AFRICAN VENTURE PHILANTHROPY ALLIANCE

THE LANDSCAPE FOR SOCIAL INVESTMENTS IN EAST AFRICA

DEMAND FOR SOCIAL CAPITAL

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AAVISHKAAR GROUP

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ACKNOWLEDGEMENTS

This report was commissioned by African Venture Philanthropy Alliance (AVPA) with support from the United States African Development Foundation (USADF), Social Capital Foundation, and Rockefeller Foundation.

The African Venture Philanthropy Alliance (AVPA) is a unique Pan-African network for social investors, headquartered in Nairobi and committed to building a vibrant and high impact community across Africa. AVPA is aligned with thriving networks in Europe (EVPA - HQ in Brussels with 250+ members) and Asia (AVPN - HQ in Singapore with 600+ members) to form a dynamic global force for social impact.

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The U.S. African Development Foundation (USADF) is an independent U.S. government agency established by Congress to invest in African grassroots organizations, entrepreneurs and small and medium-sized enterprises. USADF's investments promote local economic development by increasing incomes, revenues and jobs, and creating pathways to prosperity for marginalized populations and underserved communities.
Utilizing a community-led development approach, USADF provides seed capital and local project management assistance improving lives and impacting livelihoods while addressing some of Africa's biggest challenges around food insecurity, insufficient energy access, and unemployment, particularly among women and youth.

Over the last five years, throughout Africa, with an emphasis on the Horn, Sahel and Great Lakes regions, USADF has invested more than $115 million dollars directly into over 1,000 African owned and operated entities and impacted over four million lives.

Social Capital Foundation is a Dutch Foundation that partners with social impact first organisations who want to enhance sustainable economic opportunities for communities and small businesses.

SCF supports local talent potential, creativity and innovation with adequate tools, flexible funding and a knowledge network to maximize and scale impact.

The Rockefeller Foundation's mission—unchanged since 1913—is to promote the well-being of humanity throughout the world. Today the Foundation advances new frontiers of science, data, policy, and innovation to solve global challenges related to health, food, power, and economic mobility. As a science-driven philanthropy focused on building collaborative relationships with partners and grantees, The Rockefeller Foundation seeks to inspire and foster large-scale human impact that promotes the well-being of humanity by identifying and accelerating breakthrough solutions, ideas and conversations.

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AVPA would like to thank our board of directors for their continued support, in particular the following people who provided significant time and insights during the editorial process of this report: Julio Garrido-Mirapeix, Paul Carttar, and Monique Mathys.

This report was also made possible through the contributions of many individuals and institutions, both within and beyond the region. We are grateful to everyone interviewed who provided their time, expertise, and data throughout the course of this study.

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DEMAND FOR SOCIAL CAPITAL IN EAST AFRICA

1.1 OVERVIEW OF THE DEMAND FOR SOCIAL CAPITAL

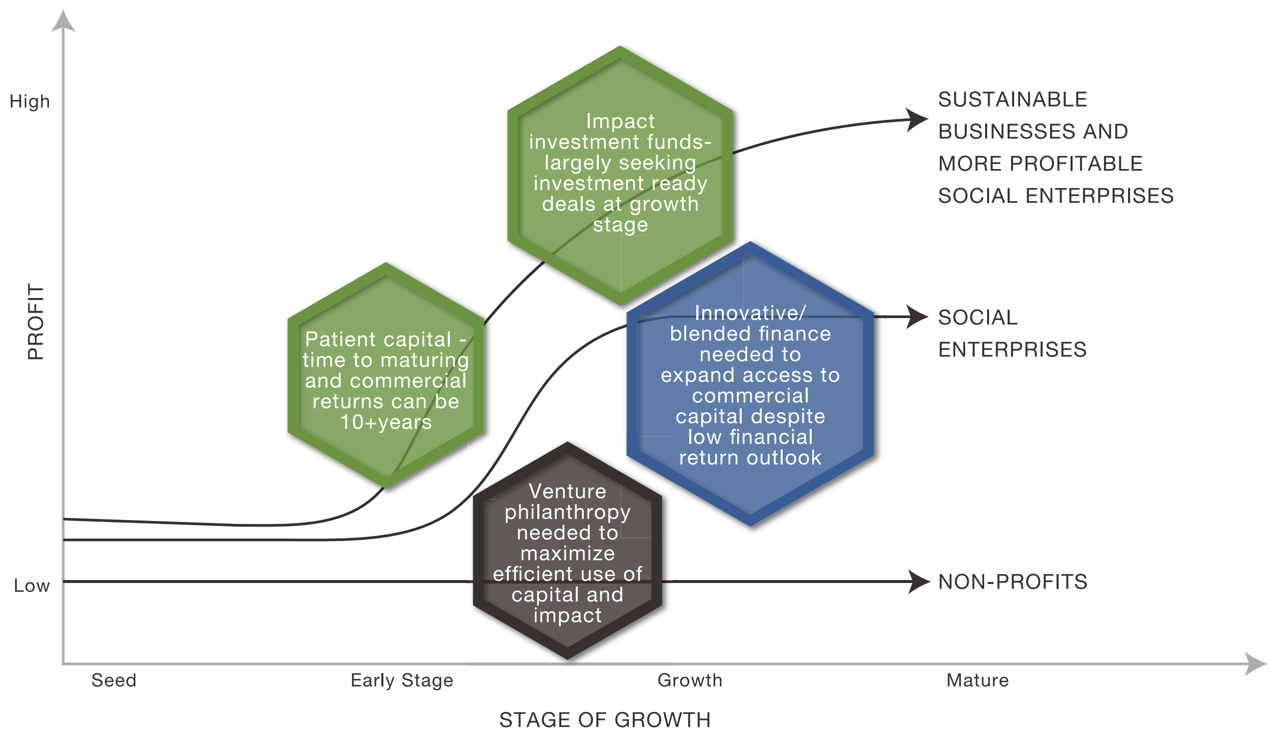
For social enterprises and impact businesses, the gap between supply and demand for social finance persists across the region, particularly for the 'missing middle'.

The supply of social capital does not match demand, especially at the early stage, with many social investors focusing on social enterprises and sustainable businesses with established business models and a good track record. In East Africa, a variety of social investors deploy pre-seed and seed-stage capital through foundations, donor-funded challenge funds, prize competitions, incubators, and angel investment models. However, these funds often require unique social business models that may not align well with the core business strategies of sustainability and scalability. Furthermore, start-ups funded through these channels often find it challenging to secure follow-on early and growth stage finance because of non-alignment with later-stage investors' interests. The well-known "missing middle" financing gap persists throughout the region, despite widespread recognition and serious attempts to address it. The missing middle gap affects start-ups seeking post-seed growth capital, as well as small and medium enterprises (SMEs)—those considered too small or risky for the commercial investors and banks, yet too big to be catered to by microfinance institutions (MFIs).

The changing landscape of international grant funding, which is a major source of funding for non-profits in the region, necessitates new approaches to mobilise local capital.

Non-profit organisations in the region continue to rely heavily on grant capital from bilateral donors and international foundations, availability of which is dwindling due to political changes in Western countries, and shifting strategies towards impact investment. As highlighted in the previous chapter, grant funding from American foundations to East Africa dropped by 97% between 2015 and 2019. This trend has the potential to hinder non-profit operations in the region substantially. In response, many NGOs have begun experimenting with hybrid profit models to increase sustainability and diversify their funding base. Non-profit organisations carry out essential activities in the social ecosystem in many social sectors and communities where enterprises often find it difficult to operate profitably. More effort is

Figure 1: Financing Requirements for Different Demand Actors over Time



needed to explore the potential of venture philanthropy and other innovative financing models to leverage local capital, improve the efficiency of non-profit's operations, and secure sustainable funding.

TRENDS AND DEVELOPMENT IN THE SOCIAL ENTERPRISE AND START-UP LANDSCAPE

> *The mobile money revolution has placed East Africa on the global map, giving rise to innovative business models that leverage digital technology to solve social challenges.*

The launch of M-Pesa in Kenya in 2007 began a technological revolution that has given rise to innovative business models in sectors such as financial services, agriculture and healthcare across the region. This, combined with the entrepreneurial spirit in the country and government interventions like the Konza Techno City—a tech park project—has driven the advancement witnessed in the start-up ecosystem. Kenya was ranked 2nd to South Africa in the 2019 and 2020 Startup Ecosystem Ranking in Africa. Globally, Kenya lost 10 positions and was ranked 62nd in the 2020 ranking as more countries enhanced their support for the ecosystem. Despite the slip, Nairobi was still ranked as the city with the most developed ecosystem in Africa.

Similarly, start-up ecosystems in other countries have been growing. Rwanda, ranking 3rd in Africa in 2020, has been one of the best performers, surpassing Nigeria. Uganda and Ethiopia also appeared in the Top 100 ranking in 2019. Furthermore, in 2019, Kenya, with US$ 564Mn, attracted 28%[54] of the total venture capital funding in Africa, ranking 2nd after Nigeria.

> *Start-up funders in the region have favoured agriculture, healthcare, energy, and financial inclusion sector, with a strong bias toward fintechs.*

Most of the start-ups established in the region have been in agriculture, healthcare, energy and financial inclusion given the many challenges in these sectors and large number of people affected by these challenges. Financial technology companies (fintech) have leveraged the high penetration of mobile money to facilitate access to quick

Figure 2: Global and Africa Start-up Ecosystem ranking

START-UP ECOSYSTEM RANKING, 2019

	AFRICA RANK	GLOBAL RANK
South Africa	1st	51st
Kenya	2nd	52nd
Nigeria	3rd	56th
Egypt	4th	60th
Rwanda	5th	64th

START-UP ECOSYSTEM RANKING, 2020

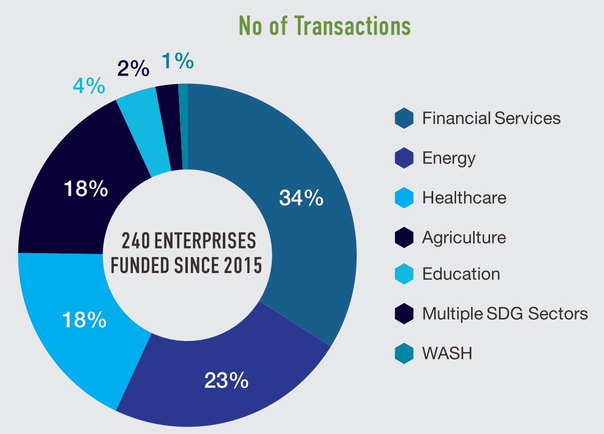
	AFRICA RANK	GLOBAL RANK
South Africa	1st	52nd
Kenya	2nd	62nd
Rwanda	3rd	65th
Nigeria	4th	68th
Egypt	5th	81st

Source: Startup Blink: Startup Ecosystem Ranking

[54] Partech: 2019 Africa Tech Venture Capital Report

loans and savings products for both business-to-business (B2B) and business-to-consumer (B2C) payments. An analysis of the SFM deals in the region shows that the largest number of deals were deployed to innovations and business models focused on solving financial inclusion challenges.

Figure 3: Overview of Social Enterprises that Received SFM and DFI Funding, by Sector (2015-2019)



Source: Intellecap Analysis based on the transaction/deal data collected[55]

> *While the number of innovative business models established has been increasing, funding has been consistently flowing into only a few enterprises.*

Investors have particularly shown an interest in solar-based energy innovators such as M-Kopa, Solar Now, Greenlight Planet, and Azuri technologies; fintech companies such as Tala and Bitpesa; and agriculture market places such as Twiga, popularly referred to as "investor darlings". Top 10 companies attracted over 69% of funding by SFMs.

> *The East Africa region has a significant proportion of expatriate founded and led enterprises and a relatively higher gender diversity level than West Africa.*

Recent research on start-ups in four African countries found that enterprises in Kenya had a high proportion of international founders. 37% of Kenyan enterprises' founders/co-founders were expatriates, compared to 10% in Ghana and 5% in Nigeria.[57] As a result, more funding in the region has gone to these enterprises at the detriment of local enterprises. Further, although relatively higher than Nigeria (15%) and Ghana (13%), only 25% of enterprises have female founders/co-founders in Kenya.[58]

In order to promote participation of Kenyans in the ICT sector, the Kenyan government passed a regulation in August 2020 that ICT companies in Kenya should have no less than 30% ownership by Kenyans.

> *Innovation focus belies a continued need for investment in essential public infrastructure and civil society.*

The strong focus on funding disruptive social innovation in East Africa has created significant benefits for marginalised and low-income communities. However, some observers have criticised what they see as "Silicon Savannah" hype, noting that digital solutions cannot replace public investment in physical infrastructure such as health clinics, schools, roads or decent jobs.[59] Sometimes referred to as East Africa's "cult of entrepreneurship", the focus on funding start-up innovation over the last decade has also come alongside a reduction in grant funding for non-profit activities (refer to Section 4.3). This trend emphasises the need for continued collaboration between the public and private sectors, supported by increasingly innovative financial solutions to drive equitable progress across all social sectors.

Source: Intellecap Analysis based on the transaction/deal data collected[56]

[55] Data collection methodology section in Chapter 1

[56] Data collection methodology section in Chapter 1

[57] Timon and Briter Bridges: Compensation Study, 2019 – 778 startups across 4 African countries were analysed as part of this study

[58] Timon and Briter Bridges: Compensation Study, 2019

[59] See e.g. https://www.thenation.com/article/archive/kenya-tech-mobile-sector-digital-hub-inequality/

1.2.1 CHALLENGES FACED BY SOCIAL ENTERPRISES AND START-UPS IN THE REGION

Impact focused enterprises and start-ups in the region face a number of supply, demand, and ecosystem challenges that hinder their growth.

Figure 4: Summary of Challenges Faced by Social Enterprises

KEY CHALLENGES FACED BY SOCIAL ENTERPRISES				
Preference for funding international founders	Inadequate funding for early-stage and growth-stage businesses	High credit cost	Bureaucracy and lengthy processes of business registration	Lack of an overarching framework for registering a social enterprise
Informality in early-stage businesses	Limited access to investors	Human capital gaps	Limited capacity building support for enterprises outside the main cities	Limited opportunities for women entrepreneurs

a) ***Preference for funding international founders:*** A large portion of the capital deployed across the focus countries has been allocated to enterprises founded and/or managed by expatriates. Cultural and business connections to international investors haves contributed to the higher level of funding to these businesses. Many observers have noted this funding bias in recent years, noting that international investors have an affinity to the business style, articulation and presentation of expatriates, which can be equated to the perception of an investment-ready target. In 2019, enterprises managed by local founders in Kenya only secured 6% of the total funding, while expat-founded start-ups received 88%[60] of the sum. Similarly, a Village Capital study, established that 90% of the capital invested in East Africa start-ups between 2015 and 2016 went to businesses run by one or more expatriates.[61] WeeTracker[62] data also show that expatriate founded start-ups are many times more likely to close investment deals than their local counterparts. Thus, establishing a partnership between local and expat entrepreneurs is becoming a popular strategy in the region to leverage international funding.

b) ***Inadequate funding for early-stage and growth-stage businesses:*** Most start-ups still rely on family, friends, and personal financing for the initial capital. A study established that over 80% of the youth entrepreneurs in East Africa use personal funds to finance their businesses, whereas 35% borrow from family and friends.[63] Although the ecosystem is growing with the emergence of social investors who target to bridge this gap by providing smaller ticket size investments, many start-ups still are locked out as investors focus on established post-revenue enterprises that are commercially viable. Also, a significant funding gap exists for medium-sized companies who are too large to access funding from SACCOs and microfinance institutions (MFIs) and too small for commercial banks and investors.

> *"The language by VCs when considering the early stage enterprises is looking for ticket size of US$ 50K and above Mn for the early stage investments. The definition of early stage is quite misaligned leading to huge gaps. US$ 5K to 50K should be the ticket size for early stage businesses."*
> *An Accelerator in Uganda*

c) ***High credit cost:*** The SEs, mainly early-stage enterprises have access to limited traditional financing options because of the high-interest rates charged by the commercial banks – approximately 20% for Tanzania and Uganda. The interest rates are even higher for MFIs who take more risk with their riskier customer segments. While interest rate capping in Kenya was intended to enhance access to finance for businesses, this was not achieved as banks put in stricter measures and collateral requirements as well as additional loan processing fees that ultimately increased the cost of capital. The cap was, however, recently lifted to help facilitate more funding to businesses that were locked out by the collateral requirements.

d) ***Bureaucracy and lengthy processes of business registration:*** Most of the countries in the region rank poorly in the corruption perception and ease of doing business rank, indicating bureaucracies and challenges in the business and investment

[60] WerTracker: Expat Bias – Kenya Start-up Scene

[61] Breaking the Pattern: Getting Digital Financial Services Entrepreneurs to Scale in East Africa and India

[62] WeeTracker

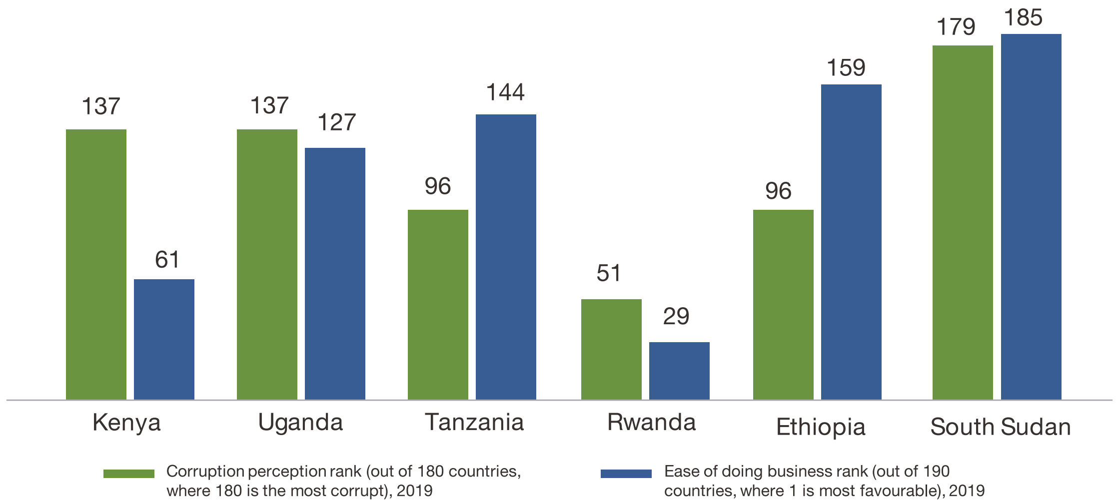
[63] Intellecap: Catalyst for change

environment. Major challenges in this regard include regulatory complexities such as lack of information on business registration, high cost of doing businesses, and inadequate tax incentives. Kenya is, however, trying to solve this challenge through the launch of an online platform for business registration with well-defines processes and requirements.

registering, also contribute to high informality levels. Such informal businesses cannot attract funding from investors as formal registration is a critical and mandatory requirement for fundraising for most financiers and investors.

g) ***Limited access to investors:*** Most early-stage enterprises, particularly locally owned, do not have access to investors, thus remain unaware of most investment opportunities. Furthermore, enterprises generally do not have required knowledge to understand and evaluate the investment instruments that would work best for their businesses. While investor readiness programs exist, these are challenged by funding, thus unable to reach a large number of enterprises.

Figure 5: Corruption Perception and Ease of Doing Business Rank



Source: Transparency International, World Bank

e) ***Lack of an overarching framework for registering a social enterprise:*** The social enterprise landscape is still nascent in the region with limited regulations guiding it. Although there are a few developments in the regulatory frameworks, the countries are yet to establish a guiding framework for SEs registration. Currently, the SEs are either registered as for-profit (sole proprietorship, partnership, or limited liability) or as non-profit organisations. However, for-profit registered SEs do not enjoy tax benefits. Across the focus countries, the SEs do not have a legal form, with most of the SEs registering as NGOs that conduct commercial activities with profits re-invested in the business.[64]

"The government's understanding of social enterprises and classification of businesses as either public or private. The is belief that this is a private investment; hence someone running social enterprises has to file taxes as someone who does mining. Social enterprises are not yet recognized as a social business with different policies/tax."

An Accelerator in East Africa

f) ***Informality in early-stage businesses:*** An average of 66% of companies across the focus countries – estimated at more than 6 million are informal.[65] One of the reasons behind the informality is the bureaucratic and lengthy registration process for businesses; this discourages businesses to formally register. The tax rates imposed on businesses, as well as the cost of

h) ***Human capital gaps:*** The inability of social enterprises to hire affordable talent and provide continuous training to their staff is a consequence of their resource limitations, limiting their growth potential. The supply of good talent at senior management positions, particularly in the technology industry, is limited and social enterprises have to compete for the same pool of talent with big technology companies leaving them at a disadvantage.

i) ***Limited capacity building support for enterprises outside the main cities:*** Most ecosystem support organisations operate from the main cities – Nairobi, Kampala, Kigali. Thus social enterprises operating outside these cities lack access to incubation and acceleration support – as most of this support requires physical presence.

j) ***Limited opportunities for women entrepreneurs:*** While there are women-owned and led enterprises in the region, such enterprises still face unique challenges, which range from social to financial barriers. Research shows that women-owned enterprises tend to be smaller in size, with more limited access to capital than their male counterparts.

[64] World Bank – Emerging Social Enterprise Ecosystems in East and South African Countries

[65] IFC Enterprise database

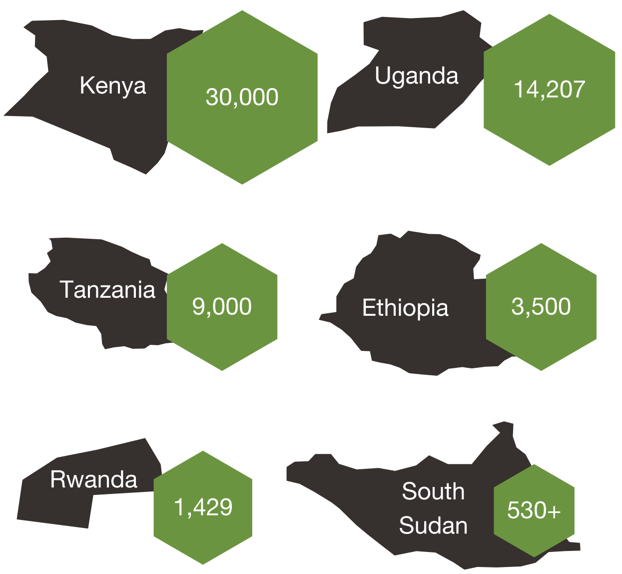
Some of the factors observed by researchers include the tendency of women to be risk-averse compared to male entrepreneurs. Women also have less access to formal education and are more prone to having time constraints because of dual responsibilities in the household and home obligations, which hinders their professional development. Furthermore, access to finance from commercial banks is limited due to lack of collateral, as most women have limited ownership of property. It is estimated that the credit gap for women-owned SMEs globally is at US$ 287 billion. This means that 70%[66] of women-owned SMEs cannot access the financing they need to grow a business. Moreover, gender imbalance is also witnessed among the investors with research showing that they preferred pitches presented by male entrepreneurs compared to pitches made by female entrepreneurs, even when the content of the pitch is the same.[67]

1.3 TRENDS AND DEVELOPMENT IN THE NON-PROFIT (NGO/CSO) LANDSCAPE IN THE REGION

> *Civil society and non-profit organisations have been instrumental in supporting donor and government initiatives to address development challenges in East Africa.*

Across the focus countries, the number of NGOs and CSOs working on initiatives, including building community resilience, gender and gender-based violence, economic empowerment, human rights, religious tolerance, youth, and women empowerment, among others, has been increasing over the years. NGOs have been instrumental in implementing initiatives on behalf of governments, donors, and foundations. CSOs/NGOs have implemented more than 50% of initiatives funded by foundations in East Africa.[68]

Figure 6: Number of CSOs/NGOs Registered across the Focus Countries



Source: USAID/FHI CSO sustainability Index Report, 2018

> *CSOs across the region have been getting low scores on financial viability – a key indicator in the CSO sustainability score.*

The CSO sustainability index measures the performance of CSOs in seven key dimensions, including legal environment, organisation capacity, financial viability, advocacy, service provision, sectoral-infrastructure and public image. CSOs across most countries in the region have scored lowest on the financial viability indicator- this can be attributed to the decline in foreign donor funding and insufficient local philanthropy and fundraising models to fill the gap.

Since 2015, the CSO's financial viability has been deteriorating in Kenya, Uganda, Tanzania, and Ethiopia, with CSOs in Ethiopia and South Sudan being the most sustainability impeded overall. Donors in the region are also shifting their strategies from long-term partnerships with the CSOs to short-term and result-based financing. In Uganda, for instance, where most CSOs rely on a single donor for up to 90% of their budget[69], the largest donor baskets such as the Democratic Governance Facility (DGF) shifted from offering unrestricted funding to supporting specific projects only, significantly affecting the financial viability of the CSOs. In addition to the dwindling donor funding, the financial viability of CSOs in Tanzania and Uganda has been affected by the deterioration of the legal environment with stringent laws and fees, which further stifled their financial viability and organisational capacity. While in Kenya the CSOs have access to funding through the national and sub-national level contracts, the process is hampered by both corruption and bureaucracy.

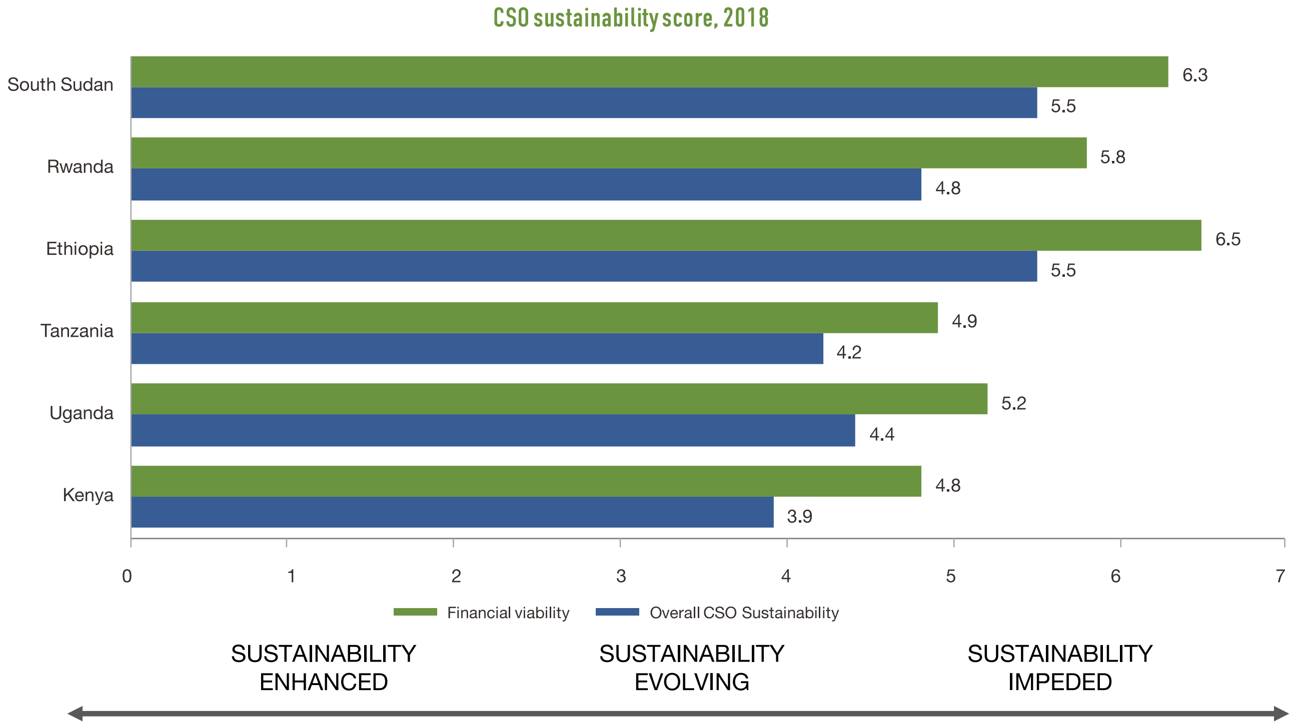
[66] Proparco: Invest2Impact

[67] Investors Prefer Entrepreneurial Ventures Pitched by Attractive Men

[68] East Africa Philanthropy Network (Formerly East Africa Association of Grant Makers)- East Africa giving report 2012

[69] USAID/FHI CSO sustainability Index Report, 2018

Figure 7: CSO Sustainability Score



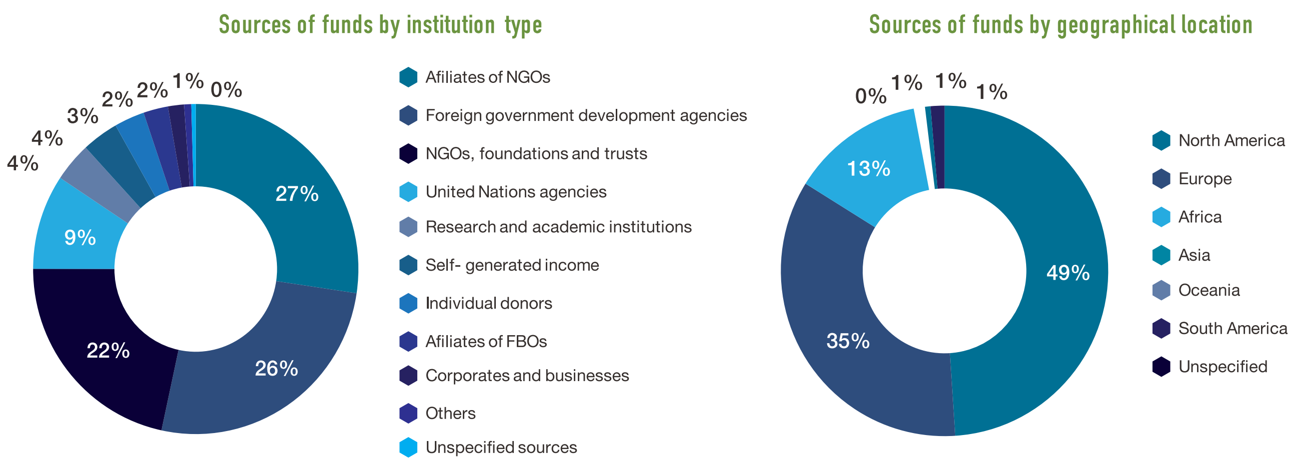
Source: USAID/FHI CSO Sustainability Index Report, 2018
NB: 7 is the maximum positive score given by the index

Local NGOs/CSOs in East Africa mostly rely on international funding resources with minimal domestic resource mobilisation undertaken.

Donors, international foundations, and NGOs contribute the largest proportion of the financial resources for local NGOs/CSOs. In Kenya, for example, international organisations, particularly from America and Europe, contributed more than 80% of the total NGO funding in the country with corporates accounting for only 2%.[70] In Uganda, it is estimated that foreign donors fund 95% of the NGOs. A study on the sources of funds for NGOs established that 75%[71] of the funds were in the form of grants by donors, mostly targeting well-established NGOs. Furthermore, in-kind donations accounted for about 65% of the funding.

Deliberate local resources mobilisation (from corporate and individual philanthropists) remains negligible across the countries. Although NGOs/CSOs receive funding from corporates, it is mainly on an ad-hoc basis and mostly in the form of in-kind support. Funding from corporates to NGOs might also decrease as corporates active in CSR activities are shifting to deploy capital through their corporate foundations. However, significant partnership opportunities still exist between the corporate foundations and the NGOs as the latter offer a grassroots presence and network with the communities which is needed for successful project implementations by the corporate foundations.

Figure 8: Sources of Funds for NGOS in Kenya, 2018



Source: NGO Coordination Board Kenya

[70] NGO Coordination Board Kenya Annual Report, 2019
[71] Funding Patterns for Non-Governmental Organizations' Services Delivery: A Case of Moshi Municipality in Tanzania

Given the decreasing funding from international sources, CSOs/NGOs are adopting alternative revenue-generating models.

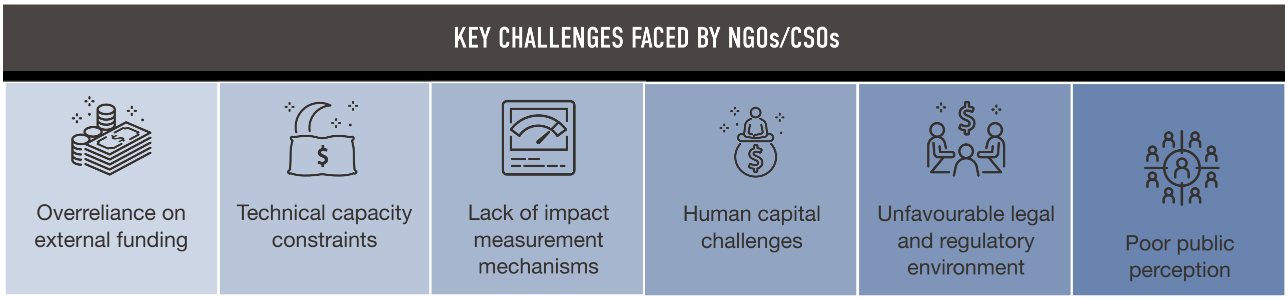
CSO/NGOs are increasingly exploring new models for generating external and internal funds. Some of the emerging sources include:

- ***Crowdfunding:*** NGOs run fundraising campaigns on local as well as internationally-based crowdfunding platforms. Most of the funds raised through these platforms are, however, mainly from international sources. Some of the active platforms include Indiegogo, GoGetFundng, and Chuffed.
- ***Internal activities:*** Some of the NGOs are introducing activities for internal revenue generation e.g. hosting events to raise funds, charging for their services, collecting membership fees, and also offering consultancy services. In Tanzania, some CSOs such as the Medical Women of Tanzania hosted a charity walk in 2018 to raise funding for breast cancer treatment and testing. However, such activities are minimal as most NGOs focus on marginalised communities, and those are unable to pay for their services. In Ethiopia, the Jerusalem Children and Community Development Organization, an NGO supporting children who are orphaned, abandoned, displaced, or lack proper care and support in Ethiopia, has been able to raise income from renting buildings that it owns[72].

1.3.1 CHALLENGES FACING NGOs/CSOs IN THE REGION

NGOs/CSOs, across the countries, face several challenges, mostly involving financial and technical capacity.

Figure 9: Summary of Challenges Faced by NGOs/CSOs



a) ***Overreliance on international funding:*** As previously highlighted, most funding for the NGOs comes from international sources, which leads to a regional trend of 'mission-drift' in CSOs/NGOs, where international donors drive project strategies. CSOs/NGOs are often not involved in project design. Thus, some of these projects fail to reflect on-ground realities. In Uganda, approximately 90% of the CSO budget is dependent on one donor, which poses significant risk should the donor withdraws funding to the country or change its strategy.[73]

b) ***Technical capacity constraints:*** Most of the funding provided to CSO/NGOs is directed towards project implementation. These organisations lack funds that can be utilized for the capacity building of the staff on technical skills such as proposal development, financial management, project implementation, and monitoring and evaluation. Lack of capacity building also has trickle-down effect; semi-skilled or unskilled staff is not able to implement the project efficiently, resulting in the required value for money not achieved.

c) ***Lack of impact measurement mechanisms:*** Most local CSOs/NGOs do not collect impact data for their projects – unless if it is a requirement by the donors. This is due to the lack of adequate understanding of impact measurement concepts and knowledge of impact data utilization for decision-making. Also, most organizations lack the required tools and systems to collect and analyse the impact data, with MS Excel being the commonly used tool amongst the organisations.

d) ***Human capital challenges:*** Given the inadequate administrative funding received by the NGOs, they are unable to hire experienced staff and mostly rely on independent project-based consultants and volunteers, resulting in challenges in building the institutional knowledge. Additionally, the usage of volunteers results in high turnover rates. The overdependence on volunteers is particularly a challenge for CSOs based in Uganda, with a ratio of one permanent staff to seven volunteers (1:7) for some CSOs[74].

e) ***Unfavorable legal and regulatory environment:*** Some of the regulations introduced by the local governments, while meant to enhance the effectiveness of the industry, hinder the operations of the CSO/NGOs. In Tanzania, for example, the NGO Act 2018 introduced multiple and costly reporting requirements for NGOs. Furthermore, while tax exemptions exist for NGOs, attaining eligibility is a rather time-consuming and challenging process.

f) ***Poor public perception:*** Across the countries, there is an increasing perception of lack of transparency and accountability, financial mismanagement, and weak accounting of funds by the CSOs/NGOs.

[72] USAID/FHI CSO sustainability Index Report, 2018
[73] NGO Coordination Board Kenya Annual Report, 2019
[74] Growing Giving in Kenya, Uganda and Tanzania, 2020