

Investors boost the 'missing middle'

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Published: June 24 2008 04:23 | Last updated: June 24 2008 04:23

William Foote had gained a place at Harvard Business School and was ready to go when he had what he calls an "existential crisis".

He had already spent some time working at Lehman Brothers as an analyst in the Latin American corporate finance group. Then followed two years in Mexico on a journalism fellowship, reporting on socio-economic development.

But neither his work on multimillion-dollar deals, such as securitisations of Mexican toll-road revenues, nor his time spent interviewing people in rural Mexico, convinced him that cash was reaching those who needed it the most.

The small businesses, too large and often too far away from urban areas to attract microfinance loans, but considered too small and risky by local commercial banks, were being left out. As Mr Foote puts it: "I saw the missing middle for myself. I interviewed farmers who were two days drive from the nearest city, were too remote to be reached by MFIs [microfinance institutions] who had no other option but to pay the fire sale prices demanded by middle men."

So when he returned to the US he ditched the idea of Harvard and, in 2000, founded Root Capital, a non-profit fund that advances short-term working capital loans and longer-term investment capital to environmentally friendly small and medium-sized companies (SMEs).

These businesses, in rural parts of developing countries, operate in areas such as sustainable agriculture and handicrafts. He has enlisted the support of wealthy individuals to help Root Capital to "try to prove the business case for lending to the rural unbankable".

Root Capital, based in Cambridge, Massachusetts, finances about 200 co-operatives and companies in 29 countries, serving 265,000 local producers.

This includes a farmer's union supporting 600 small-scale producers of organic bananas, citrus fruit and cocoa in Machala, Ecuador; sustainable coffee co-operatives in Uganda, Kenya and Tanzania; rice farmers in the Philippines; peanut growers in Malawi; and shea nut collectors in Ghana. Root Capital's average loan size at the end of last year was \$182,000.

Alongside corporate investors such as [Starbucks](#), church groups, private foundations such as The Skoll Foundation, the David and Lucile Packard Foundation, and The Lemelson Foundation, about 80 wealthy investors provide Root Capital with grants or low-interest loan capital, which yields an average of 2.5 per cent. The Skoll Foundation, for example, has provided an unrestricted grant and subordinated loan capital at 1 per cent while Canadian venture capitalist Tom Kaneb has advanced a grant to help build Root Capital's permanent loan capital.

Many funds working with SMEs in the developing world rely on grants or low-interest loan capital from the wealthy, whether they are focusing on sustainable trade, as does Root Capital, or other areas such as healthcare, affordable housing, renewable energy or clean water and sanitation.

Microfinance may have captured the imagination of social investors but even microfinance fund managers accept that it can play only one part in social and economic development. Providing banking services to those SMEs in the "missing middle" is crucial because, while a microloan can

support one street vendor or one tailor in their business, microfinance rarely creates jobs for others.

Job creation is the most obvious benefit of funding SMEs in developing countries and there is enormous potential. According to a 2004 study, Corporate Social Responsibility and the Development Agenda: Should SMEs Care?, such businesses account for 50-60 per cent of all employment in the developing world.

But it is not just about jobs. With the capital to expand, SMEs can also increase assets and productivity, and push tax revenues into the economy. That is what gets wealthy investors excited, according to Sasha Dichter, director of business development at the Acumen Fund, a non-profit that blends philanthropic and investment capital to lend to non-profit organisations, larger companies and SMEs in the developing world.

He says those who are leaders in the business world can see the catalytic role social finance can play, not just in creating jobs but also increasing revenue and building assets to drive healthy economic growth. "A lot of our individual investors have backgrounds in venture capital, private equity, hedge funds or are entrepreneurs themselves. They are taking what they know from the private sector to fight poverty in a way that they can see has a lot of impact," says Mr Dichter.

The objective of these funds is not just to create economic benefits but also to affect social and environmental change. Acumen Fund invests in SMEs that provide both social and economic benefits in local communities. One example is Ziqitza Healthcare, a private ambulance company that employs 82 people and provides a way for the sick or injured in Mumbai to get to hospital, with the cost, if they are charged at all, based on their ability to pay.

"Supporting enterprises is not just about creating jobs," says Mr Dichter. "In helping companies that are providing healthcare, affordable housing, clean water and reliable sources of energy, we are meeting the basic needs of poor people."

Mr Foote says investors in Root Capital are willing to forgo a higher rate of income, not just to create jobs and improve living standards, but also to have an environmental impact – to support environmentally sustainable businesses that combat soil erosion, deforestation and other threats to global climate change.

Yet, in spite of the best efforts of the funds operating in this area, it is still a tiny market. Microfinance has been around since the 1970s and now has total loan volumes of \$25bn, according to Deutsche Bank estimates, and thus has the record and scale to offer market returns. Consequently, it is attracting the support of institutional investors and, increasingly, retail ones too.

SME funds, in contrast, are relatively new, emerging towards the end of the 1990s. The risks and inefficiencies in this market mean it is not yet possible to offer commercial rates of return.

"We certainly can't offer fully risk-adjusted returns like Compartamos [a leading Mexican MFI] can but we're absolutely going in that direction," says Mr Foote.

Root Capital has a repayment rate of 99 per cent and has an innovative model in which it also lines up future purchase agreements between the SMEs and international buyers such as Starbucks and **Whole Foods**, which essentially provide collateral against the loan. When the natural products are shipped, the buyer pays Root Capital directly for interest and principal payments.

But, by and large, investors need to approach this market realising that some SMEs are going to fail and that they need to take a long-term view.

Jean-Philippe de Schrevel, founder and executive director of microfinance asset manager Blue Orchard Finance, recently set up the Bamboo Finance Oasis Fund. This is its first fund to invest cash from individual and institutional investors in small enterprises in areas such as irrigation,

clean water and renewable energy.

"It's very risky. I don't know yet what returns we can predict," Mr De Schrevel said at a recent conference in New York. "My gut feeling is that we will have some failures as well as some great successes, but the time is right to try."

These uncertainties about risk could pose a challenge since a number of these funds have embarked on aggressive capital-raising drives. Root Capital wants to expand from \$21m in lending capital at the end of last year to more than \$70m by 2011. Acumen Fund wants to build a \$100m lending capacity by 2011.

Nevertheless, more wealthy investors are being persuaded, says Mr Dichter, particularly now that microfinance has shown how it can be done. "Microfinance provided the model. The industry started with philanthropic capital and, as it matured, became able to absorb both philanthropic and commercial capital. Hopefully, over time, we can bring capital markets investment to SMEs."

Indeed, the hope is that by using microfinance institutions and local commercial banks as distribution channels, scale and efficiency will be brought to this market even more quickly than was the case with microfinance. Root Capital is to launch an arm of the business this year focused on bank advisory and training services to persuade local MFIs and commercial banks to move up into the SME space.

"We want to say to local institutions that are unwilling or unable to provide the financial intermediation to their local businesses: 'Look, this is the way you can do it,'" says Mr Foote.

In the meantime, funds are beginning to calculate the social, economic and environmental impact of their loans and investments. Acumen has developed an online platform for collecting and comparing the financial and social performance of its portfolio, based on quarterly data from its investments. This includes everything from cost-effectiveness and financial sustainability to the number of people who have directly benefited.

It is an audacious task, but then so is the goal of achieving widespread social, economic and environmental change in this manner. Funds that are beginning to make those changes say they need more support if SME investing is ever to achieve any scale.

Yet at least individual investors are giving those people in the missing middle a chance.

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