# Revenue Capital: Reducing, Rewarding and Realigning Risk

## Presentation Audio Transcript

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*Kristen O'Planick:* Welcome to today's Microlinks seminar, *Revenue Capital: Reducing, Rewarding and Realigning Risk*. For those joining us in the room, please silence your phones, if you haven't yet, and a special welcome to those joining us via webinar from around the world. As long as USAID has been working in small and medium enterprise development, our programs have been running into hurdles on the ground when it comes to financing the growth of these businesses. If you went out and did a survey today, in pretty much any country and pretty much any sector, the SMEs, I guarantee, would say that finance is one of their top constraints to growth.

But the revenue capital approach is breaking barriers from Tunisia to South Africa and paving a pathway to progress for SMEs who don't fit the bill for traditional banking adventure capital. Today, in partnership with the USAID Asia and Middle East Economic Growth Best Practices project or AMEG, we will explore key features of the revenue capital approach. The AMEG project supports USAID bureaus and missions in Asia and the Middle East and North Africa with activities such as assessment, knowledge sharing, strategic planning, diagnostics and innovative pilot programs.

The project focuses on a variety of key issues around economic growth and job creation. And in particular, AMEG has been working to promote familiarity and utility of the revenue capital approach to finance, growing SMEs that struggle to access the financing they need to sustain or expand. In addition to this seminar, AMEG will be releasing a comprehensive guide on the revenue capital approach next month and will be holding additional knowledge sharing events in the U.S. and abroad. So stay tuned for that. We will be sharing the guide via Microlinks in the post-event email, so you will have it handy.

Now, let me briefly introduce our speakers. They're expanded and fascinating bios are available on our event page.

Tom Gibson of SMEThink has been promoting and providing risk capital finance for small and medium enterprises in developing markets for more than 25 years. He was founding president and later chairman of the Small

Enterprise Assistance Funds, for SEAF, one of the largest global groups of private SME risk capital funds in developing markets. Since his departure from SEAF, Tom has been advising primarily on the design, development and documentation for new SME risk capital funds, as well as providing training for fund managers and stakeholders in SME finance. Working in more than 70 countries, he has held in-depth, on-site, and one-on-one, investment-related interviews with more than 600 SMEs.

Nazeem Martin has extensive knowledge of and experience in SME and entrepreneurial business finance. Having worked for Business Partners Limited, a leading on-scale provider of risk capital, business premises, and technical assistance to SMEs in South Africa, and selected sub-Saharan countries. Nazeem spent more than 18 years at BPL, retiring as managing director of the company and as CEO of its subsidiary, Business Partners International Limited, in 2016. Currently, Nazeem serves as the non-executive director on company boards, such as Business Partners Limited and E-Squared, which is an equity investor in high impact businesses. He also provides consulting and advisory services to SME and entrepreneurial financers and service providers.

And finally, Bo Cutter is a senior fellow and director of the Economic Policy Initiative at the Roosevelt Institute. He was a managing director of Warburg Pinkus, a major global private equity firm between 1996 and 2009. He served with distinction in economic policy roles during the Clinton and Carter presidencies. Bo was a chairman of the board of CARE, the global development organization, for more than seven years and is a founder and current chairman of MicroVest, a leading global micro finance fund. He is the chairman of the Tunisian American Enterprise Fund, which was founded by the U.S. government to help the Tunisian economy through private sector investment. And with that, I will hand it over to Tom.

*Tom Gibson:* Thank you, Kristen, and thank you Bill Baldridge and thank you Christy Sisko at Chemonics, and everyone who has given us an opportunity to let this exotic kind of finance see light of day here. And when I say exotic, I mean it's just more rare than it ought to be. I will describe it simply. I think Bo Cutter would tell you that I generally oversimplify it. I think

Nazeem would tell you the same thing, but I'm a salesman and so I will try to give you—to whet your appetite to find out more about what this kind of finance is. But let me say this: I'm going to not follow the slides slide-by-slide. I'll flip through them some. They can provide kind of an aid memoir to what I say and I think they will have some logic to them by themselves afterwards. But what I'd like to do is just talk about this a bit in the way that I do, professionally, in occasions where it comes up.

I have had the privilege in the last three months to spend time in Egypt and Morocco and in Palestine and in Jordan seeing entrepreneurs. I've been working with an organization called the Middle East Investment Initiative. We're putting together a fund for SMEs and developing the Middle East and North Africa and they've decided that this is the kind of finance they would like to do with SMEs there. And when I see these SMEs, which are selected through organizations that know SMEs around town, what I keep seeing is the same story. These are companies where they have established reputation, they know what they're doing, they have industrious and intelligent management, entrepreneurs, and they come to a point where they have an opportunity to expand, but there's a cost to that.

They need a certain amount of capital in order to take advantage of this opportunity and it may be just going from a domestic market to an export market, it may be going from one store to a group of stores, it may be getting a contract with a multi-national corporation that needs a certain service or a product that they make. It's this opportunity to take a big leap and that requires a certain amount of financing often for equipment, a lot of working capital to be able to take that next contract or take that next step. But they have a problem. They have a problem in that the kind of capital they need is, in the first place, larger than the collateral that they possess.

Now, why am I particularly interested in these kinds of expansion opportunities? Let me go to this. There's 30 years of economic studies that show simply that 5 to 10 percent of companies produce 50 to 100 percent of _____ new jobs in the countries where this kind of economic survey has been done. Economists call the companies in that 5 to 10 percent 'gazelles" and that means companies that have grown at least

statistically 20 percent per year for four continuous years or 30 percent per year for four—for three continuous years, but these are fast growth companies and they're mostly SMEs. I have—think, as other people do, that revenue capital is a very appropriate instrument for them.

Now, let me go ahead and define what revenue capital is. Revenue capital is risk capital. That's the first thing we need to realize. It's not venture capital, it's not banking, but it is risk capital, which means two things. It means that it does not require 100 percent collateral, which as you know is very important in this situation. It also means that it participates in something in the company that allows it to take or that insists that it takes a risk with the company. If the company's performing badly, it's a bad investment. If the company's performing well, it's a good investment. That's what makes it risk capital. Now, revenue capital is a particular kind of risk capital in which, instead of participating in a growth of the equity value of a company, it participates in a growth of the revenues of the company. Its most basic form is an unsecured loan, with a very low interest rate, and the right on the part of the investor to have a small percentage of sales of the company, of the growth sales of the company. So what it's doing there, it's kind of hybridizing a loan with a venture capital kind of structure, except it's not doing the following.

It is not looking to invest in the equity of the company, watch that equity grow, and then do what venture capitalists and private equity investors do, which is to sell the company. The business of private equity and venture capital is to invest in companies that need the capital to help that company grow and then to sell that company or, in rare cases, to list the company on the stock exchange. That's what venture capital is. It's a very tiny number of SMEs who are candidates for that sort of thing. So let me go further through these slides and introduce you to Ahmad.

Ahmad makes—not terribly exciting, makes door window frames for small commercial buildings and houses. He has done a great job of growing his company from $200,000 a year to nearly $500,000 a year in his fourth or fifth year of business. He has projected that he will grow from $500,000 now, five years later into 2021, he'll be around $775,000 a year. Good for you, Ahmad, but now he has an opportunity. A

contractor has come to him and said look, you do a great job, we like your product, we like you to build all the door and window frames for our new big apartment complex. So Ahmad is very excited about this, but what he sees is this. He says he sees that he can't do that unless he has $500,000 to invest in equipment and some working capital to take that contract. He's just not big enough and doesn't have enough equipment now. He thinks that if he could get that $500,000, he could grow not to $775,000 a year, but $2.4 million dollars a year in five years, which would allow him to—I don't know why it's saying that that way, but which would allow him to have—to just about double. If he doesn't get this kind of financing, he'll have about 16 employees in 2021. If he does and he grows the company to $2.4 million dollars, then he will have probably around 34 employees, he projects.

So that's our man Ahmad. So he's got a problem. He's made out all the paperwork, he's gone to the banks, he's given it to them and they have said he can't have the loan. Why can't he have the loan? He doesn't have enough collateral. So then, you got someone says well, if you can't get a bank loan, what you need is private equity. So he goes to the only fund he can find that's investing at less than $2 million dollars a year, an investment, I mean, and he is told by them that he's really not big enough, he's not a tech company, he's not very sexy, and he is not a company that you can buy into and sell in five years. So now, here's where we are. What does Ahmad do now? This is his situation that in the last four months, in the last 25 years, I've been looking at in these countries in MENA, I keep seeing these businesses who were in that same situation. The question is where do they go? The bank over here wants 200 percent collateral.

The VCs, what all of these conditions and they're really only investing in maybe three companies a year, so what does he do? And if you look here, the World Bank enterprise surveys, you'll see that over—the average—this is for companies, by the way, that have between 20 and 100 employees—that the average collateral requirement of companies who borrow from the bank is 203 percent in MENA, according to those last surveys. With 82 percent of SMEs having banking relations, only 21 percent are actually using banks for what they should be for, for a corporate climb, which is to borrow money to move ahead. Venture capital has its own problem here and that's this. What you see here is that in the U.S., typically, in any given year recently, the venture capital

industry makes about 4,000 investments. Now, remember, how do venture capitalists and private equity investors make their money? They make them by investing in companies that get acquired by somebody else or listed.

So at 4,000 investments a year, the number of companies that are actually listed or acquired that are backed by venture capital is generally somewhere between 450 and 550 a year while they're making 4,000 investments. But if you look at MENA, this is data from the MENA Private Equity Association, which you'll see is that of 175 private equity investments made in 2015, that same year, there are only 21 exits through acquisitions through IPOs. Now, that's fine. Venture capital and private equity do wonderful things, but they are not the answer for the SME sector. Revenue capital is not the silver bullet for the SME sector. What it is is this: it is the answer to the question that comes up with economic growth officers, economic development professionals, so often how can we grow the SME sector when no one is financing the SMEs. How can we grow the SME sector when the banks want 200 percent collateral and the VCs are only investing in three a year and the conditions of that tough for SMEs in general.

The answer is there's got to be something in the middle. There must be a hybrid of these things and so what revenue capital is, is it's an attempt to move away from collateral and to move away at the same time from basing your investment on investing in equity, growing the value of the equity, which you only realize by selling the company. It's in between there, so what we're doing with revenue capital is we are shifting this paradigm of risk capital from participating in the growth of equity to participating in the growth of sales. Now, let's see where I'm at on time here. Okay, now, what's the virtue—what are the virtues of that? Okay, well let's say I have a fund and I'm going to do revenue capital and I'm going to be investing in companies in this fashion.

One of the first things that I have to recognize is that there are laws in these countries. There are regulatory issues in these countries that don't really want me to come in and make all these loans like this. And the reason they don't is because I will be somehow competing with the banks or I will simply not be falling under banking regulation. And if I'm

doing this, I don't want to be a bank, so what do I do? What the regulations will allow me to do in most of these countries, if I make a loan to a company in which I do have some equity, I can keep doing that. That allows—what that means is I want to invest in some of the equity of the company, but here's what we do and here's the technical part that it's not too easy to grasp and that's why I leave you with the slides and we're coming out with a report that explains this in greater detail.

That is to say that we make—let's say we make a $500,000 investment in Ahmad's business. We take $450,000 and we make him a loan, a five-year loan. We give him a very low interest rate on that and then we want 2 percent of his sales. 2 percent of his sales is a reward to us for not requiring full collateral and for giving him a low interest rate. But what it also does is it motivates us to try to help him get his sales up. I can tell you that entrepreneurs get up in the morning thinking about sales. They don't get up in the morning in general thinking about their share value. So once I am—my interest is in help—my interest is in the sales. My profitability on this investment is based on the growth in the sales of Ahmad's business. Ahmad and I are lined up. We're both interested in the same thing when we get up in the morning when it comes to Ahmad's business.

I will take a little money and put it in the equity for shares in his business, but I will put it in there at a very low value. Let's say that I'll put in—given the $450,000 loan, I'll put $50,000 in, in equity, and here's what I'll agree with Ahmad, though. I'm not really interested in that equity. Makes me a partner with him, it lets me help him, it lets me make decisions with him and so forth, but what I'm interested in is sales. So I say to Ahmad okay, I come in with $50,000 and we'll say that gives me 25 percent of your company, but in five years when you have paid me the loan, when you've repaid the loan, when you've paid me all the interest, when you've paid me that portion of sales that I've taken, the 2 percent, which we hope has grown during that time, then you can have 25 percent of your company back no matter what it's worth. You can have this 25 percent that we bought with $50,000 for $100,000.

Just give us $100,000. Now, if your company is a $5 million dollar company in five years, you can still have the 25. You can still have the

25 percent of your company back for $100,000. Now, that—the basis behind that is again, to shift away from the dependence that we would have if we put $500,000 into his company in equity, in order to get a reasonable return in five years, we would have to sell his company in general and normally, we would have to sell it in order to get the kind of return on that $500,000. We'd like to get three times that in five years. The problem is where is Ahmad going to come up with—if we want three times our $500,000, where is Ahmad going to come up with $1.5 million dollars in year five?

That's the issue we're dealing with. Now, getting away from that technical issue, let me just go back to the simplest possible statement about this and that is going back to the issue of the company that has an opportunity to grow, is facing the MENA financial market, and asking us what do I do now? The whole purpose of revenue capital is when that question is asked, when it's posed, I can't get the money I need from a bank, because I don't have enough collateral, I can't get from the VC fund, the private equity fund for the reasons we discussed, what do I do now? Just give up? What revenue capital is about is figuring out some answer to that question. Something is between highly collateralized bank financing and private equity. That is what we're doing. There have been—that question is asked—every economic growth or SME development officer has at some time had someone come into the office and pulling out their hair and say what do we do now? Nobody's financing the SMEs.

It behooves us in this business to look for something else besides the two conventional sources of finance for growth or SMEs. Now what you'll find in the rest of these slides is—will take you through this. It will break down the more technical issue of the equity and the debt features and make it simpler to see and summarize what I said in the end. At this point, the point I'd like to make before these gentleman speak is simply that what they are doing is something that for which there is a very well established need out there and they've both been doing it very well. Thanks very much.

*Nazeem Martin:* Well, let me start at the beginning, which is to thank USAID and Chemonics I think for putting this together. It's something that I've

spoken, I think, rather passionately about for more than 18 years and it's nice to know that other people are starting to believe us Tom and trying and experimenting with coming up with ways in which one can _____. I had the privilege of working with a company called Business Partners for over 18 years. I say it's a privilege, because before me, there were other people. There were two other CEOs before I came along and there are a lot of other people who were working there then—still work there now and there are many other who have joined the organization subsequent to my leaving.

These people all have one thing in common. They pursue what they do with some kind of missionary zeal. They believe that having a development impact and making money at the same time is indeed possible and they go about it—this task on a daily basis. They do it with missionary zeal and they do it really well. So about 17 years ago, I think it was that I first met Tom Gibson at a seminar organized by USAID and the IFC in Windhoek in Namibia, you will recall Tom. It's beautiful to see how things evolve over time. At the time, I did a presentation, you will recall, Tom, on royalty capital, or revenue finance. The theme of that particular seminar or conference was venture capital for SMEs. So what I presented didn't sit well with most of the people there.

I think Tom didn't believe me at the time as well, but I'm glad to have noticed that Tom has, over the years, become one of the greatest disciples of revenue-based, or royalty-based, finance In fact, one of the single biggest—we didn't have to advertise. Tom told everybody in the world about the beauty of royalty-based or revenue-based finance for which I am eternally grateful. So I was privileged to work with a bunch of really great people including Tom over the years, where I think we have built up a case for a particular instrument to be used in insuring the access to finance for small and medium businesses become more readily available. So like Tom, I'm not going to go through all the slides. I think they're in the pack for you to use and refer to.

They are in a logical sequence and they'll tell you a lot about business partners and its success and otherwise. But what I want to do is maybe personalize a little example that Tom used. I'm going to play a little game with you as we go along and maybe we can devote a little bit of

time to that, so that we can fully grasp what it takes to be an entrepreneurial SME financing investor. And then I have two slides right at the end, which I will focus on—where I will give you some indication as to what are the benefits to both the investor, as well as the entrepreneur in coming up with a royalty or revenue-based capital solution and finally, I'll give you some tips about some of the pitfalls, how to overcome some of the pitfalls, which inevitably will face you if you pursue this path of trying to use royalty or revenue-based capital as an instrument to meet the requirements of small and medium businesses.

So a little bit about Business Partners. This organization, which I retired from, you might not believe that, but in fact, Tom asked me last night, "How old are you?"—I won't disclose how old I am, but I always had this idea that I wouldn't want to work in a corporate environment until I reached beyond a certain age and so a year before I reached that age, I decided that's it for me. Secondly, I also don't think that any CEO of any organization should have more than two terms. Because I think we're all human, I think at that point in time, we might have lost some of the spark. There are other people who have more energy, better ideas, which need to be pursued.

In fact, I think, whether it's in politics or business, if you serve for longer than two terms, you stop seeing what's theirs and yours. So I think we're—but we need to move on and there's always a need for new blood. So I moved on from this organization, especially risk finance. It's been around for 36 years and it provides a full product range from funding through to business premises for SMEs from which to operate, as well as technical assistance and mentorship to the entrepreneurs. They've been doing it on scale. What do I mean by that? In a bad year, they do about 250 transactions in South Africa alone. In a good year, they have been known to do up to 700 transactions. It's a lot of deals. They have an exclusive focus. They've had this focus since inception, they still have this focus. They only touch SMEs. They don't do big business and they don't do micro business.

So they have developed a deep understanding of what it takes to make an SME, a small and medium enterprise, work, and what it takes to be an entrepreneur in this space and therefore come up with solutions, which

meet the needs of these entrepreneurs. The mantra of this organization is to do good and to do well. Doing good means to touch as many small businesses is possible with this unique blend of SME finance solutions and to prove that you can make money out of it, they want to do well at the same time. And they've proved over the 36 years they've been around, they've made profits in every year. They've never made a loss. They've proven that you can over an extended period, have a sustainable development impact, and make money at the same time in a sustainable way. Since 2005, I think, people encourage the organization to expand its footprint beyond South Africa to test its model. It's been done. Initially, in Kenya and Madagascar, subsequently in Rwanda and a couple of southern African countries and more recently, also expanding into Uganda. So Business Partners has a presence in a number of sub-Saharan African countries. I'll flip through that. They've done a lot of deals over the 36 years.

They've created or facilitated a lot of jobs and they've also placed a lot of money in the hands of entrepreneurial SMEs. Just to give an indication as to the amount of money disbursed, you will notice this is a fairly rapidly rising slope on this particular graph, but it creates an impression—it might create an impression it's only royalty-based finance. It certainly isn't. The following slide gives you an indication that Business Partners has, over the years, developed a range of products or deal-structuring instruments and the amount of money that's disbursed, you will notice a large part thereof is in the royalty or revenue-based financing products, as they call it. Roughly a third to 40 percent of the transactions concluded in the value placed on an annual basis into the hands of entrepreneurial SMEs is in the form of royalty capital or revenue-based capital.

But there's a range of other products, which I was telling Bo a little bit earlier that at Business Partners, we call them products. They're not really products. If an entrepreneur comes to Business Partners, they don't come and buy a royalty capital transaction, they come for money. The way in which business Partner structures it means that it ends up—it turns out to be a royalty-based product. But there is a whole range of different ways in which you can structure transaction. The key is, you got to want to do the deal and in wanting to do the deal, you'll come up with a deal structure using the instrument that is required to insure that the entrepreneur is reasonably comfortable, the business can afford the

entrepreneur's expectations, and your expectations, and you get the kind of return that you are looking for at the same time.

So, I indicated a little earlier this company has been profitable every year since 1981 and most importantly, when it's set out to be sustainable, it said it has to provide its shareholders with a return on equity, which exceeds inflation on an annual basis. And every year, it has exceeded—it has been able to do that. It has been able to provide a return in equity, which exceeds inflation, which means that the pool of resources that this company has available to do the good work it is intended to do, right, grows on an annual basis. Okay, I think everybody talks about finance and this is a really busy slide. But what I wanted to prove with this slide is if you're going to be working in this small and medium entrepreneurial space, regardless of where you work in the world, but especially if you work in developing countries, there's much more than just money required in order to make businesses not only survive, but also thrive.

There's got to be markets. There has to be some skills, human capital. There's got to be proper governance in place and there's got to be infrastructure, which facilitates the development of business in general and in much of the developing world, certainly the markets in which we operated, not all those particular drivers are in place. One of the things that you as financier might have to do or whether you work for USAID, you might have to lobby local governments with a view to creating an ecosystem within which all the parties, from entrepreneurs to financiers and everyone else in between, they thrive rather than just survive. So it's important to know that finance—sensible financial institutions, whether they be venture capitalists or banks or SME risk capital providers, need much more than just money in order to conduct their business. They need to have the ecosystem in place, which will ensure their success.

I think that's arguably where many people fall short when they enter a new country, they try and impose a particular structure. They impose a particular way in which they conduct business and certainly, they come unstuck because they know compliance with local customs or legislation for that matter. Okay, this is a big mystery surrounding SME risk finance and I often use this as an example. Let's personalize it a little bit. Let's say I'm a really good entrepreneur. I'm pretty competent and I have good

doing and business skills and loads of entrepreneurship inside of me and I approach you. You are the financier with my business plan. Let's, for one moment, assume I want to buy this pizza store. So let's keep it simple. It's going to cost about a million dollars to do that and I've got $100,000, that's all, and I have no assets to pledge as collateral.

How do we resolve this? I think there are one of three ways in which we can, right? You can tell me I'll do you a loan for $900,000, but you can pledge me collateral, which is equal to $900,000 US dollars. I don't have that, so the banking—typical banking solution won't work. You could be a private equity practitioner or venture capitalist and you could say to me you inject your $100,000, I'll give you $900,000 as equity, but you'll say to me I have news for you. You're going to be—you're going to—I'm going to own 10 percent of the business and you're going to own 90 percent of the business. In the world of SMEs, mostly family-owned businesses, if the entrepreneur doesn't believe that he or she owns the business, when things go wrong, which often happens they fold up their hands and they walk away, right? And you, as the investor, will have to run the business, which I'm sure is not what you want to do. That's not what you set out to do.

So that's not going to work. And the third approach is not unlike the one Tom described is you as investor or financier, you acknowledge my $100,000. It goes into the business. You lend me $900,000. I don't have collateral. The only collateral I may be able to pledge to you are the pizza ovens and the last time I checked, they weren't worth much, especially second-hand pizza ovens and so you lend me $900,000 and usually at about the prime interest rate, which is grossly unfair to you. You're not getting a return, which commensurate with the risks you are taking. So you need a sweetener. The sweetener comes in the form of royalty, which might be a fraction. It might be one percent, it might be many percent of revenue over and above the capital repaid to you and the interest. The interest could also be at zero and the revenue, the percentage royalty will just increase.

So in this way, you, as a financier, would get an internal rate of return, which is comparable to the one that you would have gotten if you had financed this transaction as an equity investor. Those are just deal

structuring instruments. You can come up with various permutations to solve this little conundrum that I sketched a little earlier. Let me end—I'm going to skip that one. Let me end off by sharing some takeaways with you. What's good about this for the entrepreneur? What's good about this for the financier? Most entrepreneurs, SME entrepreneurs, won't get the money from the bank. They won't get the money from private equity investors or venture capitalists, right. So royalty-based risk finance is one way in which you give opportunities to people who otherwise may not have had access to funding. It makes funding more affordable, because it's, certainly in the case of Business Partners, we take whatever collateral we can lay our hands on, not with a view to try and minimize our risk. Of course, that's important, it's to lower the risk to us. More importantly, the lower the risk to us, the lower return we expect to make and therefore, the lower the cost of capital. So that's one way—so it makes it affordable.

It allows the entrepreneur to retain 100 percent ownership, which is important in family-owned businesses. They seldom want outside investors or third-party institutions to become a shareholder in their business. They want to pass it on from generation to generation. These businesses form the cornerstone of most countries' economies. Because the investor's at risk, the investor provides more than just money—a lot of advice and technical assistance, which the entrepreneur otherwise would not have had. And most importantly, as Thomas pointed out, there's no single large exit required to buy out an outside investor. So there are many benefits for the entrepreneur, for the financier, you can do a deal where traditional instruments like bank lending or equity investment doesn't work. You can—this gives you an opportunity to still do a deal and get a return, which is commensurate with a risk you have taken. You get—a royalty transaction is nothing but a self-liquidating investment. You get— you exit every month with a little bit of royalty that you get over and above the capital and interest repayment.

It also lowers the likelihood of an entrepreneur, because there's some risk. If you're a shareholder, then the entrepreneur might manage the exit, or the business, in such a way that the value is minimized—or the business is minimized at the time when you need to exit. And therefore, you won't realize your exit. So a royalty deal structure could give you a minimum guarantee. I'll take two more minutes and then I'll stop. What are some of the pitfalls and how can you overcome them? When you

charge a royalty fee as a financier, it's often based on the revenue. Revenue, we don't live in a perfect world. Revenue can be managed. Some revenue is in the form of cash sales. Now, do we love entrepreneurs? Of course we do. They play a very important part in the world, I guess, in the development of economies. Do we trust them? Those are two very different questions. Of course we trust them, to an extent, right?

So how do you verify that the sales or the revenue, has all been put through the _____ and not through somebody's pocket, so that's one of the risks and one of the challenges. Now, there are ways in which one can do that. One can have an elaborate monitoring and tracking system. You can also contract to ensure that you get your fair share. But it's certainly not easy, so the key issues to be aware of, moral hazard, which really is the under reporting of revenue, for a whole range of reasons, entrepreneurs are entrepreneurial. They wish to maximize the return to themselves most of the time. A royalty in the wrong hands is a very dangerous instrument. Royalties are cash hungry instruments. You take money out of a business every month depending on how you structure it. Most businesses need to retain capital over time. If you take too much at the wrong times, you can kill the business. Many businesses, the revenue is seasonal in nature—if you charge a royalty at the time when there's no revenue in the business, you will also kill it. So be wary in how one uses royalty as a structuring instrument. Revenue authorities, how do they treat royalties? Do they treat it as an expense to the SME and therefore it's tax deductible? That's very important. Do they treat it as deferred interest? So it'll be taxed at a corporate rate in the hands of the recipient, the investor. Or do they treat it as a capital event? It's important to understand the revenue environment in which you are operating in order to get the best deal possible both for the entrepreneur and for you as an investor.

The most important thing that I can say to you is if you live in the world of SME risk finance, there are many ways in which you can solve the funding problem, the access to funding problem. Whatever you do, if you're going to do risk capital, if you're going to provide risk capital, you have to behave and act and think like an investor, not like a lender. You can't at the first _____ when something goes wrong. In fact, if you do, you will lose all your money. If you act and behave like a lender and call up the collateral, which there isn't, you're going to lose your money.

You're not going to help the entrepreneur in any way, so you've got to think and act and behave and coach the entrepreneur along as though you were an equity investor, even though you don't obtain the same kind of equity of return that you would if you were an equity investor. That's it for myside, thank you.

*W. Bowman Cutter:* Hi, I'm Bo Cutter. I chair TAEF, the Tunisian American Enterprise Fund, and I also want to start by thanking AID and Microlinks for doing this. I think it really is a huge service to the world of development finance. I know that we have an extremely stern time police person that I'm—who has a deadly look, so I'm going to try to stay on time. I have carried, as you may have noted, both Tom and Nazeem put slides up and said they weren't going to speak to them all. I've carried that to a logical conclusion, which is I have no slides. I do have some points though. And I guess one of the things—points I'd really like to say is that embedded in sort of every two or three paragraphs of what Nazeem and Tom said are—is enormous wisdom about this, but also topics you could spend an hour on, each one of them.

So I'm going to be jumping over a lot of that. So let me open by saying I've been interested and involved in SME finance and SME investing for a very long time. And the reason is quite simple. As Tom implied, as Nazeem implied, whether you look at the United States or India or Ghana or Uganda or South Africa or Tunisia, the key, the characteristic without which you cannot succeed is the two inclusive economic growth is a thriving SME sector. It is not big companies, it is not foreign direct investment, it is a thriving small and medium enterprise sector. Therefore, from the beginning, as I had the honor to be asked to chair TAEF, I wanted SME investing to be our focal point. But the fact is—and I think Nazeem and Tom have implied this—there are very few examples of sustained, successful SME investing. And I've thought and I think both also implied this.

That the intellectual model, the sort of venture capital model on the one hand or the banking model on the one hand, which people brought to the world of SME investing simply didn't work, was not appropriate. Sure, there were outliers, there were moments on the edge when they worked just fine. But at the core, they didn't work. And finally, no matter what

they say, there is no government on earth that, as a part of its economic growth philosophy and strategy, actually really focuses on SMEs. So you're dealing with vast, indifference papered over by loud protestations of confidence and faith. So I had a dilemma. There weren't any models I knew of for the work that I wanted to do and I didn't kind of know where to go. But as I started and as I was in the process of becoming the TAEF chair, I learned about Nazeem and his work and either I'd call him or he called me. I can't remember, but it was very early in the process.

And he was extraordinarily helpful in kind of giving me a sense of where to start and simultaneously, Bill Baldridge of AID, had a long working relationship with Tom, as did Nazeem. And he put me in touch with Tom. Tom presented to us at the TAEF. The us at the point was three people and I was convinced almost immediately—I'd been an investor for a long time and for reasons I'll say, it sort of—it met the requirements that I didn't know I was beginning to impose, but that I was imposing on SME investing. The—what it does, I'm not going to do another explanation. You've had two really, really good ones. It finances a small business in a way that recognizes the several linked problems that a small business entrepreneur always has and always has no matter what the national or cultural context is.

So I want to underline this. I could not have moved without the ongoing work of Nazeem, without his 18 years of experience, and I couldn't have acted without the involvement of Tom, so thank you all both very much. And what you're hearing from me is not a finished product, it's a sort of report midstream from a financial investor that's implementing this approach. Tom went to Tunisia, helped us get started, spent considerable amount of time trying to understand the regulations in Tunisia. It's not an easy task. And trying to help us begin to paper it all, so that we could get started. But there's a lot more to it than that and let me, as a—underline two points as context.

The Tunisian financial sector is the product today of a combination of French Napoleonic law, which basically assumes in its regulatory structure that if something is not stated as allowed, it is not permitted. The U.S. government structure, the U.S. structure is the other way around, thank God. But it's a combination of that plus 30 years of a

kleptocratic authoritarian government that stole everything in sight and created regulations to permit them to do that. So that's one problem and the other problem is that the three vehicles that you use in royalty finance, the royalty, some equity, some debt, are completely separate legal—if they're recognized at all, in Tunisia. And in Tunisia, at least, and this one thing Tom said that I would disagree with, it is not the case that if you're invested in something you can lend to it. As a matter of fact, it is actually prohibited to lend to something in Tunisia that you're invested in.

And I think that's true in other countries, too. But because of all of that, it took an enormous amount of time for us to chart our way through the financial regulations that let us do this. It involved enormous drafting work and organizational structuring to create an approach that the Tunisian government authorities could convince themselves that their laws explicitly said we could do. And I've come to think that one of the great values of things like the enterprise funds, as instruments of policy, is that nobody else would bear that kind of overhead cost to get this done. Goldman Sachs wouldn't, my old firm, Warburg Pincus wouldn't. In order to be able to get them into what I think is a wonderful possibility, but they sure wouldn't, of making half a million dollar deals. So it is only the capacity to pay for all of that that allows this to be done.

It's also taken enormous amount of time, so we papered it all on the one hand to meet all of the regulations, then we had to paper it all on the other hand to deal both with the actual law with the lawyers and with the entrepreneurs. They had to be able to understand it. Then we had to think through how do you simplify this in a way that someone who runs a half a million dollar business can understand it, but at the same point, time is in fact a legal instrument, because we, as I think Nazeem spent a lot of time emphasizing, we're in the investment business. I mean, we're taking risks. I do not regard our money as grants. We're there to make a decent return on what happens to the money afterwards is not my business. But we're there to make a return on this and to help the Tunisian government and the Tunisian economy grow.

It's also required a high degree of flexibility. Nazeem emphasized this. This is not a cookie-cutter approach. I always have a problem when I say

that, because for the first six or seven years of my life—my name is Bowen Cutter, my nickname was cookie cutter, so I've never quite been able to say that without grimacing, because I hated it, but you can't just say to your investment officers do this, this and this. They have to see this. Nazeem calls them "coat hangers," but they have to see these instruments as things you play with and that you move them back and forth to get a kind of rate of return, which works for you and works for the entrepreneur. And sometimes you don't do a royalty. We have to date, I think on all of ours, but we're perfectly open to the notion that we won't. Sometimes, your equity is larger and it matters quite a bit to us. Sometimes, it's very small and doesn't matter to us at all. But in any case, we've now been doing this full bore for two years and this is kind of where I think we are.

We can say the approach meets successfully all the initial goals that my chief operator, Hela Fourati, and I laid out when we decided two years ago to do this. We said this is what we want to accomplish. We can explain it to entrepreneurs. We can simplify the documents. The entrepreneurs understand it and they are attracted to the instruments. The combination of the three instruments, debt, equity, and a royalty on revenues of some kind, let's us underwrite our investments in a way that is fair to both sides. We are putting money at risk and we ought to be able to get a return for it. The entrepreneur has a business they need to be able to sustain and we shouldn't be trying to extract an unfair return. We think it's about right, as evidenced by the fact that we have a mile long pipeline. We're not imposing inordinate risks on the SME itself nor are we changing the character of the business. We're not trying to make a business into a venture capital investment when we all know it can't be one. So to sum up, as both Tom and Nazeem have said, this approach doesn't solve all of the problems in the SME sector, but it goes much further than anything I have seen in the past or anything I have done to break in the code. Thanks a lot and I guess we're going to take questions now.

*[End of Audio]*