Revenue Capital: Reducing, Rewarding and Realigning Risk

Q&A Audio Transcript

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PRESENTERS

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Natalie Park: Hi, I'm Natalie Park with Fonkoze. We're a microfinance institution in Haiti. And I'm just wondering if you can talk a little bit about the range in size of the businesses that you've worked with.

Nazeem Martin: _____ in size that Business Partners does is in the order of about—it depends on the exchange rates. And my country, like many countries, have been through a lot of political upheavals, I guess. The world is a very different place today than it was not so long ago, so there's been a huge fluctuation in currency. But assuming 10 rand for $1.00, the average transaction size would probably be on the order about $350,000 to $400,000.

W. Bowman Cutter: Ours is in that same order of magnitude, which means that it's really not a microfinance instrument. I chair MicroVest, which is, I think, one of the three larger—largest of the funds. And even in countries and in microfinance institutions that really focus on enterprise as much as on personal lending, they top out at, I would guess, $25,000 to $30,000 as a transaction. I don't know the Haiti example; we're not invested in Haiti.

But the one really important thing—this is more about microfinance than it is about this, but is that within microfinance institutions, the switch from the kind of personal lending that most microfinance institutions do, and enterprise lending even at very small enterprises, is a fundamental shift. And you have to be very, very careful that the people who are doing the underwriting understand that.

Tom Gibson: My answer is this. Technically, I work with a lot of funds who are putting together designs and documentation for starting these things, and typically in the policy the range is $150,000 to $1.5 million. And the reason it's difficult to do below $150,000 is because you have to have a very intimate knowledge of the finances of the borrower, or of the investee, I would prefer to say. And that's hard to do with micros and would put a heavy burden on them. Whether or not you can ever have something royalty-based, revenue-based with micros is still, I think, a question that's not fully answered, but it would have to be a very much simpler instrument than what we're talking about.

Nazeem Martin: My answer is that if a transaction or deal is less than $50,000, then it doesn't pay. It doesn't pay for the investor. The cost of doing the due diligence, the cost of structuring the deal, the cost of making the investment decision, the cost of looking after the transaction once you've

paid out the money and done the deal, you will not a get a fair return, even, on. So if it's below $50,000, it doesn't make sense. And I think at $150,000, that's when it starts really making sense.

W. Bowman Cutter: What that implies and Bill doesn't want it to go, but what that implies is you have to look at—I think the key there is going to be using technology that cuts through that cost issue. You have to use—look at parametric data. You have to do the small deals with some scale. You cannot do the kind of deal-by-deal due diligence that even we do. So that means—but you're still responsible for the money, so you have to, I think, begin to use different kinds of variables, data from different kinds of sources, and technologies associated with that. I think they're there, and we're looking at them. But that's how you break that particular code.

Tom Gibson: I'd like to say, that's a wonderful thing to be inserted in here, and to a good degree, Business Partners has done a lot of that. But I think everybody's moving faster in that direction, blending data to come up with answers more quickly.

Christy Sisko: So we do have a question from one of the webinar participants, so I'm going to ask this to Nazeem and Bo, because I know Business Partners and TAEF has a different model for this. But the audience was wondering how you have strategic—how you help with strategic decision making for the SMEs that you're working with. Is that through having a board seat? Is it through certain technical assistance? And like I said, I know Business Partners and TAEF has a different way of going about that, so just your general approach would be really helpful.

Nazeem Martin: Thank you, Christy. I think at Business Partners, we thought that we added value effectively to an entrepreneurial business in every phase of our interaction with it. From the time in which we did due diligence, we'd identify the shortcomings in the business, and we would—certainly, if we were going to invest in them, we'd make it a condition precedent that our money would go in to put in place certain features which we deemed to be missing in the business to ensure its success, or certain things would have to be done to the business before we invested.

So there are a lot of questions asked. There's a lot of honesty. As part of the decision making, we share that information with the entrepreneur. It assists them in getting their business funding-ready if it isn't funding-ready, or if it's funding-ready but there are shortcomings, some of the funding that we will approve for the business will go towards enhancing

the business in some way or the other.

The question is did Business Partners obtain a board seat with an equity stake in a business or even a route in through _____ _____. The answer to that is no. Business Partners' approach to board seats is simple: they do not sit on any boards of any of the investment companies that they invest in. It's an interesting approach because it doesn't mean that they have no influence. In fact, I certainly think that Tom's aware that Business Partners' documentation arguably gives them more rights than sitting on a board seat. It enables him to know more of what's happening in a company than if you had a board seat.

So one of the requirements when Business Partners finances and the money's at risk is that certain information needs to be provided by the entrepreneur on a monthly basis or however frequently that is required. That information is dealt with within Business Partners. There's a meeting held between Business Partners and the entrepreneur; we call it the shareholders' meeting, if we have shares, which is the meeting between investor and—and this takes place outside of the board meeting or before a board meeting. And I think a lot of the real issues are dealt with there. Often in boards, people are diplomatic; they say the nice things; they don't deal with the other issues.

There's another aspect as well. Sitting on a board or being a director attracts another kind of risk for the director, for our colleagues, who are now directors of a company, where they were not executive—they were not responsible as executives. They didn't have the same information that executive directors have. Yet they are liable, not unlike any other director would be. And we don't want them—given the scale or the number of transactions we do, we didn't want them to be exposed to that kind of risk.

So the standard approach is, Business Partners does not sit on any of the boards of the companies that it has invested in, but it has put in place other mechanisms which enables it to monitor very closely how well or badly that company's doing, to sit down with the entrepreneurial team, understand what is going wrong, if anything's going wrong, work with them or find mentors—if we don't do it ourselves, find mentors who will work with them in order to fix things up, turn the business around, make sure that it lives up to its full potential. That's the way in which the assistance or technical assistance is provided.

W. Bowman Cutter: We do much the same thing. I'll emphasize one thing, and I'll cite one major agreement. I agree with everything Nazeem just said. We do not serve on the boards of our small-to-medium enterprise investees. It's a combination of reasons. It is the liability, but also it's a time sink. I mean, being able to find people to do that, it would eat up our staff. We have expense constraints, but they're reasonable. It's just a time sink.

We focus enormous attention on our due diligence and on the due diligence report that we provide to the investee company. And it's designed to outline to a company both its financial issues and its strategic issues that have to be resolved, in our view, that where we have to feel that there is intentionality about resolving them and, at the same time, that we have to feel this is something that is going to be—these are things that are going to be worked on through the life of our investment.

We pay a great deal of attention to that. We have spent three years now molding the due diligence approach. We have been told by people we've turned down that it was the first really good and thorough look at their business that they had ever gotten. Some of those came back and are kind of back in the pipeline. And as Nazeem said, we see that as our principal mechanism for both understanding the strategic problems of a company and helping a company do something about them.

Tom Gibson: Could I ask Bo just one thing about that? Would you say, Bo, that your due diligence is really part of the business planning process of your investee?

W. Bowman Cutter: Oh, very much. I mean, our investees are—they're like small-business entrepreneurs everywhere. I mean, they haven't been able to put together much of a business plan. They frequently don't have terribly good financials. And when they do present you with a multiyear outlook, it is, without exception, always wildly optimistic.

And the delicate process of bringing that down to earth, telling this man or woman—and about half of our investees are women—that their baby isn't quite as dynamic and wonderful as he or she thinks it is, but at the same time something to be treasured, is a delicate process. And as I look—I don't read every planning document of everybody that's submitted to us. But I do a random look, and I read very carefully all of our investment memoranda. And yeah, it forms the basis of most of the planning that these companies do.

Nazeem Martin: To add onto what Bo said, or maybe to elaborate a little bit, it is 100 percent right that all entrepreneurs are grossly overoptimistic, I would imagine, until you tell them you're going charge them a royalty based on revenue. Then all of a sudden their _____ projections would come down quite considerably. So there are ways in which one can—it's a useful tool, even in that respect, in order to introduce some realism into the projections of revenue going forward.

Tom Gibson: And if I can just add one thing, and that is to say, what is distinctly advantageous about the revenue approach is that when you are working with a business, doing diligence as part of the business planning process of that company, and the entrepreneur knows that what your interest is in the end is getting sales up, you have a very nice alignment of interests, which makes it much easier to exchange information and to gather information, which later on will help you help the business and, in fact, also help you know what the sales ought to be.

Audience Member: Thank you. Hi, good morning, Karrye Braxton from Global Business Solutions, Inc. We are coming on from both sides, formerly having done structured finance with SMEs in Ghana, to then working as a USAID contractor on a microfinance project, and then recently helping a startup firm get private equity funding. So my head is swimming right now. I think this revenue capital model is a wonderful idea. How do you get other investors, who aren't donors, interested in this? Because on one hand you have well-meaning microfinancial development institutions, and you have private equity funds that want, you know, 100 percent return in five years, they want to sell you out and make tons of money. How do you find the investors in that middle space?

Nazeem Martin: I can start off by saying that—let me look at the shareholder base of Business Partners. Business Partners started 36 years ago by the private sector, not by government in South Africa—in fact, by one of the wealthiest businessmen/families in South Africa. Just to add some color to this, it's the family that owns some of these famous brands that people like to wear, like Montblanc, which is the pens, I think; and Cartier, the watches; and Van Cleef & Arpels, which you might think is American but is actually owned by this family.

So this is a really wealthy—this man started out in business in the 1930s in South Africa, and he knew how difficult it was for him when he started out. So in about the late '70s, he wanted to do something good. He wanted to ensure that startup entrepreneurs had a leg up, had access to

finance. He was able to persuade corporate South Africa, many other big corporations, as well as the South African government, to put together Business Partners as a public-/private-sector partnership.

Although the government put up 50 percent of the initial assets, it was clearly enough to know—and I say this with the greatest of respect to government officials in the room—he insisted that this business was going be run by the private sector, along private-sector lines. So even though the South African government put up 50 percent of the money, or the assets, they only had 20 percent of the votes when it came to board decisions as well.

So this business was run by the private sector, along private-sector lines. And it had as its _____ this intention. The intent has been consistent throughout: make funding accessible for entrepreneurs who will use the funding, the technical assistance and advice, and the business premises, they're going to pursue wealth for themselves. In the process they're going to grow the economy, they're going to broaden the tax base, and they're going to create many jobs. That was the intention. But when the management team was given the money, they were told, "Don't ever come and ask us for money again." They have never asked for money again. So that was the approach.

Who were the other investors? It was big corporate South Africa, all the big corporations, and it was—so this is a public-/private-sector partnership. We've gone and raised funds outside of South Africa in different countries. Typically the people who have gone and played in this space and given some of the money have been the world's DFIs, from the IFC to the European Investment Bank to CDC to Norfund to _____ and so on.

So outside of South Africa, we haven't been able to persuade too many—except in Kenya. A private equity firm actually invested some money into the fund that we put together for SMEs. So it's early days. We think one will get there. But at this point in time, the funds aimed at providing risk capital to SMEs on scale are largely being put together by the DFIs.

Tom Gibson: If I could add to that, because it's such a good question, it's a terrific question. Right now, as Nazeem points out, most of the money going into this kind of fund, and to, in fact, SME risk capital everywhere, does come from the bilateral and multilateral development finance institutions. And that's part of their job, is to be out there pioneering and

taking a greater risk and a lesser return.

The way I see this, optimally, is that this will catch on. More people will start doing it. We can aggregate some data about it in a way that is comparable to other kinds of instruments, so that it begins to prove itself. But I think the next stage is to look for ways that governments and other institutions can co-invest with private investors in these kinds of funds in a way that improves the rate of return for the private investors. And I'll give you an example of that.

We have in this country something called the Small Business Investment Company program of the SBA. And to oversimplify that, as I do everything, what you have is the situation where, if I can get investors who will put $10 million in equity into a fund to invest in small businesses according to what the SBA thinks ought to be achieved, then the SBA will essentially lend me $20 million at a very, very, very low rate. So the difference between what we're paying on that—what the—so you have a $30 million fund: $10 million in equity; $20 million in very, very cheap debt. That debt leverages up the returns of the investors, so what happens is, if you have, for example, a portfolio that produces a 12 percent return and you're paying 2 percent on the $20 million, the difference essentially between that 2 percent that you're paying for that $20 million and the 12 percent you're making on that $20 million goes over to the equity investors. So the equity investors wind up making more money than in fact the portfolio has made.

So that is just one way of transitioning to a point where you could eventually have—if you can prove it at that point, you can have more private-sector investors taking a larger and larger percentage of these kinds of things.

W. Bowman Cutter: I'm going to respond by of some prejudices and some facts that I think are facts. The prejudices are, I really don't like private-public partnerships. I really don't like them. I'm in the unbelievably fortunate circumstance of chairing a kind of fund which is, I think—I don't think its parallel has been created anywhere else in the world.

What the U.S. did—it was the George Bush I administration that started this, in Eastern Europe. And what AID followed up with under the leadership of Tom and Sharon, who's here somewhere, and others, obviously, in Jordan and in Egypt and in Tunisia, is provides a degree of independence that is simply not matched anywhere in the world.

I had someone from the World Bank, a friend, who wants to put a lot of money into things like this, and he said to me over lunch—this was three weeks ago—he said, "We could put in much more than you have." I'm not so sure about that. But he said, "We do have a little problem." He said that "we could not design a fund that was independent. We would need to be able to sign off on every deal you did." And nobody I know who's worth a damn would take that bargain. So I speak from a very privileged position. But from that position, I am really skeptical of most PPPs, really skeptical. That's the first thing.

The second is that there's a funny thing about the way in which the private equity world thinks about itself and the way things are. If you're not the top quartile, only the top quartile, of the private equity world—and I include venture in that, I include buyout, and I include growth capital—has ever earned a risk-related return, has ever earned a return commensurate with the risks that investors take on. The median return to private equity is below the risks that investors take on, so investors essentially subsidize the private equity industry. Every private equity firm likes to tell stories about their 100-baggers. But they are unicorns. And for every one that happens, there are not 10, there are 100 that don't happen.

The buyout business has simply been a 25-year-long play on the fall in real interest rates, and that's all it has ever been. So far as I'm concerned, there has never been one scintilla of value added to a company through the buyout business. And the hedge fund business has been a miserable business for the last decade.

So people in that business—and I was in it for 15 years—have a view—and by the way, Warburg Pincus has never not been a top-quartile fund, which is—I can this from a sort of comfortable level of arrogance. People in that industry have a view of themselves and what they're going to do that is not commensurate with what they in fact do. But it means they're not going come and do what we do. They're not going to do it. They're not going to invest in it. And their investors aren't going to invest in it, which comes around to a point that I made in my talk, that you cannot—I do not think, long run, you can look at financing in the small-and-medium enterprise sector in any country in the world from foreign dollars.

Countries need to raise their own capital. I mean, the reason why Tunisia

isn't growing, among many, many reasons, isn't growing sufficiently is it doesn't invest sufficiently. That's true in lots of places. So, domestic finance. And what do I hope develops? I mean, obviously, I would love, and I am trying now to do, to complement or supplement our funds with some development bank money, and we have some very interesting and interested parties who've begun to talk to us.

But long run, this has got to be the banks and the insurance companies of the businesses we're in, of the countries we're in. And if you look at those, they suffer from a huge problem, which is they do not have available securities to invest in. I mean, one of the reasons why we have a whole middle run of successful banks in the United States—I mean, forget for a moment all the controversies around the big-money banks, but the middle range of them—is they have instruments they can invest in. And that's also true of insurance companies.

And the rates of return that we're earning are easily sufficient to attract the insurance company, bank company, or banking investment that ought to come into the sector. You need a government that believes that the SME sector is worth thinking about. You need changes in financial regulation in the financial sector. And you need a switch in financing. In almost every developing economy that I know of, the banking sectors invest most of their funds into the securities of that nation, so they're essentially monetizing the debt indirectly. That's not a way to run a country in the long run. Sorry to be long-winded about that.

Christy Sisko: From one of our online participants. What is the standard time to go through the due diligence process? Is it longer than normal, shorter? Is the business planning process more intensive?

Nazeem Martin: At Business Partners we had a bit of a dream, and the dream was that every investment officer had to do—we'd like them to do one deal a month for 11 months of the year. We understand that they may take a vacation for one month or go somewhere. Did we get close? Never. We averaged around about seven transactions per investment officer per year by the time I left.

So that doesn't necessarily answer you, but we set some benchmarks. We said that from the time of receiving a business plan until the investment decision is made, we had a benchmark which said it shouldn't be longer than 30 days. From the time—depending on what the conditions are for our funding, they maybe owned risk ones, which requires time to be

resolved. So from the time of making the investment decision until we pay out the money, a further two months, at most.

And the kind of due diligence we're talking about is not unlike what a private equity investor would do. It's a thorough one. And we have a tracking system. We actually monitor the performance of all of the investment officers. So at any point in time if a client called me to say that we are taking too long, I could switch on my computer and I would know exactly where this deal would be in its process.

So we had benchmarks, which our colleagues had to live up to. We set standards for ourselves. And this is a promise to the market out there. So on average, 30 days from the time of receiving a business plan, to an investment decision, to implement a transaction a further 30 to 60 days, depending on the conditions that's attached to the transaction. So roughly 90 days.

W. Bowman Cutter: Our time durations are not dissimilar, for a reason that won't surprise you. My chief operating officer, Hela Fourati, and her senior person went to South Africa at Nazeem's invitation and spent a week looking at all of these kinds of measures. We're nowhere near being able to do it with the kind of rigor and data that they do it. Maybe 18 years from now we will, I would hope. But that's the direction.

And we have a, I think, rigorously defined investment process. It was painful, but we got to a point where we have, I think, a very well-structured basic model for due diligence. We're aiming at a month for our—from the time we get a deal to the time when we can say to the investor that we have outlined—basically the following: we have completed the major part of our due diligence, we can outline for you what are the major question marks, and the remaining period, which will be about a month, is quickly coming to a judgment of whether or not those questions are answerable. Some of them, because of crazy tax laws and all of that, some of them have to do really with legal issues and legal structure and not with basic business issues. But basically we're aiming right now at six weeks for the process, which is somewhat short of Nazeem's goal, and we would love to get it to a month. We're not there yet.

Nazeem Martin: We're both in an earlier check as well to tell us. And I think it's all about communicating with the client, ultimately. So within seven days of—we have this little rule. We call it the seven-day rule. Within seven days of

receiving a business plan, you have to have read the business plan, discussed it with colleagues if you chose to do so, and we must be able to provide the client with an in-principle indication as to whether we're interested in the transaction or not. And then we commence with full-on due diligence, which takes another three to four weeks subsequent to that. But it's really the communication. It's telling the client, after seven days, "Yes, we're interested, but we need the following. Please provide us with that," and we then press the full due diligence.

W. Bowman Cutter: What drives entrepreneurs nuts is a black-hole phenomena, is that a plan comes in—no matter how kind of clumsily put together a plan might be at the start, it's their plan. And what drives them nuts is to have it disappear into the maw of an organization and they not be heard about again until they get told, "Well, you're not going to get the money." So we have the same set of rules.

Tom Gibson: What I hear from entrepreneurs in Middle East/North Africa is that typically when they go to a bank, they're looking to six months to a year and a half to get a decision.

Kristin O'Planick: Okay, and unfortunately we are out of time. But I would like to again thank our speakers for a very interesting presentation, a lot of food for thought for all of us, especially in terms of the expansion issue and how can we get this approach out there further.

And thank you for those joining us online. Just a reminder that the screencast webinar recording, the PowerPoint slides, and the forthcoming AMEG guide to this approach will be coming out, will be available on Microlinks.org and in your inboxes with the post-event resources email. So please share with your colleagues so that we can get this knowledge out further. And thanks to everyone, and we will see you next time.

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