An Investment Framework for the ICT Incubator Fund

A key task of the *Sustainable, Replicable ICT Incubator Study* was to understand the investment environment in which incubator organizations must operate. Therefore, a number of meetings and interviews were scheduled with individuals whose experience with venture investment and funding early stage technology companies was considered useful in enhancing the Study Team's appreciation for the financial challenges that entrepreneurs in sub-Saharan Africa face if they are to obtain risk capital. The group of interview participants included investors and ICT experts working in Africa. (The model was later vetted with individuals in Tanzania who operate organizations that serve technology entrepreneurs to ensure its design fits the environment.)

Certain assumptions concerning the companies that would populate the ICT incubators were then factored into the model. These included:

- Tend to be small in terms of numbers of employees (perhaps 2-4), and be primarily owner-operated establishments.
- Be unlikely to be commercializing intellectual property.
- Would probably not have significant assets (although some VARs and related businesses might have inventory that could be financed).
- The owners would be unlikely to have many mortgageable assets.
- After one or two rounds of "friends and family" or angel financing further rounds would have to be sought from outside investors.
- Would probably not have some types of financing available to them that are commonly expected in less challenging environments (e.g., trade credit, business credit cards and factoring of receivables).
- Could potentially benefit from micro-financing, although these often have low ceilings in the $3,000 to $5,000 range and thus, do not meet the larger financing requirements of ICT companies.

The Team then constructed a <u>model</u> of an investment fund that is reflective of the views of those investment and ICT experts who were interviewed. It is offered as one example of how such a fund might be constructed.

What follows is a high-level description of the investment environment as it applies to the ICT Incubator project and a description of an investment fund model. Given the current disruption of the investment environment, it is likely that the current global economic turmoil will have an effect on the sub-Saharan African investment market. To the extent that funds are available, investors are likely to be more risk averse in making investments and less willing to take on the level of risk that would probably accompany the development of an investment facility for early stage ICT companies. However, there is clear recognition by all concerned that ICT proliferation is an appealing strategy for economic development that has to be considered by virtually any country in Africa, including known countries of interest such as Senegal, Mozambique and Tanzania. What follows is a brief outline of two strategies that could be employed in order to provide the funds required for the tenant companies to expand. Described below, they are as follows:

- A working capital loan fund that would provide small amounts of debt financing to entrepreneurs in the incubator(s).

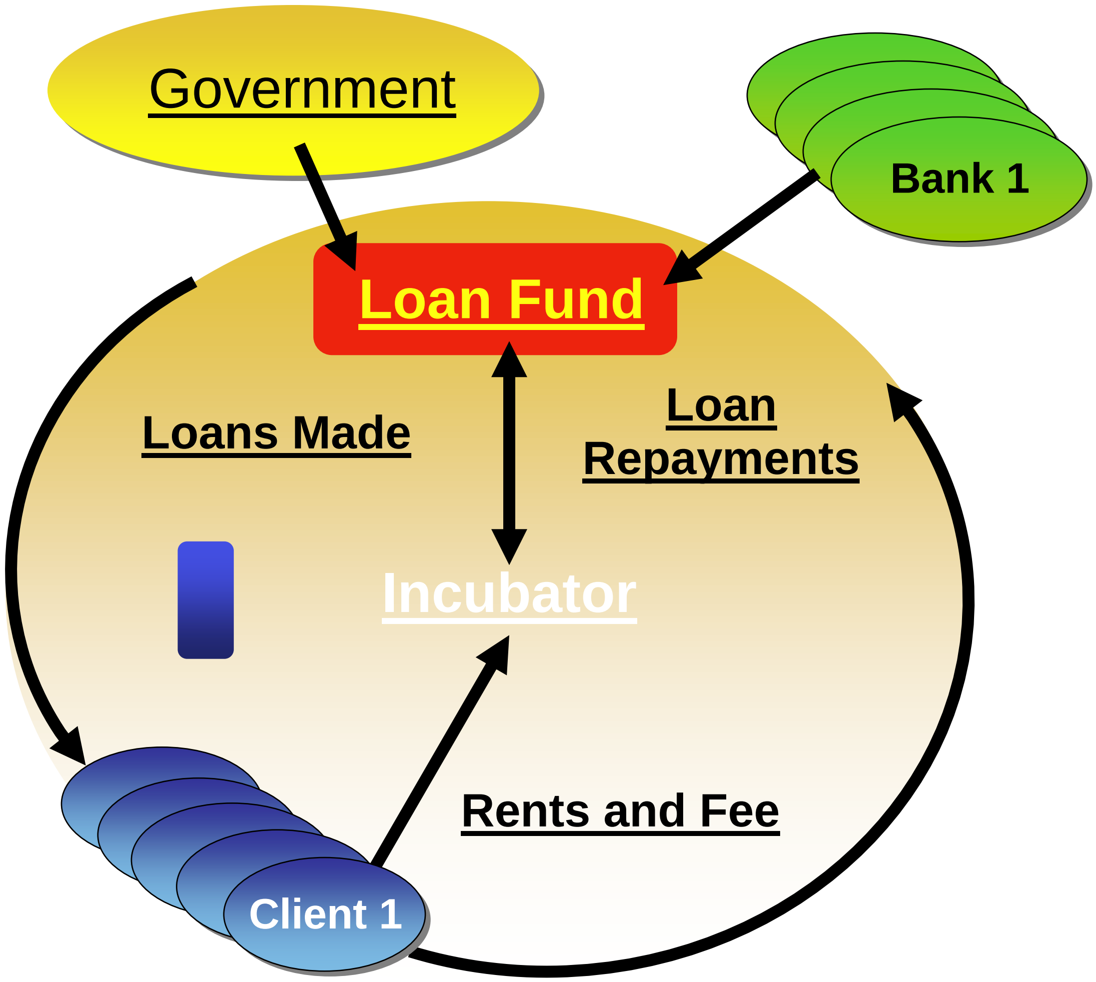
- An investment fund that would offer a combination of debt and equity financing for promising early stage ICT companies.

Working Capital Loan Fund

It is often the case that companies in incubators require working capital financing to carry them through the early stages of their development. Sometimes this is due to the fact that their larger company clients are not as conscious of their need for cash flow and treat them the same way they do other large companies where the constant ebb and flow of financial payments provides sufficient cash flow to meet daily operations coverage. This is usually not the case for early stage companies where day-to-day cash requirements must be funded by sales revenues and the ability to finance a slow-paying client is constrained or non-existent. For companies at this stage of development, a model that could be considered is to establish a Working Capital Fund that would make short term loans to deserving companies that are established in the ICT incubator.

Working capital could be provided by a fund underwritten by the government (or a surrogate) requiring the participation of several of the larger banks that have existing SME or SMME loan funds. As a partner bank will be sought to work with the venture capital fund described in the next segment of the report, it should be assumed that the partner will also play a lead role in organizing the loan fund. The government could agree to provide a significant percentage of the capitalization (perhaps as much as 50%) and the group of banks, led by the partner, would pool their capital to achieve the required size fund. In this case $200,000 is suggested as an example.

Each of five banks would pledge $20,000 to the fund which, coupled with $100,000 in government funds would represent total available capital of $200,000. The fund manager and loan officer representatives of the bank would comprise a Loan Committee. Entrepreneurs would make a business plan presentation to the Committee, and if approved, the fund manager would disburse the funds to the incubator company. If a default occurs, the government would agree to absorb up to 50% of the loss, effectively reducing the level of risk for each of the contributing banks and leveraging their funds. This type of soft fund has been used successfully in the United States and represents a strategy that could be applied effectively in support of the ICT incubator companies. The fund might operate on a revolving basis where loans would be repaid to the group and used to fund additional working capital debt for incubator companies, thus having the characteristics of an "evergreen" fund.



The assumption is that the fund would only loan up to ten percent of the capital to any one applicant, and only on the favorable vote of the members of the loan committee. The incubator manager would be responsible for preparing the entrepreneurs to make their loan presentation. Funds could be utilized for any reasonable business purpose including acquisition of office equipment, paying for marketing/advertising, covering expenses while awaiting payment by a larger company, etc.

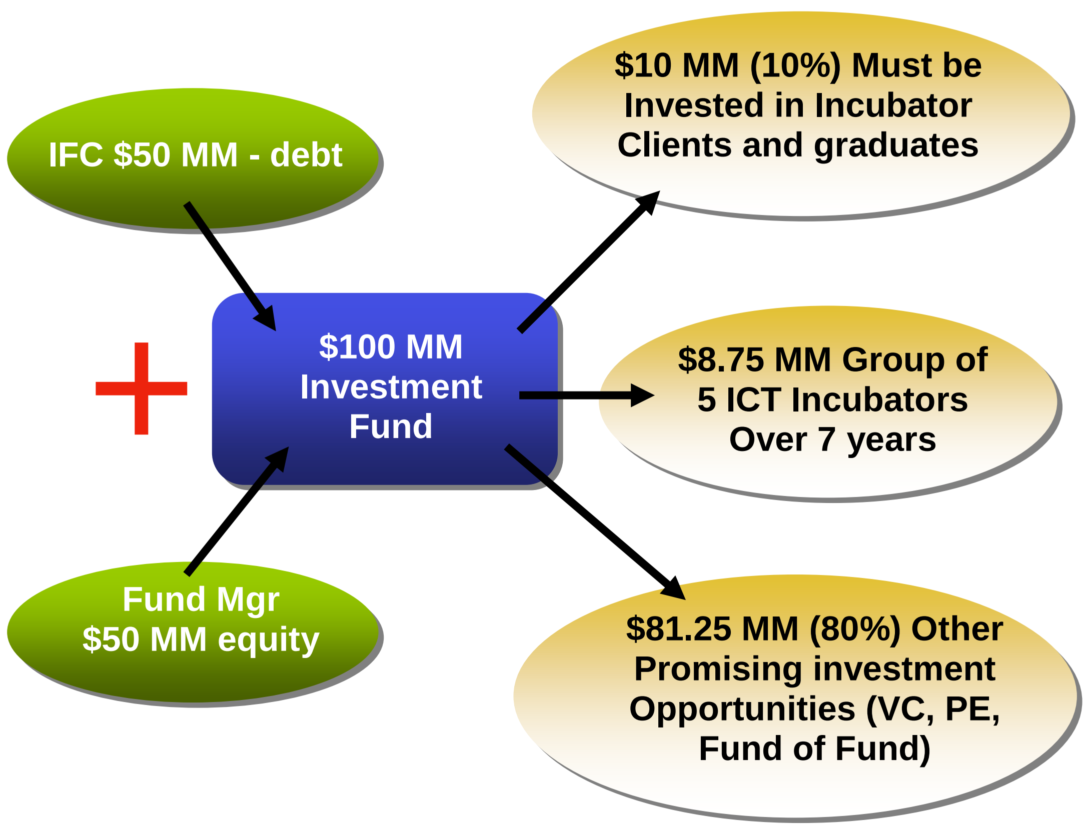
In summary, a working capital fund for ICT incubator entrepreneurs would comprise one element of the financial framework. This fund would loan on the basis of a favorable vote by the loan committee after presentation by the entrepreneur and would be used for gap financing, or other day-to-day needs of the clients.

ICT Incubator Investment Fund

A second strategy would be to raise an ICT incubator investment fund that would provide a combination of debt and equity financing for early stage companies through a capital pool raised for the purpose. The ICT Incubator Investment Fund could be created by IFC floating a tender to provide up to $50 million in debt financing to a professional venture fund manager who would have to raise at least $50 million in equity. The new $100 million fund would be required to invest up to 10% of the total ($10 million) in promising incubator companies and incubator graduate companies, and to provide up to $250,000 per year for seven years, to each of the incubators in the system (up to five) for technical assistance, manager training, marketing, etc. Upon liquidation, IFC would receive the same payout as other limited partners in the fund minus the amount of technical assistance funds paid out during the seven years of incubator support. It is assumed that, as in the case of the working capital fund, a partner bank could be responsible for assisting with management of the fund on the ground. As a test of concept, this model has been vetted with established African venture investors and met with favorable reactions as it would leverage their investment funds without undue effort being expended on what are typically high risk/high touch investments (i.e., the incubator companies). The figure below shows the potential investors, management and recipients of the fund.

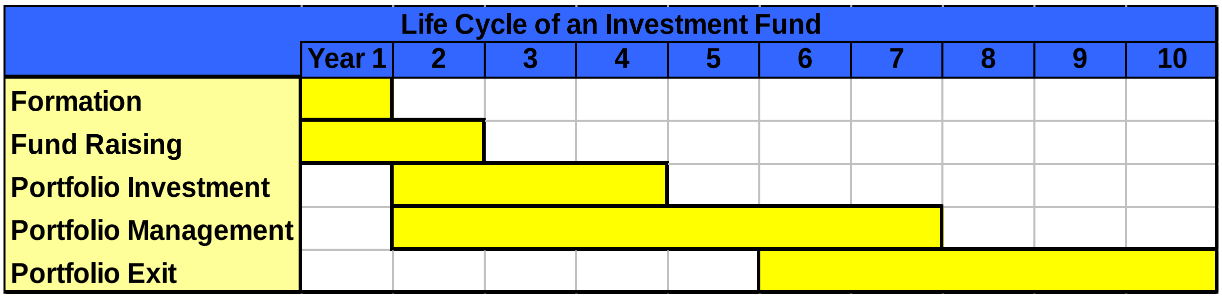
It is likely that a combination of investors would be sought to capitalize the Fund. This could depend on the location of the incubators in the network and the preferences of major investors, but it is likely that pension funds, banks, and private wealthy individuals could be approached as potential investors.

Corporate sponsors might also find it attractive to have a stake in the companies as they are likely to be major beneficiaries of the incubator in the sense that their products and services would very likely be used by the tenant companies.



The life cycle of a venture fund of this type is illustrated in the accompanying diagram. The time periods assumed are typical of venture funds in the developed world and could be extended in the African environment, however, it would be premature to make such assumptions until a fund manager is identified and a proposal put forth. Generally, the life of a fund is divided into three phases: an establishment phase wherein the business plan is developed and funds raised the investing and managing phase during which time the fund selects companies in which to invest, and then the exit in which the fund is liquidated and capital and profits are returned to the investors.

It should be stressed that the figures shown are merely examples and used for purposes of illustration. The amounts would be dependent on the numbers of incubators that would have to be supported, the interests of the fund managers, and the availability of capital.



<u>The key points of the investment fund concept are as follows</u>:

- Management of the fund should be performed by professional fund managers and should come from the private sector.
- Oversight in the incubator countries might be accomplished through a partnership with a cooperating bank.
- Investments in the fund could be tiered, based on the size of the investment and the high level of risk associated with companies in incubation programs. For example, given the high mortality rate of companies at this stage of development, it might be necessary to restrict early stage tenant companies to debt financing only, up to a ceiling of $100,000, and require a minimum level of revenues in order to qualify for the financing (it might also be limited to asset-based loans for companies at the earliest stages of development).
- Equity investments could be considered when the companies are more developed, perhaps towards the end of their tenure in the incubator.
- The fund manager should not be restricted to investing solely in incubator tenants but should have the flexibility to invest a large percentage of the capital in more secure, lower risk investments that will provide assurance to investors that the fund is diversifying the risk and has some prospect of realistic venture returns.

It should be pointed out that other elements in the incubator "eco-system" that support early stage company development such as a network of competent service providers, a skilled manager, on-site advisory services and training are all integral aspects of the program would also need to be present. These are discussed in other portions of this report.

Investment Fund Summary

The foregoing is intended to outline an investment framework that could be considered in raising a fund to support the companies in the ICT Incubator program. Two types of strategies that could be employed were discussed: a loan fund derived from a pool of capital that would be raised from participating banks, and an investment fund that could be raised from a variety of investors and invested in qualifying companies in the incubator, and other less risky investments external to the incubator. Using one or both of these techniques could be considered to meet the financing needs of the tenants.

Training: a Key Component

The Innovative Partners consulting team observed that training of personnel in the incubator is a primary concern to the management of all five of the ICT incubators that were visited to observe best practices. Provision of a training program is a significant element in any well run business incubation program; training should not be confined solely to the workers in the client companies. Technical competence should also be the responsibility of the management of the facility. It is likely that a start-up incubator in any of the IDA countries under consideration by IFC and infoDev will hire its manager and other personnel from the local service area. If properly managed, this will benefit the incubator significantly, as the manager will bring with him/her a network in the local business community that could be invaluable to the client entrepreneurs.

However, management of the facility, experience in meeting the challenges of early stage business operation, understanding how to help entrepreneurs prepare to seek financing, conduct business planning, do market research, and deal with investors is incumbent on incubator management as well.

It is likely that a system for overseeing the training and mentoring of incubator managers will be required for the ICT incubators being contemplated. This would be provided in part through the technical assistance fee discussed in the investment framework wherein the investment fund would allocate about $250,000 per year to support for the incubator which would include training and support of management as well as clients.