Increasing the reach and impact of technical assistance (TA) funding

Design recommendations for TA recycling

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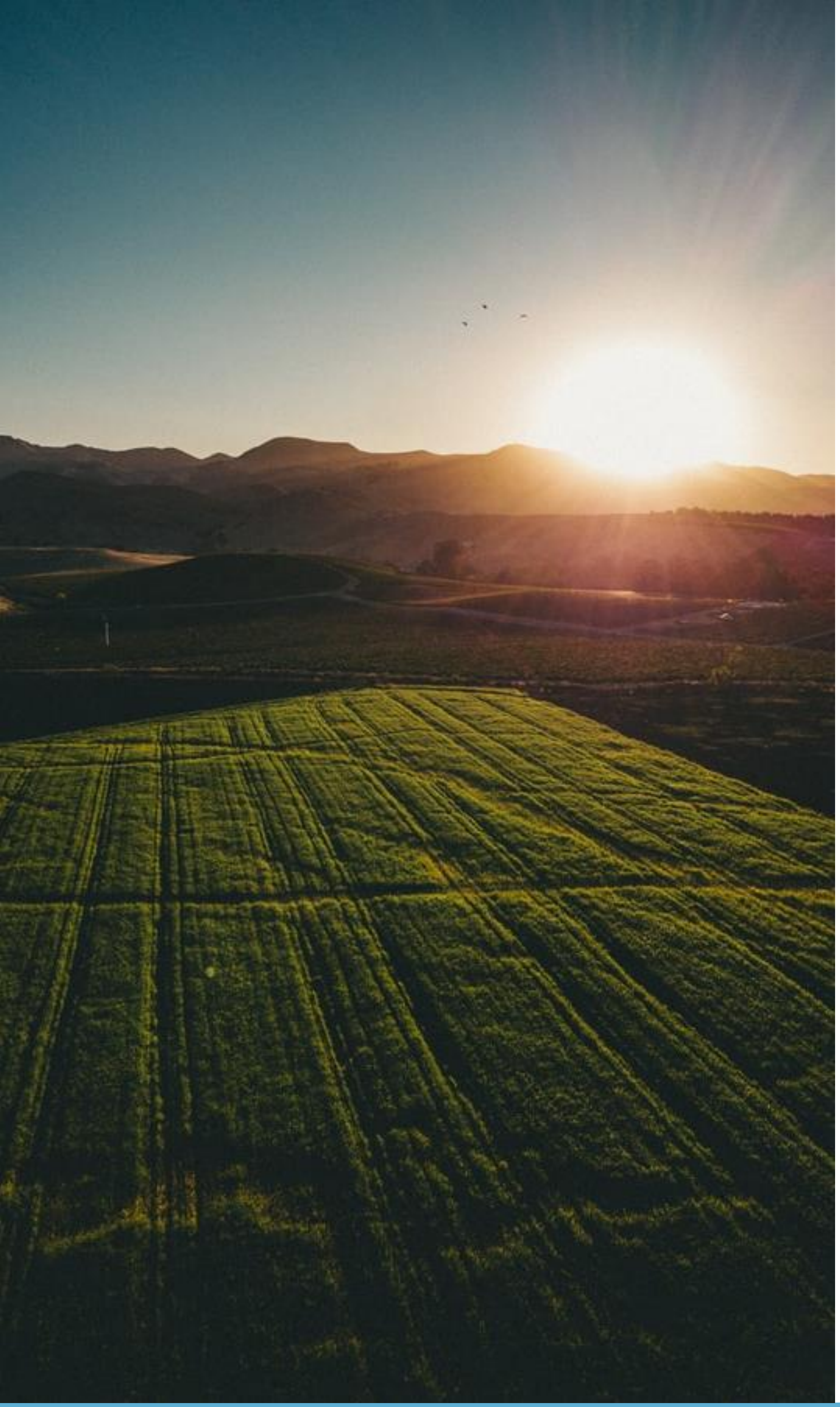

Overview of agribusiness challenges and TA status quo

Growth-stage SMEs in the agricultural sector, esp. those engaging smallholder farmers, face considerable challenges to growth

Common growth challenges of SMEs in the agricultural sector

Business fundamentals and profitability	While often contributing great impact within their communities, agribusinesses can struggle to generate attractive returns due to low contribution margins, high operating costs, and difficulties in achieving scale. Agribusinesses also frequently lack access to talent, leading to capacity limitations in strategic thinking, financial planning, operations, and other core business functions[1]
Raising capital	Banks often consider the agricultural sector, and especially SME agribusinesses, as high risk, which limits their lending to the sector. Impact investors often face challenges in finding the right investment opportunities, and then in conducting due diligence on agribusinesses in Africa. These factors, combined with many financiers being unfamiliar with specific value chains, and agribusinesses often not having strong balance sheets or collateral, among others, represent major challenges to agribusinesses trying to access finance[1]
Challenging operating environment	Agribusinesses often source from or serve smallholder farmers, which can involve costly field sourcing or distribution operations, and an increased level of exposure to diverse risks, such as droughts, pests, and similar shocks. In addition, the supporting infrastructure (e.g. cold storage or logistics partners) is often limited and underdeveloped, which leads to additional costs and further inefficiencies[1]

Sources: 1 - Bridging the Financing Gap: Unlocking the Impact Potential of Agricultural SMEs in Africa, ACELI Africa, link

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Because of these challenges, investments in agribusinesses face the risk of lower comparative returns; TA can help mitigate these risks

Commercial lenders have found the agribusiness sector to be twice as risky as other sectors

Business revenue

Agribusiness profits are rarely sufficient to provide a comfortable lending margin for commercial lenders, and raising interest rates further locks out agribusinesses from accessing financing[1]

Costs & risks

Operating costs associated with lending to agribusinesses in Africa are up to 22% higher than in other emerging markets (e.g. Latin America) and the risks are considered as twice as high[1,4]

Financial returns

Overall, the sector has been found to have returns that are 4-5% lower than other sectors for commercial lenders in Africa[1]

However, funds that provide TA alongside investment have the potential to achieve better returns

- A DFID study showed that 64% of impact investors use or plan to use TA "often" or "nearly always"[2]
- The introduction of a TA facility by African Agriculture Fund (AAF) contributed to an average cumulative growth rate of 53% per company.[3] Similarly, Business Partners International (BPI) found that investees that receive TA support had an overall default rate of 8% vs. 22% for those that did not.[4]
- TA that helps companies create more inclusive business models has enabled innovative models to be piloted and scaled at commercial levels, thus building future commercial competitiveness[3]

Provision of TA can help agribusinesses, and businesses more broadly, directly address their most pressing challenges, stimulating short and long-term growth

Sources: 1 - Bridging the Financing Gap: Unlocking the Impact Potential of Agricultural SMEs in Africa, ACELI Africa, link; 2 - Reflections on the effectiveness of TA provided by facilities linked with investment funds, link; 3- Five years of the AAF's Technical assistance facility: Enhancing the food security impact of agri-business investments in Africa, link; 4- Beyond Investment: the power of capacity-building support, link

Note: 4 – Risks are determined based on write-offs which are 2x higher in SSA agri-SME bank portfolio than the average of all other sectors for those same banks

In particular, TA can help investors and businesses address pre- and post-investment support needs

In the pre-investment phase, TA can help agribusinesses…

Define an investment strategy, evaluate investment structuring options, and prepare the required documentation

Manage investor lead generation and outreach and support with managing transaction processes, including due diligence and terms discussions

Set up basic financial, operational, or governance processes and systems to ensure investor confidence prior to investing

In the post-investment phase, TA can help agribusinesses…

Develop pricing, distribution, marketing, sourcing, and talent development strategies; or growth strategies such as new market entry or new product strategies

Drive business process improvement via process reengineering, financial analysis, and capacity building

To implement changes and achieve growth, including providing project management support or internal financial, analytical, and operational support

Source: OCA analysis

In fact, there are shared incentives for TA deployment for both funds and agribusinesses

For investors, TA can minimize downside risk and increase upside potential

Investor incentives

De-risk investments: TA is used to address key challenges to minimize business risks and to help businesses address issues, including those that they themselves may not see as a potential risk

Increase return on investment: TA enables investees to grow and optimize profitability, ultimately to maximize investment returns

Achieve specific impact metrics: Investors may use TA to enable businesses to achieve specific social impact goals

For agribusinesses, TA can improve business performance and is often instrumental in helping raise growth capital

Agribusiness incentives

Improve business performance: TA can accelerate growth and improve financial and operational performance, e.g., by overcoming capacity gaps, developing and executing a strategy, improving processes etc.

Raise growth capital: TA can support a capital raise, e.g., to help a business become investment-ready and negotiate favorable terms on financing that unlocks business potential

Source: OCA analysis

Even though TA is effective, it can sometimes be difficult for growth-stage agribusinesses to pay for TA themselves upfront

Often, agribusinesses cannot pay upfront for TA for the following reasons…

Liquidity limitations
Businesses are often unable to pay for TA given their lack of immediately available cash

Long-term payoff
While TA is paid for upfront, the gains from TA are typically realized after TA delivery and are often long-term. In that regard, TA is an investment

Timing of payments
The timing of payments for TA are often not tailored or designed to business needs, e.g. once the gains are realized

To combat this, TA is often provided for free, or subsidized, to agribusinesses and therefore TA pools are depleted quickly

- TA is often provided for free and therefore usually depleted with no replenishment, therefore reaching fewer companies
- TA that is free is typically limited in scope or narrow, and defined by set program agendas that may not meet agribusiness comprehensive or most urgent needs for growth
- Sometimes, there is no skin-in-the-game payment required from the agribusiness which can lead to lacking management buy-in and/or the TA provider not being held accountable for delivering value
- When TA is provided once, as a one-off package, rather than phased on an on-going basis to meet support needs at different (earlier stage) growth phases, the opportunity to build longer term partnership and optimize investor returns is not maximized

Source: OCA analysis

As a result, Small Foundation wanted to explore if TA can be deployed in a more sustainable manner through recycling

A recycling mechanism means that when TA is provided to companies, companies repay for this TA over time. Providing upfront funding for TA allows companies that are unable to pay upfront to access TA and repay over time; also, if the funding is recycled, i.e. repaid over time, the funding can be redeployed to fund more packages and reach more companies.

To achieve this, in a sustainable model, several key dimensions needed consideration:

Recycling mechanism
A recycling structure needs to incentivize repayment while ensuring that repayment terms are friendly and do not adversely affect company performance

Governance and team
Lean structures and processes are needed to minimize overhead costs in order to maximize the available funding for TA delivery

Synergies & incentive alignment
TA deployment needs to be well-aligned with the objectives of the fund, to optimize overall returns

The quantitative analysis suggests that a US $1 million TA pool supporting a US $25 million fund could result in each dollar of TA funding being redeployed around 3.4x over the ten-year period

Four key design elements were identified that will affect the TA recycling potential and long-term viability (1/2)

1 **Repayment structure:** The financial structure through which TA will be repaid

Examples

Debt	Mezzanine	Equity
E.g. fixed-term, interest-free debt **Pros**: Predictable recyclability, easy to explain to entrepreneurs **Cons**: Limited flexibility, same default risks as with any kind of debt	*E.g. cash-flow based payments* **Pros**: Flexible repayment, conversion "protects" against non-repayment **Cons**: Unpredictable recycling, more challenging to explain to entrepreneurs	*E.g. common or preferred shares* **Pros**: Preserves liquidity for the repaying entity; TA as longer-term investment **Cons**: Requires exit for recycling impacting probability and timelines

2 **Repayment trigger:** The events/KPIs which determine the timing of repayment

Examples

Financial performance or impact	Capital raise	Opt-in
E.g. free cash flow or EBITDA targets **Pros**: Can be well-defined, and performance-based **Cons**: Different accounting standards, and risks of manipulation by investee	*E.g. successful Series A or Series B raise* **Pros**: Capital raise targets are clear and measurable, and imply liquidity **Cons**: New investors may not want incoming funding to pay for previous TA	*E.g. opt-in to repay to access further TA* **Pros**: Investees can determine when to pay based on liquidity, positive incentives **Cons**: Unpredictable recycling, risk of non-repayment if incentives misaligned

Source: OCA analysis and consultations

Four key design elements were identified that will affect the TA recycling potential and long-term viability (2/2)

3 **Repayment incentives:** Incentives to encourage entities to repay for the TA services, either rewards or penalties

Examples

Access to follow-on TA funding	Access to new funding or better terms	Punitive measures
E.g. repay TA to unlock further TA	*E.g. follow-on financing, lower interest rate*	*E.g. add'l fees or increased interest rate*
Pros: Self-select add'l support; sequential support to maximize fund returns	**Pros**: Strong incentive to repay, add'l access to financing	**Pros**: Easy to communicate, and strong incentive to repay
Cons: Companies are less motivated to pay for the last TA package they receive	**Cons**: Can incorrectly signal guaranteed follow-on investment to the investee	**Cons**: Lacks strategic partnership vision, may create negative relationship, defaults

4 **Repayment entity:** Who pays for the TA service, for example the business, an investor, other stakeholders, or a split

Examples

Agribusiness themselves	Existing or new investors	Development partners
E.g. agribusiness pays for TA over time	*E.g. series B investor pays for previous TA*	*E.g. dev. partner pays for impact results*
Pros: No market distortion, agribusiness holds TA provider to higher standards	**Pros**: Ability to de-risk or increase upside of investment, can support capital raises	**Pros**: Incentives to align business and impact; effective funding mechanism
Cons: Affordability issues, risks of longer recycling cycles and non-repayment	**Cons**: Co-investors may not be aligned with TA recycling approach	**Cons**: Risk of distracting the agribusiness from immediate business priorities

Source: OCA analysis and consultations

Recommendations based on research and analysis

Most importantly, design decisions must align with the fund's vision, and support sustainability and an attractive proposition

Repayment structure

- **TA financing structures should mirror the investment structure** to reduce the administrative burden, i.e. debt-funded TA for debt investments, but a choice for equity investments. Doing so will help align incentives across the fund and TA
- Alternatively, **integrate the TA pool and the fund as a single unit** so that the TA package price is added to the investment required and repaid via the exact same structure as the underlying investment mechanism. Doing so; however, limits flexibility regarding TA repayment and therefore recycling

Repayment entity

- The primary **repayor should be the agribusiness**, with flexibility for multiple stakeholders to cover TA costs
- Include an **upfront cost-share of ~ 20%** to ensure "skin-in-the-game" from the onset and so that agribusinesses hold service providers to a high-quality standard
- **Development partners can be used to overlay 'RBF-type' programs, if possible,** that finance a portion of TA services if agribusinesses achieve specific impact metrics

Repayment triggers

- Adopt triggers that are **based on the achievement of specific objectives**, not ones (or alongside ones) **that are time-based**
- For pre-investment support**, repayment should be based on successful raises**
- For post-investment support, **identify triggers attributed to the delivery of TA, alongside financial indicators** to assess the agribusiness has sufficient liquidity to repay

Repayment incentives

- Integrate **voluntary repayment** alongside the core repayment triggers and incentivize agribusinesses to "opt-in" to repayment to access further support or funding
- Providing follow-on TA support to agribusinesses will help them unlock more value from the partnership (for equity investments also **increasing upside for the fund**)

Creating flexibility around tenor and triggers can help increase engagement and incentivize repayment

Trigger- and tenor-based repayments can be used in different combinations

Option 1: Business must repay at the end of the fixed tenor period

TA provided to business

Trigger 1: Financial KPI not achieved

Trigger 2: Operational KPI not achieved

End of fixed tenor period

Business obligated to repay TA

Option 2: Business must only repay if the trigger KPIs are achieved

TA provided to business

Trigger 1: Financial KPI achieved

or Trigger 2: Impact KPI achieved

Repayment triggered (either by one trigger or a combination) – business obligated to repay TA

Evaluation of options

- **Option 1:** While this creates the contractual obligation to repay, and would likely lead to higher recycling rates, it is unlikely that forcing a company to repay for TA when it is financially underperforming will lead to positive outcomes long-term
- **Option 2:** While this risks potentially increasing recycling time, it has the benefit of being concessionary to underperforming businesses and is more supportive of the long-term partnership spirit with businesses
- **Alternatives:** The TA facility could test trigger achievement every six months or year, and tie fractional payments to each phased trigger

An integrated structure will help streamline oversight, decision-making, and will help the fund remain cost-effective

Recommendations

Management integration

- Integrating fund and TA management ensures that it retains a lean team structure and streamlines processes for investment and TA decisions
- An integrated structure will enhance in-house knowledge and cooperation, provide better insight into business support needs over time, and improve portfolio oversight

Team size

- Lean team structures, subject to fund size, will reduce unnecessary overheads and reduce role overlaps
- A Managing Director will oversee the fund, supported by an Investment Manager, Ops & Finance Manager, and TA Manager. Additional hires under these management positions will support management

TA governance structure

- An integrated investment & TA committee can be responsible for approving investments and TA deployment simultaneously, and overseeing any due diligence process for the investment & TA deployment

Consulting & placement engagements

- TA should be high-quality, tailored to the most important business needs, and tied to achievable metrics
- Consulting and talent placements appear most suitable for rapid impact and to ensure quality

Note: 1. Preferably, shortlist and retain a small number of core providers for core business support and maintain a longlist of specialists for niche technical support (e.g. quality certification or agronomy support) that can be called upon for support, to ensure rapid access to TA support.

Summary of design recommendations

Team structure

Mgt integration
Fully-integrated fund and TA mgt. *will ensure a lean team structure and stream-lined processes for quicker alignment and turn-around times for investment and TA decisions*

Team size & structure
A lean structure will ***reduce unnecessary overheads and reduce role overlap***

TA deployment & recycling process

1. Screen businesses *to identify and select highest potential* ***businesses for investment***

2. Determine inv. structure, *for an investment to determine* ***TA repayment structure***

3. Select a TA package *dependent on the business' most important support* ***needs***

4. Select a TA provider *with the most relevant experience and capabilities, through a rapid* ***RFP process***

5. Deliver the TA *through* ***consulting & placement*** *engagements*

6. TA recycling *only once* ***events/KPIs*** *are achieved to trigger repayment*

Repayment & recycling structure

Triggers
Apply mix *of 1 KPI to test TA effectiveness and another to test liquidity/ability to pay*

Incentives
Opt-in provides business the option to voluntarily repay; ***follow-on packages will improve engagement***

Structure
TA repayment structures should directly ***mirror the chosen investment structure***

Entity
Primarily the agribusiness*, with added flexibility for multiple stakeholders*

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To further improve fund economics, use TA strategically and scoped to directly align with the aim of driving fund returns

There are many important considerations to be able to deliver TA sustainably in an agribusiness investment fund:

Overall fund design

- Assess mix of investments (equity to debt), and consider level of TA provided to debt investments where the upside is limited as compared to equity investments where the investor can participate in the longer-term success of the investee
- Increase fund capitalization so that overheads are spread over a wider pool under management

TA for equity investments

- Focus on supporting high-performing investments and prioritize follow-on investments in them to cross-subsidize lower return investments
- Provide targeted TA support packages, and prioritize follow-on support packages to equity investments
- Scope TA packages to have tangible, and rapid, bottom-line impact
- Create investment partnerships to increase number of exits, and ideally speed up time to exit

TA for debt investments

- Incentivize debt repayment through access to better terms, further funding, or additional TA
- Use TA strategically to minimize default risk, and to accelerate repayment
- Invest in credit management and up-front diligence to minimize the risk of default
- Consider mezzanine-like structures to include performance-based payments to the fund to increase the upside potential from TA