

# Private Sector Development Finance to Support the ‘Missing Middle’

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## Question

*What evidence is there for successful private sector development interventions on financing the missing middle of underserved SMEs in developing countries?*

- *Either through direct financing or a combination of blended finance, deal support or technical assistance.*
- *For application in Zambia but relying on evidence from a wide range of developing country contexts.*

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## 1. Summary

**Evidence indicates that business support to small and medium enterprises (SMEs) in lower middle-income countries (LMICs) can improve firms’ performance, create jobs, and have a positive effect on labour productivity** (Piza et al., 2016). The impacts of some approaches to private sector finance such as traditional loans, grants and technical assistance have been studied

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empirically, but there is limited evidence of the impacts of non-traditional and innovative financing instruments (Mallen & Bungey, 2019; Piza et al., 2016). Of those financial instruments that have been systematically reviewed, matching grants, technical assistance and tax simplification have been found to positively affect firms' performance and job creation, and technical assistance has been found to improve labour productivity (Piza et al., 2016).

**Studies of financial instruments to support SMEs in LICs and LMICs tend to focus on particular markets or adaptations to traditional funding models rather than targeted outcomes such as sustainable employment creation** (Mallen & Bungey, 2019). No evidence of the impacts of PSD finance in Zambia specifically was identified for this report. The two systematic reviews identified for this study indicate that the majority of evidence in this area comes from Latin America. Grimm & Paffhausen (2015) suggest this is because the region has experimented more with active labour market policies and has been evaluating these policies longer. Both reviews also identified a disproportionate amount of research focused on micro enterprises by comparison to small and medium enterprises, however Piza et al.'s (2016) meta regression results found that larger firms are associated with larger impacts on firm performance, employment creation and labour productivity. A significant gap in the literature identified in this report is the tailoring of finance instruments to specific target groups such as women, groups exposed to discrimination when to accessing finance or firms outside capitals and larger cities. A review of bilateral spending on PSD found that funders are less likely to report gender and disability targeting of private sector ODA by comparison to other form of ODA spending (Meeks et al., 2020).

**This report explores evidence on the effectiveness of financing options available to bilateral donors to promote private sector development (PSD) in LMICs, however the evidence base for most financing instruments is extremely limited and much of the evidence is more than 5 years old.** The report seeks to provide a (non-comprehensive) list of available Overseas Development Assistance (ODA) eligible options and a more detailed examination of those options for which evidence was identified for this review. An open search for evidence on PSD interventions to support SMEs in LMICs and LICs was carried out, followed by a targeted search of interventions seeking to support medium-sized enterprises (the 'missing middle'<sup>1</sup>) in Zambia specifically. The report begins with a brief overview of the 'missing middle' challenge in Zambia. Section 3 explores recent trends in bilateral finance for PSD. The remaining sections of the report explore available evidence on the effectiveness of specific interventions: credit guarantees, matching grants, equity investment and permanent capital vehicles, mezzanine finance, and funds of funds.

## 2. The 'missing middle' in Zambia

**Zambia is an illustrative case of the concept of the 'missing' middle' in that the majority of firms are micro, owner operated, 'survivalist' enterprises (around 77%)** (Clarke et al., 2010, the most recent data available). Enterprises over 50 employees produce the majority of Zambia's industrial output, generate most of Zambia's exports and tax revenues, but they account for around

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<sup>1</sup> For the purposes of this report the missing middle refers to the lack of medium-size firms and access to financial capital needed for small and medium firms to grow. There is no standardised definition of medium size enterprises. The IFC defines medium enterprises as having between 50-300 employees, total assets and annual sales between USD 3-15 million (see World Bank, 2019 for further discussion).

7% of employment (Clarke et al., 2010, p.14). The mining sector accounts for the largest share of the economy, while the agricultural sector accounts for nearly three quarters of employment (Clarke et al., 2010, p.13). Around 70% of SMEs in Zambia are based in the agriculture sector, made up of small agricultural farms and retail traders, and based in rural areas (Clarke et al., 2010, p.16).

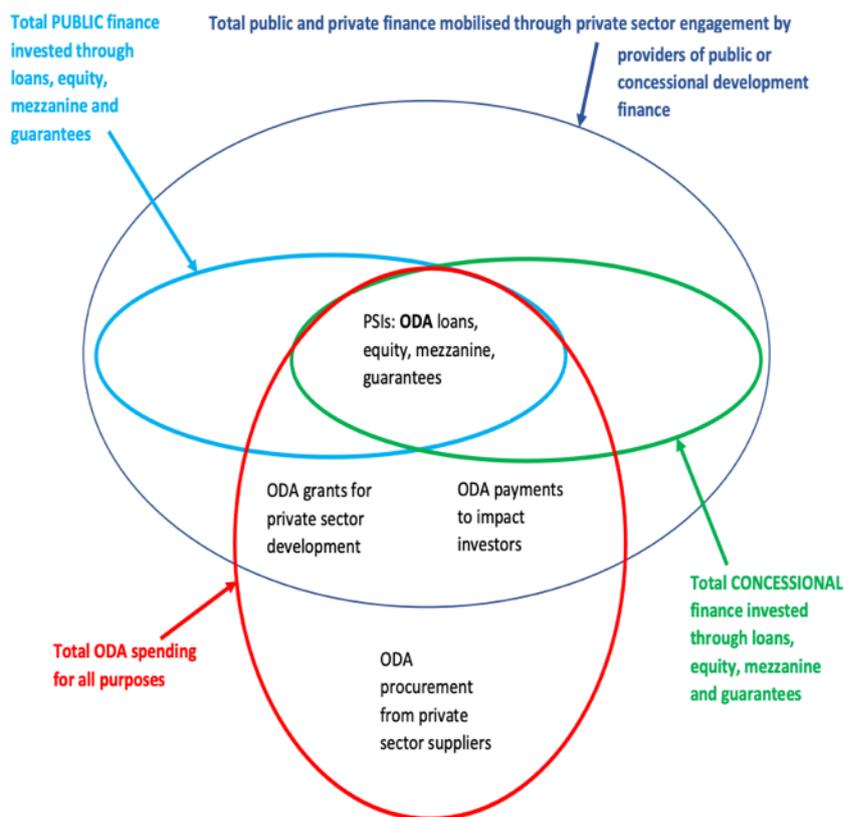
**The private sector in Zambia is uncompetitive by international standards and Zambia ranks mid-low on competitiveness by comparison to other countries in sub-Saharan Africa.** Zambia ranks among the lowest countries on the World Economic Forum's Global Competitive score, 120 out of 141 economies measured (Schwab, 2019). Particular areas where Zambia scores among the lowest in the world on the index (see Figure 1 for a breakdown of the index components) include: checks and balances, particularly the efficiency of legal frameworks and judicial independence; macroeconomic stability; flexibility of the labour market; and depth of the financial system, particularly venture capital availability and domestic credit to the private sector (Schwab, 2019). The need for financial support to PSD in Zambia and to strengthening the effectiveness of financial institutions and regulatory frameworks is therefore clearly evident.

Figure 1: Components of Zambia's Global Competitive Index Score, Source: Schwab, 2019, p. 602, [http://www3.weforum.org/docs/WEF\\_TheGlobalCompetitivenessReport2019.pdf](http://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf).

### 3. Overview of private sector finance instruments

**Financial support to SMEs in LICs and LMICs has grown, as has the range of PSD instruments being used by bilateral and multilateral donors to deliver financial support as part of ODA** (Meeks et al., 2020). Private sector instruments (PSIs) comprising loans, equity, and guarantees made up USD 2.46 billion of bilateral ODA spending in 2018, estimated to be around 2% of total bilateral ODA (Meeks, 2020, p. 9). Due to “gaps and ambiguities in the current Organisation for Economic Cooperation and Development Assistance Committee (OCED DAC) reporting arrangements... the true share of ODA devoted to PSIs is likely to be significantly higher” (Meeks et al., p.9). Meeks et al. (2020) offer a conceptual distinction between different PSD financing instruments (Figure 2). This rapid literature review, like Meeks et al. (2020), focuses on the area in the centre of the diagram, labelled ‘PSIs’, or private sector instruments.

Figure 2: Situating ODA PSD financing in the ecosystem of private investment



Source: Meeks et al., 2020, p.17, <https://eba.se/wp-content/uploads/2020/01/2020-01-Mobilising-private-development-finance-3.pdf>, licensed under the Creative Commons Attribution 4.0 International

**Inconsistent reporting of ODA contributed to PSD across countries and over time limits the ability to observe trends in the use of different instruments.** Meeks et al.'s (2020) recent survey of PSD finance among bilateral donors, informed by document reviews and interviews with bilateral agency staff, offers a snapshot of the main instruments being used by donor (see Table 1). Loans and equity are the most common approaches being used followed by mezzanine finance and guarantees.

Table 1: Types main PSD finance instrument by ODA provider

Instrument	ODA provider
Loans	Belgium, Canada, European Union, France, Netherlands, Norway, Sweden, United Kingdom
Equity	Belgium, European Union, France, Netherlands, Norway, Sweden, United Kingdom
Mezzanine	Belgium, European Union, Netherlands, Sweden
Guarantees	European Union, France, Netherlands, Norway, Sweden
Repayable grants	Canada
Shares in collective investment vehicles	Norway
First loss capital <sup>1</sup>	United Kingdom

Source: Adapted from Meeks et al., 2020, <https://eba.se/wp-content/uploads/2020/01/2020-01-Mobilising-private-development-finance-3.pdf>, licensed under the Creative Commons Attribution 4.0 International

<sup>1</sup> First loss capital describes a range of instruments where the investor undertakes to take the first loss (up to an agreed threshold) in the event of losses, in order to encourage other investors

**Two systematic reviews on the effectiveness of PSD interventions were identified that provide generalisable evidence on the effect of different instruments to support medium-sized enterprises.** Piza' et al.'s (2016) systematic review of business support interventions is the most comprehensive analysis of private sector development impacts identified for this report (see Key Websites at the end of this report for further information). Although the review does not cover all possible private sector financing options available to donors and only covers research up to 2014, the report appears to be the most thorough and most recent attempt to systematically measure the impact of PSD interventions across studies.

## 4. Credit guarantees

**Meeks et al.'s (2020) survey of bilateral donors identified a growing interest in the use of guarantees to deliver private sector finance.** The European Union is expecting to invest USD 11- 14 billion in guarantee liabilities from 2021-2027, the Government of Canada is introducing new regulation to allow the use of guarantees for development purposes and the Government of Sweden is planning to increase spending on guarantees (Meeks et al., 2020, p.42-43). "More than half of all countries in the world have a credit guarantee scheme in place and their popularity is growing" (World Bank, 2015, p.9)

**Credit guarantee schemes provide third-party credit risk mitigation to lenders through the absorption of the lender's losses on loans in the case of default, typically in return for a fee**

(World Bank, 2015, p.9). The combination of subsidy and market-based credit allocations are said to involve “less room for distortions in credit markets than more direct forms of intervention such as state-owned banks and interest rate subsidies” (World Bank, 2015, p.9). They have also been found to be relevant for increasing access to credit in LICs and LMICs with weak institutional environments because they facilitate improved “information available on SME borrowers in coordination with credit registries, and [build] credit organisation and risk management capacity of lenders (e.g., through technical assistance for the establishment of SME units” (World Bank, 2015, p.9). Credit guarantee schemes can also “be leveraged to provide countercyclical financing to SMEs during a downward economic cycle, when risk aversion may increase and a credit crunch is likely to develop (World Bank, 2015, p.9).

**A study of the impacts of credit guarantees for SMEs in Korea found a positive impact on firms’ abilities to maintain their size, increase their survival and lead to an increase in employment and wage levels (Oh et al., 2008).** The scheme was the main instrument used by the government of Korea to address a high rise in SME bankruptcies following the Asian financial crisis (Oh et al., 2008, p.338). Oh et al.’s study used propensity score matching to observe the impacts of Korea’s credit guarantee scheme on a sample of 44,013 firms that received credit guarantee support. Their results show a positive and significant effect on the outcomes noted above. However, they also observe adverse selection in terms of productivity whereby firms were being supported with lower productivity in order to increase their size and survival. The study did not find evidence that the guarantee scheme had an impact on total factor productivity growth, research and development (R&D) or on investment intensity (Oh et al., 2009, p.350).

## 5. Matching Grants

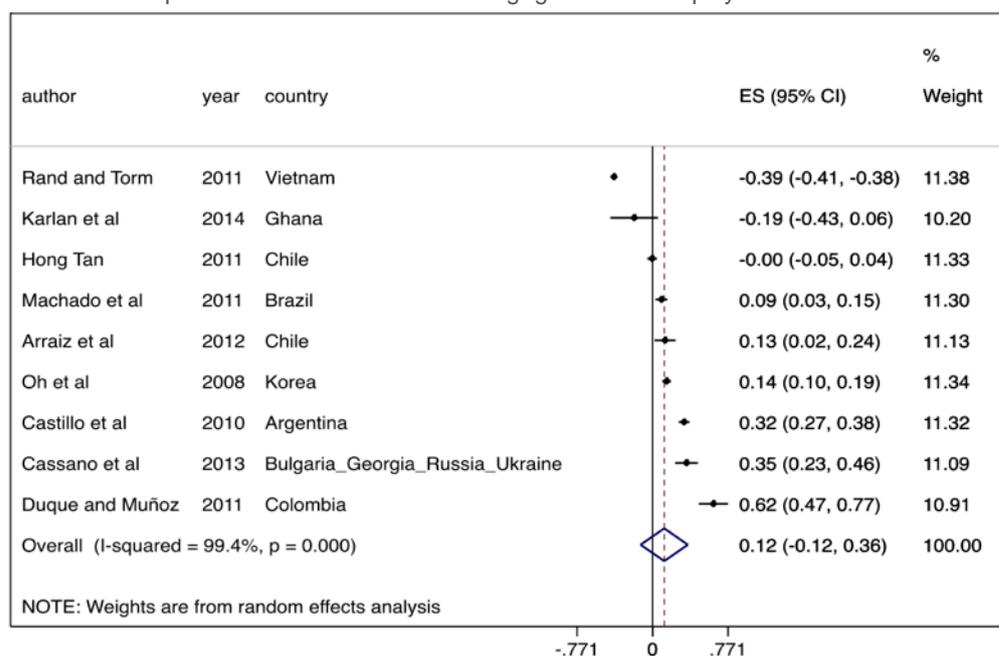
**Matching grants are one of the most widely used private finance instruments in African countries** (McKenzie, 2011). Matching grants involve reimbursement to firms for 50% of the cost of business services such as hiring consultants, marketing, training or for workers attending trade fairs (McKenzie, 2011, p. 606). “The typical justification for such subsidies is a belief that firms underinvest in these services because of externalities to other firms: for example, firms might hesitate to train workers if there is a chance that the workers will then leave and start their own firms or go to work for competitors” (McKenzie, 2011, p. 606). A review of World Bank completion reports found that a typical matching grant project involved USD 1-5 million and between 100-500 firms (McKenzie, 2011, p. 607). McKenzie’s (2011) review identified a matching grant programme in Zambia<sup>2</sup> involving 63 grants, the majority of which were below USD 50,000, 39% in the manufacturing sector, 30% in service, 14% in agriculture and 6% in tourism (McKenzie et al., 2011, p. 607).

**Due to the prevalence of studies of matching grants, they are one of the few PSD instruments that have been systematically analysed, with evidence showing a positive effect on firm performance and employment creation** (Piza et al, 2016). Piza et al.’s (2016) meta-analysis found matching grants to have a positive effect size of 0.12 standard deviations on employment creation. Figure 2 shows the effect size of each on employment of each of the study’s included in Piza et al.’s (2016) meta-analysis sample.

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<sup>2</sup> No evaluation of the Zambian matching grants programme was identified for this report.

Figure 3: Forest plot of the effects of matching grants on employment creation from Piza et al. (2016)



Note: Heterogeneity chi-squared = 1409.31, p = 0.000. I-squared = 99.4%. Tau-squared = 0.133. Test of ES=0: z = 0.97, p=0.33.

Source: Piza et al., 2016, p. 42, [https://www.3ieimpact.org/sites/default/files/2019-01/sr25-cida-business-support-review\\_gvw36pm.pdf](https://www.3ieimpact.org/sites/default/files/2019-01/sr25-cida-business-support-review_gvw36pm.pdf), reproduced with permission.

## 6. Equity investment and permanent capital vehicles

**Equity investment involves funding where the donor is allocated a shareholding, typically involving voting rights and rights to repayment on the breakup of the firm or to dispose of the shareholding** (EPS PEAKS, 2014, p. 5). “DAC guidelines on ODA concessionality for equity instruments are wider than for loans.... DFID’s interpretation of equity concessionality is that the investment has to be in an ODA eligible entity. Under current ODA regulations, the purchase of equity is an ODA flow and, therefore, the entire amount of disposal proceeds from that equity constitutes a negative ODA flow” (EPS PEAKS, 2014, p. 6). Meeks et al.’s (2020, p.35) review of bilateral aid to PSD found a decrease in equity investment between 2012-2017 from USD 528 million to USD 455 million, though this instrument remains one of the more common instruments used across bilateral donors (see Table 1 above).

**Longer-term investment horizons have been encouraged to overcome some of the leading challenges faced by SMEs including “perverse incentives to deploy capital too quickly, forcibly exiting deals at the wrong time, and the inability to scale deals over time”** (Mallen & Bungey, 2019). Mallen & Bungey’s (2019) study found that fixed term funds were one of the leading impediments to effective finance for SMEs. According to their survey of investors, “funds with fixed term fund life can lead to forced exits at a time when the SME lacks liquidity and the investor must accept a lower, undervalued, sale price” (p.6). Permanent capital vehicles have been recommended as “a means of making longer-term equity investments beyond the standard ten-year private equity model, in order to help businesses, grow in difficult markets” (ICAI, 2019, p.19). No evaluations of permanent capital vehicles were identified for this report.

## 7. Mezzanine finance

**Mezzanine finance is a hybrid of debt and equity and is typically used as a substitute to equity to increase the financial leverage of transactions** (EPS PEAKS, 2014, p. 19). In practice, Mezzanine finance serves as “debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full” (EPS PEAKS, 2014, p. 19). Mezzanine finance can take on various forms. Figure 3 provides an overview of the main mezzanine finance instruments according to different debt-equity ratios.

See: Figure 3: Main mezzanine finance instruments by debt-equity ratio, Source: Benink & Winters, 2016, p.8, <https://www.smefinanceforum.org/sites/default/files/post/files/mezzanine-finance-final.pdf>.

**This type of finance typically involves adapting existing ‘traditional’ investment instruments to address the specific needs and risks associated with medium sized firms** (Benink & Winters, 2016). The blending of equity and debt is seen as a means to balance out risk, the financial sustainability of ODA investments and broader development goals (EPS PEAKS, 2014).

“The suitability of certain instruments for a given deal depends primarily on the company’s cash flow generation and exit potential, with all mezzanine structures requiring at least one of these two characteristics to be present. However, restrictions to some instruments can also relate to (financial and tax) regulation and other local factors, making some instruments less suitable for certain regions”.

(Benink & Winters, 2016, p.8)

**No studies or reviews of the impacts of mezzanine finance were identified for this report.**

One documented example of mezzanine finance, however, is Green Africa Power (GAP), a funding facility established by the Private Infrastructure Group Trust (PIDG) and funded by DFID. GAP provided “a minimum coupon in early years with capital repayment after equity IRR [internal rate of return] to ‘back-end load’ cash flows” and a “contingent line of credit to draw down in case of delays or cost over-runs in constructions” (EPS PEAKS, 2014, p.81). The fund supported the Senergy 2 solar plant in Senegal and the first geothermal independent power producer in Ethiopia. As of 2017 the Synergy 2 plant was reported to be fully operational and due to repay its short-term construction loan the following year. Funding for Ethiopia’s geothermal plant had also been secured (PIDG, 2017, p.73). No evaluation of wider development benefits was identified, however GAP closed after its initial funding window citing a lack of “projects in the power sector that were sufficiently developed to justify continuing with a specialised facility which trades only in intermediate capital products” (PIDG, 2017, p.73)

## 8. Funds of Funds

**Funds of funds for ODA finance are not systematically defined in the literature, but the general concept involves a broad portfolio of investments that contain underlying portfolios of other funds.** DIFD’s Impact Fund, managed by the CDC (the UK’s development finance institution), is one example of a Fund of Funds as are Norway’s Norfund and the Dutch Good Growth Fund. A recent country-level Fund of Funds was established by the UK-India Fast Track Start-up Fund. Some of the financing instruments described above feature in these funds, however the mix of instruments under one larger fund also serves as an instrument in its own right. This

section describes Norway’s Norfund as it offers a well-documented and evaluated example of a fund of funds.

**Norfund was established in 1997 as a company with limited liability, wholly owned by the Norwegian Government with a mandate to “create sustainable commercial activities in developing countries”** (EDFI, 2016, p.44) The fund invests a significant amount in low-income countries, particularly in sub-Saharan Africa, and while investing a significant portion of its funds in the renewable energy sector, Norfund has also increasingly taken on higher risk investments in sectors such as agribusiness (EDFI, 2016; NORAD, 2015).

**The three main financing instruments used by Norfund are equity capital, mezzanine financing and long maturity loans** (NORAD, 2015, p.18). Equity investments make up 60% of Norfund’s portfolio, followed by SME funds, loans and mezzanine finance respectively (NORAD, 2015, p.19). Nearly half (49.4%) of investments were made in the renewable energy sector in 2013 (latest data available) followed by financial institutions (23.9%) and industrial partnerships, primarily in agribusiness (11.4%). The latest Norfund evaluation, one of the more comprehensive evaluations of bilateral finance to PSD identified for this report, allows for the estimation of jobs created by type of investment (see Table 2). While the evaluation authors caution that these estimates are imprecise given the lengthy and complex causal chain between private sector investment and employment creation, they do offer some guidance on the comparative effectiveness on employment creation for different areas of investment.

**Norfund has a strong gender component which “supports portfolio companies in sending talented participants to the Female Future Program, a program that trains women in rhetoric, leadership and board competence... and sets requirements for a gender balanced share of participants”** (Norfund, 2020, p.3). The fund’s 2015 evaluation identified the agricultural sector as having potential for gender (co-) benefits given women’s roles in agricultural development and food security but limited access to credit, lack of land ownership and limited ability to hire labour (NORAD, 2015, p.17). Norfund’s increasing share of investment in the agricultural sector has been largely in the form of equity investments.

Table 2: Employment created by NORFUND per million Norwegian Krone (MNOK) invested by investment area, 2013

Investment type	Women employed / MNOK	Jobs (direct) / MNOK	Total jobs
Financial Institutions	17.3	48.0	127,000
Industrial partnerships	1.8	11.1	40,000
Renewable energy	0.02	0.07	6,000
SME funds	6.2	14.7	141,000
<b>Grand total</b>	<b>45,337 jobs</b>	<b>126,990 jobs</b>	<b>5,884.5</b>

Author’s calculations based on NORAD, 2015, p. 200, <https://www.norad.no/globalassets/import-2162015-80434-am/www.norad.no-ny/filarkiv/evalueringssavdelings-filer/evaluation-of-the-norwegian-investment-fund-for-developing-countries-norfund1.pdf>

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