



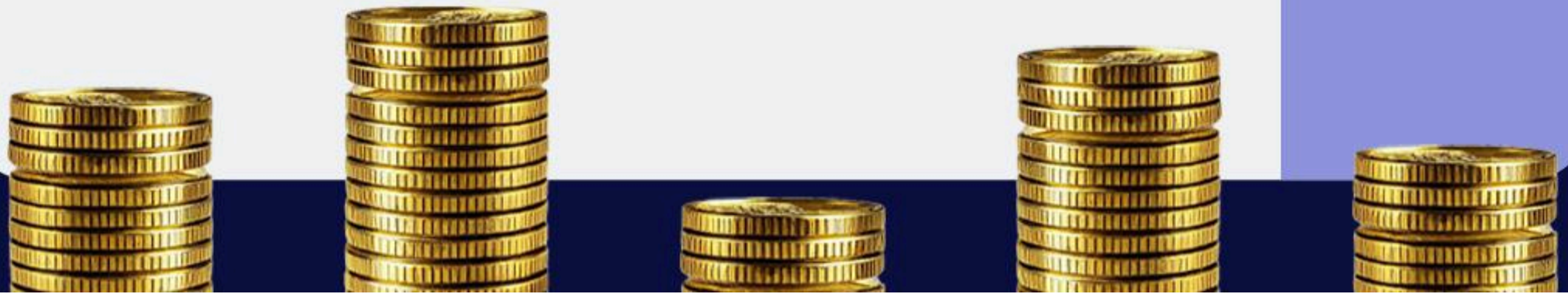
Finance 101

From Capital to Impact: Finance Fundamentals

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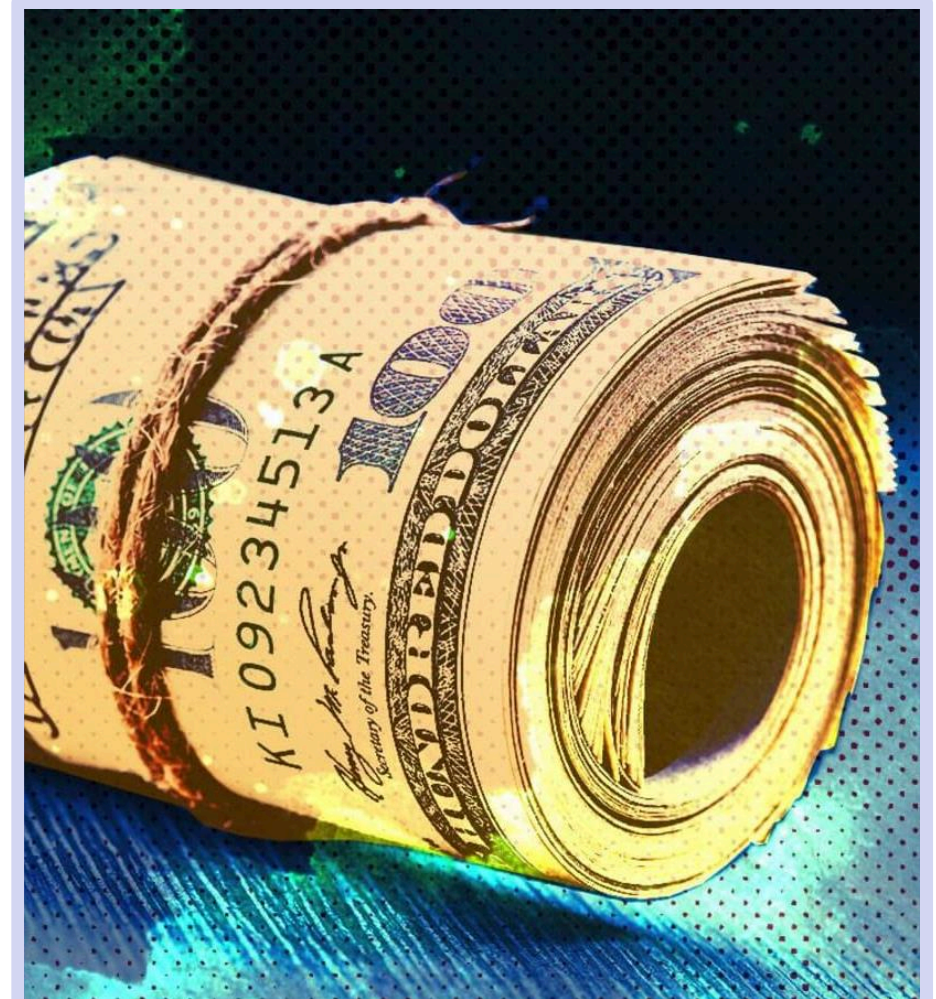


01 Understanding Capital and Financing Options

What is Capital?

Capital refers to the financial resources that businesses or investors use to fund their activities.

It can be in the form of debt, equity, or hybrid instruments. For LCPs, capital is the primary fuel for lending and investment activities, enabling them to extend credit to small and growing businesses (SGBs) and catalyze economic growth in underserved markets.



Types Of Capital:

- **Debt Capital:** Borrowed funds that must be repaid with interest. LCPs and early-stage capital providers often rely on debt to finance their operations or lend to SGBs. Understanding interest rates, repayment terms, and default risk is critical here.

- **Equity Capital:** Funds raised by issuing ownership stakes in a business. Equity capital does not require repayment but dilutes ownership. For early-stage companies, equity investors provide not only capital but often strategic guidance.

- **Blended Finance:** A mix of public, private, and philanthropic funds. Blended finance is particularly relevant for LCPs operating in higher-risk environments. Development finance institutions (DFIs) often provide concessional financing to de-risk investments, which is critical for businesses that would otherwise struggle to raise funds.

Financing Options for LCPs and Early-Stage Capital Providers

- **Microfinance:** Providing small loans to individuals or small businesses, often at the grassroots level. LCPs in emerging markets frequently employ microfinance as a tool to empower SGBs in the informal sector.
- **Angel Investors and Venture Capital (VC):** Early-stage capital providers that take equity stakes in businesses with high growth potential. Angel investors typically fund startups, while VCs may provide additional funding during subsequent growth stages.
- **Development Finance:** DFIs, donor agencies, and philanthropic foundations provide capital and technical assistance to early-stage capital providers in emerging markets. Understanding concessional loans and impact-linked financing is crucial for LCPs operating in underserved sectors.

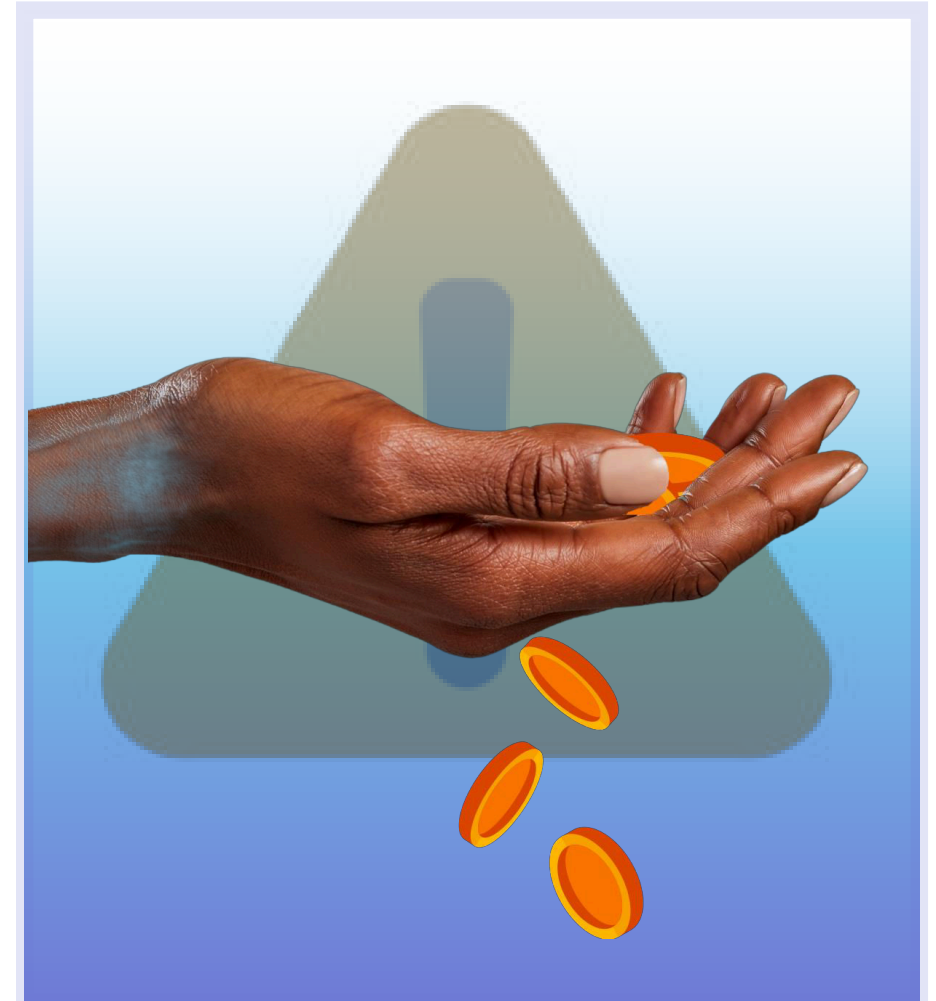
02 The Importance of Credit Risk Assessment

What is Credit Risk?

Credit risk refers to the likelihood that a borrower will default on a loan.

For LCPs and early-stage capital providers, managing credit risk is one of the most critical aspects of sustainable financial operations.

Effective credit risk management ensures that capital is allocated responsibly, reducing the probability of defaults and enabling long-term financial stability.



Credit Risk Assessment Tools:

- **Credit Scores:** These numerical ratings reflect a borrower's creditworthiness. In emerging markets, many individuals and businesses lack formal credit histories, which makes traditional credit scoring challenging. LCPs may need to rely on alternative metrics, such as transaction histories, psychometric testing, or peer assessments, to gauge credit risk.

- **Collateral Requirements:** Requiring assets as collateral for loans reduces risk but may also exclude underserved populations from accessing credit. LCPs can explore innovative approaches, such as group lending models or social collateral, to overcome this barrier.

- **Loan Repayment Plans:** Structuring loans with flexible repayment plans based on the borrower's cash flow can help reduce defaults. For SGBs, cash flow can be highly irregular, especially in sectors like agriculture or retail. LCPs must tailor repayment schedules to match the realities of their clients' businesses.

03 Key Financial Ratios for Decision-Making

Financial ratios provide valuable insight into a business's financial health, and they are particularly important for LCPs when assessing the viability of lending to SGBs or investing in early-stage enterprises.

Essential Ratios to Understand:

- **Liquidity Ratios:** These ratios measure a company's ability to meet its short-term obligations. The most common ratio is the current ratio, which is calculated as current assets divided by current liabilities. A ratio of greater than 1 means the company can cover its short-term obligations.



03. Key Financial Ratios for Decision-Making

- **Debt-to-Equity Ratio:** This ratio compares a company's total debt to its equity, providing insight into how much of the company's financing comes from debt versus owner equity. For early-stage capital providers, a high debt-to-equity ratio may signal increased risk.

- **Profit Margins:** Profitability ratios, such as gross profit margin and net profit margin, reveal how efficiently a company generates profit from its revenue. LCPs should consider these ratios when evaluating the financial sustainability of potential borrowers or investees.

- **Return on Investment (ROI):** This ratio measures the return on capital invested. For early-stage capital providers, ROI is a critical metric that signals whether an investment is generating sufficient returns to justify the risk.

04 The Role of Cash Flow Management

Why Cash Flow is Critical

Cash flow refers to the movement of money into and out of a business. For LCPs and early-stage capital providers, understanding cash flow is crucial because liquidity constraints can lead to operational failures.

Poor cash flow investee's is one of the most common reasons for the failure of small businesses, which highlights the importance of assessing a borrower's or investee's cash flow history.



Cash Flow Statements

A cash flow statement shows a company's inflows and outflows of cash. It is divided into three sections:

- **Operating Activities:** Cash generated from core business operations.

- **Investing Activities:** Cash used for or generated from investments in assets, such as purchasing equipment or selling property.

- **Financing Activities:** Cash flows related to borrowing or repaying loans and issuing or repurchasing stock.

For LCPs, ensuring that borrowers can maintain positive cash flows is a critical component of creditworthiness. Similarly, early-stage investors need to assess whether a company's operations generate enough cash to sustain its growth trajectory.

05 The Cost of Capital and Its Impact on Lending



What is the Cost of Capital?

The cost of capital represents the return that investors or lenders expect in exchange for providing capital. For LCPs, the cost of capital is a key consideration when determining the interest rates they charge on loans. LCPs often face higher costs of capital due to country-specific risks such as political instability, currency volatility, and inflation.





Impact on Borrowing Rates

In markets with high interest rates, borrowing costs can be prohibitive for small businesses. Understanding the relationship between inflation, exchange rates, and interest rates is essential for LCPs to structure sustainable lending products. A rise in inflation, for example, often leads to higher interest rates, which increases the cost of capital for both LCPs and their borrowers.



Blended Finance and De-Risking Strategies

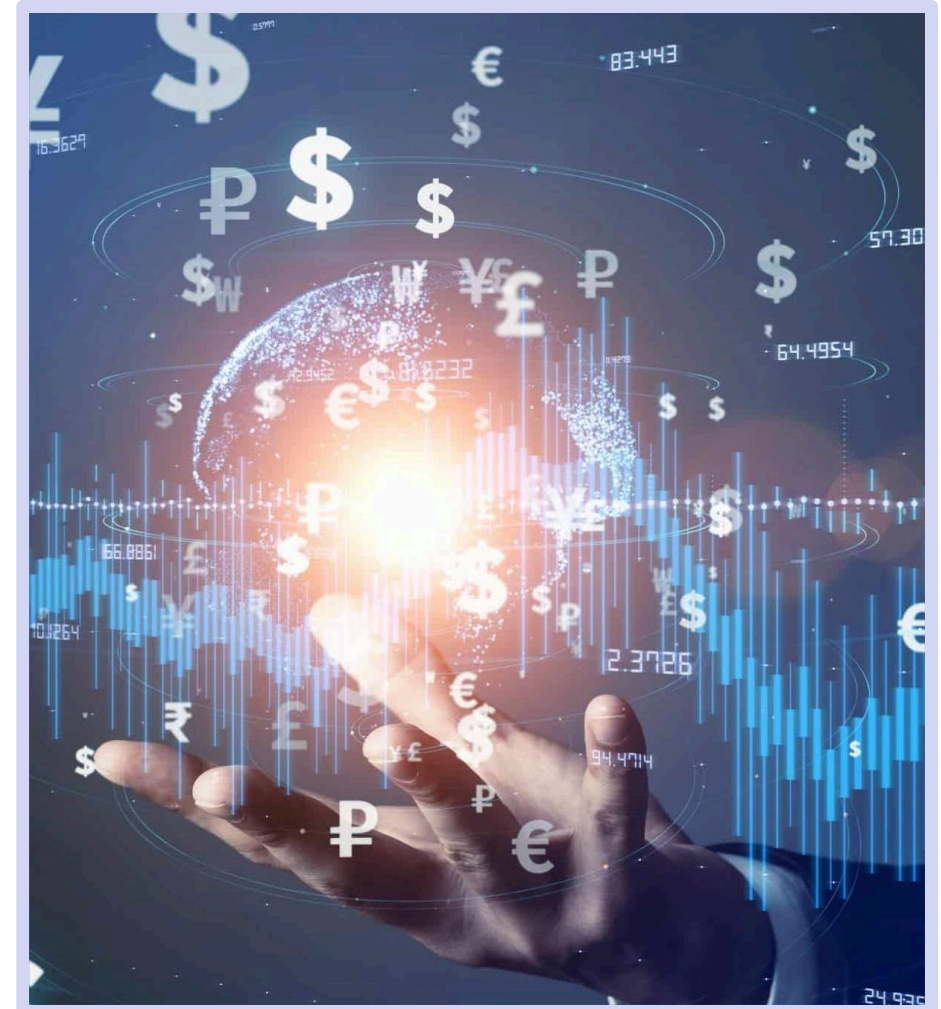
To lower the cost of capital, LCPs can utilize blended finance structures that combine concessional funds from DFIs with private capital. These blended structures reduce risk for private investors, lowering the overall cost of capital and enabling LCPs to offer more affordable credit to SGBs.

06 The Macroeconomic Environment & Its Impact on Financial Markets



Inflation and Its Effects

Inflation erodes purchasing power and can destabilize financial markets. For LCPs, inflation impacts the real value of their loans and the ability of borrowers to repay debt. High inflation often leads to rising interest rates, which increases borrowing costs and puts pressure on the cash flows of small businesses.





Foreign Exchange (FX) Risk

LCPs operating in emerging markets are often exposed to FX risk, especially if they raise capital in foreign currencies but lend in local currencies. Currency fluctuations can significantly affect the cost of capital and repayment terms. Hedging instruments, such as forward contracts or currency swaps, can be employed to mitigate FX risk.



The Role of Monetary Policy

Monetary policy, determined by central banks, directly influences the cost of borrowing and the availability of credit. When central banks raise interest rates to combat inflation, it becomes more expensive for LCPs to access capital, which can limit their ability to extend affordable credit to SGBs.

07 The Role of Capital Markets in Boosting LCP Capabilities

Introduction to Capital Markets

Local Capital Providers often focus on private equity or debt financing, but capital markets also offer a vital avenue for raising funds and improving liquidity. Capital markets (stock exchanges, bond markets) provide LCPs with opportunities to scale their operations by accessing larger pools of capital.



Benefits of Engaging with Capital Markets

- **Liquidity:** Access to capital markets provides liquidity, enabling LCPs to raise funds more efficiently than relying solely on private equity or traditional loans.
- **Diversification:** Capital markets allow for portfolio diversification, reducing the concentration risk for LCPs and improving financial resilience.
- **Transparency and Governance:** Listing on capital markets often requires improved governance structures, which can enhance credibility and attract more investors.

DFI's Role in Capital Market Development

DFIs can help LCPs engage with capital markets by offering technical assistance in financial reporting, governance, and investor relations. Additionally, they can support capital market reforms that make it easier for SMEs and other businesses to list on exchanges or issue bonds, unlocking new capital for economic development.

08 Gender-Inclusive Financing: Driving Equitable Economic Growth

What is Gender-Inclusive Financing?

Gender-inclusive financing refers to financial products, services, and policies designed to address the unique financial needs and barriers faced by women and other underserved genders.

This approach aims to create a more inclusive financial system that enables equitable access to capital, particularly for women-led businesses and female entrepreneurs, who are often underfunded despite their significant potential for contributing to economic growth.



The Gender Financing Gap

Globally, women entrepreneurs face a significant financing gap. Research shows that women receive less than 7% of venture capital funding, while women-led small and medium enterprises (SMEs) face barriers to accessing credit. This gap limits the ability of female entrepreneurs to grow their businesses, contribute to job creation, and drive innovation. In emerging markets, the problem is compounded by additional socio-cultural and systemic factors, such as lack of financial literacy, ownership rights, and access to collateral.

Gender-Lens Investing (GLI)

Gender-lens investing is an approach to investment that integrates gender considerations into financial decision-making. For Local Capital Providers (LCPs) and early-stage capital providers, GLI presents an opportunity to support businesses that are not only financially viable but also have a positive social impact by promoting gender equality.

Key strategies of GLI include

- **Investing in Women-Led Businesses:** Prioritizing funding for companies owned or operated by women can have a ripple effect on the economy, as women are more likely to reinvest profits in their communities, contributing to social stability and broader economic growth.
- **Improving Access to Credit for Women:** Offering products tailored to the needs of female entrepreneurs, such as lower collateral requirements, microloans, or flexible repayment terms, can help close the gender financing gap.
- **Supporting Businesses with Gender-Equitable Policies:** Investing in businesses that promote gender equity in their workforce, supply chains, and leadership structures further amplifies the impact of gender-lens financing. These businesses tend to perform better in the long term due to increased innovation, productivity, and employee retention.

Financial Products for Women Entrepreneurs

LCPs and early-stage capital providers can design specific financial products to address the unique needs of women-led businesses. These could include:

- **Microloans:** Smaller loans with less stringent requirements that are ideal for women in the informal sector or those starting small enterprises.
- **Crowdfunding Platforms:** Engaging women in digital finance solutions, such as crowdfunding, where they can directly connect with investors.
- **Blended Finance Models:** Partnering with development finance institutions (DFIs) to de-risk investments in women-led businesses, making it more attractive for private sector capital.

Why Gender-Inclusive Financing Matters for Economic Growth

- **Boosting GDP:** Studies show that closing the gender gap in the workforce and entrepreneurship could add trillions of dollars to global GDP. By empowering women with financial resources, LCPs can contribute to overall economic productivity.
- **Lower Unemployment Rates:** Increasing access to capital for women-led businesses not only boosts their success rates but also leads to job creation. Women entrepreneurs tend to hire other women, creating a virtuous cycle of employment and economic participation.
- **Economic Stability:** Businesses owned or led by women typically reinvest a significant proportion of their profits in their families and communities. This reinvestment drives positive social outcomes, including better health and education, contributing to long-term economic stability.
- **Financial Inclusion:** Gender-inclusive financing also drives financial inclusion. By targeting underserved women in rural areas or those in low-income segments, LCPs can bring more individuals into the formal financial system, enhancing financial literacy and economic participation.

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DEEPER DIVE USING INSIGHTS FROM THE CFF 2023 ANNUAL LOCAL CAPITAL PROVIDER SURVEY

Understanding the “Missing Middle” Financing Gap

The CFF Annual Local Capital Provider Survey 2023 emphasizes the critical role LCPs play in bridging the financing gap faced by the “missing middle”—SGBs that require capital between \$20,000 and \$2 million.

These businesses are too large for microfinance institutions but too small and risky for traditional banks or venture capital.

Key Points:

- The “missing middle” represents a significant opportunity for economic growth yet is underserved by mainstream finance.
- LCPs are strategically positioned to provide tailored financial products that fit the specific needs of these businesses, such as flexible repayment terms or hybrid debt-equity instruments.
- This concept is essential for understanding how LCPs can drive local entrepreneurship, promote job creation, and foster innovation, directly contributing to broader economic development.

Financial Instruments for LCPs: Self-Liquidating vs. Equity Investments

The survey highlights the use of self-liquidating instruments (e.g., revenue-based financing, debt) as a popular choice for LCPs. These instruments provide early cash flow returns, which is crucial for smaller funds that may not have the capacity to wait for traditional equity exits. At the same time, equity investments remain relevant for high-growth businesses.

Key Points:

- Self-liquidating instruments: Generate early returns, reducing dependency on large exits, and offer LCPs liquidity.
- Equity investments: Provide long-term growth potential but may require longer time horizons.

LCPs should assess the risk profiles and growth potential of businesses to determine the appropriate mix of financial instruments. This combination of products allows LCPs to balance immediate cash flow needs with long-term value creation.

Capital Raising Challenges and Blended Finance Solutions

The CFF survey reveals that many LCPs are struggling to reach their first close, with 55% of fund managers yet to meet capital targets. This challenge is exacerbated by smaller fund sizes (often below \$30 million), making it difficult to achieve economies of scale.

Key Points:

- Raising capital is a significant barrier for LCPs, especially in high-risk environments.
- Blended finance: A solution where concessional capital from DFIs and donor agencies is combined with private capital to reduce investment risk and attract more private sector funding.

Blended finance de-risks investments for private investors, enabling LCPs to tap into larger pools of capital. This approach is particularly useful for LCPs targeting high-impact sectors such as agriculture, clean energy, and women-led enterprises.

Risk Management: Mitigating Credit and Currency Risks

LCPs face a myriad of risks when financing small businesses, including credit risk (the likelihood of borrower default) and currency risk (volatility between local and hard currencies). The CFF Survey 2023 underscores these challenges, noting that many LCPs struggle with currency mismatches—raising capital in USD or EUR while lending in local currencies.

Key Points:

- Credit risk management: Involves rigorous due diligence, alternative credit assessments (e.g., psychometrics, social collateral), and tailored repayment schedules that align with the borrower's cash flow.
- Currency risk management: Can be addressed through local currency lending or hedging instruments to minimise the impact of exchange rate fluctuations.

LCPs must develop sophisticated risk assessment and mitigation strategies to protect their portfolios while continuing to support underserved SGBs. DFIs can offer support through de-risking instruments, such as guarantees and local currency funding solutions.

Gender-Inclusive Financing: Unlocking Untapped Growth Potential

Gender-Lens Investing (GLI) is becoming an integral part of LCP operations, as reported in the survey, with over 60% of funds adopting gender-inclusive practices. Women-led businesses remain underserved despite their strong track record of reinvesting in their communities and contributing to economic stability.

Key Points:

- Gender-inclusive financing: Encourages the allocation of capital to women-led businesses and promotes gender diversity within the investment process.
- Positive economic impacts: Women-led businesses have a higher propensity to reinvest in their local economies, contributing to long-term socio-economic stability.

For LCPs, focusing on gender-lens investing can improve their portfolio's resilience and profitability while promoting broader social and economic objectives, such as gender equality and poverty reduction.

Technical Assistance (TA): A Key to Business Success and Risk Reduction

More than 60% of LCPs surveyed offer both pre- and post-investment Technical Assistance (TA) to small businesses. TA helps improve business governance, operational efficiency, and financial management, reducing the likelihood of failure and default.

Key Points:

- Pre-investment TA: Helps assess business readiness, offering guidance on financial literacy, market strategies, and operational structure.
- Post-investment TA: Ensures businesses continue to grow and manage their operations efficiently, reducing the risk of default and enhancing repayment capacity.

Donors and DFIs should support LCPs by funding or co-financing TA initiatives, as these greatly enhance the success rates of SGBs and de-risk the capital deployment process.

Alternative Fee Structures for Fund Sustainability

The CFF survey shows that smaller LCP funds are increasingly moving away from traditional 2&20 fee structures (2% management fee, 20% performance fee). Many LCPs are adopting alternative fee models, including fixed fees or success-based fees, to ensure their sustainability given the smaller scale of their operations.

Key Points:

- Alternative fee structures: Offer more flexibility and align incentives between fund managers and investors.
- Fixed or success-based fees ensure that smaller funds can maintain operational viability while still pursuing impact-driven investments.

LCPs should explore alternative models that fit their fund size and operational constraints, enabling them to remain competitive in challenging financial environments.

Impact Investing and SDG Alignment

All LCPs surveyed align their investment strategies with Sustainable Development Goals (SDGs), particularly those focusing on decent work, economic growth, and reducing inequalities. Measuring and reporting on impact metrics is becoming standard practice, with many LCPs using these indicators to attract concessional capital and ensure accountability.

Key Points:

- Impact metrics: Include job creation, gender equality, environmental sustainability, and improved livelihoods.
- SDG alignment: Strengthens the value proposition of LCPs to DFIs and impact investors by demonstrating a clear commitment to both financial and social returns.

LCPs that align with SDGs and effectively measure impact are more likely to secure long-term funding from development finance institutions and philanthropic donors.

FINANCE 101