

CASE STUDY

BUSINESS PARTNERS LIMITED

February 2014

IMPACT INVESTING 2.0

ORGANIZATION HEADQUARTERS	Johannesburg, South Africa
YEAR FOUNDED / LAUNCHED	1981
LEADERSHIP	Nazeem Martin, Managing Director
DESCRIPTION OF PRIMARY ASSET CLASS	Blended debt and equity offerings for small- and medium-sized enterprises (SMEs)
TOTAL INVESTMENT PORTFOLIO	\$331.3 million USD ¹
GEOGRAPHIC FOCUS	South Africa
SECTOR FOCUS	Lifestyle, family-owned, SMEs
SUMMARY OF IMPACT AREAS	SME growth, job creation, improving gender representation, employing previously disadvantaged individuals, black African economic empowerment, economic development outside of urban areas
FINANCIAL PERFORMANCE	In excess of 2.5x original capitalization returned to shareholders via dividends between 2005 and 2013; 7% average ROE from 2003 to 2013
SOCIAL PERFORMANCE	Since 1981, total of more than \$1.5 billion USD invested in more than 69,500 SMEs; Created or sustained more than 550,000 jobs



¹ Unless otherwise noted, all amounts are presented in USD

Jed Emerson and Brenna McCallick were the lead authors of this case. This case study is part of The Impact Investor, a research partnership between InSight at Pacific Community Ventures, CASE at Duke University and ImpactAssets from 2012-2013. The Impact Investor project team was co-led by Cathy Clark, Jed Emerson and Ben Thornley. More in-depth impact investing fund case studies, practitioner blogs, videos from expert convenings, as well as project reports, are available at: <http://bit.ly/impinv2> and at the twitter hashtag #impinv2.

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INTRODUCTION

When thinking about the challenges of doing business in Africa, a long list of issues comes to mind. There is the lack of capital, a fragmented marketplace, and a difficult political environment, to name but three. Yet, one also hears stories of impact investors who have figured out “how to do it right” and advance not just social impact, but social impact that is financially sustainable. Developing—and then executing—a successful impact investing strategy in Africa requires flexibility and commitment, but also an ability to move across public and for-profit sectors, the capacity to draw upon new ideas for structuring a variety of capital investment options, and a vision of what “impact at scale” might look like for small to medium businesses with the potential for significant growth.

The nation of South Africa is representative of many of the challenges faced by the continent as a whole, yet also of the innovations that have enabled successful impact investment. Since the end of Apartheid in 1991, the nation has worked to build an inclusive, resilient society, including by extending economic opportunity to formerly marginalized citizens. In 2012, as part of its National Development Plan, the Western Cape Government identified several key indicators of the current outlook for economic development in South Africa:

- The first 15 years of democracy saw a significant growth in the flow of development capital into social and economic transformation. But South Africa still has one of the highest Gini coefficients² in the world.³
- Since the global recession, development assistance from governments and philanthropists has diminished considerably, as has the country’s revenue base, with low growth rates and high unemployment.
- South Africa...contains some of the most sophisticated financial infrastructure and successful private sector businesses in the world. At the same time, it has an urgent imperative for economic growth and job creation.⁴

“We need more successful small business owners to address the economic issues, corruption issues, and other systemic ills in our society. Business Partners believes this with absolute passion. This is not just a job, it’s a need.”

– ED HATTON, BPL MENTOR

While impact investing is a relatively nascent market tool for social and economic development, some institutions have been laying the foundations for decades. Business Partners Limited (BPL), a South African specialty risk-finance group, is one of the most prominent and successful impact investing firms in the country, and its track record of investing in small and medium size enterprises (SMEs) dates back to 1981.

BPL’s story is one of real growth and deep impact, starting in South Africa and continuing to move across the continent. The firm began with \$24 million USD of invested capital and has grown into a long-term investment company with a more than \$331 million net asset value. Perhaps most intriguingly, BPL’s leadership has chosen not to grow the company through the solicitation of additional capital from multiple rounds of new investors or by attempting to force strategic liquidity events in order to meet the traditional limited lifetime of private funds. Rather, they have pursued an approach that ensures long-term growth for its investees.

² Defined by the World Bank as, “the most commonly used measure of inequality. The coefficient varies between 0, which reflects complete equality and 1, which indicates complete inequality (one person has all the income or consumption, all others have none).” http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPOVERTY/EXTPA/0,contentMDK:20238991-menuPK:492138-pagePK:148956-piPK:216618-theSitePK:430367_00.html

³ Rated 63.1 as of 2005, according to the U.S. Central Intelligence Agency World Factbook. <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2172rank.html>

⁴ Institutional Resourcefulness: Towards A ‘Whole Of Society’ Approach To Social Impact In The Western Cape. Western Cape Government, Department of the Premier. 2013 IIPC Conference. http://iipcollaborative.org/wp-content/uploads/media/11_South-Africa_Cardo.pdf

What follows is the story of a set of committed investors who, working with a team of diligent managers, have built one of the leading impact companies operating in the world today. Recognized as singularly innovative, dedicated and disciplined, BPL has made a name for itself internationally as a leader in the support and development of SMEs. BPL is viewed within South Africa as one of the country's most successful public-private partnerships.

In fact, BPL's strategy has proven so effective, in 2004 the International Finance Corporation (IFC) singled the firm out as a potential partner, asking them to expand their investing activities into other African nations. "Business Partners started with some support from the South African government before it spun off, but it really balances being commercial with helping SMEs," said Tracy Washington, a Senior Investment Officer with the IFC. "They have taken the concept [of SME equity investing] to very difficult countries, and have employed a very thoughtful and intentional approach."

BPL is exemplary in its ability to maintain this balance. Over the course of more than 30 years, it has proven to be a company that operates in simultaneous pursuit of impact and financial return. As a result, it offers many lessons for investors operating in both emerging and established markets.

ORIGINS

As is true of many leading funds, BPL has evolved through various stages of development and the refinement of both its corporate structure and business strategy. In fact, BPL can be said to have had two lives: pre- and post-1996.

Around 1980, business leaders in South Africa began to recognize a growing need for a financial vehicle supporting SME growth. While SMEs are widely regarded as the backbone of any economy and a key driver of employment growth and economic activity, the development of suitable institutional financing for SMEs has faced significant challenges in emerging markets, namely:

- **LACK OF COLLATERAL.** In developing countries where bank lending is available, the lack of collateral and weak enforceability of property rights discourages banks from lending to any enterprise other than the largest concerns.
- **HIGH COST OF APPRAISAL.** Unable to obtain sufficient security for collateralized lending, lenders must rely on the strength of a company's projected cash flow to service debt. Cash flow-based lending entails considerably more due diligence and therefore is more costly than collateral-based lending. This encourages banks again to focus on only the largest borrowers, so as to amortize the costs of due diligence over a larger investment amount.
- **HIGH COST OF INVESTMENT.** SMEs are often managed by an owner-operator who has a sophisticated knowledge of the technical and operational aspects of the business, but who may lack other financial or business skills. In fact, limited financial skills are often cited as one of the main reasons for SME failure. Consequently, a third-party investor in an SME must be prepared to be involved in complementing the entrepreneur's skillset, which is expensive and usually associated only with equity investments.
- **LIMITED UPSIDE.** The majority of SMEs are lifestyle businesses providing a steady income to the owners, who have little interest in rapid growth or selling the company to a third-party. Consequently, the smaller end of the SME spectrum is rarely of interest to private equity fund

managers, who would otherwise have the resources to perform the due diligence necessary and the ability to structure appropriate investment instruments. It is only the larger end of the SME spectrum and the few high-growth potential smaller SMEs that attract any interest from private equity financiers.

- **LACK OF CONTROL.** Owner-managers typically are reluctant to give up a substantial share of ownership to external investors for fear of losing control of the business. In developed countries, external investors can structure investment instruments to provide a balancing of control rights and can rely on the legal system to enforce such rights if required. However, many developing countries lack the legislation to permit such investment instruments and enforcement through the court process is often difficult and time consuming.

BPL was created as a response to these realities. The Rupert family – specifically, father and son team Anton and Johann Rupert, owners of the large investment holding company, Remgro Limited – launched BPL in partnership with the Government of South Africa and several large South African corporations. In 1980, the Ruperts successfully brought together leaders from other top businesses on the Johannesburg Stock Exchange to lobby the government to create a new vehicle supporting emerging and small businesses.

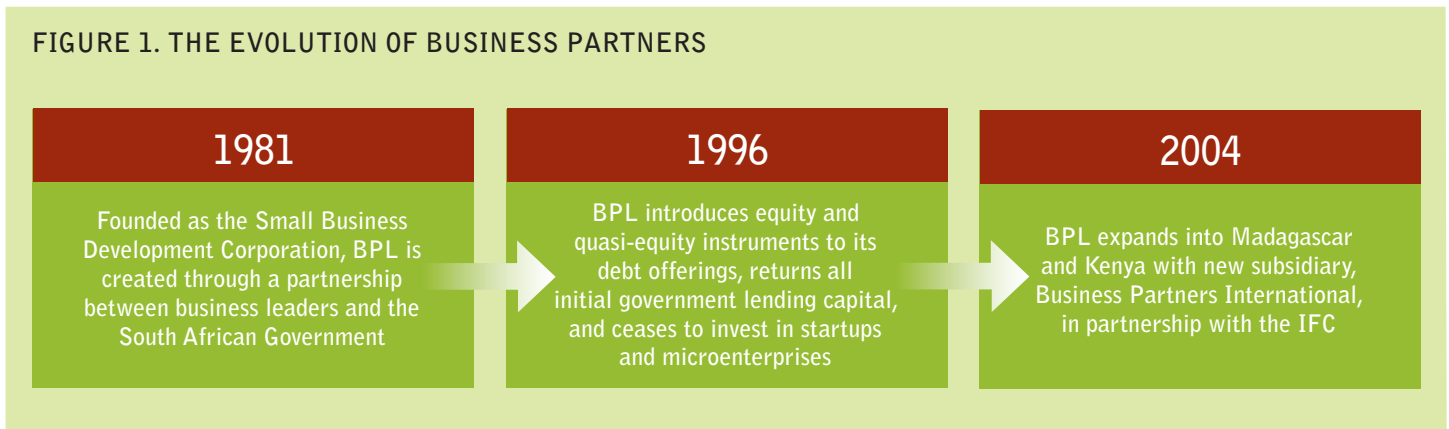
After months of negotiations, the government agreed to match what the businesses collectively contributed. The result was the creation of the Small Business Development Corporation – later renamed Business Partners Limited – in 1981. Founding shareholders included Remgro Limited, ABSA Group Ltd., Nedbank Ltd., FirstRand Bank Ltd., Standard Bank Investment Corporation, Old Mutual Life Assurance Co., South African Breweries Ltd., Sanlam Ltd., and Anglo America Ltd. The combined seed funding, including the contribution from the government, totaled \$24 million.

Initially, BPL offered debt to small businesses at all stages, from startup to expansion (though predominantly during expansion) with loans ranging from \$5,000 to \$100,000. The government’s contribution took the form of quasi-guaranteed fees that allowed BPL to support micro-enterprises and riskier startup companies. BPL also received government grants to provide technical assistance to entrepreneurs looking to grow their companies. From its launch in 1981 through the mid-1990s, BPL was managed on a profitable basis, simply as a debt fund. With only its original \$24 million of seed capital, the firm was able to grow continuously based on the reinvestment of its lending capital and the effective management of the fund by its founding partners.

Over time, however, it became clear that in trying to meet the needs of both micro-enterprises and SMEs, the overall performance of the firm was limited. The expertise BPL staff and mentors provided to all of its borrowers was not extensive enough to support the needs of the wide range of investee companies. Furthermore, the firm realized that it needed to take on more risk in its investments in order to scale its portfolio in line with its original vision of meeting both the real need and market demand for the type of capital and support offered by the firm.

“We needed to move away from behaving like a bank, providing debt instruments and lines of security, and start taking bigger levels of risk,” explains Mark Paper, who, at the publication of this case study, had been with Business Partners for 21 years, currently as the Chief Operating Officer of BPL’s subsidiary, Business Partners International.

FIGURE 1. THE EVOLUTION OF BUSINESS PARTNERS



The change was not only favored by BPL's investors, but, in fact, actively promoted by them. "The mandate from our shareholders was to touch as many SMEs as possible," Paper says. "It was not specifically to go and do business, make a profit, and provide a financial return; it was to touch SMEs – to meet their challenges by providing them with access to funding that was aligned with their financial needs, with their cash flow requirements."

Investor priorities were the driving force behind BPL's structural and strategic changes. In 1996, management made the decision to focus exclusively on SMEs and to shift from a lending entity and bank-like firm to a venture and growth firm making direct quasi-equity and equity investments in a portfolio of ventures, while utilizing some debt instruments to maintain flexibility. The evolution of BPL is shown in Figure 1. As part of its shift, BPL returned the government's initial lending capital – which had supported micro-enterprises and startups – and reduced the State's equity share in the company from 50 to 25 percent. This transaction resulted in the return of \$100 million to the government. From that point onward, BPL focused exclusively on small- and medium-sized ventures. With the introduction of an equity investment structure, BPL's transaction size grew to \$50,000 to \$3,000,000.

The transition was also marked by the adoption of a set of new impact-oriented goals:

- A bias towards black-owned small businesses in South Africa (including individuals of African and Indian descent, or others from disadvantaged ethnic groups in the country)
- Achieving gender parity within its portfolio of companies, and
- Integrating consideration of environmental and social factors into its portfolio companies

The newly reorganized BPL maintained a singular focus on reaching out to SMEs, but was also committed to maintaining its own financial viability. Therefore, executing its strategy while generating adequate cash flows to support itself was key.

FUNDRAISING: RECYCLING REVENUE FOR PERPETUAL IMPACT

In 1981, BPL was seeded with \$24 million of funding, consisting of government debentures⁵ together with the contributions from several major banks and insurance companies, as described above. The funding provided – 50 percent private; 50 percent state – was all in the form of direct equity investments that covered the costs of incorporating and establishing BPL as a firm.

⁵ As defined by Investopedia, a debenture is "a type of debt instrument that is not secured by physical assets or collateral. Debentures are backed only by the general creditworthiness and reputation of the issuer." <http://www.investopedia.com/terms/d/debenture.asp>

FIGURE 2. MAJOR SHAREHOLDERS

SHAREHOLDER	SHARES
Eikenlust (Pty) Limited (Remgro Limited)	42.5%
Small Enterprise Finance Agency (SOF) Limited	21.6%
Old Mutual Life Assurance Company (South Africa) Limited	5%
Absa Group Limited	4.7%
Nedbank Limited	3.9%
FirstRand Limited	3.5%
Standard Bank Investment Corporation Limited	3.2%
SABSA Holdings Limited	1.4%
Barloworld Limited	1.3%
South African Distilleries and Wines (SA) Limited	1.2%
Total:	88.3%

It is important to note that BPL is not a fund, but a permanent financial institution and private company. As such, the firm does not create and deploy funds with limited lifespans; instead, it maintains one perpetual, closed fund, recycling revenue, and never requiring additional injections of cash from its investors.

In its earlier years, BPL had approximately 100 shareholders, including the government. By 2013, BPL had consolidated to about 20 shareholders, five of which collectively held approximately 78 percent of the shares. The major shareholders are shown in Figure 2.

In addition to the government investment, BPL also accessed public grant funding between 1981 and 1996. Government funding enabled the firm to work in higher-risk sectors and to target start-up companies. The separate public grants program targeted what were thought to be “risky” transactions and supported troubled companies by providing lower-cost capital. By 1993, however, as BPL rethought its structure, this grants program was retired and BPL introduced equity and quasi-equity investment vehicles.

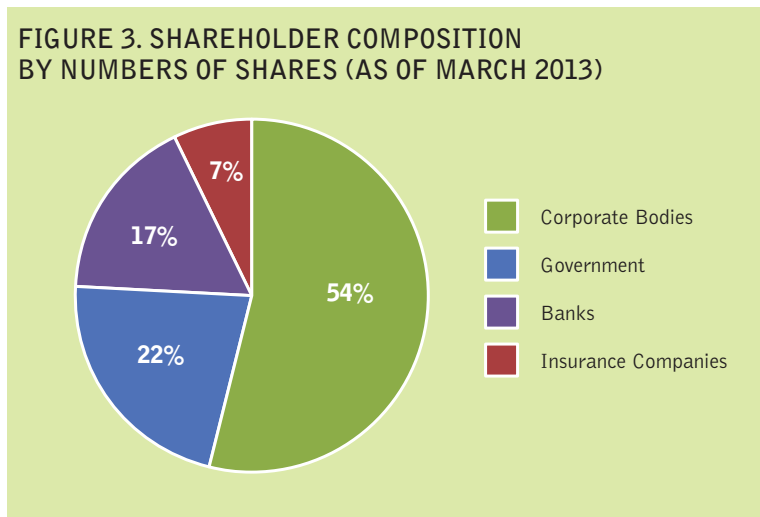
By 1996, BPL had become an independent firm, rather than a government partnership. Since the original investment strategy had allowed the firm to be financially viable from the start, no additional capital was required during this transition.

In 2009, the firm began using debt to leverage its balance sheet, obtaining loans from South African commercial banks to structure its product line. In taking on debt, BPL followed a conservative approach, using a maximum gearing of 20 percent of its net asset value. Previously, BPL had

been completely unleveraged, but with this new source of debt financing, the firm was able to continue to pursue its goal of offering SMEs financial support at a significant scale, both within South Africa and beyond. The 2013 shareholder composition is shown in Figure 3.

Over its 32-year lifespan, the firm has honed and solidified a successful strategy for funding SMEs, and has developed a methodology that can be scaled to reach as many as 700 entrepreneurs in a year—a huge number for a firm executing a private equity or venture investment strategy. “Private equity or venture capital is usually only aimed at very few businesses with high growth potential,” explains BPL’s CEO, Nazeem Martin. “We have turned ourselves into a factory, and we

provide many, many private equity or venture capital-like solutions to many small businesses out there regardless of whether they have high growth potential or not.”



THE FUND

SOUTHERN AFRICAN SME RISK FINANCE FUND*

Number of Active Investments	1,783
Value of Active Investments	\$331,300,000
Investment Size	\$50,000 — \$3,000,000
Average Deal Size	\$250,000
Average Target IRR	17.1%

* As of April 2013

INVESTMENT STRATEGY: FLEXIBILITY AND SCALE

The firm's investment strategy is quite simple: identify promising SMEs struggling to break through to their next stage of development and invest in and surround those investments with the type of intensive technical assistance and support necessary to provide them the greatest chances of success.

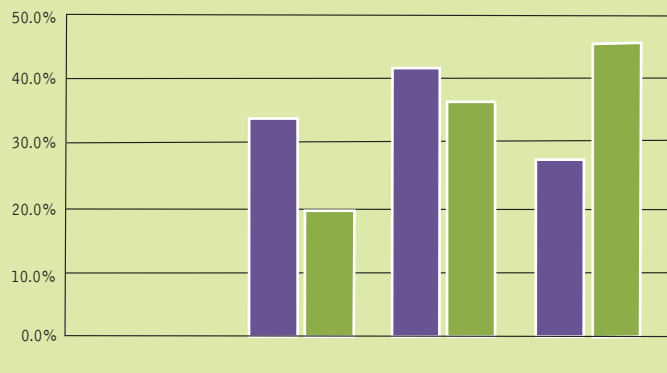
As Mark Paper succinctly puts it, "We invest in and provide access to funding for any SME venture in which we have comfort with the entrepreneur, believe in the business, and are able to implement a structure that will see an investment return proportionate to the risk." The investment strategy has been developed around the unique needs of SMEs. Early on in its history, BPL recognized that the typical private equity model placed too much emphasis on the exit event and was not conducive to the cash flow needs of a relatively new and growing business. BPL therefore began aligning the recovery and return on its investments to the cash flow ability of its portfolio companies, creating six different "coat hanger" investment products for its investment officers to tailor according to the specific needs of a given entrepreneur:

1. Equity Partner: direct equity financing
2. Risk Partner: self-liquidating quasi-equity financing
3. Royalty Partner: partially secured loan financing with a royalty payment attached
4. Property Risk Partner: premises financing
5. Loan Partner: financing on a fully collateralized basis
6. Royalty Risk Partner: combination of an equity and a loan investment with a royalty stream

As of January 2014, the firm's strategy has been effective enough that it has self-financed a significant part of its expansion, both within South Africa and, through BPI, to other nations on the continent.

In the mid-1990s, when BPL moved to introduce private equity and quasi-equity funding, it operated with a strategy that was more cash flow-friendly for investee companies. BPL found that by blending some debt instruments with its private equity investments, it was able to participate in what was, in essence, a self-liquidating component of its business with targeted returns from

**FIGURE 4.
PORTFOLIO COMPOSITION: DEBT VS. EQUITY**



	DEBT	QUASI-EQUITY (Royalty)	EQUITY**
Number of Investments	33%	41%	27%
Value of Investments	19%	36%	45%

* As of April 2013

** Various forms of this instrument might include some debt components, but effectively sees this value of exposure in companies in which BPL holds shares

its debt offerings generated in advance of its private equity strategy alone. See Figure 4 for a breakdown of portfolio composition. At the same time, by executing a private equity approach, the firm was able to benefit from the sale of certain investments, providing investees with more cash flow flexibility and, ultimately, allowing investors to profit from a “both/and” approach to capitalizing small business in South Africa.

Each year, during the budgeting process, management determines how much capital the firm needs to deploy from a financial standpoint. The team then uses the average deal size from the previous year to determine the number of deals it needs to close to deploy this amount. After those benchmarks have been set, BPL builds a strategy to meet them, involving both the investment and marketing teams to generate deal flow. In order to source deals, the investment team uses a large amount of data it has amassed on SMEs throughout South Africa, utilizing internet-based platforms to gather and store all information quickly.

Prior to 2002, BPL was executing approximately 150 investments per year. As the firm revised its investment approach to focus exclusively on SMEs, it built operating system and staff capacity that have enabled it to reach substantial scale; up until the financial crisis of 2008, BPL was closing on over 700 investments per year. At 2013 the firm was averaging just over 300 per year. Despite this remarkable jump in deal flow, BPL remains relatively conservative, maintaining an equity-to-debt ratio of 80:20.

This mass-production approach, combined with the investment team’s expertise in identifying and supporting successful businesses, has allowed BPL to grow from its \$24 million in seed funding into a financial institution worth more than \$376 million without any additional, outside investment. In line with its commitment to being financially sustainable, between 2005 and 2013, BPL has been able to return to its original shareholders (in the form of a dividend payout) two-and-a-half times their original capital invested.

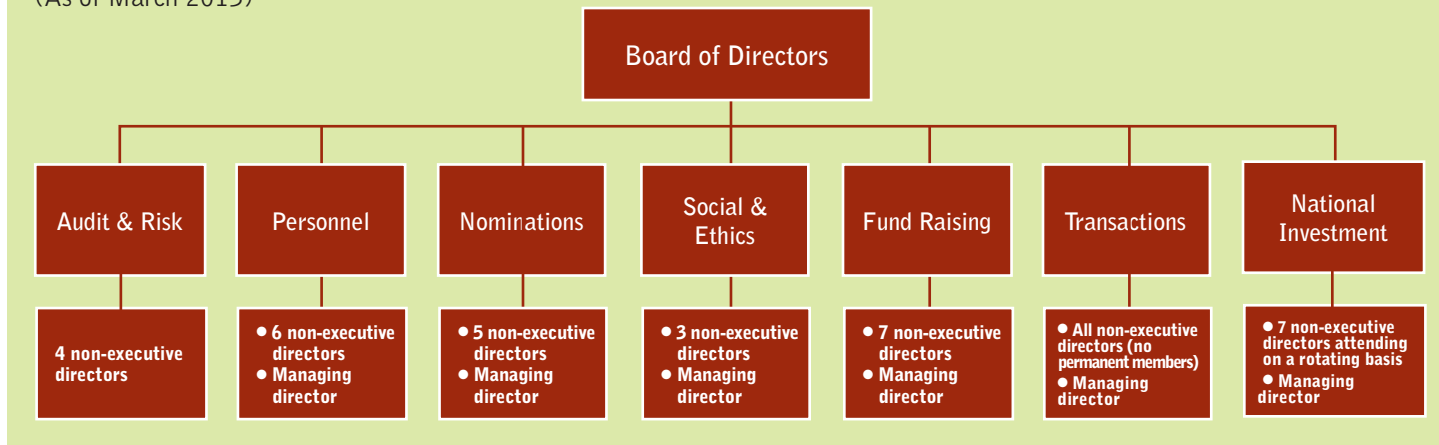
GOVERNANCE: MAINTAINING CONSISTENCY AMONG DIRECTORS AND INVESTORS

A critical ingredient in BPL’s success is having a consistent set of long-term investors that share a common commitment to growing SMEs in South Africa. This commitment has led to decisions including the development of a consensus approach to the expansion of the firm’s work, relative to both assets invested and markets entered. As an early investor in the firm, the Government of South Africa maintains representation on the board of directors consistent with that of other investors/partners.

Since BPL is a permanent investment vehicle and not a closed-end fund, the firm’s relationship with its limited partners is not traditional; that is, the relationship is not geared toward liquidating investments and turning the portfolio for financial return alone. As BPL never requires additional funds from investors, “limited partner” contributions ought to be looked at “in terms of the investment strategy that management follows,” Paper says. “We have consensus among shareholders about the goals and the direction of funds. They don’t have influence on a deal-by-deal basis, but they influence our 5-year investment strategy.”

Additionally, the stability of the firm’s leadership and their commitment to its mission has allowed BPL to grow steadily, even as it has shifted its structure. From the beginning, BPL has benefitted from clear mission alignment among its creators; their shared goal of scaling the SME market in South Africa remains the firm’s driving force to this day. As BPL made structural changes, it was able to avoid mission drift primarily because of its strong and steady leadership: in its 32-year history, the firm has had only three different Chairmen and Managing Directors. Furthermore, the governance structure, shown in Figure 5, enables an open and transparent relationship between the board and management.

FIGURE 5. BPL CORPORATE GOVERNANCE STRUCTURE
(As of March 2013)



The Board of Directors currently consists of 14 members, including Chairman Theo van Wyk, Managing Director Nazeem Martin and Executive Director Christo Botes. The Board meets five times per year. Firm leadership is underpinned by the strong alignment of interests between management and shareholders, and has institutionalized alignment of interests through an employee incentive system.

BPL has benefitted from the collective wisdom of a team of investment professionals who have committed, on average, more than 10 years of work to the firm. As of 2013, Martin had been with BPL for 15 years, and of the team of executives that reports directly to him, only two had been there less than 15 years. All other executives who make up the “core” of the Board investment committee have at least 20 years of experience at BPL.

Paper recognizes that this length of commitment is rare, especially as BPL does not offer the highest salary available to such professionals. He attributes the longevity of executive tenures to shared values and purpose. “We like to think that it is because of our ‘twin soul,’” he says. “People who work here enjoy seeing the development impact of their work, but at the same time take great comfort and pride in [working] for a profitable company.” The collective years of experience at the firm account in no small part for its success. “When a deal comes through to us,” says Martin, “it has the benefit of the wisdom of a number of people who have seen many things in their lives and understand what it takes to make a small business work.”

In South Africa, BPL operates 22 different office locations, each overseen by a regional general manager. This geographic spread gives BPL a distinct advantage. As Martin explains, “We understand that you must have a local presence. If you don’t have a local presence you won’t have deal flow, you won’t be able to do due diligence, and you won’t be able to look after your transactions efficiently and cost-effectively once you make the deals.”

Investment committees within BPL weigh in on all potential deals. Each regional manager, together with his or her team and an investment committee comprised of individuals from the regional manager's business unit, will consider investments up to about \$14,500. For transactions ranging from \$14,500 to \$33,700, regional general managers report to an executive director, who works with an investment committee of which he or she is a member and chairperson to approve the deal. An investment committee chaired by Martin must approve deals from \$33,700 to \$57,800. All deals greater than \$57,800 go through the Board investment committee, the quorum for which is composed of Martin and two non-executive directors.

In keeping with BPL's commitment to strong alignment across the organization, all investment decisions are made by consensus. If even a single member of the investment committee feels uncomfortable with a potential deal, it is either set aside for reconsideration or rejected entirely.

MISSION LOCK: A STRATEGIC APPROACH TO ACHIEVING IMPACT

BPL invests with the primary goal of generating high financial returns. However, its investors are motivated by a shared interest in sustaining an investment vehicle for capital deployment back into the target market – underserved SMEs. Through sound investment decision-making and by earning an attractive return, the firm furthers its mission of reaching as many South African SMEs as possible. BPL's shareholders place a greater emphasis on financial sustainability than on development impact, weighing these priorities at a ratio of roughly 60 to 40 percent, respectively. BPL acts in accordance with these priorities, utilizing this breakdown with regard to both its business strategy and staff performance evaluation.

Social impact is inherent to BPL's long-term goals as a firm, but management is clear that this kind of impact is only one part of their overall mission. "Current stakeholders are looking primarily at Business Partners investing capital, skill, and knowledge into all viable enterprises in both South Africa and other selected African countries. That is the mission," Paper explains. In developing the pipeline, the investment team tries to stimulate the firm's social metrics by actively seeking out businesses owned by women and/or black Africans, especially those located in rural areas in need of increased economic activity. "But these [criteria are considered] as standalone items at the time of deal sourcing," Paper notes, "and not at the time of deal approval."

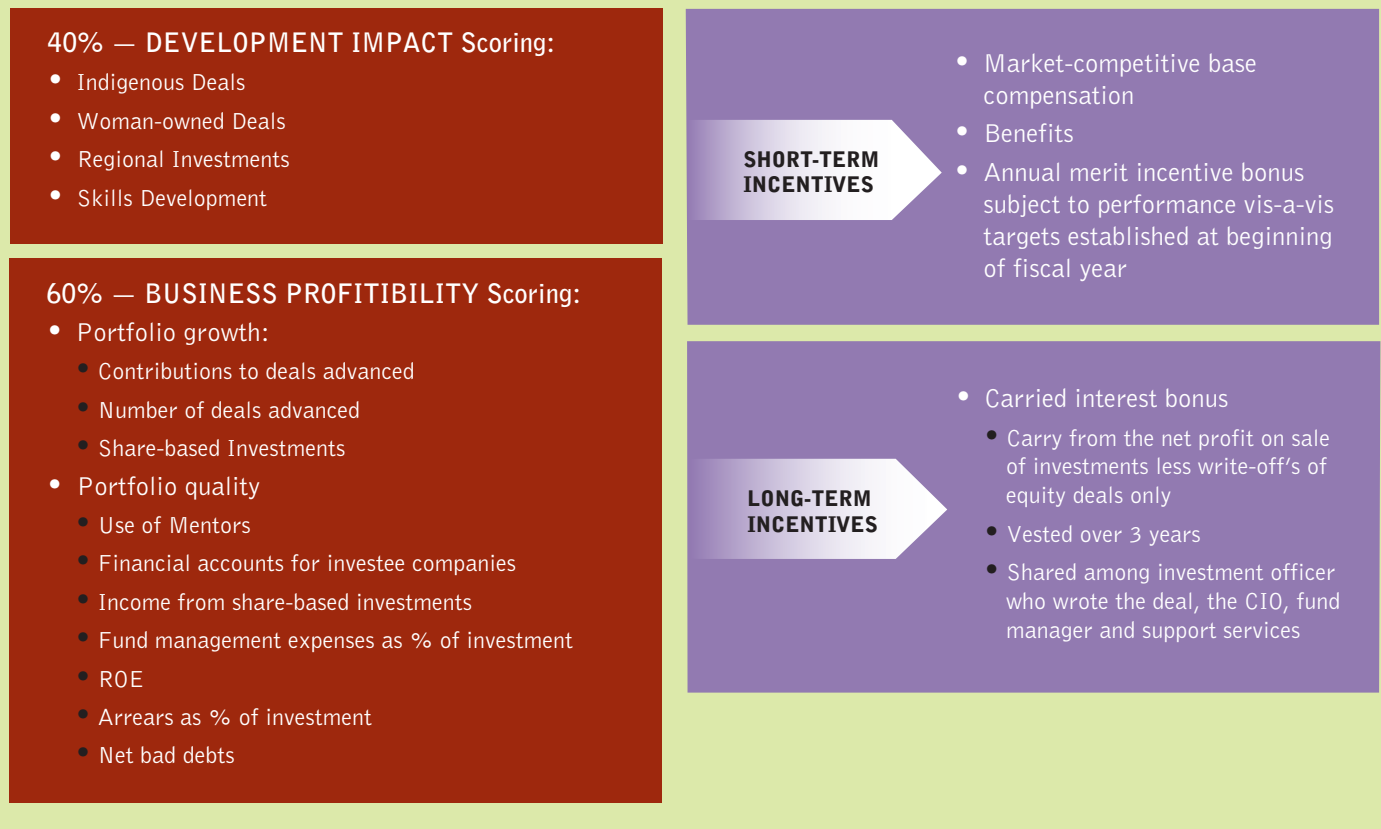
In other words, while BPL does strive to create development impact, this goal is not the firm's explicit focus in the sense that it determines individual investment decisions. Rather, BPL has designed and solidified a system by which it can identify sound investment opportunities from among a pool of impactful potential deals. This integrated "both/and" approach, in a sense, "locks in" the firm's impact and allows the team to focus on investing sustainably – primarily for financial return – trusting that their impact objectives are being met.

As a GIIRS Emerging Markets Pioneer Fund⁶, BPL regularly assesses the impact performance of its portfolio using several GIIRS measures. The firm utilizes two computer platforms for tracking – one for financial and one for impact performance – during the life of an investment. Financial information and data related to impact targets are captured in the system on a monthly basis. Upon exiting an investment, BPL uses the platforms to assess overall profitability and impact.

⁶ GIIRS 2012. "Emerging Markets Pioneer Funds." <http://giirs.org/for-funds/pioneer>.

FIGURE 6. BUSINESS PARTNERS' EMPLOYEE INCENTIVE SYSTEM

Business Partners' incentive system is designed to ensure alignment of interests between shareholders, management and investment staff:



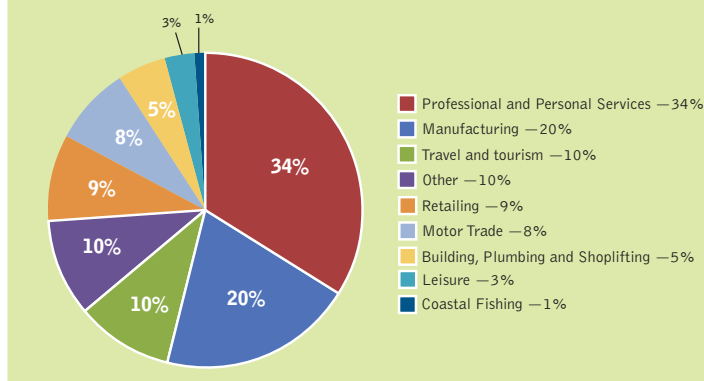
Further “locking in” impact to its investment activities, BPL has created incentives for the investment team to produce meaningful impact through its remuneration system. All employees are evaluated each month on both the basis of their contributions to the growth of the portfolio (60 percent of employee performance measures) and the development impact of their investments (40 percent of performance measures). But as Paper notes, “Both of those measures are equally balanced 50:50 in terms of the ultimate outcome – the reward that we give our investment teams. So they’re directly rewarded for not only driving the (financial) sustainability of the portfolio but also driving the level of impact that those investments are having.” Paper adds, “We want at least 40 percent of all our business generated outside [main business] hubs. We also want to see our portfolio companies adhering to environmental and social guideline best practices.”

Figure 6 illustrates the structure of the monthly performance evaluations as they relate to both short-term and long-term compensation incentives. In an intriguing reversal of the traditional model, short-term incentives are tied to development impact, while the longer-term incentives are influenced exclusively by employees’ contributions to the profitability of the portfolio. This design ensures that compensation procedures reinforce ownership by all employees over the portfolio performance throughout the life cycle of individual investments, and aligns the interests of the staff with those of investors and management. This system, combined with its approach to deal sourcing, constitutes BPL’s method of ensuring their investments are impactful and financially sustainable.

INVESTMENTS

In 2013, BPL had between 80-90 investment professionals investing capital in businesses seeking funding to expand operations and purchase additional materials. As shown in Figure 7, BPL considers investments across all sectors, (excepting on-lending activities, direct farming operations, underground mining and non-profit organizations), in formal SMEs whose gross assets are under 100 million ZAR [\$9.9 million USD], where annual turnover does not exceed 200 million ZAR [\$19.8 million USD], and/or employees are less than 500 in number.⁷

FIGURE 7. PORTFOLIO BY SECTOR
(AS OF MARCH 2013)



Despite the firm's focus on enterprises in their growth stage, approximately 5-15 percent of BPL's portfolio consists of start-ups. (This, however, is not a specific target market for BPL. When considering investment, the firm applies the same standards to start-ups as it does to SMEs: comfort with the entrepreneur, the economic merit of the business, and the ability of BPL to structure a fair deal.)

By operating in an asset class with few other players – small quasi-equity investments averaging in size from about \$23,000-\$32,000 (250,000-350,000 ZAR) – and doing so on a large scale, BPL has achieved significant success with its single fund. BPL's

flexible deal structures are designed to be aligned with entrepreneurs' needs.

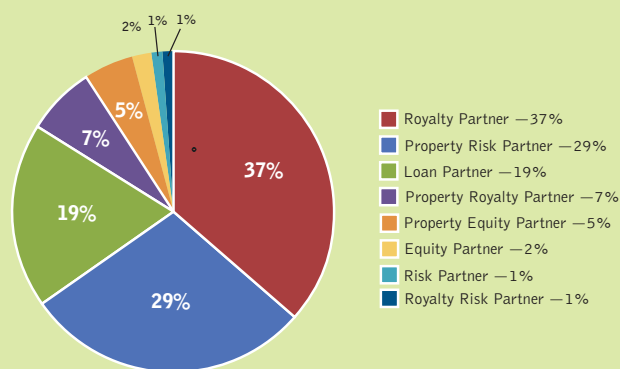
As noted above, BPL's factory-like approach to generating deals has enabled it to scale significantly. "We have developed a suite of products, kind of tailor-made solutions for SMEs," says Martin. These different product offerings are customizable to individual entrepreneurs, but their general standardization makes the process of structuring deals very efficient. These products include variations of equity, shareholders' loan accounts, revenue sharing and term loans.⁷

The debt components of all deals are offered at the prime lending rate in South Africa, or as Paper describes it, "the best rate a blue chip client would be able to secure on commercial terms should they be in a position to provide the bank with 1.00-times security." Based on this guarantee, an "average" deal would be structured to earn an internal rate of return of about 17.1 percent.

In order to achieve this return (as compensation for risk relative to the unsecured portion of the funding) while offering a low, competitive interest rate on the debt portion of an investment, BPL also utilizes both pure and quasi-equity instruments. For instance, in a typical investment, the firm would charge a royalty fee against a business's actual turnover as a quasi-equity component of the deal, while also investing equity in a portion of the company. The firm, therefore, sees a partial exit achieved during the investment term by way of debt redemption and royalty payments. As of 2013, the average interest rate on the debt portion of its deals was set at around 8.5-9 percent (as opposed to 25 percent when BPL was operating solely as a debt fund pre-1996). At exit, BPL usually aims to sell back their equity portion to the entrepreneur, thus continuing to build locally-owned firms, as opposed to those positioned for strategic acquisition at some end point in a fund's life.

⁷ "Business Finance." See: <http://www.businesspartners.co.za/about-our-finance-options/#sthash.mymUVYNs.dpuf>

**FIGURE 8. PORTFOLIO BY PRODUCT
(AS OF MARCH 2013)**



By developing products that behave like pure equity, combining some elements of mezzanine debt and royalty-soft liquidating, BPL is able to slowly erode the risk of failing to achieve the target return on their investments. This mixture of debt and equity is a true win-win for the firm and its portfolio companies: it lowers risk for BPL while placing fewer cash constraints on young, growing businesses. Figure 8 shows the breakdown of the BPL portfolio by product.

THE “FIVE PILLARS”

BPL continually grows and expands its reach primarily through its “Five Pillars,” including:

1. SECTOR-SPECIFIC KNOWLEDGE. BPL maintains an extensive database of investments it has made and business plans it has received. This database provides the firm with an understanding of the dynamics and economics of various sectors in which SMEs are often located (manufacturing and processing, business services, etc.). This understanding allows BPL to finance investments based principally on cash flow parameters, rather than on collateral parameters, which is the traditional and most wide-spread form of financing for SMEs.

2. EFFICIENT PROCESSING. Based on the knowledge derived from its database, BPL is able to determine critical credit issues for each sector and streamline due diligence to these key issues. For most projects, an initial review is usually complete within seven days, and if they proceed to full due diligence, an additional three to four weeks. For a limited number of more complex projects, processing times may be longer. Accordingly, loan and equity products are standardized, as are legal documents, with very little room for costly customization or negotiation.

3. UNIQUE PRODUCT STRUCTURES. BPL has six basic products: (i) Equity Partner, which provides direct equity financing; (ii) Risk Partner, which provides self-liquidating quasi-equity financing; (iii) Royalty Partner, which provides partially secured loan financing with a royalty payment attached; (iv) Property Risk Partner, which provides premises financing; (v) Loan Partner, which provides financing on a fully collateralized basis; and (vi) Royalty Risk Partner, which combines an equity and a loan investment with a royalty stream. Although standardized, each investment is structured to match the financing needs of the entrepreneur, the risk profile of the financing and the cash flows of the investee.

4. MENTORING. BPL requires entrepreneurs to work with mentors, where appropriate, to help guide the entrepreneur in his/her decision-making. The mentor also provides BPL with close insight and monitoring of the company. As described below, this aspect of BPL’s work is viewed as critical to its success. These mentors act not simply as general advisors, but as experienced guides with access to networks and resources critical to long-term success of invested companies.

5. ALIGNMENT OF INTERESTS. All BPL staff are evaluated according to a performance scorecard. The scorecard assesses not only profitability of each investment and number of new investments, but also factors such as promptness of reporting and progress toward such social impact goals as black economic empowerment. By tying these factors directly to remuneration, Business Partners ensures the alignment of the interest of its employees with its corporate objectives.

TECHNICAL ASSISTANCE: ENSURING LONG-TERM SUCCESS BY BUILDING RELATIONSHIPS

While not all investees take advantage of it, BPL's mentorship program is integral to its overall strategy. Not only does technical assistance significantly benefit entrepreneurs, it is essential to ensuring the sustainability of the portfolio. "Strong mentorship has allowed us to overcome the high failure rates of businesses," says Paper. "If we are going to operate in this space and do it on scale, we need this type of mechanism."

To support its portfolio of nearly 1,800 active investments, BPL has developed a database of between 350 and 400 industry experts – mentors and consultants willing to share their insights with struggling entrepreneurs. The firm has developed an online platform to match entrepreneurs with mentors quickly and easily. BPL ensures the quality of these advisors by employing the same selective screening process it uses when hiring a new staff member: all prospective mentors must

Investment Profile: Swift Silliker Ltd.

A prime example of BPL's approach to financing is the firm's investment in Swift Silliker (Pty) Ltd., which has branches in both Cape Town and Guateng. Valme Stewart, former national manager of a commercial microbiological service laboratory called Swift Micro Laboratories, is now an owner of the company, today called Swift Silliker. Partnering with BPL in 2001, Stewart privatized the previously parastatal company through a management buyout, gaining majority (70 percent) ownership of the company and honing its previously research-focused activities into increasingly commercial service offerings. Today, the company provides product-safety testing to food and beverage, cosmetics, hospitality, and related industries, and offers an on-site technical consulting service in addition to implementation of quality management systems and staff training.

In 2001, when the opportunity arose for a management buyout, Stewart jumped at the chance, but immediately met a roadblock: investors were not lining up to fund the purchase of a company whose main "products" were testing methodologies. "Many of the financial institutions I approached didn't even go to the trouble to come and see me," Stewart recalls. "Everybody thinks, 'If we invest in something and the business fails, what do we sell?'" With few physical assets, Stewart struggled to keep financiers interested, and was forced to look for nontraditional options.

Stewart's search for supportive growth financing led her to BPL. The firm, she notes, was one of "the few at that stage in South Africa to do this kind of entrepreneur-investing – looking at your business plan, being willing to help you grow the business." While she admits that working with BPL was more of a necessity than a choice, the financing and support she received surpassed her expectations. Within two to three months, BPL had completed its due diligence and structured a blended deal consisting of a five-year loan for 1.1 million ZAR (approximately \$111,003 USD) and a 30 percent equity share of the company. BPL sought an 18 percent internal rate of return, in addition to collecting a monthly royalty fee of one percent from the budgeted or actual turnover. Swift Micro Laboratories was immediately successful. While it had been growing in profitability for years when Stewart decided to become an owner, within the first year of BPL's investment, the company grew between 25-35 percent. In 2004, Stewart took out another loan with BPL for 1 million ZAR (\$100,912 USD) to purchase the consulting services portion of Swift Micro from its previous shareholders, bringing her total debt to 2.1 million ZAR (\$211,916 USD). BPL negotiated an exit at the end of loan repayment period in 2006, receiving 3.2 million ZAR (\$322,919 USD) for their 30 percent share, in addition to dividends. "It was an expensive deal," concedes Stewart, "but my rationale was that they're helping us. The more I pay them, the more I'm worth for the 70 percent that I've got."

One year after the exit, the company was continuing to grow exponentially. Stewart returned to BPL in 2007 and again in 2008 for loans totaling 15 million ZAR (\$1,513,680 USD) to purchase buildings for Swift Silliker's Johannesburg and Cape Town locations. Together with BPL, Stewart registered a property company, and continues to own 70 percent of it to this day (BPL owns the other 30). "This is a different kind of deal," Stewart notes. "In the financing of the company itself, I had to send [BPL] my account and statements. This time, as long as I know the buildings are still there and the loan is getting repaid every month, they're not involved. We see each other once a year for audited financials and to check in."

When Stewart purchased the company in 2001, its turnover was 2.4 million ZAR (\$242,189 USD) with 12 employees. Today, the company brings in over 75 million ZAR (\$7,568,410 USD) in annual revenue and employs more than 90 people. "It's been a good ride for me," says Stewart. "And BPL made this possible at the beginning when no one else would help me." As a microbiologist with no previous business experience, Stewart had anticipated setbacks in securing financing. BPL, however, took the time to understand her business plan and saw the value in her venture. Without their support, Stewart believes she would be an employee to this day, rather than company owner. "Business Partners believes in entrepreneurs," she says. "They choose entrepreneurs who are passionate about their business, and they make it possible."

fill out an application and provide excellent references, which are closely vetted by BPL. Another measure the firm utilizes for quality control is a rating mechanism whereby entrepreneurs report back on their experience with their advisors. The firm releases mentors who are consistently poorly rated and fail to perform.

Mentors act as contractors with BPL, and receive compensation for each client with whom they work. Clients pay a deposit to BPL for mentoring services. Once a mentor is identified for an entrepreneur based on an assessment of his or her needs, the mentor evaluates the client and submits a proposal to him or her. If the client agrees to the partnership, both parties sign a contract. Upon completion of the advisory services, the mentor submits a report evaluating the work to both the client and BPL. If the client agrees with the report, the mentor submits an invoice to BPL, who then pays the mentor with the client's deposit (minus a handling fee that BPL keeps).

One mentor, Ed Hatton, has worked with BPL for more than a decade. A former entrepreneur and owner of his own consulting business, as of 2013, Hatton had more than 25 years of experience in advising business owners, particularly in the IT, manufacturing, and service industries. Hatton typically spends one to two months with BPL clients, but some of his advisory relationships have lasted more than a year. His experiences working with BPL advised companies are indicative of the strong, open, and trusting relationships the firm prides itself on, and which contribute to its success.

"As a normal way of doing business, I prefer to be a part of the implementation of ideas I put forward," says Hatton, "rather than doing the ivory tower stuff and telling [entrepreneurs] what to do and having them get on with it." In his 13 years with the firm, Hatton has helped a variety of different businesses grow and flourish, especially through troubled times.

One of Hatton's proudest accomplishments was helping a quadriplegic entrepreneur named Martin Brown build his business, Radical Mobility, which manufactures and sells specialized wheelchairs for para- and quadriplegics. When Hatton got involved, Radical Mobility was struggling for market share in an industry already dominated by fairly large players. After advising Brown on developing a marketing strategy, Hatton helped Brown transform the business into what he describes as the producer of "far and away the best chair in the world for quadriplegics."

Brown currently employs about 25 people, sells his specialized chairs to individuals around the world, and operates a charity, the Martin Brown Wheelchair Fund. Hatton explains that Brown's story of struggle and success is just one example of the kind of comprehensive entrepreneurial support BPL provides, but there are countless others. "I don't see myself as a turnaround person, but as a startup mentor or business improvement mentor," Hatton says. "I'll have one or more initial meetings with a client, try to understand what is driving the business, what is holding them back, and propose a series of solutions on what needs to be done around it. Most of the solutions are relatively simple."

When asked what distinguishes BPL as a firm, Hatton muses, "There's an old-fashioned integrity about the business which I really like. It is a business which would not countenance any behavior that is suspect, would not try to take a fast track in order to get a quick return, and it values relationships that go on for decades." He also emphasizes the firm's passion for entrepreneurship and growing SMEs. "They are one of those leading the charge who says, 'If we don't get this

right, we do not have a good economic future in this country,” he says. The firm’s demonstrated commitment to ethical practices and developing the entrepreneurial footprint in South Africa attracts many potential deals and ensures that relationships are fruitful and sustained.

This integration of advisory with capital offerings provides growing companies with not only the funds they need, but the guidance and market knowledge critical to success. BPL ensures that its mentoring services offer high value-add not only for entrepreneurs but for the firm itself.

RESULTS

Since its founding, BPL has grown its total investment portfolio through positive reinvestment activity, and without further capital calls, to \$380 million, made up of over 2,200 active investments. Between 2005 and 2013, the firm returned to its shareholders in excess of 2.5x their original capitalization in the form of dividends. As shown in Figure 9, between 2002 and 2013, BPL’s return on equity fluctuated between four and 11 percent, averaging seven percent across the 11-year period.⁸

FIGURE 9. PORTOFOLIO PERFORMANCE 2002—2013

	2002	2003	2004	2005	2006	2007
	Actual	Actual	Actual	Actual	Actual	Actual
PORTFOLIO SIZE	1,102,950,948	1,042,643,702	988,280,098	1,064,107,111	1,227,902,695	1,497,715,013
NET PROFIT		117,927,000	118,715,000	120,550,000	130,398,000	160,821,000
SHAREHOLDERS EQUITY		1,439,687,000	1,528,933,000	1,605,711,000	1,714,395,000	1,942,977,000
RETURN ON EQUITY (ROE)	7.1%	8.5%	8.2%	6.6%	8.1%	9.4%

	2008	2009	2010	2011	2012	2013
	Actual	Actual	Actual	Actual	Actual	Actual
PORTFOLIO SIZE	1,672,100,435	1,988,925,181	2,050,894,340	2,041,111,000	2,024,837,000	2,052,319,000
NET PROFIT	217,471,000	130,399,000	95,502,000	107,147,000	100,079,000	136,347,000
SHAREHOLDERS EQUITY	2,133,136,000	2,170,325,000	2,299,221,000	2,369,479,000	2,441,513,000	2,544,530,000
RETURN ON EQUITY (ROE)	11.1%	6.1%	4.4%	4.7%	4.2%	5.6%

*All amounts in ZAR

In terms of social performance, BPL has invested more than \$1.5 billion in more than 69,500 SMEs since 1981. Through this process, the firm has created or sustained over 550,000 jobs, which are tracked by BPL on a monthly basis.

In addition to its commitment to SME growth, BPL is also committed to balancing racial and gender representation in its portfolio. The firm’s shift in 1996 involved the development not only of a new structure and strategy, but also a strong drive to reach black African and female business owners and entrepreneurs.

With respect to reaching more black African entrepreneurs, BPL adopted a four-pronged strategy: launching targeted marketing and outreach initiatives; creating specific “ring fenced” funds with specialized investment teams to focus exclusively on the target population; employing black African investment professionals who can utilize their own knowledge and networks to develop the pipeline; and

⁸ While other case studies list financial results in terms of IRR, Business Partners Limited is not a fund, nor does it drawdown from investors like a fund, and therefore IRR is an inappropriate measure of performance. As a permanent vehicle with corporate shareholders, the firm uses ROE to demonstrate performance.

FIGURE 10. IMPACT PERFORMANCE

IMPACT METRICS TRACKED	Job creation; Gender representation in portfolio; Previously disadvantaged persons represented in portfolio; Regional representation; TA provided; Ability of portfolio companies to generate timeous and accurate management accounts
WOMAN-OWNED PORTFOLIO COMPANIES	39.2% (699 of 1,783)s
BLACK AFRICAN-OWNED PORTFOLIO COMPANIES	45% (803 of 1,783)
JOBS CREATED/ SUSTAINED	More than 550,000 historically

incentivizing the investment team through the remuneration structure offering compensation increases directly based on the ability of each investment officer to seek out and invest in a predetermined percentage of black entrepreneurs.

BPL has utilized this strategy to target woman-owned business in the past as well, at one point creating a dedicated women’s fund led and teamed solely by female investment officers. Management has since absorbed this effort into its general investment strategy, incentivizing investment in female-owned businesses through the remuneration strategy.

BPL has implemented this strategy with impressive results. Since increasing efforts to reach black African business owners in the mid-1990s, BPL completely transformed its portfolio: while white-owned companies used to comprise 80 to 90 percent of the deals, as of March 2013, 45 percent of the portfolio was investments in black-owned companies. Female entrepreneurs also make up a significant portion of the portfolio at just over 39 percent.

CONCLUSION

BPL’s unique approach to SME finance was developed and refined in South Africa over 30 years. The firm has made more than 35,000 investments in SMEs, and aims to address the key obstacles to financing SMEs (lack of collateral, high cost of appraisal, high cost of investment, limited upside, and lack of control) by:

- Structuring and pricing investments as self-liquidating instruments that do not require full collateralization;
- Structuring and pricing investments as self-liquidating instruments that do not require full collateralization;
- Obtaining cash flow rights that maximize the alignment of interests and tie cost of capital to underlying performance of the investee;
- Using low cost and efficient processes to assess, structure and monitor investments; and
- Strengthening investments by funding and managing coordinated and highly focused technical assistance that must demonstrate an acceptable financial return and a solid commercial basis.

Using this strategy over the last three decades, BPL has created a firm with a solid reputation for integrity, commitment to impact, and financial sustainability. Its management has demonstrated a capacity to move across commercial markets and opportunities and a capacity to engage the public sector in supporting market based solutions to the challenges faced by South Africa and, increasingly, nations across Africa. BPL is showing the way forward in the development of financially profitable investment strategies that optimize the generation of real social and environmental impacts.

POST SCRIPT

BUSINESS PARTNERS INTERNATIONAL: A NEW PARTNERSHIP

During the period between its initial launch and 2004, BPL was not alone in its efforts to meet the needs of a growing SME community in Africa. The International Finance Corporation (IFC), affiliated with the World Bank, was also active, working to fund and support business development throughout the region. One of the organization's key development goals in 2004 was (and remains today) "providing SME owners and employees with the business skills needed to operate efficient businesses and access the funds that help them grow...ensur[ing] that these businesses remain profitable and able to contribute to economic growth."⁹

Recognizing SME growth is essential to fueling the economies of developing countries, the IFC identified BPL as having an investment model that could be effectively applied to other African nations. In an official description of the partnership, IFC stated, "Although banks typically dominate lending to SMEs in South Africa, Business Partners services an important niche by providing quasi-equity and unsecured lending, an expertise that would be critical in financing SMEs elsewhere in Sub-Saharan Africa."¹⁰

Prior to its discussions with the IFC, BPL had not considered operating outside of South Africa. Its founders and investors felt there was more than enough opportunity within the country to keep the firm busy for years to come. However, the IFC was persistent, engaging BPL in discussions over a two-year period. Eventually, the two entities agreed to partner on the introduction of two funds, one in Madagascar and the other in Kenya; this strategy was subsequently executed through a new subsidiary of BPL called Business Partners International (BPI).

The initial idea was to raise capital for these two funds from development finance entities (like the IFC), but to give BPL the independence to invest and manage the strategy on its own. Accordingly, in these two initial funds, the IFC ensured the funding while BPL provided its expertise to the investment process. Since its founding in 2004, the partnership has been effective in reaching a geographically diverse group of SMEs in a financially sustainable manner. Given its central role in assisting BPL in moving north of the border, in 2012 IFC moved to acquire a 20 percent stake in BPI which, until that time, had been 100 percent owned by BPL.

FUND	SIZE	INVESTORS
Madagascar	\$11 million	Norfund, Stichting DOEN, Business Partners International
Kenya	\$15 million	TransCentury, European Investment Bank, CDC Group, East African Development Bank, International Finance Corporation
Rwanda	\$8 million	International Finance Corporation, Stichting DOEN, Rwanda Enterprise Investment Company, Business Partners International
Southern Africa SME	\$40 million	International Finance Corporation, Proparco, FMO, Stichting DOEN, AfDB, Business Partners

⁹ <http://www.ifc.org/wps/wcm/connect/2bdebd004013c78ebf8eff23ff966f85/sba-proj-bpi-saf.pdf?MOD=AJPERES>

¹⁰ <http://ifcext.ifc.org/ifcext/spiwebsite1.nsf/DocsByUNIDForPrint/5859A973993F7B8A852576BA000E281C?opendocument>

As of January 2014, BPI operates four funds. Three are invested separately in Madagascar, Kenya and Rwanda. In 2012, BPI launched a fourth fund – the Southern Africa SME Fund – raising \$40 million USD for investment in Namibia, Zambia, Zimbabwe and Malawi. Investment activity for the Southern Africa SME Fund began in January 2014. BPI also launched a fund in Mozambique, but closed it quickly in late 2012 before any capital could be deployed; after consulting with investors, BPI decided to back out due to legal issues.¹¹

In November 2013, BPI announced the start of fundraising for BPI East Africa, a \$30 million USD permanent investment company (much like BPL). BPI East Africa was created to continue investment activity in Kenya and Rwanda, and to open an office in Uganda.

Financing for BPI comes primarily from Development Finance Institutions (DFIs)—and the majority of that from International Finance and Development organizations (IFDs) and European development banking institutions. With the exception of one small partner in its Madagascar fund, BPI does not raise funds from individual investors.

¹¹ To operate as a private equity investor in Mozambique, BPI would have had to establish itself as a commercial bank. Rather than undergo the process of acquiring the necessary licensing and approval to achieve this status, BPI opted to withdraw and focus on its other three funds.