CHALLENGE FUNDS AND INCLUSIVE BUSINESSES – KEY TO SOCIO-ECONOMIC DEVELOPMENT?

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ABSTRACT

This paper will introduce the concept of the challenge fund mechanism, and its role, from both a private sector development (PSD) perspective as well as from the sustainable social impact angle. The paper is informed by practical experience and reflections from the point of view of a manager who manages one of the world's largest challenge funds with a capitalisation of USD 250m and 200+ investments across 23 different markets. A challenge fund, which by nature, is a risk taking and risk-sharing PSD mechanism is used to support innovative, for-profit business ventures, which, by the virtue of being innovative, and therefore, more risky than other business ventures have restricted access to capital. A challenge fund, in a developing or frontier market context, will invest in innovative for-profit companies that exhibit strong intentionality on social impact, i.e. they will implement the inclusive business model concept. Essentially, inclusive businesses engage low income communities in a formal way either as suppliers of raw material, such as cocoa seeds, which the company then processes, or they engage low income communities as customers who buy and consume products and services which cater to them specifically. In this way, an inclusive business makes a profit and at the same time increases the income of low income communities. In this arrangement social impact remains sustainable because the business sees that it can make a profit by collaborating with low income communities. A challenge fund, by financing innovative and risky SMEs doesn't only support PSD and social impact, it also creates a tested and proven deal flow of companies for more commercial investors such as private equity funds or development finance institutions such as the International Finance Corporation. Therefore, the challenge fund mechanism serves a critical function in sustainable business and social development.

Keywords*: Agribusiness, challenge fund, climate change, inclusive business, inclusive finance, private sector development, social impact, sustainable development*

1. INTRODUCTION

1.1. What is an enterprise challenge fund?

An enterprise challenge fund is a relatively novel mechanism in the development sector which is used, and funded by, the public sector to achieve sustainable social and economic impact. The first enterprise challenge funds initially emerged in the late 1990's and were funded by European development organisations such as DFID and SIDA as well as Australian DFAT (Brain, Gulrajani, Mitchell, 2014, p. 3). In the following years, as the enterprise challenge fund mechanism was proving successful more and more development agencies and foundations started contributing to challenge funds, most notably the Dutch government, DANIDA or the MasterCard Foundation. While the challenge fund mechanism as such does not necessarily have to be directly supporting the private sector, it may specifically target gender equity or education, very many of the challenge funds are *enterprise* challenge funds which support the development of the innovative private sector, which in turns achieves inclusive social and economic development. One of the world's largest enterprise challenge funds is the Africa Enterprise Challenge Fund (AECF) which has raised in excess of USD 250 m since its inception in 2008.

1.2. How does it work?

An enterprise challenge fund provides concessional financing to innovative businesses across emerging and frontier markets where access to finance is prohibitively expensive or, quite simply, very difficult to access. Typically, this concessional funding is provided either as grants or soft loans with minimal interest, if any, and a long grace period. While providing concessional funding an enterprise challenge needs to realise that one of its responsibilities is to stimulate and encourage business mind-set which means that the companies shouldn't fall into the trap of believing that there's such a thing as cheap capital – therefore additional conditions are normally put in place such as a matching requirement, which means that the company will need to match awarded funding at a special ratio. Normally companies will compete with one another to obtain funding by submitting concept notes outlining the inclusive nature of their business model, and a detailed business plan with financial models and projected cash flows. The Swedish SIDA, which is one of the world's largest development agencies funds several enterprise challenge funds with the aim to support innovations in ICT, renewable energy or agribusiness (SIDA, 2012, updated 2015). Companies which are deemed to bring about the highest social impact will be awarded funding. It is very important to note that an enterprise challenge fund, like the AECF, will only award funding to for-profit business ventures which, apart from being profit-oriented, also implement the inclusive business model concept which benefits the poor. The supposition is that if businesses can make a profit by engaging poor people, either as suppliers or as consumers, and thereby create financial benefit for these communities, then the socio-economic impact will be sustainable. This impact will be further strengthened when other companies, realising the potential profit of working with low income communities, start crowding in.

1.3. What is it supposed to achieve?

An enterprise challenge fund has two overarching objectives: to support private sector development (PSD) and, through these investments in the innovative private sector, bring about inclusive social and economic development. These two objectives, or elements, are typically measured by establishing how the enterprises are doing from a business and financial perspective, and, how many poor people are benefiting by working with these businesses and by how much. These two elements, however, comprise a number of components that are very significant as they contribute to the overall success of achieving private sector development and inclusive social and economic development. One of these components is innovation. An enterprise challenge fund, in fact, very often is an innovation fund which funds innovation, i.e. something new, and as such, something that is perceived as risky and therefore *unbankable*. In order to meet Sustainable Development Goals and bring about rapid change, at scale, there needs to be innovation (Harvard Kennedy School). A disruptive innovation is something that changes the way an industry or a market operates. One of those disruptive innovations is the Kenyan M-Kopa which introduced mobile money transfers. Over a very short period of time millions of Kenyans suddenly gained access to financial services which they were previously excluded from as most Kenyans didn't qualify to open a bank account. This has since been replicated around the world with great success. Since enterprise challenge funds are supposed to change the way a market system works they will likely fund two or three or more businesses in the same sector, rather than funding only one business which would be deemed to have the highest potential. By funding several similar businesses it is more likely to bring about a systemic change that will change an entire market system.

Closely linked to innovation, in the case of AECF, is the fund's intentionality on addressing issues related to climate change such adaptation to climate change and renewable energy. Innovation can be used successfully to strengthen resilience of rural communities to climate change by for example supporting companies that introduce improved seed varieties. Reducing the deforestation process as well as addressing health risks can achieved through the support of companies that distribute solar cook stoves.

As an enterprise challenge fund provides *cheap* capital it needs to ensure that businesses do not become excessively reliant on donor money. There needs to be a mechanism in place whereby the businesses are stimulated to, at a point in time when their innovation is proven successful, and are in need of more expansion capital, be able to access commercial funding from banks or private equity funds. This is key in ensuring that projects don't collapse as soon as donor money has been utilised.

1.4. Inclusive business

A central element of an enterprise challenge fund's underpinning philosophy, and indeed of much of modern-day development, is the notion of inclusive business. Inclusive business is a for profit enterprise which engages the so called base of the pyramid (four billion people who live on less than USD 2.5/ day) (Simanis, Hart, 2008, p.1) in a way which is beneficial to both parties. An inclusive business makes market systems work for the poor. *The central idea is that the poor are dependent on market systems for their livelihoods. Therefore changing those market systems to work more effectively and sustainably for the poor will improve their livelihoods and consequently reduce poverty* (DCED). By integrating low income individuals into the formal economy inclusive businesses make them 'visible' for the market, for other companies that gradually will start serving these communities while making a profit. *In essence, inclusive business models try to find synergies between development goals and the company's core business operations* (WBCSD).

1.5. An enterprise challenge fund's role in the development value chain

When one looks at a business development value chain the AECF emerges as a tremendously important element of it. The AECF, or any other enterprise challenge fund, doesn't compete with commercial sources of funding such as banks or investors. A study conducted and presented by Gompers and Lerner in their article (Gompers, Lerner, 2002) asserts that nearly 90% of new businesses fail within three years without venture capital support. The AECF, specifically fills the gap where commercial investors, such as venture capitalists, perceive the business venture too risky, be it because of its innovativeness, a company's lack of adequately long track record or because of systemic risks that are too high. In fact, the AECF will not award funding to a company whenever it is deemed to be able to access commercial funding. Therefore, an enterprise challenge fund doesn't distort the market. On the contrary, the AECF and other similar funds alike, in fact, are a feeder fund to commercial investors. By providing expansion capital to innovative businesses, at an early business growth stage, the fund is 'testing' the innovation and once it becomes successful and requires further expansion capital that business becomes very attractive for commercial investors. In other words, the AECF takes a company through a growth phase where the innovation is either approved or rejected by the market. Successful 'graduates' represent a high quality pipeline for commercial investors.

2. INCLUSIVE BUSINESS MODELS IN PRACTICE

The AECF has invested in nearly 200 innovative businesses across 23 different markets which all implement the inclusive business model. It means, as was mentioned above, that the businesses need to engage smallholder farmers either as suppliers of produce, or as consumers of products or services that are designed to cater specifically to their needs. By formally becoming suppliers to a business smallholder farmers are entering the formal sector of the economy which very beneficial as they gain easier access to inputs, finance or markets. The two businesses, M-Kopa and Bioalnds, in which AECF has invested nearly USD 2m which are presented below illustrate how inclusive businesses work in practice.

2.1. M-Kopa

AECF funding was used by M-Kopa to develop and sell affordable solar powered household systems that can charge mobile phones, power light bulbs and radios (M-Kopa). The technology is 'leased' to users for a period of one year, during which time the user should be making regular payments on a daily basis. After the one year period the user becomes the owner of the system and continue using it free of charge. It is an affordable way to substitute kerosene in rural areas which lack access to the energy grid. M-Kopa uses the GSM network and mobile money transfers to collect payments from its users on a daily basis to pay. The company which was established only a few years ago in Kenya is growing exponentially with 280 000 households (M-Kopa) connected as of late 2015 and has since its establishment expanded to Tanzania and Uganda. The company is constantly developing new products and devices that can be added and connected to the system such as TVs and, possibly in the near future, also fridges or hair clippers. These add-ons are offered to loyal and predictable customers who make regular payments for the usage of the system during the first year.

This technology is transformative. Smallholder farmers, who are now able to charge their phones, can access vital mobile-based information about prices of inputs and outputs or the availability of inputs such as fertilisers or seeds. This is directly consequential to their income as they can now better plan their production and sales. The potential introduction of fridges to the system means that not only waste can be greatly reduced at household level, it also means that micro enterprises in the local market places can emerge which will be able to store food products for a longer period of time. Furthermore, once the user has acquired the system after a year of making payments they will start making very concrete savings by not having to purchase kerosene anymore. It is estimated that each household will make a saving of nearly USD 200 annually (M-Kopa).

It should be noted that M-Kopa isn't just a renewable energy company which brings savings to smallholder farmers or supports the establishment of micro enterprises. It is much more than that. More importantly, M-Kopa, in effect, is a remarkably successful financial inclusion and financial services company which brings hundreds of thousands of individuals in rural areas into the formal economy by creating both a market for them and a financing mechanism for them to access that market. By creating a financing mechanism which relies on mobile payments the company is able to acquire clients who have always been neglected by the financial sector. By monitoring the reliability of clients M-Kopa can make reasonably accurate predictions as to whether a certain client is trustworthy enough for M-Kopa to offer them an additional device for which they will be making regular payments over a certain period of time. M-Kopa has effectively broken down the barrier of financial exclusion and transforms thousands of livelihoods. Since AECF's investment in M-Kopa the company has been very successful in attracting commercial financing.

2.2. Biolands

Biolands, since 2014 owned by Barry Callebaut, one of the world's largest producers and processors of cocoa beans, has received nearly USD 1m in funding from AECF since 2009. The funding that the company was awarded by AECF was used to expand Biolands' operations in Sierra Leone and engage, over the course of a few years, nearly 40 000 farmers as suppliers of high quality cocoa beans (AECF). Biolands' main objective with expanding their operations into Sierra Leone was to create a sustainable and consistent supply of high quality organic cocoa beans which the company would process and sell on international markets. In order to achieve that end Biolands decided to set up an out-grower scheme where they would contract large numbers of smallholder farmers which would become suppliers of cocoa beans. *Outgrower schemes, also known as contract farming, are broadly defined as binding arrangements through which a firm ensures its supply of agricultural products by individual or groups of farmers. In other words, ad hoc trade agreements are being replaced by co-ordinated commercial relations* (Felgenhauer, Wolter). As is often the case in a developing economy an off taker (i.e. a company that purchases produce from suppliers) frequently needs to assume the role of an input supplier as well to ensure consistency, both when it comes to the quality of the produce as well as the quantity and on time delivery. In this particular case Biolands had to supply farmers with quality organic seeds, training, fertilizers as well as Fair Trade certification which was helpful in Biolands becoming a supplier to Barry Callebaut. The company's effort led to the successful establishment of a large out-grower scheme with farmers benefiting from the company's business model. By 2011 the average income for the farmer had increased from approximately Leones 1 600/ lb to Leones 4 000/ lb that Biolands is paying for the improved cocoa beans (DFID, 2011, p.3). Also, in some cases the average yield has increased from 20 bags to 60 bags/ acre (AECF). Effectively, Biolands made a market system work for smallholder farmers in Sierra Leone by connecting them to the global market of cocoa beans, and by doing so, increased their incomes in a sustainable way. This is an example of an inclusive business which truly managed to transform the livelihoods of tens of thousands of people in rural Africa.

3. DISCUSSION - THE NEXT GENERATION OF ENTERPRISE CHALLENGE FUNDS

Over the past fifteen years or so the challenge fund mechanism has undergone some evolution, and, the lessons learnt and accumulated experience of supporting private sector development at the same time as maintaining focus on social impact bring us to the following reflection – what should the next generation of challenge fund look like, what issues should it address? Some of these issues, as raised by Adam Brain et al. in the EPS Peaks publication (Brain, Gulrajani, Mitchell, 2014), include the *breadth* versus *depth* discussion, however, there are a few more angles that should be looked at, such as ensuring the development of a strong business mind-set in the funding company as well as ensuring that the business remains intent on benefiting the poor. Below follows a discussion which touches on these issues which are central to the next generation of the challenge fund mechanism.

3.1. Lessons learnt by the AECF

There are two angles to the *raison d'etre* of an enterprise challenge fund: the private sector development angle and the socio-economic impact. With regard to the private sector development angle – it is key to ensure that a challenge fund by de-risking an innovative business model at a stage when the business launches or commercialises a newly developed product or service, also referred to as the *Valley of Death* (Osawa, Miyazaki, 2006, p.91-116) does not develop a mentality of over reliance on cheap capital or aid money. The de-risking of the valley of death stage is represented on the graph below which is an adapted version of the graph presented by Osawa and Miyazaki in their article.

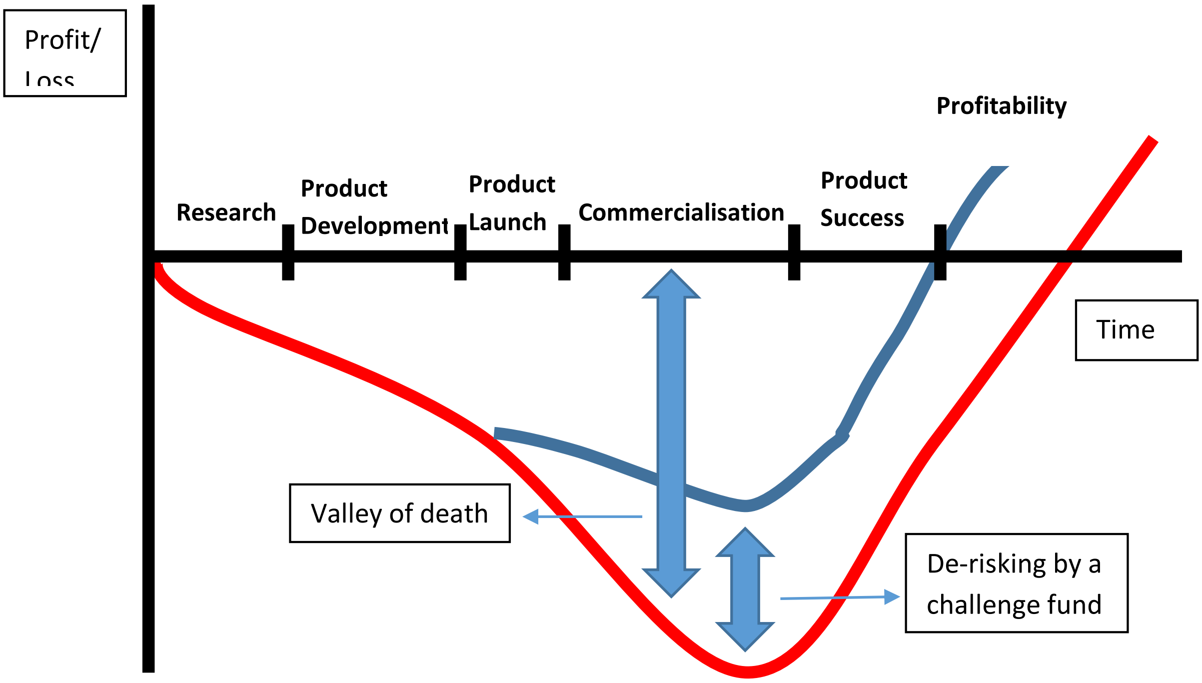

Figure 1: Adaptation of Osawa and Miyazaki, 2006

The challenge fund needs to ensure that there are mechanisms in place that will develop a strong entrepreneurial mind-set in the funded company, which will lead to the company being able to operate in a competitive business environment. This is key as the entire rationale of *using* the private sector to create sustainable socio-economic impact is that these companies, sooner rather than later, will be able to make a profit and access commercial sources of funding for further expansion. This can be achieved by being categorical about the company *having skin in the game* – that they also invest their own financial resources to match the risk taken on by the challenge fund. An additional, but equally important way on ensuring increased *professionalism* of the funded company is to enforce various compliance requirements related to financial management, HR policies or business development strategies. All of these will make a company more agile, more competitive, and in consequence more attractive for commercial investors. The socio-economic impact is clearly a very important feature of any challenge fund, and what the fund needs to ensure is that the business, over the course of time, does not deviate from the intentionality of working with, and benefiting, low income communities. Ultimately, this is a question about how rigorously the business model has been tested *prior* to the challenge fund investment taking place. As inclusive business is a relatively novel concept some companies may struggle with fully understanding what it entails. Some companies, over time, may mutate their inclusive business model into a corporate social responsibility project which doesn't bring the company any profits. Other companies still, for a variety of reasons, may tweak their product or service in such a way that it no longer serves the low income community but instead targets a better off market segment. Again, this would defeat the purpose an enterprise challenge fund. It is therefore of utmost importance for the company to have rigorously tested their model and ensure that the company will make a profit while serving low income communities. Related to socio-economic impact is the question of whether to support companies that have a relatively small financial impact on large numbers of poor people or, rather, to support companies that will have a truly transformative impact on relatively small numbers of individuals? Possibly the answer lies in technology and innovation. Challenge funds should direct their support to companies that will not only benefit large numbers of people, albeit by relatively small amounts of money, but that will also attract other complimentary businesses into a similar space. The previously mentioned M-Kopa serves as a good example. The solar energy that their devices introduce to rural areas can trigger a significant multiplier effect with many micro enterprises emerging as a consequence of energy being accessible. It is worth noting that this transformative change was, in fact, brought about by two elements or factors or components – renewable energy and financial inclusion.

4. CONCLUSION

The enterprise challenge fund mechanism, over a course of only fifteen years, assumed a central role in the private sector development and socio-economic impact alike. This time was also an opportunity for practitioners to reflect on how this mechanism works and how it should be adjusted to serve its purpose even better in the future. It appears that with massive challenges ahead, such as considerable population growth, the enterprise challenge fund mechanism will be even more relevant in combating poverty through the support of innovative private sector. The main areas that need to be further emphasised by enterprise challenge funds are suitability and business viability of a business model, likelihood of other business crowding in to create a multiplier effect, and ultimately, the support of a smooth transition of a business initially relying on concession funding to one which can successfully attract commercial investors. When it comes to specific fields or sectors where enterprise challenge funds should focus their efforts financial services for the poor is certainly one of the main ones, alongside innovations within resilience to climate change, renewable energy and agriculture. It is key that mobile technology will play a key role in this process. To achieve this, support mechanisms will be needed, especially technical assistance, both prior to the investment as well as once the investment has taken place.

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