Dalberg

# The Missing Middles:
## Segmenting Small and Growing Businesses in Emerging Markets

SME FINANCE FORUM SUMMARY PRESENTATION

FULL REPORT WILL BE RELEASED OCTOBER 2018 AND CAN BE FOUND AT WWW.FRONTIERFINANCE.ORG

OMIDYAR NETWORK

COLLABORATIVE FOR FRONTIER FINANCE

# Agenda

- Introduction to Collaborative for Frontier Finance and segmentation study
- Enterprise segmentation study and framework
- Implications and next steps

## This project is an initiative of the Collaborative for Frontier Finance (CFF)

The Collaborative for Frontier Finance is a group of fund managers, funders, and field-building organizations committed to **increasing the amount of appropriate capital available for SGBs** in frontier and emerging markets.

**Our vision**
A sustainable, diverse, and robust financing ecosystem for early stage or small and growing businesses (SGBs) that operate in frontier and emerging markets

*Founding Partners*

Dutch Good Growth Fund

OMIDYAR NETWORK

COLLABORATIVE FOR FRONTIER FINANCE

# The project segments small and growing businesses (SGBs) by their financing needs

## Overall goal

*Create a segmentation of small and growing businesses (SGBs) to help investors and financial intermediaries match appropriate financial products with different enterprise segments, as well as to help entrepreneurs understand the most appropriate investors to target*

## Objectives

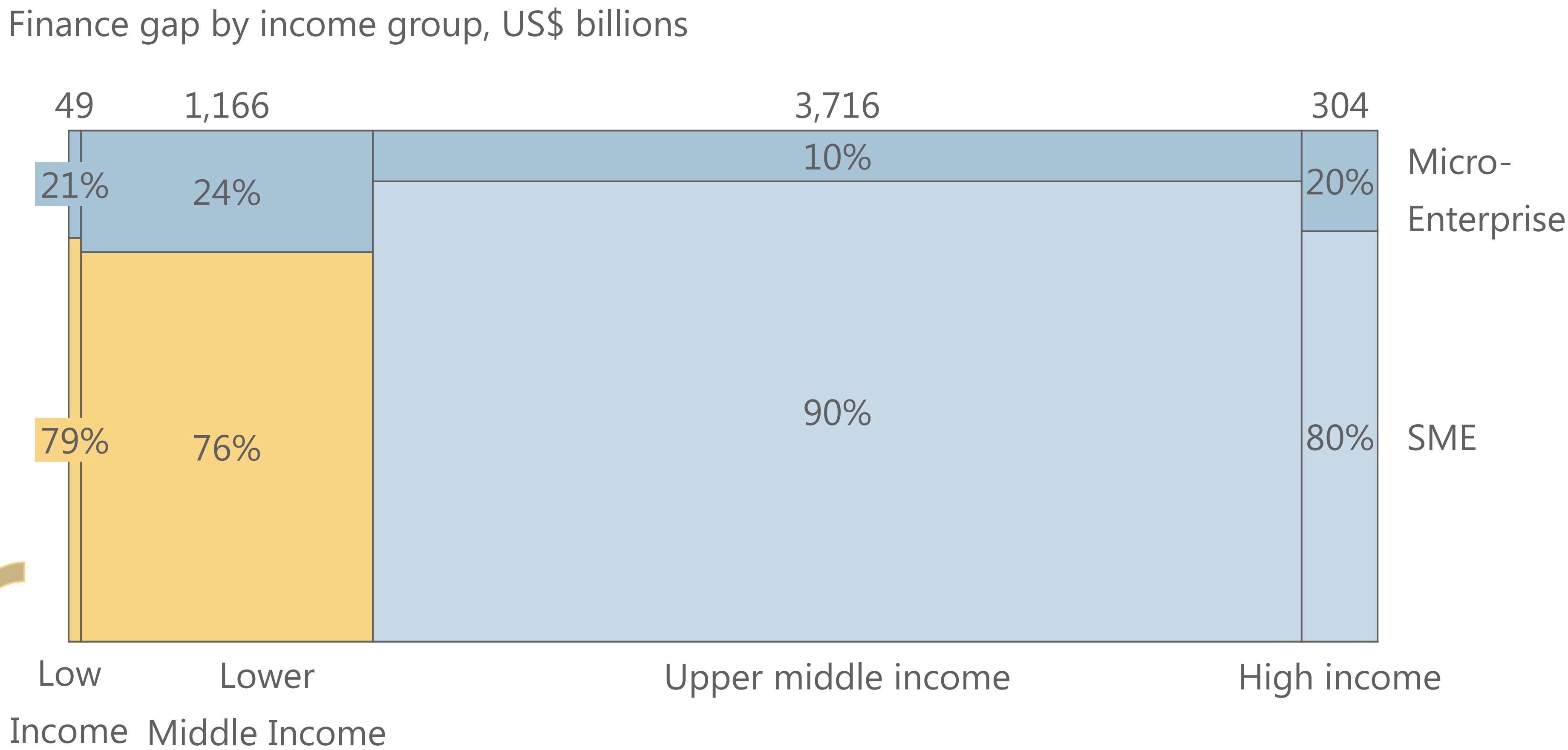
- **Build a common vocabulary** around SGBs to improve communication and collaboration
- **Create a basis for building better data** to inform expectations on risk, return, and impact and determine appropriate investment instruments
- **Improve mapping** of how financial intermediaries (VC/PE funds, specialized mezzanine / flexible debt providers, local banks, etc.) and financial instruments can meet the needs of different SGBs
- **Identify the greatest capital gaps** within SGB space in specific sectoral or geographical contexts
- **Generate more efficient matching** between enterprises and investors

## Principles

- **Focus on fundamental enterprise needs** by using enterprise perspective as key criteria for segment archetypes
- **Ground in the market** by using real world experiences of financial intermediaries and investors
- **Build on existing work** by identifying common approaches and synthesizing best practices
- **Emphasize practicality** by ensuring this product is useful for investors and not overly technical

Notes: (*) Small and growing businesses (SGBs) coined by ANDE as formal or formalizing small- and medium-sized enterprises (SMEs) that have financing needs between $20,000 and $2 million

# There is ~$930B financing gap for SGBs in low and lower-middle income countries, representing ~18% of total MSME gap




**Focus of this study is on small and growing businesses (SGBs) with between 10 and 250 employees that typically seek capital in the range of $20,000 to $2 million and are often referred to as the "missing middle" in frontier and emerging markets**

Notes: Microenterprises are defined as those with less than 10 employees and SMEs as those with 11-250 employees
Source: IFC MSME Finance Gap Database (2017)

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# This research combined three methodological approaches to inform the segmentation

## Investor and intermediary perspectives

*Conducted literature review and interviews with 50+ leading SGB investors, intermediaries, and support organizations*

Outputs

- Variables determining an enterprise's financing drivers
- Financial instruments and providers available to SGBs
- Insight on variables investors use to make investment decisions and segment SGBs

## Data analysis of SGB investment portfolios

*Gathered data from five data partners their SGB portfolios, for analysis of 350+ enterprises*

Outputs

- Data to inform quantitative elements of the segmentation
- Indicative ranges of where segment families fall
- Data partners included GroFin, Miller Center, IntelleGrow, I&P, and Root Capital

## Human Centered Design / behavioral analysis

*Conducted HCD-oriented interviews with a diverse sample of SGBs in India*

Outputs

- Framework of entrepreneur behavioral characteristics and attitudes to external finance
- Insight into how entrepreneurs make decisions regarding pursuit of external financing

# We identified six core variables that drive SGB's external financing needs

| | External finance driver | Definition | Example metrics |
|---|---|---|---|
| *Family segmentation variables* | **Lens 1: Market growth and scale potential** | Management's ambition and ability to pursue growth and scale | • Size of addressable market<br>• Competitive dynamics<br>• Growth trends and prospects |
| | **Lens 2: Product/service innovation profile** | Characterization of product/service innovation level | • Degree of disruption and innovation vs. traditional models<br>• Level of R&D-based product/svcs |
| | **Lens 3: Entrepreneur behavioral attributes** | Full range of management's behavioral and demographic characteristics | • Growth and scale ambition<br>• Appetite for risk<br>• Desire for control |
| *Sub-segmentation variables* | **Stage of development** | Maturity stage as determined by the size of capital needs | • Seed ($20,000 - $250,000)<br>• Early stage ($250,000 – 1M)<br>• Early growth ($1M – 2M)<br>• Mature ($2M – 10M) |
| | **Capital intensity** | Size and intensity of finance needs for enterprise to operate | • Business activity/sector<br>• Number of employees<br>• Asset intensity |
| | **Financial performance/ structure** | Characteristics of recent financial performance and debt structure | • Financing mix (debt/equity)<br>• Sources/uses of cash<br>• Profitability trends |

# We identify four families of SGBs that occupy the "missing middle"

## Small and Growing Businesses (SGBs)

- Commercially viable
- 5 to 250 employees
- Potential and ambition for growth
- Typically seek financing from $20,000 to $2M

**Segmentation variables***

*Used to divide SGBs into groups facing similar financing needs*

- ***Lens 1: Market growth and scale potential***
- ***Lens 2: Product or service innovation profile***
- ***Lens 3: Entrepreneur behavioral attributes***

## Four Families of SGBs:

**High-growth Ventures**

- **Disruptive business models and targeting large addressable markets**
- High growth and scale potential; typically led by **ambitious entrepreneurs** with significant risk tolerance

**Niche Ventures**

- **Innovative products/services targeting niche markets** or customer segments
- Entrepreneurs seek to *grow*, but often prioritize goals other than *scale*

**Dynamic Enterprises**

- Operate in established "**bread and butter" industries** (e.g., trading, manufacturing, retail)
- Deploy **existing products / proven business models**; seek growth through market extension / incremental innovations
- **Moderate growth** and scale potential

**Livelihood-Sustaining Enterprises**

- **Opportunity-driven, family-run businesses** with incremental growth
- **Formal or informal, and operate on a small scale** to provide income for an individual family
- **Replicative business models**, serving highly local markets or value chains

*(*) Variables identified, prioritized and validated through stakeholder interviews with ~80 SGB focused investors operating in frontier markets*

# SGB families are relatively broad categories of enterprises, but there are common 'archetypes' in each

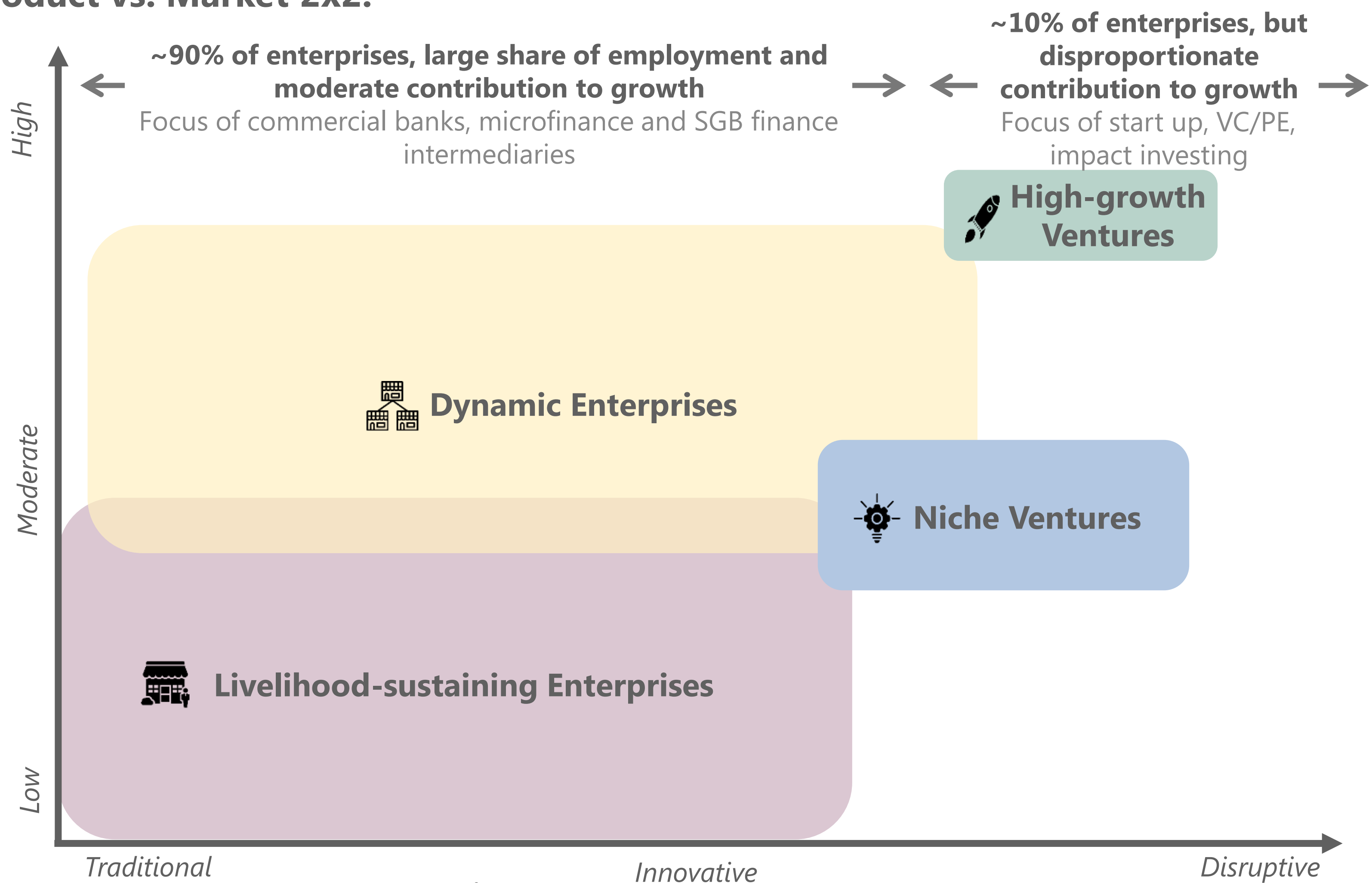
| Archetypes | | Examples |
| --- | --- | --- |
| **High-growth Ventures** | • Start-up tech ventures<br>• Highly ambitious enterprises targeting significant scale<br>• Enterprises pioneering or transforming a sector[1] | **Freight Tiger** – a young tech-based logistics company in India seeking to transform transportation<br>**PEG Africa –** A young Ghanaian-based solar company providing pay-as-you-go financing, with rapid growth into multiple African markets |
| **Niche Ventures** | • Artisans and companies in the creative economy<br>• Enterprises with a focus on serving a specific local community or target population | **Vega Coffee** – a social enterprise utilizing a direct-to-consumer business model to sell roasted coffee beans as a premium product in the US<br>**Bombay Atelier –** A high-end furniture company in Mumbai with unique, customized designs |
| **Dynamic Enterprises** | • Multi-generational family businesses<br>• Traditional businesses operating on "core" sectors for many emerging economies – i.e. agriculture, manufacturing, services, and retail | **Stick Park** – a sticker products manufacturer in Egypt founded in 1987 with slow but steady growth<br>**Laiterie du Berger** – Dairy processor using fresh milk collected from 800 farmers in Senegal<br>**CAC Chirinos –** Peruvian coffee cooperative supporting small farmers gain access to markets |
| **Livelihood-Sustaining Enterprises** | • Microenterprises that are successful and 'graduate' from microfinance to hire additional employees | **Prime Auto Garage** – a small business in Rwanda founded in 2001 that provides car repair services, which has slowly grown to over 20 employees<br>**W&R Shoes –** a small business in Nicaragua which after 27 years grew to a workshop of 15 people |

# Lens 1: The four SGB families differ by product and target market

## Lens 1: Product vs. Market 2x2:

**MARKET & SCALE POTENTIAL**

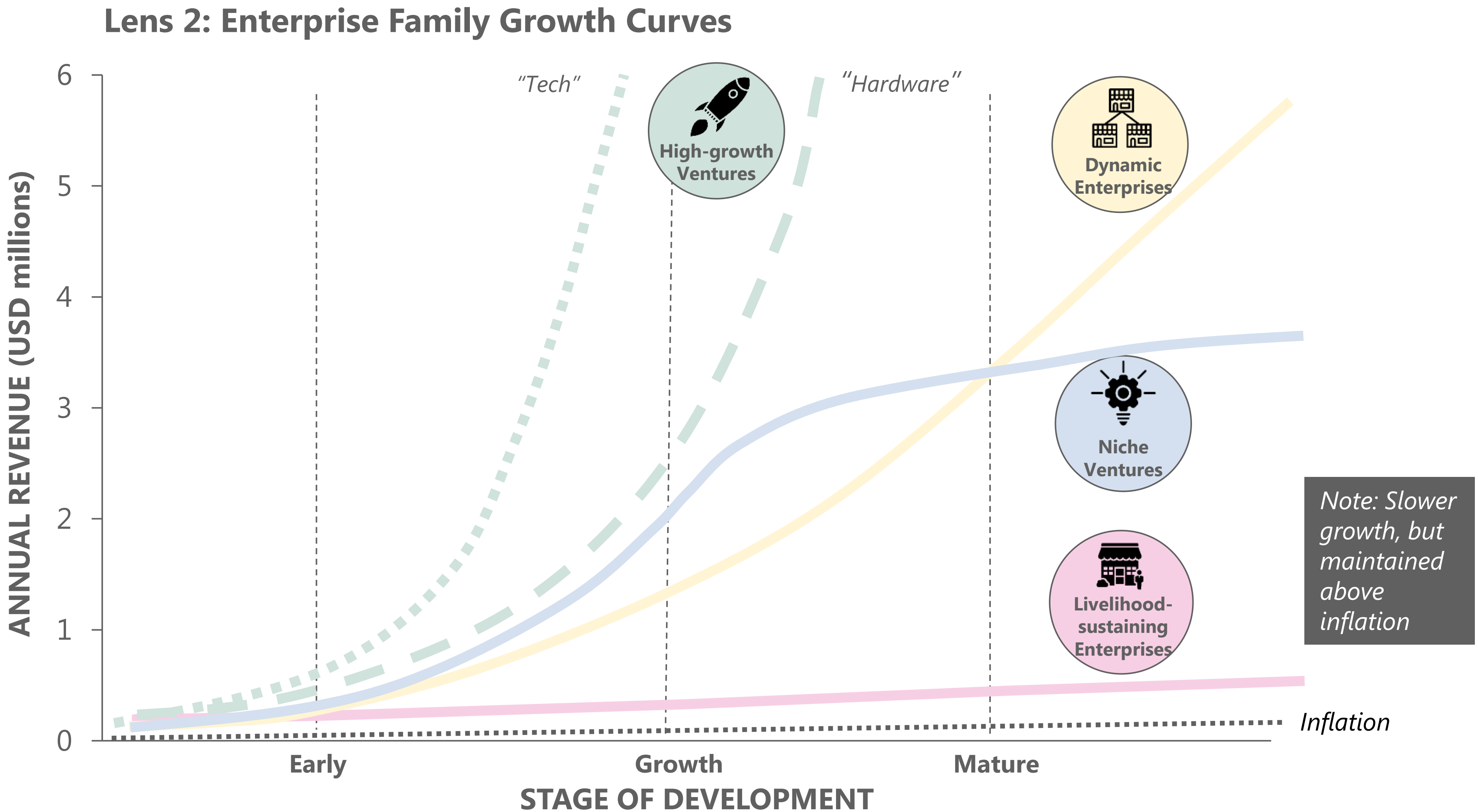
Potential of enterprise to grow and reach significant scale, considering
- → Size of addressable market
- → Competitive dynamics
- → Ability / ambition of entrepreneur & firm to achieve growth




**PRODUCT / INNOVATION PROFILE**

Extent to which the enterprise's business model and product / services are
- → Traditional: Replicative / relatively undifferentiated from existing products and services
- → Innovative: Incremental innovations to product/service/processes; market extension
- → Disruptive: Products/services are highly differentiated, disruptive to existing markets

# Lens 2: Plotting typical growth curves of each SGB segment family reveals differences over time




** Growth curves are illustrative based enterprise data collected from six fund managers and classified on their characteristics using average annual revenues and age of enterprise for each family. Curves are stylized and do not represent individual enterprises.*

** Stage of Development closely correlate with Village Capital's VIRAL framework. For example, early stage High-growth Ventures most closely align with VIRAL Levels 1-4, growth aligns with Levels 5-6, and mature most closely aligns with Levels 7-8.*

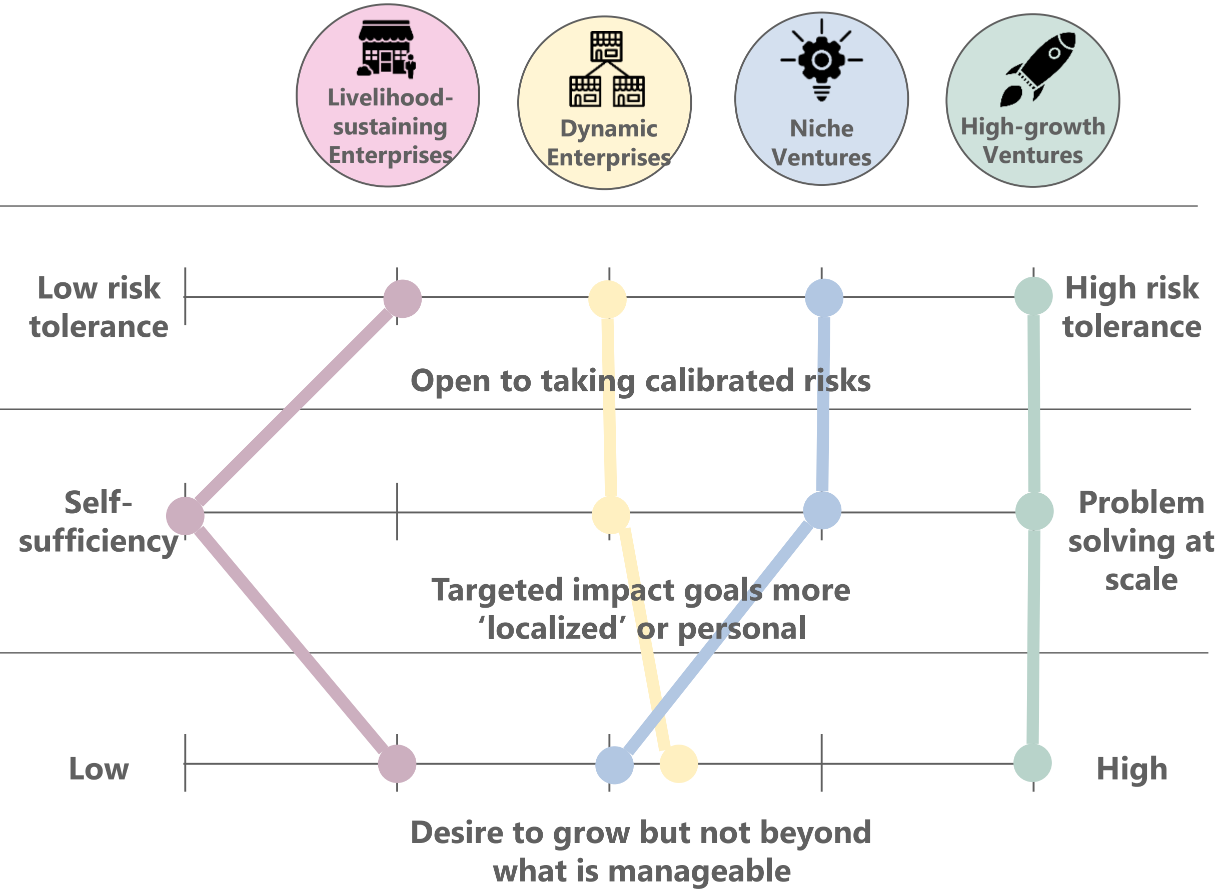
# Lens 3: The four SGB families are also distinguished through differences in entrepreneur behaviors and attitudes

## Lens 3: Entrepreneur behavioral dimensions

**Risk attitude**
*The entrepreneur's willingness to commit to business decisions that could have uncertain (or negative) effects on his or her business*

**Problem solving motivation**
*The extent to which an entrepreneur would like to have a larger societal effect through owning and operating his or her business*

**Growth and scale ambition**
*The extent to which an entrepreneur aims to grow his or her company and the pace at which he or she would like to do this*




** Behavioral dimensions are illustrative and it is important to note that an individual entrepreneur within these families could have much more variation to this simplification of behavior patterns. However, this model is indicative of a 'predominant' behavioral profile of entrepreneurs in these families.*

** Research found further variables such as control and openness to feedback are particularly useful to distinguish between Niche and High-growth Ventures to determine where financing tools such as equity could be a good fit. Additionally, entrepreneur willingness to problem solve and take risks con be constrained by ability to do so, such as limited access to finance.*

# Each of the SGB families was also sub-segmented using relevant drivers such as financial performance, business activity and stage

| ENTERPRISE FAMILY | FURTHER SEGMENTATION DRIVER | ENTERPRISE SEGMENTS |
|---|---|---|
| **Livelihood-sustaining Enterprises** | Collateral availability & financial performance | Fully credit constrained small enterprise |
| | | Partially credit constrained small enterprise |
| **Dynamic Enterprises** | Business activity as relates financing requirements | Services enterprise |
| | | Trading / merchandising enterprise |
| | | Financing enterprise |
| | | Manufacturing / processing enterprise |
| **Niche Ventures** | Business model as relates to financing needs | Service innovator |
| | | Product innovator |
| **High-Growth Ventures** (**Hardware based**; **Tech based**) | Stage of development | Startup venture |
| | | Promising venture |
| | | Poised for growth |

# Beyond the need for broader access to working capital and TA, each family has its own risk-return matches and potential remedies

| Enterprise Family | Key Financing Gaps and Risk-return Mismatches | Ideas for Action |
|---|---|---|
| *High-growth Ventures* | • Applying "Silicon Valley" venture capital **growth and timeline expectations** to "asset-heavy" ventures | • **Increased use of longer term fund structures** – structuring investments with lower management fees, higher carry and flexibility for longer term exits such as 15+5 year limited life funds<br>• **Increase use of alternative financing vehicles** and instruments that allow for more flexible time horizons & exits – such as mezzanine instruments as well as evergreen or permanent capital vehicles |
| *Niche Ventures* | • Applying VC **scale expectations** to ventures with limited scale potential, smaller addressable markets | • **Stimulate local sources of risk capital** in frontier markets where venture investing remains limited<br>• **Strengthen funding networks and collaboration** to rapidly refer deals to financial intermediaries more aligned with niche venture growth trajectory |
| *Dynamic Enterprises* | • **Highly underserved segment:** considered too risky for commercial banks; growth profile not aligned to VC; too small for most PE | • Expand specialized financial intermediaries **providing flexible debt and mezzanine** financing instruments as well as **evergreen funds**<br>• **Increase commercial bank understanding of market opportunities** within SGB segments and provide technical assistance on tailored financial instruments for different segment families |
| *Livelihood-sustaining Enterprises* | • Gap between financial needs and the **actual cost to serve** | • **Expand low cost data-driven tech platforms** that provide bundled financial and non-financial services<br>• **Standardize products and procedures** to achieve economies of scale and increase efficiencies, particularly for debt-like mezzanine fund managers<br>• **Improve fund economics** through hiring talented local staff and providing training to new graduates for lower average salary costs |

Source: Dalberg interviews and analysis, The Noun Project

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# The Collaborative for Frontier Finance prioritized multiple Initiatives addressing SGB families financing needs

| Clusters | Prioritized initiative | Enterprise family impacted |
|---|---|---|
| Very Early Stage Funds | Fund of funds | High-growth Ventures; Niche Ventures; Dynamic Enterprises |
| Mezzanine Financing | Peer-to-peer network for fund managers | High-growth Ventures; Niche Ventures; Dynamic Enterprises |
| | Performance benchmarks for mezzanine funds | Niche Ventures; Dynamic Enterprises |
| | Mezzanine fund manager training | Niche Ventures; Dynamic Enterprises |
| | Shared service company | High-growth Ventures; Niche Ventures; Dynamic Enterprises |
| Angel Investing Networks | Accelerator for angel investment networks | High-growth Ventures; Niche Ventures |
| Capital Advisory Models | Post investment TA facility | High-growth Ventures; Niche Ventures; Dynamic Enterprises; Livelihood-sustaining Enterprises |
| | Pre-investment advisory facility | High-growth Ventures; Niche Ventures; Dynamic Enterprises; Livelihood-sustaining Enterprises |

Source: GDI/Collaborative for Frontier Finance

# Applying framework and deepening research on financing needs are actionable next steps to increase investment in SGBs

- Further validate the segments and provide more quantitative markers by analyzing larger data sources, such as DFI SME portfolios
- Apply the segmentation framework to a given market or sector to identify most significant market gaps and investment opportunities
- Conduct more in-depth analysis of the characteristics and financial needs of a given enterprise segment family
- Deepen the analysis on how specific investment instruments can meet the needs of enterprise segments at different growth stages
- Overlay other behavioral or entrepreneurial characteristics onto this framework, with a specific focus on youth, women, and inclusivity

# Participant insights

**How useful is this new typology for the bank?**

**How much does it conform to your own client experience?**

**What questions about your market might it still not answer?**

# Appendix