LOOKING FOR THE "MISSING MIDDLE" OF ENTERPRISE FINANCE

Investors and donors are spurning clean energy enterprises in developing countries despite the tremendous potential for social and economic impact.

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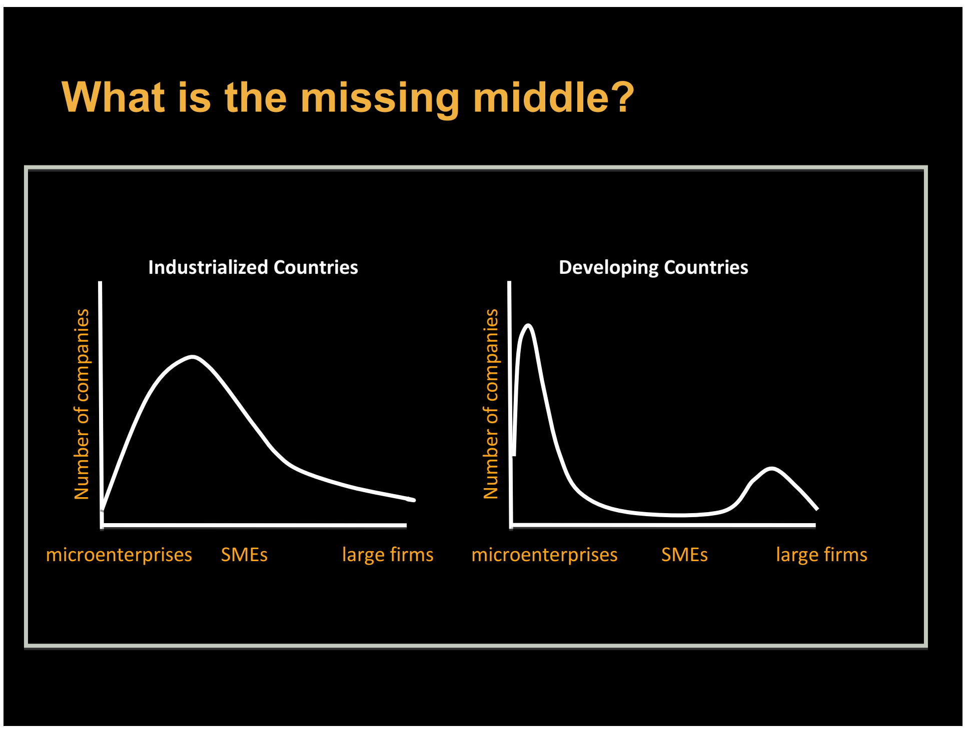
By Ellen Morris, Ph.D.

One fact starkly illustrates the huge challenges that lie ahead for entrepreneurs looking to launch or grow an energy enterprise in a developing country. Small and medium enterprises (SMEs) account for as little as 10-15 percent of GDP in developing countries compared to 50 percent in OECD countries.

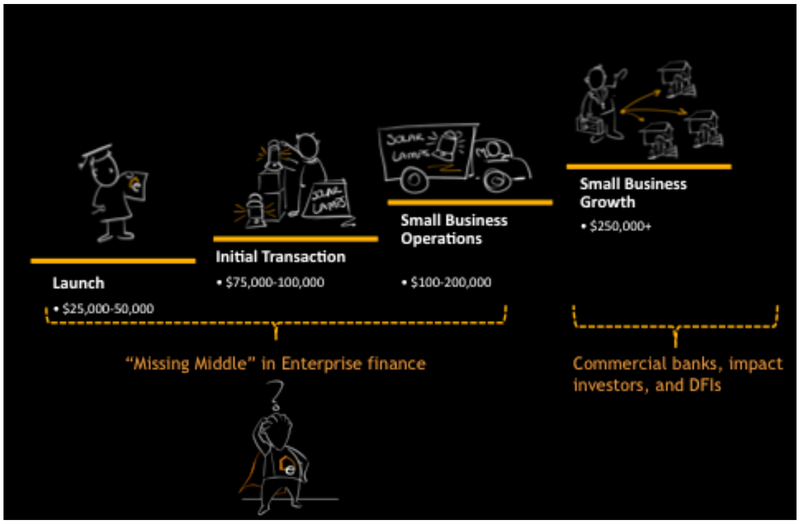


What is holding developing county SMEs back from the potential economic gains that are happening in other parts of the world? Simply put—it's a gap in access to enterprise finance called the "missing middle."

Investors and donors shy away from this sector because they consider it too risky and too costly to invest in smaller sized clean energy enterprises, despite the tremendous potential for impact—in improving the economy, protecting the environment, and promoting social development.

The “missing middle” falls somewhere between traditional microfinance, where loans average around $500, and commercial investment, where investments are upward from $1 million. Entrepreneurs who want to launch or grow a business, typically need capital in the range of $30,000-$250,000—a gap that is not being filled at the moment.

The need for seed capital is well recognised, but investors are reluctant to step in. Importantly, people and institutions that do have the tools and know-how to manage costs and risks are drawn to other sectors, where it is easier to get quick wins.



This topic was at the forefront of the UNCDF CleanStart panel discussion I facilitated, which explored how start-up and working capital needs for small to medium-sized energy enterprises are falling into the “missing middle” and the different business models that are in play to address it.

What’s needed is a way to take a person with a good idea, and provide business training and coaching to help build skills and confidence to start their own business. A top quality business plan in the hands of a local entrepreneur is the first step in a process to eventually bridge the investment gap in developing country markets.

The “missing middle” can be found if investors and donors begin to recognise that SMEs require smaller amounts of affordable capital along with the skills and confidence to sustain a business.

Success can be built on a solid foundation of ongoing business operations and incremental growth that gets entrepreneurs poised for scale-up in a sustainable and profitable way.

Panel Discussion

Local energy entrepreneurs find that capital is scarce and difficult to sustain despite availability and, in some cases, enthusiasm for clean energy shown by investors.

Mathieu Ruillet, Country Director of GERES Cambodia, said: "What's missing for us is finding a bridge between impact investors or development banks, which are talking millions, and what I have in my portfolio of 100-200 entrepreneurs who can absorb between $100, $1000 possibly $10,000.

The Kenya National Domestic Biogas Programme is developing commercial biogas projects. It is aiming to install 46,000 biogas units in the next four years.

Programme Coordinator**, George Nyamu,** said credit is scarce and difficult to sustain despite what he perceives to be many profitable opportunities.

In fact most of the Programme's customers have funded biogas units from their own funds. In the four years the programme has been running, only 18 per cent of the 10,000 units installed are funded by credit.

The criteria used by many MFIs to evaluate loans to biogas providers in Kenya are simply too rigorous and exclude many potential customers, Nyamu said.

"Entrepreneurs can't get start-up capital and they can't get bridge-financing to be able to pick up on the volume of work available.

"With biogas there is a big disconnection between anticipated benefit and the actual cost of investment.

"And on the customer side, MFI's tend to look at loans as consumptive rather than productive loan and therefore treat it as a more risky venture [and in some cases] a no-go zone..."

"Lenders get very excited when you talk about clean energy, but when it comes to actually lending the money they become very elusive," Nyamu said.

Mohammed Parpia, founder of Tanzania's Zara Solar – a husband and wife team – which imports, sells and installs solar systems as well as providing customer finance – said Zara has encountered similar frustrating barriers while building its own business since 2005. The business turns over almost $10,000 some days.

"If you go to an MFI in Tanzania they'll charge between 3 per cent and 6 per cent a month… so a solar system becomes very expensive. This is why MFIs have not been successful in Tanzania," Parpia said.

He puts down Zara's success to selling high-quality products at affordable prices.
"We can do this because we buy in bulk. We enjoy economies of scale, so we pass on the benefits to end-users. We managed to get loans from outside Tanzania," he said.

James Addo, Senior Manager, Impact Investment Advisory Services, at Dutch government funded SNV said lenders have to be creative.

"A practical way would be to locally raise funding in collaboration with a DCA or a guaranteed group such as PFAN, or even the UNCDF… the core objective being to lower the cost of capital to both sides – the entrepreneurs and customers.

"The big question is: who do you take the risk on? The entrepreneur who is hungry and will get the work done, or the household that owns the assets?"

"Therein lies the rub. I can't give you a definitive answer. I wish I could, if I could I wouldn't be sitting here, I'd be working. That's where we now, trying to figure out where the lower risk equation is."

Daniel Potash is Chief of Party at the Private Financing Advisory Network (PFAN), Asia, a 5-year USAID project born out of the US Energy Department in 2005.

"There were a lot of good ideas looking for capital and there was capital available for projects, but they were somehow not finding each other and enabling transactions to take place. PFAN focuses on small- and medium-sized clean energy enterprises ($1 million to $50 million).

"Today I've been hearing about a lot of projects that are considerably below that size range. We found these businesses; even though they can be headed by some very capable people… they still needed coaching and mentoring in order to successfully get some financing."

As well as policy dialogue with governments to ensure an enabling policy environment, PFAN also trains financial institutions, such as Malaysia's CIMB Bank and Kasikornbank in Thailand – two of the largest SME lenders in the region – on loan and leasing products.

Does it make sense to develop specialised SME financing institutions to fund clean energy providers, or continue to rely on MFIs?

"In my view [specialist institutions] are better suited. They tend to supply longer term loans and larger capital needs, said Ellen Morris, panel facilitator and founder of Embark Energy.

"History has shown that MFIs are not coming to the table for the end-user or the entrepreneur for whatever reason. Helping MFIs get to that point is crucial but also find alternative means in the interim".

Ellen Morris, Ph.D, is founding partner of Embark Energy. Embark's mission is to create profitable energy businesses by linking energy entrepreneurs with learning resources, products and finance