



# SME INVESTMENT FUND FEASIBILITY STUDY

ADDRESSING THE NEED FOR ACCESS TO RISK CAPITAL FOR WELL-MANAGED, HIGH-POTENTIAL GROWTH SMEs IN BOSNIA & HERZEGOVINA

**22 September 2021**

This document was produced for review by the United States Agency for International Development. It was prepared by:

**Financial Markets International**   
implementer of the

**USAID Bosnia & Herzegovina Financial Reform Activity (FINRA)**

This document is made possible by the generous support of the American people through the United States Agency for International Development (USAID). The contents are the responsibility of the authors and do not necessarily reflect the views of USAID or the United States Government.

## **Acknowledgements**

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The team wishes to express its appreciation to the many interviewees and informants from companies, financial institutions, professional service providers, and donors, listed in an annex, whose friendly availability and inputs were so important to the production of this report.

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*This report is presented in two separate volumes. The first is this document, the body of the Study, and Volume 2 contains the combined Annexes to the Study.*

## Acronyms and Abbreviations

<u>Item</u>	<u>Meaning</u>
A2F	Access to Finance
AIF	Alternative Investment Fund
APRMBIH	Association of Private Risk Managers of BiH
AUM	Assets Under Management
BAM	Bosnia-Herzegovina Convertible Marks
BGF	Bosnia & Herzegovina SME Growth Finance Fund
BiH	Bosnia & Herzegovina
BLSE	Banja Luka Stock Exchange
BPL	Business Partners Ltd. (South Africa)
BRFF	Bosnia Reconstruction Finance Facility
BSAs	BiH Bank Supervisory Agencies (FBA & BARS)
CBBH	Central Bank of BiH
CoC	Chamber of Commerce
COSME	Competitiveness of Small and Medium-Sized Enterprises program
CzDA	Czech Development Agency
DCA	Development Credit Authority (USA)
DFC	US International Development Finance Corporation
DGGF	Dutch Good Growth Fund
EBRD	European Bank for Reconstruction & Development
EDIF	Enterprise Development & Innovation Fund
EFSE	European Fund for Southeast Europe
EIB	European Investment Bank
EIF	European Investment Fund
ENEF	Enterprise Expansion Fund
EU	European Union
FBA	FBiH Banking Agency
FBiH	Federation of BiH
FDB	Federation Development Bank
FINRA	Financial Reform Agenda Project (USAID)
FMC	Fund Management Company
FMO	Netherlands Development Finance Company

<u>Item</u>	<u>Meaning</u>
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GIZ	German Corporation for International Cooperation GmbH
I&P	Investisseurs & Partenaires
IFC	International Finance Corporation
IFI	International Financial Institution
IBRS	Investment-Development Bank of Republika Srpska
IRR	Internal Rate of Return
ISA	Insurance Supervision Agency of BiH
JSC	Joint Stock Company
KCGF	Kosovo Credit Guarantee Fund
LCR	Liquidity Coverage Ratio
LGF	Loan Guarantee Facility
MFI	Microfinance Institution
MM	Million
MSME	Micro, Small, & Medium Enterprise
NBFI	Nonbank Financial Institution
NPL	Nonperforming Loan
NSFR	Net Stable Funding Requirement
OPIC	Overseas Private Investment Corporation
PE	Private Equity
PRFRS	Pension Reserve Fund of Republika Srpska
PSC	Private Sector Credit
PSC/GDP	Private Sector Credit-to-GDP Ratio
RDA	Regional Development Agency
RR	Royalty Rate
RS	Republika Srpska
SASE	Sarajevo Stock Exchange
SDC	Swiss Development Corporation
SDGs	Sustainable Development Goals
SECO	State Secretariat for Economic Affairs (Switzerland)
SGB	Small & Growing Business
Sida	Swedish International Development Agency

<u>Item</u>	<u>Meaning</u>
SMEs	Small & Medium Enterprises
TAEF	Tunisia American Enterprise Fund
TASME	Tunisia American SME Company
UBBiH	Bankers Association of BiH
UNDP	United Nations Development Program
USA or US	United States of America
USAID	United States Agency for International Development
VC	Venture Capital
WB	World Bank
XSML	eXtra Small Medium Large
Y	Year

## Executive Summary

This Study, commissioned by USAID Bosnia & Herzegovina, was motivated by the serious inadequacy of business access to finance in Bosnia & Herzegovina, especially for SMEs, and even more particularly for their ability to source “risk capital” – generally subordinated, cash flow-based finance. This major obstacle to SME growth and competitiveness is primarily due not to a lack of standard bank finance in BiH, but to the near-complete absence of *nonbank* finance.

The establishment of an investment fund registered in BiH, and dedicated to the provision of growth finance to SMEs, is the most direct way both to begin addressing the yawning nonbank finance gap, and to demonstrate the use of the local capital market as a channel for private sector finance in general, which has not been the case to date. The purpose of this Study is to evaluate the feasibility of such a fund, with respect to its establishment, its funding, its investment, and its profitability.

The proposed fund – herein called the BiH SME Growth Finance Fund (BGF, or “the Fund”) – would raise some \$30 million (MM) in initial capital in privately-placed equity and debt securities to foreign and local investors; would be registered locally, governed by BiH company and securities law; would provide finance to SMEs mainly through medium-to-long-term subordinated revenue capital instruments (whose yield is tied to a royalty on company revenues), would be evergreen (reinvesting loan principal repayments), and would have a high-volume deal orientation, extending some \$30MM to 150 companies over its first five years, and a projected \$100MM to 500 companies by year twelve (Y12). The fund would aim to provide adequate returns to investors, while materially advancing development objectives including economic growth, financial sector development, employment and household incomes, gender mainstreaming, and climate and environmental protection.

Prepared over April-September 2021 with contributions from a 13-person team consisting of staff and outside advisors of the USAID BiH FINRA project, information-gathering came mainly from direct interviews with some 115 different companies, financial institutions, government agencies, professional services providers, and development assistance projects<sup>1</sup>.

Based on this information and analysis, this Study concludes that in fact, **the establishment and successful operation of such a fund is entirely feasible**. It finds that:

- *Legally establishing the investment fund is feasible.* Despite the lack of enabling legislation and regulation currently in BiH, according to legal counsel engaged for this study there is EU-compliant Alternative Investment Fund (AIF) legislation that would enable establishment of the BGF, and can be readily drafted and adopted here. AIFs are collective investment vehicles targeting specific types of investments, and the concept has been widened to address SME finance. This body of law already exists in neighboring Croatia and Serbia. Financial sector oversight institutions in BiH that were interviewed

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<sup>1</sup> All interviewees are listed in Annex 1, contained in the accompanying Volume 2 of this report.

for this study welcomed the concept and are expected to cooperate in the required legal-regulatory development.

- *Building a pipeline of viable investee SMEs is feasible.* It is reasonable to expect that out of a population of some 6,000 SMEs in BiH – companies in the 10-250 employee range (of which over 80% are 10-50 employees) – there are at least several hundred that are viable and would have the most potential to productively employ BGF finance, and provide a strong fund and investor return on it.

For purposes of this study, the FINRA team interviewed over 80 SMEs representing all regions, major industry sectors, and sizes in BiH. Screening and analysis was conducted to determine the degree to which these companies could satisfy the Fund’s three fundamental investment criteria: (i) a clearly demonstrable, available market opportunity, (ii) high growth potential – the probability that given finance, the firm’s total sales will at least double within 3-5 years, and (iii) plainly capable management. A pro forma pipeline of 70 companies was constructed for this Study, of which nearly half (32) were assessed to well-satisfy these three criteria, and if financed would require an estimated \$6.4MM in BGF funding. In other words, this first cut of candidate SMEs could absorb one-fifth of the Fund’s initial capitalization within weeks of launch.

The study also notes the feasibility of engaging a network of regional economic development agencies across BiH with whom BGF will be able to partner to magnify its outreach and assist in promoting, originating, assessing, and monitoring fund investments.

- *The Fund’s approach to SME financing is feasible.* The study describes examples of SME-oriented investment funds in other countries that have successfully employed revenue capital instruments. In addition, the revenue capital concept was explained to the pro forma pipeline SME owners interviewed, who in general found it attractive for their growth finance needs, appreciating the subordinated, uncollateralized, and risk-sharing nature of the instrument, and the consequent justification for a relatively high Fund target yield.
- *Finding investors to capitalize the Fund is feasible.* The study describes a range of prospective investors in the fund. A number of these were interviewed, and they all expressed interest in considering investment after receipt and review of this report. These included donors that have supported access to finance in BiH, and/or have invested in business finance funds in other countries, as well as potential institutional investors in BiH, which included commercial banks, some of whose leaders indicated interest to FINRA in supporting an SME investment fund at an early stage of development of the concept.
- *Recruiting capable fund management staff is feasible.* Proper staffing of the BGF requires a team of individuals that combine experience in fund management, enterprise development assistance, private business, investment and lending, and regional / country knowledge. A properly experienced CEO is likely to be recruited internationally, as well as one or two senior investment officers, while the rest of the professional investment staff can be found in BiH, thanks to 25 years of donor economic growth projects, as well

as the entry of international commercial banks, that have built a highly capable cadre of business performance consultants, financial analysts, and credit officers in BiH.

- *The BGF is feasible according to quantitative analysis.* The FINRA team developed a sophisticated financial planning and projection model to test profitability and yield potential. The model brings together key parameter assumptions as to capitalization and investor return requirements, average loan size, portfolio growth given per staff workload capacities (screening-originating-closing and assets under management), revenues from loans (interest and royalty rates), average loan term and repayment, loan write off rate, personnel and operating expenses (including payments to originating partners and outsourced fund administration and professional services). Based on these inputs, the model projects that BGF will reach profitability by Y6, and positive operational cash flow by Y8.

This study details these areas of feasibility, and concludes with a recommendation to proceed with developing the necessary enabling law and regulation, and conducting in-depth meetings with potential investors to obtain preliminary commitments for the initial capitalization. Both of these tasks can be taken on by FINRA within the remaining term of the project (September 2022). In the year following that, the study recommends registering the fund, engaging staff, securing investor funding, and commencing operations.

## 1. The SME Access to Finance Challenge and Opportunity

Dynamic smaller and mid-sized enterprises in Bosnia & Herzegovina (BiH) have extremely limited access to growth finance, which stunts not only their own business potential, but the economic development of the entire country. Despite the fact that this problem has long been observed, not enough has actually been done about it. This report proposes and evaluates the feasibility of a Bosnia & Herzegovina (BiH) SME Growth Finance fund (BGF, or “the Fund”), initially capitalized at \$30 million, that will deliver a competitive return to investors, while having visible economic development, job-creating, and other development objectives impact. In addition to its primary purpose of expanding small and medium enterprise (SME) access to finance, the proposed fund is designed to catalyze further development of the local capital market as a source of private sector finance, which it has not been to date, and provide a channel for productive use of the substantial excess liquidity in the BiH banking system.

### 1.1 The Growth Finance Gap in BiH

The “missing middle” in finance – the absence of funding available to businesses that are between micro- and very large enterprises – is one of the most well-reported characteristics of financial sectors, not only in BiH but in virtually all developing countries.

What progress has been made in reducing this gap in BiH was due mainly to the penetration of banks into business lending over the 2000s decade. Between 2001 and 2008, when the Global Financial Crisis (GFC) hit, the country’s private sector credit (PSC) burgeoned from under 25% to over 65% of gross domestic product (GDP). However, this impressive increase still left the PSC/GDP ratio at only about one-third that of the high-income economies (which averages about 165%), and only about half that of middle income economies as a group (120%)<sup>2</sup>.

There has been no further progress in BiH since then. Indeed, the ratio has fallen back to about 60%. Bank lending to the private sector, which surged 25-30% *annually* in the years up to 2008, averaged only about 4.5% annual growth over the ten years after the GFC (and that was weighted toward households, not businesses), and then fell during the COVID-19 pandemic recession.

Ironically, there is plentiful liquidity in the BiH banking system. Between 2009 and 2019, 11.1 billion BiH convertible marks (BAM) in deposits flowed into BiH banks. But they lent out only a little more than half of that (BAM 6 billion) to the private sector, and only BAM 2.3 billion of that – just one-fifth of total inflows – financed business credit. Almost half of the entire inflow of bank deposits over the decade went into deposits in foreign banks, BiH government bonds, and reserves. BiH commercial banks now hold over BAM 3 billion in excess reserves at the Central Bank of BiH (CBBH) – about double their required reserves.

These funds are not going into private sector credit because of weaknesses in the financial sector enabling environment (some of which will be discussed below) and because of the substantially tightened bank supervision regime that has occurred globally since the GFC, which is being rapidly in BiH.

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<sup>2</sup> World Bank Database, 2020 data. <https://databank.worldbank.org/source/world-development-indicators/preview/on?l=en#>

In fact, it is not really the banks that are to blame for the unsatisfactory level of private sector credit in BiH. About 80 percentage points of the overall PSC/GDP ratio in the high-income economies represents banks. This is not that far above the roughly 60% PSC/GDP ratio of BiH, which, as seen in the table below, is almost entirely bank finance: banks (plus microcredit organizations) hold over 90% of all financial assets. So BiH banks compare not that unfavorably to banks in high-income economies in providing credit to the private sector. The problem for access to finance, particularly for businesses, and especially for SMEs, is not *bank* finance; rather, it is the almost complete **absence of nonbank finance**. For high-income economies as a group, nonbank finance accounts for over 40% of private sector credit, and in both the USA and EU, it is over half. In BiH, it is less than 10%, at best.

Financial Assets of BiH Financial Institutions 2019		
Intermediary	BAM MM	Share %
Banks (incl MFIs)	34,442	91.2%
Leasing Companies	398	1.2%
Investment Funds	862	2.3%
Insurance Companies	2,078	5.5%
<b>Total</b>	<b>37,780</b>	<b>100%</b>

Source: Central Bank of BiH

BiH has little independent leasing, insignificant factoring and purchase order finance, minimal equipment finance, tiny defined-contribution pension funds, a very small insurance sector (whose assets, when not in real estate, are anyway held in bank deposits), and no local mezzanine, private equity, or venture capital funds. Its capital markets provide virtually no business finance. All this is despite the fact that enabling legislation is in place for many of these channels, which are particularly suitable for SME finance.

This absence of nonbank finance is what motivates the present proposal to establish a fund that targets SMEs that cannot access traditional bank financing adequate to realizing their legitimate growth opportunities. The fact that these companies have essentially no nonbank finance options at present means that there is a substantial need, which should present many opportunities for such a fund to be profitable and sustainable.

For BGF to be feasible, four things must be established:

1. The legal structure for the fund, enabling it to raise funds and make investments in line with its concept
2. The existence of a viable pipeline – a pool of SMEs that meet the fund’s investment criteria and are interested accessing finance from the fund on its terms
3. The interest and willingness of investors to finance the fund, through purchases of its equity and debt securities
4. The ability to recruit a qualified fund management team.

These are the subject areas of this feasibility study. The following provides a summary description of the BGF concept.

Table 1: BGF Concept Summary

<b>Name:</b>	<b>Bosnia &amp; Herzegovina SME Growth Finance Fund (BGF)</b>
<b>General Form:</b>	Private securitized investment vehicle, closed-end; minimum initial size \$20 million, growing to \$30 million in Year 5; potential eventual cumulative disbursements to SMEs totaling approximately \$100 million by Year 10 to some 500 companies, given reinvestment of loan principal repayments
<b>Organization:</b>	Private unified fund and management company registered in BiH as a joint stock company (JSC) under EU-compliant AIF law (to be adopted), and compliant with existing applicable companies, banking, and securities law and regulation of the Federation of BiH (FBiH) and Republika Srpska (RS)
<b>Term:</b>	Long-term / perpetual lifetime (evergreen), with loan reflows and earnings redeployed in new investments
<b>Capitalizing Securities:</b>	Privately-placed equity and debt to local and international investors; different tiers reflecting seniority and yield according to type of investor
<b>Other Foundation Funding:</b>	Donor grants
<b>Investors:</b>	Bilateral donors, international financial institutions (IFIs), BiH government entities, BiH commercial banks and insurance companies, foreign private funds (especially impact investors)
<b>SME Financing Instruments:</b>	Subordinated and generally unsecured debt instruments earning a hybrid yield from a fixed interest rate and royalty on revenues; principal repaid over a standard medium term (prepayable at borrower discretion without penalty); normal financing range \$100,000 - \$500,000
<b>Portfolio Companies:</b>	Limited liability SMEs, typically 10-100+ employees, annual revenues \$500,000 to \$3,000,000; multi-sector
<b>Key Investment Criteria:</b>	<ul style="list-style-type: none"> <li>• Clearly demonstrable market opportunity</li> <li>• High growth: expected minimum 2x sales growth within 3-5 years, given financing</li> <li>• Capable lead and operational management</li> </ul>

## 1.2 BiH SME Growth Finance Fund Purposes

The purposes of the Fund are to expand finance to SMEs in BiH, while addressing other development objectives, providing a competitive return to investors, stimulating development of the local capital market for private finance and for nonbank finance more generally, while providing a channel for productive employment of excess liquidity in the BiH banking system.

- *Providing SME Access to Finance*

At the microeconomic level, the *BiH Access to Finance Assessment*, recently produced by the USAID BiH Financial Reform Activity (FINRA), reported the results of extended onsite interviews with companies throughout BiH, in a range of sizes, representing key export sectors (USAID 2020). The survey found that while the larger companies had satisfactory credit through banks, the growth potential of SMEs has been limited to: (i) the resources of their owners, (ii) their profitability / retained earnings, and (iii) the availability of unpledged real estate and equipment collateral.

Beyond family and friends, there is no significant source of risk capital to SMEs in BiH. BGF's principal purpose is to begin to fill this critical access to finance gap.

- *Achieving Development Objectives*

Increased access to finance to enable qualifying SMEs to reach their market potential is key to BiH economic development, since a country's economic growth is no more nor less than that of its aggregate enterprises. Investment selection will be guided by evaluation of individual business performance and management capability, but those that satisfy these criteria will be further prioritized according to additional longstanding development objectives of USAID and other donors. Other things equal, and according to an organized rating system, companies will be preferred which expect to generate more well-paying jobs, which increase female participation in the economy (especially in ownership and management), and which avoid contributing to global climate change or any other form of environmental degradation. BGF reporting to investors will include financial and non-financial information that captures progress toward these and other development impact objectives.

- *Rewarding Investors*

According to the detailed financial planning model developed for this study, discussed in detail below, the BGF can be expected to provide an above-market yield subject to medium risk to commercial investors through its senior securities, a higher return to impact investors and others willing to purchase its subordinated securities, and a reasonable dividend, after a period, to its equity investors.

- *Channeling Excess Liquidity and Catalyzing Nonbank Finance Development*

Fundamental to the BGF concept is its registration on, and issuance of its capitalization instruments through, the local capital market, in order to help open this channel to private sector credit, which has been negligible to date. The BGF will serve as a pilot, demonstrating the viability of investment funds dedicated to particular types of finance – not just alternative investment funds (AIFs), but as well home mortgage funds, equipment finance funds, and similar. And, by

providing high-quality private sector securities that can attract investment by local banks, insurance companies, and pension funds, BGF will stimulate others to issue corporate bonds and commercial paper to take advantage of these sources.

As noted above, the BiH banking system holds the equivalent of over \$2 billion in excess liquidity, above and beyond its required reserves and EU-compliant prudential liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) standards. One reason for this is that other than standard loans to businesses and households, the only available local financial assets are government bonds. The expressed interest of key BiH commercial bank CEOs in supporting SME finance through such a Fund was one of the catalysts for this Study.

None of the past or present investment or development funds focused on BiH, or in the Western Balkans region, have had precisely the business model that will be outlined below, whose design is dictated by the multiple objectives outlined in this section.

### 1.3 Overview of BGF Asset Portfolio

To address the inadequacy of access to finance for SMEs in BiH, BGF will seek to build a large portfolio of investments in such companies. The portfolio will range over industry sector, geographic region, and SME size, for wide economic growth impact, and for portfolio risk diversification, to elevate the prudential quality of the Fund's investor securities.

Growth finance enables an SME to undertake the product development and capacity expansion necessary to fulfill demonstrable market opportunities. This is especially needed for enterprises with higher growth potential, which have already pledged their available collateral toward bank loans, and in any case, even though profitable, have cash flow pressures due to that growth. In short, they need risk capital. While equity finance would seem to be suitable for this purpose (even if it were available), it would not be attractive to most closely-held SME owners, who are not interested, at least at the growth stage typical of such businesses in BiH, in welcoming unfamiliar parties into their ownership ranks. Equally important, investor exit options for equity in SMEs are extremely limited within a reasonable time horizon. So, in the case of SMEs, neither demanders nor suppliers of risk finance are interested in equity.

The proposed design of the Fund's financing instruments, therefore, must satisfy the need for risk capital in a form that is attractive to prospective borrowers while providing reasonable returns and, through diversification, protection from risk to the Fund and its investors. The most straightforward such instrument is the revenue capital, a debt security subordinated and unsecured (other than through an equity pledge). This Study employs this as the standard BGF investment asset, with a fixed interest rate, obligatory principal amortization over a medium- to long term, and the primary yield component from a royalty rate payment on revenues.

Based on our detailed Financial Plan & Projection model ("the Model", discussed below), the average IRR target for BGF investments would need to be in the 15% range in order for the fund eventually to achieve profitable operations and pay investors a reasonable return. Specifically, fund revenues from SME loans are assumed to come from an average 5% fixed rate of interest paid on outstanding loan balances (comparable to the 3-6% range charged by BiH banks to established creditworthy borrowers) and an average royalty rate of 0.5%-1.0% of total revenues,

paid over the life of the loan. These parameters are similar to those of successful funds in some other countries also targeting SME finance (reviewed below), and proved acceptable to the several dozen SMEs surveyed by the USAID FINRA team in preparing a pro forma “pipeline” for this report.

To achieve this, BGF would likely be structured under EU-compliant Alternative Investment Fund (AIF) law, to be developed and adopted with the technical assistance of the USAID FINRA project. It would then be able to fund itself by issuing equity and debt securities, registered on the local capital market, to a range of local and international official and private investors.

#### 1.4 Overview of Fund Structure

For purposes of this Study, the Fund structure design that will be elaborated is a single internally managed finance company, organized under to-be-adopted AIF law (which already exists in neighboring Croatia and Serbia), whose liabilities are principally investor securities, and assets loans to SMEs. Rather than the investment fund with separate fund management company (FMC) model (though also compliant with AIF law), the single finance company model is more streamlined from a legal-regulatory point of view, more conducive to a sustained / evergreen term of operation (with extended fundraising and leveraging), and, by offering stability and continuity, is more amenable to supportive grant funding and pursuit of related development impact objectives.

As will be further discussed below, professional staffing will consist of international and local experts with substantial experience in fund management, SME development, and investment/credit analysis; knowledge of the BiH economy; extensive personal networks in BiH private and public sectors; and seasoned awareness of the risks that must be navigated in making such investments in BiH.

## 2. BGF Target Market

### 2.1 Macroeconomic Indicators of Investment Opportunity

The lack of access to finance and low PSC/GDP ratios in BiH and other developing countries is often blamed on the companies themselves, which are said to be “not bankable.” But in fact, there are many hundreds of midsized firms in BiH that are capably managed and face market demand that is far larger than they are able supply, simply because there is no available credit or investment for product development and capacity expansion. Aside from direct observation, there are three macroeconomic reasons to think that this should be the case.

Bosnia’s demographic and income characteristics are promising for business growth in general. BiH is a market of some 3.5 million people, whose per capita income has more than doubled over the past 15 years. Average annual household income is now about BAM 31,000 – up almost BAM 15,000 since 2005.

GDP \$ / Capita			Domestic Demand \$ B		
2005	2019	Growth	2005	2019	Growth
2,980	6,025	102%	19.1	31.0	62%

Source: World Bank Databank

Though several important BiH sectors are export-oriented, three-fifths of its production is for the domestic market, which has expanded by over 60% in the past 15 years. Once the COVID-19 crisis is past, these trends can only be expected to resume, having already begun showing signs of doing so in 2021. The BiH internal market will provide growing opportunity to local producers in the years ahead, and eventual accession to the EU will provide wider opportunities for producers in that huge single market. BiH already benefits from membership in the Central European Free Trade Area (CEFTA), and has favorable trading agreements with the EU.

As for exporters, their sales have risen dramatically over the same period. Even though the current account deficit is often lamented, the growth of goods exports has in fact greatly exceeded that of imports over the past 15 years. As seen in the chart, 2019 exports of goods and services were 2.3x their value in 2005, while goods and services imports were about 1.4x that level.

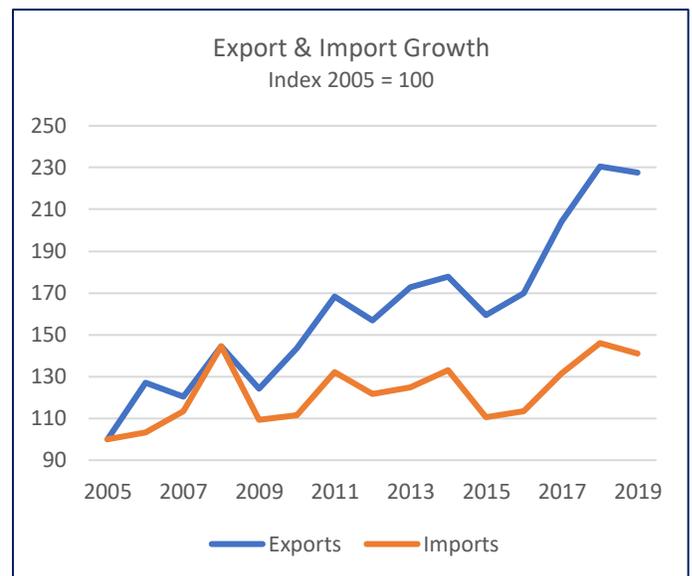
BiH has major export advantages. Its location is excellent, with freight able to reach any buyer in Western Europe by truck within a week. The country has been a traditional supplier of light manufactured goods to the EU, and many companies already connected to value chains there, including major brands. It has an educated workforce and strong engineering professions, with highly advantageous labor costs. Meanwhile, frequent design adjustments by European buyers, in-season reorders, and tighter inventory control are shifting demand in many consumer-oriented sectors from the Far East back to the region, to Bosnia's benefit.

USAID, German Corporation for International Cooperation GmbH (GIZ), United Nations Development Program (UNDP), European Bank for Reconstruction and Development (EBRD), and other donors have dedicated significant

resources to strengthening the demand side of the market for finance over the past 25 years, through enterprise competitiveness projects often targeted on key export sectors. These efforts have contributed significantly to business growth, by helping to improve general business management, upgrade product design and quality, find export markets, elevate productivity, and access qualified workers. These sustained interventions, in other words, have made thousands of BiH SMEs more viable and therefore "bankable" in the broader sense.

## 2.2 Sectors and Products

BiH has several general competitive advantages, arising from its natural resources and geographic location, and human capital attributes. The following table summarizes them, and identifies the main sectors open to SMEs that they benefit.



**Table 2: Overview of BiH Competitive Advantages Benefitting SMEs**

<b>Advantage</b>	<b>Description</b>	<b>Sectors / Products – SMEs</b>
<ul style="list-style-type: none"> <li>• Natural Resources</li> </ul>	<ul style="list-style-type: none"> <li>▪ Extensive mixed forests; annual growth well above cut; good forest management practices</li> <li>▪ Long tradition / experience in forestry and downstream products</li> </ul>	<ul style="list-style-type: none"> <li>• Wood furniture</li> <li>• Furniture elements</li> <li>• Wood construction components</li> <li>• Prefabricated wood houses</li> </ul>
	<ul style="list-style-type: none"> <li>▪ Temperate climate, arable land, plentiful water</li> </ul>	<ul style="list-style-type: none"> <li>• Agriculture</li> <li>• Food processing</li> </ul>
	<ul style="list-style-type: none"> <li>▪ Plentiful sun + limestone-based soils (Herzegovina)</li> </ul>	<ul style="list-style-type: none"> <li>• Wine</li> </ul>
	<ul style="list-style-type: none"> <li>▪ Certain minerals; stone; sand and gravel</li> </ul>	<ul style="list-style-type: none"> <li>• Building materials</li> </ul>
	<ul style="list-style-type: none"> <li>▪ Numerous high-flowrate rivers and streams (BiH is the only net exporter of energy in the Balkans)</li> </ul>	<ul style="list-style-type: none"> <li>• Mini-hydroelectric power</li> </ul>
	<ul style="list-style-type: none"> <li>▪ Mountains, forests, rivers, lakes – general natural beauty</li> </ul>	<ul style="list-style-type: none"> <li>• Tourism</li> </ul>
<ul style="list-style-type: none"> <li>• Location</li> </ul>	<ul style="list-style-type: none"> <li>▪ Exporting: direct surface connection to huge EU market (with mostly free trade)</li> <li>▪ Ability to respond to EU buyer orders with short / in-season turnaround times in small and large quantities</li> </ul>	<ul style="list-style-type: none"> <li>• Light manufacturing products: metal, wood, textiles, plastics</li> <li>• Auto parts</li> <li>• IT, online customer service centers</li> </ul>
<ul style="list-style-type: none"> <li>• Engineering Skills</li> <li>• Low Labor Cost</li> </ul>	Exporting and outsourcing: <ul style="list-style-type: none"> <li>▪ Long tradition in mechanical engineering education and application, especially in metal, power, and wood sectors</li> <li>▪ Labor costs 1/4 those of EU</li> </ul>	

Again, the focus in the table is on the competitive advantages that provide business opportunities not to large companies – such as mineral resources that can only be exploited by extensive mining operations – but by SMEs that could be candidates for BGF investment.

There are many viable SMEs in BiH that meet the assumed criteria for BGF investment, as will be further described below. From a broader industry point of view, Annex 3 in Volume 2 of this report contains surveys reviewing four driving sectors that have often been highlighted in BiH and have been the focus of competitiveness development projects over the years by USAID and other donors. These are the wood, light metal, textile/leather, and ICT industries. The following table summarizes the data from these surveys.

**Table 3: Summary of Selected Sector Surveys**

Sector, Product Lines	# Companies	Sales			Employment	
		BAM millions 2020	Per Company	Ann Growth 2015-2019	#	Per Company
<b>Wood</b> – furniture, furniture elements, prefab houses	1,656	2,619	1,581,500	8.1%	36,788	22
<b>Metal</b> – various light metal processing	923	2,333	2,527,600	11.0%	21,786	24
<b>Textiles</b> – apparel, leather products, auto seat covers	518	960	1,853,300	7.3%	33,678	65
<b>ICT</b> –application programming	776	650	837,600	18.2%	6,675	9
<b>Total/Average</b>	<b>3,873</b>	<b>6,562</b>	<b>1,694,300</b>	<b>10.0%</b>	<b>98,927</b>	<b>25</b>

There are approximately 4,000 companies in these four sectors (two-thirds of all SMEs in the country), most of them “true SMEs” – the “missing middle” – as indicated by their average sales and employment data. Their weighted-average growth rate in the five years prior to the pandemic recession was a strong 10% per annum.

BiH is extremely well-positioned to access the vast EU market, for both outsourcing and original products, with an immediately adjacent location, much lower labor costs, capable designers and engineers, and entrepreneurial owners. These sectors have benefitted greatly from over two decades of focused development assistance, mainly in managerial capacity-building and penetration of EU and even US and Asian markets via major trade show exhibition and connection to sales networks. The increasing participation in the country of BiH diaspora, both as investors and sales agents, is facilitating transfer of technology and know-how, and access to new markets.<sup>3</sup>

However, the impact of these significant competitive advantages on company and overall economic growth is seriously limited by the scarcity of one critical ingredient for any firm’s success: access to finance to realize obvious market potential. BiH companies with demonstrable market opportunities need to be able to acquire the modern equipment and working capital, complementing their low labor costs and locational advantages, which would allow them to produce in volume and at global quality levels. All this takes is growth finance, often in the form of risk capital, and that is the opportunity that BGF is positioned to address.

<sup>3</sup> The USAID BiH Diaspora Invest project has assisted some 150 diaspora-owned or partnered companies, which are exporting over 70% of their production to mostly EU markets.

## 2.3 The BiH SMEs Footprint

The universe of companies in BiH breaks down as follows:

<b>Size Category:</b> <b># Employees:</b>	Micro 0-9	Small 10-49	Medium 50-249	Large >249	<b>SMEs 10-249</b>
# Companies:	59,540	4,991	1,076	193	<b>6,067</b>
Total Employment:	134,933	101,307	107,022	136,608	<b>208,329</b>
Value Added (BAM MM):	1,556	1,586	1,561	4,702	<b>3,147</b>

Note: These are latest data from 2015 but still representative of prevailing structure of the economy.

The target for BGF is the small and medium subsets in the table – the approximately 6,000 SMEs, four-fifths of which are in the 10-49 employee size range. These companies employ over 200,000 people, and their value added, BAM 3.1 billion, accounts for almost 10% of total BiH gross domestic product (GDP). These are the companies with the greatest potential for rapid growth, but at the same time the most difficulty in obtaining growth finance from existing sources.

If the initial target size of the fund is \$30 million, and the average deal size is \$200,000 (within a normal range of \$100,000-\$500,000), then to employ that founding capital the Fund needs to find, of those 6,000 SMEs, approximately 150 – some than 2% of the universe – that are viable and suit the principal criteria: demonstrable market, high growth, and capable management. Assuming an evergreen fund that reinvests its loan principal repayments, eventually reaching \$100 million in total loans would require financing 500 companies, still only about 8% of all of the SMEs in BiH. While still a fraction of the SMEs footprint, these numbers are in keeping with the “high-volume” orientation of the proposed BGF.

## 3. **SME A2F Support Options – Global, Regional, BiH**

In this section, in order to demonstrate the feasibility of and need for an SME-oriented risk capital fund in general terms, we first review examples in other developing countries that have an investment focus and approach similar to the BGF concept, then describe investment funds active in the Southeast Europe region (none of which are comparable to BGF), then donor programs supporting SME access to finance in BiH (which have generally not focused on the risk capital need).

### 3.1 SME Growth Finance Funds in Other Developing Countries

Though there are some unique aspects of the proposed BGF design, in particular its local securities market registration, the basic model – capitalization by a range of investors, from donors to commercial banks, and financing primarily to SMEs using instruments with revenue royalty payments delivering a significant share of the return (revenue capital) – has been successfully employed in several developing and transition countries, with good results.

Africa appears to have been the birthplace of this type of lending, and the continent continues to benefit from it more than other emerging market regions. High-income countries, while not reviewed here, have also seen significant interest and growth in revenue-based financing

instruments. The feasibility and success of funds like these and their various approaches to investing informed the Fund concept presented in this Study. We look at seven examples:

- *Business Partners Limited (South Africa, Kenya, Malawi, Namibia, Rwanda, Uganda, Zambia)*

Revenue Capital (RC) and similar royalty-based structures were pioneered some 40 years ago by Business Partners Ltd. of South Africa (BPL). Its shareholders are its individual founders, the Small Enterprise Finance Agency of South Africa, and some South African banks, insurance companies, and investment companies. BPL has had good success with its business model and with the funds it has spawned and managed. By the mid-2010s, BPL reported a total of more than \$1.5 billion invested in some 69,500 SMEs in seven countries, claiming to have created or sustained more than 550,000 jobs. Like the proposed BGF model, BPL is not a fund, but a permanent private finance company. As such, rather than raising, deploying, and profitably returning a fixed / limited fund to investors, the firm maintains perpetual, closed funding, recycling revenue and repayments, seeking and obtaining development partner grants, and conservatively leveraging its balance sheet with commercial bank credit (maximum 20% of net asset value). It has not required additional capital injections from its investors. BPL's published target portfolio internal rate of return (IRR) is approximately 17%. While actual return performance and profitability are not publicly reported, the long and sustained life of BPL evidences the success of an SME-focused RC model.

- *Tunisia American SME Company (TASME)*

TASME, founded in 2015, is an investment company fully owned by the Tunisia American Enterprise Fund (TAEF), one of the enterprise funds originally facilitated by USAID in many countries (including CEE) in the 1980s-90s. TASME's investment model was adapted from that of BPL in South Africa. At the end of 2020 TASME's portfolio consisted of 20 companies, with disbursed investments representing \$24.9 million of its total capital of \$50 million. The main elements of the TASME investment model are a low, fixed-rate loan, a royalty payment based on revenues, and a minority equity participation. TASME's investment focus is on existing SMEs in the expansion phase. The investment range has been about \$250,000 to \$2.5MM; the average about \$1.25MM. Five investment managers implement the investment strategy and monitor TASME's investments.

Though successfully employing RC finance, TAMSE's approach to investment selection is like that of a private equity fund, as is obvious from the limited number of deals done over the five+ years of its existence.

- *Gazelle Finance Fund (Moldova, Georgia, Kyrgyzstan, Armenia, Ukraine)*

In 2013, Eurasia Foundation provided the seed capital to launch Gazelle Finance, headquartered in Tbilisi, an independent FMC, to provide growth capital and mezzanine financing to high-growth SMEs in the Eurasia region. In 2017, Gazelle closed its first fund, Gazelle Fund LP, with \$31 million in total capital commitments. Since then it has assembled a portfolio of 13 companies with an average investment amount of about \$800,000, in a range of \$200K-\$3MM. Among Gazelle's investors are OPIC, Netherlands Development Finance (FMO), and DGGF.

Like BGF, Gazelle's strategy is to target the “missing middle” – less than \$3.0MM in annual revenues, by its definition – that have high growth potential but cannot secure adequate bank finance to realize it, for example due to collateral constraints. Two instruments are used: income participation (royalty) loans and minority equity investments. The FMC also provides consulting services to help ensure the success of its investees. It has received financial support from USAID missions in Georgia and Ukraine.

- *GroFin SGB Fund (Kenya, Uganda, Tanzania, Rwanda, Ghana, Nigeria, Ivory Coast, Senegal, South Africa, Zambia, Egypt)*

Founded in 2004 and headquartered in Mauritius, GroFin was a pioneer in investment fund-based risk capital finance to SMEs, which it refers to as small and growing businesses (SGBs). It is currently active in eleven African countries, sub-Saharan plus Egypt. Funded by a range of investors, as of Q1 2021 it reports about \$125MM in largely standardized up to 8-year mezzanine loans to 220 locally owned and managed SMEs, claiming to have created or sustained over 14,000 direct jobs – on average, \$560K per loan (target range is \$100K-\$1.5MM, or around one-third of annual revenue), and 60 jobs per company. Some collateral and personal guarantees are required. All investees receive post-investment consulting assistance. Its main priority is sustainable employment, with attention to gender and environmental sustainability and resilience. It is supported by USAID, KfW, DFID, Norfund, Shell Foundation, Dutch Good Growth Fund (DGGF), impact investors Calvert Impact Capital and Skoll Foundation, and PE fund Anthoss

- *Investisseurs & Partenaires (Burkina Faso, Cameroon, Côte d'Ivoire, Ghana, Kenya, Madagascar, Niger and Senegal)*

Created in 2002, I&P is an impact investment group that manages a family of funds and programs entirely dedicated to supporting Sub-Saharan Africa growth and social progress by investing in SMEs there. I&P's impact strategy revolves around six fundamental pillars of the framework established by the United Nations Sustainable Development Goals (SDGs). Along with its investment, I&P requires a seat on the company Board and serves as a member actively involved in charting and implementing the business strategy. I&P employs a variety of financial instruments, but mainly minority equity investments and royalty-based loans. Technical assistance resources are raised from investors and donors and invested in skills development, and knowledge transfer for entrepreneurs. Investments can range from a few thousand Euros to €3 million. I&P is in the process of creating and sponsoring 10 impact funds in 10 countries in 10 years, thus financing nearly 300 companies in sub-Saharan Africa. Five funds are already operational. These funds can finance between €50,000 and €500,000. I&P's investors include EIB and the French Economic Development Agency's Proparco.

- *eXtra Small Medium Large (Dem Rep Congo, Central African Rep, Uganda, Angola)*

Founded in 2008, XSML is an investment fund manager with a focus on frontier markets of Central Africa. Currently XSML is managing three fund vehicles, totaling \$120 million, which utilize mezzanine or quasi-equity instruments. These include debt with profit sharing, royalty payments, preferred shares, convertible debt, and warrants. XSML collaborates closely with management and uses a separate technical assistance facility to support investee companies.

Investments are in the range of \$250,000 to \$5 million, with the average being a little under \$1 million. To date, XSML has invested about \$60MM some 50 companies. Investors include various multi- and bilateral development organizations. It is funded by the Belgium Investment Company for Developing Countries, British CDC, DGGF, FMO, IFC, and Proparco.

- *Dutch Good Growth Fund (fund of funds with investments in 70 countries)*

The Dutch Good Growth Fund (DGGF) was set up by the Dutch Ministry of Foreign Affairs with a mission to support Dutch entrepreneurs doing business in developing countries and emerging markets. DGGF mainly invests in funds that in turn invest in businesses in the DGGF target countries, with a focus on “missing middle” entrepreneurs, often the counterparts of Dutch business pursuits. DGGF provides capital to local funds through equity, mezzanine, and debt instruments. Several of DGGF’s investee funds utilize royalty-based structures and instruments, and as a consequence DGGF has significant experience and knowledge of this type of financing, having published a survey of SME-focused mezzanine / risk capital funds in developing countries (DGGD 2016).

In sum, all of these funds share at similarities with the BGF model, primarily in their focus on missing middle finance for SMEs, and in using blended or mezzanine financing instruments. As a group, some are more private equity-like (Gazelle), investing in fewer deals and highly hands-on, and others more bank-like (GroFin), providing straight mezzanine loans to a high volume of clients. The rest are somewhere in between, and use revenue capital extensively. Notably, all of these funds either directly or through partnerships provide post-investment consulting support to investee companies.

### 3.2 Investment Funds in Southeast Europe

#### *Types of Funds*

All the funds prioritizing Southeast Europe and investing directly in companies are private equity (PE) or venture capital (VC) investment funds. Some are quite large (over €100 million); others are mid-sized (€30-100 million). Most, if not all, have IFI or bilateral donors participating in their capitalization – the European Investment Fund (EIF), EBRD, and KfW being the largest.<sup>4</sup> Examples are the Western Balkans Enterprise Development and Innovation Facility (EDIF) and the Enterprise Expansion Fund (ENEF), which are covered below. There are also a few smaller, fully privately-financed venture capital funds within the region, mainly focused on technology startups.

The typical model is a public-private partnership. For example, EIF provides seed money, determines the general investment strategy, and selects a private management company, which raises additional mainly private capital, and manages the vehicle.

These funds focus almost exclusively on equity finance, often seeking majority stakes in order to guide growth, investment, and profitability until eventual exit, either to another financial or a strategic investor. There are no vehicles operating in the region specializing in mezzanine debt finance, though two are being planned in Croatia. These will reportedly rely on their close

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<sup>4</sup> Some very large global private equity funds have also selectively invested in SEE, including US-based KKR.

business relationships with commercial banks, which are interested in subordinated credit to support further lending to some of their solidly growing client companies.

#### *Investee Focus*

While many of these funds claim to target “SMEs,” this is misleading. SMEs by international standards are large by Southeast Europe standards. Given the high fixed cost of investment origination and selection, the lower limit for individual investment for these funds surpasses average SME size in BiH. Generally, the bigger and more international in scope the fund is, the bigger the minimum investment per enterprise, as follows:

- € 10 million for the large cross-national PE or VC funds (over €100 million AUM)
- € 3-5MM for the medium-sized PE or VC funds (€50-100 million AUM)
- € 1MM for the smaller new players (such as the mezzanine funds planned in Croatia), and even there the preferred investment range is €2-3 million<sup>5</sup>

Given these targets and their PE/VC investment focus, these funds end up doing a highly selective limited number of deals per year, in companies expected to produce extraordinary rates of return within a medium-term time horizon.<sup>6</sup>

#### *Credit Lines and Loan Guarantee Facilities*

Virtually all other forms of support for SME access to finance in the region, all backed by donors, have operated through commercial banks, microfinance institutions (MFIs), and sometimes leasing companies. By far the largest of these is the European Fund for Southeast Europe (EFSE), which was established in 2005. It originally targeted countries of the former Yugoslavia, eventually expanding its footprint to Bulgaria, Romania, Turkey, the Caucasus, and Moldova-Belarus-Ukraine. Its lending is done entirely through financial institutions in these countries.

In contrast to the larger minimum investment size preferences of the PE and VC funds, EFSE’s focus is on micro, small, and medium enterprises (MSMEs), and really more toward the micro end. Over 80% of its sub-loans currently are less than €20,000. Since its inception, it has lent a lot – over €8 billion – but to 1 million clients, for an average loan size of €8,000. In BiH, EFSE lends through 13 commercial banks, and though its average loan size has been about €42,000, it is not really reaching “the missing middle.”

Other donor-supported access to finance (A2F) programs have targeted those middle SMEs. These include bilateral donor-backed loan guarantee facilities (LGFs, discussed further below), World Bank- and EU-provided credit lines, and others. In aggregate they have been considerably smaller than EFSE. The LGFs, which have helped banks lend to SMEs by effectively increasing the borrower’s overall security package, and the credit lines designed for banks for on-lending to SMEs, had a significant impact in earlier years, but today have less, since the banking system already has substantial excess liquidity. In any case, both the LGFs and credit lines still depend

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<sup>5</sup> According to interviews with their organizers

<sup>6</sup> Startup/scaleup funds allow for significantly smaller minimums, but these are usually specialists for potentially fast-growing internet/technology firms.

on the banks' rigorous risk assessment procedures, which have become increasingly conservative with the tightening of the banking supervision regime in the years following the GFC.

Finally, there are national development banks. In BiH, there are two, the Federation Development Bank and the Investment-Development Bank of RS (IDBRS). They also lend mainly through commercial banks. Given their development credit orientation, their terms and conditions are somewhat more favorable than standard bank term loans, but still must be adequately collateralized.

In sum, none of these sources provides risk capital – subordinated loans with quasi-equity features – to mid-cap SMEs. In fact, such finance does not exist in the region. Potentially, however, given their geographic focus, some of the investors in funds operating in Southeast Europe, such as EIF and KfW, can be viewed as potential investors in BGF.

### 3.3 Donor Programs to Expand A2F in BiH

Donors supporting BiH economic growth have long recognized the A2F problem and have implemented a series of programs over time to address it. These have added a significant amount to the supply of business credit over time. They have operated mainly through the banking system. Summaries of the most significant donors are included here.

- *USAID / US International Development Finance Corporation (DFC)*

The first large business finance program in BiH was the USAID-administered Bosnia Reconstruction Finance Facility (BRFF), a \$250 million loan fund adopted by a special act of US Congress in the Spring of 1996 to help restart the Bosnian economy after the war. Virtually all of the major companies in BiH – the former State-owned conglomerates that had had marketing offices worldwide prior to the war – were destroyed or idle, with thousands of their workers “on the waiting list” (*i.e.*, unemployed). BRFF was administered via two large (over 100-person) projects: one responsible for the lending, and the other for origination and consulting. Subsequent to this early initiative, USAID enterprise competitiveness programs have run more or less continuously, and usually included grant components, managed by the projects. These funds have totaled approximately \$20 million.

US government A2F support has also taken the form of a series of LGFs, originally provided by USAID's Development Credit Authority (DCA), which were later transferred to DFC.<sup>7</sup> These facilities all worked through agreements with commercial banks, seeking to stimulate lending, sometimes focused on certain sectors, by providing a guarantee on principal repayment, usually 50%, and thereby creating additional security that complemented collateral provided by the borrowers themselves. The programs have often leveraged technical assistance through other USAID enterprise competitiveness programs. In recent years, USAID/DFC has cooperated with Swedish International Development Agency (Sida), the current program focused on providing finance to BiH diaspora seeking to return and start businesses in BiH. In aggregate over the past two decades, these programs have supported at least \$50 million in bank lending to BiH SMEs.

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<sup>7</sup> DFC took over these and other USAID development finance initiatives in 2020.

- *European Union (EU)*

The EU has been active in A2F support in BiH since the war through initiatives such as the Western Balkans EDIF. With the stated purpose of “widening the scope of SME finance,” EDIF provides grants, guarantees, on-lending facility loans to local financial institutions, in addition to supporting two equity funds that provide early- and later-stage investments. It reports approximately \$40 million in financing in BiH alone, but this has been achieved primarily through a credit line to ProCredit Bank, which is focused on microenterprises and very small SMEs.

The EU-sponsored European Investment Fund (EIF), part of the European Investment Bank (EIB), supports SME finance through a range of intermediaries including commercial banks and special-purpose funds, including the Western Balkans EDIF. In 2020, it announced loan guarantee programs for with Raiffeisen and UniCredit, covering BiH, to address the impact of the COVID-19 crisis.

Other EU-backed programs include the \$40 million European Fund for BiH, administered by KfW and aimed at SMEs, again through commercial banks and microfinance institutions. Swiss Development Cooperation (SDC) is launching a 62 million Swiss franc program focused on diaspora-backed and youth-managed startups. The EU4Business and EU4Agri programs, run by GIZ, UNDP, the International Labor Organization, and the Czech Development Agency (CzDA) total approximately €36 million and are mostly grant-based. Others – like Competitiveness of Small and Medium-Sized Enterprises (COSME), Horizon Europe, Eureka, and Creative Europe – assist SMEs in obtaining finance from local commercial banks, or provide grants to subsidize research, development, and innovation activities at qualifying SMEs.

- *EBRD*

In addition to its private equity and senior and subordinated term loans investments, both directly and through funds, and major infrastructure loans to governments, EBRD has provided roughly \$300 million over the past 25 years for general business finance in BiH, mostly in the form of credit lines to commercial banks. It also sponsors the aforementioned \$100+ million ENEF, covering the Western Balkans, which is putatively focused on SMEs, but only according to an EU-level definition, which captures large BiH companies with big financing needs. It has concluded just fourteen investments since establishment in 2016, with an average deal size of \$4 million. These are not the “true SMEs” that are the great majority of businesses in BiH and are the target of the BGF.

- *World Bank*

Over the past two decades, the World Bank has provided nearly \$500 million in A2F support, through various programs, mostly in the form of loans to government to enable it to provide credit lines to BiH commercial banks and the FBH and RS development banks for on-lending to business. Its most recent such program was \$65 million to help firms get through the pandemic recession. It has some \$125 million in programs in the pipeline, directed at the wood and agriculture sectors.

### *Contributions of Donor Programs and the Persistent Risk Capital Need*

The donor A2F programs implemented through commercial banks were particularly helpful in the decade or so after the war, when domestic deposit growth was weak, and the BiH banking system, in need of drastic transformation to private ownership from the prior State-owned system, was weak and illiquid. Eventually, a handful of major EU banks moved in to dominate the system (Raifeissen, Unicredit, Sparkasse, Intessa, Addiko), and overall lending increased 20%-30% per year in the years up to the GFC. The donor programs became more narrowly significant, focusing on particular sectors.

By now, the donor programs as typically structured – credit lines or guarantees to commercial banks – contribute a more limited portion of the supply of finance. As noted above, there is no lack of liquidity in the BiH banking sector. Deposit inflows are far larger than the banks are channeling to private sector credit, and they are sitting on excess reserves in the central bank that are as large as their required reserves. As for nonbank finance, other than through the limited direct grants to companies, no donor programs have significantly addressed the extreme lack of it.

It is also instructive to consider the scale of donor A2F support relative to the need. Using a simplified calculation, for BiH to increase its PSC/GDP ratio from the present 60% eventually to 90% – still well below the average of even the middle-income countries – would require over \$3 billion in additional credit to businesses on the books of BiH financial institutions.<sup>8</sup> This can be compared to BiH commercial banks' \$1.2 billion in credit growth to business over the *decade* up to 2020 (excluding the pandemic year contraction). This amount was not even enough to elevate the bank business credit-to-GDP ratio, which in fact fell by two percentage points over that period. While it is difficult to obtain exact figures from the wide variety of donor sources surveyed above, the total support by all donors to BiH business A2F over that same period could not have exceeded \$500 million. And most of that went through banks, so to that extent is already reflected in the \$1.2 billion total. It is likely that donor assistance helped keep the PSC/GDP ratio more or less constant, at best.

In sum, there is a clear market opportunity for a fund with the proposed design of the BGF, providing risk capital to true SMEs with high growth potential and capable management. Admittedly, the BGF as envisaged in this report, while projected to achieve some \$100 million in disbursements to some 500 SMEs over its first decade, would itself provide only a fraction of what is required. Nevertheless, BGF will demonstrate the feasibility of nonbank business finance channeled through the capital market, and its potential for expansion of the PSC/GDP ratio.

## **4. Fund Structure**

### **4.1 BGF Legal Form**

FINRA sought a legal opinion regarding the establishment of an investment fund to provide growth finance to SMEs in BiH, a country consisting of two highly autonomous Entities – the

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<sup>8</sup> 2020 GDP = \$21.2 billion;  $\times 0.3 = \$6.4$  billion; of which if 50% business sector = \$3.2 billion

Federation of Bosnia & Herzegovina (FBiH) and the Republika Srpska (RS) – each with its own key financial sector supervisors (for banking, securities, and insurance), and its own (though largely parallel) set of related laws and regulations. Financial institutions and Investment funds of any kind can nevertheless operate freely in both Entities, regardless of their domicile, obeying the laws of their home Entity.

However, existing investment fund (IF) law in BiH (*i.e.*, the two Entity IF laws), while similar to that in other countries of the region and fully compliant with EU/global standards, does not accommodate the BGF concept. It addresses only funds that invest in publicly-traded securities and whose shares are themselves publicly-traded. It does not permit such funds to invest in or lend to limited liability companies (LLCs) at all – the prevalent form of SME registration in BiH. Hence, there is no legal avenue, currently, for local registration and operation a nonbank investment fund making loans to BiH companies.

Note that this is only an obstacle because the Fund is to be registered locally and issue securities on the local capital market. This is a unique feature of the BGF concept. If the Fund's objective was limited to providing finance to SMEs (and development objectives directly associated with the companies financed), then the Fund, like many others, could simply be registered in Delaware or Luxembourg and would be able freely to finance BiH companies, both through equity investments and loans.

To reiterate, however, local registration is fundamental to the BGF concept, because while delivering finance to SMEs is the main motivator, the other major purpose, and a key development objective, is to insemminate the mobilization of private business finance through the local capital market, including from the substantial excess liquidity in the banking system.

There is a different body of law that, if developed and adopted in BiH, will enable the BGF concept – EU-compliant Alternative Investment Fund (AIF) law. Both Croatia (EU member) and Serbia (not an EU member) with similar legal systems do have EU-compliant AIF legislation in place. BiH does not, but even if it were not necessary for BGF, such law at any rate will eventually need to be introduced in BiH for purposes of EU accession, and will encourage other initiatives to expand nonbank access to finance.

According to legal counsel engaged for this Study, the BGF concept can be implemented through a vehicle that is:

- A closed-end Alternative Investment Fund (AIF), without fixed term, and
- A joint stock company (JSC), rather than a limited liability company, and
- Financed by the private placement of equity and debt securities, and
- Managed internally – *i.e.*, a single entity, rather than a separate fund and fund management company.

This will require the development and adoption of AIF law, which does not currently exist in BiH, though it does in neighboring Serbia and Croatia. Following the acceptance of this Study and assuming a desire on the part of key government counterparts, FINRA expects to proceed to support drafting of AIF law for BiH. While parallel development in both RS and FBiH will be

pursued, as is USAID FINRA’s extensive experience and standard practice, adoption in either entity will enable BGF operation throughout BiH.

Registration and regulatory oversight of such a fund under EU-compliant AIF law would be under the Securities Commission (SC) – of FBiH, RS, or both.<sup>9</sup> The SC will license the Fund, register it, and approve its Rules of Operation. In keeping with global standards, it would also approve management and supervisory board members, and issuance and registration of equity and debt securities. Under foreign exchange law, investment by foreign entities in the Fund would be registered with the relevant Entity Ministry of Finance.

Current BiH law entitles the entity bank supervision agencies – the Federation Banking Agency (FBA) and Banking Agency Republika Srpska (BARS) to supervise loans by financial institutions to companies. It is possible that existing law will need to be clarified to ensure that capital market-based funds registered under securities law and making loans to companies are not subject to supervision by the BSAs.

In preparation of this Study, representatives of several financial sector oversight institutions were interviewed to gauge their receptiveness to the Fund concept and the legal/regulatory adaptations that it will likely require, including the Federation Banking Agency and the FBiH and RS Securities Commissions. All expressed their readiness to consider the Fund and its needs, in light of the contribution that it would make to SME access to finance and capital markets development in BiH.

The Legal Opinion detailing the above conclusions is contained in Annex 4, Volume 2 of this report.

#### 4.2 Capital Structure and Investor Securities

The BGF will be capitalized with both equity and debt securities. As will be elaborated in the Financial Plan and Projection below, a majority of the capital of mezzanine-type funds similar to BGF in other developing countries has been equity, and a recent report by the Emerging Markets Private Equity Association found that 79% of emerging market private credit fund respondents to a March 2019 survey utilize no leverage (EMPEA 2019). A high level of equity preserves cash flow, but leverage increases the return on equity. Furthermore, one of the development objectives for the BGF is to help stimulate the emergence of a viable capital market for private sector debt. Consequently, it is planned that approximately two-thirds of initial BGF capitalization will be in equity, and one-third in debt securities, split between senior and subordinated, to suit different categories of foreign and domestic institutional investors.

Additional foundation capital is likely, especially at startup, in the form of grants from donors interested in supporting SME access to finance in BiH and the potentially replicable BGF concept. While such contributions are cannot be booked as equity, they would help defray startup costs, and beyond that both provide the liquidity cushion that the fund will need (projected at 10% of

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<sup>9</sup> After not being operative for almost two years for political reasons, the FBiH Securities Commission was finally appointed and recommenced operations in September 2021. It will be burdened with a large backlog of pending filings.

assets, in keeping with the practices of similar funds), as well as flowing through into retained earnings.

Under existing company law in BiH, the JSC form would allow the AIF to fund itself in any other way if needed and desired in later years, including taking out standard bank term loans and working capital lines, or issuing commercial paper or asset-backed securities to further stimulate development of the local capital market. EU-compliant AIFs have no regulatory limitations or thresholds on their indebtedness.

As a JSC, BGF like all others will be required to register securities issued to investors with the Securities Commission and the Registry of Securities, even if privately placed. Issued securities would then be transferable. Private placement is appropriate for this kind of fund, and avoids other requirements of public issuance, including issuance of a prospectus and limitations on types of investments. Private placement is largely self-regulated, as long as investors qualify as professional and can meet minimum investment limits (often \$50,000). Before concluding an investment agreement, AIFs are obliged to provide key information to the prospective investor, including fund investment policies and rules of operation. The level of detail should allow investors to understand the types and significance of risks, with an assessment of the consequences of investing in the AIF.

Both legal and natural persons, domestic and foreign, can own equity and debt securities of an AIF. Domestic investors in the Fund are expected to be commercial banks, government development banks, and possibly companies. Foreign investors enjoy the same rights as domestic ones, and are entitled to invest, and to reinvest profits of such investments into any and all sectors of the economy of BiH, and in the same form and under the same conditions as defined for residents of BiH. BiH law governing foreign investment has precedence over other relevant law.

#### 4.3 Taxation

The Entity Tax Authorities and the Indirect Taxation Authority of BiH will supervise the tax aspects of AIF business operations. Regarding the tax treatment of capital investment, the Fund itself would not be taxed on monies raised but would be subject to local corporate income tax on profits. Foreign and domestic investors are subject to 10% withholding tax on dividend income, and 5% on interest income. For foreign investors, this amount may be reduced by applicable double taxation treaties. For this study the KPMG accounting firm in Sarajevo was engaged to comprehensively outline BGF tax aspects, and its memorandum is provided in Volume 2 of this report, Annex 6.

#### 4.4 Sources of Capital

Obviously, BGF's establishment relies on the feasibility of securing its required funding, both for startup costs and initial operations, and to make investments in SMEs. Given the demonstrated interest of a variety of investor types in providing funding to other SME-focused vehicles in developing countries, it is reasonable to expect their consideration of the BGF. These investor types include mainly bilateral and multilateral donors and development finance institutions, the privates sector-led impact investment community, BiH government agencies, and BiH

commercial banks. Funding could be expected to come through purchases of the Fund’s equity and debt securities with both commercial and concessional terms, and through direct grants. EMPEA (2019) identified 126 development finance institutions (DFIs), government agencies, pension funds, banks, asset managers, insurers, family offices, endowments, and foundations with disclosed commitments to emerging market private credit funds, of which BGF could be another.

In preparation of this Study, the concept was discussed with a number of potential sources of funding in face-to-face meetings. These included USAID, DFC, EBRD, KfC, WB, IFC, EFSE, the Swiss Agency for Development & Cooperation (SDC), Sida, the Investment-Development Bank of Republika Srpska (IDBRS), and two international commercial banks operating in BiH. All expressed a positive interest in receiving this Feasibility Study and subsequently considering investment in the Fund. We briefly summarize these organizations interviewed, and then mention others that, based on their other investments, could likely be interested.

#### Institutions Interviewed

- *USAID*

USAID has actively supported enterprise competitiveness and financial market development in BiH for 25 years. Through its numerous competitiveness projects, it has provided at least \$30MM in grant funding for SMEs, not to mention the postwar \$250MM Bosnia Reconstruction Finance Facility (BGFF) that it administered. In neighboring Kosovo, USAID provided \$6MM in a capital grant for the locally-registered Kosovo Credit Guarantee Fund (KCGF), and \$5.5MM in technical assistance to help get it off the ground. This type of support is possible for BGF.

- *Swiss Cooperation Program for BiH*

Established by the Swiss Agency for Development and Cooperation and the Swiss State Secretariat for Economic Affairs, the Swiss Cooperation Program for BiH focuses on economic development, employment, health and local governance and municipal services. The program’s budget for 2021-2024 is approximately \$70 million. SDC expressed interest in seeing the Feasibility Study.

- *Swedish International Development Agency (Sida) and Embassy of Sweden*

Sida is currently working on mapping out future interventions regarding economic development assistance in BiH and future programs for SMEs. Sida has co-funded grant programs with USAID for BiH enterprise development projects, and expressed potential interest in further collaborating with USAID in supporting BGF.

- *World Bank Group & IFC*

World Bank in BiH currently has active programs in BiH supporting SME development and employment support. It also has SME-targeted equity finance initiatives in other Western Balkans. IFC is planning a new regional SME enterprise fund for the Western Balkans that will prioritize agriculture and digital transition. Both WB and IFC are open to considering BGF investment options.

- *EBRD*

As noted above, in BiH EBRD has provided credit lines to commercial banks, invested in funds (EFSE, INVERA), and made direct loans and equity investments in companies. EBRD is interested in discussing direct investment into BGF and the possibility of direct or indirect support through its existing BiH investment funds.

- *KfW Group*

KfW's access to finance activities were also mentioned above. Its representatives in Sarajevo expressed clear interest in the BGF concept, noting the need for alternative, nonbank finance for SMEs.

- *BiH Banks*

The strong early interest in a dedicated SME investment fund by the CEOs of two international banks operating in BiH (Sparkasse and Addiko), expressed at public conferences and in face-to-face interviews with FINRA, was an original motivator for establishing the feasibility of the BGF concept. They both noted the general lack of access to finance for SMEs and the need for nonbank finance alternatives. Observing the lack of options for prudent investment of a portion of their own banks' portfolios in BiH private sector debt securities, they both considered that their banks would be able and willing to invest in such instruments issued by BGF.

- *Investment-Development Bank of Republika Srpska*

IDBRS, the RS government development bank, currently serves as an asset manager for six different loan and grant programs aimed at financing companies looking to increase exports and sales and employ new workers. IDBRS stated its interest in further discussion as the potential for investment in the Fund, once the Feasibility Study is available. IDBRS also proposed that it could provide partial principal guarantees for qualifying BGF borrowers, which is an attractive option.

- *DFC*

Formerly the Overseas Private Investment Corporation (OPIC), DFC works independently but also jointly with USAID, through the Mission Transaction Unit. Its financing support comes through political risk insurance, senior loans, investment funds support, project/corporate financing, loan and bond guarantees, and equity investment in funds. As noted above, it has provided loan portfolio guarantee facilities to several BiH banks.

DFC is a "transaction shop" with a dedicated USAID window for new business lines. It is demand-driven, relying on programs like FINRA to elevate market opportunities that are strongly aligned with USAID Mission Development Objectives.

#### Other Potential Investors

Based on their SME-oriented investment activities in BiH and other developing countries, the following are examples of others that could be expected to have a potential interest in BGF investment, and should be among those approached following the distribution of this Study.

- *Netherlands Development Finance Company (FMO)*

FMO is a particularly innovative bilateral DFI. In addition to investing its own capital, it manages funds on behalf of the Dutch government and others in the fields of energy, infrastructure, climate adaptation, forest management, and micro and small enterprise access to finance sectors. FMO funds start-ups and established SME businesses through equity and various types of debt and hybrid instruments, including guarantees. In BiH, FMO has four active investments, all to microfinance institutions, with the most recent being in August 2018.

- *EIB / EIF*

Although EIB has more than eight times the assets of EBRD, only 10% of its funding goes to projects outside the EU Member States. BiH is not a member state, but EIB has supported 55 infrastructure and private sector projects there, totaling over €3 billion, since 1977. One quarter of that amount has gone to credit lines. In addition to loans, EIB offers equity, venture debt, quasi-equity, guarantees, and advisory services. It has an explicit desire to co-finance early stage and expansion capital in highly innovative companies, alongside institutional investment partners. This activity is often done through its EIF subsidiary.

EIF is focused specifically on SME finance and is able to invest from its own balance sheet and mobilize capital from EIB, the European Commission, and others. The vehicles and tools it utilizes include equity, debt, guarantees, and securitization. It has SME loan guarantee programs with Raiffeisen Bank BiH and UniCredit (a regional cover which included its BiH bank) to continue providing working capital to innovative SMEs and those affected by the COVID-19 crisis.

- *Impact Investors*

According to the Global Impact Investing Network’s latest survey of approximately 300 impact investor organizations (GIIN 2020), about 50 had investments in the Eastern Europe / Eurasia region, totaling about \$3.7B. This list can be further analyzed as to evidence of investment in SME-oriented credit funds similar to BGF, and follow-up interviews conducted with those most likely to be interested.

## **5. BGF SME Financing**

This section addresses the asset side of the BGF – its downstream investment instruments that channel finance into SMEs.

### **5.1 Target Investees**

BGF will seek out for investment high-growth SMEs by local standards – average employment of 50 people (in a range of 10-100+), average annual sales of \$2.5 million (in a range of \$250,000-\$5 million), and average individual loan need size of \$200,000 (in a range of \$100,000-\$500,000). When it comes to acceptable risk capital – subordinated loans with quasi-equity features – this “missing middle” cohort has no source of finance at all, beyond a few venture capital funds pursuing the next technology unicorn. Addressing this clear financial market supply-side opportunity, BGF will implement an efficient origination, due diligence, and selection process to build a diversified portfolio of investments in a relatively large number of companies.

## 5.2 Financing Instruments

In order to maximize the efficiency of its operations and present a clear and understandable product to target SMEs, BGF’s standard financing will be in the form of so-called Revenue Capital (RC). Other claim forms, such as working capital lines, standard term loans, and common equity will not be excluded from possibility, but are expected to be rare, and have not been considered for purposes of this feasibility study either in interviews with prospective pipeline companies or in the fund financial projection model presented below.

### 5.2.1 *Revenue Capital*

Revenue capital possesses characteristics of an equity investment, because in the typical and most straightforward case, the majority of the investor’s yield comes through a royalty payment on revenues, and therefore depends on the success of the investee company in meeting the business and financial expectations that justified the investment in the first place.<sup>10</sup>

Such loans fit the definition of “risk capital.” In part, this is due to the equity-like component of the yield on the financing – the royalty on revenues. It is also due to the fact that they are typically subordinated loans, often uncollateralized. They are extended primarily on the basis of cash flow projections. Most BGF financings are expected to have these characteristics.

Revenue capital is also quite attractive to those in need of finance. As previously noted, most SME owners, at least at the stage typical of BiH, do not want to sell shares in their companies, so are uninterested in the kind of equity finance that might come from a venture fund. Nevertheless, facing clear market opportunities but without access to bank finance to realize them, due to lack of collateral or other limitations, they understand that their need is for risk capital, and see royalty-based loans as a reasonable form for structuring such finance. They are attracted to the fact that such a loan involves risk sharing, with the provider earning a higher return if things go well, but a lower one if expectations are not met. As site visits and interviews with over 70 potential pipeline SMEs in preparation for this report confirmed, their owners understand that such risk on the part of the creditor, plus the subordinated and typically uncollateralized nature of the loan, justifies a cost of capital that is substantially higher than for a bank loan. However, if the finance enables a doubling or tripling of sales within 3-5 years, as the entrepreneur expects, that cost can be easily borne, and definitely worth paying.

As will be reviewed in the financial projection discussion below, the royalty is expected to be in the range of 0.5%-1.0% of revenues to achieve the target overall yield, which will be set according to the individual borrower risk assessment.

### 5.2.2 *Borrower Equity*

BGF will generally avoid equity investments, because the closely held owners of most of the SMEs in its target market are not interested in selling shares, and, more importantly, options for the Fund to exit an equity investment in a typical SME are extremely limited. Loans with partially equity-like yields are far preferable to actual equity. Nevertheless, a pledge of owner equity may be adopted as a standard form of backup guarantee, as further discussed in the following section.

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<sup>10</sup> A good description may be found in USAID (2017).

### 5.2.3 Loan Security

BGF will not act as standard secured creditor. It will take higher risk for higher expected return. Nevertheless, since on occasion loan security agreements may include standard collateral assets (most likely in a second position), and/or a pledge of owner equity required, the loan security system in BiH can be briefly reviewed.

Generally, all typical collateral agreements are in use in BiH: mortgages on real estate, and pledges of movable property, securities, deposits, and company equity. All are registered, including pre-registration of liens on buildings under construction. In practice, for most commercial bank loans, security agreements are strict, and prioritize real estate collateral (preferably urban), using conservative appraised valuations that must substantially exceed the loan amount. Receivables and inventory, the most common assets of growing production companies, are virtually ignored as collateral; working capital revolvers secured by these assets do not exist. These strictures evidence the credit market opportunity for the type of finance that BGF is designed to provide, especially for those companies which, due to their high growth potential, have already burned through their existing hard collateral in securing prior senior bank loans.

If a loan is in default and collection must be enforced (disregarding bankruptcy), the process goes through the court system, even where a pledge agreement on movable property places repossession under the creditor's direct control. Despite a superficially accommodative legal framework, the process is not efficient. Enforcement procedures on businesses can take 3-5 years to resolution, with numerous operational and transactions costs. Auctions of collateral are governed by the court, which sets minimum acceptable prices and allows successful bidders to renege on their commitments with minimal penalties, forcing the procedure to start over again. Debtors are able to use various means to complicate enforcement proceedings and gain time. Obtaining information on debtors' assets that could be pursued in recovery is difficult.

Again, for what is expected to be the typical BGF revenue capital loan, standard collateral will almost always not be available as security, and therefore not required, so having to deal with these problems will be rare. Instead, it is expected that a pledge of owner equity will accompany the typical BGF loan. In general, pledges of shares are also subject to legal enforcement through the court. However, there are ways to contract the transfer obligation directly (out-of-court), including agreement as to valuation, and these will be pursued for BGF equity pledges.

A detailed legal opinion on using equity pledges as loan security is provided in Annex 4.

## 5.3 Governance and Fund Management

### 5.3.1 Governance

Based on legal opinion, a closed-end AIF established as a privately-placed joint stock company – the form recommended for BGF – needs to have a Supervisory Board of at least three members. There are no restrictions as to nationality. Supervisory Board members, who are approved by the Securities Commission, should be individuals of good reputation with relevant professional expertise and experience, and no personal conflict of interest.

Although not mandated by BiH law, BGF will have an Investment Committee that will establish the general investment guidelines and criteria for the fund (*i.e.*, the investment strategy), and approve investments. The Investment Committee will include persons not involved in the day-to-day operations of the Fund.

The Supervisory Board will adopt the Fund's investment policies – collectively, its objectives, framework, rules of operation, and reporting requirements. The investment policies will include a level of detail that shapes actual performance metrics and procedures.

Fund management and staff are responsible for operating the fund in a manner consistent with the investment policies, and for informing the committee of any changes that would allow for improved results against investment objectives – financial and non-financial – informed by a standardized monitoring, evaluation, and learning procedure.

BGF may also have an Advisory Board that gives guidance and direction to the Supervisory Board, Investment Committee, and management team, consisting of local and international professionals with SME investing experience, and share the Fund's development objectives.

### *5.3.2 Management, Professional, and Administrative Staffing*

The planned management and professional staffing team will build over time after launch, from six employees in Year 1 to sixteen in Y5, and eventually to twenty when BGF is fully mature. The staffing plan at that point, with main qualifications, is as follows:

- A CEO with investment fund or bank credit management experience, development assistance experience, private sector business experience, in BiH or other Western Balkans or Europe/Eurasia transition region countries.
- Two Senior VPs and three VPs, with a combination of development assistance, private sector business experience, and banking experience, in BiH or other Western Balkans or Europe/Eurasia transition region countries.
- Three Senior Investment Officers and four Investment Officers, with a combination of development assistance, private sector business experience, and bank credit officer experience, in BiH.

The management and investment professional staffing will be supported by an expected seven finance, IT, and administrative positions. Experienced external fund/loan administration is also planned, for cash management and accounting; loan documentation; custody and compliance; treasury operations; preparation of financial and investor statements; investor and investee data protection; and submission of tax and regulatory filings. The Fund will be independently audited.

This staffing structure, which is reflected in the Fund Financial Plan & Projection model presented below, is expected to be sufficient to enable the deal origination, screening, conversion, and portfolio monitoring activities required to reach a level of closed 50+ investments annually by Year 5.

The availability of candidates to fill these positions is expected to be good. The CEO position will be the most challenging, and will be recruited internationally through an intensive search. The senior managers (SVPs and VPs) will be recruited within BiH and possibly neighboring Western

Balkans or Europe/Eurasia countries – Moldova, Georgia, Armenia, etc. – that have economies broadly similar to Bosnia’s, and are still subjects of extensive development assistance from USAID, EU, WB, UNDP, Sida, SDC, GTZ, and other bilateral donors. The staff Investment Officers will all be recruited within BiH.

Development assistance projects in BiH and regional countries over the past twenty-five years have employed and trained hundreds of local professionals in enterprise development as well as operational and administrative management, and the consolidation of the banking sector under a handful of large international banks has trained a substantial cadre of credit and risk management professionals. From these sources, the ability to recruit a high-quality, experienced team for BGF, which will certainly be regarded as an innovative and attractive place to work, is highly feasible.

### 5.3.3 *Investment Operations*

Investment operations consist of (i) originating and screening potential investments (ii) analyzing and conducting due diligence of investee candidates, (iii) negotiating terms with investees and closing investments, (iv) monitoring, evaluation, and reporting, (v) remedial or improvement consulting, and (vi) administration and operations.

Some of these functions are fully internal, while others will be implemented with the support of outside partners.

- *Origination and Screening*

BGF will be able to readily identify and capture a wide range of potential investees from inception, due to both the experience of its staff and its network of institutional partners, well known to the staff, covering the entire country. As noted above, BGF will draw much of its local staff from a corps of professionals who have built their analytical and consulting capacities, from over two decades of experience on donor enterprise development / competitiveness projects, and have intimate knowledge of dozens of BiH SMEs and wide personal networks.

As elaborated in the Partnerships section below, enterprise competitiveness projects such as USAID’s Cluster Competitiveness Activity (2004-2008) and FIRMA (2009-2012) fostered close working relationships with a network of regional development agencies with offices throughout the country. These RDAs, as well as cantonal and entity-level chambers of commerce, collectively representing hundreds of firms, greatly magnified the outreach of these and other donor projects. BGF will replicate these relationships. It is expected that at least half of the candidate investees will be originated by the RDAs/CoCs, for which the Fund will provide finders’ fees. This ability to outsource a significant portion of investee origination to partners will enable a high level of Fund operational efficiency.

This strong foundation of knowledge means that the BGF will be able to gather dozens of viable investee candidates within a few weeks of launch and begin concluding financings shortly thereafter. In preparation of this feasibility assessment, FINRA recruited a small team of consultants with the kind of enterprise development experience described above. Their instructions were to identify SMEs expected to satisfy the Fund’s fundamental investment criteria – demonstrable market, high growth potential, capable management – and to conduct site visits

to them, to gauge their need for risk capital, and present how the Fund would provide it, through the revenue-based financing instrument. Within about six weeks the team built a pro forma pipeline of some 70 companies covering multiple sectors, a range of SME sizes, and all BiH regions.

They found widespread interest in the product. Though virtually all of the companies had bank loans, many had already committed their available collateral, and were unable to access finance for the equipment and working capital necessary to exploit waiting market opportunities. Many were frustrated with their inability to access additional bank finance and the absence of any alternative source, other than owner resources and retained earnings. Several confirmed that their banks would be willing to provide additional loans if the firms could find complementary subordinated credit.

- *Investment Selection and Due Diligence*

FINRA has developed a 70-company pro forma pipeline database to determine key financial performance metrics of SMEs in BiH. It produced the following summary characteristics:

**Table 5: Pro Forma Pipeline Companies Database Summary**

	<u>Total</u>	<u>Average/Co</u>	<u>Maximum</u>	<u>Minimum</u>
Sales:	\$113.2 MM	\$1,568,000	\$8.8 MM	\$118,900
Employment:	2,745	39	223	3
Expected BGF Financing:	\$13.4MM	\$191,500	\$500,000	\$50,000

This indicates the range of “true SMEs” to be targeted by the fund. Due diligence would be required to conclude each financing, but this pro forma pipeline at least suggests that there is a ready universe of companies that could pass an initial screening based on the fundamental three-part criteria of demonstrable market, high growth potential, and capable management. On a judgmental nine-point scale, assigning up to three points for each of the three foundation criteria, the team rated 32 of the 70 companies at seven or above. Two-thirds of the companies recorded annual sales growth of greater than 10% in the five years before the pandemic recession. Using a judgmental ten-point system, with lower meaning less risky,<sup>11</sup> the average company risk rating was 2.7.

These are indicative elements of an initial screening framework. The characteristics of the pro forma pipeline that was assembled for this study support the feasibility of the BGF’s high-volume investment model. After further due diligence, it is not unreasonable to expect that at least one-fifth of these already identified companies could go on to be financed. Such due diligence will cover (i) market and growth potential, (ii) management qualifications and organization, (iii) development impact potential, (iv) creditworthiness<sup>12</sup>, and (v) operational efficiency.

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<sup>11</sup> Risk factors covered years in business, number of customers, number of suppliers, number and experience of senior managers, EBITDA %, and trend sales growth.

<sup>12</sup> In BiH there are two private providers of credit information – LRC Credit Bureau and Bisnode (a subsidiary of Dun & Bradstreet). Both provide company business and financial analysis and credit rating services to bank lending

A key element of due diligence will be the preparation of the company financial projection model, which, while demonstrating the adequacy of cash flow to service the BGF loan, will establish the mutually-agreed medium-term Base Sales Growth Path to which the revenue Royalty Rate will apply, as well as the quantitative key performance indicators (KPIs), applying to both business and development objectives.

- *Negotiation and Closing*

BGF's negotiation and closing process will require some explanation to the borrowers, since the royalty-based portion of the required payments may be unfamiliar to them. However, potential investees will have been informed about and agreeable to the product and its terms (standard Base Interest Rate and loan term) in the initial screening phase, and the important Base Sales Growth Path to which the Royalty Rate will be applied will have been estimated and agreed at the financial projection stage. Finally, since the loans will normally be uncollateralized, apart from a simple equity pledge, complex security and shareholder agreements will be unnecessary. Annex 6 in Volume 2 provides the expected term sheet for the standard financing instrument.

In site visits and interviews conducted for this Study with potential pipeline companies, the purposes, nature, and broad terms of the expected standard BGF financing instrument were explained. The great majority of companies were highly interested in the concept and favorable to pursuing the potential for finance using it.

Our Fund Planning & Projection model, further discussed below, anticipates that with by Year 4, with a management and investment staff of twelve and the input of partner organizations, BGF will be able to close approximately one deal per week.

- *Investment Monitoring, Evaluation, and Reporting*

BGF will have a documented monitoring and evaluation procedure, based on standardized monthly reports that all investees will be required to submit. Quantitative information will be maintained in an analytical database designed to elevate potential business performance and loan risk issues. BGF staff will perform periodic site visits to investee companies. Risk management will be systematized, prioritizing early intervention. Early intervention will be supported by consulting assistance provided through BGF's partner network (discussed in the following section).

Management will prepare and deliver regular quarterly reports to the Board of Directors and investors, supplemented by interim reports in the case of significant new developments. Reports will cover performance against all key indicators vis-à-vis their targets, commercial and development impact. BGF will

#### 5.3.4 *Partnerships and Support Services*

BGF will actively build a formal network business development service (BDS) providers with strong track record in implementing SME-oriented programs. As noted above, they will

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operations, and would be available to BGF. Lenders can also access entity-level financial information agencies to which companies are required to submit semiannual and annual financial statements, as well as the Central Credit Registry at the CBBH, which maintains data on company indebtedness.

substantially leverage BGF's outreach for originating promising investments. Post-investment, they will assist in monitoring of the investments they will have originated that were successfully closed. They will also be engaged to technical consulting assistance to investee companies in need of it, whether to further enhance their already-demonstrated competitiveness, or to provide remedial advice in the event that results disappoint initial expectations.

Prominent among these partners are the regional and municipal economic development agencies (RDAs) covering the entire country.<sup>13</sup> The well-populated and vibrant BDS ecosystem also includes employer and business associations<sup>14</sup>; chambers of commerce<sup>15</sup>; incubators, technology parks/innovations centers<sup>16</sup>; training providers, donor projects and business assistance facilities<sup>17</sup>, international and local accounting and consulting firms<sup>18</sup>; and independent private consultants. These capacities have been built over many years, and all of these BDS providers will be well-known to local BGF staff.

BDS providers will earn fees for successful deal origination and for follow-on monitoring and consulting services. In many cases these costs will be limited or shared by the partners, many of which are nonprofit and supported by local government and donors.

Finally, BGF will also work closely with BiH commercial banks, some of whom are expected to be investors in the fund. In preparing the pro forma pipeline selection for this report, there were several examples of companies whose banks were willing to lend, but not for the full amount needed for a particular equipment investment. Their banks confirmed readiness to collaborate with a fund supplying subordinated credit to fully fund the need. Close business relationships with bankers will be a key channel for origination of good BGF investments, and to gain complementary monitoring support.

In sum, this expansive partnership network justifies the expectation that a strong pipeline of high-quality BGF investments can be rapidly identified and closed, in volume, and well-monitored and supported post-investment.

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<sup>13</sup> Tešanj Regional Development Agency (TRA), Prijedor Economic Development Agency (PREDA), Zenica-Doboj Canton Economic Development Agency (ZEDA), Sarajevo Regional Economic Development Agency (SERDA), City Development Agency of Banja Luka (CIDEA), Regional Economic Development Agency of Central Bosnia Canton (REZ), Development Agency of Republika Srpska (RARS), Tuzla-based Regional Development Agency of North-East BiH (NERDA), and Mostar's Regional Economic Development Agency of Herzegovina (REDAH).

<sup>14</sup> Including Mozaik, U Plusu, entity/state level industry and sectoral associations

<sup>15</sup> The Foreign Trade Chamber of BiH, FBiH Chamber of Commerce, RS Chamber of Commerce, 10 cantonal chambers of commerce in the Federation, AMCHAM

<sup>16</sup> Some leaders are Intera Technology Park Mostar, ICBL Center in Banja Luka, BIT Center Tuzla, WMTA Training Center Banja Luka, and Academy 387 Sarajevo.

<sup>17</sup> Currently active programs include USAID WHAM, USAID Diaspora Invest; EU4 Business, EU4 Agri, and EU4 Business Recovery (implemented through consortium of UNDP, GIZ, and ILO under the Norway-funded Economic Governance for Growth program); the Swiss-funded Market Makers project; the Swedish/SIDA-funded Challenge to Change (C2C) program; and German (GIZ)-funded projects providing technical assistance to SMEs in digitalization and economic development.

<sup>18</sup> The local offices of Deloitte, Ernst & Young, KPMG, PWC; local consulting firms such as Targer Consulting, SYS Company, and DS Consulting.

## 6. Financial Plan and Projection

Determining the feasibility the BGF requires the construction of a detailed financial model based on assumptions about costs, revenues, and other factors – including, since there is a royalty-based component to loan repayment, the financial performance of the fund’s investee companies. Key investors and the fund manager will make their own decisions about the fund’s financing structure, operational profile, and terms offered to downstream borrowers. The objective here is to present model assumptions and resulting output based on available information and local knowledge about what the Fund could ultimately look like. In addition to all of the legal and qualitative observations and conclusions provided above, BGF’s feasibility must be shown in the numbers, using reasonable, conservative assumptions.

This discussion of the Financial Plan and Projection Model (“the Model”) covers four topics, the parameters of which impact the potential performance of the Fund. These are: (i) capitalization and early balance sheet growth, (ii) revenues, (iii) expenses, and (iv) cash flow and equity investor returns.

All monetary amounts in the tables below are expressed in USD.

### (i) Capitalization and Early Balance Sheet Growth

The financing structure will have equity and debt components. While still uncertain, for purposes of this study, a recent report provided a useful base case assumption (Symbiotics 2019). It found that a sample of twenty private debt funds surveyed over a five-year period were capitalized on average by 64% equity and 36% debt. The BGF Model uses those ratios, splitting the debt portion evenly between senior and subordinated investor bonds.

The senior and subordinated debt financings, in two rounds, will be denominated in BAM (though expressed in USD in the tables below) and have 10-year maturities, with level annual principal repayments. They are expected to be purchased mainly by local banks, insurance companies, pension funds, and development banks, as well as foreign impact investors possibly. The senior bonds are projected to carry a 5% annual rate of interest, which represents a 1.5% premium over the rate offered by BiH commercial banks to high quality corporate customers. Subordinated bonds are priced at 8%, which is considered a sufficiently high-risk premium above the senior debt to attract investors.

While, conservatively, donor grants are not assumed in the projection model, they may potentially contribute to initial capitalization, and likely to BGF startup costs.

<u>Sources</u>			<u>Uses</u>		
Senior Debt	\$ 3,774,375	11%	Loans to SMEs	\$ 30,812,320	} 67%
Subordinated Debt	3,774,375	11%	minus: Repaid Principal	-7,412,583	
Equity	27,450,000	78%	Working Capital	11,541,673	33%
			Other Assets	57,340	0%
<b>Total Sources</b>	<b>\$ 34,998,750</b>	<b>100%</b>	<b>Total Uses</b>	<b>\$ 34,998,750</b>	<b>100%</b>

	<b>Year:</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>Total</b>
Equity		4,270,000	0	9,150,000	0	14,030,000	\$ 27,450,000
Senior Debt		0	1,200,938	0	2,573,438	0	3,774,375
Subordinated Debt		0	1,200,938	0	2,573,438	0	3,774,375
<b>Total:</b>		<b>4,270,000</b>	<b>2,401,875</b>	<b>9,150,000</b>	<b>5,146,875</b>	<b>17,030,000</b>	<b>\$ 34,998,750</b>

Investor equity inflows in Years 1 and 3 are followed by debt inflows matching the 64%/36% equity/debt shares in Years 2 and 4. The financing in Year 5 was assumed to constitute sufficient equity to serve as the last financing needed under the constant level of 52 new loans per year projected thereafter, so no additional debt was assumed following that.

	<b>Year:</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
Number of New Loans		7	17	26	52	52
Amount of New Loan Disbursements		1,400,560	3,401,360	5,202,080	10,404,160	10,404,160
Cumulative Disbursements to SMEs		1,400,560	4,801,920	10,004,000	20,408,160	30,812,320
<b>Portfolio Outstanding</b> (net of repayments & write-offs)		<b>1,400,560</b>	<b>4,498,799</b>	<b>8,661,606</b>	<b>16,900,615</b>	<b>23,039,593</b>

The Symbiotics study also found that a sample of 43 funds over five years had an average loan portfolio constituting 82% of total assets. Adopting this standard, the BGF model channels 81% of its capital into SME loans by the end of Year 4 (Y4).<sup>19</sup>

Through Y5, with the approximately \$35MM in equity and debt investor funding, and reasonable assumptions as to staffing and the pace of origination and closing, the model projects cumulative disbursements of approximately \$31MM to approximately 150 companies.<sup>20</sup>

As for other financial assets, the same Symbiotics report found that the 43 funds surveyed held considerable levels of liquidity, 11%-14% of total assets, a relatively large share, despite the fact that the interest rate earned on cash deposits was considerably below their cost of funds. For the BGF projection, a figure of 10% was used for this parameter, considered reasonable due to the financing flexibility available to an evergreen fund, which does not need to build up balances for the eventual windup of a typical closed-end fund, and can more routinely access bank working capital financing for short-term liquidity needs.

<sup>19</sup> The corresponding 67% figure in Table 6 and the high 11% working capital share are distorted by the inclusion of the large financing round in Year 5, for the Model downstreams to SMEs until later years.

<sup>20</sup> A report commissioned by the Dutch Good Growth Fund (2016) concluded that for a small cap SME mezzanine finance fund to be sustainable, it needs to reach a minimum size of \$30MM. According to the model, BGF will surpass this total assets level in Y7.

*(ii) Revenues*

With the exception of modest income from an assumed 0.5% rate of interest earned on cash balances above BAM 1MM, the fund’s revenue is entirely derived from its lending activities, are composed of (i) a 1.0% origination fee charged to borrowers, (ii) a base interest rate of 5.0% on outstanding loan principal, and (iii) a 0.5%-1% royalty rate paid on annual revenues. These are averages assumed in the model for the total loan portfolio, based the actual historical and projected financial data in the pro forma pipeline companies database. In practice, the portfolio will consist of loans of different sizes, risk ratings, tenors, base interest rates, and royalty rates.

Borrower royalty payment revenue is more complex to model. Assumptions for this component were informed by data from and discussions with BiH SMEs. It was determined that an average borrower is interested in a loan amount that represents 15% of most recent annual revenues, is whose revenues are expected to grow at an average rate of 20% per annum over the subsequent seven years. Using these figures and the fund’s assumed 15%-16% portfolio return (not including the origination fee), an average royalty rate of just over 0.5% would be needed. In practice, variation in the size of the loan relative to recent revenues would be a determinant (among others) that would result in a range of applied royalty rates.

	<b>Years:</b>	<b>1-2</b>	<b>3-4</b>	<b>5-6</b>	<b>7-8</b>	<b>9-10</b>
Origination Fee Revenue		24,010	78,031	104,042	104,042	104,042
Base Interest Revenue		35,014	329,010	998,505	1,433,529	1,609,120
Royalty Revenue		27,776	320,899	1,171,408	2,266,485	3,243,425
<b>Loan Portfolio Gross Revenue</b>		<b>86,800</b>	<b>727,940</b>	<b>2,273,955</b>	<b>3,804,056</b>	<b>4,956,587</b>
Payable to Partner Organizations		-7,090	-24,348	-37,299	-40,892	-42,268
Interest Earned on Cash Bal		8,060	14,589	27,471	21,046	14,083
<b>Total Net Revenue</b>		<b>87,770</b>	<b>718,181</b>	<b>2,264,127</b>	<b>3,784,210</b>	<b>4,928,402</b>

As seen in the table above, some two-thirds of loan portfolio gross revenue comes from royalties, and about one-third from the base interest rate on the loan.

Net revenue from loans is reduced by fees paid to partners for assistance in initial screening and origination of prospective investments, conducting due diligence, and monitoring investments post-closing, as described in the partnership section above. This service arrangement is assumed to cost the fund an upfront fee of 0.5% of the disbursed amount (essentially taking half the assumed upfront fee charged by the fund to the borrower) and 0.10% annually on the outstanding loan balances (i.e., lowering BGF’s annual return by ten basis points out of its target 15.5%). It is assumed that 50% of BGF’s loans will be originated by partner organizations and therefore subject to these payables.

*(iii) Expenses*

Lending is not a fixed asset-intensive business; its major expenses are connected to people and capital. Employees and outside parties are expected to play important roles in the day-to-day operations of BGF.

Consistent with the in-house fund management approach, portfolio growth and management tasks are assumed to be performed by skilled investment professionals out of offices in BiH, supported by information technology and administrative employees. Growth in the number of annual investments evaluated and closed, and with that overall portfolio expansion, will require concomitant staff increase. Reflecting the staffing and standardized origination, due diligence, selection, closing, and monitoring procedures described, the Model assumptions result, once beyond the start-up phase, in the following approximate workload metrics:

- 40 potential deals evaluated per investment officer per year
- 8 deals closed (20% of those evaluated) per investment officer per year<sup>21</sup>
- \$2.5MM in assets Under Management (AUM) per employee<sup>22</sup>

	<b>Years:</b>	<b>1-2</b>	<b>3-4</b>	<b>5-6</b>	<b>7-8</b>	<b>9-10</b>
# Investment Officers		2.0	4.5	6.0	6.3	7.0
Deals Worked / Investment Officer		31.7	42.3	43.3	41.7	37.1
Deals Closed / Investment Officer		6.3	8.5	8.7	8.3	7.4
# Investment Professional Employees		5.0	9.3	11.3	12.3	13.0
AUM/Employee		444,118	1,682,174	3,283,164	3,981,783	4,100,240

These ratios apply to the full BGF staffing outlined above: 7 investment officers, reporting to and supported by six higher-level managers, for 13 total investment professional employees. As noted, deal evaluation and investment monitoring effort, in half of the cases, will be complemented by formal BGF partner organizations.

The projection model's sales, general, and administrative (SG&A) expense category captures all the costs of running the Fund's daily operations, including employee wages and other related direct-hire personnel costs (office rent, etc.), as well as fees paid to other professional service providers. It does not include loan loss provisioning, write-offs for uncollectable loans, depreciation, amortization, interest paid on the fund's debt, or taxes.

<sup>21</sup> The DGGF (2016) survey of funds reported an average of 4-8 deals closed per investment officer per year.

<sup>22</sup> This is within +/- 50% of the \$3.6-3.9M M average per employee found in the DGGF (2016) survey of funds.

<b>Years:</b>	<b>1-2</b>	<b>3-4</b>	<b>5-6</b>	<b>7-8</b>	<b>9-10</b>
SG&A Expenses/AUM	18.02%	5.13%	2.90%	2.99%	3.14%
Employee Payroll	301,547	462,499	568,677	676,995	768,017
External Fund Administrator	8,000	25,562	50,370	61,714	65,695
Other Professional Services	81,077	56,048	88,368	103,745	109,671

Symbiotics (2019) found that the expense-to-assets-under-management ratio for funds in making direct investments in small businesses averaged 4.2% for the funds surveyed. The table above shows the evolution of this ratio in the Model, which starts off quite high, due to significant start-up costs and the small asset size of the Fund, but eventually settles around 3%. Though somewhat lower than that of the aforementioned survey, this is considered reasonable for BGF due to the fact that it is a unified fund+management operation with mostly local staff, as opposed to a fund that would have to hire an external fund management company, as was the case for most of funds surveyed. Also, when compared to the DGGF (2016) survey's finding of \$3.6-3.9MM in average AUM per employee, BGF's \$2.5MM figure suggests that staffing assumptions are reasonably conservative.

Given the high costs of staffing and managing fund administration, especially given the eventually large number of borrowers and the accounting and collection of interest and royalty payments, outsourcing of this function to a professional services provider is likely be more economical, and is assumed in the Model. Indicative pricing for such a service bundle, based on input from the local branch of a large international bank, was 20 basis points of AUM per annum. This was used in the Model, resulting in the payments in the table above.

Other professional services, meanwhile, include legal, accounting, audit, and general consulting. These costs were estimated based on information from the BiH market.

Loan portfolio-related expenses are not additional to SG&A. Write-offs are assumed at a rate of 7.5% per year, beginning in Year 3 (net of loan provisioning). While somewhat lower than the 10%-15% range found in the Symbiotics survey of funds, this is believed to be a realistic estimate, based on the Fund's conservative 15% loan-to-annual borrower revenue average<sup>23</sup>, and, given the near-complete absence of competition on the supply side of the risk capital market in BiH, BGF's ability to build a well-diversified portfolio, from a large universe, of the highest-quality high-growth SMEs.

<sup>23</sup> SME borrowers from some other royalty-based lenders can reportedly receive from 33% to 50% of annual revenue in loan principal. See for example Lighter Capital (<https://www.lightercapital.com/>); GSD Capital (<https://www.gsdvs.com/>)

<b>Table 12: Portfolio Repayments &amp; Write-offs</b>					
Two-Year Totals					
<b>Years:</b>	<b>1+2</b>	<b>3+4</b>	<b>5+6</b>	<b>7+8</b>	<b>9+10</b>
New Loan Disbursements	4,801,920	15,606,240	20,808,320	20,808,320	20,808,320
Principal Repayments	-303,121	-3,099,382	-9,733,368	-14,874,852	-17,917,640
Loan Write Offs (Realized)	0	-105,042	-645,258	-1,560,624	-1,560,624
Portfolio Outstanding	4,498,799	16,900,615	27,330,309	31,703,152	33,033,208

Write-offs at the assumed 7.5% rate are realized with a lag. In the table, they are expressed as two-year totals, reaching approximately \$780,000 per year, once the portfolio origination rate levels out at 52 new loans closed per year.

Netting revenue and expenses, BGF is expected to become profitable by Y6, as rising interest and especially royalty revenues from prior lending are realized without incurring significant additional operating expenses.

Payment of interest to investors in the Fund's senior and subordinated bonds is a continuous regular expense, taken account of in the P&L summary table below.

<b>Table 13: Projected Profit &amp; Loss Summary</b>					
Annual Averages					
<b>Years:</b>	<b>1-2</b>	<b>3-4</b>	<b>5-6</b>	<b>7-8</b>	<b>9-10</b>
Total Net Revenue	87,770	718,181	2,264,127	3,784,210	4,928,402
Loan Loss Provision & Write-offs	-168,705	-517,589	-713,743	-944,294	-830,189
Salaries, General & Admin Expenses	-480,389	-632,095	-805,048	-949,857	-1,060,758
Depreciation, Interest & Taxes	-29,558	-209,720	-440,593	-405,830	-523,630
<b>Net Income</b>	<b>-590,883</b>	<b>-641,223</b>	<b>304,744</b>	<b>1,484,229</b>	<b>2,513,824</b>

*(iv) Cash Flow and Investor Returns*

As for dividends, though subject to declaration by the Board of Directors, they can be expected to commence at some point after overall cash flow, taking account of disbursements and repayments from portfolio lending operations, becomes positive. Taking all of the above parameter assumptions into account, the Model projects positive cash flow by Y9, with initial dividend payments to equity investors in that year. Long term, the Model projects an annual dividend yield of approximately 10%.

<i>Table 14: Components of Cash Flow</i>					
Two-Year Totals					
<b>Years:</b>	<b>1+2</b>	<b>3+4</b>	<b>5+6</b>	<b>7+8</b>	<b>9+10</b>
Operations & Lending	-5,336,079	-12,742,833	-9,026,616	-1,065,250	3,808,693
Investment in Fixed Assets	-50,020	-7,320	-2,440	-2,440	0
Financing	<u>6,671,875</u>	<u>13,816,500</u>	<u>12,520,250</u>	<u>-1,509,750</u>	<u>-2,764,425</u>
<b>Total Cash Flow</b>	<b>1,285,776</b>	<b>1,066,347</b>	<b>3,491,194</b>	<b>-2,577,440</b>	<b>1,044,268</b>
End of Period Cash Balance	2,107,830	3,855,940	9,579,208	5,353,896	7,065,811

Expanded tables for sources and uses, profit and loss, balance sheet, and cash flow projections can be found in Volume 2, Annex 7 of this Study.

## 7. Recommendations and Next Steps

Assuming agreement as to the principal findings of this Study:

First, as to the serious need for risk capital for SMEs in BiH, and the suitability of the BGF concept to address it, and

Second as to the feasibility of legally structuring the Fund for registration and operation in BiH according to the concept, of sourcing a plentiful pipeline of viable SMEs for investment, of finding and engaging a well-qualified investment management team, and of attracting investors, then

The principal recommendations of this Study, with next steps, are as follows:

i) Proceed immediately to prepare the legal-regulatory foundation for registration of the Fund. For this purpose:

- Present the BGF Concept and the findings of this Study to regulatory agencies that will or could have an oversight role or interest, including the two Entity Securities Commissions, Banking Supervisory Agencies, and Finance Ministries, to obtain their buy-in to proceed.
- Research, draft, and adopt Alternative Investment Fund (AIF) law and implementing regulation for BiH that will enable the fund to operate according to the Concept.
- Research, draft, and adopt other law / regulation that may need amendment in order to accommodate the new AIF law and the BGF concept, if any.

With the technical assistance of USAID FINRA, these steps should be able to be completed within one year of the date of this Study (September 2022).

It should be noted that even if the BGF is not established, the preparation and adoption of AIF law is necessary for the development of nonbank finance in BiH, as well as for eventual EU accession, and therefore in keeping with FINRA's scope of work.

ii) Present the BGF Concept and findings of this Study to prospective investors, in order to obtain firm pre-commitments to capitalizing the Fund once it is registered and qualified management and professional staff engaged.

- Key donor and foreign investor meetings: DFC, EBRD, EIF, IFC, Sida, FMO, selected impact investors, others.
- Key domestic investor meetings: commercial banks, insurance companies, pension funds, development banks, companies

Within six months of the date of this Study, these investor meetings, facilitated by USAID FINRA, can be conducted and commitments for the approximately \$30MM in equity and debt capitalization obtained (March 2022).

The following steps should be able to be accomplished within six months of the adoption of the enabling law and regulation described above (June 2023).

iii) Register the Fund as a JSC under AIF and Company law in either RS, FBiH, or both.

- iv) Secure commitment for some level of grant funding from USAID and/or other donors to help subsidize BGF startup costs, and potentially contribute to initial capitalization.
- v) Recruit a well-qualified CEO and the initial team of senior and second-level managers and investment officers.

Within six months of registration, the BGF should be able to launch operations (September 2023).

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