Making impact investment a financing solution for African businesses

Florian Léon, Sitraka Rabary

FONDATION POUR LES ÉTUDES ET RECHERCHES SUR LE DÉVELOPPEMENT INTERNATIONAL

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Investing

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Florian Léon, Sitraka Rabary

Florian Léon, Reasearch Officer, FERDI

Sitraka Rabary, Reasearch Assistant, FERDI

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CETTE PUBLICATION A BÉNÉFICIÉ D'UNE AIDE DE L'ÉTAT FRANCAIS AU TITRE
DU PLAN D'INVESTISSEMENT FRANCE 2030 PORTANT LA RÉFÉRENCE ANR-16-IDEX-0001.

In the face of climate and social challenges, the financial sector can no longer limit itself to an approach focused solely on profitability. Two movements are converging. On the one hand, more and more players are calling for the extra-financial impact of investments to be taken into account in their strategy. International regulations, such as the ISSB and the CSRD, are putting increasing pressure on companies to do so. On the other hand, development financiers (governments, foundations, international financial institutions) are looking for innovative ways to accelerate growth in poor countries and contribute to global public goods through the private sector.

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. . . /. . . It is this dual demand that is being met by impact investors, a category of players that essentially began to emerge at the turn of the century. While the industry has emerged in North America and Europe, it is developing rapidly in emerging markets. In Africa, impact investing is still in its infancy, despite strong demand for capital from high-impact companies.

This note is based on the results of a study conducted by FERDI's Impact Investing Chair (Léon and Rabary, 2024). It proposes a series of recommendations to make impact investing a major tool for financing African businesses and the continent's development.

Impact investing, a general interest player in the market

Impact investors contribute to a voluntary, predefined mission of general interest, with measurable results, through a market activity - most often investments in financially sustainable private companies. They distinguish between the economic and social profitability of their investments, and the financial profitability, which for some may fall short of market expectations. The impacts sought may be economic (e.g., direct and indirect job creation), social (e.g., improved levels of education or health), environmental (e.g., reduced pollution) or governance-related (e.g., formalization of businesses, reduction in corruption).

All private investments have positive and negative impacts, whether direct or indirect. A "traditional" responsible private investor will seek to maximize profitability. Impact investors differ from traditional investors in that they intend to make an impact, and they link financial profitability to the achievement of the impact they have chosen as their mission.

For example, the issue of employment in Africa is a major challenge in the context of rapid demographic growth and limited economic growth. The challenge is enormous, with only a quarter of the newly active finding formal employment (African Development Bank, 2018). An impact investor whose mission is formal employment in poor African countries will seek to support start-ups and small and medium-sized enterprises (SMEs) that meet this mission. Taken together, these investments could have a significant impact on job creation, and the businesses supported are financially successful. However, the combination of the loss experience of these companies in complex political and security environments, tax and exchange rate losses, the cost of approaching the small companies financed, and other factors could lead to a low net profitability for the financiers of this impact investor (Severino, 2023).

In all cases, impact investors must demonstrate "additionality". It is not enough for them to choose a mission and pursue it in the marketplace to claim to be in this category. They must support projects and companies that are neglected by other financiers, otherwise they would have no legitimacy to distinguish themselves from, for example, traditional responsible private investors. This explains why impact investors will operate primarily in disadvantaged areas as well as in emerging industries (Cole *et al.*, 2023). They also seek to maximize the extra-economic benefits of their investments (extra-financial additionality). In other words, even if a traditional investor and an impact investor are financing the same project, the latter will pay attention to the impacts generated and will therefore encourage the financed company to maximize these impacts. In this case, it is even very likely that maximizing these extra-financial impacts is the reason for the investor's intervention.

Impact investing, a promise for the African continent

Impact investing can make a significant contribution to the development of the African continent. We have already mentioned its contribution to

job creation, especially in the continent's poor and fragile countries. It provides a financing solution for SMEs in Africa. These companies have difficulty accessing debt and equity financing due to a perceived unfavorable risk/reward ratio and a lack of domestic savings. This lack of finance hampers the growth prospects of these businesses, inhibits entrepreneurial dynamism and ultimately penalizes economic development (Buera *et al.*, 2011).

The development of formal firms in Africa also generates many positive impacts beyond the employment that impact investors promote. Businesses are a source of tax revenue for governments and foreign currency when they export (or substitute for imports). By providing decent jobs and social protection, formal enterprises also offer an opportunity to improve the health of workers and their right holders. Similarly, workers can invest in their children's education. Enterprises are also a source of emancipation for women, who can gain financial independence. Finally, the impact can also be environmental, as formal enterprises have a greater responsibility in this area than informal ones.

There are many other contributions to African development that impact investing is making, and could make even more.

The first of these contributions is access to basic goods and services. The energy, health and education sectors are particularly affected. Impact investors are playing an essential role in the development of decentralized green energy on the continent, in places where public authorities do not provide access to the grid, or do so inadequately, especially for the most disadvantaged citizens, but also for businesses. In education, families are looking for alternatives to public education, which is sometimes inaccessible and sometimes of insufficient quality. In health care, impact investors are supporting numerous private or mutual initiatives aimed at the middle and working classes. In fact, wherever public authorities are unable or unwilling to provide basic services, impact investors seek to formulate and support pragmatic solutions adapted to people's financial resources.

A second category of initiatives targets financial and economic inclusion. This is a long-standing theme of general interest, which has been addressed in particular by microfinance. Impact investors are extending this historic mission in Africa by supporting technological innovation by African players. They also support the development of digital marketplaces in all areas, including employment. They enable African products to access international markets via digital platforms.

A third of these contributions benefits the environment. A generation of impact investors is increasingly responding to climate change. This is obviously the case when it comes to reducing emissions. We have just mentioned investment in decentralized green energy. But it is also the case with carbon offsetting, where impact funds support sustainable solutions that generate carbon credits. We are also seeing the emergence of a growing number of initiatives supporting adaptation to climate change, for example.

Finally, nutrition represents an important potential contribution of impact investing. Africa's dependence on imports, low agricultural productivity, poverty and demographic growth, which result in both a large rural population and rapid urbanization, climate change and biodiversity loss, create a central public policy issue in which impact investors can play an important role by supporting the creation and development of a sustainable agriculture and agri-food and distribution sector.

As we shall see below, this potential is still insufficiently and unevenly realized.

Impact investing in Africa: a highly diverse landscape

Despite the promise of impact investing in Africa, the scale of the potential contributions to development and the multiplicity of initiatives that have emerged since the turn of the century,

little is known about this sector and the obstacles to its development. The Impact Investing Chair (subsequently, the Chair) of the FERDI has initiated a study (Léon and Rabary, 2024) aimed at lifting the veil on this industry while studying the constraints faced by impact investors.

Impact investors were identified based on five explicit criteria that distinguish them from traditional investors. The mapping exercise identified 255 impact investors active on the African continent. For each of them, we collected general information (name, date of incorporation, location of headquarters, size, financial instruments, sector of interest). In addition, for a limited sample of investors, the mapping extracted data on the portfolio, identifying 1,148 companies funded by 74 investors. Finally, the study included interviews with several fund managers.

The richness of this new data has made it possible to highlight some key facts about impact investing in Africa.

First, the distribution of funds is very uneven. A few very large structures dominate the volume of activity. Mega-sized funds (defined as those managing more than $1 billion in assets) account for only 7% of the number of funds, but generate more than 80% of the total activity on the continent.

Second, Africa-based investment funds are small players in the market. African impact investors account for 40% of all structures, but these structures manage just over 15% of assets. Furthermore, funds based on the continent are concentrated in a handful of countries. Five countries (South Africa, Ghana, Kenya, Mauritius and Nigeria) account for three-quarters of African funds and 95% of assets under management in African funds.

Third, investment is very unevenly distributed. Geographically, a few markets attract the majority of investment. For example, most of the companies financed are located in three English-speaking countries: South Africa, Kenya and Nigeria. In contrast, investment fund activity in Central Africa is very low. The sectoral distribution is also concentrated on a few sectors. The main sectors targeted are agriculture, finance, energy, health, technology and education. This distribution, and in particular the importance of agriculture, highlights the dual constraint of impact investing. On the one hand, fund managers need to target high-impact sectors. On the other hand, they need to find profitable companies to finance. As a result, low-impact sectors (such as extractive industries) or sectors without profitable companies (such as social sectors) are largely neglected.

Impact investing: still not enough momentum

Although the sector is growing strongly in Africa (14% per year according to the Global Impact Investing Network), this figure needs to be put into perspective given the strong growth of impact investing globally (18%), particularly in mature markets (over 30% in the United States and Europe). The mapping also highlights another worrying finding: the slowdown in the emergence of new structures since 2020. This dynamic is at odds with very strong demand, given the large number of high-impact companies that are unable to raise capital. It remains to be seen whether recent initiatives such as the Mastercard Africa Growth Fund or FASA (a joint initiative between USAID and NORAD) will change the dynamic.

There are a number of barriers to the development of the impact investing in Africa.

First, many funds struggle to attract capital, whether from private or public sources. This issue is particularly critical for new structures that are struggling to complete their fundraising rounds. Although capital is available to invest in the sector, new funds often lack the capacity to meet the requirements of these financiers, who, with the notable exception of the Mastercard Foundation, have become overwhelmingly public. The decline in international direct investment has reduced the number and financial strength of mul-

tinational corporations willing to support impact investing, which they have done despite its low profitability because of the strategic co-benefits they expected. International institutional financial investors, which initially had little presence in Africa, have disappeared.

Second, as the mapping shows, there are few local investors, which reduces the ability to raise funds. African investors are only modestly replacing international investors, reflecting the continent's limited national savings. The small number and size of African industrial and financial enterprises means that they play a significant role, but it is essentially local and sub-regional. They are concentrated in the continent's largest countries. Pension funds, regional development banks and African sovereign wealth funds are beginning to take an interest in the sector, as in the case of the Fonds Souverain d'Investissements Stratégiques du Sénégal (FONSIS) or the West African Development Bank (BOAD) in the WAEMU, but the movement is still small. The limited contribution of African investors also creates a currency mismatch problem. International investors have capital in hard currencies (dollars, euros), while local companies need funds in local currencies. This leads to exchange rate risks with local currencies that are sometimes unstable, such as the Ghanaian cedi or the Nigerian naira. The profitability of investments can therefore be undermined by the depreciation of the local currency.

A third difficulty that undermines investor returns is the difficulty of exiting on favorable terms. The investment fund model is based on an expected return at the time of exit. This means that fund managers must be able to find shareholders willing to buy back their holdings at fair value, thereby realizing a capital gain. Aside from the foreign exchange risk mentioned above, investment funds have difficulty finding international or domestic investors willing to buy back shares in companies at the expected price. Investors are often forced to sell their shares at a lower price than expected. For example, they may have to sell to owners who do not have the same financial resources as international funds. In addition, impact investors are often forced to delay their exit in order to improve the terms of their exit. The use of so-called "self-liquidating" financial structures (mezzanine, semi-equity, long debt, etc.) is often cited as a way around this problem. But it runs up against a fundamental problem: many small African businesses are already heavily indebted, and their rapid growth requires them to find financing that does not depend on the cash flow capacity of the business to repay it. This is obviously true for the entire start-up sector, and even more so for the technology sector. This explains why, despite regular calls for their development, these so-called "self-liquidating" structures have had only modest success.

Finally, managers are disadvantaged by the difficulty of accessing skilled labor. Impact investing requires not only good financiers, but also people who are at the forefront of impact measurement. Both types of talent are in short supply on the continent. Investment funds face competition from other structures that offer better salaries and career prospects (such as international funds or large development institutions). This difficulty makes funds more vulnerable, both in terms of investments and their ability to credibly measure their impact. Measuring impact is a complex activity that involves going beyond direct short-term effects (Severino, 2022). The ability to produce reliable data on impact also tends to reassure capital providers, thereby facilitating access to capital. However, it is difficult to find human resources at an acceptable cost for impact funds.

Recommendations

The results of our study suggest that while impact investing certainly plays an important role in specific niches, such as entrepreneurship, its macroeconomic contribution is still limited, despite its very significant potential to address a wide range of important public policy issues on

the African continent, all at a moderate cost to African and international public finances due to the expected active participation of private capital in its development.

The main concern at the moment therefore does not seem to be to multiply the number of pilot projects, which are numerous and many of them convincing, but to scale them up. Under these conditions, the question of financing and the number of active teams on the ground can only be at the top of the list of concerns, especially if we take into account the results of our study, which show a worrying reduction in the number of funds created over the last three years.

There are a number of levers that can be pulled to make this sector a major player in financing high-impact ventures on the continent.

Simplifying access to public capital to reduce the financial constraints on impact investing funds is a priority action. Public resources should be made more accessible to impact investing funds, especially small and local ones. A number of blended finance facilities have recently been established by major donors such as the World Bank (through the Private Sector Window) and the European Union (through the Africa Investment Facility). These facilities provide grants, offer guarantees, or allow for the creation of subordinated tranches to cover any initial losses incurred by investors. They are crucial to enable greater involvement by public private sector financing institutions or DFIs (European EDFIs such as Proparco or FMO, IFC, AfDB, etc.), whose historical business model imposes significant financial constraints. Nevertheless, these institutions still seem to be insufficiently accessible to impact investing funds. Public institutions have a de facto monopoly on access to these facilities. The procedures to access them are cumbersome and costly. As a result, disbursements from these mechanisms are slow. These two levers must be used to expand access to public finance. It is hoped that the USAID-NORAD initiative will contribute to a major change in the next few years. However, this initiative is focused on the agriculture and agri-food sector. As important as it is, it covers only part of the impact investing landscape in Africa. Similarly, African governments could do more and better to finance this sector by relying on public financial institutions and their sovereign wealth funds. Finally, we suggest that access to these facilities be extended to actors other than DFIs to speed up disbursements and broaden the range of beneficiaries.

Developing the contribution of African and international foundations to impact investing is also an avenue to be pursued. The Mastercard Foundation has begun to make a difference that could be systemic, particularly through its MFAGF fund of funds. Others could follow this path. They can follow two technical paths: investing their capital in impact investing in line with their impact mission, and using their resources for grant-making to support the capital and capacity of impact funds. Despite the growing interest of international foundations in impact investing, Africa remains a poor relation in terms of their mobilization.

The main potential source of additional international private capital for impact investing seems to lie with major international investors. In our view, this means creating funds of funds for them. The difficulty in targeting African impact funds lies in the fact that large foundations, family offices or institutional investors tend to intervene with high unit amounts that cannot be absorbed by most funds operating in Africa. One solution to this problem is to rely on funds of funds. These structures pool contributions from different owners of capital to finance investment funds. This is why recent initiatives such as the MasterCard Foundation Africa Growth Fund or the aforementioned NORAID-USAID FASA have emerged. But we need to go further and harder, which means creating structures that are acceptable to large international private institutional investors or African pension funds. This also means addressing their liquidity and return constraints. We propose that public actors create global funds of funds that could be listed and/or for which

they would provide liquidity to address the first constraint. The second, profitability, is a more general issue that is currently being addressed through a mix of public and private resources.

Greater attention could also be paid to improving the profitability of impact funds for investors, especially public investors. There are two possible ways to do this.

A first series of avenues relates to the intrinsic profitability of investments. The selection and monitoring costs borne by the funds have little correlation with the amount of the initial investment. Impact investors often invest limited amounts in financed companies. The result is a low return on investment. This return can be further undermined by unfavorable exit conditions that force investors to sell their holdings at a lower price than expected at the end of the investment cycle. Finally, young companies can take a long time to become profitable and therefore attractive to standard investors, particularly in the African context. Several solutions can be envisaged to improve this profitability. These include improving exit conditions by generating secondary markets. Institutional investors could also move away from traditional investment fund structures by accepting longer investment periods and more flexible exit dates. The example of Laiterie du Berger presented in the report highlights the importance of being patient in order to recoup one's investment! A standard solution for dealing with this issue is to move away from investment fund formulas towards financial company formulas with an unlimited lifespan, making it easier to make investments with longer exit horizons.

Another avenue to explore is to **find mechanisms to improve the risk/return trade-off** for those allocating capital to impact investing. The study highlighted the dominance of exchange rate risk for investors, but impact investors face other macroeconomic and extra-economic risks, starting with relatively high management costs due to the small size of final investments. There is a wealth of thinking about de-risking tools. As we argued above, blending mechanisms to cover both the exchange rate problem and management costs should be of greater benefit to private investors, not just DFIs. Another approach would be to look more closely at investment structures that are based in the countries where the investments are to be made, and that are financed to a significant extent in local currency.

Finally, **investment funds would benefit from a move upmarket, especially but not only in terms of measuring impact**. Many funds are young and inexperienced. The quality of funds could be improved through technical assistance and sharing of experiences. In addition, there is currently a lack of training specific to the industry, which reduces the supply of skilled labor. Similarly, the dissemination of best practices, especially in terms of impact measurement, and the improvement of the dialogue between practitioners and the research community are ways to spread best practices. Funds can also act at their own level by aligning incentives with their own logic. For example, case managers could have incentives linked to both financial performance and impact. The resources devoted to improving methods and teams are a costly investment, but useful in giving the fund credibility and attracting capital.

Impact investing is an innovative financing solution that is part of the process of incorporating co-benefits into finance. The development of this industry opens avenues to fill the financing gap faced by many high-impact African enterprises. Making impact investing a sustainable financing solution involves facilitating access to public and private capital for funds, addressing the factors that affect the profitability of funds (particularly foreign exchange risk and exit conditions), and improving the quality of funds through a combination of solutions such as technical assistance and lessons learned.

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Contact
www.ferdi.fr
contact@ferdi.fr
+33 (0)4 43 97 64 60

n° ISSN : 2275-5055

Publication director: Patrick Guillaumont