International Recognition:

Despite significant under-funding and consequent under-staffing, during the 3-year period of the Grant, the Institute has become a well-known organization within the international development finance community. The following are indications of its recognition:

- The Institute has been engaged to present seminars on SME risk capital in Central Asia, Southeast Asia, Western Europe, Latin America, Sub-Saharan Africa, The Middle-East, and the U.S.

- During the Grant period, the Institute's chief executive has been asked to represent the Institute by making key-note speeches and presentations at a wide variety of gatherings on SME development and finance. These presentations have been key to disseminating the lessons learned and best practices identified by the Institute. They include, but are not limited to, the following examples:

  Presentation on innovations in SME risk capital, "Competitiveness: Key to the SME Agenda", sponsored by the Euro-Jordanian Industrial Development Initiative, the Euro-Arab management School, and the Canadian International Development Agency; Aqaba, 2003.

  Presentation on SME venture capital in emerging markets, "Annual Meeting of the U.S. National Association of State Venture Funds"; Baltimore, 2003.

  Keynote speech and presentation on small businesses support in the U.S., "Workshop on SME Finance in the Asia-Pacific Region", sponsored by APEC Finance and Development Program (AFDP), Seoul, 2003

  Presentation on new strategies in SME venture capital, "African Fund Managers Seminar", sponsored by the Community Development Venture Capital Alliance and the Ford Foundation; Atlanta, 2003.

  Presentation on quasi-equity funds system in Africa, "IFI Working Group Meeting on SME Finance", sponsored by

IFC with participation of USAID and European bilateral development finance agencies; Vienna, 2003.

Presentation to the Bangladesh Bank (central bank) on structuring government-sponsored SME funds; Dhaka, 2003
Presentation on "Financing the Middle Class in Developing Countries", a seminar for USAID officers and SME finance contractors; Washington, 2002)

Presentation on selection criteria for the use of the Millennium Challenge Account at the USAID sponsored meeting of the Advisory Council on Voluntary Foreign Assistance (ACVFA); Washington 2002.

- With full-time staff of only two to four persons during the Grant period, the Institute has been engaged in training and advisory assignments for an extraordinarily diverse clientele. Among such clientele are major publicly-funded development organizations, including the Asian Development Bank, International Finance Corporation, Inter-American Development Bank, the World Bank (IBRD), USAID. Furthermore, the Institute has received contracts with full or partial funding from an equally diverse group of agencies and ministries of national governments, including those of the following countries:

Bolivia	Namibia
Brazil	Oman
Chile	Rwanda
China	Trinidad and Tobago
India	Rwanda
Jordan	Zambia
Kuwait	

- An Internet search using the Institute's full name as key words through the Google search engine currently produces more than 300 references.

Development of New SME Financing Technologies:

One of the principal mandates proposed for the Institute by its initial grantors was that the Institute identify best practices in risk capital for SMEs and advise its grantors and other stakeholders in SME finance of the potential and mechanics of such practices. After its first two years of operations, having met with officers from more than 50 SME funds on five continents, the Institute began work on the design of a model for SME risk capital with the intention that it combine those best practices into a replicable strategy for capitalizing, investing, and ensuring the viability of SME risk funds. The Institute's efforts in this regard have produced perhaps its most significant achievement and are likely to be the key to the expansion of its revenues and reputation.

Among the Institute's principal objectives in designing this strategy has been to address two of the most pressing issues in the relatively young field of SME risk capital:

- how to invest on a commercially sustainable basis in SMEs for which the prospect for exiting equity participations has traditionally been low, and

- how to attract private and institutional investors and competent fund managers to SME funds which, due to their comparatively high risk, are normally funded entirely by public monies.

The model of funds developed by the Institute to address these issues is based on a combination of proven best practices in small business finance worldwide. The capitalization plan for SME funds under this model is based on programs of a number of governments which provide low-cost leverage, debt guarantees, or "soft" equity to small business funds in order to attract more commercially oriented equity investors who would otherwise have considered SME investment too high-risk. Examples of this concept are the Small Business Investment Company (SBIC) program of the U.S. Small Business Administration (SBA), Israel's Yozma program, and the Australian Innovation Investment Funds. While these programs operate in highly developed environments, the leveraged fund concept is equally rational for virtually any developing or transitional market country.

The risk capital investment methodology of the SME funds proposed focuses primarily on the expansion of existing, early-stage SMEs. Such funds will ordinarily invest for significant minority equity positions in the SME investees while limiting their total exposure in equity to generally no more than 25% of the total amount invested in each enterprise. The larger portion of the investment will be in the form of relatively low-interest loans having attached rights to a small percentage of the investees' sales ("royalty rights"). In this investment strategy, returns to the funds are less dependent upon the determination of, and participations in, earnings, preferring rather a participation in gross sales. Even more significantly, returns on investment are not dependent upon third-party exits through public offerings and acquisitions.

In addition to these capitalization and investment strategies, the Institute has proposed that such funds be enhanced by the establishment of grant-based pools of monies (TA Facilities) outside the accounts of the funds in order to provide for additional, demand-driven technical and managerial assistance to SMEs in the funds' portfolios.

The Institute has now completed the full design for the model and its constituent parts, along with sample legal documents necessary to its implementation. Among the projects based on this work in which the Institute has been or is now engaged are the following:

- During late 2002 and early 2003, under contracts with the SME Department of the World Bank Group, the Institute designed a system of funds for Sub-Saharan African countries to be assisted and monitored under a single umbrella organization in the much the same way that a franchise is organized. Based on this work, the IFC is now in negotiations with the South African SME finance organization, Business Partners Limited, to serve as franchisor and establish a first three funds in Ghana, Kenya, and Madagascar.

- Under contracts with the USAID-sponsored AMIR program in Jordan, the Institute has advised the Jordanian government and the USAID-supported association of Jordanian information technology companies, Int@j, on risk capital for Jordanian SMEs in the IT sector. The Institute has recently been approached by Int@j and Jordan's ambassador to the U.S. to discuss the establishment of a fund following the model described above.

- The Institute currently has a contract with the Government of Rwanda to prepare all documentation, legal and descriptive, necessary to the establishment of a fund, again, based on the Institute's model and to assist in raising the fund and identifying its fund manager. The GoR has already issued a Declaration of Intent to provide $4 million in IDA loan proceeds as low-cost leverage for the fund.

- During 2001 and 2002, the Institute worked with USAID in Namibia to introduce the concept of risk capital to the country and to subsequently design a full program through which the GoN can sponsor one or more leveraged funds using the model. The GoN is currently discussing the possibility of using $5 million from the newly created Namibian Development Bank as leverage for the initial fund.

- The Institute is currently in discussion with officers of the Asian Development Bank with regard to establishing SME funds based on the model in Nepal and Pakistan, where an initial contract in this regard has already been completed.

- The South Asia Development facility of the IFC engaged the Institute several months ago to advise the central bank of Bangladesh on the use of a $50 million Equity and Entrepreneurship Fund (EEF) managed by the central bank. The IFC has subsequently approached the Institute about a longer contract to convert part of the EEF to leverage for one or more funds under the Institute's model.

- At the request of USAID's Office of Credit and Investment, the Institute has prepared a preliminary design for the use of guarantees from the Development Credit Authority to leverage SME equity funds. While, it appears that current legislation governing the DCA may preclude its use as recommended by the Institute, we hope to be able to work with USAID to expand DCA further into non-asset based financing mechanisms.

While the Institute is particularly active in working with governments and organizations to implement the model described above, it also continues to work on the identification and implementation of other innovative and successful risk capital practices, including strategies for larger funds seeking to invest in SMEs with the potential for exits of equity through sales to third-parties.

Non-Remunerating Activities Adding Value to the Field:

While the Institute is dependent upon revenues from advisory contracts and training, as originally contemplated, it has not become merely a non-profit consulting firm. On the contrary, the Institute regularly engages without compensation in advising development institutions, governments, and risk capital funds in best practices it has identified and in answering requests for information from around the world.

Moreover, as time permits, the Institute continues to perform research into issues of SME development and SME finance and has amassed a considerable collection of articles, websites, and contacts related to the field.

Self-Sustainability:

While the Institute has clearly not achieved the scale it initially projected norhas it been able to provide the diversity of services it sought to provide, it has been fully self-sustaining, without the need of grant funding, for more than a year. Although it has failed to reach its original revenue projections as proposed to USAID, it has, during the Grant period, nonetheless produced revenues in excess of five times the amount of grant funding provided by USAID and more than double the total amount of grant funding from all sources.

Weaknesses in Performance under the Grant:

Revenue Less than Targeted

The original projections presented to USAID called for a total of approximately $2.4 million in revenues during the Grant period. However, The Institute's actual revenues during the period amounted to just over $1.5 million. During its second year, the Institute learned that $200,000 of the $300,000 in grant proceeds expected from the MIF, some 22% of expected initial grant support for capacity building, was not to be disbursed, due at least in part to budgetary issues at the IADB. At the same time, while the Institute's first (and only) Global Practitioners Forum in SME Finance was universally considered a programmatic success, the event lost more than $100,000.

This combined loss of expected revenues essentially eliminated the organization's working capital and decreased staff from a budgeted five persons to only three, making it impossible to undertake the full range of anticipated activities.

Activity in the E&E Region Less than Targeted:

The Institute was unable to concentrate its initial efforts in the E&E regions as intended and has not yet been able to achieve significant benefits which are specific to the E&E region.

Of the full amount of the Grant, $290,000 was contributed by the E&E Bureau and $10,000 was contributed by the former Global Bureau. While it was understood that the Institute was to be a global organization without a permanent concentration in E&E, it was also understood that the Institute would make every effort to give greater attention to the E&E region in the early years of the Institute. To-date, however, the Institute has held only one seminar within the region. Furthermore the Institute has received no other contracts for work in the region, despite continuous efforts to obtain support for work there, within the context of the Institute's mandate to be financially self-sustaining.

We believe that the reasons for this failure to meet expectations within E&E include the following:

- Funding for development work within the region has decreased significantly during the Grant period.

- With the exception of the SEAF funds, most SME investment within the region has increasingly redefined "SME" in larger magnitudes of investment size such that most SME venture capital funds are more strictly commercial rather than developmental and better served by organizations such as the European Venture Capital Association (EVCA). For example the European Bank for Reconstruction and Development (EBRD) whose first SME equity funds in Russia were limited to maximum investments of $300,000, now sites as EBRD-sponsored "SME funds", investment vehicles which typically invest in the $1 million to $5 million range.

- EBRD has been persuasive with host governments in the region in its increasing bias in favor of bank credit lines. Interest in new risk capital funds targeting SMEs has declined as a result.

Despite these obstacles to a greater presence for the Institute in the E&E region, several of the Institutes seminars in the U.S. and elsewhere have been attended by participants from E&E countries. Moreover, the Institute's staff and "faculty" (described below) have their greatest concentration of experience in the E&E region and it is hoped that this will lead to further engagement in the region.

Decision Not to Establish the Institute as a Member-Based Association:

It had originally been the intent of the Institute that within its first two years, it would take on the characteristics of a member-based association for SME risk capital funds and their stakeholders. As such, the Institute would provide, within a more modest scope, services similar to the EVCA in Europe and the National Venture Capital Association (NVCA), the National Association of Small Business Investment Companies (NASBIC), and the Venture Capital Institute in the U.S. The underlying assumption of this effort was that there is a clear distinction between private equity and venture capital organizations in developed countries and SME-oriented vehicles in developing and transitional economies. While this assumption remains true, what was not well understood at the time is the vast heterogeneity among SME funds and the extent of costs involved in establishing a global association of such a heterogeneous membership. Therefore, for the following reasons, the Institute elected not to become a member-based association:

- As the Institute began to perform research on, and make contacts with, practitioners of SME risk capital, it became increasingly evident that there is a substantial separateness between those SME funds combining developmental and financial objectives and the many so-called "SME funds" with purely financial objectives. This latter group, as mentioned above, typically invests at the $1 million to $5 million level in substantially larger companies than, for example, Small Business Investment Companies (SBICs) in the U.S. whose average investment at present is less than $600,000. With such disparities among SME funds, it became difficult to design member services which would at once be relevant and useful to the broad range of funds within these two basic categories.

- The Institute's initial projections for the costs of membership acquisition and servicing were significantly underestimated. Given the financial and staffing constraints described above, it became clear during the first year that the Institute might risk being in a position of having collected member fees and then being unable to provide services justifying such fees.

Current Status and Future Plans:

Structure:

The Institute has recently undergone a restructuring. One of the issues it has had to face is the unpredictability of the amount and timing of revenues. Another issue less common to other organizations is that the advisory and training work which the Institute undertakes is of such a specific nature and at such a high level of technical detail that only experienced investment practitioners are appropriate to the provision of such training and advice. Appropriate professionals in risk capital are generally those who are still engaged in the practice in some form. Moreover, the Institute could not hope to be able to afford to hire such individuals on a full-time basis.

Therefore, the Institute has reorganized into a small organization with only two full-time professionals, both experienced in private equity and venture capital in developing and transitional economies, while putting together a "faculty" of high-level practitioners who work with the Institute on its training and advisory engagement on a part-time, sub-contractor basis. Examples of this group of practitioners who work with the Institute include[1]:

- Austin Belton, former Wall Street senior banker, investment officer with the funds department of Overseas Private Investment Corporation (OPIC), for senior advisor on SME equity funds with the MI, and most recently head of the New markets funds program of the U.S. Small Business Administration.

- Christopher Davis, New York-based venture capital attorney, former attorney at the Ford Foundation and the OPIC funds department as well as author of key documents used by the SBIC program of the SBA.

- Robb Doub, managing partner of New Markets Growth Fund (based at the Dingman Center of the University of Maryland), with eight years prior experience as an investment officer and fund manager for SEAF in Eastern and Central Europe.

- William Grant, former small business banker in the U.S., former co-manager of international programs for Shorebank, and current director of small business lending for the Eurasia Foundation.

- Robert Stillman, former venture capitalist (30 years experience), foremer vice president for equity funds of OPIC, assistant administrator of the SBA, and head of the SBIC program, and current president of Milbridge Capital.

These individuals and other professionals have worked with the Institute on both training and advisory assignments in increments of between two and twenty days per project. In the case of their work with the Institute, because it is a non-profit development organization and because they find the find the work stimulating, these professional are willing to be paid daily fees which, while significant, are far below their

[1] All of these persons work with the Institute on a part-time basis with the permission of their current employers, including those who work for the U.S. government.

market value. Once again, professionals of this level of experience would likely be both unobtainable and unaffordable as full-time staff.

Future Plans:

Given that the model for capitalization and investment described above represents an amalgam of what the Institute has found to be best practice for the smaller, more developmental SME investments generally overlooked by venture capital and given the positive global reception of the model, much future activity of the Institute may involve the adaptation and assistance in implementation of the model in various parts of the world.

Nonetheless, the Institute is still engaged in promoting a relatively broad range of risk capital strategies for a broad spectrum of SME-oriented investment vehicles and programs. For example, the Institute recently conducted a two-day seminar sponsored by the Venture Capital Incentive Programme of Trinidad and Tobago. The seminar was for SME fund managers and officers of financial institutions and governments throughout the Caribbean region. Participants included representatives of funds investing as low as the $50,000 level and as high as $2 million per investment. The Institute presented a wide variety of instruments and strategies, including a number pioneered by SEAF for SME investments where third-party exits are anticipated.

In all of its contracts, the Institute builds in substantial margins such that money will be available to pay for work done without compensation and in the hope that the Institute may be able at some tome to hire additional support staff and to begin to expand its services in the directions originally envisaged.

While the Institute is currently self-sustaining, it is difficult to predict at this point the extent to which it will be able to grow in the future. Certainly such growth will require additional grant funding as well as contract revenue. However, the Institute has not yet recommenced its efforts to obtain grant funding, given the significant time entailed in such efforts.

Finally, the Institute would welcome from USAID the identification of potential opportunities, both paid and unpaid, for the Institute to be of greater value in the E&E region.

Final Budget Statement for the Three-Year Period of the Grant

On the following page (Attachment 1) is a final statement of the use of proceeds from the Grant as well as cost-share figures. Given that Grant proceeds were used to augment cost-share funding from other sources in all line items in which Grant proceeds were expended, line item allocations for Grant proceeds are exactly as projected.

We remain grateful to USAID and to the Grantee, SEAF, for their generous support in Institute's activities.

Sincerely,

Tom Gibson

Attachment 1: Final Budget Statement