MINISTRY OF FOREIGN AFFAIRS

PROGRAMME COMMITTEE

TITLE: Capital Injection in the African Guarantee Fund for Small and Medium-sized Enterprises (AGF)

MEETING DATE: 3 October 2013

PRESENTING UNIT: Africa Department (AFR)

CONCEPT NOTE

Capital Injection into

The African Guarantee Fund for Small- and Medium-Sized Enterprises (AGF)
1. INTRODUCTION
As an outcome of the Danish Africa Commission, the African Guarantee Fund for Small and Medium-Sized Enterprises (AGF) was initiated in 2010 as a limited shareholding company with registration in Mauritius and operational headquarters in Nairobi. The purpose of the AGF is to contribute to growth and employment in Africa by enhancing Small and Medium-Sized Enterprises’ (SME’s) access to finance through the provision of loan and equity guarantees to financial institutions for their lending to SMEs. In addition, the AGF supports capacity development both for partner lending institutions to provide financial services to the SME market segment and for SMEs to improve their business management skills. The AGF started operations in 2011 and was officially launched in 2012 with an initial share capital of USD 50 million provided by the three founders: the African Development Bank (AfDB) with USD 10 million and the Governments of Spain and Denmark with USD 20 million each. In addition, the Government of Denmark provided USD 2.8 million for initial preparatory activities, start-up costs and operational support during AGF’s first year of establishment, and USD 2.3 million for capacity development for a separate Capacity Development Trust operated by the AGF. AfDB has further committed USD 1 million towards the Capacity Development Trust. As outlined below, Denmark’s approach to AGF is being adjusted to reflect the current strategy for development cooperation, in particular concerning tax havens and CSR-principles. Further, it is proposed to include broad-based dialogue with Danish enterprises seeking partnerships with African SMEs – reflecting the Danish Government’s priorities for growth and employment in Denmark, as well as Africa.

1.1. Key Strategic Questions
Q1: The AGF was created as a private company in order for it to operate on commercial terms and potentially to be able to attract private capital. However, the guarantee business generally does not provide high returns on capital – and therefore, it does not appear likely that private capital will be forthcoming. Under such a scenario, what exit strategy could Danida pursue?

Q2: The AGF was registered in Mauritius, although operating out of Kenya. The rationale for this choice was that Mauritius has a sound legal framework (allowing financial institutions to operate across the African continent) and the capacity to provide oversight of the financial sector (following internationally recognized standards). However, the set-up has created operational difficulties and directors of the Board are currently exploring the possibility of shifting registration to Kenya. This would entail higher taxation – and hence, higher volumes of business activity and capital would be required for AGF to become financially sustainable. Denmark works in the Board to ensure that operations are efficient, the regulatory environment for AGF is sound, and AGF continues to operate on commercial terms, including paying taxes. Should Denmark continue to pursue this line in the Board – that would require a larger capital base to attain financial sustainability?

Q3: The AGF is only now starting to develop indicators for monitoring development outcomes through the reporting by its customers, the financial institutions. Such indicators would need to be few and simple, and the information easy to obtain from the ‘end users’, i.e. the SMEs that receive loans backed by AGF guarantees. Any other initiatives would need to be conducted outside AGF itself. In order to secure monitoring of development results (incl. adherence to CSR-principles and other cross-cutting issues), it is proposed to include substantial funds for monitoring and evaluation. These funds would also be used to seek
stronger synergies with other finance instruments for the private sector, including Danish companies seeking partnerships with African SMEs. Does the Programme Committee have additional suggestions for how to further strengthen synergies between an institution such as the AGF and the private sector?

1.2. Summary of conclusions regarding envisaged support
AGF is at a point at which the successful start-up phase is morphing into an operational phase, where momentum has to be sustained for a while. The business approach is sound and the AGF brand is becoming increasingly visible. Business opportunities are developing and the maximum volume of activities given the current capital level is predicted to be reached within the next 6 months – and AGF has room for business expansion with the current staff capacity. AGF has demonstrated the relevance of its guarantee products through a high demand from partner lending institutions. AGF needs more capital to gradually develop into an important pan-African financial institution and reach a stage of robust profitability. Access to finance remains one of the main challenges for the SME sector in Africa, which contributes about 50% of GDP and at least 60% of total employment – thus, AGF’s contribution to increase lending to SMEs is likely to have an important impact on economic growth and generation of employment. Additional capital from Denmark would be important in order to attract capital from other potential donors, such as DFID and JICA. As a company operating on commercial terms, AGF will not be able to engage itself in thorough monitoring, which would be necessary to document its results, i.e. its impact on growth, employment, and social profile issues. Complementing AGF’s monitoring system and exploring synergies with other finance instruments would enhance the visibility of AGF’s results and could attract other investors.

2. CONCLUSIONS FROM PREPARATORY ANALYSIS
The Ministry of Foreign Affairs of the Government of Denmark undertook a review of AGF in early July 2013, which constituted the key preparatory analysis for the capital injection.

During the last 18 months, AGF has established its physical presence in Nairobi; established an organisation with 13 well qualified staff (plus two interns); and put in place and documented most of the necessary processes, procedures and controls. It has successfully launched its business activities and is gaining recognition in the market, as evidenced by AGF winning the African Banker Award for Financial Inclusion in April 2013. AGF is now in the transitional phase between start-up and full operation. During the start-up phase, the management has demonstrated the ability to adapt AGF’s business model to the realities of the market.

AGF has made excellent progress in building a promising portfolio of guarantees in a remarkably short time. By the beginning of July 2013, agreements with 10 banks had been signed for guarantees amounting to a total of USD 15.8 million, while agreements with five banks amounting to a further $33 million had been approved and were proceeding to signature. The pipeline under consideration constituted a further $64.8 million of guarantees with 11 banks. Assuming that all approved and pipeline projects are signed, the total portfolio would be USD113.5 million, representing a leverage of 2.3 on AGF’s capital of USD 50 million.

The market approach taken by management has been to test a mixture of different types of target groups and products to position AGF within the market and to establish the market niches that AGF is best able to fill. At one end of the spectrum, they have worked with very
large regional or Pan-African banks on master portfolio guarantees, in some cases covering many countries. In these cases AGF has partnered with other guarantee providers, which has enabled AGF to leverage on both the financial offering and the experience of existing guarantee providers in order to enter the upper end of the market. At the other end of the spectrum, AGF has signed a relatively small facility with a small Kenyan bank that was already in the SME market. In this case, the innovative element of the deal was to provide the bank with a portfolio guarantee to enable them to start a factoring service for SMEs - thus becoming the first commercial bank in Kenya to offer factoring to SMEs.

In the first year of operation, Kenya has dominated the deal flow, which is not surprising, given AGF is based in Nairobi and that Kenya has a dynamic and relatively innovative banking sector. The portfolio is rapidly diversifying, however: adding projects approved but not yet signed brings the Kenya proportion down to 15.3% of the total value. The master portfolio guarantees and other new guarantees in the pipeline hold the promise of a significant increase in the country coverage of AGF business.

The AGF Capacity Development Trust (CD Trust) was formally registered in January 2013 as a non-charitable purpose trust attached to AGF. The CD Trust has been registered with an initial property of USD 2.3 million (part of the Danish 2010 commitment to AGF). AGF will act as fund manager on a cost recovery basis. A capacity development strategy paper (2013-2016) and operational guidelines have been prepared. AGF’s customers have to contribute to financing capacity development activities, as the CD Trust will contribute max. 50%. The initial AfDB commitment of USD 1 million for capacity development is expected to be disbursed in the near future. The new potential AGF investors have also indicated a positive interest in supporting the capacity development activities.

The current institutional setup has resulted in managerial and administrative delays and frustration. The Board of Directors has therefore engaged external advice to investigate possible institutional options, including the establishment of an international development finance institution, and the related tax implications of relocating the AGF company registration from Mauritius to Kenya. This could be in the form of: 1) a Non-Governmental Organisation, 2) a company limited by guarantee, 3) an inter-governmental organization, or 4) a regional office of an international organization.

The possible change of status towards a public benefit/non-for-profit organization does in principle collide with the original intention of establishing AGF as a limited liability company with the ambition of the AGF operating on commercial principles and terms. The risk is that a change would send signals to the partner lending institutions that AGF is a donor-funded organisation, which would threaten to undermine the business reputation that AGF has successfully built. This favours registration as a limited liability company under the Kenya Companies Act as a preferable alternative. There are, however, numerous complexities that have to be investigated, even if this option is chosen. In any case, it seems premature to pursue these options before the current set-up has been further tested.

AGF has prepared a scenario with a capital injection of USD 100 million within the next 3½ years and a scenario without additional capital injections. The flat line scenario shows that profitability will be achieved only with very low costs of credits (guarantee losses) combined with a leverage of three (which is the level currently decided by the Board of Directors). The
scenario with a capital injection shows that profitability will be reached in 2015 with a total capital injection at the level of USD 50-60 million and credit costs around 2%. Bringing forward any capital injection assumed in 2015 and 2016 will assist AGF in reaching profitability earlier, assuming that the market can absorb the guarantee products and volume offered by AGF.

The operational parameters of importance for profitability are, among others:
1) Treasury income is forecast slightly above 2% net. The current market conditions enable a return of 3-3½%, which would mean early profitability and higher benefits from an early additional capital injection.
2) The average guarantee utilisation pricing is projected with a slightly upward trend in the flat line scenario as AGF applies a selective use of scarce capital, whereas the capital injection scenario indicated that the pricing is expected to be stable at just above 2.5%.
3) The leverage limit of three will in both scenarios be reached in 2014, indicating that AGF does not anticipate any challenges in utilising the capital available.

The level of operational expenses is not materially affected by a higher guarantee volume. Therefore, there is room for business expansion with the current staff capacity, which would not be overstretched at the business level that would result from a capital increase of USD 50 million and a leverage of three. This implies that the marginal return would be substantial when increasing the volume by either increasing the leverage and/or increasing the capital base.

Very little work has been done to date on the establishment of the Monitoring & Evaluation (M&E) system. It is essential, however, that the current transitional stage includes the design and implementation of a rigorous M&E system, incorporated in a clear guideline document. A realistic approach needs to be taken to designing the outcome indicators that will be continuously monitored. As far as possible, those indicators will need to draw upon information that is already collected by partner lending institutions as part of their normal business. The indicators should therefore be designed in consultation with existing AGF customers, to ensure that the requirements are realistic and not excessively burdensome. In order to supplement the M&E efforts of AGF, it is recommended that funds for this purpose are availed outside the AGF itself.

3. PRELIMINARY OVERVIEW OF ENVISAGED CAPITAL INJECTION

3.1. Justification for the support
Although it is premature to document the development results of AGF, there are clear indications that the AGF plays an important role in enhancing growth and job creation in Africa. The AGF has quickly built a large portfolio of guarantees, thus enhancing lending by African financial institutions to SMEs. And African SMEs play a critical role in economic development as well as job creation, alongside larger enterprises and “survivalist” enterprises in the informal sector. The realization of SME growth potential depends largely on the removal of a number of barriers, mainly within four key areas: (a) regulatory environment, (b) access to markets, (c) people and training, and (d) access to finance. The AGF addresses finance and people and training, while the other two areas are mainly within the remit of high level government policies and strategies in the countries where AGF operates.
AGF is at a point at which the successful start-up phase is morphing into an operational phase in which momentum has to be sustained while, at the same time, developing an administration that can handle the increased workload. The key business approach and administrative frameworks in the form of manuals and procedures are in place and sound, together with a competent staff. The AGF brand is becoming increasingly visible and business opportunities are developing as a result of which the maximum volume attainable within the current capital level is predicted to be reached in the next 12 months. The forecasts show that the current capital levels are insufficient to support the increase in business volume required to reach profitability unless leverage (risk) is increased above the current maximum threshold. Consequently, there are strong indications that an additional capital increase within the next six to nine months is timely and opportune to sustain momentum towards profitability and thus, realising substantial development results, as: (i) AGF has demonstrated the relevance of its guarantee products through a high demand from partner lending institutions; (ii) AGF is engaging in initial capacity development initiatives that have a social profile, targeting smaller financial institutions, SMEs and even vulnerable groups; (iii) AGF has started active collaboration with other guarantee schemes to increase the business platform and harness business synergies; (iv) AGF has room for business expansion with the current staff capacity, which would not be overstretched at a higher business level; (v) AGF’s role and work has been internationally recognised, as evidenced by winning the African Banker Award 2013 in the category of Financial Inclusion; (vi) AGF needs more capital to develop into an important pan-African financial institution and reach a stage of robust profitability; and (vii) access to finance is still a main constraint for SME development; enhanced access to lending will have an important impact on economic growth and the generation of employment.

The envisaged capital injection will make Danida the first mover among the initial founders and send a signal to other potential funders that Danida finds the management and approach credible. Furthermore, the capital injection will provide a more realistic capital base for planning a three year rolling framework (a sort of ‘business plan light’), as part of AGF’s efforts to become yet more business focused.

3.2. Outline of support strategy
The Danish support will take the form of a capital injection, complemented by strengthened M&E outside AGF itself. A combination of a capital injection and operational grants was considered but a pure capital injection is preferred as (a) provides more votes for Denmark at the Annual General Meeting; (b) provides the Board of Directors with the full discretion to allocate the capital injection; and (c) will be administratively easier for AGF as well as for Danida as there will be no additional reporting requirements. Placing deeper M&E efforts outside the company means that the AGF can continue to operate on commercial terms.

The possible provision of an operational grant was considered, since it would produce a healthier operational result that could benefit fundraising activities. It would, however, also entail an implicit indication of donor dependence, thus potentially defeating the purpose of Danida being a shareholder acting on strictly commercial terms. The symbolic value of Denmark increasing its shareholding rather than injecting an operational grant will also emphasise reliance on and trust in the AGF management arrangements and business model. Furthermore, it should be appreciated that the earmarking of funds towards certain operations to some degree defeats the principle of the Board of Directors being responsible for all corporate matters.
Danida intends to outsource the seat at the Board of Directors to IFU to enhance the finance, market, and commercial skills in the Board of Directors while at the same time ensure personal continuity. The outsourcing will be handled exclusively by Danida: a part of the tentative support will therefore be earmarked towards this together with a provision to enhance M&E and strengthen synergies with the private sector, including Danish enterprises.

3.3. Preliminary budget

The envisaged support is expected to run over a four-year period, which coincides with the requirement for Danida as a founder to retain its shares five years from start-up of the AGF. The preliminary budget of DKK 100 million is proposed to be distributed as follows:

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<td>1 Capital Injection</td>
<td>95.00</td>
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<td>2 Outsourcing of Board seat</td>
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<td>3 Monitoring and Evaluation</td>
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<td><strong>Total</strong></td>
<td><strong>96.25</strong></td>
<td><strong>1.25</strong></td>
<td><strong>1.25</strong></td>
<td><strong>1.25</strong></td>
<td><strong>100.00</strong></td>
<td><strong>100%</strong></td>
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AGF is currently working on attracting additional capital injections and counter guarantees as follows:

- Due diligence underway by Japan (JICA) on a possible USD 10-12 million capital injection.
- Discussion with Netherlands on possible USD 20 million capital injection.
- Active discussion of capital injections with Germany (DEG), Norway (Norfund) and China Development Bank; and discussions scheduled with Turkey, (TIDCA), South Korea (KOICA) and the Islamic Development Bank.
- Further partnerships with other guarantors under discussion: SIDA guarantee fund, USAID (Development Credit Authority); as well as continuing cooperation with ARIZ and ATIA on a case by case basis.

3.4. Organisation and Management structure

The Board of Directors has the overall responsibility for providing policy and strategic guidance to the management and ensuring that the required resources for the development and operation of AGF are available and effectively managed. The Board shall, according to the constitution, consist of no more than nine members of which 3 are representing each of the three founders until the fifth anniversary of the incorporation of AGF, 2 are Mauritius Directors by ordinary resolution, and the remainder are appointed by each of the major shareholders or shareholder groups. In order to strengthen its capacity, the Board appointed an additional independent Director with strong professional qualifications in July 2013.

The daily operations are under the responsibility of a Chief Executive Officer, who is supported by an executive team consisting of a Chief Financial Officer, a Business Development Director, a Human Resources Director, a Risk Manager (under recruitment), and an Internal Control Director.
3.5. Monitoring & Evaluation
AGF management is developing an M&E system, which will be an on-going monitoring process, focused on the outputs and outcomes of AGF activities. Such information will need to be provided by AGF's customers (the partner lending institutions) and realistically only include one or two additional indicators to the financial indicators already used by the financial institutions. AGF is collaborating with existing customers to design a system that will be manageable by the financial institutions. It is expected that these indicators will include e.g. SME turn-over and employment – and thereby provide some indication of the development results of AGF's activities on in terms of growth and employment.

In order to document the development results of AGF’s business, considerable additional information is required – as envisaged in the initial Information Memorandum, surveys should be undertaken to complement AGF financial and capacity development products in terms of outputs, in order to document outcomes and results – as well as also issues such as the additionality requirements of the AGF; the extent to which the AGF benefits young people and women; the social performance of the AGF; and its compliance with the Decent Work Agenda. These social and economic impacts take time to be realized and they are very difficult to calculate and to verify. Information additional to the on-going monitoring process within the AGF would be collected from surveys. Strong evidence of development results would be useful for AGF in efforts to attract new potential investors to AGF (possibly including private social funds), as well as support capacity development efforts by building business cases, e.g. for adherence to CSR-principles.

3.6. Cross-cutting Issues
The African Guarantee Fund, which operates continent-wide in Africa and is a private corporation focused on providing guarantees on loans provided by African financial institutions to African small and medium sized enterprises. Thus, it is an indirect instrument at arms-length from actual lending policies of the financial institutions and real sector activities, policies and regulations. Restrictions on AGF’s core business of providing guarantees would need to fulfill AGF’s need to generate revenues and operating profits and to remain attractive to both customers and investors. It is not the mandate or comparative advantage of AGF to undertake screening of the loan portfolios for which guarantees may be provided w.r.t. cross-cutting issues. Through capacity building efforts, however, cross-cutting issues could be addressed with the aim of strengthening policies in partner lending institutions by building business cases for e.g. adherence to CSR-principles.

3.7. Financial and Operational Risk Management
AGF has developed a comprehensive set of policies and manuals. The administrative setup will develop further as AGF evolves from a start-up to an established organisation with an accelerated activity level and complexity in the administrative duties due to, among others, more products, capacity, higher volumes, customers starting to claim under their guarantees, and capacity development activities gaining momentum.

3.8. Risks
Given the nature of its operations, AGF is exposed to a number of different types of commercial risks and risks affecting AGF’s ability to achieve its outcomes and outputs as outlined in the logframe. In addition, the shareholders are confronted with certain reputational
risks arising from the legislation under which AGF is incorporated and licensed and the commercial principles under which it operates.

Due to subsidised competition, guarantees cannot be priced and designed so as to be attractive for partner lending institutions, yet financially feasible for the AGF. The collaboration with other guarantee schemes, selection of countries without large subsidised schemes, emphasis on non-price parameters (simplicity of products and procedures, fast and transparent claims procedure, and minimal reporting requirements) and the use of capacity development elements provide a framework that will allow AGF to mitigate the supply side risks while at the same time building customer relations benefitting the demand side. This risk is rated medium/high.

Higher than expected credit guarantee/loan losses leads to reduced profitability of guarantees and compromised sustainability of the AGF. The risk will be mitigated through the application of stringent risk management; prudent and thorough due diligence; a dynamic country/region and product mix; and development of new products. The risk is rated medium.

Partner lending institutions do not have the expected capacity and/or do not perform as expected, leading to frustration, higher transaction costs, and higher-than-expected losses and are therefore unwilling to continue SME lending. The risk will be mitigated through stringent risk management, prudent and thorough due diligence, and the development of new products. This will be supplemented by targeted capacity development support to develop relevant products for the financial institutions, as well as customer monitoring systems and routines – including credit and capacity development products that target their clients, the SMEs. The risk is rated medium.

Interest rate risks, liquidity risks, and other financial risks hamper AGF’s ability to invest its capital at sustainable levels, thus depleting its capital base. The risk will be mitigated through a solid investment strategy, limited leverage, and a constant monitoring of the risks pertaining to assets as well as liabilities to adjust in accordance with the situation and prevailing market conditions. The risk is rated medium.

The foreseen capital injection cannot be raised and therefore AGF’s sustainability/profitability is threatened. The AGF management will continue and, if needed, intensify the efforts to mobilise capital. The risk is rated medium.

Issues pertaining to corruption and money laundering may cause reputational damages to the AGF and its shareholders. AGF recognizes the need to promote ethical business practices and good governance in compliance with international standards as part of its guarantee and investment decision process. The AGF is guided by international best practices concerning analyses of integrity issues related to private-sector lending and investment decisions, and has developed comprehensive anti-Money Laundering Procedures and Manual in accordance with Mauritian legal requirements. The risk is rated low.

The institutional framework with AGF being registered in Mauritius and the Board of Directors, management and staff receiving compensation comparable with the private sector may cause reputational damages to the shareholders. Danida will be an active shareholder and will work towards the mitigation of this risk by AGF showing results on a commercial as well as an impact and outcome basis, thus demonstrating that the approach is sustainable and has benefits in terms of growth and employment. The risk is rated medium.
Annex 1: Process Action Plan

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<th>Activity</th>
<th>Timing</th>
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<tr>
<td>1</td>
<td>Submission of Concept Note to KVA for Programme Committee</td>
<td>11 September</td>
<td>AFR</td>
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<td>2</td>
<td>Programme Committee</td>
<td>3 October</td>
<td>AFR</td>
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<tr>
<td>3</td>
<td>Finalisation of project document on the support to AGF</td>
<td>October</td>
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<td>4</td>
<td>Desk Appraisal</td>
<td>Mid-October</td>
<td>TSA</td>
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<td>5</td>
<td>Submission of Appreciation Note for the External Grant Committee</td>
<td>25 October</td>
<td>AFR</td>
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<td>6</td>
<td>Presentation for the External Grant Committee</td>
<td>13 November</td>
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<td>7</td>
<td>Approval Note to the Minister for Development</td>
<td>November</td>
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<td>8</td>
<td>Minister approval</td>
<td>December</td>
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Annex 2: Assessment According to Budget Support Principles

N/A

See section 3.6: Cross-cutting Issues
Annex 3: Gender Equality Rolling Plan

N/A

See section 3.6: Cross-cutting Issues
Annex 4: Environmental and Climate Screening Note

N/A

See section 3.6: Cross-cutting Issues
Annex 5: HRBA Screening Note

N/A

See section 3.6: Cross-cutting Issues