SUPPORTING INNOVATION IN SMEs IN LEBANON THROUGH A PUBLIC/PRIVATE EQUITY FUND: THE iSME FUND

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Introduction: In addition to weak institutional structures and inefficient business regulatory environments, access to non-bank financing is a key constraint highlighted in the World Bank’s (WB) MENA Financial Sector flagship report. For innovative start-ups in particular, a main barrier to finance is the high aversion to risk – as well as the collateral demanded from investors – by the banks. Lebanon is a typical example of a country where the banking sector is stable with high levels of liquidity, and where the government has put in place various incentive mechanisms and programs to encourage lending for small and medium enterprises (SMEs). These include subsidized interest payments, exemptions on compulsory reserves on creditors, and a credit guarantee program – yet lending still largely remains confined to large firms.

Lebanese start-ups suffer from three substantial gaps in their country’s financial environment: (i) funding at the early concept stage where entrepreneurs need to develop their ideas into a viable concept and product; (ii) early stage seed funding needed when starting a company; and (iii) absence of venture finance needed for the firm to reach its growth stage and beyond (a critical stage in firm expansion when a large number of jobs are created). It was to fill these gaps that the government of Lebanon (GoL) via the Ministry of Finance requested support from the World Bank for a US$30 million project to encourage the equity investment market to increase early stage investment finance for financially viable, new, and existing innovative firms. This will be the World Bank’s first project of this kind in the MENA region.

Project description: The project, “Supporting Innovation in Small and Medium Enterprises” was approved by the Council of Ministers and signed by the World Bank and the Minister of Finance on February 13, 2013. It will be implemented by Kafalat s.a.l. the country’s credit guarantee agency. The project’s main component comprises an Innovation in SMEs funding program (the iSME Fund). The iSME Fund will provide two sources of financing: i) US$2.5 million for Concept Development Grants (CDGs); and ii) US$25 million for equity investment in Seed, Early/Venture, and Growth stage firms. The remaining project amount will support project management, strategic training activities, marketing, and outreach to the business community, venture capital partners, the diaspora and community at large to promote the project and the fund’s beneficiary entrepreneurs.

Components of the iSME Fund: There are two funding components in the fund:

A. Concept Development Grants are for entrepreneurs to develop their innovative ideas and can be used to collect information and proof of concept to attract external investment by addressing key risks. These
can include a business plan, marketing/sales strategy, sector or market assessment, other supportive tools, documents and presentations.

B. Equity investments will be made in an enterprise alongside another institutional investor\(^3\). To qualify for the equity investment, the entrepreneur needs a commitment from an investor after which he or she would approach the iSME Fund seeking a matching participation. Co-investments by the iSME will be made at three stages of risk finance corresponding broadly to: (i) seed capital (US$25,000–US$200,000); (ii) venture capital (US$200,000–US$500,000); and (iii) growth capital (US$500,000–US$2,000,000). A small percentage of the iSME funds will be invested in growth capital of US$2 million to ensure the viability and sustainability of the iSME funding program over the longer term.

Hence, the equity investment scheme relies on partner investors to both identify and promote new business projects and provide the active mentoring and professional inputs that characterize truly effective equity investments. A registry of carefully screened and approved co-investors will be developed and updated on an ongoing basis. Registration for investor partners is open throughout the year and investors can register at any time. Approved investors are required to have: (i) a capital structure that allows them to finance high risk start-ups and/or growth-oriented existing companies; (ii) the capacity to appraise investment opportunities on a professional basis; (iii) the capacity to offer mentorship and other support for the companies and entrepreneurs in which they invest; and (iv) additional financing to sustain the firm in case of a change of plans.

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\(^3\) Institutional investor in this case is defined as standalone funds, holding companies, formal business angel groups, and investment banks (excludes regular commercial banks). They should have a track record in investing in early stage and/or mature companies and present evidence of their professional capacities and capital availability.

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**Project Beneficiaries:** Beneficiaries will be potential and existing entrepreneurs with new commercial ideas and existing SMEs that are on the verge of expansion. The other key beneficiary groups are institutional small investors and angel funds (the partner investors), whose financial incentive is an important mechanism to ensure the success of the project and achieve its development objective. By providing an incentive to eligible small investors, the project ensures that these investors will then source, review, and guide new entrepreneurs. This will increase early stage equity investments in new and innovative firms and create a critical mass of such firms.

**Key Design Challenges and Issues:**

*The Pipeline of potentially successful innovative entrepreneurs is low.* It is not enough to simply have financing and a great new idea. Would-be entrepreneurs need to go beyond a static business plan or filling out a financing application. Entrepreneurs need to have soft skills to manage a start-up enterprise, motivate employees, assemble diverse individuals into a cohesive team, tailor a product to a well-defined market, adapt rapidly to fast-changing markets and consumer sentiment, and understand how to convert an innovation into a viable business. The Project team members addressed this issue by receiving separate funding from the Development Grant Facility (DGF) for a program called “Supporting the Ecosystem for Fostering Dynamic Entrepreneurship in MENA” (EFDE). This 3 year regional initiative will work to increase the level of new viable businesses through a program that will scale up best practice regional incubators/accelerators and service providers willing to work with local partners in each country to support potentially innovative entrepreneurs to start a business and make it attractive for investors who would help them grow.

**Equity Investments and their High Risk profile.** Public sector stakeholders and others should be made aware upfront that risk capital is by definition high risk and that a key development objective of the project is to correct a market failure in start-up and early stage equity
funding. In other words, foster a more robust risk-taking culture, learning from failure, thereby stimulating entrepreneurship and over time enhancing the potential for additional private sector jobs. Another important point is that while risk capital will incur some losses, when it succeeds, it will assure monetary returns that in most cases can compensate for the financial losses. The iSME fund incorporates a balanced risk portfolio approach with the goal of generating a positive aggregate return. This will allow funds to be rolled back into the facility, creating a sustainable source of financing for seed and early stage financing into the future. This is still no guarantee that there will be positive returns but the lessons from failure are invaluable and will serve to improve performance and productivity of entrepreneurs and other related market agents in future ventures to create a more sophisticated and competitive market.

Nevertheless, measures to mitigate some of the investment risks have been put in place:

1. A list of approved and vetted Institutional investors (VC funds, holdings, etc.) will be prepared. The iSME will invest in deals that have been committed to by the institutional investors thereby establishing the first risk filter on company viability and potential success.

2. Background review and secondary due diligence is performed by Kafalat – this constitutes the second risk filter on the partners, governance, and soundness of the proposal.

3. Review and approval by an independent Investment technical committee effectively establishing the third and final filter on the commercial viability and potential success of the venture as vetted by an independent body.

**Aligning public and private sector incentives - Profit vs. national development** – Most Venture capital funds in the region, rather than playing their true role of seeking out and structuring promising start-ups, tend to focus on private equity in existing firms with an established track record that need to be turned around and restructured. This was confirmed through discussions with Lebanese venture capitalists and angels and validates the need for the government to step in and fill this gap. Despite the risks involved, investors and angels can still be lured by the high returns that can come from investing in early enterprises. Indeed, the iSME fund is designed to provide a funding platform that can scale this up by sharing that risk. The key is to find an entity that can manage the fund effectively as a private sector player, while ensuring the development objective of facilitating access to equity financing for early stage firms and supporting economic growth. To achieve this balance the project design encompassed the following:

- The government as a partner works at-cost and thus is able to cede the higher returns to the enterprise and private sector partners as long as it can retain enough to cover its costs. This will serve as the incentive for the private sector;
- The government as the main stakeholder is important as it will put development objectives as a condition in the implementation and management of the project;
- A flat fund management fee will be used. Even though incentives are important for ensuring quality performance based on returns, working based on a flat fee allows the fund manager to be neutral and able to ensure meeting the development objective of supporting very early stage firms. This makes the next point very important;
- Broaden the search of implementing managers/entities beyond traditional fund managers and find one that (a) works with all players in the ecosystem; (b) is vested in achieving socio-economic development and upholds its reputation in this perspective as much as its professionalism and (c) reputation as a private sector financial institution. Lebanon has this structure in Kafalat. However, where there is no comparable organization, it may well be worth investing in building the appropriately qualified private management entity.
Sound governance structure and transparency – key to ensuring participation entrepreneurs and investors. The success of the project rests on the trust that entrepreneurs and investors have in the process. Decision-making must be undertaken by those that are most qualified technically but also independent so as not to face conflicts of interest. The government who is responsible for the funds must also be able to properly monitor and take action when necessary. Yet if the government is placed too close to the operational process there is a risk of political capture. Having a private sector entity manage the fund is essential but the fund manager and government employees alike must be protected from being solicited and lobbied for awards. Therefore it is imperative that the decision-making process is well structured, and transparent for proper monitoring by the MOF, while being independent to ensure decision-making based on sound commercial and investment principles.

For the Grants a pool of evaluators consisting of technical experts will review and decide on the winners. The evaluators will be selected from across the spectrum of industry, finance and business across all of Lebanon to ensure the proper availability of an adequate range of expertise and knowledge. The World Bank will give its no-objection to the list of Evaluators in terms of meeting the project criteria of relevant expertise, diversity and representation.

For the equity investments Kafalat will establish an Investment Committee (IC) to review and decide on the best proposals. IC members will be high status individuals, averse to reputational risk from the private sector, who will perform this role and will not receive financial remuneration or benefits. They will have strong entrepreneurship experience and complementary commercial and technical expertise. The composition of the IC is intended to reassure investor partners that there is no capture by vested interests in the public or private sectors. The WB will give its no-objection to the IC once it meets the project’s IC structure criteria.

The decision-making authority of the IC is bound by strict terms to ensure proper checks and balances between the IC, iSME management, and the public sector.

Government oversight - The MOF will have broad oversight of the project and receive quarterly reporting from Kafalat regarding project activities.

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