

From Poverty to Prosperity: Understanding the Impact of Investing in Small and Medium Enterprises

Data Survey and Case Study Analysis of
SEAF Investments

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SEAF Your Global Investment Partner
Connecting Local Enterprises with the World

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It has long been recognized that small and medium enterprises (SMEs) are a potentially powerful tool for economic growth and poverty reduction. There have been several broad brush studies conducted in recent years that seek to examine this insight for the entire SME sector. However, these studies are not based on actual analyses of how growing SMEs actually effect such development. As an SME investor in challenging and emerging markets over the last 18 years, SEAF offers a global portfolio that is ideally suited for investigating this impact based on actual “on-the-ground” data.

In 2004, SEAF published a report that measured and analyzed the developmental impacts of ten of its SME investments in emerging markets. The report looked beyond traditional financial returns to assess the impacts of growing SMEs on the lives of employees and other stakeholders in the local economy. Based on positive feedback on the report and an expressed interest in seeing SEAF expand its analysis to a broader pool of companies, SEAF has prepared this report, which presents the cumulative analysis of almost 50 SMEs in the SEAF portfolio.

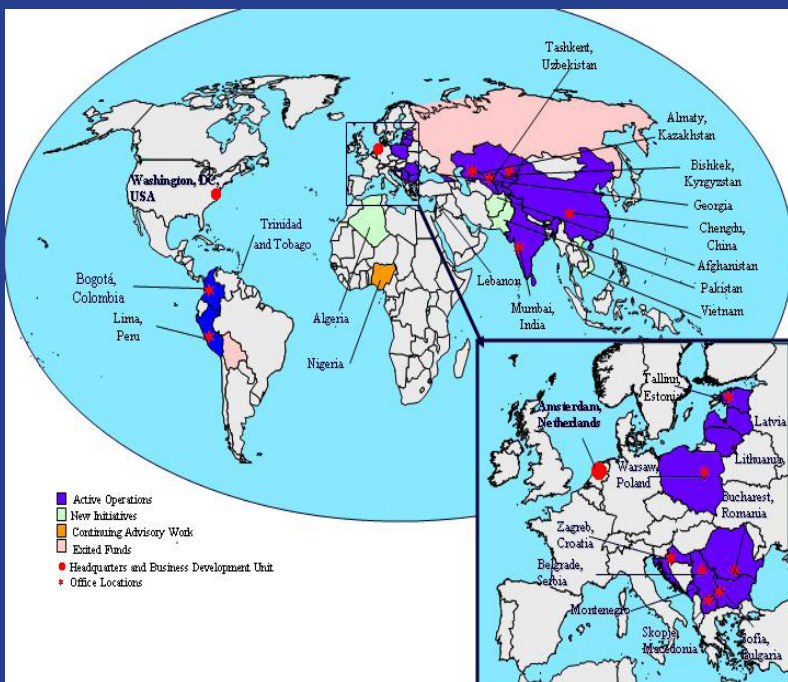
Building on the experience of the 2004 study, SEAF has been able to collect new and broader data. As opposed to the 2004 study, which was backwards looking, SEAF has been able to establish monitoring criteria on an ex ante basis, allowing for a more direct insight into how investments in SMEs throughout the world have reduced poverty and improved the lives of the many stakeholders affected by the SMEs in question. The new analysis has also permitted SEAF to better understand and document the multiplier effect of SME investing and the benefits going especially to poor and low-skilled workers. It has also helped SEAF to better quantify and understand other significant impacts of SMEs, the most compelling being the role that SMEs can play in building the capacity of local suppliers and micro-entrepreneurs, by serving as an “aggregator” of such suppliers that would otherwise lack access to larger, even global markets.

About SEAF

Headquartered in Washington, D.C. with 19 offices worldwide, SEAF is a global investment management firm that provides risk capital to small and medium enterprises (SMEs) in emerging markets. SEAF selectively invests in locally-owned SMEs with high growth potential through equity participation and appropriate fixed-term risk capital instruments. As an active, long-term partner with its investees, SEAF also provides appropriate business support through its local staff and global network. SEAF's objective is to generate commercial returns for its investors by leveraging its investment approach, institutional experience, and the insights of local staff, while achieving superior development impact in the communities and countries in which it is engaged.

SEAF-sponsored investment funds focus on SMEs in areas of global economy that commercial venture funds typically overlook because of their relatively remote location, small market size, lack of other investors and perceived exit opportunities in the market, cultural differences, or other comparatively high market risks. SEAF has repeatedly found that with its investment experience and a solid understanding of the local market, attention to smaller, high potential companies in developing economies can generate positive returns. SEAF's experience demonstrates that SMEs frequently have significant competitive advantages—including an ability to build leadership positions through differentiated products and services, as well as sustainable cost advantages derived from local human and other resources.

Founded in 1989 as part of the international humanitarian organization CARE, SEAF spun off in 1995 to focus solely on investments while retaining its core economic development mission. Since then, SEAF has sponsored and managed 23 private equity funds totaling more than \$400 million in capital, investing in 29 countries in Central and Eastern Europe, Asia, and Latin America. To date, SEAF's total invested capital exceeded \$175 million through 249 completed SME investments.



Critical to SEAF's long-term success has been its ability to identify promising investments in challenging economic and political environments and to achieve successful exits. To date, SEAF had achieved full and partial exits from 147 investments, generating a gross multiple of 1.7 times invested capital in US dollars.

Investors in SEAF-managed funds include multilateral and bilateral development finance institutions, pension funds, insurance companies, banks, and high net worth individuals (see Annex 3 for a representative list of investors).

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Special thanks are due to all of the investors in SEAF funds (listed in Annex 3), which have invested in SEAF funds worldwide. Their continuous support has enabled SEAF to carry out its commercial and developmental mission.

This report has been prepared by SEAF headquarters staff in Washington D.C., led by Stephanie Komsa (Project Manager), with support from SEAF country offices. Special thanks are due to SEAF Chief Executive Officer Bert van der Vaart, SEAF Chief Operating Officer Mildred Callear, and former SEAF Executive Vice President of New Business Development MinhChau Nguyen, all of whom provided valuable guidance and support to make this report possible. SEAF also gratefully acknowledges Claudia Berg (Research Analyst) and Constantine Bogdan (Deputy Director, SEAF Trans-Balkan Romania Fund), who assisted with the design of the survey and preparation of survey materials from the SEAF-Romania office, and all other SEAF staff members in the field who assisted with interviews and data collection.

Executive Summary

It has long been recognized that SMEs can be a potentially powerful tool for economic growth and poverty reduction. Several studies conducted in recent years have taken a relatively undifferentiated view of the entire SME sector, often including micro-enterprises and spanning various countries. However, none of these studies examines specific experiences at the actual SME level and how SMEs actually effect economic development. SEAF believes that without a specific understanding of what happens at the SME level, any top-down correlation analysis risks misunderstanding the mechanism by which SMEs grow and impact their communities. SEAF in particular believes that there is a subset of SMEs that are extraordinarily growth-oriented; namely, those SMEs willing to accept third party capital in order to grow. It is this subset of SMEs that SEAF believes has a profound impact on the economy. *As an SME investor in challenging and emerging markets over the last 18 years, SEAF offers a broad portfolio that is ideally suited for investigating this impact based on actual “on-the-ground” data.*

In 2004, SEAF published a report that measured and analyzed the development impacts of ten of its SME investments, five rural and five urban, in Latin America and Central Europe.¹ The report deployed methodology, developed by the International Finance Corporation (IFC) for project finance appraisal, that looks beyond traditional financial returns to assess the impacts of growing SMEs on the lives of employees and other stakeholders in the local economy. The 2004 Study showed that, on average, every dollar invested in the companies generated an additional ten dollars in the local economy. It also demonstrated that SMEs tend to hire and train low-skilled workers and promote from within, demonstrating that SMEs generate jobs appropriate for the low-skilled poor, which can be a very effective tool for poverty alleviation.

Based on positive feedback on the value of the first study and an expressed interest in seeing SEAF expand the study to a broader pool of companies, SEAF has since conducted a data survey of 40 companies and 8 new in-depth case studies. The report herein presents the combined results of the data survey, the original case studies, and the new case studies—in total, a pool of 49 companies.²

The results of SEAF’s efforts support the conclusions of the 2004 Study: investing in SMEs can result in significant economic development and poverty alleviation. Building on the experience of the first study, however, SEAF has been able to collect broader and more meaningful data that in fact demonstrate a stronger impact than previously understood. The new analysis has led to improved figures delineating the multiplier effect of SME investing and the benefits going particularly to low-skilled workers. This analysis has helped SEAF to better quantify and capture other significant impacts of SMEs, particularly the role that SMEs can play in building the capacity of local suppliers and micro-entrepreneurs and in providing them with access to larger and higher value-added markets. The following summarizes these new and improved findings:

¹ This report is published on SEAF’s website, www.seaf.com. It is hereinafter referred to as the “2004 Study”.

² Forty companies in the data survey, 10 original in-depth case studies, and 8 new in-depth case studies. Some of the case studies overlap with the data survey.

Greater Multiplier Effect Than Previously Understood

- The combined set of 18 case studies shows that every dollar invested generates, on average, an additional **12 dollars** in the local economy.
- The results can also be presented in terms of an Internal Rate of Return (IRR). The 18 companies profiled generated an average Economic Rate of Return (ERR), which includes both the financial and quantifiable social returns, of **66 percent**, versus an average Financial Rate of Return (FRR), which includes returns to financiers only, of **21 percent**.
- This multiplier effect is experienced among multiple stakeholders—including employees, suppliers, competitors, producers of complementary goods, the local community, and the broader local economy—to a greater extent than captured previously.

Improved Data on the Impact on the Lives of Employees

- The data survey and the additional cases have reinforced the conclusion that SMEs tend to hire and train low-skilled workers and promote from within, demonstrating that SMEs can generate jobs appropriate for the poor and can be an effective vehicle for achieving poverty alleviation.
- The 2004 Study concluded that approximately two-thirds of employees are unskilled or semi-skilled, but the more recent data survey shows that in fact **72 percent** of new jobs generated go to unskilled or semi-skilled employees.
- The data survey also shows that SEAF companies have sustained an average annual employment growth rate of **26 percent** and a wage growth rate of **25 percent** in US dollar terms, by far surpassing national growth rates for each country.
- Almost all employees at the surveyed companies (**83 percent**) receive health and pension contributions from their employers. This is because SMEs are formal companies that contribute on behalf of their employees to social programs, in countries in which such programs exist, and in many cases provide ancillary discretionary benefits.
- **85 percent** of the SMEs surveyed provide formal internal or external training to their employees.
- Case study interviews confirm that employees are grateful for the stability and security of their jobs. Employees have been able to provide a better life for their families, qualify for loans against their predictable salaries that allow them to invest in their homes or education for their children, or save for the future. A major factor in this asset accumulation is the perceived stability of their jobs, the training and promotions they have received, and their confidence in their enhanced job skills and the future of their employers.

Better Understanding of the Role of SMEs as “Aggregators” of Micro-Suppliers

- Through the data survey, SEAF found that each SME—through its purchase of inputs—supports an average of **331** other local businesses, broken down as follows: **18** manufacturers, **10** distributors, **20** service providers, **3** equipment suppliers, and **280** micro-suppliers and farmers, with a high of **6000** farmers and micro-suppliers for one investee.

- Moreover, the SMEs surveyed generated an annual average of **\$3 million** in business for domestic suppliers in 2005, representing an average of **45 percent** of revenues.
- Of the companies surveyed, **27 percent** have extended trade credit or other forms of financing to their local suppliers—a generally underestimated multiplier effect.
- Case study interviews with the management of SEAF investees and their suppliers provide numerous examples of SMEs serving to address the barriers that micro-suppliers face by operating as collection centers, value-added processors, and distributors to higher value markets, as well as by providing their suppliers with technical and financial support.
- The above data demonstrate that SMEs truly function as “market aggregators” for farmers, micro-entrepreneurs, and other small suppliers; in other words, SMEs serve as a critical link to connect smaller suppliers with customers farther up in the value chain.

Meaningful Benefits to Other Stakeholders

- Armed with the experience of the 2004 Study, SEAF has better captured the benefits that SME investing generates for other stakeholders. Based on the 18 case studies, of the 12 dollars generated per dollar invested, more than **\$4.92—or 41 percent**—benefits *those outside the enterprise*: consumers, competitors, producers of complementary goods, local communities, and local governments.
- Rooted in their local communities, the entrepreneurs and their SMEs are positioned to identify unmet local consumer demands and, with the help of financing and strategic support, work with other stakeholders to address market deficiencies. Case studies have provided numerous examples in which customers receive greater choice, improved quality, or lower prices and in which competitors benefit from demonstration and spillover effects.
- SMEs make valuable contributions to their surrounding communities—as a percentage of revenues, these contributions are on par with Fortune 100 companies. Based on the survey, each SME contributed an annual average of almost **\$3,000** to charities and other local community causes in 2005.³ Such support has included contributions to local infrastructure and support for orphanages, community events, and other charitable causes.
- As formal enterprises, all surveyed companies contribute taxes to local governments, in the form of corporate income tax, net VAT, and other taxes—averaging **7 percent** of revenues in the year 2005.

Other Impacts of SEAF’s Investments

- Companies surveyed have shown significant improvements in formalization and corporate governance through their involvement with SEAF.

³ This represents approximately 0.1 percent of their revenues in 2005. While at first glance this may seem insignificant, it is comparable to the corporate giving of the Fortune 100 companies. Among 40 members of the Fortune 100 that completed a corporate giving survey, the total median giving (cash and in-kind donations) in 2005 as a percentage of revenues was 0.14 percent. See <http://www.corporatephilanthropy.org/research/pubs/GivinginNumbers2006.pdf>.

- As a condition of SEAF’s investment, **30 percent** of the companies surveyed adopted formal corporate structures with boards of directors or equivalent oversight bodies for the first time (the remaining 70 percent had such structures before partnering with SEAF).
- SEAF prompted **26 percent** of the companies surveyed to obtain third party audits (with the other companies receiving audits by SEAF or already having third party audit practices in effect).
- As a result of SEAF’s investments, many companies have gained access to global markets for the first time. Since SEAF’s investments in the surveyed companies, there has been a **75 percent** increase in the number of companies that export.
- Among the companies that export, a number have been able to acquire ISO, organic, or other industry certifications with the help of SEAF and have been able to export higher value products to a new and expanded customer base.
- On average, every dollar invested by SEAF has leveraged an additional **\$1.63** from other financiers (debt and equity). We believe this leverage is a result of each SME’s formalization, improved performance, and the added equity cushion from SEAF’s investments.

Conclusions and Policy Implications

As with the findings from the 2004 Study, the results of the data survey and additional case studies suggest that when private investors, socially responsible investors, or development institutions invest in SMEs, there are quantifiable and substantial improvements in terms of socioeconomic growth, stability, and poverty reduction.

The 2004 Study proposed that Development Finance Institutions (DFIs) could undertake a mixed approach to development—targeting both development and financial returns—by expanding their support for private investment focused specifically on local SMEs. The report also offered ways in which policy makers and investors could leverage the beneficial effects of SMEs on economic growth and poverty reduction, such as using SME entrepreneurs as a cost effective channel to deliver poverty-reducing services, identifying effective poverty programs, and cultivating socially responsible entrepreneurs and sectors. The findings from our recent data surveys and further case studies also support these recommendations.

Additionally, this report presents the following specific guidelines for those DFIs and socially responsible investors that are interested in pursuing such a two-pronged approach:

- **Invest in enterprises with high growth potential.**⁴ The results presented herein demonstrate that supporting SMEs with high growth potential can generate significant and sustainable development impact. Whether or not the existence of a vibrant SME sector as a whole is an important foundation for economic growth and poverty alleviation, SEAF’s

⁴ By “high growth potential”, we are not targeting, for example, conventional “high growth” sectors such as telecommunications and software, although such sectors may be very positive as well. Rather, we are referring to SMEs whose owners/entrepreneurs are interested in growing their businesses and demonstrate the potential to do so, regardless of the sector, whether it be fish farming, distribution of fast moving consumer goods, or other sectors in which opportunity presents itself.

studies show that its portfolio of companies (those that pass the review and due diligence of a seasoned fund manager and are willing to accept third party capital to pursue growth) generate attractive financial returns, demonstrate strong development performance in terms of indicators related to employees, suppliers, and other stakeholders, and make other important developmental contributions that are less easily quantified, such as addressing market deficiencies, bringing micro-suppliers into the value chain, and making profound differences in the lives of employees. It is hoped that DFIs and other investors can benefit from this study in designing their strategies for identifying, investing, and supporting the more promising, growth-oriented SMEs.

- **Use the combination of the data survey and case study approach to measure development impact.** If SME investing is done to achieve development impact, it is imperative that the impacts be measured. There is an interest and growing effort in the SME development field to develop a common methodology for measuring the social value of investments. SEAF has already designed, tested, and institutionalized a data survey tool that allows important impacts to be quantified. Complemented by the case study approach, we believe we have also been able to capture significant non-quantifiable impacts, of which policy makers in development should equally be aware. We hope that the experience and results of SEAF's development impact initiative will serve the enterprise development community in creating common metrics and approaches for measuring the social impact of SME investment and SME support programs. For this purpose, SEAF discusses its methodology in Chapters 1 and 2 and includes the form used to collect survey data in Annex 1.
- **Explore the possibilities of targeting investments to achieve development goals and motivating fund managers to meet development benchmarks.** Based on the data survey and case studies, we have a solid understanding of the concrete (and quantifiable) impacts that SMEs can have on stakeholders in the local economy. This information can allow development-oriented investors to maximize development impact by incentivizing the targeting of SMEs with specific characteristics, depending on specific development priorities and goals (for instance, impact on suppliers and micro-suppliers versus impact on employees, tax collection, or impact on consumers). Moreover, with a system to track and measure development indicators, it is now possible for investors to establish development benchmarks that a fund should be expected to achieve.⁵ Such quantifiable objectives allow investors to measure and reward specific achievements, not just financial returns. In Chapter 4 we discuss how to appropriately structure such incentives.
- **By focusing attention on the “Market Aggregator” concept, this report suggests a specific “poverty reduction” mechanism, which may sustainably link microfinance borrowers with scalable and sustainable growth.** There has been increasing concern that micro-borrowers are unable to scale up and sustainably improve their revenues. Given the amount of capital now flowing into microfinance institutions (MFIs), the Market Aggregator model suggests a specific channel that would connect micro-borrowers to growing regional and even international markets. Such a channel would allow many micro-suppliers to expand their revenues and profits, and ultimately join the formal sector.

⁵ SEAF's 2004 Study was taken into account by the Millennium Challenge Georgia, working in concert with the Millennium Challenge Corporation (MCC), in devising explicit development criteria, which together with a financial carried interest incentive, provided SEAF (as the Fund Manager selected to manage the Georgia Regional Development Fund) with tangible incentives to maximize desired development objectives. See website, Millennium Challenge Georgia (www.mcg.ge).

With this report, SEAF aims to help policy makers, donors, investors, and others working in the development community better understand SMEs and their potential as drivers of economic growth and development. SMEs are often referred to as “the missing middle”. SEAF hopes that this report demonstrates more tangibly the meaning, as well as the significance, of this concept. As this report shows, SMEs provide reliable and quality employment within their local communities, function as a critical link and aggregator for smaller local suppliers, reliably address market deficiencies and customer needs in the local economy from the “bottom up”, serve as an example to other companies, and ultimately become the drivers of tomorrow’s economy.

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Chapter 1. Data Survey Results

Overview

In late 2004, SEAF launched an ongoing data survey to track socioeconomic indicators for its investees. On a semi-annual basis, we sent SEAF's data collection form (see Annex 1) to SEAF's field offices in Eastern Europe, Asia, and Latin America. To date, three rounds of historical data have been collected from 40 companies in ten countries. To best capture the various economic impacts of SME investment, SEAF collected data on employment, wages, benefits, training, suppliers, customers, taxes, community development, formalization, and corporate governance. In this chapter, we provide an overview of the pool of companies surveyed and present the results of the latest survey (in which SEAF collected data through calendar year 2005) as follows:

- Growth in job opportunities
- Wage growth
- Provision of non-salary benefits
- Impact on the poor
- Development of job skills
- Opportunities for women
- Impact on suppliers
- Benefits for customers
- Contributions to local communities
- Impact on rest of society

Some of the most compelling findings are summarized in the box below:

Box 1. Stakeholder Impacts

Employees

- 26% compounded average annual employment growth since SEAF's initial investments.
- 72% of new jobs generated since SEAF's initial investments have gone to unskilled or semi-skilled employees.
- 25% compounded average annual wage growth in US dollar terms since SEAF's initial investments.
- 83% of employees receive health and pension benefits.
- 85% of the SMEs provide formal internal or external training to their employees.

Suppliers

- An average of \$3 million per investee generated in business for other local companies in 2005 (equal to roughly 45% of revenues for the year).
- Each SME—through its purchase of inputs—supported an average of 331 other local businesses in 2005, broken down as 18 manufacturers, 10 distributors, 20 service providers, 3 equipment suppliers, and 280 micro-suppliers and farmers, with a high of 6,000 farmers and micro-suppliers for one investee.
- 27% of the companies surveyed have extended trade credit or other forms of financing to their local suppliers.

Rest of Society

- Each SME sells to an average of approximately 580 business customers (among those with businesses as customers) or 2,400 individual end users (among those with individual end users as customers).
- All SEAF SMEs surveyed contributed taxes to local governments, averaging 7% of revenues in the year 2005.
- Each surveyed SME contributed an average of almost \$3,000 to local charities and other community activities in 2005.

Formalization and Improved Business Practices

- 30% of companies did not have a Board of Directors or equivalent until SEAF invested (the remaining 70% had such structures prior to their partnership with SEAF).
- 26% of the companies were prompted to obtain formal third party audits (others are audited by SEAF or already had audit practices in effect).
- Since SEAF's investments in the surveyed companies, there has been a 75% increase in the number of companies that export.
- Every dollar invested by SEAF has leveraged, on average, an additional \$1.63 provided by other financiers.

Survey Pool

SEAF surveyed a total pool of 40 companies spanning 10 countries, collecting historical socioeconomic indicators for each year beginning with the year prior to investment through the end of the year 2005. The pool of companies used in each analysis presented in Table 1 ranges from 28 to 40, depending on the availability and reliability of data for each company for a given indicator. In all cases when we compare initial data with year 2005 data to assess change over time, we exclude two new companies for which we have data for only one period.

When analyzing what we refer to as “Initial Year” data, we are using the year prior to SEAF’s investment or, in cases in which that is not available, the year of investment or a more recent year. When analyzing what we refer to as “Year 2005” data, we use 2005 data for active companies, but for exited companies we use the most recent year of data collected (usually the year of exit, which is the year 2005 or earlier).

Data from SEAF’s more mature funds (i.e., the countries with the longest average number of years invested), such as Croatia, Romania, and Macedonia, may provide a better sense of the long-term impact of SME investments. SEAF notes the specific results for these countries for some of the analyses in this report.

Growth in Job Opportunities

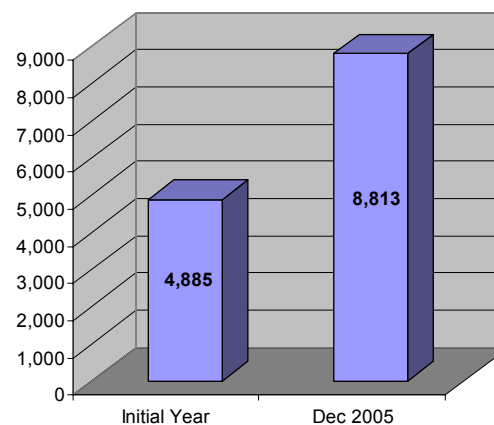
Our analysis of job creation confirmed that SMEs generate significant employment. As seen in Figure 1, employment at 38 companies has grown from a total of 4,885 in the Initial Year to 8,813 as of December 2005.⁶ This represents an average compound annual growth rate (CAGR)⁷ of **26 percent**.⁸

As can be seen from Table 2 on the following page, all of the Funds except for Bulgaria have had strong positive impact on employment

Table 1. Surveyed Portfolio Companies

Country	Portfolio Companies		Average Number of Years Invested
	Active	Exited	
Bulgaria	5	0	3.0
Croatia	6	1	3.6
Kazakhstan	1	0	1.2
Kyrgyzstan	1	0	1.4
Macedonia	4	0	3.9
Peru	3	0	0.7
Romania	5	2	2.8
Uzbekistan	3	0	1.8
China	8	0	1.0
India	1	0	0.5
	Total 40		Av. 2.3

Figure 1. Growth in Number of Employees



26% compound annual growth rate, based on the average number of years invested

Source: Survey data from 38 companies

⁶ These figures exclude two new portfolio companies for which we have data for only one period. The total number of employees in 2005 for all 40 companies is 11,964.

⁷ The Compound Annual Growth Rate (CAGR) is the year-over-year growth rate of an investment over a specified period of time.

⁸ This is the CAGR for the change in the total number of employees for the 38 companies, based on the average number of years SEAF has been invested in the 38 companies (2.6 years).

growth⁹. The Central Asia portfolio (Uzbekistan, Kazakhstan, and Kyrgyzstan) has the highest annual growth rate. This fund consists primarily of start-up companies and, although it is anticipated that the annual growth rate in employment may taper off as time passes, it is still expected to be significant. SEAF’s more mature portfolios—Croatia, Romania, and Macedonia—have healthy average annual employment growth rates of 15, 23, and 18 percent respectively. These funds likely best reflect the long-term impact of SME investments.

Table 2. Employment Change of Sampled Firms by Country

Country	Number of Companies	Average Number Years Invested	Initial Year Number of Employees	Year 2005 Number of Employees	Compound Annual Growth Rate
Bulgaria	5	2.6	383	391	1%
Croatia	7	3.4	224	366	15%
Romania	7	3.4	1,512	3,061	23%
Macedonia	4	4.0	171	330	18%
Central Asia*	5	1.2	90	268	148%
Peru**	1	2.0	104	331	78%
China	8	1.5	1,926	3,331	44%
India	1	1.0	475	735	55%
Total	38	2.6	4,885	8,813	26%

* Includes investments in Uzbekistan, Kazakhstan, and Kyrgyzstan.

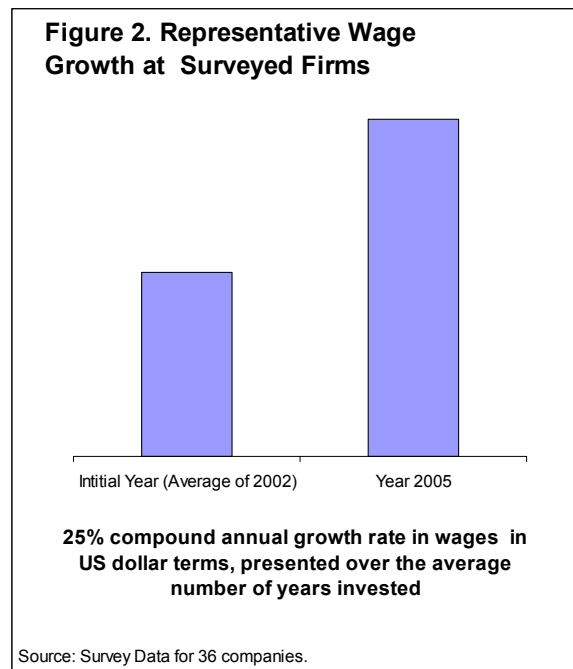
** Excludes two new investments.

Wage Growth

In analyzing the direct benefit of wages paid and wage growth history at SEAF’s portfolio companies, we examined two main aspects: wage growth since the time of SEAF’s investments and how the companies’ wages compare to the national average. We compare how wages differ by skill and gender in later sections entitled “Increasing Job Opportunities Suitable for the Poor” and “Creating Opportunities for Women”.

Wage Growth Sustained Since SEAF Invested

In analyzing the wage growth of SEAF investments, we examined the change in the average wages (gross annual wages including



⁹ The impact on employment growth of the Bulgaria portfolio was slowed by the inclusion of one new investment with negative employment growth (resulting from its restructuring to improve profitability and make future growth possible). Given this company’s relatively large number of employees (falling from 155 in 2004 to 72 in 2005), it out-weighed the positive employment growth at the four other Bulgarian companies.

bonuses) for 36 companies.¹⁰ As shown in Figure 2, we found that the average wages for the 36 companies grew at a weighted average CAGR of **25 percent** in US dollar terms.¹¹ The weighted average CAGR in local currency terms was 21 percent.

All but three of the 36 companies (an exited company in Romania, a start-up company in Uzbekistan, and a company in China) have experienced steady upward trends in average wages since the time of SEAF’s investments. Even for these three companies, while the wage impact appears to be negative, a closer analysis demonstrates that it is not. Wage growth within each skill group (unskilled, semi-skilled, and skilled) was positive within each of the three companies, but only because the number of unskilled employees increased so significantly at these companies over the investment period (at a rate of more than twice than that of semi-skilled and skilled employees), the overall average wage went down. Thus, we consider the wage impact for these three companies to be positive because they have created new jobs along with steady wage increases for each set of skill levels. This data reflects SEAF’s findings from the case studies that SMEs tend to hire more unskilled workers than larger companies or government/NGOs, and that SMEs have to train these employees to become productive (see “Developing Job Skills” section). As employees become more productive, entrepreneurs also begin to pay them more. As the rate of hiring new employees slows down at these firms, we expect that the overall wage growth will become positive as well.

Company vs. National Average Wage

Besides wage growth, we compared the average wage for each company to national average wages. We found that for a pool of 38 companies,¹² the companies’ wages were, on average, approximately **37 percent higher** than the national average wage in 2005.¹³ We found that 20 companies (or 53 percent) have wages above the national average wage, 15 (or 39 percent) are below the national average wage, and 3 (or 8 percent) are on par with the national average wage. In analyzing the characteristics of the companies with average wages below the national average, we found that these companies have high proportions of unskilled and semi-skilled workers. These companies have an average of 80 percent semi-skilled and unskilled-skilled workers, and unskilled workers alone comprise the majority of employees at five of these companies. Given our findings that SMEs tend to hire unskilled workers and train and promote from within (and thus provide wage

Table 3: Unemployment Rates, 2005

Bulgaria	11.5%
Croatia	18.0%
Macedonia	37.2%
Romania	6.3%
Kazakhstan	8.1%
Kyrgyzstan	NA
Uzbekistan	0.7% officially but estimated at 25% unofficially
Peru	7.6%, with widespread underemployment particularly in rural areas
China	9.0%
India	8.9%
<i>Source: Economist Intelligence Unit</i>	

¹⁰ We excluded four companies from the pool: two new companies without separate initial and current wage data and a start-up company without historical wage data, and one company for which we have insufficient wage data.

¹¹ Investment periods for the pool of companies in this analysis range from 1 to 6 years. To give more weight to those companies in which SEAF has been invested longer, we therefore weigh the wage CAGR for each company by the number of years invested. The average number of years invested for the 36 companies is 2.67 years.

¹² We excluded two companies for which we had insufficient data.

¹³ This is a simple average of the premium (percentage over the national average wage) of each company.

increases), we expect that, as the rate of hiring new employees slows down, the average wages at these companies will increase and eventually surpass the national average wage.

The countries in which SEAF typically invests have high levels of unemployment, as can be seen in Table 3. Thus, even though in some cases wages are below the national average wage, there is still a positive impact of providing employment with a steady paycheck for otherwise unemployed unskilled and semi-skilled workers.

Non-Salary Benefits

As with formal enterprises in the West, it is expected that many of the surveyed SMEs would provide their employees with health, pension, and other benefits, as well as stable salaries that cover vacation and sick time.

Our analysis showed that, in 2005, all but one of 40 companies provided employees with benefits. Given that some of the companies do not provide benefits to all employees, we also conducted an analysis of the number of employees receiving benefits. We found that **83 percent** of employees at the 40 firms received health insurance and pension benefits in the year 2005.¹⁴

This percentage of employees receiving benefits in the year 2005 is up from just 70 percent in the Initial Year of investment, resulting from the fact that a number of companies have begun providing benefits or increased the portion of employees receiving benefits since the time SEAF invested. Five of the companies in the survey have significantly increased the percentage of people receiving health and/or pension benefits from the time of SEAF's investment. For example, one company in Peru has, with SEAF's encouragement, increased the percentage of employees receiving health and pension contributions from 5 percent to 95 percent in one year. Even the one company that did not provide benefits in 2005 has begun to do so in the year 2007. Given the increase in the percentage of employees receiving benefits and the employment growth at the companies (see "Growth in Job Opportunities"), the number of people receiving non-salary benefits at the 40 companies has increased significantly since SEAF's investment: from 6,536 to 9,899.

Box 2. SMEs provide health, pension and other benefits to employees:

- **83%** of employees receive health insurance and pension contributions from their employers
- **37%** of companies provided additional benefits.



Fifteen of the companies (**37 percent**) provided their employees with benefits beyond what is required by law in 2005 (i.e., benefits in countries in which no such requirements exist or benefits in addition to those required by law in countries in which such requirements do exist). Such benefits include private health insurance and pension plans (also included in the above analysis), as well as on-the-job accident insurance, Christmas gift certificates, on-the-job meal tickets, company phones, and company cars. Three of the companies, all in Central and Eastern Europe,

¹⁴ Depending on the health and pension system in the country, the company's contributions may go to individual employee accounts or to general government pools on behalf of the employee.

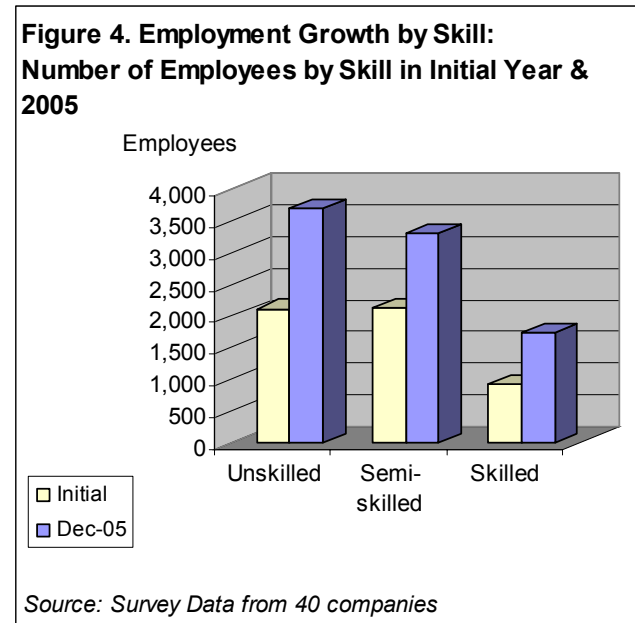
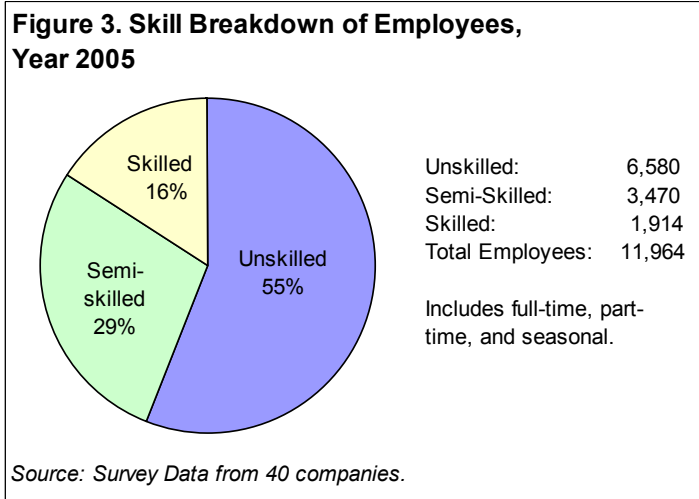
are providing private health insurance in addition to any public health insurance contributions required by law. SEAF case studies have also shown that many of the employees did not receive benefits at their previous jobs or were previously unemployed.

Increasing Job Opportunities Suitable for the Poor

As of December 2005, **84 percent** of the jobs at the 40 surveyed firms go to unskilled and semi-skilled workers (see Figure 3 to the right). This percentage has been generally consistent since the Initial Year of investments.

Moreover, most of the new jobs created since the Initial Year have gone to unskilled and semi-skilled workers. For the 38 companies, **72 percent** of new jobs went to unskilled and semi-skilled workers.¹⁵ Figure 4 demonstrates visually the new jobs generated

per skill level. These data demonstrate that SMEs generate jobs suitable for the poor, and then train many of these employees on the job.



We also found that wages for unskilled and semi-skilled employees have been steadily increasing since the time that SEAF invested, partially attributable, we believe, to the fact that SMEs train unskilled and semi-skilled employees, making them more productive and leading to higher wages. All but 4 of 34 companies¹⁶ had positive wage growth for unskilled employees. Of these 4 exceptions, 2 had no change and 2 had only a slight decline of approximately 5 percent per year. All but 5 of the companies had positive wage growth for semi-skilled employees, and of these 5 exceptions, 2 had no change and 3 had negative growth. Overall, unskilled and semi-skilled average wages grew at a CAGR in US dollar terms of 18 percent

¹⁵ Excludes the two new Peru companies.

¹⁶ Six companies were excluded from the skill wage analysis: one did not provide reliable wage data, two exited and did not supply gross wage data broken down by skill, and three were recent investments with only one year of data available.

and 19 percent respectively.¹⁷

Developing Job Skills

Training received during employment is a substantial asset for employees as it permits wage increases and a skill mobility premium. All of the surveyed companies provide training to their employees. The cost of training varies and is not always easily quantifiable.

Among the 39 companies that provided data on training, 33 (or **85 percent**) have provided their employees with formal training—either internal or external—since SEAF’s investment. Formal training ranges from external courses to in-house instruction from experts and managers on various topics. Of these, 29 companies provided their employees with external training and 15 provided employees with internal or on-the-job training (11 provided both).

Box 3. SMEs tend to hire and train from within:

- **85%** of the SMEs provide formal or informal training to their employees
- **\$4,256** per company spent on external training in 2005
- **9.4%** of employees promoted in 2005



Twenty-nine companies provided data on formal expenditures on training in 2005. These companies expended a total of \$123,432, an average of **\$4,256 per company** (this figure does not include the less tangible on-the-job training which undeniably occurs as well).

Although the survey structure does not allow for data collection to link the training specifically to promotions and salary increases, we did track the number of promotions, defined as an increase in responsibility and salary, at each company. We found that for the 37 active companies that provided data on promotions, 1,000 employees out of a total of 10,608 (**9.4 percent**) were promoted in 2005.

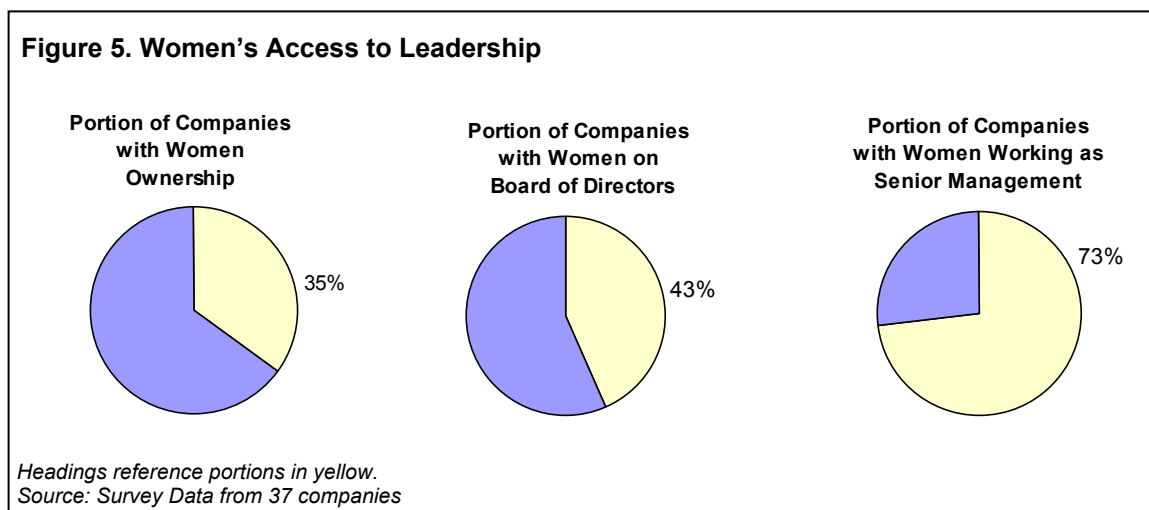
Although the training and promotion data are not necessarily directly correlated, we know from our case studies (in which individual employee interviews were conducted) that many employees credit their training for their promotions. The survey data and case study results on training and promotions together suggest that SMEs invest in training their employees and that they promote from within. SEAF believes the explanation is that SMEs have a more difficult time attracting skilled personnel than do larger companies and as a result they compensate for this by investing in training for their own (initially less skilled) employees. Although the countries surveyed have relatively high unemployment rates (making labor easy to find), we learned from our in-depth case study field research that it is nevertheless very difficult to find skilled labor (see Table 6 for unemployment rates in the surveyed countries).

¹⁷ This is the average of the CAGR for each company weighted by the number of years invested and by the number of employees.

Creating Opportunities for Women

Access to Capital and Leadership Positions

As of December 2005, 13 of the 37 active companies (**35 percent**) had women owners. The percentage ownership at these 13 companies ranged from 1 percent to 40 percent. Sixteen (**43 percent**) of the companies in our sample had women on the board of directors or an equivalent supervisory board. The representation of women on the board of directors at each of these 16 companies ranged from 2 percent to 66 percent. Women made up a much larger percentage of senior management among the companies in our sample. In 2005, women were working as senior managers in 27 of the companies (**73 percent**). At these companies, women comprised between 20 percent and 67 percent of senior management positions, averaging 34 percent per company. See Figure 5 below.



The above data speak well of the role that women play in the leadership of the surveyed companies when considered in light of other data, such as that for more industrialized and developed countries. According to Fortune Magazine, there are ten female CEOs in the Fortune 500 (2 percent of companies) and ten female CEOs in the Fortune 501-1000 group (also 2 percent of companies).¹⁸

The survey data suggest that SMEs are more likely to hire and promote the best people they can find on an objective basis, possibly due to the relative lack of prestige and greater progressiveness of SMEs versus that of large and established companies or government institutions. In this category as well, SMEs are more likely to provide a greater choice for individuals who are not connected to powerful families or who do not attend prestigious schools. The result seems to be positive from the standpoint of providing opportunity and growth regardless of gender.

¹⁸ Fortune Press Center, April 3, 2006, see http://www.timeinc.net/fortune/information/presscenter/fortune/press_releases/20060403_fortune500.html.

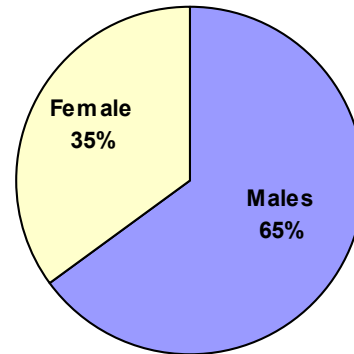
Access to Employment Opportunities

In 2005, women comprised **35 percent** of employment at the 37 active companies. This is slightly higher than the percentage in the Initial Year, which was 32 percent. These data would suggest that SMEs in general understand that discrimination against women is not likely to be in their interests, or stated differently, that there is every reason to hire and promote the best qualified people they can find, regardless of gender.

Wage Equality

As part of our study, we examined how average female wages compared to average male wages at each company. We found that in 2005, for a pool of 37 companies, women were earning on average **7 percent** less than men.¹⁹

Figure 6, Breakdown of Employees by Gender, 2005



Source: Survey data from 37 companies

At most of the companies (regardless of whether men or women earn more), average wage disparities were not caused by wage differences of men and women within the same skill group. Rather, average wage disparities were more often due to the relative proportions of men and women within a skill group. For example, in a company in which there are relatively more men in low-skilled positions and relatively more women in management, women will earn more than men on average.

Opportunities to Advance

As mentioned above in the “Developing Job Skills” section, we are tracking the number of employees promoted at each company. We found that women at the surveyed SMEs received a proportional number of promotions relative to the overall gender breakdown of employment. In 2005, for the 36 active companies that provided a gender breakdown of promotions data, women accounted for 36 percent of employment and received **30 percent** of the promotions for the year. Similarly, in the Initial Years of investment for the same pool, women made up 33 percent of employment and received 35 percent of promotions.

Impact on Suppliers

Through our survey, we found that SEAF’s investments have generated business for other companies in the local economy. In our data collection form (see Annex 1), we track the percentage of cost of goods sold (COGS) and capital expenditures going to other domestic businesses²⁰ and the number of domestic suppliers by type.

¹⁹ This is a simple average of the wage disparity for each of the 37 companies. Includes data for 2004 on one of the exited companies and excludes three other companies (two exited companies and one company for which wage data by gender was not available).

²⁰ Among COGS and capital expenditures going to other domestic businesses, we include purchases of goods and services from any domestic company and exclude only purchases (goods and services) directly from companies located abroad. We include local importers/distributors of imported goods because there is still a financial benefit going to these companies. We found it is also clearer to exclude only items and

Generating Revenues for Other Local Companies

For the 32 portfolio companies that provided data on the topic, we found that approximately **59 percent** of COGS and capital expenditures went to other domestic businesses in 2005. The remainder of cost of goods sold and capital expenditures went to internal wage bills and to purchases of goods and services directly from abroad. In absolute dollar terms, these 32 companies generated \$98 million in business for other domestic companies in the year 2005, or an average of approximately **\$3 million** per portfolio company. Given the relatively small per company turnover for each of the SMEs surveyed, this constitutes a significant amount. In percentage terms, **45 percent** of revenues of the surveyed companies goes to other domestic businesses (i.e., every dollar of sales generates approximately \$0.45 for other domestic companies). Overall, the data demonstrate a significant spillover effect of SEAF's investments to other domestic companies. When combined with the larger portion of expenditure taken up by the internal SG&A, SMEs would seem to provide a powerful domestic economic multiplier effect.

Aggregation of Suppliers

We found that a wide range of domestic companies benefits from business generated. The 35 companies on which SEAF has a breakdown of number of suppliers (30 survey companies plus 5 case study companies from the 2004 Study) sourced from over **11,500** domestic suppliers. Each SME supports, through its purchase of inputs, an average of **331** domestic companies, broken down as follows:

- **18** manufacturers;
- **10** distributors;
- **20** service providers;
- **3** suppliers of equipment; and
- **280** farmers and micro-suppliers, ranging as high as **6,000** for one of SEAF's investees.

These results demonstrate that SMEs truly serve as “market aggregators” for farmers, micro-entrepreneurs, and other small suppliers; in other words, SMEs serve as a critical link to connect smaller suppliers with customers further along in the value chain. As stated in the introduction, micro-entrepreneurs and smallholder farmers generally face challenges in accessing markets, understanding the sophisticated and changing demands of global consumers, and producing and distributing products competitive for global supply chains. Without the larger SMEs acting as processors and marketers to access these larger markets, it may be questioned whether these micro-suppliers would be able to take advantage of the positive business opportunities that exist in a global market.

Box 4. Supplier Impact:

- Every dollar of sales generates approximately **\$0.45** for other domestic companies.
- On average each SME, through its purchase of inputs, supports **18** manufacturers, **10** distributors, **20** service providers, **3** suppliers of equipment, and **280** micro-suppliers and farmers
- **25%** of SMEs have extended financing to their domestic suppliers.



services purchased directly from abroad, rather than setting guidelines on what imported goods to include or exclude based on value added by other domestic companies.

Providing Support to Domestic Suppliers

Lastly, **27 percent** of the companies in our sample (10 out of 37 portfolio companies that provided data on the topic) have extended trade credit or other forms of financing to their domestic suppliers. Support has included trade financing and cash advances. In addition, we know from our in-depth case studies that some of our companies have provided technical assistance to suppliers and have helped them to improve the quality of their products (see Chapter 2).

Box 5. Molino, Grain Processor: Helping Suppliers to Access Finance

Molino's purchase of grain from small farmers constitutes a market receivable, which can then be used as collateral to obtain agricultural loans to increase production. Interviews with farmers indicate that without these loans, they would not have been able to expand beyond self-sufficiency.

Photo: Farmer's house in Ayacucho financed after sales relationship with Molino.



Benefits for Customers

From an economic perspective, the impact on customers is properly measured by consumer surplus. Formally, however, consumer surplus is difficult to quantify because it requires estimation of price elasticity and the demand and supply curves for the overall market. To at least understand the scope of customers impacted, rather than the scope of impact on each type of customer, SEAF tracks the number and types of domestic customers. Among the companies surveyed that sell to business customers (i.e., sale of goods or services to corporate customers or intermediary businesses²¹), each sells to an average of approximately **580** companies. Among the companies surveyed that sell directly to individual end users, each sells to an average of approximately **2,400** customers.²²

Box 6. Mako Market: Providing Supply Benefits for Corporate Customers

Macedonian portfolio company Mako Market, a fast moving consumer goods producer and distributor, has been supplying to Tinex, a Macedonian supermarket chain, for several years. A Tinex manager told SEAF that it values Mako Market's ability to meet its orders consistently and on a timely basis, as well as its unique buyback guarantee. Tinex buys a large variety of products from Mako Market and plans to increase its purchases and Mako Market's shelf space allocation.



Tinex's store in Skopje



Vienna: Mako Market's new chocolate spread

²¹ For instance, a producer or distributor that sells to retail stores rather than directly to end consumers.

²² Thirty six of the 40 surveyed companies serve business customers. Of the 37, we exclude from the calculation 5 companies without data and 1 company that is a startup not yet with customers. Two of the companies export 100 percent of their products to foreign businesses, but we do not exclude them from the calculation of the average (they are counted as having zero domestic business customers). Twelve of the 40 surveyed companies sell directly to individual end consumers. Of the 12, we exclude from the

The following breakdown of the goods and services provided to customers among the 40 surveyed companies helps to demonstrate how businesses and customers benefit from the value-added products and services they provide:

Breakdown of the Goods and Services Provided to Business Customers among Surveyed Companies:

- Production of food products for distributors, supermarkets, and other retailers;
- Distribution of food products to supermarkets, mini-markets, kiosks and gas stations;
- Distribution of produce and semi-processed produce to processing companies;
- Farming of fish for sale to supermarkets;
- Production of packaging for food processing companies;
- Catering services for retail chains, hotels and restaurants;
- Production of office and school supplies for distributors and corporate customers;
- Distribution of office and school supplies to retail chains and retailers;
- Distribution of mobile phone products to small retailers;
- Leasing of cable and internet lines to corporate customers;
- Provision of software (ranging from basic computer applications to ERP software) and IT services for private businesses (including car dealerships, distribution companies, and retailers), schools, and government agencies;
- Storage and distribution of fuel products for fuel distributors;
- Production of stone products (e.g., granite tiles and countertops) for retailers;
- Installation of electrical infrastructure for industrial and corporate customers;
- Manufacture of electronic spare parts for distributors, small repair shops and industrial businesses.
- Manufacture of valves for industrial production companies; and
- Manufacture of water treatment equipment for water treatment plants.

Breakdown of the Products and Services Sold Directly to Individual End User Customers among Surveyed Companies:

- Coffee and ice cream;
- Stationery;
- Cable and internet services;
- Mobile phone products;
- Photography products;
- Stone and stoneware products;
- Hotel accommodations;
- Supermarket products; and
- Snack foods.

While the above data and breakdown of the goods and services of the surveyed companies provides a sense of the scope of benefits to customers, SEAF's case studies demonstrate in more depth exactly how customers benefit from lower prices, greater supplier reliability, wider choice, or improved quality (see Chapter 3).

calculation two companies without data and two companies that are outliers (a company with approximately 50,000 customers and another with approximately 440,000 customers). Eight companies are included in both pools because they have both business and individual customers.

Impact on National Governments

We found that SEAF's investments play an important role in generating revenue for their countries' governments, which can then be spent on priorities that benefit the broader local society, such as local infrastructure, health services, and education. Unlike micro-enterprises and other small, informal businesses, due to their size, status, and visibility, SMEs must comply with local tax filing requirements. **All** of the surveyed companies pay some form of taxes to their local governments, including corporate income taxes (once the company begins generating positive net income), Value Added Taxes (VAT), import duties, employee income tax withholdings, and other taxes. For a pool of 36 active portfolio companies, approximately **7 percent** of revenues were paid to the local governments in the form of taxes in 2005.²³ This is consistent with the historical data for prior years, which has been in the 7-10 percent range. SMEs constitute the first level of formality in most economies, which provides for sustainability of responsible governments and increasing accountability, both from the perspective of the enterprise to its government, as well as ultimately from the government to the enterprise. In addition, through income tax withholdings, employees also enter the formal system and become part of the country's tax base.

Box 6.

Taxes: Unlike informal businesses, **all** of the surveyed SMEs contribute taxes to local governments (corporate income taxes, VAT, employee tax withholding, and/or others). Average of **7%** of revenues paid as taxes in 2005.



Formal businesses (left) are more likely to pay taxes than informal businesses (right).

Growth in Exports

Empirical evidence demonstrates that SEAF has helped its portfolio companies to connect with the global market. A number of the companies in which SEAF has invested have begun exporting or have increased their exports since SEAF's initial investment date. Out of a set of 36 companies with historical and current export data, eight companies exported at the time of SEAF's investments, and 14 companies export today. This represents a **75 percent** increase in the number of companies exporting. Six of the eight that exported at the time of SEAF's investments have substantially increased their export revenues. Table 4, which presents the historical export revenues of the surveyed companies, shows that in addition to an increase in the number of companies exporting, there has been a significant increase in both the dollar amount exported and the percentage of revenues derived from exports. These figures have increased since the initial investment dates, as well as since last year.

²³ This figure of seven percent excludes government subsidies received by the companies. The three Peruvian companies receive export subsidies and therefore have negative net contributions to the government.

Table 4. Export History

	Initial Year	Year 2004	Year 2005
Number of companies exporting	8	12	14
Total exports	\$2.4 million	\$7.3 million	\$12.1 million
Average export revenue per company (among those that export)	\$305,990	\$604,978	\$870,105
Average exports as a percent of revenues (among those that export)	10%	12%	19%

Source: Survey Data from 36 companies

SEAF believes that its role in helping companies to enter export markets or to expand their customer base in export markets is significant. Even companies that do not export are affected by the standards and efficiency of transformation achieved in the global and regional markets. By helping companies with this initial step forward to build competitiveness and an understanding of how to operate in global markets among global competitors, SEAF portfolio companies will continue to grow long after SEAF exits and thus contribute more significantly to their country's competitiveness long after SEAF exits.

Impact on Business Practices and Corporate Governance

The data collection process has also helped us to ascertain that investment by third parties into SMEs will also tend to help companies to formalize their business practices and improve governance.

- **Formalizing Corporate Structures:** Prior to SEAF's investments, **30 percent** of the companies (12 out of 40) did not have a formal board of directors or equivalent oversight body. All of these companies were required to establish a board of directors or equivalent oversight body prior to SEAF's investment. Interestingly, even after SEAF's exit, former portfolio companies still maintain such board or equivalent bodies today.
- **Institutionalization of Third Party Audits:** **26 percent** of the companies (10 out of 39) had never received formal third party audits until SEAF invested (all SEAF investments are required to have annual third party audits).
- **Adopting global or national industry standards:** **10 percent** of the surveyed companies (or 4 out of 39) have acquired ISO or other industry certifications since the time that SEAF invested.

Contributions to Local Communities

SEAF's research has shown that SMEs, even those in the early stages of growth, make charitable contributions to their local communities. In 2005, for 28 active companies that provided data on the topic, total annual charitable contributions (cash and in-kind) were \$80,424, equal to an average of **\$2,872 per company**. This represents approximately 0.1 percent of their revenues in 2005. While at first glance this may seem relatively insignificant, it is comparable to the corporate giving of the Fortune 100 companies as found in a survey conducted by CorporatePhilanthropy.org²⁴. Contributions have included donations of cash and in-kind support

²⁴ Among 40 members of the Fortune 100 that completed a corporate giving survey, the total median giving (cash and in-kind donations) in 2005 as a percentage of revenues was 0.14 percent. See <http://www.corporatephilanthropy.org/research/pubs/GivinginNumbers2006.pdf>.

for orphanages, retirement homes, anti-drug programs, sports events and sports clubs, town festivals, cultural events, and other good causes. For example, Perpetuum, an information technology company in Croatia, sponsors the Dubrovnik Summer Arts Festival, an association for the blind, and a local youth soccer team.

From the case studies, we found that SMEs make other valuable contributions to local communities through their operational activities, which are not captured in the figures above. Examples include: Artima, a Romanian supermarket chain which has contributed to the local infrastructure in the areas surrounding its stores; Gica, a Macedonian egg producer that restored an abandoned farm and built an access road shared by the local neighborhood; and PPZP, a Polish breeder of pigs that has made its own clean water system accessible to the neighboring village in rural northwest Poland. These examples and others are expanded upon in Chapter 3.

Despite the fact that SMEs are small, we believe they make contributions to their local communities because they are rooted in their communities and understand where even limited contributions can make a meaningful impact.

Improvement in Access to Capital

Based on a pool of 25 companies, for every dollar invested by SEAF, **\$1.63** was invested by other financial institutions (\$0.67 in equity and \$0.97 in debt). SEAF was indeed critical in helping to bring these other equity investors to the table, as the concept of third party financing was no longer alien to the local entrepreneurs, and SEAF's presence was of comfort to the new equity investors. Third party debt financing is spread out among 17 companies. SEAF's role in bringing in these debt investors was important also, as the equity cushion makes it more feasible for banks to lend by providing a stronger equity cushion and potential collateral in the form of assets acquired with the equity investments. SEAF's insistence on improving the financial accounting and control functions of its investees means that banks can be assured of the reliability of the financial information they receive. Most of the companies that have not received third party financing are more recent investments, and we expect that these companies will obtain third party financing as the investment matures.

Table 5, Non-SEAF (Third Party) Financing Provided to Companies

Pool of companies	25
Companies receiving third party financing	17
Companies receiving third party debt financing	17
Companies receiving third party equity financing	6

Conclusion

The portfolio-wide data collection project is proving to be an effective means to verify on a larger scale the conclusions from our 2004 Study and to further quantify and understand the development impact of investing in SMEs on a routine and efficient basis. The case studies explore in detail the impact across stakeholders for a select set of companies, and these broader data collection results help to demonstrate that the case study conclusions do likely hold on a wider scale. By continuing to track this data on a yearly basis and gradually increasing the pool of companies that SEAF monitors, we hope to build an even deeper understanding of the role that SMEs can play in development.

The picture that has emerged from the data is that growth-oriented SMEs are able to perform effectively within the political and economic contexts in which they operate and, in doing so,

connect employees, suppliers, customers, and governments. As the first stage of formality, SMEs are critical to their local and national governments, not only as payers of taxes and social security, but also as accountable counterparties for compliance with environmental, health and safety, and labor regulations. SMEs tend to hire unskilled and low-skilled people—often those without family connections or coming from poorer backgrounds. SMEs must train these employees to be able to compete with larger and global rivals, with the result that its employees gain skills, and therefore substantial increases in compensation. As demonstrated by SEAF’s financial performance (see “About SEAF” at the beginning of this report), SMEs—particularly SMEs that are open to accepting third party financing and the corporate governance and accountability that comes with such capital—can achieve high growth rates. In becoming successful and sustainable enterprises, they provide increasing value and choice to their customers, suppliers, and to people seeking employment in the communities in which they are located. In each of the foregoing ways, as well as those detailed throughout this chapter, SMEs are critical in providing greater hope and stability for the future of the developing world.

Chapter 2. Case Studies: Estimating the Multiplier Effect

Overview

In the venture capital and private equity industries, returns to investors are typically measured with an Internal Rate of Return (IRR), which is a type of annual rate of return on the amount initially invested.²⁵ Returns to investors can also be expressed as Net Present Value (NPV), which is the dollar amount generated over the life of the investment expressed in present value terms.²⁶ While the results of the Data Survey provide valuable measures of the socioeconomic impact of SEAF's investments beyond the financial returns, they do not clearly demonstrate to investors the full return or multiplier effect that they are achieving with their investments (that is, the financial return plus the additional, external social returns) in terms of the traditional industry measurements.

It was with this in mind that SEAF, thanks to the generosity of the Swiss Secretariat for Economic Cooperation and Development (SECO), the Ford Foundation, and the UK Department for International Development (DFID), conducted its case study work for the 2004 Study. SEAF conducted 10 in-depth case studies allowing it to estimate the social impact of its investees, incorporate them into a financial cash flow model for each company, and estimate the multiplier effect of SME investments in financial terms. The 2004 case study results showed that every dollar invested in the profiled companies generates on average an additional 10 dollars in the local economy²⁷.

Since 2004, SEAF has conducted 8 additional in-depth case studies. The combined result of the original 10 case studies and the 8 new case studies confirms the significant multiplier effect of the 2004 Study: ***On average, for all 18 cases, every dollar invested in the profiled companies generates 12 dollars in the local economy***²⁸. This reaffirms that SME investment can be a powerful vehicle for economic growth and poverty reduction

Each case study includes both a qualitative and quantitative component—the former to better understand the role that SMEs can play in the local economy and what the specific impacts of SMEs are, particularly those that are not quantifiable, and the latter to understand the scope of the impact, or the multiplier effect, vis a vis traditional financial returns. This chapter presents the methodology used for the quantitative component of the case studies, the selection of companies profiled, and further details and analysis of the quantitative results. The qualitative impacts are covered in Chapter 3.

²⁵ Internal Rate of Return: The rate of return that would make the present value of future cash flows plus the final market value of an investment equal the current market price of the investment.

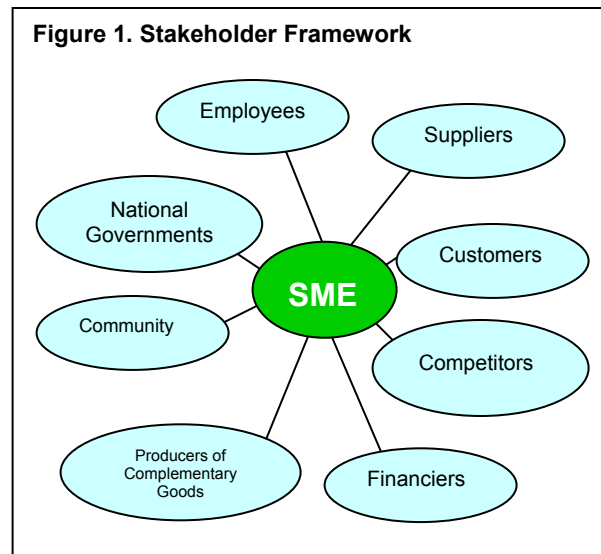
²⁶ Net Present Value: The present value of an investment's future net cash flows minus the initial investment.

²⁷ The case studies demonstrated a number of other benefits which were too difficult to quantify reliably, but which were nevertheless real benefits of the investment. SEAF used conservative assumptions for many of the key quantified benefits as well.

²⁸ At a zero percent discount rate.

Methodology

SEAF's methodology for calculating the multiplier effect is based on an IFC model devised by Frank Lysy.²⁹ The model uses a stakeholder framework to analyze the socioeconomic externalities of each investment, by individually assessing the impact on each broad category of stakeholders—or groups—that are affected by SEAF's investments: financiers, employees, customers, suppliers, competitors and new entrants, producers of complementary goods and services, the local community, and national governments (see Figure 1).



The benefits to financiers (debt and equity investors) are captured in terms of a traditional IRR, based on the traditional cash flows of the company, expressed as what the Lysy model refers to as the Financial Rate of Return (FRR). The benefits to additional stakeholders are then quantified and incorporated into the cash flow model for the company. These cash flows are used to calculate what the Lysy model refers to as the Economic Rate of Return (ERR), which captures the combined benefits to financiers and the additional stakeholders.

The financial and social cash flows can also be used to calculate a net benefit/cost ratio—that is, the net dollar benefit to stakeholders divided by the total amount invested in the company. This figure provides the dollars generated per dollar invested referred to in the “Overview” section of this chapter and elsewhere in this report. In line with traditional Net Present Value (NPV) methodologies used in finance, the Net Economic Benefit/Cost Ratio can be discounted into present value terms to adjust for risk and inflation. SEAF has made such adjustments and presents its results on the following pages at a zero percent discount rate and a ten percent discount rate, in order to allow the reader to consider the range of impact at various costs of capital.

As stated above, with the calculation of the multiplier effect using case studies, it is theoretically possible to complement the results of the Data Survey by presenting social impacts in a format consistent with and comparable to traditional measures of financial performance. The information required to quantify such social impacts, however, is significantly more extensive than that obtainable through the Data Survey's information collection form alone.

The model requires that all impacts be quantified as incremental dollar benefits to stakeholders. For employees, for example, this requires interviewing employees to understand what their income or job situation *would have been* had they not been employed by the SME, and only counting the increment of what they are being paid over what they estimate they would have otherwise received. For suppliers or corporate customers, it means gaining an understanding of

²⁹ See “Assessing Development Impact,” Frank Lysy, International Finance Corporation, 1999.

how their revenues and earnings would compare if they did not do business with the SME. For end customers, it requires an estimation of the price savings or dollar value of other benefits of the products of the SME, if able to be estimated at all. To gather the information required to calculate these estimates, SEAF conducted field visits, interviews with company management, employees, and other stakeholders, and focused macro-economic and market research.

For additional information on SEAF's methodology, please refer to Annex 2.

Selection of Case Studies

As described above, the methodology required to estimate the impact of investing in SMEs requires extensive information gathering. As such an extensive effort would not be practical or cost effective to make for every company in the SEAF investment portfolio, the case studies serve as a representative set of the overall SEAF portfolio. Out of a portfolio of approximately 250 companies (active and inactive since inception), SEAF selected the 18 companies shown in Table 1 for the intensive case studies.

Table 1. Case Study Companies

Company	Country	Core Business	Investment Date	SEAF Investment (US dollars) ³⁰
Cases from 2004 Study (10 companies)				
Artima	Romania	Supermarket Chain	2003	3,096,525
Fideos	Bolivia	Organic and Gluten-Free Pasta and Snack Producer	2002	410,000
Ken-4	Bulgaria	Meat Processor	1995	594,299
Molino	Peru	Grain Mill	1997	312,921
PPZP	Poland	Pig Farm	1993	1,194,455
Printop	Peru	Industrial Ink Producer	1997	330,000
Symbio	Poland	Organic Produce Distributor	1998	357,103
Tambo Inca	Peru	Flour Mill	1999	808,000
Telezimex	Romania	Electronic Components Distributor	2001	279,312
Victoria Classics	Peru	High-End Clothing Manufacturer	1999	245,000
New Cases (8 Companies)				
DCM	Croatia	Cable Television and High-Speed Internet Provider	2001	4,164,067
Perpetuum	Croatia	Software Distributor	1999	255,000
Gica	Macedonia	Chicken, Egg, and Animal Feed Producer	2003	1,000,000
Mako Market	Macedonia	Fast Moving Consumer Goods Distributor	2002	1,100,000
Aqua Tudakul	Uzbekistan	Fish Farmer and Processor	2004	232,290
Business Leasing	Uzbekistan	Commercial Leasing Company	2004	1,200,000
Sabare	India	Textile Manufacturer & Supplier of Home Furnishings	2005	6,799,637
BFW	India	Machine Tool Manufacturer	2005	5,666,634

³⁰ As of December 31, 2005.

The selection of companies was made based on data availability and the willingness of the entrepreneurs and employees to participate. Within this framework, however, SEAF sought to select a set of companies for the case studies that would be representative of the overall SEAF portfolio in terms of firm characteristics, geographical and industry sector diversity, and investment performance.

As can be seen in Table 1, the set of companies selected for the case studies includes firms from each region of the world in which SEAF operates (Central and Eastern Europe, Latin America, and Asia) and a balanced mix of firms operating in urban and rural areas. The 18 cases also compare relatively well to the overall SEAF portfolio in terms of firm size, investment size, and investment performance. For consistency, because case studies are based on data through December 31, 2005, SEAF compares them to SEAF-wide data for its active funds as of December 31, 2005. As shown in Table 2, the cases compare reasonably well to the overall SEAF portfolio of active SEAF funds in terms of number of employees and gross IRR to SEAF, and, when the two India companies (BFW and Sabare) are excluded from the case study pool, also in terms of annual revenues and investment size (case study figures are slightly higher than the SEAF-wide figures but are still generally reflective of the kinds of investments SEAF makes).

Table 2. Comparison of Case Studies to Overall SEAF Portfolio of Active Funds*

	SEAF-wide Averages (for Active SEAF Funds)	Averages for Set of 18 Case Studies	Averages for Case Studies excluding 2 Indian companies
Annual Revenues	\$5.4 million	\$13.0 million	\$6.9 million
Number of Employees	150	169	110
Investment Size	\$773,000	\$1.4 million	\$791,130
Gross IRR to SEAF	19%	22%	22%

*Based on December 2005 data or earlier year of exit.

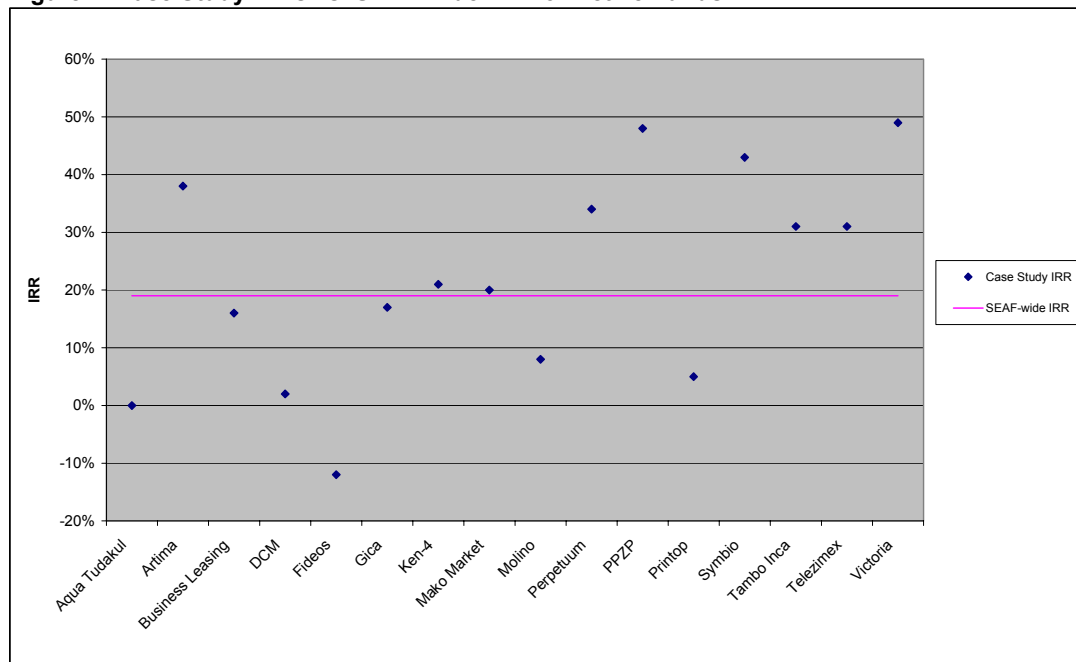
**Realized and unrealized IRR. Note that the SEAF-wide IRR for active funds as of December 31, 2006 is 21 percent, which is well in line with the case study IRRs. The IRR for the case studies is the same as the IRR for the case studies excluding the two India companies because the India companies' IRRs are not available for 2005 (see explanation in text below).

The two India enterprises studied are somewhat larger than SEAF's typical investment, in terms of investment size, revenues and number of employees. Although these enterprises are still SMEs³¹, the objectives of the India Growth Fund as well as the larger size of the Indian market and capital needs provides for a relatively larger range of "SMEs" in the Indian context versus in other SEAF countries. The IRR for the case study pool including the two India companies is the same as that when excluding them because IRRs for the two Indian companies were not available in 2005 (investments were made in year 2005 and investments are held at cost in the first year). However, it should be noted that as of December 31, 2006, the realized and unrealized IRRs for the two India companies, BFW and Sabare, were valued at 95 and 24 percent respectively, due to strong growth and performance, which would bring the overall average IRR for the 18 cases up from 22 percent to 26 percent. These figures are, however, still reasonably similar to the SEAF-wide IRR for active funds as of December 31, 2005 (and in fact quite close to the SEAF-wide IRR for active funds as of December 31, 2006, which is 21 percent). Nonetheless, in the "Results" section below, SEAF presents the case study results excluding BFW and Sabare as a supplement to the results for all 18 cases.

³¹ Sabare was awarded the title of "SME of the Year" in the Textile Category during CNBC's Emerging India Awards in 2006.

While the average IRR for the case studies is slightly higher than that of the overall SEAF portfolio, the IRRs of the case studies provide a good mix of those above and below the SEAF-wide average, as can be seen in Figure 1. Again, it is also worth noting that the SEAF-wide IRR for active funds as of December 31, 2006 is 21 percent, which is in line with the average December 31, 2005 IRR for the case studies. The IRRs for SEAF's investments tend to increase with time, as the benefits of an investment are typically most noticeable after the first three years, whereas SEAF's portfolio at any one time will tend to be an average holding of approximately two years.

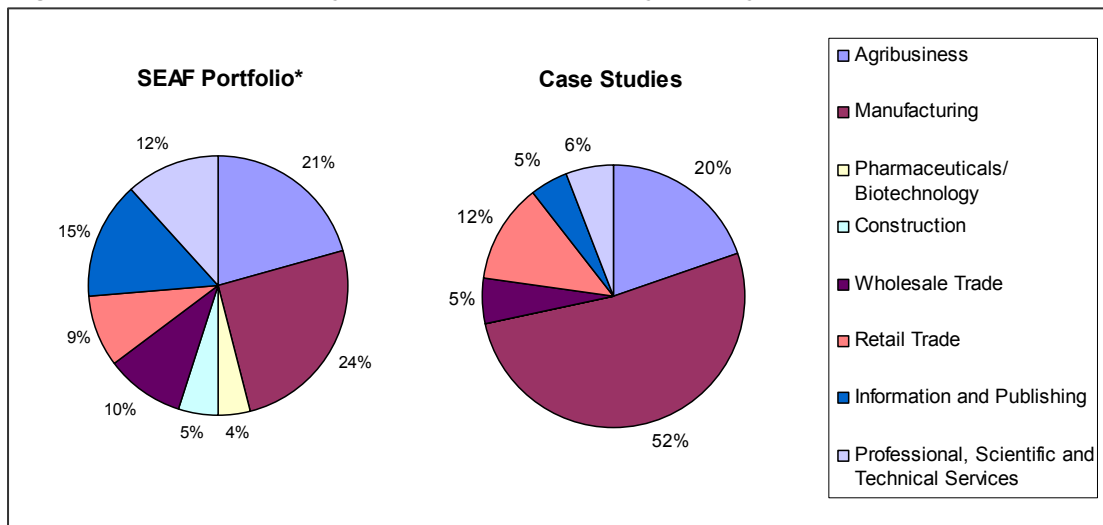
Figure 1. Case Study IRRs vs. SEAF-wide IRR for Active Funds*



*SEAF-wide Realized and Unrealized IRR for active funds as of December 31, 2005. The two Indian companies are excluded here because the IRRs for December 31, 2005 are not available (see above for explanation).

The set of case studies is also generally comparable to the overall SEAF portfolio in terms of industry breakdown, as shown in Figure 2. The relatively higher proportion of manufacturing among the case study pool versus the overall SEAF portfolio is due to the India companies (because the breakdown is based on dollars invested).

Figure 2. SEAF-wide Industry Breakdown vs. Case Study Industry Breakdown



Breakdown based on dollars invested as of December 31, 2005.

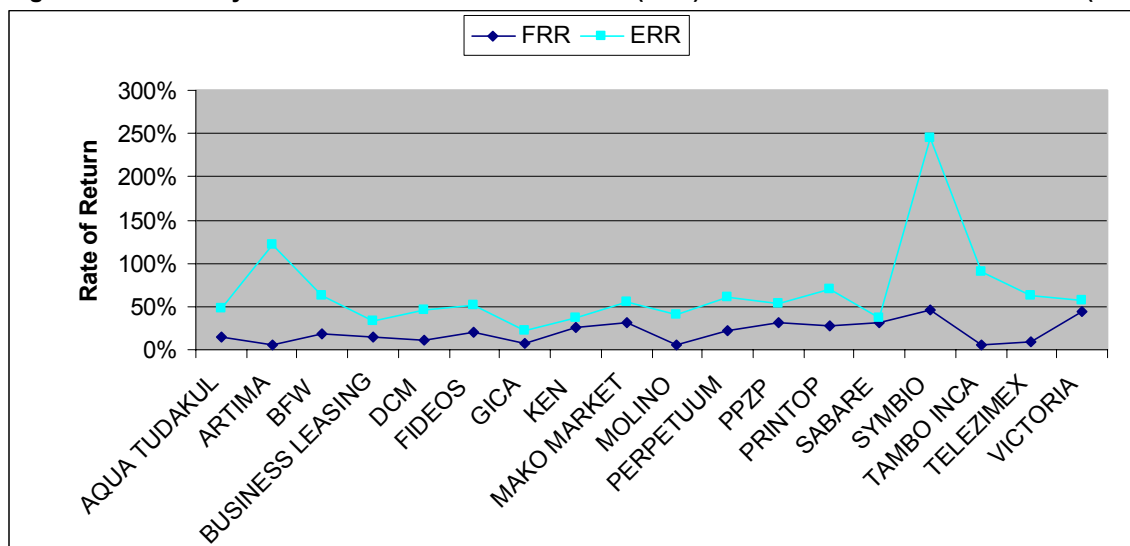
Since the set of case study companies is broadly representative of the overall SEAF portfolio, we believe that the results of the case studies are also representative of the overall SEAF portfolio. As mentioned above, because the characteristics of the two Indian firms are less reflective of the overall SEAF portfolio, SEAF notes the case study results excluding the two firms in the section below.

Results

Using the methodology described above, the overall results of the case studies are significant, demonstrating that SME investment can be a powerful vehicle for economic growth and poverty reduction. ***On average across all the case studies, each dollar invested by SEAF generates an additional \$12 in the local economy***³². Expressed in terms comparable to an IRR, the 18 case study companies generated an average Financial Rate of Return (FRR) of **21 percent** and an average Economic Rate of Return (ERR) of **66 percent**. Figure 3, which plots the FRR and ERR for each investment, visually demonstrates the economic impact that goes beyond financial returns.

³² At a zero percent discount rate. At a discount rate of 10 percent, the result is \$6 dollars per dollar invested.

Figure 3. Case Study Results: Financial Rate of Return (FRR) versus Economic Rate of Return (ERR)



The results are presented on a company-by-company basis in Table 3. The IRR to SEAF measures the return on the investment made by the respective SEAF fund only. The IRR is derived from SEAF’s valuation of the realized and unrealized value of the investment based on European Venture Capital Association (EVCA) methodology. The FRR measures the private returns to all of the financiers of the company (the local partner, SEAF, and other debt and equity investors in the company). The ERR measures the return to all of the financiers of the company and society at large. The Net Economic Benefit/Cost Ratio, which represents the dollars generated for financiers and society at large for each dollar invested, is shown for each company at a discount rate of zero (presented at additional discount rates in Table 4).

It should be noted that the EVCA-based SEAF IRR and the case study results are based on analysis as of December 31, 2005 or earlier. Although SEAF updates its EVCA-based IRR calculations on a semi-annual basis, it was not feasible to update the case study calculations due to the complexity of information gathering and analysis, as indicated in the “Methodology” section above. However, it should be noted that many of the EVCA-based IRRs for SEAF have changed since December 31, 2005. We note the revised IRRs in the case study summaries included in Chapter 3 and conclude that the development impact (expressed as ERR) has changed accordingly. Again, we note that the SEAF IRR differs from the FRR because the FRR measures the financial returns to *all* financiers, not just to SEAF.

Table 3. Case Study Results: Financial and Economic Returns of SEAF Portfolio Companies

Company	Country	SEAF investment year	Internal Rate of Return to SEAF	Financial rate of return (%)	Economic rate of return (%)	Net economic benefit/ cost ratio at 0% discount
Aqua Tudakul	Uzbekistan	2004	0%	14%	47%	7.14
Artima	Romania	2002	38%	6%	122%	6.81
BFW	India	2005	NA	18%	62%	22.80
Business Leasing	Uzbekistan	2004	16%	14%	33%	4.48
DCM	Croatia	2001	5%	11%	46%	2.80
Fideos	Bolivia	2002	-12%	21%	51%	11.82
Gica	Macedonia	2003	17%	8%	22%	5.86
Ken-4	Bulgaria	1995	21%	26%	37%	16.12
Mako Market	Macedonia	2002	20%	31%	55%	15.95
Molino	Peru	1997	8%	6%	40%	4.23

Perpetuum	Croatia	1999	34%	23%	61%	23.53
PPZP	Poland	1993	48%	32%	54%	14.34
Printop	Peru	1998	5%	27%	70%	10.14
Sabare	India	2005	NA	32%	37%	22.61
Symbio	Poland	1998	43%	46%	245%	14.86
Tambo Inca	Peru	1999	31%	6%	90%	3.75
Telezimex	Romania	2001	28%	9%	62%	24.17
Victoria Classics	Peru	1999	49%	45%	57%	4.54
Average				21%	66%	12.00
Average excluding India case studies				20%	68%	10.66

As seen in the table above, all of the SMEs in the set have achieved a significant economic rate of return. Even in investments with relatively low FRRs, such as Fideos, Printop, DCM³³ and Molino, we observe notable economic impact.

When we exclude the companies from India, which are larger than the typical SEAF investment and have had superior financial performance (as of December 31, 2006), the average FRR, ERR, and Net Economic Benefit/Cost Ratio are still strong, at 20 percent, 68 percent, and 10.66 respectively.

The Net Economic Benefit/Cost Ratio is presented in Table 4 below at a 0 percent discount rate and at a 10 percent discount rate, so that the reader may understand the impact across a range of costs of capital:

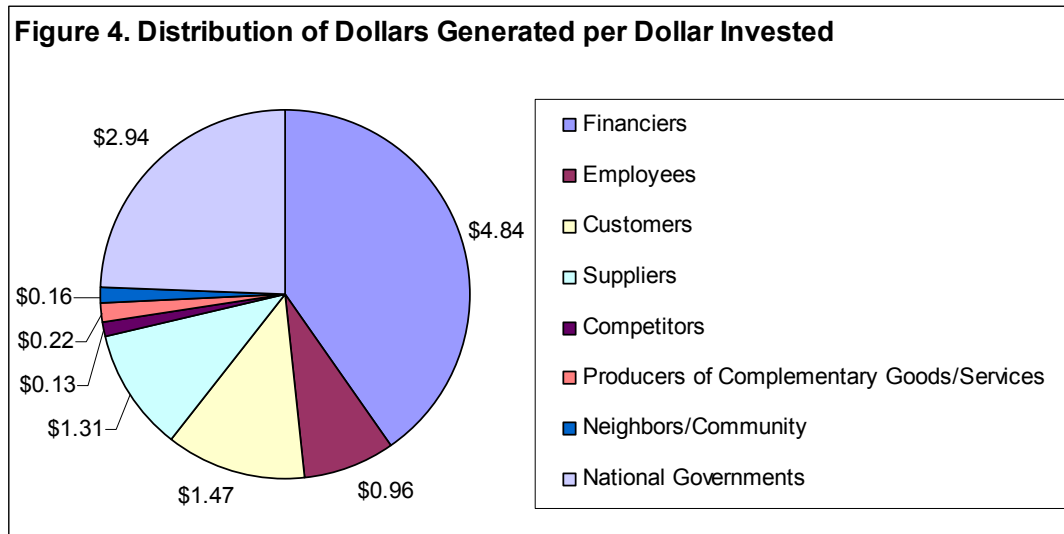
Table 4. Net Economic Benefit/Cost Ratios

Company	Country	At 0% Discount	At 10% discount
Aqua Tudakul	Uzbekistan	7.14	3.38
Artima	Romania	6.81	3.94
BFW	India	22.80	14.80
Business Leasing	Uzbekistan	4.48	0.32
DCM	Croatia	2.80	1.46
Fideos	Bolivia	11.82	5.37
Gica	Macedonia	5.86	2.09
Ken-4	Bulgaria	16.12	5.94
Mako Market	Macedonia	15.95	10.04
Molino	Peru	4.23	2.54
Perpetuum	Croatia	23.53	9.43
PPZP	Poland	14.34	5.00
Printop	Peru	10.14	6.41
Sabare	India	22.61	12.54
Symbio	Poland	14.86	10.90
Tambo Inca	Peru	3.75	2.28
Telezimex	Romania	24.17	8.65
Victoria	Peru	4.54	2.90
Total		12.00	6.00
Total Excluding India Cases		10.66	5.04

³³ Despite a low FRR for this company, SEAF exited the company successfully and the company is performing well. The company's revenues have increased from \$6.4 million in 2005 to \$9.04 million in 2006. SEAF successfully exited from DCM, earning a multiple of 1.5x its capital and an IRR of 8 percent.

Distribution of Impact among Stakeholders

As seen in Figure 4, the economic impact expressed as dollars generated per dollar invested are spread throughout the stakeholders in the respective local economies. The highest proportion of the impact goes to financiers (40 percent), followed by the national governments (25 percent), which consists of tax payments to local governments. The remainder is distributed among the rest of the stakeholders, with approximately 30 percent of the impact spread evenly among customers, suppliers, and employees and with approximately 5 percent spread evenly among producers of complementary goods and services, neighbors/community, and competitors/new entrants.



It should be noted that SEAF observed some impacts that could not be incorporated into the quantitative model due to the inherent difficulties of quantifying certain impacts. Benefits to customers, competitors and new entrants, and producers of complementary goods are particularly difficult to quantify. For example, Artima—a supermarket chain—set up stores in second and third tier cities throughout western and northwestern Romania, bringing convenience and affordable quality products to people who previously did not have easy access. The positive impact for consumers in meeting their food needs predictably, conveniently, and reliably by a high quality, fairly priced assortment are significant but not quantifiable. To be conservative, benefits to customers were typically only quantified when SEAF could estimate consumer surplus, such as in the form of a price benefit or the introduction of a new good. With the eight new case studies, efforts were made to better quantify the impact on these stakeholders, and the ratios of distribution to these stakeholders has improved since the 2004 Study. We believe, however, that the benefits to these three stakeholders remain underestimated.

Is Impact More Significant in Less Developed Countries?

Several readers of SEAF’s 2004 Study asked if the quantified development impact is inversely related to the level of economic development, due to diminishing marginal returns, i.e., is the development impact higher in less developed countries, and vice versa.

Based on SEAF’s analysis, there does not appear to be a strong relationship between the Gross National Income (GNI) per capita and the ERR of each investment. SEAF’s selected set of 18 companies spans ten countries. Table 5 below shows that strong ERRs are more or less equally

distributed among countries with high GNI per capita, medium GNI per capita, and low GNI per capita. While the two strongest ERRs are among the companies in the top and middle range per capita incomes, the median ERRs for each country grouping are relatively similar.

Table 5. Case Study Performance vs. Country Development

<u>Country Grouping Based on</u> <u>GNI per Capita</u>	<u>Company</u>	<u>Country</u>	<u>GNI per</u> <u>Capita*</u>	<u>Case Study</u> <u>ERR</u>	<u>Median</u> <u>ERR</u>
Top GNI per Capitas	DCM	Croatia	9330	46%	58%
	PERPETUUM	Croatia	9330	61%	
	PPZP	Poland	8190	54%	
	SYMBIO	Poland	8190	245%	
Middle GNI per Capitas	ARTIMA	Romania	4850	122%	57%
	TELEZIMEX	Romania	4850	62%	
	KEN	Bulgaria	3990	37%	
	GICA	Macedonia	3060	22%	
	MAKO MARKET	Macedonia	3060	55%	
	MOLINO	Peru	2920	40%	
	TAMBO INCA	Peru	2920	90%	
	PRINTOP	Peru	2920	70%	
	VICTORIA	Peru	2920	57%	
Low GNI per Capitas	FIDEOS	Bolivia	1100	51%	47%
	SABARE	India	820	37%	
	BFW	India	820	62%	
	AQUA TUDAKUL	Uzbekistan	610	47%	
	BUSINESS LEASING	Uzbekistan	610	33%	

*The World Bank Data, 2006, USD, Atlas Methodology.

Chapter 3. Case Studies: Stories of Economic Transformations

Introduction

SEAF's case studies capture not only quantifiable impacts from the case study multiplier effect estimate, but also personal stories and other impacts. Through an extensive information gathering process, including field work, interviews with employees and other stakeholders, and market research, SEAF has collected numerous testimonies about the transformations that have resulted from investments into SMEs:

Improving Lives of Employees

- Employees of the profiled SMEs truly value the stability of their employment and payment of health and social welfare benefits. Previously, many employees were either unemployed or working informally, often without regular pay or benefits.
- Confident about the stability of their jobs, employees are able to provide for their families, invest in tangible assets, and save for their children's future.
- Most of the SMEs invest heavily in employee training, thus helping employees to advance to higher skill levels, earn higher salaries, and gain the security of skill mobility. While our research shows that unemployment rates in the profiled companies are high, managers of the profiled companies explained that it is nevertheless very difficult to find appropriately skilled labor and that they face a more difficult time attracting skilled personnel than do larger companies. It is as a result of this that SME managers compensate by investing in training for their own, initially less skilled employees.

Creating Business and New Opportunities for Suppliers

- Suppliers benefit not only from increased business from SMEs, but also from the support and incentives provided to help them improve their performance and expand capacity.
- Micro-suppliers and micro-entrepreneurs profit from the supply-chain linkages provided by SMEs. By purchasing and aggregating the products of micro-suppliers and providing them with market expertise and other value-added services and support, SMEs serve as a point of access for micro-suppliers and micro-entrepreneurs to revenue streams from larger urban, national or regional enterprises and to regional and even global export markets.

Spreading New Technologies and Innovative Practices to Other Players in the Market

- Positive impacts on customers can include more choice, better quality goods, and lower prices. Entrepreneurs of local SME are uniquely rooted in their local communities and as such are well positioned to identify unmet local consumer demands and, with the help of financing and strategic support, work with other stakeholders to address market deficiencies.
- Competitors can profit from demonstration and network effects, while producers of complementary goods may see an increase in demand for their products resulting from an investee's success and growth.

Local Communities and the Rest of Society Benefit

- As part of formalization, SMEs play a role in tackling community problems by contributing to local tax revenues. Depending on local government priorities, these could include infrastructure, education, or public health.
- Most often as prominent, formal businesses in their local communities, entrepreneurs and their SMEs contribute actively to community activities and charities, and are typically well respected as investors in community development. Examples include contributions to infrastructure (roads or parks), or to local causes (orphanages, schools, or cultural activities).

The case study summaries on the following pages provide testimony, through company-specific examples, of the transformations described above.

Case Study Summaries

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Chapter 4. Conclusions and Policy Implications

SEAF's data survey and case study analysis suggests that investing in SMEs with two distinct attributes can result in substantial social returns. These attributes are: (1) owner/entrepreneur demonstrates strong interest in and potential to grow the business; and (2) owner/entrepreneur is willing to accept third party capital and the accountability that accompanies outside financing. SEAF's hands-on experience suggests that when these two attributes are present, SEAF is able to forge a strong investment partnership. SEAF brings to this partnership not only its capital but its substantial experience in helping companies improve both business operations and strategy. As a result, these SMEs provide reliable and growing salaries to their employees, serve as points of access for smaller local and micro-suppliers to reach larger markets, and address market deficiencies and local customer needs. They are significant partners of local and national governments, and to a quantifiable extent, contribute to "civil society" in their communities. Such benefits generally arise not because of any consciously altruistic intent of the entrepreneurs, but because of the sustainable, formal business strategies that entrepreneurs, with the help of SEAF's partnership, pursue. Enterprises accepting third party capital must implement good governance to satisfy their investor partners and to maintain appropriate checks and balances on the parties. They must hire, train and promote the best employees they can find regardless of gender. They must comply with environmental, health and safety codes, and must become reliable and competitive counterparts for their customers. While SEAF does not wish to challenge the positive contributions of so-called "social entrepreneurs", SEAF believes that the above factors are a *necessary* part of the growth and development of sustainable SMEs, and that therefore investing in such SMEs is likely to provide a more reliable and scalable means to achieve the development impact detailed in this report.

We concluded from our 2004 Study that Development Finance Institutions (DFIs) and other investors can achieve a dual mandate—targeting both development and financial returns—by expanding their support for SMEs. The report also suggested ways in which policy makers and investors could leverage the beneficial effects of SMEs on economic growth and poverty reduction,³⁴ such as using SME entrepreneurs to deliver poverty-reducing services, health coverage, training, and networking, and in targeting certain sectors of activity likely to yield higher multiplier effects. These conclusions still stand.

With this study, however, we have also concluded that SEAF, DFIs, and other responsible investors in SMEs could have an even greater impact on economic growth and poverty reduction by (1) investing in enterprises with high growth potential; (2) using the combination of the data survey and the case study approach to measure development impact; and (3) targeting investments to the types of SMEs that can achieve specific development goals, including by giving fund managers financial incentives to meet development benchmarks or focusing funds on the types of investments that can have a particularly profound impact (e.g., the "Market Aggregator" concept). These conclusions are reviewed in more detail below.

³⁴ SEAF's 2004 Study is available on SEAF's website, www.seaf.com.

Investing in High-Growth SMEs

Our cumulative studies show that when SMEs with high growth potential³⁵ are selected for investment (i.e., those that pass the review and due diligence of a seasoned fund manager and are willing to accept third party capital to pursue growth), they can generate not only significant financial returns, but important socioeconomic returns as well. Traditional financial markets have largely overlooked the SME sector, especially in emerging markets. There are many reasons for this; chief among them is the perceived risk of SME investment and of the emerging market in question. SEAF's investment experience, however, has demonstrated that investing in SMEs with high growth potential can bring about financial success (for SEAF's financial performance, see "About SEAF" at the beginning of this report) as well as much broader economic growth and poverty alleviation. With this in mind, Development Finance Institutions (DFIs) and other interested investors could achieve both development and financial returns by devising strategies that identify, invest in, and support the more promising, growth-oriented SMEs.

From SEAF's experience, it is clear that "not all SMEs are alike"; that is, any SME development initiative should seek to find and promote, first and foremost, the growth of precisely those SMEs which have the greatest potential for growth and therefore sustainability (the section "Maximizing Development Impact" covers how, additionally, specific development impacts can be targeted depending on the objectives of the investors). From a strategic point of view, SEAF has found that its most financially successful investments meet one or more of the following criteria:

- *Growth-Minded Entrepreneurs Willing to be Held Accountable.* SEAF looks for companies managed by entrepreneurs who are interested in and committed to realizing capital appreciation over the next three to five years. Entrepreneurs should also be ready to commit to a relatively higher degree of corporate transparency than the local norm (and preferably the global standard). An entrepreneur willing to accept accountability in pushing towards the realization of a growth plan and who is willing to accept third party capital to achieve growth is the kind of entrepreneur that will be willing to take the other key steps needed to achieve sustainable growth.
- *Business models that address market deficiencies and unmet local demand.* Entrepreneurs who seek in the first instance to address local market deficiencies and meet local demand are in SEAF's experience both realistic and correctly focused on achieving results which will also achieve the developmental results identified by this Study.
- *Desire to achieve Market Leadership.* SEAF seeks to identify entrepreneurs that wish to achieve market leadership, albeit in a narrowly defined but sustainable niche.
- *Multiples Growth.* SEAF targets entrepreneurs active in industry sectors with price/earnings or other acquisition multiples that SEAF believes are likely to grow substantially given the stage of development of a given economy.

³⁵ By "high growth potential", we are not targeting, for example, conventional "high growth" sectors such as telecommunications and software, although such sectors may be very positive as well. Rather, we are referring to SMEs whose owners/entrepreneurs are interested in growing their businesses and demonstrate potential to do so, regardless of whether the industry is fish farming, distribution of fast moving consumer goods, or other sectors, and are willing and open to taking on third party equity capital, together with the greater accountability that is entailed.

- *Willingness to Exit Jointly or Buy Back at Approved Value.* Ideally, the entrepreneur is ready to work to exit the business with SEAF in three to five years. Alternatively, he or she must be ready to negotiate an acceptable buy back of SEAF’s interest that recognizes both the growth in value of the company and SEAF’s role in helping achieve it.

The aforementioned criteria are in addition to due diligence and other prerequisites for investment, including a good local reputation for integrity and respect for people (including his or her employees), a viable business plan, a capacity to manage human resources, a willingness to contemplate improving the company through the use of technology, and a willingness to become accountable to a Board of Directors.

Only a company that can operate on a sustainable basis can continue to make a positive impact in the economy, and the selection and review process described above will help to ensure the financial success of investments and the profitability and sustainability of investees.³⁶

The Value of Systematic Measurement of Development Performance: Combining Case Studies with Data Surveys

Until the 2004 Study, there had been few rigorous assessments of the development impact of investments in SMEs. Empirical evidence supporting the claim that SME investment can be an effective tool for economic growth and poverty reduction is especially important to SEAF’s investors. Indeed, the study was motivated and funded in large part by development institutions (SECO, DFID, Ford Foundation, and USAID) for this purpose. In seeking to make such an assessment, SEAF was advised by outside economists to work both through a data survey as well as a “bottom-up” intensive case study method.

Taken together, this approach provides a concrete understanding of the economic and more “human” transformations resulting from SME investments. As we have seen, the data survey enables tracking and analysis of key impact indicators while the case studies allow us to quantify the impact in IRR terms (FRR and ERR) and net present value terms (Net Economic Benefit/Cost Ratio). The more intensive approach of the case studies also allows the capture of less quantifiable impacts on the lives of employees and other local stakeholders—these are the qualitative impacts that policymakers want to identify and assess. As we have seen, the data findings have been broadly consistent with the in-depth case studies, providing added credibility. Though costs prohibit SEAF from expanding the case study analysis, we will scale up the data survey to capture the effects of an ever increasing pool of SEAF investments. Going forward, SEAF intends to broaden its socioeconomic data collection to encompass its entire active portfolio. Having data on the kind of employment growth or wage growth that an SME portfolio

³⁶ An additional benefit of an approach that prioritizes financial success, even for a donor that is not interested in financial returns, is that the SME fund then has the potential to return capital invested and generate returns that could be used for other developmental purposes. For example, USAID has invested in a number of SEAF funds in Central Europe. As it is receiving returns on its investment in these SME funds, it has decided to support the Center for Entrepreneurship and Executive Development—an organization active in Bulgaria, Romania, Slovenia, and Montenegro—which provides practical training and networking opportunities for SMEs in the Balkan region (see www.ceed-global.org). This program would not have come into existence without the reflows from investment in SMEs in SEAF’s funds in the region or SEAF’s experiences with SMEs and their areas of weakness in which training and networking could make a great difference. USAID has recognized the merits of this program with exceptional support and encouragement.

can sustain is valuable and, we believe, will be even more revealing if continued over the life of the investments.

The ability to monitor and measure development impact is important not only so that policymakers understand the role that SMEs can play in development, but also because it gives managers and auditors of development institutions the capability to measure their success in achieving specific development goals.

There is an interest and growing effort in the development community to develop a common methodology for measuring the social value of investing in SMEs. On the basis of SEAF's study, SEAF believes that it has "beta-tested" a replicable tool that development institutions could use to assess how SME investment activities can contribute to overall development goals. SEAF hopes that other investors, development institutions, and donors will consider this methodology in order to better understand and enhance the impact of their resources devoted to SMEs.

Maximizing Development Impact: Targeting Investments and Motivating Fund Managers

With an understanding of the specific, concrete and quantifiable development impacts that SMEs can have, development institutions and other investors can devise approaches that focus on or even enhance these impacts. All investments should be motivated by certain minimum bottom line financial returns, but development impact can be maximized by specifying—and, as we shall examine below, motivating investment managers to achieve—investment criteria to include additional measurable developmental characteristics. For example, investors with a development bias may want to incentivize fund managers to identify and invest in SMEs with one or more of the following characteristics, depending on the specific development priorities or goals of the investors:

- Employ a significant proportion of people whose labor opportunity cost is low (unemployed and underemployed, usually represented by a high percentage of low-skilled labor and women), thus generating additional incomes with large multiplier effects.
- Provide substantial non-salary benefits or implement employee benefit programs as a strategy to attract and retain employees;
- Provide skill development and training or invest in training to meet the human resource needs of the company;
- Work with local suppliers to improve the quality, value-added nature, or flow of inputs from local suppliers to the processing or distributing SME;
- Engage in active compliance with local tax, labor, environmental, health and safety requirements and regulations; or
- Engage the local community by participating in local business associations or other partnerships or by supporting community activities and charities in recognition that it helps to build firm reputation.

Examples of Development Funds

SEAF's experience has shown that significant impact can be made by investment funds that strive to achieve development impact. For example, SEAF's first Peru fund (FAPE) was guided in its establishment by social objectives, in which the investment parameters were to invest no more than \$350,000 in SMEs preferably engaged in nontraditional exports or located in poor regions of the country. As demonstrated by the case profiles on Molino and Printop (see Chapter 2 for quantified development impact and Chapter 3 for case study highlights), the social impacts of the companies in the FAPE portfolio has been profound³⁷. Similarly, SEAF's North Fund was established to invest in the high unemployment regions of northern Poland. To assess the development impact of the North Fund on increasing employment in the region, SEAF's local office tracked employment at each portfolio company. Likewise, SEAF's newest fund, the Georgia Regional Development Fund, focuses on companies operating in the regions outside the capital city with specific measurable developmental impacts identified and compensated, while allowing a lower financial rate of return as the hurdle rate for the fund manager (see discussion below).

Motivating Fund Managers to Meet Developmental Benchmarks

Not only can investment funds achieve development goals by targeting certain investment criteria, but with a functional system to track and measure development indicators in place, investors have an opportunity to establish benchmarks that a fund should be expected to achieve. SEAF's experience is that investors interested in the achievement of specific development benchmarks can devise an incentive structure that motivates fund managers to achieve such benchmarks.

As mentioned above, Millennium Challenge Georgia (MCG), with support from the Millennium Challenge Corporation (MCC), has recently established the Georgia Regional Development Fund (GRDF), which SEAF was selected to manage by open tender. This is the first investment fund that incorporates formal incentives to achieve development goals. Launched in late 2006, the GRDF is part of the MCG's overall initiative to develop Georgia's local economy. The objectives of the fund include making investments in local SMEs that will grow and expand on a sustained basis, serve as models for other Georgian entrepreneurial activities, further the development of the economy specifically outside of the capital city, Tbilisi, and contribute to the reduction of poverty in Georgia. Instrumental to achieving these objectives is the incentive structure that has been established for SEAF as the fund manager. Aside from a traditional management fee, a carried interest in the returns generated by the fund has been established which begins even when the Fund Manager has returned only 70 percent of the principal (although the carried interest becomes more meaningful only after the principal is fully returned). In addition, an annual performance bonus has been set that rewards SEAF and its management team to achieve specific development impacts. The bonus is based on the extent to which SEAF exceeds annually projected hurdles for select development performance indicators, including investees' gross revenues (proxy for growth), aggregate wages (proxy for productivity), taxes paid (proxy for formality), and expenditures on locally sourced goods and services (proxy for multiplier effect). SEAF's 2004 Study was taken into account when MCG established this approach, and it is hoped that this new report provides additional insights to help investors to pursue similarly structured funds.

³⁷ However, the failure of the investors to identify quantifiable developmental objectives up front ultimately led to dissatisfaction with the fund's results, as the shareholders increasingly focused on the financial returns as the only quantifiable measure.

Use of “Market Aggregator” Fund Approach to Link Micro-Borrowers to Larger Markets

As one final example of how this report can help policymakers and investors maximize the development impact of their investment and yet still achieve potentially attractive financial returns, this report provides evidence that SMEs can serve as effective “Market Aggregators”. In particular, SMEs can positively impact poor farmers or suppliers of semi-finished goods by serving as collection centers, value-added processors, and/or distributors to larger markets, as well as by providing suppliers with technical assistance (designs, instruction on growing organic fruits and vegetables, certifications, etc.) and (limited) financial support. This evidence suggests a possible role for certain SMEs to act as a mechanism for sustainably linking microfinance borrowers with growing regional and global markets.

There is increasing concern about the apparent inability of the vast majority of micro-borrowers to scale up and sustainably improve their revenues. While micro-borrowers may seek to access larger regional and global markets, numerous barriers often prevent them from doing so. These include language differences, lack of know-how, lack of working capital, a lack of understanding of consumer demands related to quality and design, lack of scale, and concerns about business risks and sustainability. Yet without accessing these markets, micro-suppliers are often taken advantage of by multiple layers of middlemen, themselves often unscrupulous, ignorant, or undercapitalized. It is hardly a wonder that the fruits of globalization, in which high value added markets could in fact be located and pay substantially higher prices for micro-suppliers, are not felt at the level of individual farmers or piece work producers. Given the amount of capital now flowing into microfinance institutions (MFIs), the need has never been greater to connect micro-borrowers to markets that they would otherwise be unable to access. A properly executed Market Aggregator fund or facility would use SMEs as a vehicle through which many micro-suppliers could expand their revenues, profits and ultimately join the formal sector. For example, SEAF’s Polish investment in Symbio permitted that company to identify and then train more than 350 small farms in rural eastern Poland in production methods for organic fruits and vegetables. By aggregating their product, and later processing such products, Symbio has been able to serve as a reliable counterparty to such large purchasers of organic product as Cascadia and Pro Natura. The result, as described in the case study on Symbio, is not only a profitable investment for SEAF’s investors and the entrepreneur, but also markedly increased profitability for the small farmers in eastern Poland. These small farmers have increased their gross profit per hectare by five to ten times their previous levels.

A Market Aggregator fund could potentially be synergistic with the needs of multinational corporations as well. While sourcing from emerging markets is potentially a cost effective way to solve the growing input needs of multinationals, the lack of organization, formality, quality and reliability of micro-suppliers poses significant risks. Multinationals obviously prefer to work through a minimum of suppliers or intermediaries who will reliably deliver consistent quality products. Market Aggregating SMEs can be an attractive intermediary through which multinationals can source from emerging market micro-suppliers.

Lastly, SEAF’s monitoring and evaluation program, with a focus on measurement of supplier impact, could be a critical component for a Market Aggregator fund. The ability to measure and monitor supplier impact, as well as the extent of impact possible as demonstrated from this report, has been the driver for this concept and would provide investors with a mechanism for measuring their intended impact.

Conclusion

SEAF hopes that this report will help donors, investors, and others working in the area of development better understand SMEs and their capacity to serve as drivers of economic growth and development. As is hopefully demonstrated in the Report, SMEs not only generate quality employment opportunities – sustainable jobs with increasing salaries as employees become more valuable through training and specialization – within their local communities, but also serve as a crucial link to regional and international markets for smaller local suppliers. SMEs quite literally address market deficiencies and customer needs in the local economy, thereby improving people’s lives. They make critical contributions to local government and local communities, and play a key role in the development of a stable, civil society in the developing world.

SMEs are often referred to as “the missing middle”, yet few have understood fully how critical SMEs are as the pathway to prosperity. Even fewer have sought to harness the power that these companies have to drive growth, poverty reduction, and development.

SEAF believes that the demonstrated high development impact of SMEs warrants greater attention to devising sustainable financing schemes which focus on providing risk capital in combination with integrated business assistance to SMEs. When the developmental returns are included with the purely commercial returns, there can be few investments as economically profitable in the developing world.

Annex 1. Data Survey Form

Company Name: _____
Company Business: _____
Company Contact: _____
Local SEAF Contact: _____
Date of Completion: _____

Country: _____
Fund: _____
Investment Date: _____
Base Year: _____

The information you supply below will be used in combination with that provided by other SEAF investees, in aggregate form only, for analysis of the impact of small and medium size enterprises (SMEs) on local economies.

Please enter information for the periods specified below, as far back as 2000 if possible. For all currency entries, please enter the local currency amount unless otherwise specified. SEAF will collect this data on a semi-annual basis. If entry is 0, please enter "0"; if entry is not known, please enter "x"; if entry is not applicable, please enter "NA". Grey boxes do not need to be completed.

We ask that you return the completed form to the Local SEAF Contact within 3 weeks of receipt. Do not hesitate to contact the SEAF Investment Officer or Director General if you have any questions or concerns. We greatly appreciate your time and cooperation on this project.

1 General Notes on the Company	
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A. Employment

	1999	2000	2001	2002	2003	2004	2005
Number of employees:							
2 Full-time							
3 Part-time							
4 Seasonal							
5 TOTAL (Lines 2+3+4)	0	0	0	0	0	0	0
Number of employees by gender:							
6 Male							
7 Female							
8 TOTAL (Lines 6+7, should equal Line 5)	0	0	0	0	0	0	0
Number of employees by skill:							
9 Unskilled (manual unskilled labor, unspecialized store clerks)							
10 Semi-skilled (manual skilled labor, technicians, basic administrative staff)							
11 Skilled (associates/analysts, professional staff, management, accountants, lawyers, IT staff, etc)							
12 TOTAL (Lines 9+10+11, should equal Line 5)	0	0	0	0	0	0	0
13 On average, approximately what % of time do part-time employees work as compared to full-time employees?							
14 On average, approximately what % of time do seasonal employees work as compared to full-time employees?							
For all non-seasonal employees:							
15 Number of males promoted							
16 Number of females promoted							
17 Number of voluntary departures							
18 Number of involuntary departures							
19 Women working as senior management (as a % of total senior management)							
20 Women on Board of Directors or equivalent oversight or supervisory body (as a % of total members)							
21 In the years covered above, please briefly describe any event causing major changes in employment (for example, information on outsourcing, acquisitions or spin-offs).							
Comments/Clarifications							

B. Wages

	1999	2000	2001	2002	2003	2004	2005
Average GROSS ANNUAL wage (as full-time equivalent wage, excluding bonuses) for:							
22 Male employees							
23 Female employees							
24 Unskilled employees							
25 Semi-skilled employees							
26 Skilled employees							
27 All employees							
28 Total GROSS ANNUAL wage bill (excluding bonuses)							
29 minus employee income tax withheld							
30 minus other deductions							

31	NET ANNUAL wage bill (Line 28-29-30)	0	0	0	0	0	0
32	Please specify what is included in the "other deductions" in Line 30 (health insurance, pension plans, etc.)						
33	GROSS ANNUAL Bonuses/Profit-sharing						
34	% of employees receiving bonuses/profit sharing						
	Comments/Clarifications						

C. Benefits

	1999	2000	2001	2002	2003	2004	2005
35	Does your company contribute to or provide employees with:						
	Health Insurance? (Enter Yes/ No)						
36	Pension plans? (Enter Yes/ No)						
	If yes to the above, for what % of your TOTAL employees do you provide these benefits?						
37	Health Insurance?						
38	Pension plans?						
	Do you provide benefits beyond those required by law?						
39	Health Insurance? (Enter Yes, No)						
40	Pension plans? (Enter Yes, No)						
	If yes to the above, for what % of your TOTAL employees do you provide these benefits?						
41	Health Insurance?						
42	Pension plans?						
	How much do you spend ANNUALLY company-wide on:						
43	Health Insurance required by law?						
44	Health Insurance NOT required by law?						
45	Pension plans required by law?						
46	Pension plans NOT required by law?						
	About how much do you spend annually on OTHER benefits for employees (such as unemployment insurance, life insurance, cars, mobile phones, meals, etc)?						
47	Required by law?						
48	NOT Required by law?						
49	Please briefly specify what is included in Lines 47 and 48.						
	Comments/Clarifications						

D. Training

	1999	2000	2001	2002	2003	2004	2005
50	Number of employees who received external training paid for by company.						
51	Please describe what is included in Line 50 (eg workshops, classes, training provided by vendors, courses, certificate programs, degree work, etc.)						
52	Estimated total cost of external training covered by company.						
53	Estimated hours of internal or on-the-job training per employee PER MONTH, on average.						
	Comments/Clarifications						

E. Community Impacts

	1999	2000	2001	2002	2003	2004	2005
54	Company sponsors charity / community programs (Enter Yes/No).						
55	Please describe what is included in Line 54.						
56	If Line 54 is yes, quantify the amount of support provided (local currency amount).						
	Comments/Clarifications						

F. Government/Public Impacts

	1999	2000	2001	2002	2003	2004	2005
57	Net VAT/sales taxes						
58	Import customs duty						
59	Corporate income taxes						
60	Employee income tax withheld (Line 29)						
61	0	0	0	0	0	0	0
	Other taxes (net)						
62	Subsidies received						
63	0	0	0	0	0	0	0
	Net Government Impact (Line 57+58+59+60+61-62)						
	Comments/Clarifications						

G. Formalization of Business

	1999	2000	2001	2002	2003	2004	2005
64 Were the company's financial statements for the year audited by a 3rd party firm? (Enter Yes/No)							
65 Does the company have a documented company structure with a formal Board of Directors or equivalent oversight/supervisory body? (Enter Yes/No)							
66 Does the company have any industry certifications (ISO or other)? (Enter Yes/No)							
Comments/Clarifications							

H. Supplier Impact & Other Items

	1999	2000	2001	2002	2003	2004	2005
67 Revenues* (in US DOLLARS)							
68 COGS* (in US DOLLARS)							
69 Capital Expenditures* (in US DOLLARS)							
70 % of revenues that are from exports							
71 % of COGS from DOMESTIC suppliers							
72 % of Capex from DOMESTIC suppliers							
73 Number of DOMESTIC Suppliers (please briefly describe, for example: 80 farmers, 10 distributors, 10 manufacturing companies, etc)							
74 Number of DOMESTIC Consumers (please briefly describe, for example: 100 end-users, 12 supermarkets, 10 distributors, 200 kiosks, 40 retail stores, 15 corporate clients, etc.)							
75 Does the company extend trade credit or other financing to local suppliers? (Enter Yes/No)							
76 % of company owned by women (Domestic, not foreign. If family owned count female portion.)							
Comments/Clarifications							

*Data in lines 69-71 is from SEAF financial records. Please help us by filling in any missing historical years IN US CURRENCY.

Annex 2. Case Study Methodology

SEAF quantifies the development impact of each portfolio company using a *Development Impact Model* adapted from one developed by the Economic Department of the International Finance Corporation (IFC)³⁸. This model measures the economic impact on each group of stakeholders that are affected, either directly or indirectly, by the investments into the company. SEAF calculates the present value of net cash flows generated for all stakeholders and divides it by the present value of the dollars invested over the life of the company; this provides us with *the additional dollars generated in the local economy per dollar invested*.

The model is based on the recognition that not all of the impact or value of a market transaction is reflected in price paid. Such effects beyond the price paid are variously referred to as externalities, public goods, or consumer surplus. In the case of the impact of or value derived from investing in SMEs, there are impacts, whether positive or negative, that are not captured in the returns to financiers. These excess values, that is, the aggregated value to all members of the economy, must be added to the net profits of the SME's financiers themselves to assess the value of the investments to the economy as a whole. It is the overall value that represents the *total development impact* resulting from the investments. The stakeholders potentially impacted by investments are broken down into the following categories:

- Financiers
- Employees
- Suppliers
- Customers
- Competitors & New Entrants
- Producers of Complementary Goods & Services
- Local Community
- National Governments

SEAF builds its model for each company using data provided by the company, including financial statements and market statistics, and makes extensive use of information gained through interviews with stakeholders. The model is based on ten years of cash flows (usually from inception of the company and projected cash flows) and a terminal value. The model results are expressed as internal rates of return (IRRs) and present value net benefit/cost ratios calculated at various discount rates. Both are in real terms, as the cash flows used in calculations are in constant US dollars. The benefit of calculating figures in real terms is that the reader may select the discount rate he or she thinks is most appropriate for risk without having to consider inflation, also making it easier to compare case studies.

The impact on financiers is measured as the traditional financial returns that they receive from the company, using a cash flow model. Using the *Net Financial Cash Flow*, we calculate the internal rate of return (IRR) to all of the financiers of the company, which per the IFC model we call *Financial Rate of Return (FRR)*. It should be noted that we measure the return to *all* of the financiers (including both the investments from the Fund and those from other parties) over the entire life of the company.

³⁸ "Assessing Development Impact," by Frank J. Lysy, International Finance Corporation. October 20, 1999.

Next we evaluate the impact on the other stakeholders (see stakeholder list above) over the life of the company. As with the Net Financial Cash Flow, we count the social benefits from inception onwards, including projected years. The *Net Social Cash Flow* is calculated as the premium over the benefit that the stakeholders would receive elsewhere, or would receive if the portfolio company did not exist. For example, the benefit to suppliers is calculated as the net income resulting from the portfolio company minus the estimated net income they would receive elsewhere if the portfolio company did not exist.

We add the Net Social Cash Flow to the Net Financial Cash Flow to calculate an IRR that represents the total development impact of the company, or return to all stakeholders, which per the IFC model we call *Economic Rate of Return (ERR)*. Again, the ERR represents not the economic return from the Fund's investment alone, but the economic return generated by all of the debt and equity investments in the company over the life of the company.

Finally, we calculate the *Net Economic Benefit/Cost Ratio*, which represents the additional dollars generated in the economy from one dollar invested. The *Net Economic Benefit* is the present value of the Net Financial Cash Flow and the Net Social Cash Flow, and the *Cost* is the present value of all of the debt and equity investments into the company, over the life of the company (*Financing Cash Flow*).

The following is a generic, numerical example to help the reader understand how SEAF calculated its findings. Actual figures are proprietary and therefore are not disclosed in this report. The numbers used are fictional but intended to be realistic. In the sample model, SEAF calculated a Net Economic Benefit/Cost Ratio of 11.73 at a zero percent discount rate, comprised of 6.42 for financiers and 5.31 for other stakeholders in the local economy. Thus, at a zero percent discount rate every dollar invested into the company generates an additional \$11.73 in the local economy. In each financial model, we calculate the ratio at three different discount rates—0 percent, 5 percent, and 10 percent—so that the reader may consider the impact at various costs of capital.

SAMPLE (HYPOTHETICAL) CASE STUDY MODEL

**SUMMARY SHEET
ALL IN CONSTANT USD, IN YEAR 2001 PRICES**

Cash Flows	2001	2002	2003	2004	2005	2006	2007
	Actual	Actual	Actual	Actual	Actual	Actual	Projection
1. Financing Cash Flow							
A. New Loans from SEAF	0	0	0	0	150,000	0	0
B. New Loans from Other Sources	0	0	0	0	0	0	0
C. New Equity Injections from SEAF	0	250,000	300,000	200,000	0	0	0
D. New Equity Injections from Other Sources	650,000	0	0	0	0	0	0
--> Sum of Items A thru D	650,000	250,000	300,000	200,000	150,000	0	0
2. Net Financial Cash Flow (Net Financial Benefit to Financiers)							
A. Revenues	900,000	1,000,000	1,025,000	1,050,000	2,000,000	2,200,000	2,500,000
B. Minus COGS	(720,000)	(800,000)	(820,000)	(525,000)	(1,000,000)	(1,100,000)	(1,250,000)
C. Minus SG&A and R&D	(300,000)	(350,000)	(400,000)	(400,000)	(700,000)	(770,000)	(875,000)
D. Minus Taxes	0	0	0	(25,000)	(60,000)	(66,000)	(75,000)
E. Minus Capital Expenditures	(300,000)	(70,000)	(100,000)	(300,000)	(100,000)	(19,000)	(20,000)
F. Minus Increase in NWC	(200,000)	(33,333)	(8,333)	(8,333)	(316,667)	(66,667)	(100,000)
--> Sum of Items A thru F	(620,000)	(253,333)	(303,333)	(208,333)	(176,667)	178,333	180,000
3. Net Social Cash Flow (Net Benefit to Other Stakeholders)							
A. Employees	10,000	15,000	20,000	19,000	30,000	50,000	52,000
B. Suppliers	30,000	20,000	18,000	25,000	50,000	60,000	100,000
C. Customers	9,000	10,500	11,000	12,500	25,000	60,000	80,000
D. Competitors & New Entrants	1,000	600	700	890	1,000	1,500	1,800
E. Producers of Complementary Goods	11,000	5,000	8,000	10,000	15,000	20,000	30,000
F. Neighbors	0	0	0	1,000	2,000	3,000	10,000
G. Rest of Society	80,000	60,000	40,000	10,000	16,000	400,000	260,000
--> Sum of Items A thru G	141,000	111,100	97,700	78,390	139,000	594,500	533,800
4. Net Economic Cash Flow (Sum of Items 2 & 3)	(479,000)	(142,233)	(205,633)	(129,943)	(37,667)	772,833	713,800
Calculations							
5. FRR (IRR of 2)	24%						
6. ERR (IRR of 4)	42%						
	<i>At discount rate of:</i>	0%	5%	10%			
7. PV of Financing Cash Flow (PV of 1)	1,605,000	1,424,252	1,278,314				
8. Financial NPV (NPV of 2)	10,304,259	5,271,638	2,617,578				
9. Social NPV (NPV of 3)	8,526,390	5,277,494	3,416,255				
10. Economic NPV (NPV of 4)	18,830,649	10,549,132	6,033,833				
11. Net Financial Benefit/Cost Ratio (8 divided by 7)	6.42	3.70	2.05				
12. Net Social Benefit/Cost Ratio (9 divided by 7)	5.31	3.71	2.67				
13. Net Economic Benefit/Cost Ratio (10 divided by 7)	11.73	7.41	4.72				
14. Breakdown of Net Economic Benefit/Cost Ratio (Line 13):							
Financiers	6.42	3.70	2.05				
Employees	0.60	0.42	0.30				
Suppliers	1.08	0.74	0.53				
Customers	1.15	0.79	0.56				
Competitors & New Entrants	0.04	0.03	0.02				
Producers of Complementary Goods	0.32	0.22	0.16				
Neighbors	0.02	0.02	0.01				
Rest of Society	2.10	1.49	1.09				
--> Sum	11.73	7.41	4.72				

<--Additional dollars generated from \$1 invested.

Annex 3. Representative List of SEAF Investors

AFP Integra

AFP Prima

Baltics American Enterprise Fund (BalAEF)

Belgian Investment Office (BIO)

Black Sea Trade and Development Bank (BSTDB)

Calvert Social Investment Fund

Calvert World Values International Equity Fund

Colfondos

Deutsche Investitions- und Entwicklungsgesellschaft (DEG)

Evangelische Kirche in Hesse and Nassau (EKHN) (Pension Fund)

European Bank for Reconstruction and Development (EBRD)

FMO

Finnish Fund for Industrial Cooperation (Finnfund)

Ford Foundation

Foundation for the Development of Polish Agriculture (FDPA)

International Finance Corporation (IFC)

Kazakh National Innovation Fund (KIF)

Kotak Mahindra Bank

Life Insurance Corporation of India (LIC)

Millennium Challenge Georgia Fund (MCG)

New York Life International, Inc.

Norwegian Investment Fund for Developing Countries (Norfund)

Polish Cooperation Fund

Pound Capital

Proteccion

Provenir

Seguros Suramericana

Small Industries Development Bank of India (SIDBI)

State Secretariat for Economic Affairs (SECO)

Swedfund International AB of Sweden

Swiss Investment Fund for Emerging Markets (SIFEM)

U.S. Agency for International Development (USAID)