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INCLUSIVE BUSINESS CAMBODIA

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THE INCLUSIVE BUSINESS RISK REDUCTION AND SOCIAL INNOVATION (IB-RRSIF) FOR CAMBODIA

A concept note

While doing inclusive business landscape studies and policy work in various Asian economies[1], the establishment of a risk reduction facility with elements of social impact incentives emerged in various discussion with impact investors, IB companies and the government as a key feature for investment promotion.[2] This brief paper summarizes the rationale for and the feature of such a IB risk reduction fund, and gives a practical (and actual) example from Cambodia (low-cost housing sector), how it could be institutionalized.

Rationale for a fund that reduces the investment risks of IB investors: When discussing with impact investors and IB businesses, it is always argued that sufficient funding is available in the market, but investors are reluctant or need lots of time to structure the respective deals. This is mainly because of two reasons: 1) the proposed project is not investment ready or does not have sufficient social impact, and 2) investors perceive risks – real or assumed – and prefer to wait and see the company's further performance potential, before actually investing in a new business model. While business readiness will be addressed through business coaching services, investors' readiness can be encouraged by establishing a risk reduction financing facility. Often, impact investors are close to making a deal, but there are a few perceived or real risks which hinders them to a final agreement with the company. In such case, a modality that helps reducing the risk for the investor would come in handy. Such IB risk reduction facility or fund (IB-RRF) would thus unleash investments that are nearly investment ready but do not materialize due to various reasons.

Rationale for social impact incentives: Companies designing new business lines for creating social impact among the BoP welcome incentives for doing so and passing on to their clients through higher ay or better and cheaper goods and services. To encourage companies strengthening their social impact. A social innovation incentive (SII) component is proposed to be added to the IB-RRF and a combined IB-RRSIF being created. The SII component would only be for strengthening the growth of social impact; through the IB business model. It would not finance the social impact per se. The incentive would be between $100.000 and $250.000, and be given as a grant to the final beneficiaries, but structured through the impact investors. Not all IB-companies promoted through the RRF would automatically also receive the SII financing. The necessity for SII financing would be assessed separately. The funding would also go through impact investor and company to the final beneficiary; it shall not be used by

[1] The author did such studies and policy discussions as staff of the Asian Development Bank (ADB) and the head of the bank's Inclusive Business initiative between 2011 and 2017 and later as IB and impact investing consultant for ESCAP and iBAN.

[2] Other suggestions for IB promotion comprise, among others 1) IB institutionalization, 2) IB awareness raising and awards, 3) IB accreditation, 4) IB business coaching, 5) prioritizing IB and social enterprises in public procurement, 6) IB risk reduction for impact investors, 7) including IB in the investment incentive scheme of a country, 8) integrating IB in the SME and poverty reduction programs, 9) specific IB reporting, and 10) facilitating regional exchange on IB. Similar recommendations are included in the IB policies of Cambodia (also reflected in Cambodia's IBeeC strategy), Malaysia, Myanmar, Philippines and Viet Nam. The IB policy promotion guide is also endorsed by the ASEAN Economic Ministers for mainstreaming in the ASEAN region (see https://asean.org/storage/2020/09/ASEAN-IB-Promotion-Guidelines-Endorsed-at-the-52nd-AEM.pdf).

the company to increase profitability of the business nor to subsidize otherwise unviable aspects of the firm. The payment would be result based.

How would an IB-RRSIF work? The IB-RRSIF would be a convertible debt fund, where the IB risk reduction fund would co-invest equity and other forms of patient capital as seed funding in the initial growth stage (not start-up) of a company (say 10%-15% of costs) to kickstart the investment, while the impact investor would finance the remaining. If the investment is a financial success, the investment from the government would be converted into a loan, had to be returned to the government, and would then be re-invested in other companies (revolving fund mechanism). If the total investment does not meet the agreed financial results criteria, the IB-RRF share would serve as a grant. It is assumed that any investment which qualifies as IB has sufficient social impact so that impact for the public (society) is given. Hence, in any case the joint fund investment is successful, as it would yield social results, even if the financial performance may not fully meet the initial expectation. There are many business models, where such risk reduction facility would help unleashing funding and investments, which otherwise would not mature.

Procedure: Through the proposed IB-RRSIF, the government (or development institution) would co-invests (15 to 20 per cent of the total investment value) in the first phase of an IB model (e.g. the first one or two years). The investor(s) provide(s) the remaining 80 to 85 per cent. The IB model will then be upscaled by the investor(s) alone in phase 2. The government's co-investment will be designed for the whole investment (the two phases), but the money will be released in the first phase. The investor(s) cover(s) most of the investment and of the risk. The financing will be used to reduce the investment risk and unleash actual financing from impact investors in accredited IB companies. The government investment is in the form of equity (or quasi loan) and if the investment achieves the planned social outcomes but does not meet the agreed financial returns, the government investment will be converted into a grant. Otherwise, it will be paid back (without interest) starting from year 2 of the project implementation and completing the repayment by year 5.

The proposed features of such IB fund: The following outlines the various criteria and design features of such IB-RRSIF.

- Such fund is not a credit line nor a guarantee nor equity investment nor a subsidy. Rather, the government will co-invest in the first phase of an IB business which will then be upscaled by the investor in phase 2. While the risk financing is for phases 1+2, already in phase 1, the investor places the majority of the investment and risks.
- The financing will be used to reduce the investment risk for the investor (not the company) to reduce the investment risk and unleash actual financing from impact investors in accredited IB companies.
- There is international experience and successful examples using such investment tool. For example, they are used in Latin America by the Inter-American Development Bank for IB and other financing and they are also emerging in Asia.
- The IB-RRSIF is different from a traditional guarantee instrument as it does not ensure an investor that its investment risks are covered, but provides an opportunity for the government to share risks with the private sector in exchange of actual results on social value, without subsidising that investment.
- The investment would be given on quasi commercial terms and need to be paid back when the investment is profitable, while they would be given as grant when the investment has social impact but less agreed commercial return. The terms are such that the government investment is given as an equity (or quasi loan) to the investor; in case the investment achieves the planned social outcomes but does not meet the agreed financial returns, the government investment will be converted into a grant. Otherwise it will be paid back (without interest) starting year 2 of project implementation and complete repayment by year 5 the latest.
- The risk reduction facility could include financial instruments such as risk guarantees, early growth phase co-investment, result based financing tools, collateral reducing

instruments, special conditions for utility businesses with longer maturity of loans etc., diversified risk spread through additional equity encouragement, among others.

- Total government investment share would not be more than 15-20% of the total investment sum. Hence, the public investment (and the risk for the government) is much lower than in a traditional debt fund. Also, the due diligence work and final responsibility for the investment would remain with the investor and not with the government or a government guaranteed investment fund.
- Various potential investors would be allowed to draw from such fund. The IB-RRF would therefore not be given to a fund manager. Rather, eligible investors will be pre-screened and an IB Investment Board will decide on the IB deals to be supported.
- The IB-RRSIF is actually a public sector tool. However, it could also be established under a development bank private sector approach, for example by an institution like ADB-PSOD or IFC.
- In the case of Vietnam, it was proposed to establish the IB-RRSIF under the Ministry of Planning and Investment, in the case of Cambodia under the Ministry of Finance, and in the case of Malaysia under the SME Corp.
- To avoid misuse, and to ensure that the (public) funding goes only to those companies that create the expected social results, co-investments from the IB-RR Fund would only be for prior accredited IB firms[3].
- To ensure transparency and social results, only IB accredited companies can receive funding from the risk reduction facility., as fr these companies the social impact and the commercial return is properly established. It is suggested that decisions on deal financing being made by an IB Investment Board comprising SME Corp. Malaysia (as chair), up to five representatives from the IB Steering Board (three from government, two from business associations), and one representative from the Ministry of Finance or a development bank.
- As it is estimated that 80%-90% of the IB-RRF investments will be repaid by the investors within 5 years. The investor’s repayment of the government share could thus be used to make the risk reduction facility a revolving fund. As some (say 10-15%) IB-RRF investments would not yield commercial results sufficient to qualify the project as successful, a development approach must be followed where government and private sector co-invest together and the government (or the development finance agency) is ready to take also some failure risks. A pure private sector approach with a high-risk premium cannot work.
- The IB-RRSIF could also be established as a regional fund covering various countries in ASEAN. Initial discussion on the fund has been held with Cambodia, Malaysia, Myanmar, and Viet Nam. Other countries in ASEAN may also be interested to join.

The fund can be with the government and does not need a fund manager. Such risk reduction facility can be established within a government agency (e.g. Ministry of Finance, a development bank, Ministry responsible of SME promotion), or dedicated SME bank. fund board will be sufficient to decide on the IB deals to be supported, as it will be the impact investors doing the actual due diligence on the company. While setting up the fund the development partners as main investor may do an initial due diligence of eligible impact investors and banks to access the fund. Decisions on deal financing will be made by the investment board comprised of government, business associations, financing agencies. In the case of Cambodia, it was recommended to establish the IB-RRSIF under the Ministry of Economy and Finance.[4]

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[3] IB accreditation is a transparent composite tool implemented jointly by government and business associations to identify IBs. It is meanwhile introduced in 5 ASEAN countries of which 4 are finalizing their procedures for rolling out IB accreditation.

[4] A similar fund was also initially discussed in Viet Nam and Malaysia. In Vietnam the Ministry of Planning and Investment was suggested as coordinating agency, and in Malaysia the SME Corp under the Ministry for Entrepreneurship Development. The investment board in each country could comprise 5 representatives from

Costs The costs for Cambodia are estimated at be $25.1 million. For financing the IB-RRSIF in Cambodia, the government (through MISTI and Ministry of Economy and Finance) would welcome contributions from development partners[5] and the Ministry of Finance for its endorsement. Table 1 below provide a summary of the expected cost and portfolio for the IB risk reduction facility in Cambodia.

An example of the RRF part of the fund from Cambodia: Below is an example from Cambodia, where such IB-RRF would have unleased immediately a potential investment by a local impact investor:

- An impact investor was in a two-year discussion with a company providing low-cost housing. The company is profitable, and the business case is in line with the impact investors' objective. The company has successful experience in building a small number of houses (200 units) and wanted to scale up to 1,000 houses. The investment would have been used for buying the land and carry out the initial land development for the 1,000 housing project, while the actual cost for building would be financed through the company's own funding and the houses built and sold in a staggered way. Housing for the poor is an important social good in that country, and the highest cost share is buying land.
- The company wanted to buy a large plot at once because the land price would be lower, the housing would then be more affordable for the poor, and the business achieve a higher return. The impact investor, while trusting the company's ability to build 200 houses, was reluctant to invest in a 1,000 housing project because of the company's lack of experience in handling such a bigger project. The impact investor, finding that the deal with the company was 90-95% ready, suggested the government co-invests 15% of the total land costs through the risk reduction facility. Total investment costs for purchasing the 5 hectares land (housing for 1,000 families) and doing some initial investments for land development was USD 2 million, of which the government should shoulder $0.3 million as an initial equity investment (patient capital to be repaid within 5 years) through the risk reduction facility.
- The agreed rate of return for the risk reduction deal was 20%, while actual calculations between company and investor gave a profitability of over 30%. The proposed agreement between the investor and the government would be that if the houses in phase 1 of the total investment (200 houses) sell at a profit margin less than 15%, the government financing would be transformed into a grant. However, if the houses sell at a profit rate higher than 15%, the government share would be repaid by the investor as a loan. The likelihood that the return would be lower than initially calculated was estimated by the two partners at less than 5%. Even if the investment would not be financially successful in the first two, it would be successful from a social perspective as it would allow to build 200 houses in the first year and 250 more houses in the next year, more than double than the initial project.

For further information please contact the Inclusive Business Secretariat or the consultants to MISTI (Dr. Armin BAUER[6], Ms. Ratana Phurik Callebaut[7]).[8]

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the IB steering board (3 government agencies and 2 business association) and 1 person from a development bank. Management posts would be used to do additional due diligence and impact assessments and to host the investor committee meetings.

[5] Some development banks and other financing institutions (like ADB, AfD, CIDCO, CIFEM, EC, KOICA, World Bank/IFC) may be interested in financing such IB-RRSIF fund at either individual country or regional level.

[6] Dr. Armin BAUER, was principal economist in the ADB (1995-2007), worked with GIZ and KfW, and engages since 2018 as consultant on inclusive business and impact investing, among others. While working for ADB, he headed between 2011 and 2017 the institutions Inclusive Business initiatives. Since 2019 Mr. Bauer works as consultant to the government of Cambodia on Inclusive Business. For further questions, please contact Mr. Bauer through mail@armin-bauer.com, or 0049-174-8392569 (phone, WhatsApp) or armin_bauer2506 (skype).

[7] Ms. Ratana Phurik Callebaut is – among others - consultant to MISTI on Inclusive Business. She is a private sector development specialist and a CFA charter holder. She is involved in various impact and venture financing networks. For further questions, please contact Ms. Phurik Callebaut at ratana.phurikcallebaut@gmail.com.

[8] For implementing its IBeeC in a multi-stakeholder approach, MISTI established an IB Secretariat. For further information, you can also contact Mr. CHORN Vanthou (chorn_vanthou@yahoo.com, +855-89-429-068) Mr. PHENG Kimheng (phengkimheng11@gmail.com, +855-98-828333) in IB secretariat or Ms. Sopheara EK, local consultant to MISTI (sopheara@bdtrus.com).

Table 1: Estimated cost of the proposed IB-RRSIF for Cambodia (million US$)

Cost estimates for the IB Risk Reduction and Social Innovation Fund (IB-RRSIF) (US$)		
	Cambodia	
	million USD	%
smaller deals		
total investment size (without social incentive)	0.1-0.5	
average investment (without social incentive)	0.3	
number of investments	25	42%
total small investments, of which from	10.0	
impact investors contribution	6.0	
IB-RRSIF	4.0	18%
loan component (for reducing risks)	1.5	11%
per deal in %	20%	
grant component (for enhancing social innovation)	2.5	29%
per deal (million $)	0.10	
medium-sized investments		
total investment size (without social incentive)	0,5-2,5	
average investment (without social incentive)	1.5	
number of investments	20	33%
total medium-sized investments, of which	33.0	
impact investors contribution	25.5	
IB-RRSIF	7.5	34%
loan component (for reducing risks)	4.5	33%
IB RR share (%)	15%	
grant component (for enhancing social innovation)	3.0	35%
per IB-RRSIF investment	0.15	
large investments		
total investment size (without social incentive)	>2.5	
average investment (without social incentive)	5.0	
number of investments	15	25%
total larger investments, of which	78.0	
impact investors contribution	67.5	
IB-RRSIF	10.5	48%
loan component (for reducing risks)	7.5	56%
IB RR share (%)	10%	
grant component (for enhancing social innovation)	3.0	35%
per IB-RRSIF investment	0.20	
Subtotal - investments		**100%**
total number of investments	60	
average investment size (including commercial investment and SIF component)	2.0	
total investment, of which	121.0	
impact investors contribution	99.0	82%
IB-RRSIF	22.0	18%
loan component (IB-RR, for reducing risks)	13.5	
grant component (IB-II, for enhancing social innovation)	8.5	
Other financing of the IB-RRSIF	**3.1**	
management and impact assessment	0.8	3%
contingencies (10% on TA and investment each)	2.3	9%
Total IB-RRSIF	**25.1**	**100%**
assumed commercial default (small deals = 20%, medium deals = 15%, large deals = 10%) --> to be converted into a grant	2.7	12%
available for reinvestment (RRIF minus default minus SIF grant minus other financing)	10.8	43%