SHAREHOLDER LOAN FUNDS FOR SMEs IN DEVELOPING MARKETS

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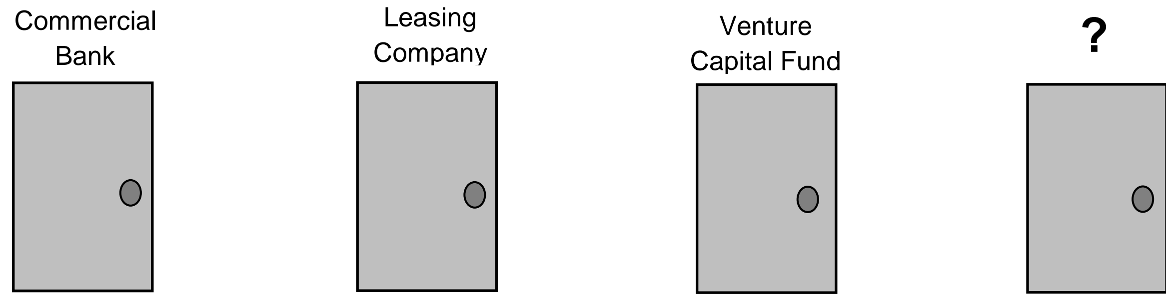
Introduction

In most developing markets the majority of viable small and medium enterprises (SMEs) tend to remain small, slow-growing and largely self-financing. Abundant expansion opportunities languish across the sectors due less to the absence of able entrepreneurs than to the absence of adequate expansion financing. Particularly in the current credit climate, the majority of SMEs in developing markets are simply unappealing candidates for the long-term, cash-flow based financing that growth-oriented SMEs should have.

Commercial banks, whose core lending practices incur minimal risk, have little incentive to use depositors' funds to make loans to SMEs, particularly to those offering less than full collateral coverage and inadequate documentation. Leasing companies in developing markets are equally risk-averse, preferring to lease only a narrow range of easily remarketed assets. The relatively rare venture capital intermediaries targeting SMEs finance only a miniscule percentage of potentially successful SMEs.

There are other ingredients in the mix of reasons for which financial sectors deny the SMEs the financing they need. However, the principal problem is an uncomplicated matter of risk and return. Lending to SMEs beyond the short-term presents too much risk for commercial bankers and too little return for venture capitalists.

Imagine an entrepreneur with the ability to put $500,000 to good use to realize an expansion opportunity and all of the local economic benefits that come with it. Then, imagine that the entrepreneur knocks on three doors: the commercial bank's, the leasing company's, and the venture capitalist's. Being politely turned away from all three for self-apparent reasons, where does the entrepreneur knock next? This paper outlines a new type of financial intermediary not currently in the market and calls it a "Fourth Door Fund."



The Need for Another Door: Expansion Financing

Without cash-flow based financing in the start-up and early stages, SME entrepreneurs are typically forced to finance their businesses through their own limited resources and those of family and friends. Typically, this condemns businesses to grow slowly, if at all. The necessity of financing growth through its own cash flows significantly limits or precludes an SME's ability to:

(1) take advantage of new market opportunities,

(2) access new technology, and/or

(3) benefit from the improved internal capacity and external reputation it may have earned.

These are three of the transformative ingredients in a business expansion. Almost invariably, they will need to combine with expansion financing to produce significant growth.

Some SMEs manage to obtain medium- to long-term installment loans for purposes such as plant improvements, additional working capital, or, for example, new delivery trucks. Credit lines and guarantees have been valuable and effective at inducing banks to extend loan tenors for these types of secured loans.

However, donor-supported lending programs have shown more limited success in promoting long-term financing in amounts *greater* than:

(1) the collateral offered by the prospective borrower,

(2) the current annual sales of the prospective borrower, and/or

(3) the current net worth of the prospective borrower.

Loans that exceed one or more of these amounts constitute, at least for the purposes of this paper, "expansion financing".

> ***Examples of Expansion Financing***
>
> SMEs typically seek expansion financing to expand from:
>
> → *1 shift a day with interruptions to 2 shifts a day year-round,*
>
> → *fruit growing to fruit processing,*
>
> → *a 2-color printing press to a 4-color press and pre-print capacity,*
>
> → *a local market to a national market,*
>
> → *a national market to export,*
>
> → *a supermarket to a supermarket chain.*

> In seeking expansion financing, an SME entrepreneur is, in essence, saying:
>
> ***"Lend me more than I have. And any lesser amount than I'm asking for will do me little good."***

SME expansions are the main drivers of a thriving SME sector. As compared with start-ups or businesses receiving short-term working capital or trade finance, the expansions made possible by long-term, cash-flow based financing generally produce *more rapid and significant growth* in:

- revenues,
- wages paid,
- skilled jobs, and
- taxes paid.

Typically, such gains are realized within the first 12 to 24 months from the beginning of the expansion.

The purpose of Fourth Door Funds is to finance SME expansions.

The Need for Another Door: Expansion Financing and the Other Three Doors

The need for something like Fourth Door Funds is defined by the difficulty SMEs have in accessing expansion financing through the first Three Doors. Access to finance for SMEs is a broad topic which has generated countless studies and programs. However, the obstacles to expansion financing in the current financial markets of developing countries can be distilled to a small number of recurring themes:

Door	Reasons for Lack of Expansion Financing
Commercial Bank	*Reason #1:* Financing trade, servicing the retail needs of large firms, and investment in government debt instruments are so low-risk and high-return that banks have little incentive to take higher risk by offering long-term loans to SMEs. *Reason # 2*: A typical bank's depositor base is relatively narrow and short-term, providing a technical obstacle, or at least a disincentive, to make long-term loans.
Leasing Company	*Reason # 1*: Reluctance to finance difficult to remarket assets such as "first mover" technology, sophisticated software, rapidly depreciated hardware, or highly customized equipment. *Reason # 2:* Fixed and inflexible payment schedule, combined with high interest, can be out of cadence with the cash-flow pattern of the SME during the expansion.

Venture Capital Fund	*Reason # 1:* VCs invest for long-term capital appreciation, meaning exiting equity investments through sales of the investee company to third-parties. Third-party exits at the SME level are rare in developing markets. *Reason # 2:* VC funds in developing markets are rare and getting rarer as investment size rises in search of exit-able deals.

Fourth Door Funds: A New Door to Risk Capital

Risk Capital vs. Venture Capital

Fourth Door Funds do not attempt to cure the expansion financing problem by simply providing long-term, market-rate, unsecured loans that banks will not. This would likely require significant subsidies, the perils of which are well-known. When developing country governments and development institutions confront this dilemma, they frequently and reasonably turn to the idea of "equity funds" or venture capital in search of a solution. Venture capital funds provide "risk capital," so do Fourth Door Funds. However, the essence of the specific investment strategy of Fourth Door Funds lies in its distinction from venture capital. Fourth Door Funds are, above all, an alternative to venture capital.

The distinction between venture capital (VC) and risk capital, as used in the discussion of Fourth Door Funds, is that venture capital depends for its viability on realizations of long-term capital gains from sales of equity participations. Fourth Door Funds do not. In conventional venture capital, in order to cover write-offs and lackluster performances within the majority of a relatively high-risk portfolio, at least a small but significant number of equity investments must be exited at high multiples of the original price paid for the investee's shares. Fourth Door Funds attempt to establish more even portfolios with fewer failures and fewer "stars."

In the case of Fourth Door Funds, "risk capital" refers simply to:

(1) *non-asset-based financing,* meaning financing accessible to SMEs which cannot offer full collateral coverage for bank loans, and

(2) *participating investment*, meaning investments sharing risk with SMEs that, in their early and expansion stages, cannot afford heavy debt burdens.

Such cash-flow based, risk-sharing investments *may or may not* include equity participation. Even in the case of equity participation, risk-capital may not depend upon realizing capital gains as the central factor in the investor's rate of return.

Assuming the extreme rarity of an SME entrepreneur with available monies to repurchase the fund's shares at several times the fund's original purchase price, almost invariably, the Fund's equity holding must be either sold to a third party (a "trade sale", in the case of an acquisition by another company, or a "financial sale" in the case of acquisition" by a financial intermediary).

U.S. "Venture-Backed" Exits CY 2007	
Approximate:	
Number of funds:	*750*
Number of new investments:	*3,400*
Investments per fund:	*5*
Number of M&A exits:	*350*
Number of IPO exits:	*85*
Total exits:	*435*
Exits per fund:	***0.5***

Source: National Venture Capital Association and Thompson Financial

For a quick understanding of the difficulty of achieving third-party venture capital exits in developing markets, one need only look at the rarity of such exits in the U.S., the world's most active and accommodating VC market. In 2007, only about half of all U.S. funds achieved even one third-party exit. Can an SME venture fund in a developing market expect to exit even a third of its investments through acquisitions and IPOs, a performance which would be six times superior to the typical fund in the U.S.?

A principal objective of Fourth Door Funds is to provide risk capital for SME expansions that do not depend on a sale of the investee to third parties or public offerings of the SME's shares.

Risk Capital and Risk Adjustment

Before describing Fourth Door Funds in moderate detail, we need to consider the first obstacle to SME risk capital: the concept of risk-adjusted return. Risk adjustment refers to the need for an investor to seek a higher return in order to compensate for a higher risk of loss. Conventional venture capital in developed markets is based on the premise of taking high risk to achieve high returns of a magnitude rarely, if ever, achievable in developing markets. In most low-income countries, the conundrum for SME investors is that, while high return multiples are uncommon, risk is nonetheless almost invariably high.

Below, for example, are the kinds of "risk premiums" – layers of risk – which a fund manager might impose on a prospective SME investment when calculating the fund's return. Although different investors will assign different return adjustments to different risk premiums, according to their experience and perceptions, the risk adjustments below are reasonably consistent with normal practice:

Risk Adjustment in the Context of SMEs

Risk Adjustment	Premium
✓ "market" return on fully secured corporate financing (opportunity cost)	10%
✓ adjustment for size and SME sector perceptions	5%
✓ adjustment for less than 100% collateral	10%
✓ adjustment for political/market vulnerability	5%
✓ adjustment for difficulties in exiting	10%
Total risk premium adjustments	**40%**
+ management fee and fund expenses	5%
Investors' required IRR ("hurdle rate")	**45%**

The issue in risk financing of developing market SMEs is, of course, that a 45% return on an investment is simply not, with any frequency, realistic. Why, then, would it be realistic to expect wise investors and fund managers to bet their money or stake their livelihoods on SME risk capital funds? Innovative adjustments must be made to traditional risk capital and venture capital models in order to make SME funds attractive to a wider range of rational investors. Such adjustments must somehow simultaneously:

Diminish risk at the level of the individual investment while, somehow, boosting returns to investors in the fund to above the net return expected from the fund's portfolio.

Adjusting risk adjustment:

Fourth Door Funds work within a dual strategy. Their aim is to close the "gap" between the risk-adjusted return sought (e.g., 45% IRR) and the actual return which can be realistically expected from a portfolio of SME investments. The first element of the strategy addresses how to decrease risk at the level of individual investments by shifting from dependence upon capital gains to participating in the gross sales of the investee SMEs. The second addresses how to increase the expected return to investors in the risk capital intermediary. This second piece involves: (1) structuring the capitalization of SME funds such that investors' differing return objectives are reflected in differing instruments by which SMEs are capitalized and (2) enlisting governments as engaged stakeholders in SME risk capital.

Fourth Door Funds are very much about squeezing the risk-adjustment gap from both sides.

What Fourth Door Funds should and should not do:

In order to justify their entry into the financial sector, what should be the principal mandate and functions of Fourth Door Funds as the new door in the market? Fourth Door vehicles should, without exception, do all of the following:

- *provide mid- to long-term financing in the general range of $100,000 to $ 1,000,000;*
- *provide cash-flow based financing, requiring less than 100% collateral coverage;*
- *link returns to the investee SME's performance, de-linking them from so-called 'market' interest rates;*
- *shift the focus of risk capital from share value to sales volume;*
- *offer streamlined, replicable transaction structures;*
- *shift investment operations from expatriates with investment banking skills to local professionals with business-building skills;*
- *offer direct hands-on technical and management assistance;*
- *attract diverse investors with diverse motives and diverse return expectations; and*
- *seek government-sponsored incentives to invest.*

Given the many market failures of developing financial sectors – or *not* developing, as the case often is in low-income countries – what, then, should Fourth Door Funds not do? In particular, they should:

- *not accept deposits or offer retail banking services;*
- *not offer short-term finance, leasing, factoring, straight lending, or any of the functions provided through the other "doors;"*
- *not attempt to meet the financing needs of all SMEs, but rather focus on SME expansions and start-ups having characteristics similar to expansions;*
- *not provide financial advice or consulting services to SMEs other than portfolio investees or investors other than investors in the Fourth Door Fund; and*
- *not provide business development and technical assistance services to SMEs other than portfolio investees.*

These fundamental characteristics provide both the rationale and a snap-shot of Fourth Door Funds. They also describe a practical, SME-focused intermediary dramatically different from other institutions and intermediaries in developing financial sectors.

The Shareholder Loan Investment Strategy

Structure and Terms:

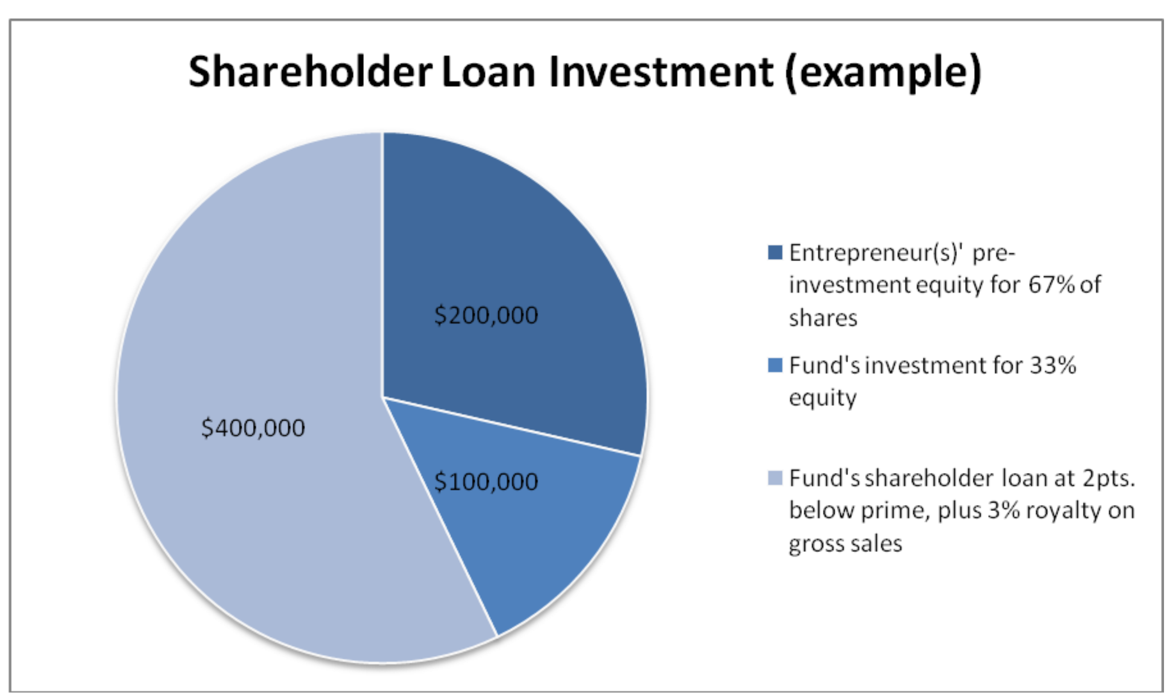
The heart of the concept of a Fourth Door Fund (a "Fund") is a practical investment strategy designed to reduce the risk in risk capital investment in order to close the gap between risk-adjusted return expectations and realistic expectations for actual returns. Specifically intended for investments in the $100,000 to $1,000,000 range, it targets existing SMEs having opportunities for significant expansion but insufficient collateral to obtain commercial bank loans. Below is an example (of many possible examples) of a typical Shareholder Loan Investment Structure.

Example of a Shareholder Loan Investment *(in USD)*	
Assumptions:	
SME's required expansion financing:	500,000
Entrepreneur's pre-investment equity:	200,000
Structure of Investment:	
Fund's equity contribution:	100,000 (for 33% of shares of the investee SME)
Shareholder loan from the Fund:	400,000
Total investment:	500,000
Terms of Shareholder Loan:	
Base interest rate on loan:	local prime minus 100 to 200 basis points
Royalty as % of turnover:	½% to 5% of gross sales
Term of loan:	5 years, amortized at 25% of principal p/a after a one-year grace period on principal
Terms of the Equity Portion of the Investment:	
Dividends distribution requirement:	none
Collateral requirement:	all available collateral, plus pledge of shares, but no requirement of 100% collateral coverage
Exit price:	a pre-established nominal multiple of original purchase price (e.g., 3 times) – or – a pre-established fraction of gross sales in the year prior to exit

The above example contains each of the fundamental elements of the Model:

- ✓ a minority equity investment,
- ✓ a relatively low-interest loan, and
- ✓ a royalty participation in the turnover of the investee.

Below is a simpler representation of the shareholder loan structure with the Fund's contributions shown in gray. (A term sheet with greater detail for a Shareholder Loan Investment is provided in Annex 1.)



The key strategic elements of the Shareholder Loan Investment Strategy from the Fund's point of view are that:

1. Designed for the typical SME expansion situation in which the investees pre-investment equity is considerably less than the amount of required expansion financing, ***the Fund has invested for 33% of shares while exposing only 20% of its money in equity.*** The Fund is nonetheless a full partner in the business, generally with a seat on the investee's board, and holds an amount of shares surpassing the usual threshold of 26% often needed to block decisions requiring a super-majority of votes.

2. The investment is essentially ***"self-liquidating,"*** as opposed to requiring liquidation of the investment by sale to a third party. The Fund's up-side is being paid throughout the life of the investment through the payments of royalties rather than waiting four to six years for an uncertain exit through a trade or financial sale.

3. The nominal ***repurchase price of the equity is sufficiently low*** for the entrepreneur to be able to repurchase the Fund's shares at an amount which is likely to be available through a combination of personal funds and distributable earnings of the business.

Of equal importance are the strategic advantages of the model for the investee SME for which, again, the Model has been specifically designed. Below, using typical sales growth assumptions for a successful SME expansion, the following flows illustrate the cost of financing to the SME and the reflows to the Fund.

Illustrative Shareholder Loan Investment Flows						
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Sales	500	750	900	1090	1300	1550
interest payments	(16)	(14)	(10)	(6)	(2)	
principal payments	0	(100)	(100)	(100)	(100)	
Revenues to Fund Equity exit proceeds	31	137	137	138	144	300
IRR on shareholder loan:	12.2%					
IRR on equity:	20.1%					
Blended IRR:	14.9%					

By contrast to the above scenario, a bank loan, particularly in the case of a loan to a smaller company without full collateral, will normally not provide for a one-year grace on principal. Interest payments will typically be several points above prime. Therefore, combined principal and interest payments will be heavy in the first two years of the loan, just at the time when the SME may have maximum proportional need of working capital to launch and nurture the expansion.

However, in the above flows, the payments on the shareholder loan are low in the first year and relatively flat in the succeeding four years, even as the company expands. The investee compensates the Fund for its risk only in the later years of the investment when it can better afford to do so. The loan begins as inexpensive debt obligation during the early phase of the investee's expansion when maximizing cash-flow is crucial to growth. Only when, *and if*, the sales of the business become substantially greater do the royalty payments, combined with the base interest rate, begin to constitute a relatively expensive loan.

In addition to these basic elements of the Model, the following key terms, which should be agreed in every investment, further reveal the practical nature of the Model:

Royalty basis: Royalties paid must be the *greater* than (1) gross sales projections on which the investment has been based or (2) actual gross sales.

Prepayment penalty: Given that the Fund's "up-side" is deferred to the later years of the investment, the terms of the Model call for a prepayment penalty equal to (1) the expected interest on the remaining portion of the loan, *plus* (2) the projected royalties to be paid during the remainder of the loan period.

Equity adjustment rights: The Model assumes that the entrepreneur(s) will repurchase the Fund's shares. However, the ability to exit the investment in more conventional venture capital terms, through an acquisition or IPO, is ensured with "tag-along" rights by which, if the investee

SME is sold to a third-party buyer, the original terms of repurchase are cancelled and the Fund has the right to sell its shares to the third-party at the same price paid for the shares of the other owner(s) of the SME.

Fundamental Virtues of the Model

To summarize the principal advantages of the Model, particularly in contrast to venture capital:

- Having 75% to 90% exposure in debt, limiting equity to between 10% and 25% of exposure means less risk.
- Less pressure on exits means the Fund can be more easily managed by local talent (without investment banking experience).
- Current income from interest and royalties means investments are easier to monitor by management.
- Current income from interest and royalties means projections are more firm and the Fund is easier to monitor by investors.
- Less pressure on exits means more time for direct assistance to portfolio investees.
- Replacing dividends with royalties and pre-establishing a fixed exit price mean there is no need for arguments over earnings to undermine trust.

Elements of the Shareholder Loan Investment model have been adopted by a number of funds worldwide and new funds are being raised which explicitly inform prospective investors that the new fund will be using the Shareholder Loan strategy for the reasons described above. GroFin, a $160 million SME financing organization sponsored by the Shell Foundation and a small number of official development finance institutions, has been investing in several African countries for the past four years almost exclusively through royalty-based loans and shareholder loans with equity participations. Business Partners Ltd. of South Africa, one of the most successful SME financing institutions worldwide, has pioneered a version of the Shareholder Loan Investment model during the past decade. Annex 2 provides evidence of their success with such investments.

Standardization, Replication, and Increased Numbers of SME Expansions Financed:

Standardization is an essential, if not *the essential*, indispensable feature of Fourth Door Funds. SMEs undergoing significant expansions represent the largest group of immediately available investment opportunities in developing markets and produce the most rapid and far-reaching socio-economic benefits of any group within the SME sector. For these reasons, Fourth Door Funds are conceived to address this single segment of the private sector. By targeting a group of businesses with multiple affinities, Fourth Door Funds are able to impose a high degree of standardization on their investment instrumentation, terms, and operational processes.

Above all:

The concentration of focus, simplicity, fairness, practical design, and replicability of Fourth Door Funds allows them to proliferate more rapidly and invest in far greater numbers of SMEs than do venture funds or any other existing vehicle for cash-flow based SME finance.

Again, the concept is ambitious. It has been constructed for the potential to be broadly replicated in developing markets worldwide. The following sections on fund capitalization underscore the importance of standardization in expanding the number and nature of investors in SME finance.

Fund Capitalization

SME funds are capitalized by a relatively small but diverse group of bilateral and multilateral development institutions, national development banks, pension funds (through special allocations), private financial institutions, corporations, and a small number of private foundations and non-profit development organizations. Among the traditional dilemmas of SME risk capital has been the disadvantage of having a limited number of investors with a wide diversity of motivations and return targets among them.

Below is a list of the typical types of investors in SME funds with what have appeared over the years to be some of their actual or potential financial expectations (as opposed to objectives) and non-financial objectives:

Investor Type	Financial Expectations	Non-Financial Objectives
International [Development] Financial Institutions (IFIs) E.g., IFC, FMO, Proparco, IIC, OPIC, Norfund	Generally pegged to minimally basis point over bond yields or treasury notes with targeted non-risk adjusted commercial yield.	▪ fulfilling development or charter mandate ▪ mobilizing private sector investment ▪ public, government, and board relations

Investor Type	Financial Expectations	Non-Financial Objectives
Private Sector Financial Institutions	Varies, but generally prefer non risk-adjusted commercial yield.	▪ on-the-ground presence and experience without risking large sums ▪ local market knowledge ▪ conditional for investment from IFIs in larger funds
High Net-Worth Individuals (rare)	Varies but normally want higher returns than institutions, commensurate with tax-free bond yields.	▪ affinity or relationship with host country ▪ religious reasons ▪ social reasons
Non-IFI Development Agencies E.g., USAID, DfID, CIDA	Want vehicles to be commercially viable for development reasons, but often have no interest or ability to receive returns.	▪ fulfilling long-terms development mandates ▪ mobilizing private sector investment ▪ improving capital markets ▪ strategic political reasons, including "tokens of friendship" and post-conflict stability
National Development Banks	Generally require non risk-adjusted commercial yield.	▪ responsiveness to ministries of industry and other government bodies in developing SME sector ▪ demonstration of SME potential to commercial banks ▪ out-sourcing difficult portfolios to funds ▪ responsiveness to political cycles

Investor Type	Financial Expectations	Non-Financial Objectives
Multinational Corporations E.g., energy and mining, banks, insurance companies	Varies, but generally basis points over bond issues.	▪ government and community relations in countries where they have manufacturing or distribution ▪ protection of exploration and extraction rights ▪ public relations with investors ▪ create and improve local in-puts and service providers
Private Foundations	For grants – no return. For program related investment (PRI) – partial to very low returns.	▪ fulfilling board and IRS driven mandates ▪ complementarity with other charitable and socio-economic programs ▪ board and public relations

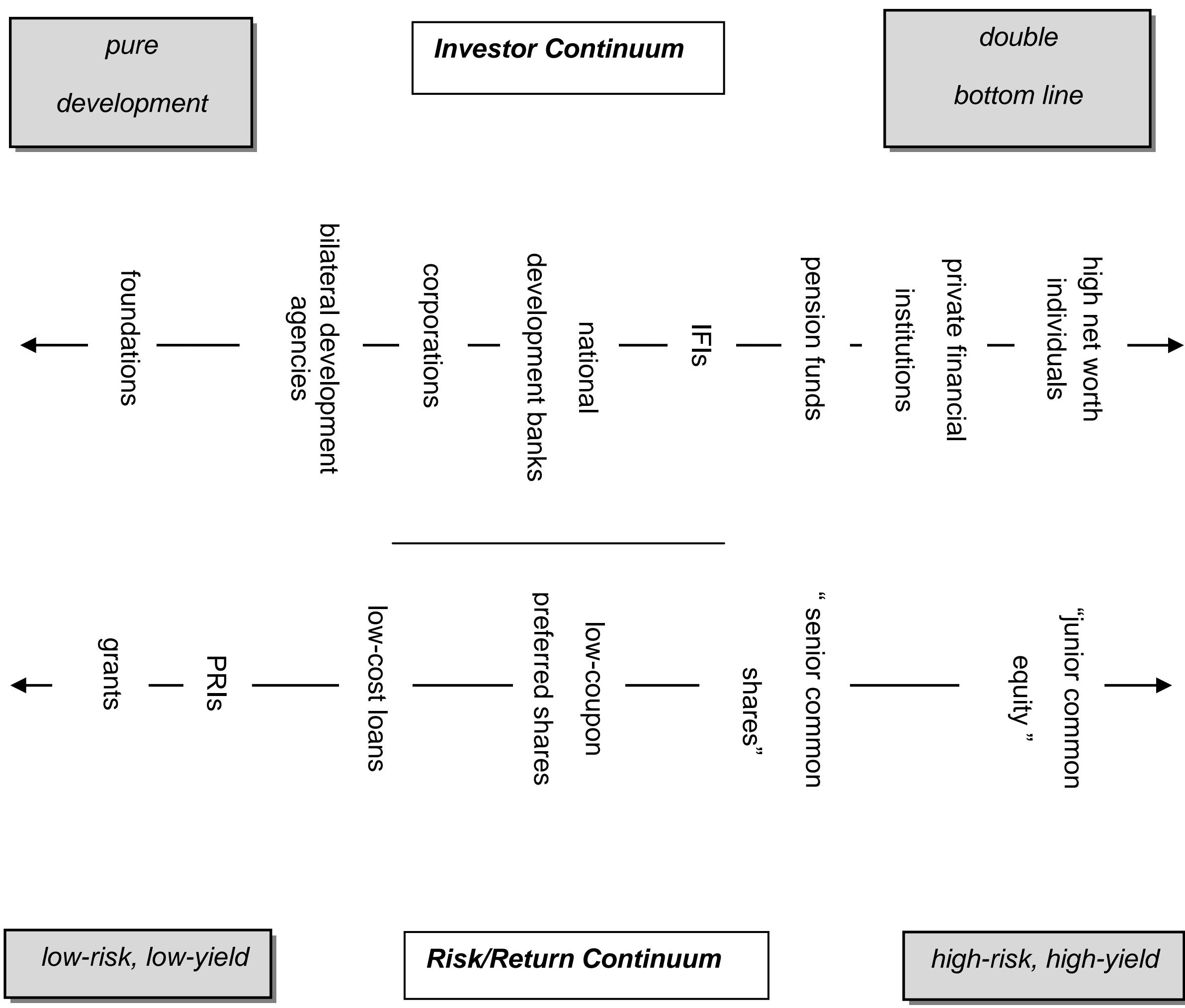
These institutions, corporations, development banks, and foundations do not march in lock-step toward a single result. They have different non-financial and financial aims. Diverse as their motivations and financial expectations are, however, for unexplained and unexamined reasons, they have all been herded into the corral of common equity, a situation in which what they own scarcely reflects the diversity in why they own it.

In the for-profit capital market there are also many different kinds of investors, with different preferences for risk and return. Experts structuring financial transactions, such as acquisitions or structured financings, create financial structures composed of a number of different securities, each with different risk and return characteristics. For example, the acquisition of a company may combine a mixture of senior secured debt, junior unsecured debt, preferred stock, and common stock. Each security has a different balance between risk and return, designed to appeal to a different type of investor. This facilitates raising capital from a much broader range of investors than would be possible if only one financial instrument were used. What Fourth Door Funds propose is to apply this insight from the private capital market to what might be called the "development capital market."

The motivations of the investors listed above spread out across a continuum in which more-or-less pure developmental objectives (foundations, development agencies) and indirect commercial and developmental benefits (corporations) lie toward one end and more yield-driven

"double-bottom line" expectations (IFIs and, potentially, high wealth individuals) lie in various degrees of close proximity to the other. Why should there not be a companion spectrum in which grants, the lowest risk investments of all, given that they need not have a financial return, are at one pole and common equity, presumably the highest risk and highest return instrument, is at the other?

For illustration, observe the reasonably close match between potential Fourth Door Fund investors on the "Investor Continuum" and the financial instruments on what might best be called the "Leverage Continuum" below:



Just as the risk-reward equation in individual investments can be adjusted by less conventional mixes of loans and share participations, the equation can also be adjusted for fund investors by equally unconventional ways of structuring debt and equity. Below is an illustration of how a USD 15 million SME fund with diverse investors might be capitalized:

Investor	Amount	Instrument	Risk	Return
IFI	5,000,000	common equity	highest	highest
corporation	4,000,000	preferred equity with low coupon rate	moderate	moderate
national development bank	4,000,000	10-year loan w/ 5-year grace at interest rate below preferred coupon	low	low
foundation	2,000,000	PRI	lowest	lowest

In essence, this approach represents an “each according to his means” approach to capitalizing an SME risk capital fund in which risk is roughly commensurate with return for each investor.

The “Risk/Return Continuum” might also be called the leverage continuum. It is structured such that those investors whose low return requirements in essence “leverage up” the returns of those who require higher returns. This mechanism is the basis for a number of prominent public-private partnerships in highly developed countries for capitalizing risk capital funds for smaller and riskier businesses.

Public-Private Partnerships in SME Risk Capital

Fourth Door Funds, if supported by the appropriate sponsors and thoroughly documented in the design and policies, should be attractive to governments, particularly to ministries of industry and trade who are constantly frustrated in their efforts to grow the SME sector within an ultra-conservative capital market. A number of developed-market governments have introduced programs intended to provide incentives for private investors to invest in companies whose small size or “niche” may not be attractive to most private equity or venture capital investors.

The basis of these programs is that government is willing to spend money or forgo revenues in order to accomplish an economic objective which the private sector has failed to accomplish. In the case of inducements to private investors to invest in equity, the incentives provided are for institutional and private investors to invest indirectly through equity participations in professionally managed funds. Among the strategies employed by governments are:

- tax breaks to investors,
- loss insurance,
- equity participations by government with capped returns and restricted voting rights, and
- fund leverage, i.e., a low-cost loan from the government.

Of these, the last, “fund leverage,” is the most promising and has been the strategy of the U.S. Small Business Investment Company program of the U.S Small Business Administration (SBA) and the Australian Innovation Investment Funds (IIFs). Even with a 10% participation in the profits of the fund, in the case of the SBIC program, the low cost of money provides for a significant enhancement to the equity investors' return if the fund is successful.

The leverage fund mechanism should certainly not be seen as limited to governments. Any potential investor in a Fourth Door Fund which, by policy or objective, can accept a low return but requires the comfort of seniority, can accomplish the same objective of attracting the more risk-tolerant common equity investors to a Fund.

Summation

The Fourth Door Fund concept model is intended to reduce the risk in risk capital by shifting dependence on third-party exits of equity to on-going participations in the gross sales of investee SMEs. By combining the Model with innovatively structured capitalization in which investors with greater non-financial objectives leverage the returns of those seeking higher financial returns, Fourth Door Funds can begin to close the gap between fully risk-adjusted returns and the level of returns one might realistically expect.

The developing world cannot simply rely on banks and leasing companies to finance the massive growth in the number and performance of SMEs on which the economic future of many developing markets may depend. The dearth of *non* asset-based, expansion finance for SMEs is arguably the largest constraint to private sector growth in the SME sector. In order to proliferate points of access to SME risk capital, corporations, foundations, government and development institutions will need to work together to push expectations from both the risk and reward sides toward the risk-adjusted financial and developmental outcomes which a wide diversity of investors seek.

It is an ambitious undertaking to introduce a new type of financial intermediary into developing financial markets. It is even more ambitious to propose that such intermediaries be replicated to the point of becoming standard worldwide. The concept of the Fourth Door Fund, at the very least, is intended to point to a serious market failure in the development of the SME sectors on which the economic future of many countries may depend. It is hoped that it also may be instructive in pointing a way toward a remedy for that failure.

Annex 1

Summary Terms for a Shareholder Loan Investment

Equity investment:

Type of security:	Generally, common equity.
Percentage equity ownership acquired by the Fund:	Range: 26% to 49% of total shares.
Treatment of dividends or distributions:	No distributions made. (See "Participating Loan Feature" below).
Equity repurchase terms:	Equity is subject to call by owner/company or put by the Investment Partner after agreed period, generally 4 to 6 years provided that: • loan principal and interest repaid, and • royalty payments are current. Equity repurchase price set at either: • agreed multiple of original purchase price, or • agreed multiple of sales/revenue (greater of actual or projected during term, and formula based after term).
Tag-along and claw-back rights:	• Right to sell along side majority owner/owners in sale of owner's/owners' interest in the business. • Right to recover any difference between repurchase price and subsequent sale of the business within 1 year from repurchase.
Drag along rights:	No right of Investment Partner to force a sale of shares to third parties.
Management participation:	Board seat or equivalent.

Shareholder Loan:

Principal amount:	Minimum size: USD 200,000 equivalent Maximum size: USD 1,000,000 equivalent
Term:	Minimum stated term: 3 years Maximum stated term: 6 years
Base Interest rate:	Generally national “prime” (local preferential lending rate for established clients) or below “prime,” compounded quarterly.
Currency:	Local.
Interest grace period:	Maximum 10% of term of loan.
Principal Amortization:	• Quarterly payments. • Level (interest and principal).
Principal Amortization grace period:	10% to 25% of term of loan.
Prepayment:	Prepayment penalty based on the difference between (i) cumulative paid royalties and (ii) projected royalties over the term of the loan, (see “Royalty Feature" below).
Milestones for tranche funding of loan commitment:	Dependent on investee’s planned use of loan proceeds.
Collateral for Loan and Royalty Feature:	Available assets, including: • physical assets, • security assignments, • lock box agreements or equivalent control of cash receipts, • (in certain cases) majority owner(s) personal guarantees, and • pledge of equity.

Royalty Feature:

Rate: In addition to Base Interest Rate on Shareholder Loan, Investee will pay a fixed percentage of the greater of:

- actual sales/revenue or
- projected sales/revenue (per plan during term and after term per formula).

Period for computation: Quarterly (subject to variation for seasonal businesses).

Period for payment: Quarterly principal and interest payments.

Term: Royalty runs until equity is repurchased (if permitted by local law) or until loan principal is fully amortized.

Financial Reporting: Quarterly financial and developmental reports.

Protective covenants:

- financial tests/ratios
- restrictions on additional debt
- approval of major corporate transactions
- approval of business contracts and expenditures over a set limit

Default conditions:

- failure to pay principal, interest, royalties
- breach of protective covenants

Remedy options:

- acceleration of principal and interest on loan
- investor right to put equity to owner(s)/ manager(s) at repurchase price
- suspension of non-financial assistance
- assumption of control of board/business

Governing law: Local national law, including arbitration.

Annex 2

The Experience of Business Partners Limited

The Shareholder Loan Model is a variation of an SME risk capital investment strategy pioneered in Africa by Business Partners Ltd, formerly the Small Business Development Corporation of South Africa. Business Partners is an 80% privately owned, commercial development bank financing micro, small, and medium companies through offices throughout South Africa. Its longest standing shareholders include Old Mutual, Standard Chartered Bank, De Beers, Remgro and other of the largest corporations in South Africa. At the end of 2007, BP's total assets exceeded 2 billion rand and its return on equity was 8.8%, quite extraordinary for a development-oriented bank.

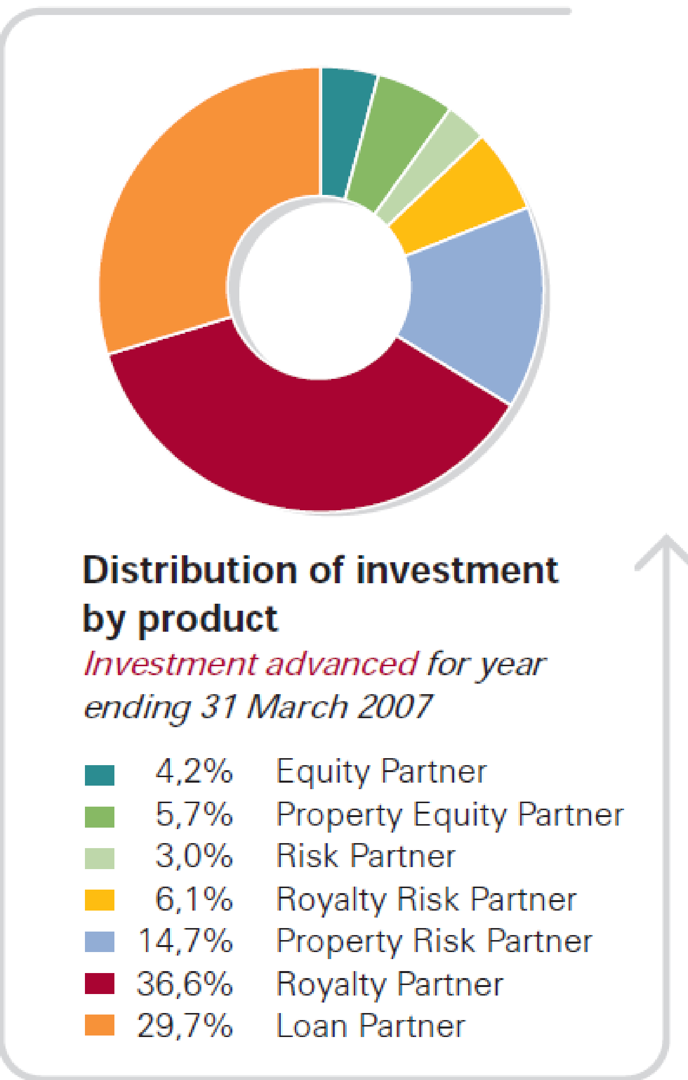
Although Business Partners has the longest experience with shareholder loan investments of any SME financing institutions, only in the past two to three years have they begun to harvest these investments. For this reason, Business Partners has not yet segregated the results of its royalty-based investments for public consumption. (We can also assume that Business Partners may prefer not to highlight for its clients the fact that certain instruments are significantly more profitable than others and, therefore, more expensive to the client.) This said, there are significant indications to be gleaned from Business Partners' 2007 Annual Report that royalty-based loans, both with and without equity participations, are doing well for them. In reviewing these figures, note that "Royalty Risk Partner" is the same thing as what this technical brief refers to as a shareholder loan investment, i.e. a small equity participation combined with a much larger loan bearing both interest and royalties on sales. In particular, please note the following in the Annual Report excerpts:

- Revenues from royalties in 2007 were up nearly 30% over 2006.
- Royalty Risk Partners in 2007 represented 6.1% of BP's portfolio while straight equity investments, Equity Partners, represent 4.2% of the portfolio. Given that capital gains have more than doubled in 2007 over 2006, we can reasonably assume that the equity portions of the Royalty Risk Partner investments represent a significant contribution to this growth in income from capital gains.
- Of combined revenues of about R270 million from loan interest, royalty payments, and capital gains on exits of equity, more than R38 million came from royalty payments on loans while some R36 million came from realized capital gains. Bear in mind that all royalty loans, with or without equity participations, also require interest payments at rates generally set within 200 basis points of prime. Therefore, not only do royalty-based instruments represent a significant portion of total revenues from loans, they also represent a significant portion of payments on debt instruments.

The most persuasive argument indicating Business Partners' success with shareholder loan investments can be inferred from the two facts that Business Partners' senior officers have significant performance-based elements to their compensation packages and that the number of such Royalty Risk Partner investments in Business Partners' portfolio has steadily increased since the instrument was introduced.

Financial Review

The equity and quasi-equity nature of the Business Partners investments are bearing fruit. Revenue in the form of income from associated companies and royalty fee income, increased by 52 and 26 percent respectively and amounted to R57,6 million (2006: R43,0 million). Furthermore, dividends and surpluses on the realisation of investments amounted to R31,8 million (2006: R24,3 million) an increase of 30,8 percent.



NOTES TO THE FINANCIAL STATEMENTS

for the year ended 31 March 2007

	GROUP		COMPANY	
	2007 R000	2006 R000	**2007 R000**	2006 R000
18. REVENUE				
Revenue consists of:				
Interest on business investments	**148 037**	117 984	**147 633**	117 453
Interest on cash and cash equivalents	**25 085**	30 394	**24 649**	30 143
Royalty fees	**38 301**	30 382	**38 253**	30 354
Financing fees	**6 958**	5 708	**6 958**	5 697
Dividends received	**4 493**	12 707	**2 867**	14 882
Fund management fees	**14 186**	6 733	**12 412**	6 733
Rental income	**48 641**	45 733	**43 397**	40 518
Property management fees	**10 605**	10 036	**12 918**	11 819
Professional services rendered	**3 933**	4 125	**3 933**	4 124
	300 239	263 802	**293 020**	261 723
19. OTHER OPERATING INCOME				
Profit on realisation of assets	**36 443**	15 668	**37 313**	14 868
Recovery of property expenses	**15 457**	14 633	**13 108**	12 337
Fair value adjustment of investment properties	**23 172**	15 439	**22 868**	14 371
Fair value adjustment of financial instruments	**(1 685)**	5 404	**5 673**	4 039
Interest on other loans	**1 331**	1 714	**1 262**	1 683
Other	**7 036**	4 459	**3 217**	4 266
	81 754	57 317	**83 441**	51 564
20. OPERATING EXPENSES				
Staff costs (refer note 22)	**114 690**	103 222	**111 210**	103 222
Bad debts – net of recoveries and impairment reversed	**6 701**	(308)	**7 331**	49
Bad debts written off	**32 613**	29 064	**31 776**	28 716
Bad debt recoveries	**(22 353)**	(19 344)	**(21 876)**	(19 222)
Impairment on investments reversed	**(3 559)**	(10 028)	**(2 569)**	(9 445)
Repairs and maintenance	**9 762**	6 932	**8 026**	5 781
Other administrative overheads	**55 207**	52 340	**52 009**	50 229
	186 360	162 186	**178 576**	159 281

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