USAID

FINANCIAL SECTOR PROGRAM

Report on the model & appetite for a Debt Fund to support SME lending in South Africa

May 2011

FSP FINANCIAL SECTOR PROGRAM

USAID FROM THE AMERICAN PEOPLE

NeXii Where capital meets impact

Agenda

- Introductions
- Research Scope
- Assessments
    - Demand for the Fund
    - Regulation and Incentives
    - Risk Appetite of South African Bond Market
- Fund / Bond Structure Options
    - Enterprise Impact Fund / Bond Options
    - SME Development Fund Options
- Overview and Key Findings
- Recommendations and Next Steps

Research Scope

- Identify profile and rank possible partner firm(s) that could use the bond guarantee to raise capital and manage on-lending applications to NBFIs:
  - Create a detailed profile of key players in the South African market to determine a short list of candidates who can hold the guarantee, use it, and apply the funds.
  - Define characteristics that candidate must have in order to be considered for the shortlist.
  - Determine which firms meet the criteria enumerated above by applying the criteria and ranking accordingly.
- Understand the risk appetite of the South African fixed income market:
  - Compile a summary of the last three years of non-sovereign bonds segmented by risk rating. Within each risk rating, identify the average amount of bond, tenor and pricing.
- Define the potential demand of target applications of the fund:
  - Estimate the financing need of NBFIs in the market place to determine potential market demand for on-lending capital to meet SME credit needs A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency.
- Understand the regulatory benefits and constraints for investors buying the bond and for partner firm managing the fund

Assessment: Fund Demand

Fund Demand Process → Email invites → Demand analysis → Peer Committee review → Demand & Capacity profiled

Criteria

- Range of products & services offered
- Scale & reach of target market
- Average loan book size
- Scale of finance to SMEs

Respondent	No. of loans disbursed	Average size of loans	Total value of loans disbursed
Blue Financial Services	34	R547,700	R19,011,871
Mettle Factors	13,816	R17,003	R 234,915,190
NURCHA	64	R6,539,353	R418,518,582
Regent Factors	7	R1,500,000	R15,000,000
Sasfin	-	-	R116,000,000
SA Taxi Finance	20,815	R 77,207	R3,688,579,692
Sisonke Fund	38	R658,000	R25,000,000
Spartan Technology Rentals	34	R80,352	R2,731,982
True Group	39	R5, 411,745	R21,128,050
Total	**34,809**	**R14,931,360**	**R4,540,885,367**

- Absorptive capacity of 6 applicants:
  - Range: from R177million to R1billion
  - Average: R130,000

Assessment: Regulatory Policies

- Key Findings
  - The growth potential and the SME development is hampered by the prevailing ineffectiveness of the rule of law and the general lack of respect thereof:
    - generally inappropriate regulations for the SMEs (e.g. outdated and unnecessary regulations causing adverse effects such as unnecessary cost on business and growth traps)
    - the inappropriate design of institutional structures and their insufficient capacity to support SMEs in their compliance with current laws and regulations
    - inadequate representation of the SMEs in policy formulation processes
  - Investors are not against investing in high social value outcomes
  - BUT uncertainty and misunderstanding of how, why and where to do so are investment barriers

Uncertainty = > investor avoidance = > lack of demand for products

=> shortage of supply of appropriate products

Assessment: Regulatory Policies

- Regulatory policies that could influence EIF uptake:
  - Microeconomic reforms as detailed in 2011 Budget
  - Industrial Development Zone – the “New Growth Path”
  - Section 12J of the Income Tax Act:
    - Venture capital companies (VCC) & venture capital tax incentives
  - Environmental fiscal reform
    - 3yr accelerated depreciation allowances for renewable energy and bio fuels production investments
    - additional allowances for investment in energy efficient equipment (50% of cost)
  - BBBEE potential benefits and incentive mechanisms
    - Enterprise Development Element
    - Socio-Economic Development Element of BBBEE
  - Pension Funds Act
    - Proposed amendment of Regulation 28

Assessment: Risk Appetite

Risk Appetite Process → Desk-based research & Expert interviews → Analyse: JSE Corporate Bond Data (3yrs) → Risk Appetite profiled → Expert and Peer Committee Review → EIF Options Designed

- Key Findings
  - The corporate bond investor is a sophisticated investor with an appetite for diverse products
    - Clear appetite for bonds is evident, across the spectrum of credit ratings
    - Consistent appetite for pick up and credit enhancement by securitization notes
  - SA's bond market needs innovation and new financial products on par with global trends
    - Mismatch between the demand for and supply of bonds
    - European and Indian SME financing markets are about 20 years ahead of South Africa
- Factors for structuring EIF
    - Perception of risk: SME market is high risk => above-market returns to compensate
    - Market conditions at time of launching EIF (now is the time!)
    - Demand for exposure to SMEs in investor portfolios (incentives needed?)
    - Additional reporting requirements, e.g. development impact reports

Fund / Bond Structure Options

- General characteristics of EIF
  - Target companies: SMEs
  - Fund size: Department of Economic Development growth financing target R1.2bn
  - Underwriters: DBSA, IDC, DTI, DFIs
  - Investors: institutional and retail
  - Rating: at least A- overall; AA preferred
  - Return:
    - SME loans priced between 12%-15%
    - Bond return 7%-10%
    - JIBAR plus 4.5%-6%
  - Challenge Fund link

- EIFs realize multiple advantages for USAID, SMEs and NBFIs, incl.:
  - Innovation
  - Market capacity building
  - Access to untapped capital

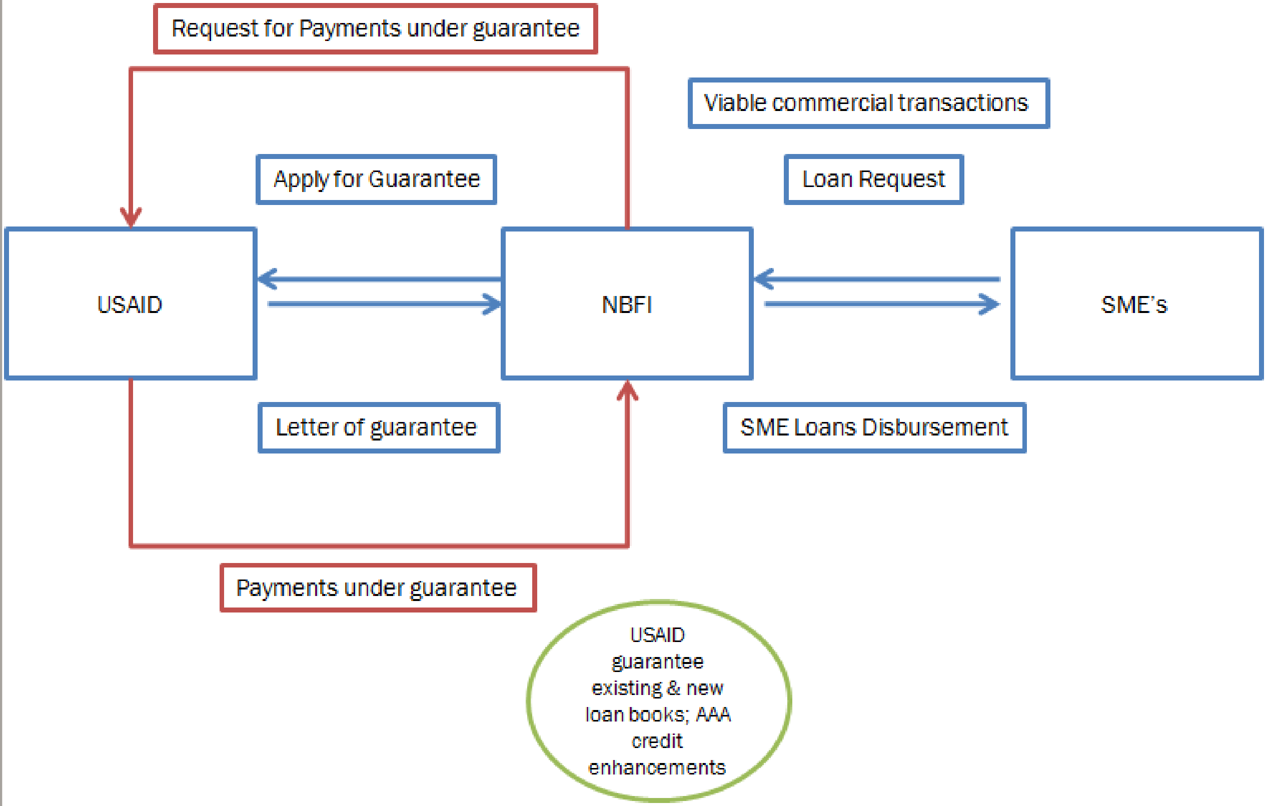
EIF Fund/Bond Structure Options

- Enterprise Impact Fund / Bond Options
  1. Credit Guarantee for Loan Books
  2. DFI issued Vanilla Bond
  3. Collateralized Loan Obligations / Securitization
  4. Guarantee directly to Asset Managers
  5. Fund of Funds
  6. Guarantee in partnership with Institutional Partner

Preference share structures ruled out by:

- The expected Dividends Tax regulation from April 2012 onwards
- Interest on debt is tax deductible whereas dividends are not

Credit Guarantee



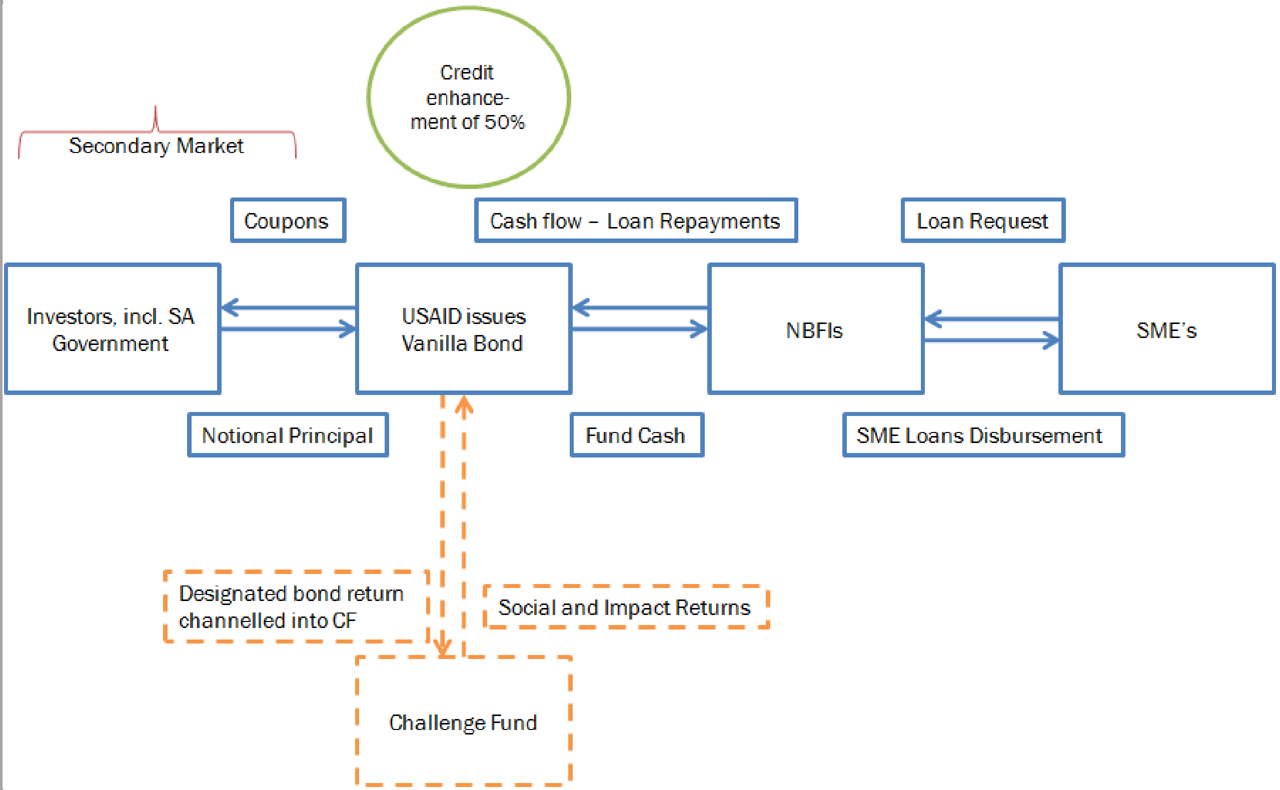
Attributes

- Status Quo
- Credit guarantee to NBFIs

Appetite

- Experience has shown low uptake
- NBFIs raise new capital for onlending instead of using existing capital

DFI Issues Vanilla Bond



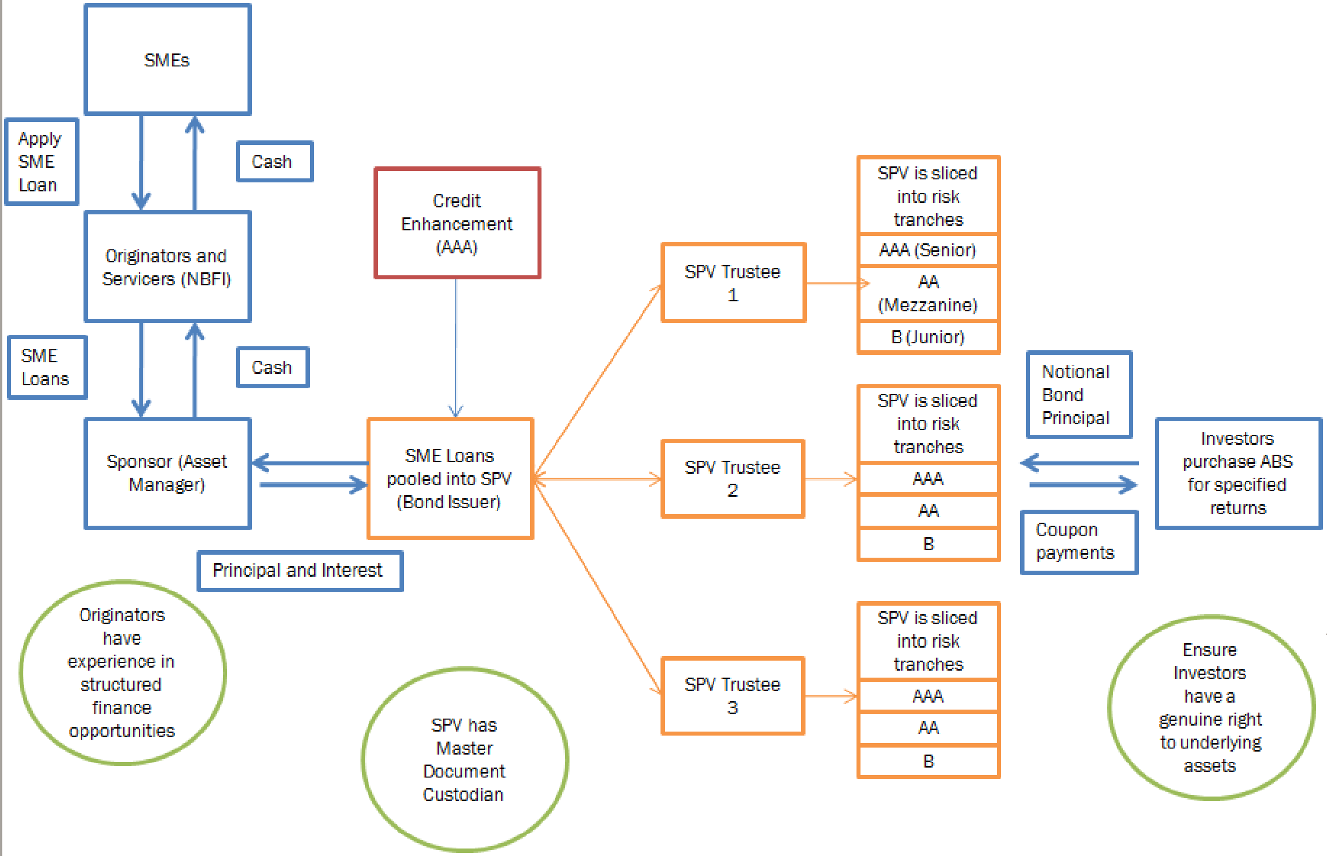
Attributes

- Vanilla bond with USAID guarantee
- Rating risk: With 50% unsecured – market may not know how to price this

Appetite

- Bond coupled with development fund option (Challenge Fund / SIB) can attract large appetite
- Additional features:
  - Callable bond
  - Early redemption

CLOs / Securitization



Attributes

- Create SPV for SME loans
- Tranche loans – each with own credit rating
- Underwrite by USAID guarantee and SME collateral
- Rating risk: With 50% unsecured – market may not know how to price this

Appetite

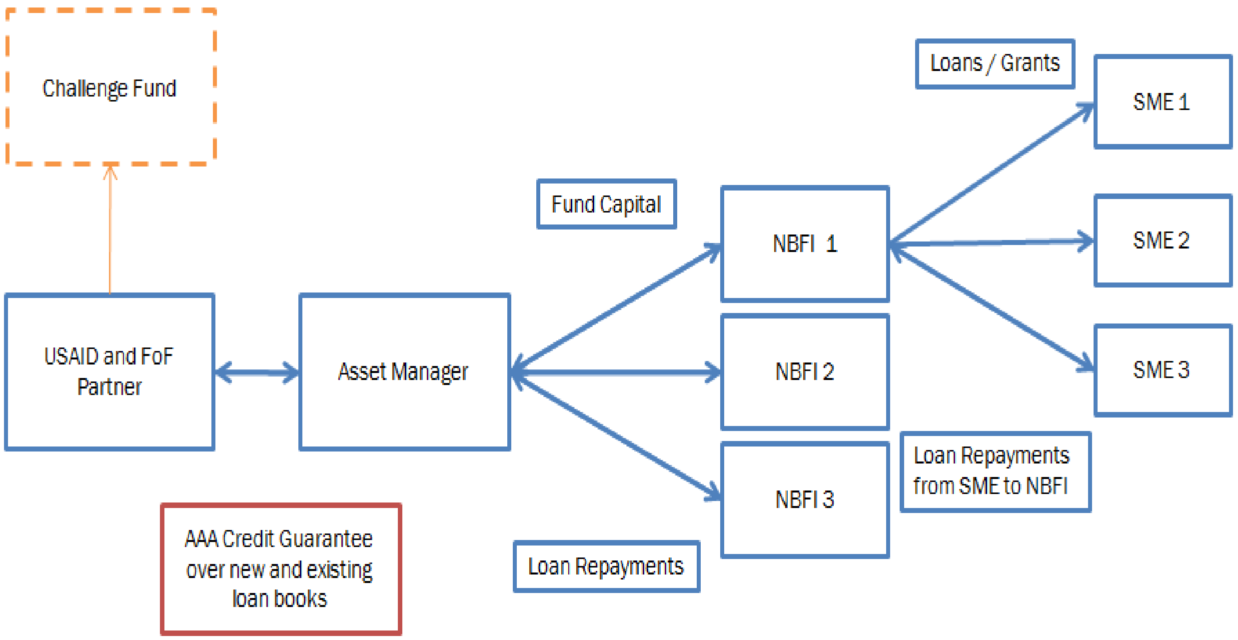
- Large global demand and use of SME securitization (since late 1990's)
- Strong use of this vehicle in Europe

Guarantee to Asset Managers

- Guarantee Directly to Asset Managers
  - DFI extends the guarantee directly to an asset manager for use in their existing portfolios to expand into responsible investment unlisted space

- Appetite
  - This guarantee leverages existing market offerings
  - Reduced risk for asset managers
  - Enable asset managers to build their capacity and track record within the sector of SME lending
  - Reduced time taken for SMEs and NBFIs to access capital
  - Enhanced monitoring and tracking
  - This structure does not suffer from the limitations of a partially guaranteed, low rated bond structure because it operates outside of the formal bond market
  - Potential to unleash future credit from banks to NBFIs and SMEs

Fund of Funds



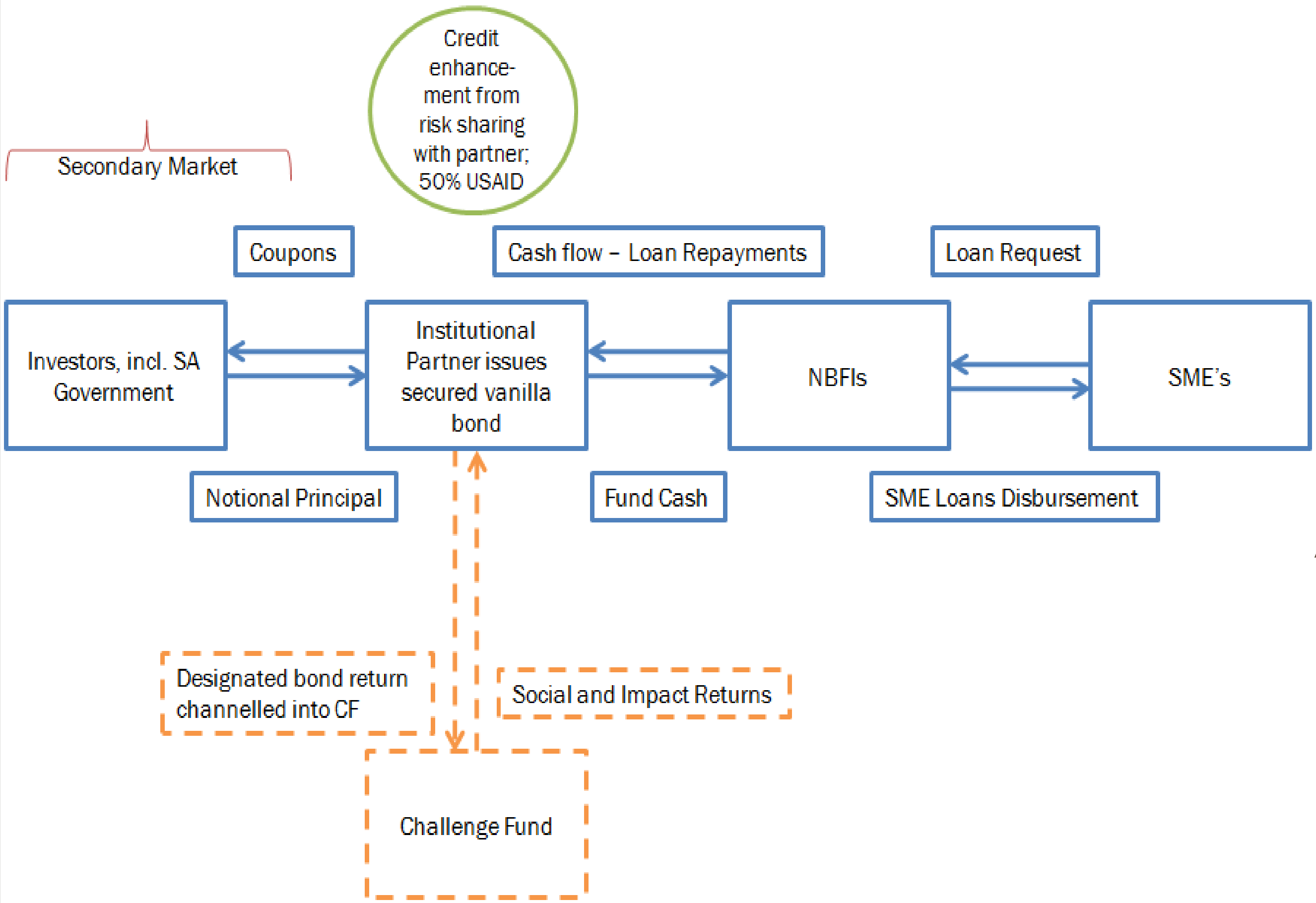
Attributes

- Hold a portfolio of funds
- Extend guarantee over existing loan book or funds
- Work with multiple asset managers

Appetite

- High expected appetite
- Leverage existing financial vehicles
- Combine and grow multiple asset managers' skills and capacity

DFI & Institutional Partner



Attributes

- Vanilla Bond
- Risk-sharing partnership with institutional partner (DBSA / TIGF)
- USAID 50% guarantee
- Institutional partner underwrites remaining 50%

Appetite

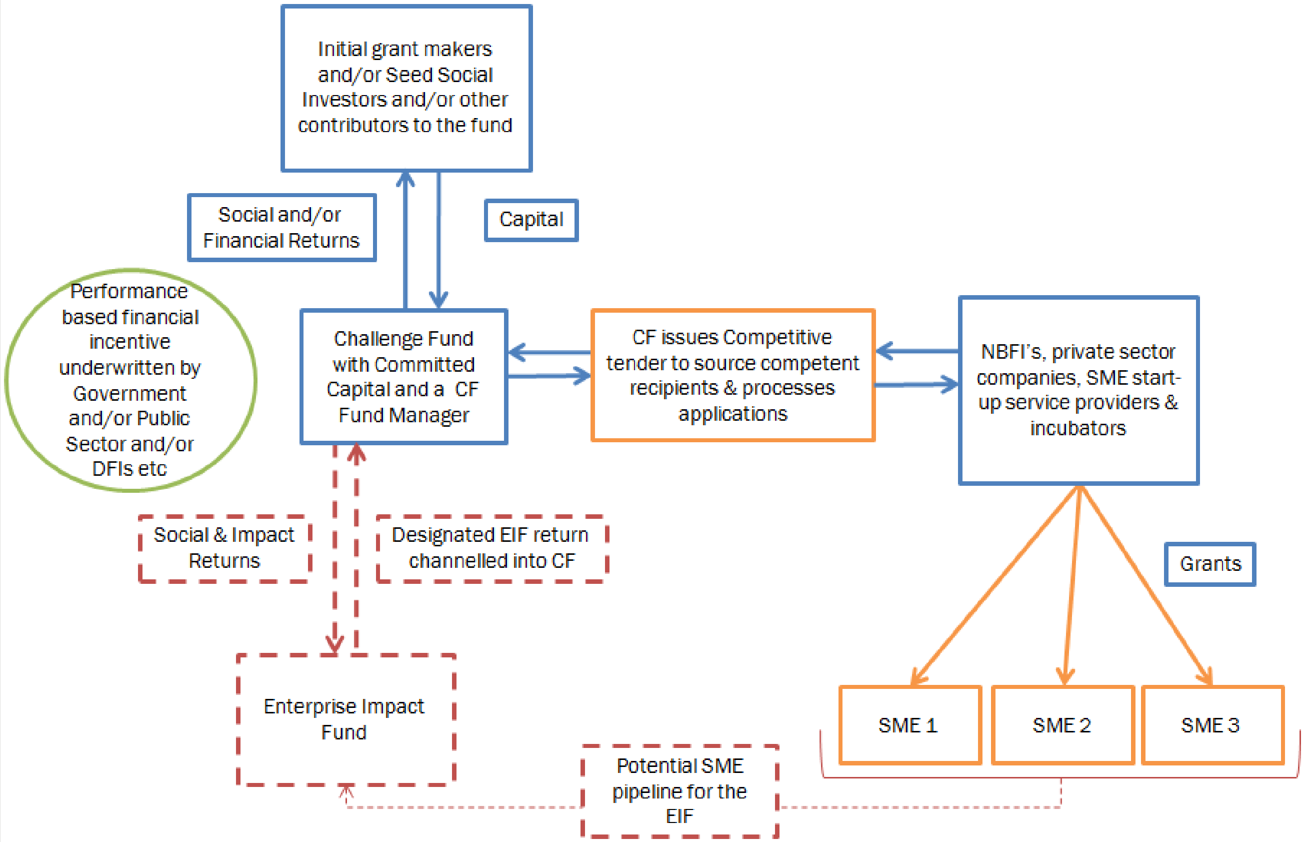
- Partnership should be well received by market
- Perception of risk mitigated
- Development fund (Challenge Fund / SIB) increase attractiveness

Development Fund Options

- Structure capitalized social venture capital fund to support SME development on a grant basis
  - Track record
  - Build capacity
  - Market confidence
  - Foster USAID's mission to facilitate growth and competitiveness of SMEs
- Provide incentives
  - Tax benefits or BBBEE / SED credits
  - Pipeline development for NBFIs or SMEs to access the EIF
- SME Development Fund Options
  1. Challenge Fund
  2. Social Impact Bond

  Venture Capital Company
    - VCC allowance
    - Equity only and not covered by USAID guarantee

Challenge Fund



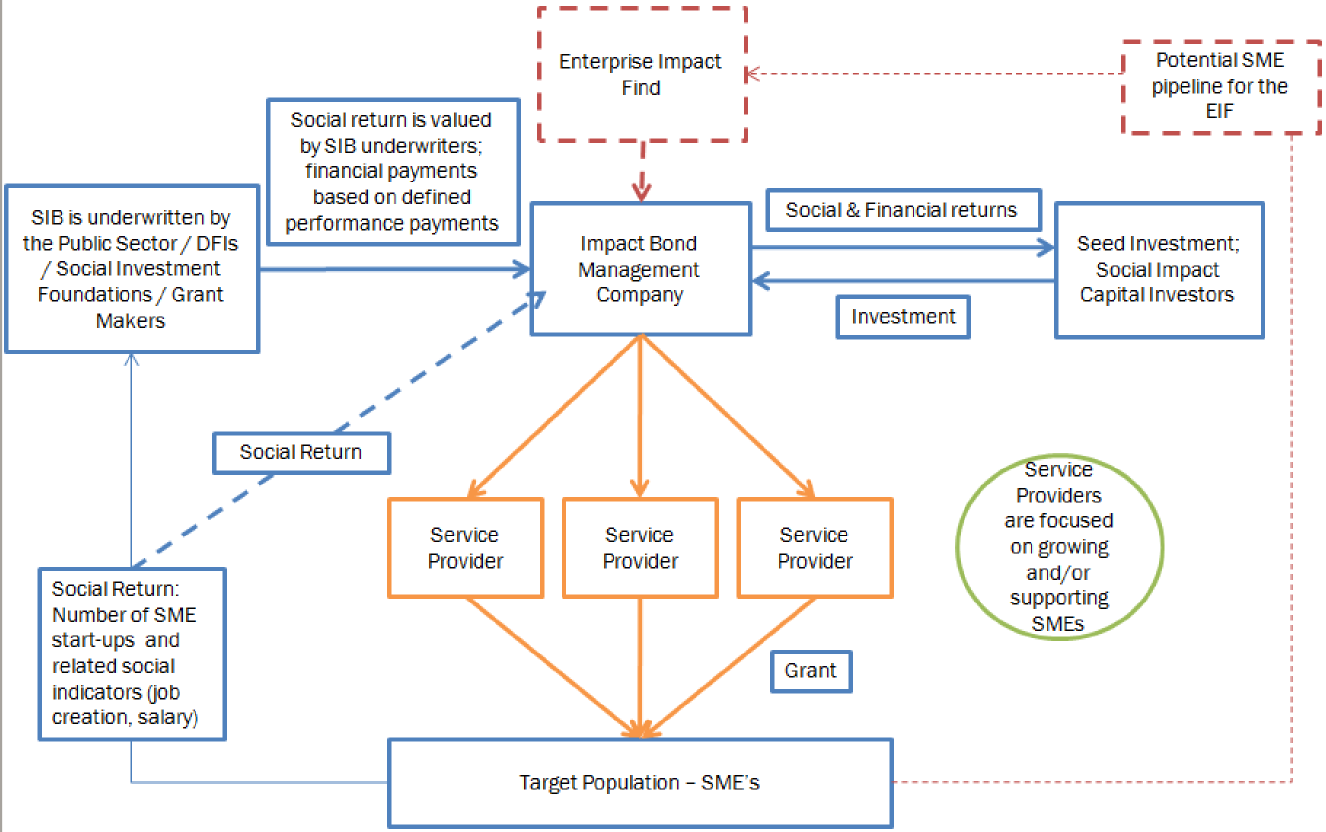
Attributes

- Risk sharing with private sector and/or SMEs
- Grants made in recognition of clear objectives
- Grant application process is based on competition
- Challenge Fund needs to demonstrate additionality

Appetite

- Proven instrument in stimulating private sector innovation
- Increasingly used by DFID and other donors over the last 5 years.

Social Impact Bond



Attributes

- Defined social outcomes
- Incentivize service providers
- Financial return based on social outcomes
- Leverage existing networks and vehicles
- Quantify social outcomes

Appetite

- SIB's are designed and used in UK and US
- Perceived Government Service Providers' track record may mute local appetite

Overview and Key Findings

- A definite need for access to affordable capital – demand based on 7 respondents of R2 billion in 12 months would presume a significant market which US$200m would not necessarily meet in full
- A strong and general reluctance to extend unsecured, and even partially secured, credit because of the perceived risks associated
- Establishing a debt fund sufficiently enhanced by a credit guarantee would be strategically very effective by providing security to attract institutional investors and enable the SME sector to establish a track record that would demonstrate investment potential
- Success of an EIF will depend on the investment fund structure and whether this can sufficiently reduce the perception or risk to encourage institutional investment
- Additional “soft” incentives would be nice to have but will not overcome the lack of strong fundamentals underlying the bond itself
- Development fund options would be an additional significant boost to the sector but not necessarily address the core issue of increasing affordable SME lending in the immediate term

Recommendations & Next Steps

- Convene a field building stakeholder workshop with partners sharing similar interests and commitments.
  - **WHO**:
    - DFIs – DBSA , IDC, DFID, SECO, TIGF, EDD, DTI, key financial Institutions and Corporate Foundations
  - **WHY**:
    - Consider the findings of this research
    - Discuss potential avenues for collaborative participation and joint action
    - Engage additional support for the EIF
    - Determine the potential for a challenge fund / impact bond which would further opportunity in the sector (especially if underwritten by EDD/IDC)
    - Articulate barriers and inefficiencies to address and solve
    - Develop an action plan for participative action **OR**
    - Define USAID FSP stand alone action
- Invite asset managers to tender for the EIF with an RFP that requires them to both design a solution and interrogate the various issues that this research has raised;
- With an EIF in place and capital available, research, profile and “map” the sector to assess true market size whist also engaging in field building and advocacy

THANK YOU

Tamzin Ractliffe

NeXii

Where capital meets impact