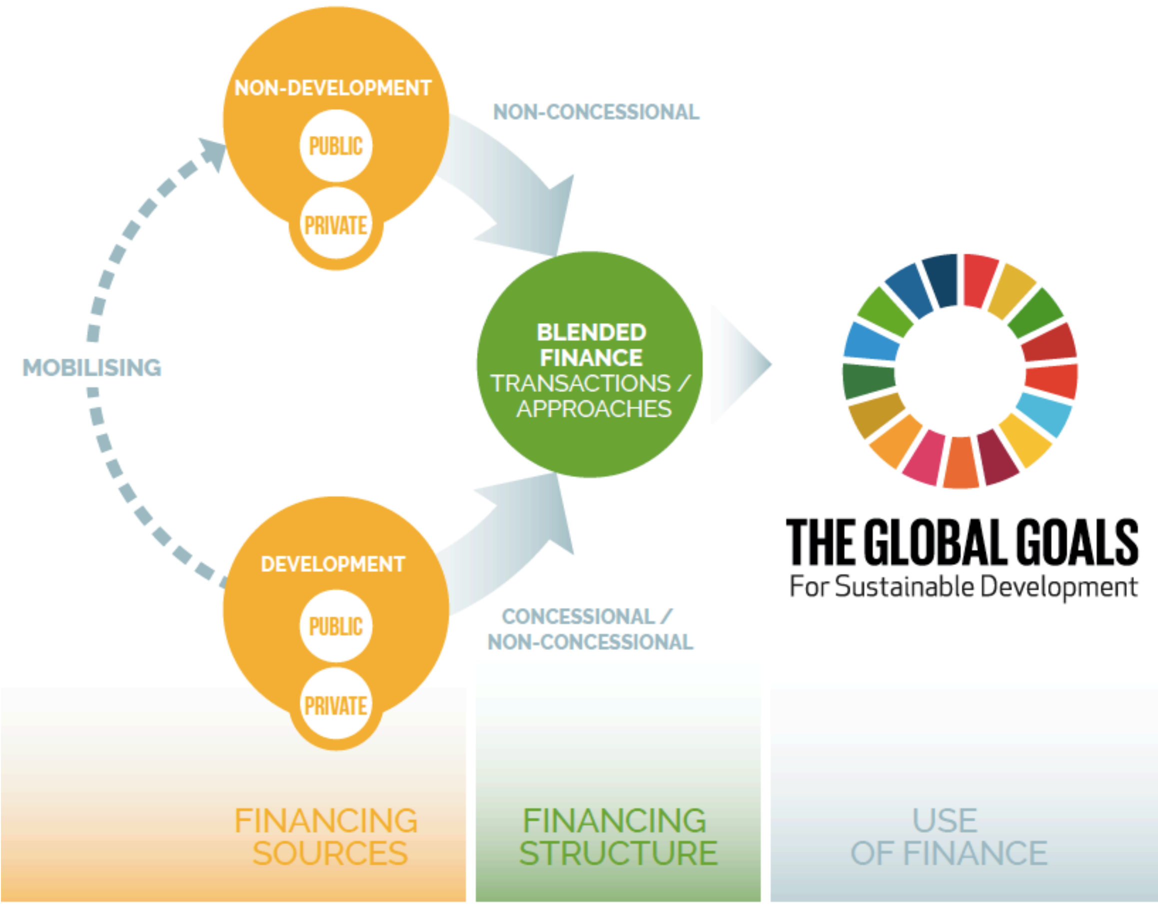
Financing SMEs in Mozambique

Mapping of alternative Blended Finance vehicles and identification of a suitable Blended Finance solution



FSD Moç

Consultancy services provided by:

ThirdWay Africa

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Executive Summary

Financial Sector Deepening Moçambique (FSD Moç) commissioned ThirdWay Africa (TWA) to provide a study on the access to financing for Mozambican Small and Medium Enterprises (SMEs), with a subsequent view on suitable options for a Blended Finance (BF) structure that would facilitate improved access to financing, from both the equity and debt perspectives.

As part of the research conducted to support this study and recommendation, TWA has engaged several players in Mozambique to consider the existing challenges of local stakeholders, with a view to design an adequate Blended Finance structure that can demonstrate to be *Scalable* and *Sustainable* – as per the FSD Moç's ambition.

The research and interviews revealed the key perceptions and challenges of SMEs with regards to accessing financing solutions, risk and non-risk adjusted alike. The current landscape with the SME space is much more familiar and welcoming of Debt as a source of risk-adjusted financing, with Equity being scarce and subject to resistance and unwillingness for shared ownership. In terms of non-risk adjusted financing, Grants are seen as less important due to their lack of scalability and sustainability, and typically not encouraging accurate accounting or risk assessment business practices. Guarantees, in this respect, are better received, and yet their implementation in Sub-Saharan Africa have consisted of limited scope Guarantee programs which yielded poor utilisation rates and have therefore typically not been sufficiently scalable to make a lasting impact in the accessibility to financing for SMEs.

The key challenges to access finance were identified as non-sector specific, and reflective of the overall state of the private sector in Mozambique coupled with the country's economic cycles. The two key examples were *Risk Mitigation* and *High Transaction Costs*. In order for an improvement in the access to financing for SMEs, these issues would need to be addressed in a scalable and sustainable manner in a Blended Finance vehicle(s).

The herein detailed options for Blended Finance vehicles target the key findings of the study, as described above, and focus on Fund structure for both equity and debt specific vehicles. The Fund structure was determined to be the most implementable within Mozambique, to achieve the goals of *scalability* and *sustainability*. When compared to the traditional Blended Finance vehicles that partner commercial institutions/players with development or government agencies, the Fund structure has an expanded ecosystem of stakeholders. Both the highlighted Fund structures, a Private Equity Impact Fund and a Club of Guarantors Guarantee Fund, include 2 distinct groups of secondary stakeholders: 'NGO Technical Assistance Providers' and 'Commercial Value Chain Partners'. These inclusions are driven by the feedback attained by TWA during their stakeholder interviews:

- *Technical Assistance* is viewed by all players as a key component of sustainability of any financing endeavor, as there typically are areas of insufficient commercial, accounting or operational experience from SMEs across sectors.

- *Commercial Value Chain Partners* were indicated as key risk-mitigating players which greatly increases the confidence of commercial lenders when providing credit to SMEs, across sectors. A partner that can guarantee the off-take of any production would greatly empower the business model of the SMEs receiving financing, thus diluting risk and creating a sustainable base of credit-worthy or investable companies.

1. Background

Frontier and emerging economies generally have a large number of microenterprises and some large firms, but far fewer small and medium enterprises. Small and medium enterprises (SMEs) form a key element of the development story for economies in their transition from "developing" to "developed". In high-income countries, SMEs are responsible for over 60% of employment, whilst in developing countries they account for only a fraction of that. This lack of representation in the firm size distribution in developing countries has led to the term 'missing middle' being used to describe the gap.

The term "missing middle" is also used in literature to refer to the lack of financing options that these SMEs have available to them. They fall within an underserved part of the financing spectrum – characteristically too large for funding by regular banks or private equity firms but too small for microfinance institutions. In the Mozambican context, loans tend to be unattractive due to pricing and conditions set by commercial banks (terms, interest, collateral). There is low participation of private equity firms due to high transaction costs and asymmetric information. In addition, there is generally a mismatch of cash-flow ramp up and debt repayment profiles on typical loans to SMEs, often leading to financial distress in early stage funding.

2. Defining SMEs

In 2011 the Government of Mozambique (GoM) – Decree 44/2011 of 21 September – defined micro enterprises as those with less than 5 employees *and* an annual turnover of less than MZN 1.2 million; small as having 5-49 employees *and* an annual turnover of MZN 1.2 million to 14.7 million; and medium as having 50-100 employees *and* an annual turnover of MZN 14.7 million to 29.97 million. In addition, if a company is more than 25% owned by a large organisation (> MZN 29.97 million in annual turnover *and* 100+ employees) this negates its status as an SME. In the event of a discrepancy between the two criteria, turnover takes precedence. For example, if a company had annual turnover of MZN 18 million but only 10 employees, the entity would be categorised into the "medium enterprise" bucket. This categorisation is followed by IPEME (Instituto para a Promoção e Desenvolvimento das Pequenas e Médias Empresas) which participated in the local stakeholder interviews, as explored in section 5.

Figure 1: Definition of enterprise categories

Enterprise	No. of employees	Annual turnover (MZN)
Micro	< 5	< 1.2 million
Small	5 - 49	1.2 – 14.7 million
Medium	50 - 100	14.7 – 29.97 million
Large	100 +	29.97 million +

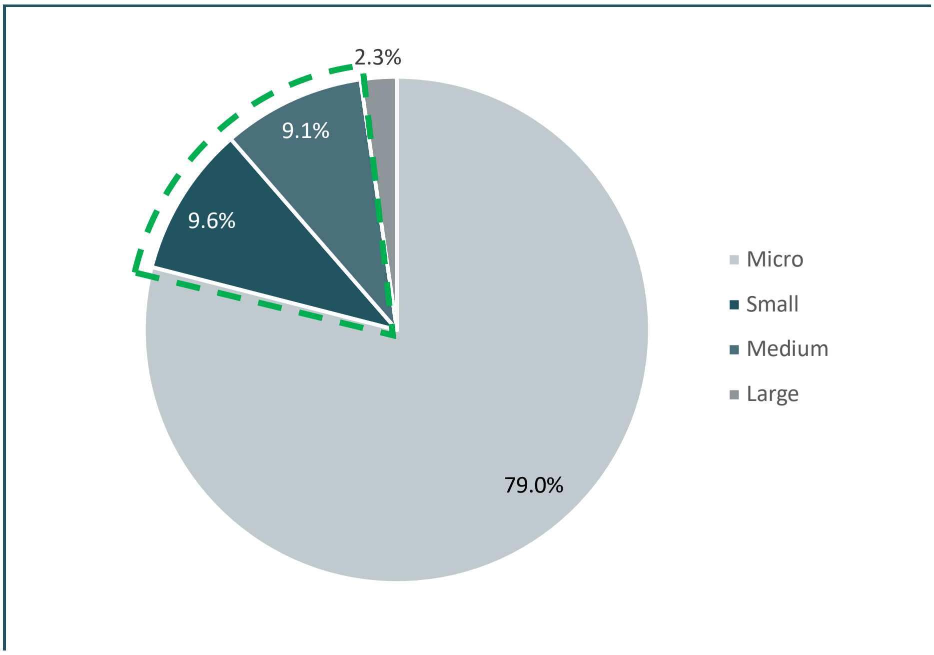
Prior to this GoM decree, the Mozambican National Institute of Statistics (INE) defined an SME as a firm with less than 100 employees – an overly broad segmentation, capturing in excess of 98.6% of Mozambican registered firms. Although subjective, this new definition with joint-criteria provides a more precise definition of SMEs. It is now in line with some of the stronger country definitions of SMEs as outlined in the International Finance Corporation (IFC) worldwide SME definition country matrix.

3. SMEs in Mozambique

Segmentation of registered firms in Mozambique

Using the GoM definition discussed in section (2), SME's account for 18.7% of all firms registered in Mozambique. A more granular segmentation can be seen below:

Figure 2: Segmentation of registered enterprises in Mozambique



Source: Observatório Internacional Sebrae (Aug. 2018)

Enterprise	Share
Micro	79.0%
Small	9.6%
Medium	9.1%
Large	2.3%

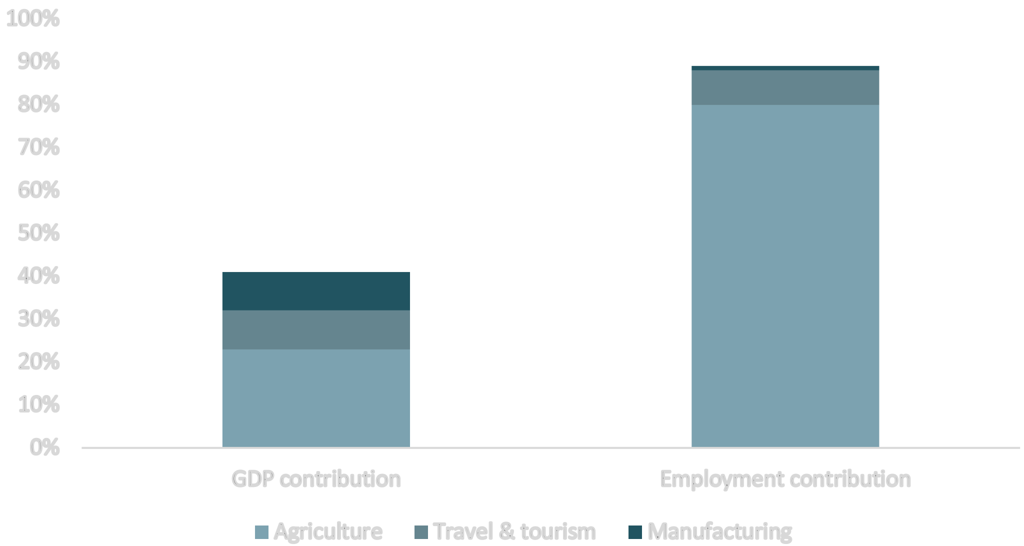
Including micro enterprises, MSMEs represent 97.7% of total registered companies in Mozambique. Whilst they only contribute 33% to total annual turnover (MZN 132bn), they are responsible for a significant share of employment. The FinScope MSME Survey in Mozambique (2012) finds that almost every second adult in Mozambique engages in MSME activities. Whilst Micro Enterprises form a significant part of the volume of Mozambican companies, their circumstances remain far too varied for a consolidate segment approach to providing access to financing recommendations. The key concern regarding Micro Enterprises is their lack of access to banking solutions, as seen in Figure 5 on page 6 below, which can be typically seen as a key requirement to the provision of financing.

Sector focus and methodology

In this study we will focus on SMEs in the agriculture, manufacturing and travel & tourism sectors. The chosen sectors have been agreed upon with FSD Moç, which also are based on findings from prior commissioned reports by FSD Moç. The sectors that have been selected to represent the significant share of the Mozambican economy and in turn to form recommendations that are applicable to the Mozambican economic context.

We used two criteria in our methodology for sector selection – contribution to GDP, and contribution to employment. Our analysis found that these three sectors make up 41% of contribution to GDP and 89% of contribution to employment. A more detailed breakdown of this can be found in the figure below.

Figure 3: GDP and Employment Contribution in key SME sectors



Sources: FAO, WTTC, Deloitte, World Bank, TWA Analysis

Sector	GDP contribution	Employment contribution
Agriculture	23%	80%
Travel & tourism	9%	8%
Manufacturing	9%	1%
Total	41%	89%

Manufacturing

The manufacturing sector in Mozambique is still underdeveloped but has several advantages that give it a favourable outlook if the financing gaps can be solved. Mozambique's wealth of natural resources and strong transport linkages to South Africa (the Maputo Corridor), Malawi and Zambia (the Nacala Corridor), Zimbabwe, Malawi, Zambia and DRC (the Beira Corridor), competitively priced supply of labour present opportunities for processing. In addition, if financing constraints can be overcome, there is significant growth potential for the manufacturing sector considering low domestic competition and an almost guaranteed source of demand from imminent downstream Liquid Natural development in Northern Mozambique.

Agriculture

The agriculture sector has robust growth rates, averaging over 5% a year between 2005 and 2015, however there is still significant untapped potential with only a fraction of its 36 million hectares of arable land currently being utilised. Mozambique has excellent agro-climatic conditions and great export potential, being situated favourably to service Asian and Middle Eastern markets. However, SMEs generally underinvest due to a lack of financing, which results in low productivity and poor infrastructure.

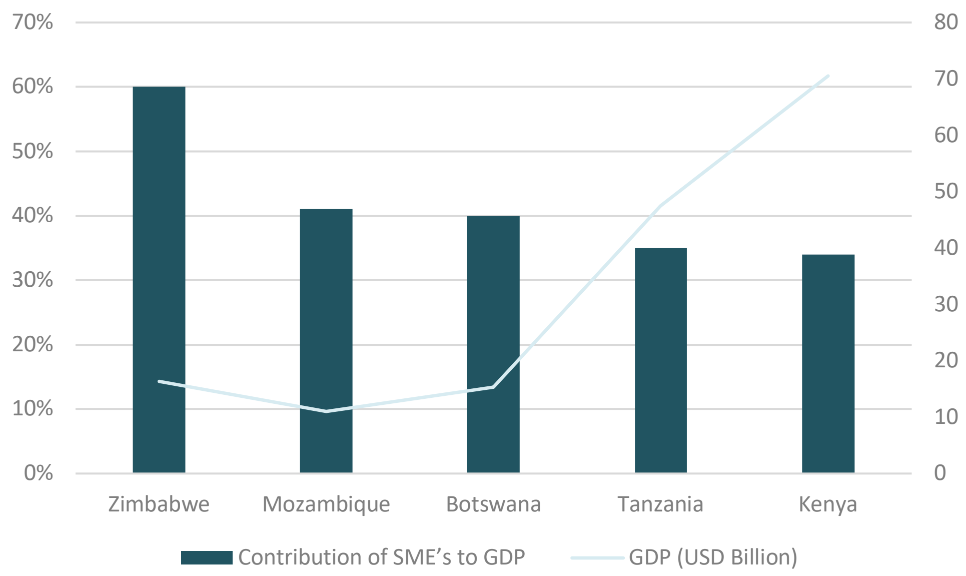
Travel and tourism

Mozambique has significant natural wealth – its tourism assets include 2,700km of coast line facing the Indian Ocean, biodiversity rich ecosystems including "big five" game safari, remote archipelagos, well preserved corals and a diverse cultural heritage. Its travel and tourism industry is growing, however, despite contributing above the sub-Saharan Africa (SSA) average to GDP and employment it falls below the SSA average for investment, at only US$200mn in 2017 compared to the SSA average of double that. This is partly due to a lack of financing for SMEs, who make up the lion's share of economic activity in this sector.

Regional Peer Comparison – SMEs Landscape

This section provides some context of the landscape of Mozambican SMEs in comparison to other countries in the region.

Figure 4: Demonstration of SME's contribution to GDP per Country[1]



Source: Kenya National Bureau of Statistics, Research Gate (2015), LEA (Botswana), World Bank (2016)

Figure 4 shows how the contribution of SMEs to GDP in Mozambique compares to that of other Southern and Eastern African countries listed above. Zimbabwe has the largest GDP contribution from SMEs, with a significant delta compared to the other countries. TWA's analysis suggests Zimbabwe's high GDP contribution of SMEs is due to a structural shift in the operating economy, from predominantly large corporations to small and medium enterprises. Disregarding Zimbabwe, we see that the contribution of the SME sector to Mozambican GDP is in line with other countries in the surrounding region. We infer that although the SME space in Mozambique requires development, especially with regards to facilitating access to financing, the evidence suggests that the SME contribution to the economy is largely in line when compared to that of neighbouring countries.

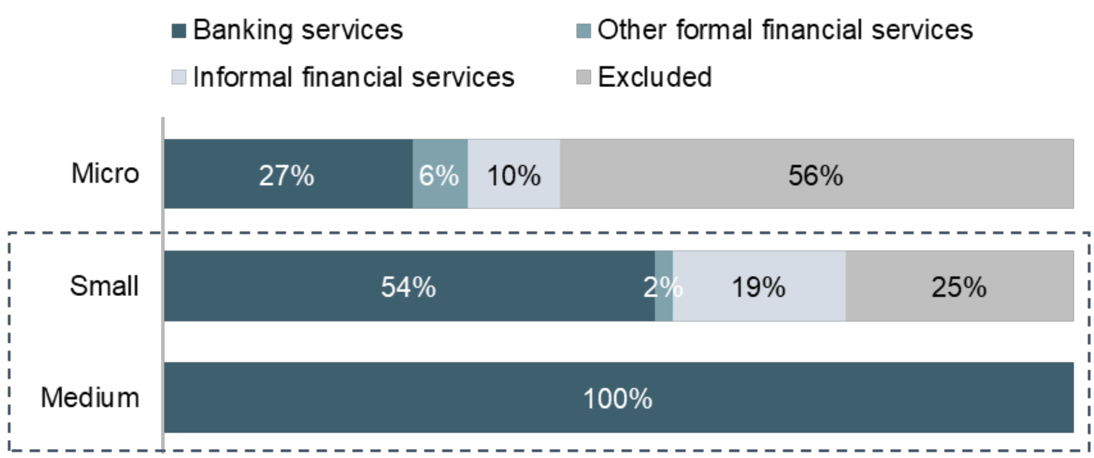
Despite this observation, the size of the Mozambican economy, in terms of GDP, is smaller than others in the region, and thus developing the SME sector in Mozambique will be of critical importance to drive the overall development in the country's economy and close the gap to Tanzania and Kenya (with GDPs between 5 and 7x the size of Mozambique).

[1]*Note: the statistics regarding the SME contribution to share of the respective countries GDP stem from various sources across multiple year ranges and is compared to the total GDP (USD)World Bank statistics of each respective country in 2016. Various sources were utilised as desk research did not reveal the relevant statistics from a uniform source and time period.*

Sources:
http://www.ejournalofbusiness.org/archive/vol4no4/vol4no4_2.pdf
http://www.lea.co.bw/sites/default/files/publications/Packaged%20BIDPA%20Study.pdf
http://www.rbz.co.zw/assets/governor-s-welcome-remarks-.pdf
https://www.researchgate.net/publication/323511693/download
Kenya National Bureau of Statistics

Imperative to the development of SMEs is their access and use of banking services, as this represents a fundamental first step in the subsequent access to financing. The following Figure 5 breaks down Mozambique's use of financial services based on the size category of the company:

Figure 5: Use of banking services or products by area of the respondent



Source: FinScope MSME Survey Mozambique 2012

Whilst medium sized firms widely use banking services, as much as 44% of small sized firms are financially excluded or use informal financial services. Small enterprises in frontier economies are often in a transitionary stage characterized by being too small for fiduciary obligations required by formal financial services but too large for the typical informal financial services which many small firms rely on. As the figure shows, this can leave them completely excluded as demonstrated by 25% of small sized firms in Mozambique. It is clear that in parallel to measures to increase financing access for SMEs, more must also be done to bank smaller firms and provide them access to commercial banking services.

Key Take-Aways: Mozambique's SME landscape can be compared to that of other regional peers, in that it faces similar challenges in its development. The smaller size of the Mozambican economy compared to peers highlights the importance of the development of the SME sector. Key take-aways include:

- Access to banking services will require support in order to ensure that the large number of firms in the SME sector can be supported by Blended Finance structures.
- The Mozambican economy will require significant growth to catch-up to regional leaders, and hence SMEs will require a development path that includes access to growth and working capital. Economies of scale, both from production and distribution capabilities, are not yet benefitting the Mozambican SME sector when compared to peer economies, and hence consolidation/streamlining of value chains will provide immediate boosts to the scalability of the sector in the long-run.

4. Blended Finance and vehicles

Introduction to the concept of Blended Finance

Blended Finance (BF) revolves around the concept of leveraging return-seeking capital with the use of development finance or philanthropic funds. These two forms of capital are explained below:

1. **Return-seeking capital** is capital that targets risk-adjusted financial returns on investment. Returns are risk adjusted to the extent that an investor will be expecting higher returns from a riskier investment, that way, if two or more investments have the same return over a given period of time, the one that has the lowest risk will have the better risk-adjusted return.

   Most return-seeking risk-adjusted investments are made by players from the private sector, whereas public players tend to predominantly carry out non risk-adjusted investments.

2. **Development Finance** aims to facilitate access to financing or provide financing to projects that intend to yield social or environmental returns at terms that are more attractive than the ones offered in the markets. As such, development finance is considered to be non risk-adjusted capital.

   Development finance is often deployed by Development Finance Institutions (DFIs), which are specialised development banks or subsidiaries set up to support and foster private sector investments in developing countries. They are usually majority-owned by national governments and source their capital from national or international development funds or benefit from government guarantees. This ensures their creditworthiness, which enables them to raise large amounts of money on international capital markets and provide financing on very competitive terms.

By introducing both of these sources of capital into a single instrument and within an investment vehicle, Blended Finance can be used as a risk-lowering construct with the development finance contribution acting as a return-seeking investment catalyser. Commercial institutions seeking returns will see their investments empowered by the impact seeking, non risk-adjusted, development finance tranche.

Beyond the definition presented above, various other definitions for BF are in use. The World Economic Forum defines Blended Finance as *"the strategic use of development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets, resulting in positive results for both investors and communities".* This definition highlights the concept of BF as a mechanism to improve the access to financing in developing economies, such as Mozambique.

Blended Finance vehicles can be varied in their composition, and in how both of the capital components interact, firstly within an instrument, and secondly as part of a larger structure that defines the investment vehicle. The types of development finance and commercial capital that can be used within a BF instrument will also vary and are worth considering. Figure 6 below presents different types of development finance and private commercial finance to provide a summary of the scale of each type of capital currently available for Blended Finance, as detailed in the report of the Blended Finance Taskforce[2]:

Figure 6: Blended Finance Definition and types of capital currently available

Philanthropic development finance

Capital with some objective other than maximizing returns – includes but is not limited to concessional capital

Concessional ODA from donor countries
- Total annual ODA flow $143 billion 2016
- Total estimated available concessional facilities for blended finance around $20 billion today

Concessional or commercial funds MDBs and DFIs
- Total annual flow MDB and DFI activity around $220 billion 2016

Philanthropic funds from foundations
- Total AUM around $1 trillion

Investment by impact funds below market rate
- Total annual commitments around $1-2 billion 2016 (16% of total estimated below market rate, closer to capital preservation)

External private commercial finance

Capital whose primary objective is maximizing commercial returns

Commercial investment by asset owners (e.g. pension funds, insurers, SWFs), asset managers, project developers and endowments

- Total overall AUM estimated at $200 trillion
- Total AUM 'alternatives' estimated at $6 trillion

Investment by impact funds at or close to market rate

- Total AUM $114 billion
- Total annual commitments $22 billion in 2016 (84% of total at or closer to market rate)

Source: "Better Finance Better World" The Blended Finance Taskforce, in partnership with the Business & Sustainable Development Commission and SYSTEMIQ (Jan. 2018)

Framing the value of Blended Finance in the Global context

The Sustainable Development Goals (SDGs), are a global call to action to create inclusive prosperity for all and represent the aligned vision of 170 nations and territories as represented by the United Nations General Assembly. The SDGs are a set of 17 interconnected global goals that are now being adopted by governments, multinationals, NGOs, entrepreneurs and communities to create a sustainable future based upon inclusive social, environmental and economic development by 2030.

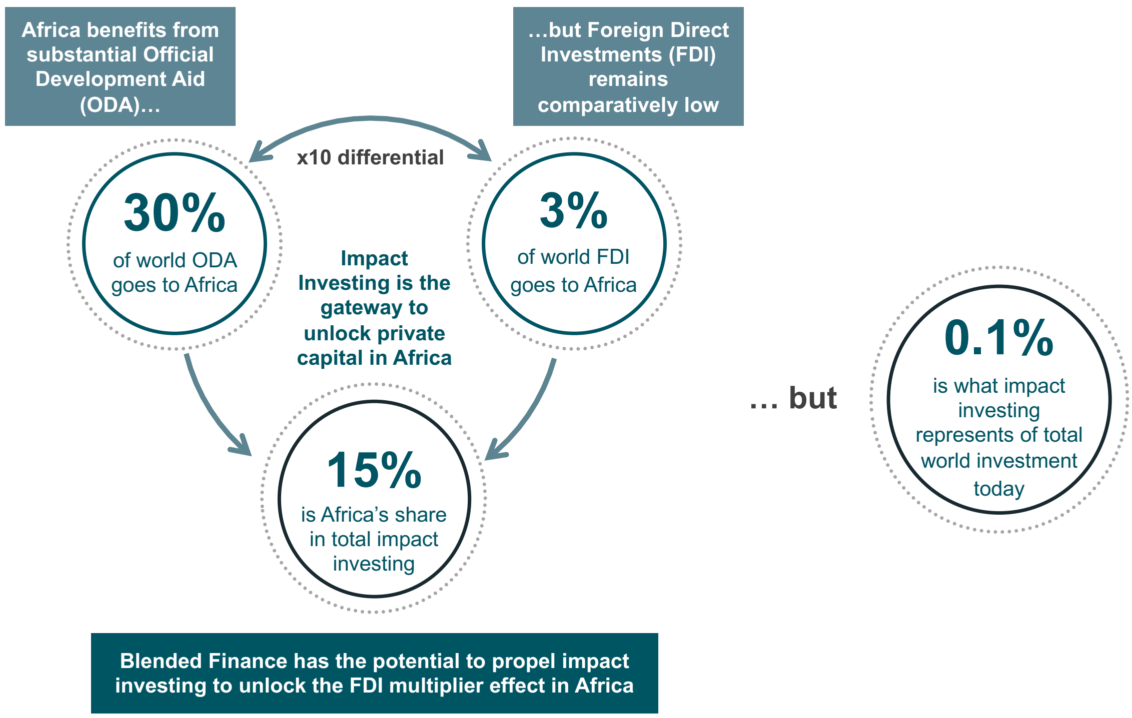
The achievement of the Sustainable Development Goals requires an innovative approach to catalyse private capital. As a result of that need, Impact investing has emerged as an investment strategy aimed at *achieving positive impact alongside financial return*.

Within this framework, Blended Finance has the potential to propel impact investing to unlock the FDI multiplier effect in regions such as the African continent.

Figure 7 shows the relevance of Impact Investing and points out how Blended Finance could play a crucial role in this framework:

[2] *The Blended Finance Taskforce was launched in 2017 as an initiative of the Business & Sustainable Development Commission (BSDC).*

Figure 7: The relevance of Impact Investing and the role of Blended Finance



Source: World Economic Forum, World Bank, IMF, UNCTAD

Proliferation of Blended Finance

Blended finance is used to materialize worldwide commitment towards inclusive sustainable development: today, the Blended Finance market is worth +US$100bn. Having more than doubled in size over the past 5 years, momentum is building, and the market is expected to continue growing and could double again in the next 3-4 years as providers of concessional and other forms of development capital earmark more money to be used for blending. Private investors will look to leverage this risk cushion. Nowadays, expected returns on Blended Finance vehicles and facilities generally fluctuate between 10-20% for institutional investors (depending on risk allocation). Going forward, Blended Finance will require innovation to allow its market to fully cater to frontier opportunities, reaching projects in remote locations through more custom-made funds that ensure solutions for small-scale and higher-risk frontier projects. The key components of scalability and sustainability will be critical in ensuring a continued proliferation of Blended Finance.

Figures 8 and 9 provide a framework with which to consider the construction of a Blended Finance vehicles – identifying the A) ***Instruments*** (Fig. 8) and their key risks (Fig. 9), and B) S***tructure*** (Fig. 10) of said vehicle. Within a single structure several instruments may be deployed, and thus the possibilities are substantial of significantly varied BF vehicles being deployed to target one geography, sector, or impact goal. This framework will be used in Section 5 to consider appropriate vehicles that are best suited to enabling financing of the Mozambican SME sector.

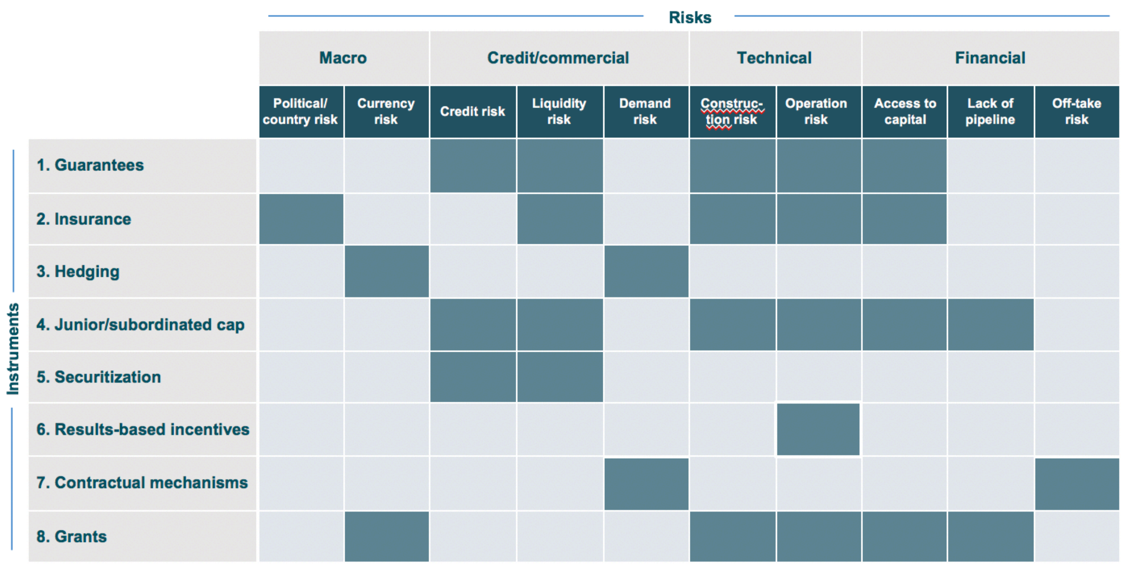
The subsequent sub-sections further illustrate BF examples to date, and specific case studies of their utilisation, the last of which with a Mozambican geographical focus.

Figure 8: Blended Finance Instruments

Instrument	Description	Risks / barriers mitigated	Example provider(s)
1. Guarantee	Provides protection to one party if the other party fails to perform. Guarantees are provided by a third party who "steps into the shoes" of the defaulting party so that the innocent party does not suffer loss. Guarantees are a form of credit enhancement, strengthening the creditworthiness of the investment because of the promise from the guarantor to complete performance in the event of default. As such, guarantees are one of the most catalytic forms of blending. There are many types of guarantees including first loss, partial risk or credit guarantees and trade finance guarantees.	Access to capital; credit / counterparty risk; off-take risk; construction / completion / technical risk; demand risk	GuarantCo; USAID
2. Insurance	Insurance provides protection by promising to compensate for a specified loss or damage in return for payment of a specified premium. There are many types of insurance; one of the most common is political risk insurance to protect against adverse government actions or war, civil strife, and terrorism. Insurance provides a more stable environment for investments into developing countries. Along with guarantees, they are one of the most catalytic forms of blending.	Political risk; construction risk; operation and output risks; upstream resource-related risks; access to capital	OPIC; MIGA
3. Hedging	Hedging reduces the risk of adverse current price movements in an asset and its associated earning stream. Currency hedging reduces or eliminates exposure to the movement of foreign currencies – addressing one of the key risks for investing in emerging markets.	Currency / Commodity risk	TCX
4. Junior / subordinated capital	Subordinated (debt) or junior (equity) protects senior investors by taking first losses on the value of the security i.e. if something goes wrong, the most junior / subordinated tranche will be paid out last. First-loss capital takes a position that will suffer the first economic loss if the assets below it lose value or are foreclosed on (this can also be provided through a grant or guarantee).	Multiple risks including off-take, construction, and reputational risks; access to capital	FMO; KFW DEG
5. Securitisation	Securitisation refers to the process of transforming a pool of illiquid assets into tradable financial instruments (securities).	Liquidity / time horizon; scale; counterparty / off-take and credit risk	European Investment Bank
6. Results-based incentives (e.g. pay-for performance schemes)	Instruments that provide incentives and disincentives to achieve desired outcomes or results (tie at least a portion of payments to achievement), including social impact bonds and performance-based contracts. This type of financing is aimed at rewarding innovation and successful implementation of a project with clear climate benefits.	Operation and output risks	IFFIm; Bill & Melinda Gates Foundation
7. Contractual mechanisms (e.g. feed-in tariffs or off-take agreements)	There are various contractual and project finance arrangements to support the development of bankable infrastructure projects including public and private off-taker agreements, subsidies such as feed-in-tariffs, and tax credits. These mechanisms involve an agreement between producers and buyers of a resource to purchase or sell portions of future production. These agreements are to secure financing for a production facility or buy the equipment needed to extract a resource (e.g. power purchase agreements (PPAs) in the energy sector).	Demand risk; financing risk (demonstrate bankable revenue stream)	ofgem; Google
8. Grants (especially for technical assistance)	Capital which is paid in without any expected repayment or compensation over a fixed period of time. It could include money for technical assistance or project preparation to bring a project to bankability. Grants can be critically important for pipeline development, especially in less mature sector and riskier geographies, creating significant (if often hard to measure) crowding in of private capital	Access to capital; high transaction costs; operational risks; lack of bankable pipeline, lack of local intermediaries; lack of capacity	The Rockefeller Foundation; SIDA

Source: "Better Finance Better World" The Blended Finance Taskforce, in partnership with the Business & Sustainable Development Commission and SYSTEMIQ (Jan. 2018)

Figure 9: Overview of Risks per Blended Finance Instrument



Source: 'Better Finance, Better World (World Economic Forum) – Adapted by TWA

Figure 10: Overview of Structures of Blended Finance Vehicles

Blended Finance Vehicle – Overview of Structures

Project level	• Public and private capital is blended within a single projector company's financial structure	**Example** – Elazig Turkey, Lake Turkana Wind Project, &Green, SPCG
Fund level	• Public and private investors pool resources to be invested in multiple projects or companies	**Example** – Climate Investor One (CIO), Danish Climate Investment Fund (KIF), &Green
Fund-of-funds	• Funds that in turn invest in other funds	**Example** – GEEREF I & II. Sarona
Facility (institutional level)	• A long term or permanent institution is set up, or modified, to blend finance, thereby main streaming the use of blended finance	**Example** – IFC Managed Co-Lending Portfolio Program (MCPP), GuarantCo
Market level	• Market mechanisms which blend public subsidies to encourage private investment	**Example** – UK and German FiT schemes, Fannie Mae/Freddie Mac
Project preparation support/ intermediaries	• Public support for project preparation and intermediaries has also been used as a way to mobilise private investment by addressing specific barriers, especially information gaps	**Example** – ACEF, Aligned Intermediary, CPI's the Lab

Some of the structures detailed above may be more or less feasible to deploy in the context of the Mozambican economy and regulation. The structure perspective of a BF vehicle will be in focus in section 5 herein, to determine which structure is more adaptable to the current challenges in enabling the access of finance to SMEs in Mozambique.

Brief case studies illustrating Blended Finance single instruments or structured vehicles

1. The Hivos-Triodos Fund (HTF)

Project name: Hivos-Triodos Fund (HTF)	**Instruments in use:** guarantees, loans, equity and technical assistance	
Timeframe: Since 1994	**Geographic scope:** Global	**Budget:** €78.8mn

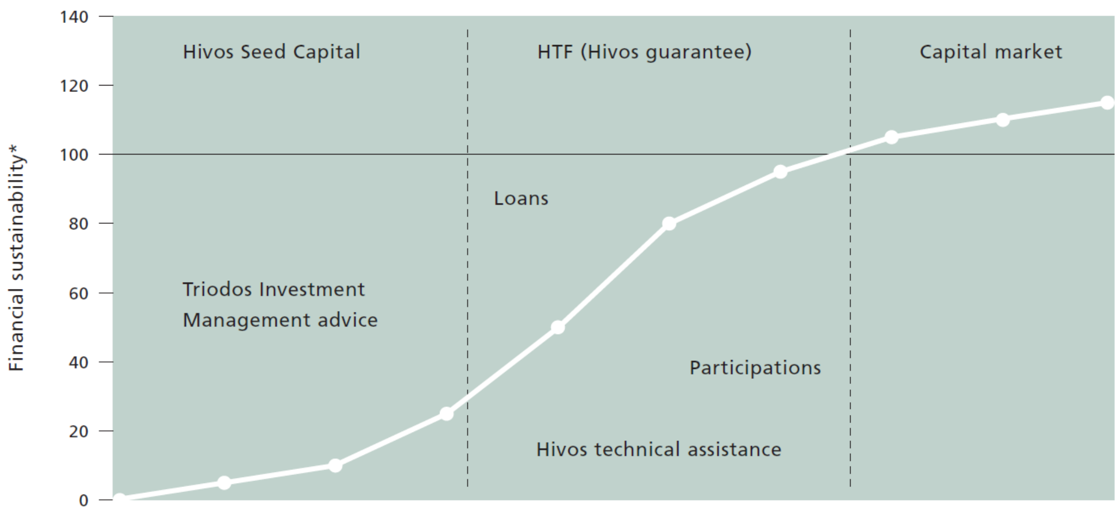
The Hivos-Triodos Fund (HTF) emerged in 1994 from a need by micro finance institutions to access small capital (<US$100k) to support low income strata in developing countries. The HTF started offering a – for that time – unique package of support to early-stage MFIs which included convertible grants and grants for capacity building. In 2001 this led to the setup of a Seed Capital programme, assisting MFIs to reach a level of maturity which would allow them to qualify for HTF or local credit funding.[3]

With the introduction of Hivos' Life Cycle Model, HTF started supporting MFIs throughout the various stages of development. Depending on a range of factors (among others, perceived financial sustainability of the MFI), HTF provides seed capital, loan guarantees and loans (typically 3-5year bullet loan, market-conform interest rate) to local financial institutions and funds that focus on reaching hard-to-reach target groups, especially women and people in rural areas. In addition, HTF provided equity investments (normally 5-20% of the shares) to companies

[3] *Evaluation: Hivos seed capital program for microfinance*. Nedworc Foundation, May 2010.

and organisations. Figure 11 below highlights the different phases of the HTF's use of Blended Finance.

Figure 11: Life Cycle Model supporting MFIs in different phases of development

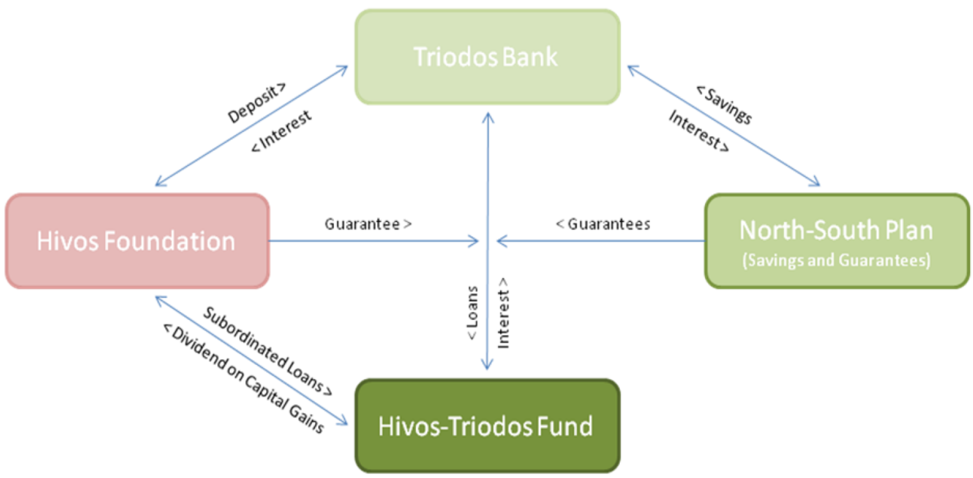


** Financial sustainability is the extent to which an organisation is able to cover its total expenditure from the income it generates (excluding donations).*

The blended use of financial instruments is demonstrated by the cooperation model between Hivos and HTF (see Figure 12). Hivos offers the following type of financial instruments:

- Account holders in the north-south deposit financial savings into Triodos Bank which is then able to on-lend to HTF;
- Financial guarantees to the credit lines between the Triodos Bank and HTF, used to guarantee portfolio losses and to mitigate currency exchange risks taken by HTF;
- Interest-free, sub-ordinated loans provided by Hivos to HTF allowing HTF participate in MFIs and selected companies.

Figure 12: HTF funding structure



2. Women in Energy Enterprises in Kenya

Project name: Women in Energy Enterprises (WEEK)	**Instruments in use:** mix of guarantees, grant funding and loans	
Timeframe: 2014-2018	**Geographic scope:** Kenya	**Budget:** €7.17mn (7 countries)

The Women in Energy Enterprises (WEEK) initiative is a project that ENERGIA (an international network on gender and sustainable energy) implements in Kenya to assist women entrepreneurs to develop selected renewable energy value chains and is part of the Women's Economic Empowerment (WEE) approach. This approach involves developing Women Entrepreneurs (WEs) and their networks in the solar lighting, biomass briquetting and improved cook stoves value chains. The programme is implemented in Indonesia, Kenya, Nepal, Nigeria, Senegal, Tanzania and Uganda.

At the programme level, WEEK has received c.US$7mn worth of grants from various entities.

In Phase 1 of the project in Kenya (mid-2015 to end of 2016) the use of Blended Finance was demonstrated through the loan products that were offered to individual Women Energy Entrepreneurs as Micro Finance Institution clients. The aim was to facilitate the MFI's lending to the WEs by making available US$39,000 of grant funding from the WEEK project to MFI to set up a loan guarantee fund (guaranteeing 50% of the loan risk) to mitigate the financial risks for the MFI. The loan guarantee was also used by Practical Action to negotiate a lower interest for the WEs from 21% to 15%. The ticket size for the loans offered by the MFIs using this model was between US$1,000 and US$5,000.

1. GAPI, Loan Guarantee Fund, Mozambique

Project name: Agro-Guarantee Fund	**Instruments in use:** guarantees	
Timeframe: 2013 - Ongoing	**Geographic scope:** Mozambique	**Budget:** >US$3.8million

The Agro-Guarantee Fund results from an agreement between the Governments of Mozambique, the Kingdom of Denmark and Gapi-SI, with the objective of improving access to bank credit for agribusiness. Led by Gapi, the Fund kickstarted in 2013 when a number of financial institutions came on board in collaboration with the Mozambican Association of Banks.

Since beginning its operations, the Agro-Guarantee Fund, which has eight subscribing banks, has already made it possible to grant credit amounting to MZN 230mn (US$3.8mn) to around 90 small and medium-sized enterprises, which has enabled the creation of more than 5,000 jobs. In the scope of the Agro-Guarantee Fund, Gapi grants guarantees to the subscribing banks, which include BCI, BIM, BTM and FNB, and Societé Generale, in the range of 20-70% of total loan size and at a nominal limit of MZN750,000 and MZN15mn, with the ceiling forecast to increase to MZN20mn. Whilst the facility has not provided as much credit as was ambitioned, this project has been successful in the response from the national banks, with the subscriptions rising to 8 from an initial ambition of having 4 participating banks. A change in the mindset of the commercial banks in Mozambique towards the SME sector will be of critical importance to improving access to debt financing.

5. Blended Finance for Mozambican SMEs

In order to assess the viability of specific Blended Finance structures with the aim of facilitating access to finance for Mozambican SMEs, the TWA team conducted in-depth interviews with key players in this ecosystem. This section, composed of 2 parts, covers the content from this process, the key challenges for SMEs, as well as the conclusions reached to inform a selection of options on a Blended Finance structure for this purpose.

Part 1: **Overview of Stakeholder Interviews in Maputo**

As part of the discovery process for this study, TWA conducted a series of interviews with key stakeholders on the provision of financing, and corporate readiness to SMEs in Mozambique. The interviews were geared towards better understanding each institution's experience and outlook with regard to the importance and challenges for different financing alternatives, as well as to detail their views on the potential Blended Finance vehicles that could address the identified challenges.

A total of 10 institutions to be interviewed were agreed with the FDS Moç team, with the purpose of selecting a group representative of the extended environment of stakeholders that play a part in the facilitation, provision, or preparation of financing for SMEs. Institutions selected comprised both the public/development agency and commercial providers of financing, as well as the wider array of NGOs and Incubators that focus on Technical Assistance. These can be leveraged by SMEs to ensure a readiness to receive financing or ensure the adequate usage and strategic planning for financing. A focus was placed in institutions that have had previous experience with Blended Finance instruments or have included such instruments in their forward-looking strategies to engage and support SMEs. TWA leveraged its contacts within Mozambique to ascertain participation and validated the selection with FSD Moç to ensure agreement in the representativeness of the participating institutions.

The following institutions, and individuals, participated in the interviews:

Figure 13: Stakeholder Interview Participants

Institution	Type	Participant (Role)
BARCLAYS *Barclays Moçambique*	***Commercial Bank***	**Bernardo Aparicio** • (Head of Corporate Finance) **José Pacheco** • (Chief Investment Officer)
IPEME INSTITUTO PARA A PROMOÇÃO DAS PEQUENAS E MÉDIAS EMPRESAS *IPEME*	***Public Sector***	**Eleutério Mabdjaia** • (Dir. Of Financial Assistance, Comms and Marketing) **Yerussalema Chambal** • Financial Technical Assistance
KFW *KFW*	***Development Agency***	**Jens Dorn** • Senior Project Coordinator
Norfund *Norfund*	***Government Owned Private Equity***	**Chishamiso Mawoyo** • Head of Regional Office

AgDevCo *AgDevCo*	***Impact Investor***	**Rui Afonso** • Country Director
gapi sociedade de investimento *GAPI*	***Development Financial Institution***	**Antonio Souto** • Chief Executive Officer
ideialab *IdeiaLab*	***Entrepreneur Incubator***	**Sara Fakir** • Co-Founder & Chief Executive Officer
iC impacto capital *Impacto Capital*	***Investment Management & Advisory Firm***	**Diogo Cunha Lucas** • Chief Executive Officer
Romeu Rodrigues	***Expert***	**Romeu Rodrigues** • Former chairman of a Mozambican construction contractor association
AFRIGOTEL ARMAZENAGEM FRIGORIFICA, LDA. *Afrigotel*	***SME***	**Patrick Fernandes** • Chief Financial Officer

Summary of Interviews

The interview process provided a range of differing points of view with regards to the most important components and challenges to finance the 'missing middle' in Mozambique. However, all interviewees identified similar critical factors to facilitating access to financing for SMEs. This consistency in the appraisal of the current landscape is somewhat surprising, given the wide array of activities for SMEs, but does illustrate that the fundamental barriers of entry for affordable financing alternatives are mostly a **product of the wider state of the private sector in Mozambique**, and **the country's economic cycles**. Figure 14 below highlights the identified key challenges:

Figure 14: Summary of Stakeholder Interviews

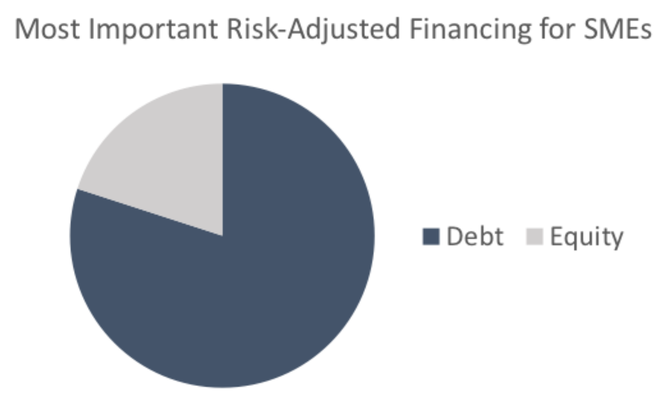
Summary of Stakeholder Interviews: Views on Challenges for SME financing in Mozambique

	Key Barriers to Financing	*Key Deficiencies for SMEs*
Development Agencies / Government Institutions	• High transaction costs made identifying targets for financing challenging • SMEs required a significant amount of Technical Assistance in order to be deemed credit-worthy by banks • Shared-ownership is unusual in Moz, discouraging equity investors	• SMEs suffer mostly from a perspective of 'free-money' when receiving funds from development agencies, breeding complacent business practices • Most SMEs are non-bankable, hindering their ability to participate in development programs
NGO/Incubators: Technical Assistance	• Finding the 'stars' within each sector is a long and costly exercise because most firms are missing either internal governance, a scalable business model or a structured team • Impactful technical assistance, that lasts years, is very difficult to provide	• Good products/services are hindered in their growth by a lack of distribution and reach within the country • The younger generation does not have access to equity substitutes, such as personal loans secured against salary, reducing the possibility of new SMEs
Commercial Financial Institutions	• The cost and effort of debt recovery dissuades banks from the SME sector • Traditional risk assessments are hard to conduct, due to lack of data in SMEs. As such, risk proxies, such as transactional history with large players, can be indicators or credit worthiness	• Outside of Agriculture, most SMEs focus on trading of services or goods. Those businesses lack the necessary collateral to improve access to credit • The lack of scale for all SMEs results in banks considering large corporate loans as the key priority

Furthermore, interviewees were asked to consider a ranking of the scarcity and importance of both risk and non-risk adjusted capital, with the following break-down of responses:

<u>Overview of Views on Debt vs Equity finance, and experience with BF Instruments</u>

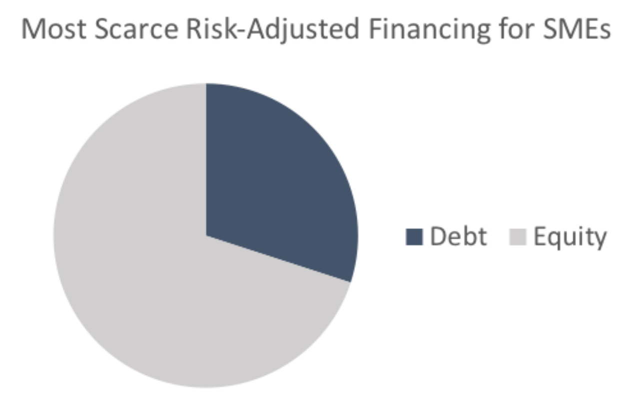
Figure 15: Ranking the Importance of Debt vs Equity



Overall respondents in their majority considered that Debt was more important than Equity for SMEs. This feeling was typically justified with a view towards the business culture of the country, where it is less common for SME business owners to accept or procure investors with whom to share ownership. This perception is considered the status quo also due to the relative lack of equity (see below), and thus the lack of familiarity as a viable sourcing of finance and technical assistance.

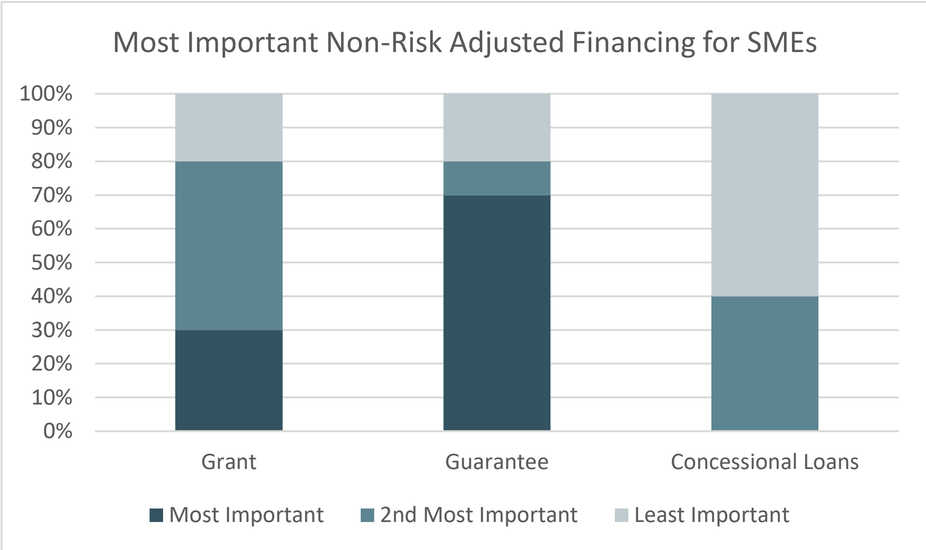
Interviewees highlighted that entrepreneurs considered shared ownership problematic due to the difficulty in ensuring sufficient *trust* with a potential equity investor, particularly in having confidence there would be no conflict in agreeing upon future business decisions. The relative scarcity of equity investors for the SME sector, outside of the scope of 'friends and family', reinforces the lack of familiarity with the mechanisms that can be put in place to establish a decision-making frame work within shareholder agreements, such as super-majority decisions on protected matters, etc. As the sector expands and develops, the availability of equity investors should over time provide a more open mind-set for this type of financing among SME owners.

Figure 16: Ranking the Scarcity of Debt vs Equity



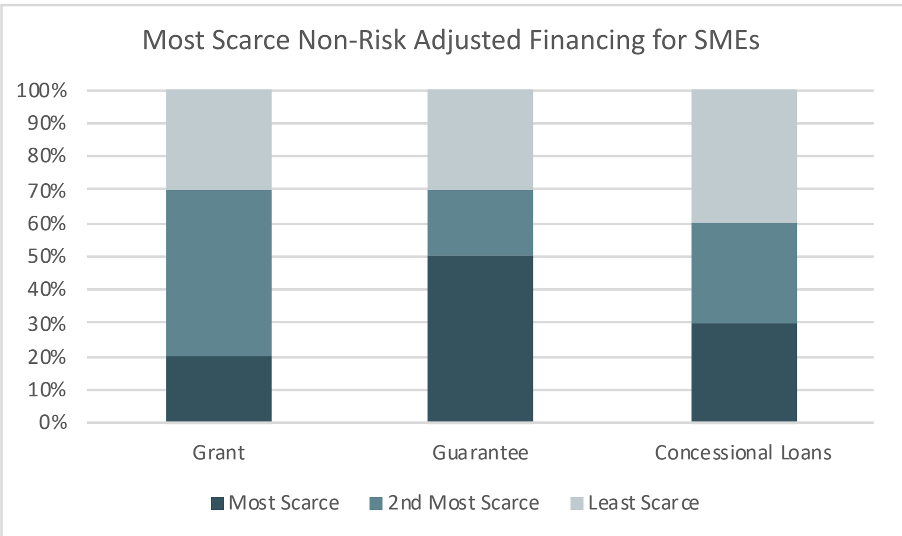
As seen in figure 16, the availability of equity for SMEs is considered to be very low among 70% of our interviewers. This lack of access not only informs the perceived lower importance of equity, but furthermore is addressed through debt-related solutions. A typical example provided by several interviewees was the access to personal loans, obtained through salary-based credit worthiness reviews, that are then deployed as de-facto equity into SMEs. As such, traditional third-party equity investors are hard to find in the context of Mozambican SMEs.

Figure 17: Ranking the Importance of Grants, Guarantees and Concessional Loans



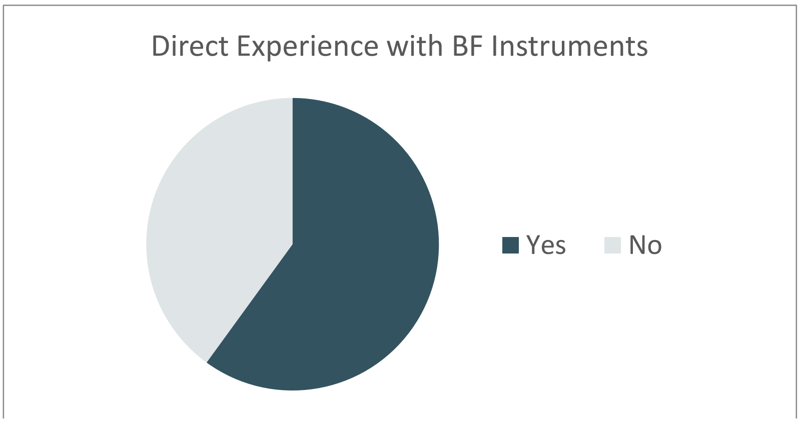
As seen in figure 17, Guarantees are considered to be the most important type of non-risk adjusted financing for SMEs. Interviewees noted the potential of Grants to empower a business, as noted by their second place in the ranking. However, it was noted that poor business practices, particularly in bookkeeping and risk assessment, can be more commonly found among Grant recipients, due to the non return-seeking nature of that type of financing. Guarantees, on the other hand, encourage SMEs to maintain the adequate level of formation to ensure creditworthiness for commercial lenders, considering that there is a return-seeking component to Guarantee financing, whereas Grants can be viewed among business owners as 'free money'.

Figure 18: Ranking the Scarcity of Grants, Guarantees and Concessional Loans



As seen in Figure 18, Guarantees are considered to be the scarcest type of non-risk adjusted financing for SMEs. Whilst the majority of interviewees were aware of previous Guarantee programs, their perceived importance, as seen in figure 17, lead respondents to consider them to be scarce in comparison to their importance.

Figure 19: Experience with Blended Finance Instruments



The majority of interviewees had some experience participating in, or managing, Blended Finance instruments. Those without direct experience, such as the NGO Advisors/Incubators, had participated in the preparation of SMEs for applying to receive Blended Finance in the past, and hence showed indirect familiarity with some BF structures.

Key Requirements for Financing in SMEs

The majority of interviewees pointed towards working capital requirements being the most common financing need, and growth capital seen as a secondary priority. The access to credit is particularly important to support short-term working capital shortages, particularly since many SMEs at some point in their journey face a situation where the capital expenditure has been in place, but the liquidity for the variable costs of their business model may not be available. Firms are then forced to find other solutions (friends and family, personal loans) that may work, but if unable to do so they are commonly forced to sell their assets or have their business fail.

Interviewees noted that with additional access to financing, SMEs would more readily view growth capital as a key requirement, to be used in the advancement of the companies in the strategic stages of their business plan. However, whilst the sector remains primarily capitalised through friends and family, the need for additional financing will likely remain focused mostly on working capital needs.

Overview of Key Challenges

Once interviewees established their experience with BF, and their views toward the SME sector, they were asked to consider the key challenges that lenders/investors face when considering financing SMEs in Mozambique.

The following section provides an overview of the two critical challenges identified throughout the SME landscape – with sector specific nuances not appearing as relevant for the finance providers.

Risk Mitigation

Risk Mitigation is the first critical issue that makes access to finance a challenge for SMEs in Mozambique. From the perspective of lending institutions focusing on debt, or investors looking for equity, SMEs are considered to be riskier recipients of finance in the current environment. This observation holds true across sectors and contributes to an issue further described below – high transaction costs – due to the thorough and non-generic due diligence required when assessing the risks inherent to the operations and business model of a given SME. This situation affects both commercial and development investors, as each of them is looking to ensure the sustainability of their investment, irrespective of whether the capital deployed is risk adjusted.

The issue of Risk Mitigation can be further explored through tangible and intangible components:

- *Tangible Risk Mitigation*: This process would follow the 'formation' of the practices within the SME to cater to the due diligence and operational track record requirements of traditional lending practices. Having access to audited accounts, a transactional history along the value chain and a support hierarchy (board of directors and management) are all components that can help mitigate risk and facilitate access to finance.

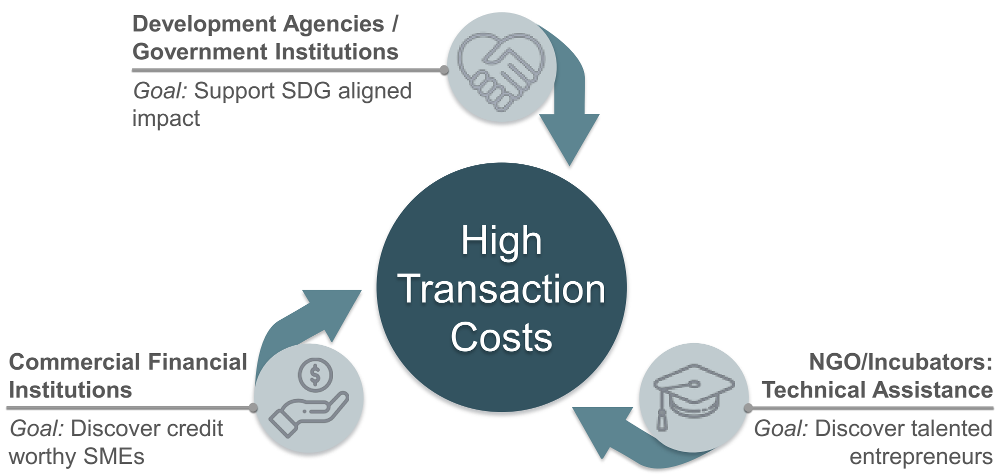
- *Intangible Risk Mitigation*: This process is personified through Technical Assistance that can be provided to an SME. Traditionally, this assistance is facilitated through development agency programs or entrepreneurial incubators, and can also be provided through equity investors, though there are less examples of the latter in Mozambique.

Key Take-Aways: To ensure sustainability and scalability for the structure to provide access to financing to SMEs in Mozambique, risk mitigating components must be included and monitored over time. These provisions must ensure risk is mitigated from both tangible and intangible sources, to enhance the chances that the effect of finance will result in sustainable growth for the target SMEs.

Lowering Transaction Costs

The second critical issue of the existing difficulties of providing financing to SMEs in Mozambique is the necessity of incurring high transaction costs to satisfy all stakeholders of their respective due diligence requirements. The granularity of the SME space affects commercial capital providers, development agencies and entrepreneurial incubators alike:

Figure 20: Stakeholder requirements lead to high transaction costs



As the Mozambican SME sector matures, with the average size of each enterprise growing over time, it is to be expected that transaction costs will decrease due to efficiencies in the access to necessary information to conduct a *due diligence*. An example of this expected positive evolution would be the ease accessing background credit ratings in mature economies, through centralised databases such as Experian. However, the historical requirements for such facilitating services to be present in Mozambique are yet in a more distant time horizon, and thus any effort to reduce transaction costs with the interaction, classification and risk assessment of SMEs must include additional measures specifically targeting this issue.

In the past, Blended Finance initiatives, such as the FECOP (Fundo Empresarial da Cooperação) which provided a guaranteed credit facility to MSMEs, tackled the issue of high transactional costs by ensuring a parallel provision of Technical Assistance (TA) to firms. This effort ensured that the target firms benefitted from exposure to risk mitigating best practices as well as providing a good proxy to the commercial institutions to assess the 'readiness' of business owners to efficiently utilise the financing they were procuring. Whilst this, and other similar examples, still resulted in a significant transactional cost for the provider of the Technical Assistance, the benefits did seek to reduce the transactional cost of some other stakeholder such as the commercial banks. In essence, the inclusion of Technical Assistance in the financing structure allowed for the credit-worthiness considerations to benefit from the work conducted by the TA partners.

Key Take-Aways: To ensure sustainability and scalability for the structure to provide access to financing to SMEs in Mozambique, transactional costs must be reduced across all stakeholders. As such, the environment of stakeholders must be broadened to include different players beyond just the SMEs and the financing providers. Considering the difficulty in servicing such a granular landscape, measures to aggregate demand, capacity or fiscal weight will be key to provide some economies of scale benefits to address the high transaction costs.

Technical assistance providers, whether implementing assistance programs or incubating co-operatives among smallholders, conduct costly and valuable work with SMEs. Including their endeavours in a financing ecosystem would allow both commercial and development institutions to leverage that work and reduce their own due diligence processes, or at least supplement the information they themselves gather on each SME assessed to receive financing. An ecosystem of players can enable each stakeholder to 'stand on the shoulders' of the work conducted by the group – to the greater benefit of all of them. Blended Finance vehicles deployed to facilitate access to financing to SMEs must consider a structure that can appropriately sustain and govern the ecosystem of players.

Part 2: **Blended Finance Options for Mozambican SMEs**

The second part of this section covers viable options for Blended Finance to be deployed in the provision of either debt or equity financing to SMEs in Mozambique. As covered in section 4, the possibilities of creating a Blending Finance solution will vary significantly when considering ***instrument*** and ***structure*** alternatives. In order to specifically address the risks identified by Mozambican stakeholders – high risk and transaction costs in the provision of financing to SMEs, the structure of Blended Finance solutions is of paramount importance.

Instruments alone may provide the conditions to reduce the risk of a transaction for return seeking investors, though they will not be able to provide sufficient benefits to address the high transaction costs of providing financing to SMEs. The depth and fragmentation of the SME sector in Mozambique, provides a challenging environment in which to conduct the required due diligence on SMEs in a cost-effective manner, and as such financing solutions must focus on providing the required *scale*, with participation of a wider group of stakeholders that may, through collaboration, provide economies of scale that mitigate the transaction costs.

Blended Finance vehicles: Considerations for Mozambique

In order to assess different options for Blended Finance vehicles for aiming to catalyse financing into Mozambican SMEs, we undertook a high-level set of observations and assessment of suitability of the different *instruments* and *structures* in the Figures 21 and 22, below. It is important to note that our observations are based on a qualitative assessment of the feedback gathered through interviews and discussions and ThirdWay Africa's experience in the market, rather than a quantitative empirical methodology.

Figure 21: Observations of Blended Finance Instruments for deployment in Mozambique

Instruments			Relevance in the context of Moz SME Financing
	1 Guarantee	• Guarantees currently have a mixed track record in Mozambique, on the one hand they have been available in the market for several years, but on the other their success rate has been mixed • Nonetheless, guarantees are a widely understood product by the commercial banking system and if efficiently designed and deployed can have a significant multiplier effect as they leverage the existing banking infrastructure	◕
	2 Insurance	• Typically it is used for single project-deals (although not exclusively) and generally for investment structures that have mobilised meaningful amounts of capital to be able to cover the cost of insurance • The availability of these products may fluctuate with the macroeconomic climate as the main agencies like MIGA may shy away from insuring projects with deemed high country risk, like Mozambique in late 2016	◑
	3 Hedging	• This is a largely unavailable product in situations with deemed low liquidity, like for example hedging FX fluctuations in frontier economies as long as the hedge is provided by commercial institutions • Institutions like the IFC have local currency hedging products, but for a limited number of countries	◔
	4 Junior / Subordinated Capital	• Although an attractive and flexible mechanism, to date it has not been widely observed in the context of the Mozambican market • Given the high perceived risk of investing in SMEs in frontier markets, these instruments are likely to generate a meaningful multiplier effect given the blanket risk coverage that "subordination" offers other investors	◕
	5 Results Based Incentives	• In order to successfully deploy securitisation schemes, a large and relatively standardised pool of assets is required, as such it is typically difficult to do this in shallow markets	◑
	6 Securitization	• Similar to Junior/Subordinated capital, these can be attractive instruments, but not yet widely observed • Objectivity in results-measurement is required in order for the programme to be successful. As such issues like language barriers, poor availability of data or poor perceived governance of programmes/projects can be an inhibitor to such instruments	◔
	7 Contractual Mechanisms	• Typically more relevant for industry-related changes, i.e., promoting the de-carbonisation of an economy by incentivising renewable energy investments through tariffs or tax breaks • In Mozambique, fiscal incentives available for certain sectors or types of investment for Apex-registered foreign investors	◔
	8 Grants	• Widely used and accepted instrument across developing and frontier economics and thus quite readily available in Mozambique to use in new structures • As BF evolves it is likely that development agencies and philanthropic organisations will evolve grants (i.e. returnable-grants) increasing alignment between all financial stakeholders in a capital structure	◕

Overall, we believe there is <u>ample flexibility at the instrument level</u> to blend one or several instrument into a vehicle with the aim of mobilizing risk-adjusted capital. Having said this, in the context of Mozambique and the blended finance market in general, it is worth noting that instruments like grants or guarantees are more widely recognized and available than for example hedging mechanisms.

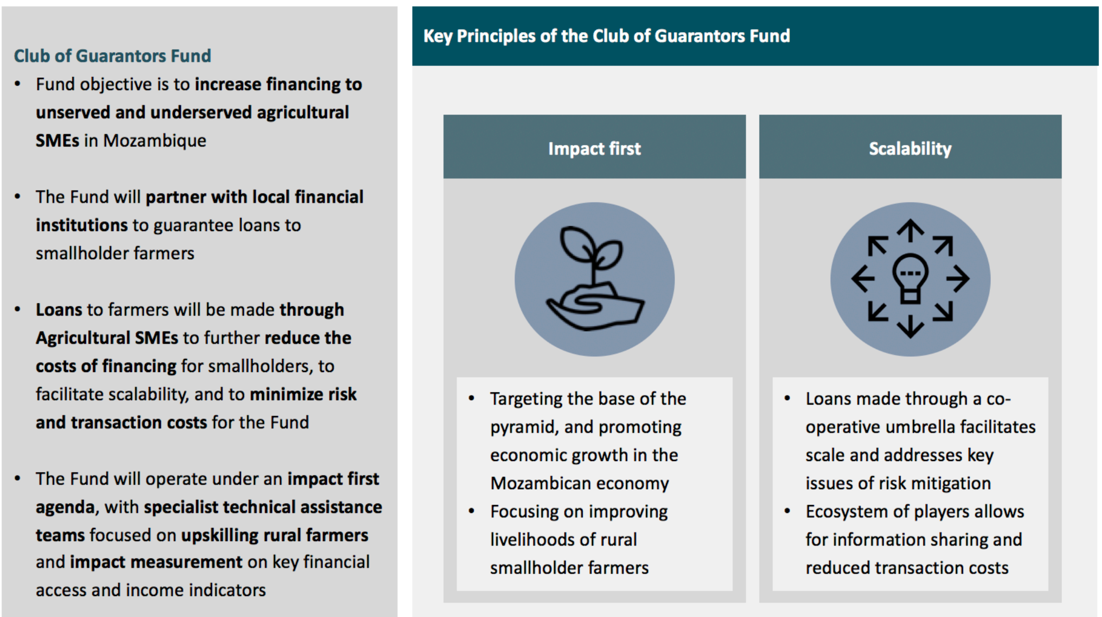
Figure 22: Observations of Blended Finance Structures for deployment in Mozambique

Project level	• Fails to address the high transaction costs by maintaining the focus at a project level, as such a project level structure will not provide the required scalability in the Mozambican SME context
Fund level	• The Fund structure can manage different stakeholder institutions within, aligned by an investment thesis and an impact first agenda. International domiciling removes the potential challenges to scalability and sustainability posed by local regulation
Fund-of-funds	• Lack of existing Funds in or focused on Mozambique precludes this structure from being a feasible first proposal to bring financing to SMEs. Less applicable structure for a country specific focus
Facility (institutional level)	• Due to the long-term and more rigid nature of Facilities, the obvious jurisdiction for a country focused facility would be Mozambique. This would present regulatory challenges, such as those voiced by GAPI, versus a foreign domiciled blended finance vehicle
Market level	• Market level mechanisms are typically anchored on leverage provided by public sector subsidies or incentives (such as subsidised energy tariffs), which tend to be sector specific, and which may not be consistently avaiable. The considered structure would not aim to be sector specific.
Project preparation support/ intermediaries	• Mozambique has existing players that follow a Project Preparation Support structure, such as FSD Moç, and hence additional focus on similar funding will not act as catalytic due to 'competition' with existing entities

With regards to structure, we believe that fund structures represent an adequate balance between scalability and reducing transaction costs as well as feasibility. With project-level structures, transaction costs can be more onerous compared to the total size of the facility and larger structures like funds-of-funds will be difficult to implement without a pre-existing fund ecosystem, as such they are generally used within a more regional or global geographic focus. For the purposes of addressing the needs of the Mozambican SME sector and exemplifying options for Blended Finance vehicles, we have preferred to focus on ***fund*** structures, while being more flexible on the instruments to be blended.

A fund structure for a Blended Finance solution may be implemented to deploy both equity and debt financing to the investee projects or companies, and the rest of this section covers a deep-dive into Mozambican focused structures, with diverse instruments within it, for both types of financing: *Private Equity Impact Fund* (Equity), and *Club of Guarantors Guarantee Fund* (Debt).

Figure 23: Key Principles of Fund Structure Blended Finance Solution



The impact first agenda of a Fund structure provides the common ground for the inclusion of more stakeholders than in Blended Finance solutions historically deployed in Mozambique. Return seeking investors, whether they provide equity or debt financing, are increasingly focused on discovering reliable models to finance SMEs, not only due to the return opportunities they provide to their portfolios, but also as a means of furthering *impact* by increasing the prosperity and advancement of developing economies such as Mozambique. Similarly, Commercial Value Chain Partners, such as large corporates that have already invested in the country, have expanded Corporate Social Responsibility goals in their agendas, favouring support of smallholders in the local economy. This local content focus will be of particular importance to the SME sector in Mozambique, as the expected investment in the economy's gas industry will provide significant opportunities to numerous national value chains. Fostering local content as part of the objectives of a Blended Finance investment structure is commonly referred to an **Inclusive Development** focus on the Fund's *Investment thesis*. The remainder of the players, namely Development Agencies and NGO Technical Assistance providers, are founded on their impact first agendas. A Fund's *impact first* principle creates a common goal all stakeholders will want to contribute towards.

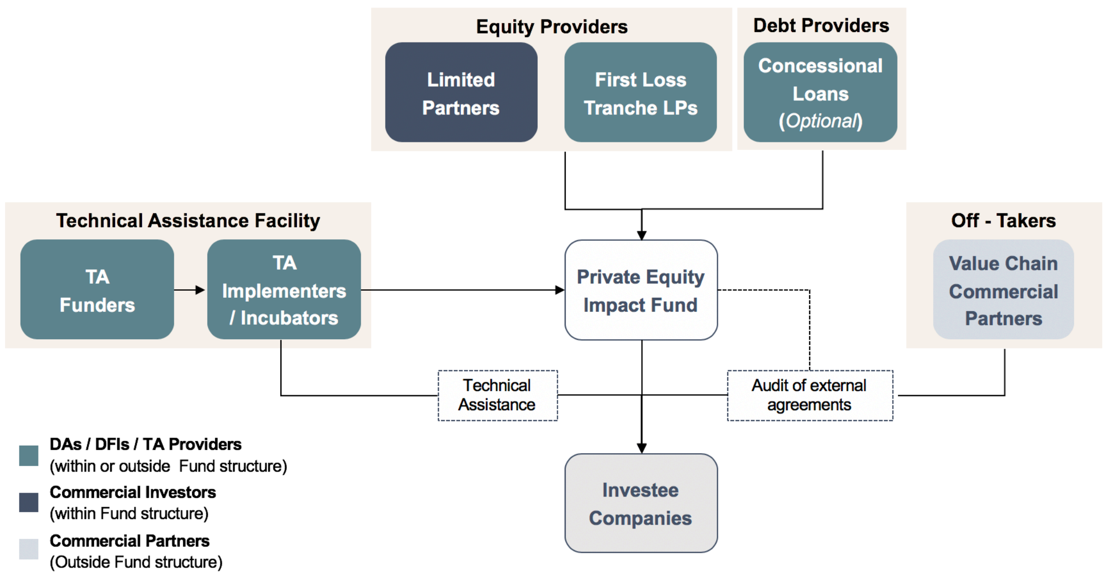
Secondly, the scalability of a Fund provides a sustainable future for this financing structure. Unlike the majority of solutions previously deployed in the region, a Blended Finance Fund aims to include several stakeholders within each type, i.e. a number of return-seeking investors (such as funds of funds or family offices), development agencies, corporate value chain partners and NGO technical assistance providers. The inclusion of an increased number of stakeholders protects the Fund structure from the risk of being discontinued due to a change of goals, agenda or circumstances of any one stakeholder. The scalability principle thus futureproofs the overall Blended Finance structure and enables stakeholders to either come in and out over time (Club of Guarantors Fund - Debt) or to invest with a set of agreed horizons and exit strategies (Private Equity Impact Fund – Equity) without compromising the continued access to finance for SMEs or the viability of the structure.

I) Private Equity Impact Fund – Equity Focused Blended Finance Vehicle

A Private Equity Impact Fund would have as a primary target the investment in the equity of SMEs, with the provision of growth capital with the anticipated upside return as a firm increases in scope and operating capacity. The provision of financing is thus focused on strategic growth objectives, rather than covering operating expenses with working capital. However, such an investment will also have a non-financial benefit to SMEs, as expertise and guidance will be provided through the knowledge of the fund manager. These non-financial benefits can be further enhanced through the creation of a wider group of stakeholders that participate within or interact with the Fund to enhance the assistance provided to the firms invested in.

Fig 24, below, provides an overview of the primary stakeholders within this structure, and their interaction with target investee SMEs.

Figure 24: Private Equity Impact Fund Structure



In the overview above, the set-up of a Private Equity Impact Fund would see Equity Providers provide financing to the Fund, that is then allocated to Investees as Equity. This financing is blended as it originates from two different capital pools: commercial return-seeking investors (LPs - private capital) and development finance (First Loss Tranche LPs – DAs / DFIs). The section below will provide an in-depth view on the structure, players and governance considerations of a Private Equity Impact Fund.

Blended Finance Instruments, Stakeholder Interaction, and Governance of the 'Private Equity Impact Fund'

In order to ensure the principles outlined in Fig. 23 for the Private Equity Impact Fund, TWA has designed example overviews of how such a Blended Finance solution would work in terms of: A) Blended Finance Instruments, B) Stakeholder Interactions and C) Governance. This section covers each of these components, with supporting illustrations in Figures 24 and 25:

A) Blended Finance Instruments in a Private Equity Impact Fund

As covered in section 4, a Blended Finance solution could include multiple instruments in a single structure, with individual ones targeting a specific component of the 2 key challenges identified that difficult the access to financing to SMEs: *high risks* and *transaction costs*. For the purposes of this illustrative example, TWA has decided to focus on **Junior/Subordinated Capital** as the main instrument category and selected within it two different instruments:

- **First-loss equity tranche**: to be provided by a development agency, foundation or a below-market rate impact investment organization like an impact-focused family office (e.g., Blue Haven Initiative). This tranche could represent 10 - 20% of the total LP base of the fund, share in the equity upside on a pro-rata basis, but absorb the first losses of capital wholly up to their full investment amount
- **Concessional debt** (at the fund-level): to be provided by a DFI like OPIC which could leverage the fund's LP equity on a ratio of say 1:2 at a low rate of interest of say 3 – 5% (achieved through OPIC issuing in the markets COPs – Certificates of Participation that are fully guaranteed by the US Government)

This structure financially results in a potentially attractive risk-adjusted position for equity LPs into the fund, given the "cheap" leverage provided by the concessional debt, combined with the downside protection provided by the first-loss tranche. A similar construct is observed for example in the case of the Sarona Frontier Markets Fund 2, although in this case the chose structure is one of a Fund of Funds given global focus.

B) Stakeholder Interactions in a Private Equity Impact Fund

Following the structure detailed in Figure 24, the Private Equity Impact Fund will have several interactions between stakeholders that defined to provide the required consistency in investment and monitoring practices that will underpin the ability of the Fund to be *scalable* and *sustainable*.

- Commercial Limited Partners (Primary)
    - Providers of return-seeking equity to SMEs, in accordance to the eligibility standards and investment mandate of the Private Equity Impact Fund. These stakeholders typically include commercial Fund of Funds, High Net Worth Individuals and Family Offices and Development Financial Institutions.
- Development Agencies and Development Financial Institutions (Primary)
    - In the Private Equity Impact Fund structure, Development Agencies (DAs) and Development Financial Institutions (DFIs) can fulfil one or two roles. The first is as the first-loss equity LP tranche, which would be subordinated to commercial LPs in the ownership structure of the fund. The second role would be as providers of concessional loans to beneficiaries, as part of the extended support the Fund can provide to SMEs, beyond the headline equity investments. The Overseas Private Investment Corporation (OPIC) is an example of an institution providing similar support to Private Equity Funds with impact agendas.
- SMEs – Investee Companies (Primary/Beneficiary)
    - These stakeholders are the beneficiaries of the financing provided through the Private Equity Impact, and as a result have the obligation of ensuring the required record keeping, to track the development of the business, as well as validating their contribution to any off-take agreements facilitated through the structure. Co-Operatives or Associations would provide added benefits to the structure due to their capacity to create scale as production aggregators.
- Value Chain Commercial Partners (Secondary)
    - The Private Equity Impact Fund will have the mission to identify and recruit commercial value chain partners for their target SME beneficiaries. The agreements will be made at the Fund level and validated yearly through audits, to ensure that the commercial value chain partners are receiving the produce with the standards required, and that the co-ops are building business processes that are aligned with commercial best practices. This opportunity will

be particularly salient in Mozambique through the local content agendas of the corporates that will invest in the northern region of Cabo Delgado as part of the development of the country's natural gas industry.

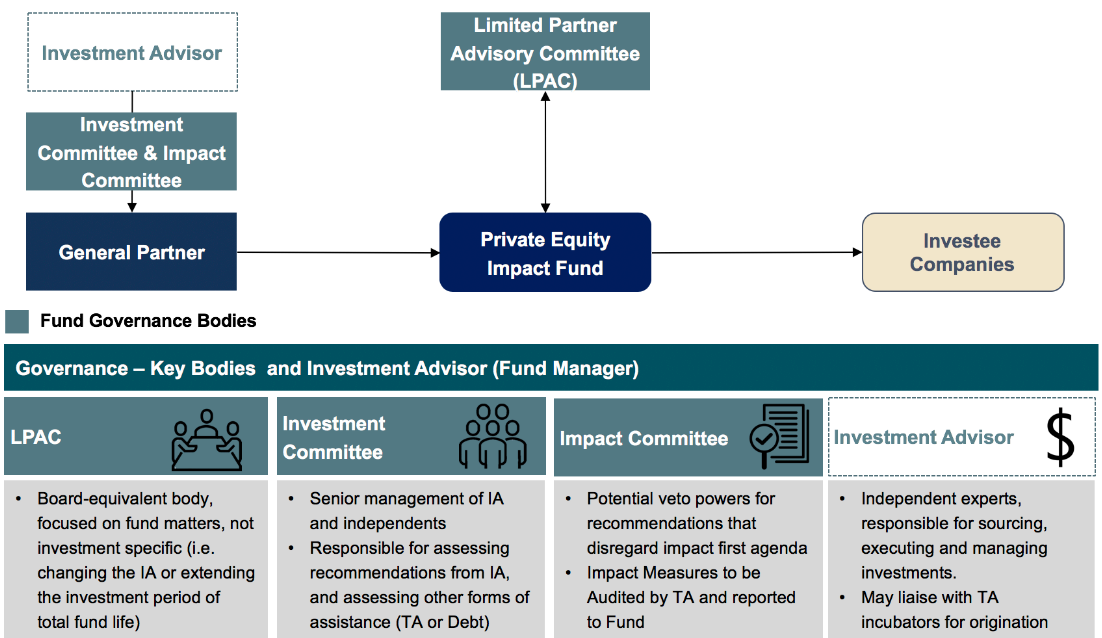
- NGO Technical Assistance (Secondary)
    - These stakeholders are critical to the success of the Private Equity Impact Fund structure due to their role in accompanying the beneficiaries throughout their growth, ensuring key risks and requirements are identified and addressed as the SMEs grow through the access to financing. The NGO TA providers (implementers/incubators) will additionally be critical in originating potential recipients of finance, pursuant to criteria agreed with the governance bodies of the Fund (detailed in the following section).

C) Governance Considerations for a Private Equity Impact Fund

The set-up of adequate governance bodies will be critical to the successful *scalability* and *sustainability* of the Fund as an equity focused Blended Finance structure. Ahead of the finding the right participants within each governance body, it is imperative to define an (1) *investment thesis* and (2) an *investment strategy*, which would among others the target investment lifecycle of beneficiaries (i.e. early-stage/VC vs. growth capital/PE). The thesis will detail the aspiration for inclusive development, that fosters demand and growth within target sectors through the provision of equity financing to a target group of SME beneficiaries (identified either by sector, type, value chain or following a bespoke segmentation). Furthermore, the strategy will inform the investment mandate of the fund, which include specific guidelines on the fund's investment process and selection as well as the Fund Terms: Target Fund Size, Fund Life, Investment Period, Management Fees & Carried Interest, Minimum LP Investment, Target Portfolio, Sector Exposure, Maximum Single Investments and Blended Finance Instruments deployment (such as concessional debt through participating DAs or DFIs) among others.

Figure 25, below, highlights the key governance bodies and the respective roles of the Private Equity Impact Fund: *the Limited Partner Advisory Committee, the Investment Committee, the Impact Committee*, as well as highlighting the role of the *Investment Advisor*, which will have Fund Manager responsibilities.

Figure 25: Governance Bodies of the Private Equity Impact Fund



Final Thoughts on the Private Equity Impact Fund

Following the completion of this study for FSD Moç, ThirdWay Africa believe that a Fund structure for Private Equity investments, which makes use of several Blended Finance instruments (primarily the inclusion of First Loss Tranches, and concessional debt), would provide the required *scalability* and *sustainability* to facilitate access to ***equity*** financing to Mozambican SMEs. The Fund would address the key risks identified as challenges in the provision of finance to SMEs and enable the creation of a larger ecosystem of players that find common ground in their *impact agenda*.

The structure would require significant early stage partnerships to be feasible, as well as defined exit strategies and terms to ensure a feasible realisation of return for equity investors. Considering these requirements, the timeline for the investment terms of the Fund is likely to be focused on long-term investments, i.e. 10 year, in order to allow for the further development of the market conditions that facilitate an exit for equity financing, such as a liquid national stock exchange or the growth of other similar PE funds. Whilst the national focus of the investment criteria will be specific to Mozambique, it may be necessary that Mauritius is selected as the domicile of the Fund, due to the regulatory on-boarding advantages that would provide to foreign Limited Partners.

II) 'Club of Guarantors' – Debt Focused Blended Finance Vehicle

This ***Fund*** structure is focused on the provision of ***debt*** rather than equity, which can serve the purpose of supporting growing businesses through facilitating working capital as well as growth capital. Whilst the availability of equity will be important in the long-term future of Mozambican SMEs, the existing state of the country's private sector, and the relative scarcity of any source of capital for SMEs, result in debt being the key priority to satisfy the immediate need for financing. For the purposes of the deep-dive herein into a debt focused fund structure, Agricultural SMEs were used as the example target sector for financing, through the creation of a 'Club of Guarantors' Fund.

The ***Guarantee*** based instrument for non-risk adjusted capital was considered to be the most appropriate due to the relative short-comings of other alternatives, as well as the contribution towards addressing the key challenges to financing SMEs, identified in Part 1 above. Out of other potential debt focused options, draw-backs were attached to each one if applied on a stand-alone basis. These are summarised below. Some mechanisms will still be utilised in the wider ecosystem of stakeholders to support the ***Guarantee*** based solution of the 'Club of Guarantors'.

Other Blended Finance Instruments

1. *Insurance*: The provision of insurance from development finance funds could be used as a mechanism to mitigate the risk of SMEs in the due diligence of commercial lenders. However, the transaction costs would only increase for development agencies, with the set-up and management of insurance pools. Furthermore, the risk of diluting the available capital through an adverse event would undermine the continued access to commercial access unlocked through the availability of insurance.
2. *Hedging*: Addressing currency risk not deemed to be a priority for the SME sector.
3. *Junior/Subordinated Capital*: The risk mitigation provided through a 'first-loss mechanism' can be positively applied to equity financing of SMEs though it is not applicable in the '*Club of Guarantors*' structure, due to its focus on debt finance.
4. *Results-based Incentives*: Structures within this option have a successful track record when applied to more mature economies, where specific sectors can be targeted for receiving such financing. In the context of the wider SME space in Mozambique, the application of results-based incentives, would significantly contribute to the transaction and management costs, without mitigating the risks for commercial lenders.
5. *Securitisation*: This mechanism would not be appropriate for SMEs based on a trading business model – which constitute a significant part of Mozambican SMEs. Furthermore, the process of evaluating assets, and ensuring recovery mechanisms would add to the already high transaction costs.
6. *Contractual Mechanisms*: This feature is included in the 'Club of Guarantors' option, to underpin the strength of the ecosystem by strengthening the value-chains of SME associations/co-operatives. As a stand-alone measure it would not sufficiently mitigate the risk of commercial lenders or reduce transaction costs.
7. *Grants:* As shown in part 1 of this section, Grants are considered to be a poor mechanism to include in a Blended Finance instrument, as they have a long history of creating unsustainable financing models. It is the perception of all interviewees that grants perpetuate the 'free-money' perspective in the recipients, thus not encouraging them to develop a scalable business model.

Key Characteristics of a 'Club of Guarantors'

This optional structure is composed of 5 stakeholder groups:

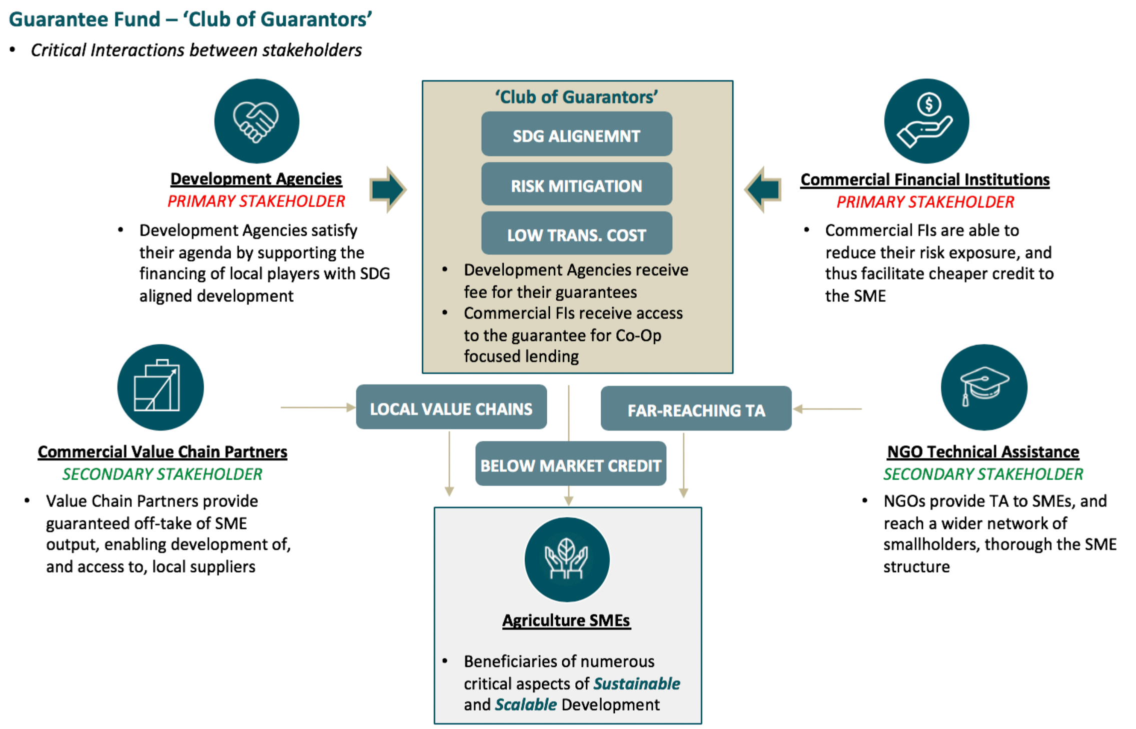
- Development Agencies (Primary)
- Commercial Financial Institutions (Primary)
- Agriculture SMEs (Primary/Beneficiary)

- Commercial Value Chain Partners (Secondary)
- NGO Technical Assistance (Secondary)

Stakeholder Interaction, Structure and Governance of the 'Club of Guarantors'

In order to ensure the principles outlined above for the Club of Guarantors, TWA has designed example overviews of how such a Blended Finance vehicle would work in terms of: Stakeholder Interactions, Structure and Governance. This section covers each of these components, with illustrations in Figures 26 through 30:

Figure 26: Interaction between Stakeholders in a Guarantee Fund



The Club of Guarantors would require the Primary Stakeholders to form the backbone of the financial structure, and then rely on the benefits of economies of scale that the Agriculture Co-Ops/SMEs would provide to ensure scalability. The Secondary Stakeholders would further support the club structure enhancing the credit worthiness (off-take agreements) and ability to grow (Technical Assistance) the Agriculture SMEs (or Co-Operatives/Associations if applicable).

To better understand these interactions, it is necessary to delve into the governance of the structure, and the accompanying 'contractual map'. Below is a summary of the key governance roles of each stakeholder – including the SME recipients of finance – followed by an illustration of the 'contractual map' in Figure 27:

- Development Agencies (Primary)
  - Providers of Guarantee Funding, and leaders of the *Impact First* agenda, ensuring SDG alignment, and overseeing the auditing of the external agreements of the Club of Guarantors.
- Commercial Financial Institutions (Primary)
  - Providers of Loans to SMEs, in accordance to the eligibility standards of the Club of Guarantors. Once a SME has been validated by the Fund's Investment

Committee as eligible for the Fund, the bank(s) will conduct their own risk assessment to provide a loan. These institutions will bear some, but not all, of the responsibility for originating the SMEs that may receive financing.

- Agriculture SMEs (Primary/Beneficiary)
    - These stakeholders are the beneficiaries of the financing provided through the Club of Guarantors, and as a result have the obligation of ensuring re-payment and that financial auditing occurs as agreed, as well as validating their contribution to any off-take agreements facilitated through the structure. Co-Operatives or Associations would provide added benefits to the structure due to their capacity to create scale as production aggregators
- Commercial Value Chain Partners (Secondary)
    - The Club of Guarantors will have the mission to identify and recruit commercial value chain partners for their target co-op recipients. The agreements will be made at the Club level and validated yearly through audits, to ensure that the commercial value chain partners are receiving the produce with the standards required, and that the co-ops are building business processes that are aligned with commercial best practices.
- NGO Technical Assistance (Secondary)
    - The stakeholders are critical to the success of the Club of Guarantors structure due to their role in accompanying the co-ops throughout their growth, ensuring key risks and requirements are identified and addressed as the SMEs grow through the access to financing. The NGO TA providers (implementers/incubators) will additionally be critical in originating potential recipients of finance, pursuant to criteria agreed with the commercial financial institutions.

As highlighted in the interactions above, the origination of eligible SMEs (or co-operatives or associations in some cases) will have two possible funnels: Commercial Financial Institutions (Banks) and NGO Technical Assistance providers (TA Incubators/Implementers). Incentive mechanisms can be implemented for either type of origination, to promote the utilisation of the Guarantee Fund. Examples of incentives schemes include:

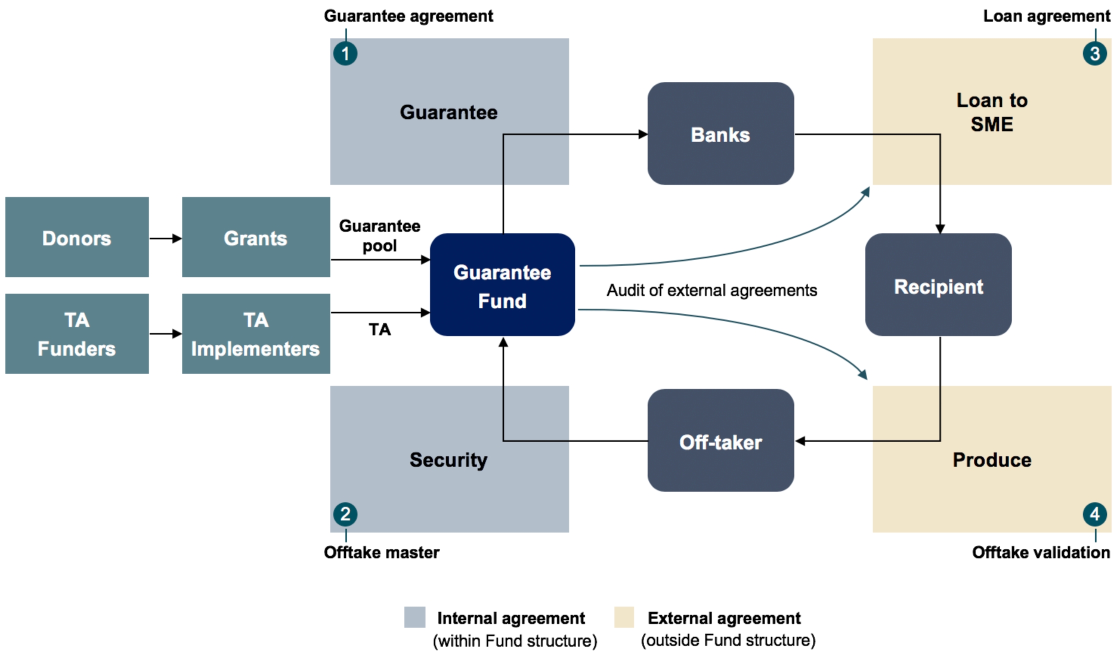
- A reduction in the cost of the Guarantee for each bank, calculated on the basis of the volumes of financing provided through the Club of Guarantors vehicle. Banks with higher utilisation rates will have a cheaper cost for the year or could see Guarantee fees waived entirely for high utilisation levels.
- NGO Technical Assistance providers could have an increase in the monetary assistance provided by the fund for each SME they originate which is then successfully financed.

For any incentive scheme implemented, the Board of the Fund would have approval of the values and criteria. The secondary purpose of the incentive schemes will be to foster a competitive environment between the banks, as a potential guaranteed loan they refuse to 'bid' for would be very likely to result in additional 'business' for a competitor. This change in mindset from Mozambican commercial institutions is required for the *scalability* of the use of guarantees, as currently it is considered a less profitable endeavour to engage with the SME sector, due to the perceived opportunity cost of focusing on the large corporates in the country.

For further reference, Figure 29 below provides an insight into the suggested governance structure of the Club of Guarantors vehicle and the Guarantee Fund within it.

Figure 27 below, is an illustrative example of the obligations of each stakeholder and the contractual agreements each would have as members of the ecosystem within the Club of Guarantors structure.

Figure 27: Contractual Map of the Club of Guarantors *(illustrative)*



Starting from the left, the Donors (development agencies) and the providers of Technical Assistance (TA Funders and TA Implementers), all agree to provide their respective inputs in the Guarantee Fund – the guarantee contributions themselves or Technical Assistance. The fund would then facilitate a guarantee to the participating banks, as seen in (**1**) Guarantee Agreement. This agreement would work as previous similar Blended Finance instruments, where the banks would compensate the Fund for the guarantees provided with an annual fee, in exchange for a percentage of the capital deployed in loans to be protected by the guarantee in the event of defaults. Origination incentive schemes, as explored in the previous page, may affect the overall cost of the Guarantees for each member bank.

The commercial financial institutions, referred to in Figure 27 as 'Banks', would then participate in (**3**) Loan Agreements with the agriculture co-ops. They would be key originators of potential co-ops, alongside TA incubators. The terms for accessing risk assessment would be agreed at the Club level and be based primarily on the financial checks of the commercial financial institutions, and the *entrepreneur readiness* as assessed by TA incubators. Prior to a bank initiating their own due diligence process, the Fund would provide a preliminary validation through its *investment committee*. This committee would act as a key governance body of the fund, and its duties are further detailed in Figure 28 below.

Upon loans being provided at cheaper rates than standard non-guaranteed loans, the SMEs, referred to in Figure 27 as 'Recipients' would receive on-going technical assistance support and enter into (**4**) off-take validation agreements with commercial value chain partners. The off-take agreement itself (**2**) would be created and negotiated by the commercial value chain partners and the Guarantee Fund, to align the Corporate Social Responsibility (CSR) agenda of participating corporations and the development agencies and NGOs. SMEs that are identified as suitable for a given off-take agreement are then on-boarded as a part of receiving finance and subject to validation by the commercial value chain partner behind that off-take agreement.

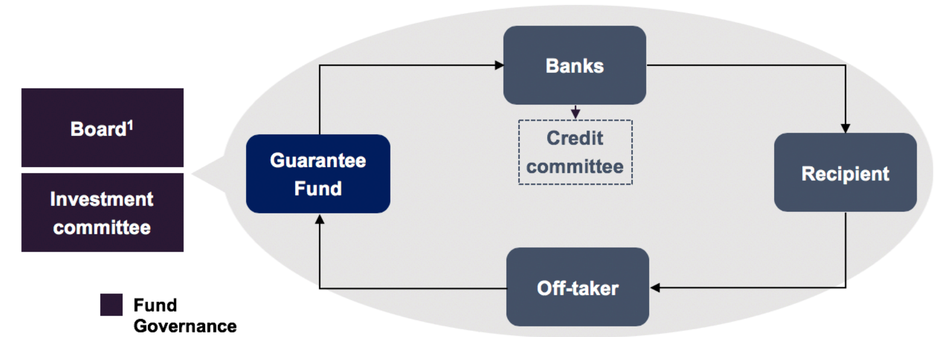
Figure 28 highlights the nuances of the 4 agreements described in the governance structure:

Figure 28: Deep-dive into Governance Agreements of Club of Guarantors Structure

	Agreement	Description / Indicative terms
INTERNAL	1 Guarantee agreement	**Description** • Agreement between the bank(s) and the Fund with terms of provision of guarantees **Indicative terms** • Bank to be provided with the right to call on the guarantee to recover loan losses based on eligibility criteria including pricing and credit scoring
INTERNAL	2 Offtake agreement (Master)	**Description** • Master agreement between off-taker(s) and Fund defining supply and purchase terms with recipient (e.g. committed volumes, payment terms etc.) **Indicative terms** • Pricing and quality matrix to meet industry standards • Fund withholds termination rights
EXTERNAL	3 Loan agreement	**Description** • Agreement between the bank(s) and the recipient(s) detailing the terms of the loan **Indicative terms** • Bank(s) to price loan taking into account off-taker agreement(s) and guarantees • Loan agreement to be audited on pricing to ensure savings are captured by the recipient, conforming to the agreed guidelines with the Fund
EXTERNAL	4 Off-take agreement (Validation)	**Description** • Agreement with off-taker specific terms such as shipping, packaging and addendums, and validation of master offtake agreement **Indicative terms** • Off-taker(s) to withhold right of first refusal • Off-take agreements to be audited on to ensure smallholder value as well as to ensure produce conforms to agreed quality standards

In order to ensure the success of the Club of Guarantors on an on-going basis, and to ensure there is a differentiated structure from previous Guarantee programs that have been mostly under-utilised and not scalable, this Fund structure would require a **Board** and an **Investment Committee** that validate, complement and audit the participation of all key stakeholders, as well as foster a competitive environment between participating banks:

Figure 29: Governance of Club of Guarantors – Board and Investment Committee Oversight



Governance – Key Bodies / Activities

Board	Investment Committee	Auditing
• One seat on the board for each Donor • One seat for each Partner Financial Institution • One seat for each TA implementer sub-team (i.e. Incubator vs Trainer)	• Investment committee to be held monthly, and assess each originated transaction for Fund approval, to then provide the 'Go' decision for a specific bank's credit committee to conduct financial due diligence	• External contracts to be audited by the Fund annually • Impact Measures to be Audited by TA • Off-take and Loan agreements to be reviewed against the Fund's objectives

[1]Board to meet bi-annually with reviews fortnightly and reports annually

The Fund's **Board** holds the main duties of ensuring the operation of the 'Club of Guarantors' remains in accordance to the Fund structure principles detailed in Figure 23. In order to fulfil said duty, the Board would review the external audits of all loans and off-take agreements, which will be conducted by previously approved third-parties.

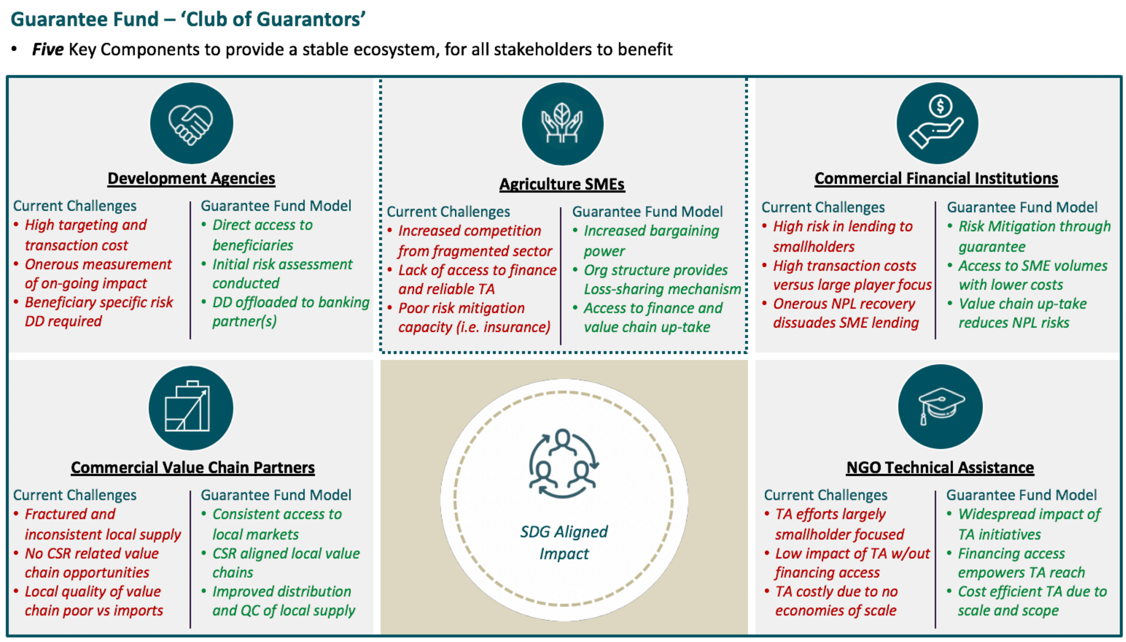
The Fund's Investment Committee would have the key, monthly, responsibility of validating and approving originated SMEs, and managing the incentive scheme for either the bank(s) or NGO TA provider(s) that originate a SME that successfully receives financing. The final financing decisions, including the terms and values, will depend on each bank. More than one bank may evaluate an SME that is applying for a guaranteed loan.

Final Thoughts and Benefits for each Club of Guarantors Stakeholder Type

Following the completion of this study for FSD Moç, ThirdWay Africa believe that the 'Club of Guarantors' blended finance structure would provide a *sustainable* and *scalable* solution to improve the access to ***debt*** finance for SMEs in Mozambique.

The structure would require significant early stage partnerships to be feasible, as well as the set-up of the governance bodies, and required legal agreements, but it would result in a strong ecosystem of stakeholders that are able to take advantage of their existing activities in supporting and assessing the finance-readiness of SMEs. The inclusion of several players of each type of stakeholder, i.e. more than one development agency/bank etc., would provide the scale required to ensure the Club of Guarantors can accommodate the entry and exit of participants whilst continuing its operations. Furthermore, the expanded ecosystem would provide a unified effort towards the *impact first* agenda of all players, increasing the value of the existing SME specific impact focused efforts by providing scale and access to financing in a sustainable manner. Figure 30 illustrates the current challenges and the respective benefits of each stakeholder in the 'Club of Guarantors' ecosystem:

Figure 30: Benefits and challenges in a Guarantee fund



TWA thanks FSD Moç for the opportunity in conducting this study and welcomes any related queries that may arise. TWA would welcome participation in FSD initiatives that may follow.

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Acronyms and Abbreviations

AUM	Assets Under Management
BF	Blended Finance
CSR	Corporate Social Responsibility
DFI	Development Finance Institution
FSD Moç	Financial Sector Deepening Mozambique
GDP	Gross Domestic Product
GoM	Government of Mozambique
IFC	International Finance Institution
INE	National Institute of Statistics
MDB	Multilateral Development Bank
MSME	Micro, Small and Medium Enterprises
NPL	Nonperforming Loan
ODA	Overseas Development Assistance
QC	Quality Control
SME	Small and Medium Enterprises
SSA	Sub-Saharan Africa
SWF	Sovereign Wealth Fund
TA	Technical Assistance
TWA	ThirdWay Africa
HTF	Hivos-Triodos Fund