

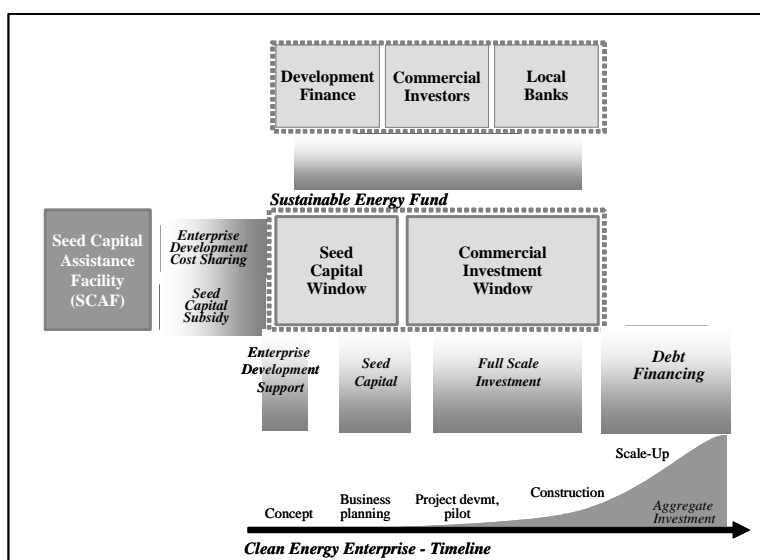
Seed Capital Assistance Facility (SCAF)

Concept Brief

SUMMARY:

A new energy initiative called the Seed Capital Assistance Facility (SCAF) is currently in preparation for implementation in a number of GEF eligible recipient countries¹. The initiative involves the creation of a GEF and UN Foundation sponsored facility dedicated to helping early stage sustainable energy enterprises access start-up seed capital from mainstream² energy investors. The Facility will be implemented through the Asian and African Development Banks, leveraging off of existing sustainable energy support programmes.

Through sharing enterprise development and transaction costs and providing a seed capital subsidy, the facility will help close the gap between what local sustainable³ energy entrepreneurs are able to offer in terms of returns on investment, and the requirements of the investment community. By bridging this gap, the facility will 1) help provide entrepreneurs with the enterprise development services and early stage risk capital they need to develop sustainable energy businesses and projects; 2) increase the scale and scope of these sorts of clean energy investment opportunities available to commercial financiers; and 3) increase the volume of more commercially oriented capital available to the seed finance sector.



SCAF Conceptual Structure

Rather than waiting on the side-lines for the sustainable energy sector to mature on its own, through this facility the finance community will be able to play a more direct role in accelerating renewable energy sector growth by channelling appropriate forms of investment capital to early stage project developments. By building experience in this area, it is hoped that early stage seed capital investing will increasingly be seen as a viable and cost effective strategy for building long term commercial energy investment portfolios.

Feedback Sought:

UNEP is currently inviting feedback on the SCAF concept from a range of actors in the energy investment community. Interested parties are invited to provide input that will inform further development and implementation of the Facility. Feedback should be sent electronically to lchaljub@unep.fr Information on UNEP's sustainable energy finance programme is available at www.unep.fr/energy/finance and www.sefi.unep.org

¹ The facility is currently in the CEO endorsement stage of GEF project development.

² Mainstream investors are defined as those financiers currently active in the energy sector in target regions, including development banks, local and regional commercial banks, national investment authorities, private investors, etc.

³ i.e., renewable energy and energy efficiency.

1. SCAF FACILITY RATIONALE – ENERGY ENTERPRISE DEVELOPMENT

In many developing country markets, small and medium sized enterprises (SMEs) have shown promise as a means to deliver new clean energy technologies and services to populations currently without access to modern forms of energy supply. In particular in rural and peri-urban areas, independent sustainable energy enterprises can frequently provide better adapted and more efficiently packaged small scale energy technologies than centralised utilities. Ranging from off-grid wind and solar home systems, to small hydro IPPs and industrial waste-to-energy projects, local sustainable energy enterprise can provide demand-oriented solutions that ideally complement the commercial and technological strengths and limitations of large utilities.

However, the supply of energy services via renewable energy or efficient energy technologies is often considered “new” and dismissed as “too small and too risky” by conventional investors. Therefore, only a very few private sector clean energy enterprises are financed today in developing countries. Furthermore, in most regions the challenges to clean energy enterprise development go far beyond mere access to capital. Most energy entrepreneurs also need a great deal of assistance to assess market opportunities; to prepare feasibility studies, proposals and business plans; to develop contracts and payment mechanisms; and overall to meet the demands and needs of customers and institutional contexts.

One solution is to offer entrepreneurs a combination of business development ‘hand-holding’ and start-up seed capital⁴. Such an enterprise development model was developed by the Rockefeller Foundation in the early 1990s and spun off in 1994 as the “public purpose” investment company E+Co⁵. E+Co’s enterprise development services provide the information, tools, consulting and direct assistance to entrepreneurs so that they can wisely use seed capital to start building a sustainable business enterprise that can supply affordable, reliable and appropriate energy services to customers.

It is the close coupling of enterprise development services and seed capital provision that clearly differentiates E+Co’s approach. All investments have a comprehensive, pre-determined exit strategy based on performance and cash flow. The seed capital is provided generally as debt⁶, structured with reasonable terms and conditions, including the interest rate, currency of repayment, length of loan, grace period and security. The investment objectives are, successively, for the enterprises to perform as planned; to repay their obligations; and to be positioned to grow. The initial emphasis is on performance not return; return is realised through later rounds of investing.

Since 2000, UNEP has been working to scale up this approach through a Rural Energy Enterprise Development (REED) programme involving E+Co, the United Nations Foundation, SIDA, BMZ and a diverse group of local enterprise development partners⁷. A few other initiatives, public and private, have become active in the clean energy seed finance area although the sub-sector is still small, both in terms of actors and financial scale.

The general experience of efforts to date have shown that assisting entrepreneurs to take risks, to innovate the way they deliver goods and services, and to experiment and refine their business models, can be an efficient and effective way to develop and grow new sustainable energy markets. However the approach is unlikely to mature to any appreciable scale unless more mainstream investment capital can be encouraged to participate at the early stages of enterprise growth. New approaches are needed to provide solid linkages between the early stage seed capital support and the subsequent commercial capital energy investment activities.

⁴ Typically in the \$50,000 to \$250,000 range, seed capital is used to finance companies or projects that have no significant track record and are therefore perceived by financiers as being prone to excessive risk and transaction cost. Seed Capital is used to prepare a larger implementation project or to prove the concept of an energy services company in a new market. The approach used to date has shown that through a combination of seed capital and support services many otherwise non-viable investments can mature to sound businesses and produce sustained financial and non-financial returns.

⁵ Since 1994 E+Co has made over 110 energy enterprise investments in more than thirty developing countries in Latin America, Africa and Asia. See www.energyhouse.com for more information.

⁶ Although equity investments were initially popular in the 1990s, the lack of exit opportunities has made them now less common although quasi-equity components are sometimes still included, particularly with higher risk projects.

⁷ For example, see www.ared.org or read the general background document titled “Open for Business: Entrepreneurs, Clean Energy and Sustainable Development” (www.uneptie.org/energy/publications/files/openforbusiness.htm).

2. BARRIERS TO SCALING UP THE SEED CAPITAL SUB-SECTOR

While there is increasing interest in the seed capital sub-sector, almost all of the support to date has come from foundations and donors, sources that are able to underwrite the broader developmental returns of seed capital investing. Although these sources have been critical to the early development of the seed finance model, attracting more mainstream capital to seed stage investing will be needed to realize the full potential of this area of investment activity. The challenges in the immediate future are to go beyond individual transactions and small portfolios.

Expanding the seed capital approach will require:

- i. Increasing the experience base with sustainable energy enterprises and the human capacity to provide support services and investment capital to these firms;
- ii. Increasing the scale and scope of opportunities available to mainstream investors; and
- iii. Increasing the volume of more commercially oriented capital available to this sector.

This facility specifically looks to address these challenges. The two largest hurdles to engaging commercial or near commercial investors in seed capital stage investing are the higher transaction and management costs of smaller and less developed clean energy transactions, and the lower risk-adjusted returns of these investments.

Seed Capital Barrier 1 – Higher Enterprise Development and Transaction Costs

Even if a fund manager is interested in seed capital investing, covering their costs can be difficult. On a seed capital financing of an early stage renewable energy enterprise, a commercial asset management fee of 2% to 3% is substantially below the real cost of sourcing, transacting and providing enterprise development services to the investment. Looked at as individual investments, the barrier of transaction costs seems insurmountable as it can cost between \$25,000 and \$50,000 to prepare and execute a \$100,000 seed transaction, and even the post-investment enterprise support costs can outweigh a commercial asset management fee.

There are some cost savings when approached on a portfolio basis. However, linking seed capital investments with follow-on financing is the only realistic way to fully address this barrier in the long term. Linking the two means seeing the seed capital investment process as a deal origination strategy for commercial capital investments. By investing seed capital in a portfolio of small investments, one can create the pipeline for subsequent growth and commercial capital investing: To incur a \$25,000 to \$50,000 cost for a seed transaction can be a very valuable use of funds, if the transaction succeeds in significantly reducing the costs of sourcing and transacting more commercial investments in the \$500,000 to \$5 million range.

However, until investors can see that such integrated investment strategies will work, they will generally sit on the side-lines and wait for the pipeline of early stage enterprises to mature on their own – a slow and inefficient process from the global development perspective.

Seed Capital Barrier 2 – Lower Returns

Similarly, if seed capital investments are looked at in isolation, the risk adjusted returns demanded by investors are often not achievable by early stage sustainable energy SMEs. E+Co experience demonstrates that at the transaction level (before losses and costs) dollar denominated returns of 5 to 7% are possible and returns of 10-30% (as demanded by investors) are not achievable. However, the work to date has shown that seed capital investing, when done as part of a comprehensive, multi-stage portfolio strategy, can achieve solid and attractive base returns on a portfolio basis. A 5% return on a seed portfolio might be acceptable to mainstream investors if one in four investments in the seed portfolio later matures into a >15% return on a larger growth capital investment. Adopting such a portfolio strategy has shown the potential to achieve the base returns investors desire and to lower overall portfolio risk through improved deal origination and diversification.

3. SCAF STRUCTURE

To address the above issues and barriers to early stage finance of young clean energy enterprises, the SCAF will offer investors and fund managers two cost-sharing support lines:

Enterprise Development Support

The first support line will be a cost sharing formula to energy fund investors for them to include a percentage of smaller, earlier stage seed capital transactions within their portfolio. For example, a \$20 million fund might be asked to set aside 5% to 10% of total capital for earlier stage, seed investing in return for which the SCAF would double or even triple the commercial fund management fee to cover the increased cost of sourcing and

transacting the seed scale investments. As part of this arrangement the fund manager would commit to identifying and developing a pipeline of early stage clean energy projects, and providing enterprise development services to qualified local entrepreneurs. Each fund manager would offer a different set of services, based on the local context, however the common elements of these services would involve:

- identification and training of new ‘pre-commercial’ clean energy entrepreneurs;
- provision of enterprise support services including tools and assistance for concept development, fact-finding and business planning⁸;
- assistance with feasibility analysis and financial models; and
- support with project implementation, product/service development, company scale-up.

The Enterprise Development support would come in the form of annual fees based initially on the amount of seed capital under management, and subsequently on the value of the seed capital portfolio. The support line would be time limited to between three and five years, the period during which a seed capital investor provides the most enterprise support to the portfolio and the time it takes to graduate seeded enterprises to growth capital investments, if/when this occurs. The seed fund manager will be obliged to meet an investment schedule failing which the annual enterprise development support payments would decrease. This is to prevent the moral hazard of funds being allocating to seed capital windows, but not being drawn down.

Seed Capital Subsidy

Besides sharing some of the transaction costs of preparing early stage energy investments, the SCAF would also provide a seed capital subsidy to buy-up the investment returns offered by these early stage seed financed enterprises.

The seed capital subsidy would be designed to offset the hurdle of higher perceived risks and lower expected returns when dealing with early stage sustainable energy enterprises. This involves the reality that seed capital investments take a period of two to four years to mature into more commercial growth capital opportunities, if and when this occurs⁹. The mechanism proposed is to offer time limited support to cover a portion of the incremental returns hurdle, the gap between what a portfolio of early stage enterprises are able to provide in terms of risk adjusted returns on investment, and what more growth capital oriented investors are able to finance.

It is expected that three to four year payments will be negotiated. Thus, if a growth capital oriented fund manager needed to achieve a 10.5% return on a portfolio basis (after management costs and losses) and the seed capital window was only expected to provide a 4.8% return, the SCAF would be willing to cost-share part of the difference projected over a three to four year investment window¹⁰.

Even if only a small portion of the investments seeded by a fund mature into truly successful growth or commercial investments, then the incremental return from these follow-on investments more than compensates for the seed capital stage risk absorbed. For example, if two of ten seeded investments mature such that \$3 million can then be placed at 17%, then the combined return of the seed investments (4.8%) and the later stage investments (17% less costs) outperforms the benchmark 10.5% target by almost a full percentage point at 11.4%. Since a follow-on investment would be less risky than either the seed investment or a first investment in larger commercial capital transaction (because of familiarity), it is believed that such positive experience will change the portfolio habits of commercial investors.

⁸ See for example the REED Entrepreneur Toolkit (<http://www.areed.org/training/toolkit/index.htm>).

⁹ If not, they either result in outright failure, or failure to grow (a small business stays small but still repays the loan).

¹⁰ For example, a set of ten \$150,000 seed capital investments might under-perform one \$1.5 million investment by an amount equal to about \$318,000 on a present value basis, representing the difference between a 4.8% return (IRR) and a 10.5% pro forma IRR. To compensate for taking on this lower return portfolio, the SCAF would negotiate a set of time-limited payments intended to partially cover this IRR gap.

Example: Expanding a Proposed Sustainable Energy Fund to Include Seed Capital

Fund Manager XYZ are in the process of raising capital for a \$25 million sustainable energy fund (called the XYZ Fund). The new fund will invest in renewable energy and agro-industrial energy projects, energy efficiency and ESCOs in countries A, B, C and D.

At present it is planned that the fund will invest in reasonably secure “cash flow and capital appreciation” projects in the Euro 2 to 4 million range. Although XYZ believe that doing smaller seed capital investments as part of the fund strategy could be an effective means to build the pipeline of growth capital investments, this combined seed/growth capital approach is still seen as too risky and too costly by investors. Without outside considerations, XYZ would need to price any small scale investment at a level which is generally out of reach of smaller project developers. Incremental transaction costs and risk-return perceptions prevent the creation of a seed capital window in the XYZ Fund.

The proposed Seed Capital Access Facility could help address this problem. By sharing part of the enterprise development and transaction costs and offering a return subsidy or ‘buy-up’, the Facility would allow XYZ Fund investors to consider allocating \$1.5 - \$2.5 million within the fund for early stage, seed capital investing. A contract would be developed between SCAF and XYZ Fund at the outset that committed SCAF to provide a share of the higher management costs associated with smaller transactions and an interest rate supplement.

In practice this will work as follows. XYZ Fund investors are seeking a 10.5% return on a portfolio basis, after losses and costs. It is expected that a seed capital window would achieve a 4.8% return, creating a 5.7% gap and costing three times as much to prepare and manage. In this case the SCAF would contract for a share of these two differences as follows:

Enterprise Development Costs - The Facility could tentatively negotiate a total enterprise development and transaction cost-sharing agreement of between \$300,000 and \$500,000 to cover the incremental costs of working with entrepreneurs to prepare investments, and then transacting and managing a portfolio of small seed finance deals. This support would be paid out over 3 to 4 years in annual installments.

Seed Capital Subsidy - The Facility might provide an annual investment premium of 2% to 4% for each seed finance transaction taken over a period of three to four years. Although negotiated up-front at the funds inception, the payments would be made at the time of each individual investment. On a set of seed capital investments totaling \$2,000,000, this premium would be between \$122,000 and \$340,000.

Thus, SCAF could foresee a commitment of between \$422,000 and \$840,000 to the XYZ Fund to help it integrate a seed finance window within the overall investment strategy. The SCAF could not cover the entire investment gap, but could help close it to the point where the deal origination value of the seed portfolio to the more commercial investment window more than compensates for the sub-commercial returns offered by

4. SUPPORT FOR THE DEVELOPMENT OF NEW CLEAN ENERGY FUNDS

The SCAF will also provide support and technical assistance to specialist fund management companies and other local entities to scope out, develop and capitalise new sustainable energy funds with a seed finance component.

This could include support for: feasibility studies; preparation and issuance of fund solicitation documentation; ‘walking around’ monies for fund capitalisation; set-up of financial planning/-analysis procedures; set-up of financial control and risk management procedures; training of fund/subfund managers; assistance with the development of investment pipelines. Support will generally be provided as a sharing of the incrementally higher costs associated with clean energy fund development, with the fund proponents expected to cover the majority of the overall cost. Funds will not be available to cover fixed or payroll costs of the fund manager or proponents.

5. FEEDBACK WELCOMED

UNEP is currently seeking feedback on the SCAF concept from a range of actors in the energy investment community. Interested parties are invited to provide input towards further development and implementation of the Facility. Any input provided should include a presentation of the submitting company/organisation and feedback, as appropriate, on the overall concept of the facility, the structure of the proposed support lines, and the interest of the submitting organisation to eventually access SCAF support. Inputs should be submitted electronically to lchaljub@unep.fr