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A NOTE ON FINANCING IN DEVELOPING ECONOMIES

As of the date of this note, financing environments varied significantly across developing economies.[1] Differences in legal structures, operating conditions, and available capital sources created a myriad of conditions for entrepreneurs to navigate when seeking funds to develop their ventures. One systemic trend, however, did exist: entrepreneurs consistently cited access to financing as one of the top three obstacles to achieving growth (see **Exhibit 1**).

This note does not seek to provide a "one size fits all" model to addressing this challenge. Rather, this note is intended to provide entrepreneurs with a starting point to better understand the types of financing available in developing economies, the sources of this capital, and the means to locate these investors. Entrepreneurs can use the examples in this note as a springboard to craft solutions for the challenges posed by their specific financing environments.

SOURCES OF FINANCING IN DEVELOPING ECONOMIES

The evolution of a successful new venture can be divided into four consecutive and distinct stages: exploration, development, revenue, and profit. Understanding a company's position within this life cycle enables a founder to better evaluate financial resource needs and plan for growth. Specifically, an entrepreneur must attract adequate capital in each stage to fund the next stage's development and provide a cash cushion in case of a downside event.

[1] The term "developing economy" has no single definition but is used in this note to be inclusive of what are commonly referred to as "emerging markets" and "frontier markets." The International Monetary Fund, World Bank and United Nations have compiled listings of "developing economies" based upon various, and differing, statistical measures. These listings and other references can be accessed under the "Developing Country" entry in Wikipedia that can be found at http://en.wikipedia.org/wiki/Developing_country.

Jason Luther (MBA '13) and Lecturers Steve Ciesinski and Howard Rosen prepared this note as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Investors evaluate the various cash-flow profiles and risk/reward ratios in this four-stage life cycle when considering an investment and identifying milestones for value inflection. As a result, different capital sources may become more accessible to a company as it matures (see **Exhibit 2**). Analyzing this dynamic is especially important for entrepreneurs when aligning their company's needs with the proper funding sources.

This effect is intensified in developing economies where access to funding is relatively scarce. In these economies, entrepreneurs can raise capital from sources ranging from friends and family to public markets, each with its own accompanying set of obstacles to overcome. The following text provides descriptions of these investor bases, including suggestions on where to find investors, the value they provide, and in what stage they should be approached. (See **Exhibit 3** for a full list of the database URLs and research resources referred to in this note.)

Friends and Family

The most prominent source of initial capital for entrepreneurs in developing economies is friends and family. These investors are more likely than others to hear an entrepreneur's "pitch" and are usually more inclined to say "yes" to capital requests. Friends and family tend also to be more forgiving with respect to valuations and are more willing to allow an entrepreneur to keep greater ownership in a company.

Friends and family investments, however, come with several challenges. Most of those investors are less sophisticated and cannot differentiate good deals from poor ones. Those investments that go bad can strain relationships between founders and their investors. Moreover, this source tends to be cash constrained (friends and family commonly invest small amounts—in the hundreds of thousands of dollars—and typically not more than $1.5 million collectively), which limits the types of business models that can utilize this capital. Because of their lack of experience in the investing field, friends and family are often unable to price and structure an investment. Accordingly, many capital injections are structured as convertible notes so that later funding rounds, which are predominately executed by experienced investors, can help price an instrument.

Friends and Family in Developing Economies

Much of the wealth in developing economies is concentrated in a small minority of individuals and families. These groups are difficult to network with without warm introductions or pre-established relationships. Many entrepreneurs find it effective to use their alumni networks to connect with high net-worth individuals in their regions of interest. Successful entrepreneurs also stress the importance of maintaining local contacts, advisors, and employees to access investor circles.

A Word of Caution to Entrepreneurs

Entrepreneurs from developed economies should be wary of illegitimate investors in developing economies. Founders can establish local friendships to build credibility and gain perspective on who can and cannot be trusted in the their respective economies.

Crowdfunding

Crowdfunding is the act of raising a pool of small contributions—primarily in the form of debt, equity, or donations—from a large number of investors to finance a project or start-up company. Through Internet sites known as crowdfunding platforms, entrepreneurs raise pools of $1,000 to $1,000,000 from investors ranging from uneducated to highly sophisticated. This form of financing grew in prevalence after the 2008 global financial crisis, when traditional forms of capital became more restrained and less accessible to entrepreneurs.[2]

By providing the technology to systematize and make the fundraising process more scalable and transparent, crowdfunding eases many burdens associated with friends and family financing. Moreover, with the increasing penetration of the Internet and social media, entrepreneurs in developing economies face diminishing barriers when accessing this particular investment community. By 2013, approximately one third of the world's population had access to the Internet; and it was estimated that by 2018, approximately 40 percent of people living in Africa would own smartphones.[3] These statistics signal an increase in connectivity and, consequently, crowdfunding's potential to support future entrepreneurial efforts in developing economies.

In 2013, The World Bank conducted a comprehensive evaluation of the crowdfunding environment, including analysis of the investment platforms, the benefits of crowdfunding, the opportunities in the developing world, and crowdfunding's impact on the fundraising ecosystem. Entrepreneurs interested in using crowdfunding to raise capital should review this document[4].

Crowdfunding in Developing Economies

By 2013, the U.S., the U.K., and France were home to 344, 87, and 53 crowdfunding investing platforms, respectively. Latin America and the Caribbean had similarly strong funding communities, growing from five platforms in 2010 to 41 in 2013. The estimated funds raised by crowdfunding platforms worldwide in 2013 was $5.1 billion,[5] and was forecasted to reach $96 billion by 2025. Much of this value was expected to be accounted for by activity in China, East Asia, Central Europe, Latin America, and the Middle East and North Africa (MENA). In total, 45 nations had active investing platforms, including developing economies such as Chile, Kenya, and Lebanon. (**Exhibit 4** provides the number of crowdfund investing platforms in selected countries. A more complete list can be found on Statista's website.)

Entrepreneurs seeking access to this capital can do so through a variety of platforms. Websites such as "thecrowdcafe" and "crowd funding conference and seminar" provide comprehensive lists of crowdfunding platforms as well as news about recent crowdsourcing developments and

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[2] *Crowdfunding's* Potential for the Developing World. 2013. *info*Dev. Financing and Private Sector Development Department. Washington, DC: World Bank.
[3] Ibid.
[4] Ibid.
[5] Statista, "Estimated Volume of Funds Raised by Crowdfunding Platforms Worldwide Between 2011 and 2013," 2014, http://www.statista.com/statistics/269957/estimated-volume-of-funds-raised-by-crowdfunding-platforms-worldwide/ (accessed January 7, 2014).

the resources and tools to create crowdfunding campaigns. *Thecrowdcafe*, in particular, allows an entrepreneur to search for a platform by security-type, market, and country.

Incubators

Business incubators are organizations that provide start-up companies with formal and informal access to capital, office workspace, and shared services. Business incubators house advisors and mentors who coach new entrepreneurs through the early stages of their company's development. This network also provides advice and expertise on support services such as legal, financing, banking, and human resources. Incubators are suitable for pre-revenue stage companies and smaller firms that have just begun selling products or services.

Incubators in Developing Economies

By 2013 there were about 7,000 incubators worldwide. Incubators could be found in developing economies such as East Africa countries, Nigeria, Pakistan, and Thailand. Nairobi, Kenya, was home to incubators and accelerators such as 88mph, iHub, and The Nairobi Hub, which provided everything from shared workspace to working capital. Similar organizations, including Hive Colab and The Hub Kampala, existed in Uganda. Uganda's ecosystem, however, was more NGO and non-profit centric and was thus less entrepreneurial and had less of an evolved incubator community.[6]

In many Latin American nations, incubators are associated with universities. For example, Adolfo Ibáñez University hosts one of Chile's largest incubators.[7] Chile also has "Start-up Chile," a seed accelerator created by the Chilean government to attract entrepreneurs of all nationalities to create businesses in Chile. After application, those accepted into the program receive a $40,000 grant per project, a one-year resident visa for all teammembers, and workspace.[8]

For aspiring entrepreneurs, the National Business Incubation Association (NBIA) website offers a comprehensive list of incubators for a select group of countries. NBIA's website also provides entrepreneurs with information and networking resources to help grow their companies. Similar incubator databases and lists can be found for Asia and Africa.

Another potential source of support for entrepreneurs is the non-profit organization, Endeavor. Endeavor's model is to identify and back promising entrepreneurs in developing economies. These entrepreneurs either apply online to join Endeavor's network or are introduced to Endeavor through existing relationships. Endeavor then evaluates a candidate based upon his or her ambition, character, business model, and potential to have a lasting impact. Most businesses that apply are either bootstrapped or family and friends funded and generate revenues of approximately $500,000 to $1 million annually. If selected to join Endeavor, entrepreneurs gain

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[6] Interview with Karl Skare (Stanford Graduate School of Business MBA '13) on October 30, 2013.
[7] Interview with Lily Lyman (Stanford Graduate School of Business MBA '14) on November 22, 2013.
[8] Start-up Chile, "FAQ," http://startupchile.org/about/faqs/ (accessed January 17, 2014).

access to a network of business leaders, advisors, lawyers, and operators. Those who are not selected are often passed along to investors who are more aligned with the entrepreneur's needs.[9]

Business Angel Investors

Business angels are high net-worth individuals who are tremendously experienced in a specific industry and often take a hands-on role in their portfolio companies. These angels represent a significant source of capital for early-stage ventures, executing investments predominately in the $100,000-$250,000 range, but occasionally injecting as little as $50,000 in personal capital.[10] More affluent angel investors, known as Super Angels, also exist in many developing economies. This subgroup consists of high net-worth individuals who invest over $1 million of their own funds. Angel investments are mostly structured using preferred shares, convertible debt, or shareholder loans.

Whereas business angels were historically family and friends, an emergence of the institutional angel investor took place in the early 2000s. This investment niche arose in part due to the venture capital industry's perception that start-up opportunities were too small to provide adequate returns for the high-levels of risk.[11] Accordingly, many of these angels aggregated to form funds focused on investing in early-stage ventures. Forming such groups allowed angels to invest larger sums of capital than an individual could and to overcome the relatively weak institutional support in developing economies.

Business Angels in Developing Economies

By 2008, well-developed angel groups and individual angels could be found in India, Brazil, Argentina, and the Philippines.[12] In India, angels existed since the early 1990s, with their presence strengthened by the establishment of the Band of Angels. This organization focused on introducing Indian and international entrepreneurs and angels to cultivate an environment conducive to early-stage investing. These investments ranged from $100,000 to $1 million and had a time horizon of three to five years with an exit occurring through initial public offering (IPO) or strategic sale.[13] Similarly, Brazil maintained communities of angel investors. These organizations were inspired by the creation of Gavea Angels, a group of 13 angel investors, in 2004.

By 2013, Africa had established numerous business angel networks as well, including the Angel Investment Network, a South African investment club with over 29,000 investors and total investment capital of more than 8 trillion rand (approximately $750 billion). Angel Investment

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[9] Start-up Chile, "FAQ," http://startupchile.org/about/faqs/ (accessed January 17, 2014).

[10] Roberto Zavatta, "Financing Technology Entrepreneurs & SMEs in Developing Countries: Challenges and Opportunities," infoDev, The World Bank, June 2008, http://www.infodev.org/infodev-files/resource/InfodevDocuments_542.pdf (accessed December 3, 2013).

[11] "Business Angel Investing in Developing Economies: Policy Implications for Southeast Asia," Kauffman Foundation's International Research and Policy Roundtable, March 11-12, 2012, http://www.kauffman.org/~/media/kauffman_org/archive/resource/2012/5/irpr_2012_scheela.pdf (accessed December 3, 2013).

[12] Roberto Zavatta, op. cit.

[13] Ibid.

Network provides a platform for entrepreneurs and global investors to connect on growing projects of mutual interest. Other funds, such as West African Synergies and Jacana Partners were founded by internationals wishing to support economic growth in Africa through capital investments.[14] Multiple informal investment clubs comprised of affluent local investors, each contributing roughly $500,000 into his or her respective fund, also exist in many African countries. These clubs often provide lines of credit of up to $100,000 (and at an interest rate of approximately 30 percent) in return for equity in a start-up company.[15] Additional angel investor groups in Africa can be found through lists on websites such as "Silicon Africa" and "Answers Africa."

In many developing economies, entrepreneurs can raise angel funding through relationships established by actively networking with individuals at local restaurants, malls, and bars. Specifically, the expatriate community in many of these economies is often small and well-connected and can serve as a viable source of capital. Building these relationships also proves essential in other stages of a company's lifecycle as much of its success in a developing economy is contingent upon which influential people the entrepreneur knows. One entrepreneur, when interviewed, stated: "your network is everything in developing economies." This entrepreneur further claimed that cold e-mailing investors works far less often than meeting as many people as quickly as possible.

AngelList provides entrepreneurs with a comprehensive database of angels and angel networks worldwide. The Keiretsu Forum also offers entrepreneurs a global investment community of angel investors, ventural capitalists, and corporate and institutional investors operating 27 chapters on three continents.

Banking Institutions

Commercial Banks

By financing research and development, capital equipment, and working capital through debt, entrepreneurs can avoid equity dilution. This form of capital comes in a variety of structures, including secured versus unsecured, callable, interest only, and amortized.

Unfortunately, entrepreneurs who seek debt in developing economies are faced with unfavorable conditions. Banks in developing economies often maintain tight criteria for assessing credit worthiness, including requiring two to three years of operating history[16] and collateral to secure loans (some institutions in Africa require at least four years of audited financial statements[17]). Moreover, banking industries in many developing economies are highly concentrated and uncompetitive, leading to conservative lending policies and usurious interest rates.

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[14] Answers Africa, "10 Angel Investors in Africa That Can Grow Your Business," http://answersafrica.com/angel-investors-in-africa.html (accessed January 5, 2014).

[15] Interview with Faraimose Kutadzaushe (Stanford Graduate School of Business MBA '13) on January 11, 2014.

[16] Interview with Karl Skare (Stanford Graduate School of Business MBA '13) on October 30, 2013.

[17] Interview with Faraimose Kutadzaushe (Stanford Graduate School of Business MBA '13) on January 11, 2014.

Many developing economies maintain an informally tiered banking system. The higher tier consists of large, international banks (e.g., Barclays) that are less willing to take on insolvency risk that early-stage ventures pose. Accordingly, these banks are much stricter when extending credit to aspiring entrepreneurs and offer less favorable terms. Conversely, lower-tier banks are willing to take on more risk and are thus more likely to extend credit and give beneficial terms to attract new customers (e.g., Chase Bank Kenya[18]).

In many developing economies—specifically, those in Africa—a bank's lending process begins with those employees who are too low in the institution's structure to make lending decisions. Applications then proceed through various channels to (senior) bank managers. As most transactions are relationship-driven, those applicants having pre-existing relationships with these senior managers often have a better chance of having their loans approved.[19]

Recently, governments, NGOs, and private institutions in developing economies have made efforts to increase the availability of capital to micro- and small-enterprises. Products like credit guarantee schemes (CGSs) encourage banks to lend credit to borrowers by reducing the amount of collateral necessary to obtain a loan. Under this system, CGSs provide borrowers with bank loan guarantees that replace, in part or in full, the need for collateral.[20] CGSs are prominent in Europe and are emerging in India and Africa.

Entrepreneurs considering CGSs are encouraged to review the German Federal Ministry for Economic Cooperation and Development's publication on CGSs in developing economies, which provides an overview of CGSs, as well as examples of how they are implemented in various countries. The World Bank also offers a comprehensive review of CGSs in the Middle East and North Africa Region.

International Financial Institutions

International Financial Institutions (IFIs) provide financial support in the form of grants and loans to governments and private businesses in developing economies. IFIs are comprised of the International Monetary Fund (IMF), The World Bank, the International Finance Corporation (IFC), multilateral development banks, and other international development agencies. Specifically, the IFC provides loans to early-stage companies and expansion projects in those member countries with developing economies. These loans are fixed or variable rate and often have maturities of seven to 12 years and one- or two-year grace periods.[21]

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[18] Chase Bank Kenya is not affiliated with the "higher-tier" bank, JPMorgan Chase Bank.

[19] Interview with Faraimose Kutadzaushe (Stanford Graduate School of Business MBA '13) on January 11, 2014.

[20] German Federal Ministry for Economic Cooperation and Development, "SMEs' Credit Guarantee Schemes in Developing and Emerging Economies, July 2012, http://www.aecm.eu/servlet/Repository/?ID=1302 (accessed on January 3, 2014).

[21] International Finance Corporation, "Loans for IFC's Own Account: A-loans," http://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/what+we+do/investment+services/loans (accessed January 8, 2014).

National and Multilateral Development Banks

Multilateral Development Banks (MDBs) offer entrepreneurs in specific regions of the world with services similar to those provided by the IFC. For example, the Inter-American Development Bank offers loans, grants, and research services to 48 member countries in Latin America and the Caribbean. Other MDBs, such as the African Development Bank and the Islamic Development Bank, serve similar functions in member countries with developing economies in Africa and in the Middle East, respectively. Moreover, the Asian Development Bank and the European Bank for Reconstruction and Development provide services to their own developing economies. Many multilateral development banks, however, have political requirements that prohibit lending to certain developing economies. This limits these banks as a viable financing source for many entrepreneurs.

National development banks, such as the Brazilian Development Bank, also finance and support development and business growth in developing economies.

Microfinance Institutions

The global community took steps to address capital restrictions in developing economies through the provision and support of microfinance institutions (MFIs). MFIs provide financial products and services, such as loans, savings, and insurance, to predominately rural, low-income individuals who do not have access to alternative forms of capital or banking services.

Due to the limited financial viability of borrowers, microfinance loans are made in small amounts (often between $10 and $1,000). Some institutions, however, offer short- and medium-term loans of up to $100,000, depending on a borrower's ability to supply collateral. Interest rates on these loans tend to be higher than normal banking rates, but lower than rates charged by village money-lenders and other informal sources.[22]

For entrepreneurs, Mix Market is a tremendous source of information on the Microfinance industry in a specific developing economy. Mix Market is sponsored by the Bill and Melinda Gates Foundation and provides detailed summaries of the state of a developing economy's microfinance industry as well as cross-market analysis based on selected indicators and MFI groupings. More importantly, Mix Market provides a comprehensive database of microfinance institutions, including details on their backgrounds, funding sources, products and services, and contact information. The interface also provides particulars on average loan balance per borrower and whether or not a microfinance institution is regulated in its industry.

Venture Capital

A few developing economies, like India and China, have sizable and well-developed venture capital industries, but most do not. Venture capital funds in these economies provide entrepreneurs with not only more capital than many other institutional investors, but also with domain expertise and mentorship. This capital, however, often comes with unfavorable valuation levels, short investment time horizons, and "cram down" provisions. Common

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[22] CGAP, "Microfinance Frequently Asked Questions," http://www.cgap.org/about/faq (accessed December 20, 2013).

instruments used by venture capitalists are preferred shares, convertible debt, and shareholder loans.

Venture Capital in Developing Economies

Venture capital in developing economies became more prominent with the rise in valuations in North America for both early-stage and later-stage investments. This made it more difficult for investors to achieve high returns by investing in domestic companies, leading to an exodus of capital toward firms in developing economies.

By the early 2000s, developing economies had begun adapting their infrastructure to create attractive environments for venture capital investment. In Vietnam, the Philippines, Brazil, and Argentina, quasi-equity structures had been used to execute larger deals. Other economies helped firms develop public/private partnerships to mitigate risk associated with investing in smaller deals. In India, for example, funds began evaluating co-investment structures to spread risk allocation.

Depending on location and industry, entrepreneurs seeking venture capital funding potentially have access to a range of investment institutions. Specifically, U.S. investment firms such as Sequoia Capital and Khosla Ventures operate funds and offices focused on developing economies. Khosla Ventures' "Khosla Impact" fund, in particular, provides capital to early-stage ventures in India and Africa.

For entrepreneurs, websites such as VentureChoice and Bloomberg provide a comprehensive venture capital and private equity investor directory. The Emerging Markets Private Equity Association (EMPEA) also provides an exhaustive list of venture capital and private equity investors who invest early-stage and expansion capital in high-potential businesses.

In Latin America, the Latin American Private Equity & Venture Capital Association (LAVCA) generates extensive industry research and provides resources for entrepreneurs in local economies. Furthermore, angel, private equity, and venture capital investor platforms such as CB Insights offer complete, real-time, and easy-to-use databases with information on an investor's industry focus, location, funding history, competitor set, key people, and transaction-by-transaction deal history.

Silicon Valley Venture Capital

Start-up entrepreneurs in developing economies are not necessarily confined to local capital sources. For example, many Israeli firms have successfully raised Silicon Valley capital by headquartering their companies in the San Francisco Bay Area and maintaining small marketing, sales, research and development, and operations departments in their developing economy. This approach enables the CEO to meet with Silicon Valley venture capitalists regularly for guidance and board meetings. It is then the CEO's responsibility to commute between the company's headquarters and its other established locations. Entrepreneurs from developing countries such as Brazil, Chile, China, and India have also successfully raised financing through this method.

A Word of Caution to Entrepreneurs

In some developing economies, governments provide funding to investment holding arms for holding, managing, and investing purposes. Entrepreneurs should note that many of these organizations claim to be venture capitalists, but in fact have widely different incentives than an actual venture capitalist does. For example, these organizations often expect immediate dividends, desire high employment rates, and maintain low tolerance for failure—all of which are generally counter to how start-ups operate. Moreover, these investors do not sit on boards or provide operational guidance and mentorship. Examples of these institutions can be found in developing economies such as Brazil, Chile, Malaysia,[23] and many others.

Entrepreneurs should also be aware that the standard financing terms in developing economies may vary greatly from those in Silicon Valley. For example, in Nairobi, Kenya, typical discount rates on convertible notes may be as high as 40 percent. Lower pre-money valuations due to the higher risk associated with investing in developing economies were also common.[24]

Private Equity

Whereas private equity funds predominately focus on more mature firms with established track records, some investing in earlier stages of a company's lifecycle can be seen in a variety of industries in developing economies. This dynamic varies depending upon the quality of entrepreneur and the maturity of the industry. Since private equity firms focus on investing in proven economies and products, many are not staffed to provide hands-on, operational supervision that may be needed when investing in less-mature companies and economies.

In developed economies, private equity firms use predominately common and preferred stock, debt, and convertible preferred shares. Accordingly, investors can mitigate risk by staging investments to better oversee and incentivize management in portfolio companies. Conversely, those funds in developing economies often use only common stock. Much of this is due to the legal systems established in different economies.

In Asia, for example, a company cannot establish different classes of stock with different voting rights.[25] This is of great concern to investors seeking the option to seize control of a company during times of controversy. Investments in common-law countries (for example, India) are more likely to be fashioned using preferred stock than common stock or debt and tend to provide more contractual protection via contingencies such as anti-dilution provisions. In many developing economies, these rights are absent due to weak enforcement capabilities through less evolved court systems.

Private Equity in Developing Economies

Private equity funds in developing economies are raised for a myriad of investment purposes. Some are opened to establish joint ventures, while others are created with the intention of purchasing firms in specific regions or countries. Many of these investors are based in developed economies, specifically the United Kingdom and the United States, and seek to capitalize on growth in developing economies.

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[23] Khazanah Nasional is an example of the Malaysian Government's "Strategic Investment Fund."
[24] Interview with Karl Skare (Stanford Graduate School of Business MBA '13) on October 30, 2013.
[25] For further information, see "A Note on Private Equity in Developing Countries," HBS No. 9-811-102.

In general, private equity investments in developing economies fall into five broad categories: Privatization, Corporate Restructuring, Provision of Growth Equity, Strategic Alliances, and Infrastructure Funds. For an aspiring entrepreneur, the two most relevant categories are privatization and growth equity. Information on global private equity penetration is provided in **Exhibit 5**.

A substantial financing gap exists in many developing economies for companies seeking additional capital while in certain stages of growth. Specifically, many economies have yet to develop capital markets, which makes it difficult for regional companies to access international equity markets. Those companies capable of listing themselves publicly are often harmed by doing so. In particular, many small Indian companies that have yet to create much demand for their shares are forced to enter public markets to raise funds, thus limiting the stock's potential and stymieing the firm's ability to achieve a proper growth cycle.[26] This can lead private sector companies to seek growth capital through larger, institutional investors. Private equity funds are able to fill this niche investment gap.

Capital Markets

Capital markets provide entrepreneurs with access to capital at a price and scale not normally attainable through other means. These funds are obtained through offerings on security exchanges and can be used to repay debt, generate working capital, or provide liquidity to investors, employees, and other interested parties. Initial public offerings (IPOs) also encourage market exposure for a company and its product.

Accessing these markets, however, does have downsides. By taking a company public and adhering to the associated disclosure requirements, expenses increase, and an entrepreneur needs to change his or her mindset to prioritize quarter-by-quarter results. These disclosures also provide greater transparency of the company's strategy, thus proving helpful to competitors. Moreover, increased public scrutiny and greater accountability to a broader range of investors make it difficult for entrepreneurs to focus on day-to-day activities and responsibilities.

Capital Markets in Developing Economies

Due to the relative immaturity of IPO markets in developing economies, investors rely heavily on profitable sales to strategic investors to exit their holdings. Many developing economies, however, do not contain large buyers with the financial means to execute such purchases. This makes exiting portfolio companies in these countries more difficult and can lead to a private equity or other investment company selling its holdings below value.

A recent trend toward international acquirers has helped relieve some of these issues. Moreover, companies in developing economies can access capital by cross-listing their shares on foreign and domestic stock exchanges. For example, South African-based Old Mutual cross-listed its equity on the Johannesburg exchange and London Stock Exchange, and the Industrial and Commercial Bank of China cross-listed its equity in the Hong Kong and Shanghai exchanges. This allows developing economy companies to tap the resources and advanced IPO systems in

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[26] For further information, see "A Note on Private Equity in Developing Countries," HBS No. 9-811-102.

more developed economies. Other developing economies have begun employing their own exchanges. For example, China inaugurated its Shenzhen and ChiNext exchanges to provide exit options for less-established companies (although trading on most Chinese exchanges was considered opaque).[27]

Exchanges in developing economies, such as those in Africa, Latin America, and the Middle East supplied roughly half of the total IPOs in 2013. The Hong Kong Exchange, in particular, raised $18.1 billion, with Asia Pacific exchanges as a whole accounting for three of the top—and five of the worst—performing IPOs of the year.[28] (Global IPO regional and exchange breakdown by U.S. dollars, as well as global IPO annual returns figures by region are provided in **Exhibit 6** and **Exhibit 7**, respectively.)

CHALLENGES WITH RAISING CAPITAL IN DEVELOPING ECONOMIES

Most entrepreneurs growing enterprises in developing economies are hindered by the limited access to growth and expansion capital between $50,000 and $1 million. Provided below are several challenges encountered by entrepreneurs when attempting to raise capital in this range. By finding ways to address these challenges, companies can mitigate risk at various stages in a company's growth and reduce investor hesitancy to invest.

- **Information Asymmetries Between Ventures and Lenders or Investors.** Investment risk is compounded by the lack of adequate credit reporting agencies in developing economies. Luckily for investors in the United States, organizations that aggregate and report credit history exist. In developing economies, the lack of these entities can lead to information asymmetries between companies and lenders and create disconnects in the fundraising process. Moreover, smaller companies in developing economies are often less rigorous than their developed-economy counterparts when detailing and maintaining business plans and financial statements. This affects a lender's ability to assess high- versus low-quality firms and utilization of funds after investment and ultimately cultivates a hesitance to back new ventures.

- **Lack of Collateral.** Depending on industry and product, companies can face challenges when raising debt. Banks mitigate risk by requesting collateral in proportion to the size of a loan. If a company does not have tangible assets (often only accepted in the form of property/land and not equipment or machinery[29]) to serve as collateral, then it has little option but to seek equity capital. <u>This challenge is consistently cited as the largest obstacle for entrepreneurs when raising early-stage financing.</u>

- **Limited Protection Offered by Law to Creditors and Investors.** Developing economies tend to have less mature legal and enforcement systems. This lack of regulatory policy can prevent investors from injecting capital into companies in economies where this

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[27] For further information, see "A Note on Private Equity in Developing Countries," HBS No. 9-811-102.

[28] Renaissance Capital, "Global IPO Market Bounces Back in 2013," December 18, 2013, http://www.renaissancecapital.com/ipohome/review/2013globalreview.pdf (accessed January 8, 2014).

[29] Interview with Faraimose Kutadzaushe (Stanford Graduate School of Business MBA '13) on January 11, 2014.

infrastructure is weak. Limited protection for minority shareholders, corruption in government, investor, and entrepreneur networks, and weak governance can affect the development of venture capital and angel financing in various economies. This can also affect the financial instruments used from economy to economy.

- **Other Regulatory and Beyond-Market Hurdles**
  Progressive regulatory reform in developing economies acts as a catalyst for investor influx. In particular, China and India opened sectors of their economies. South Africa and Mexico followed suit by instituting policies to create transparency in corporate governance. The converse can be seen in economies such as Russia and several former Soviet Republics, however, where lack of reform hampers potential investor penetration. In other developing economies, financial instability, uncertain accounting standards, immature capital gains tax codes, restrictions on foreign investment, and regulatory hurdles incentivize investors to seek other opportunities. In Ethiopia, for example, it is nearly impossible for a non-Ethiopian majority owned company to operate.[30]

- **Sizable Transaction Costs.** Relative to the size of most early-stage investments, transaction fees can be prohibitively costly for many investors. Appraising loans, conducting due diligence, and employing counsel are usually assessed on a fixed-fee basis. In developing economies, where adequate infrastructure and reporting systems may not be in place, these activities can prove burdensome. Thus, many early-stage angel and institutional investors may stray away from seeking opportunities in these developing economies.

- **Tradeoffs Based upon Country of Incorporation.** Entrepreneurs need to be cognizant of how their choice of country in which to incorporate ultimately affects their potential investor base. For example, those companies incorporated in India are likely to face difficulty when raising funding from venture capitalists in developed economies because of issues with legal systems and capital gains taxes. Conversely, those entrepreneurs incorporating companies in a developed economy are likely to encounter hesitancy from investors in developing economies. Consequently, entrepreneurs need to determine where they are most likely to obtain capital. Some companies hedge this issue by incorporating a holding company in a developed economy and an operating company in a developing economy.[31]

- **Shortage of Bankable or Investable Firms.** Lastly, there may simply be too few investible companies to encourage capital providers to enter a developing economy.

CONCLUSION

Due to the relatively limited access to capital in developing economies, entrepreneurs seeking financing must take great care when building an effective fundraising strategy. Specifically, successful founders must understand their company's position within the four-stage life cycle to best target the appropriate capital sources and determine both current and future cash needs. Using the information presented in this note (and the resources listed in **Exhibit 3**), an

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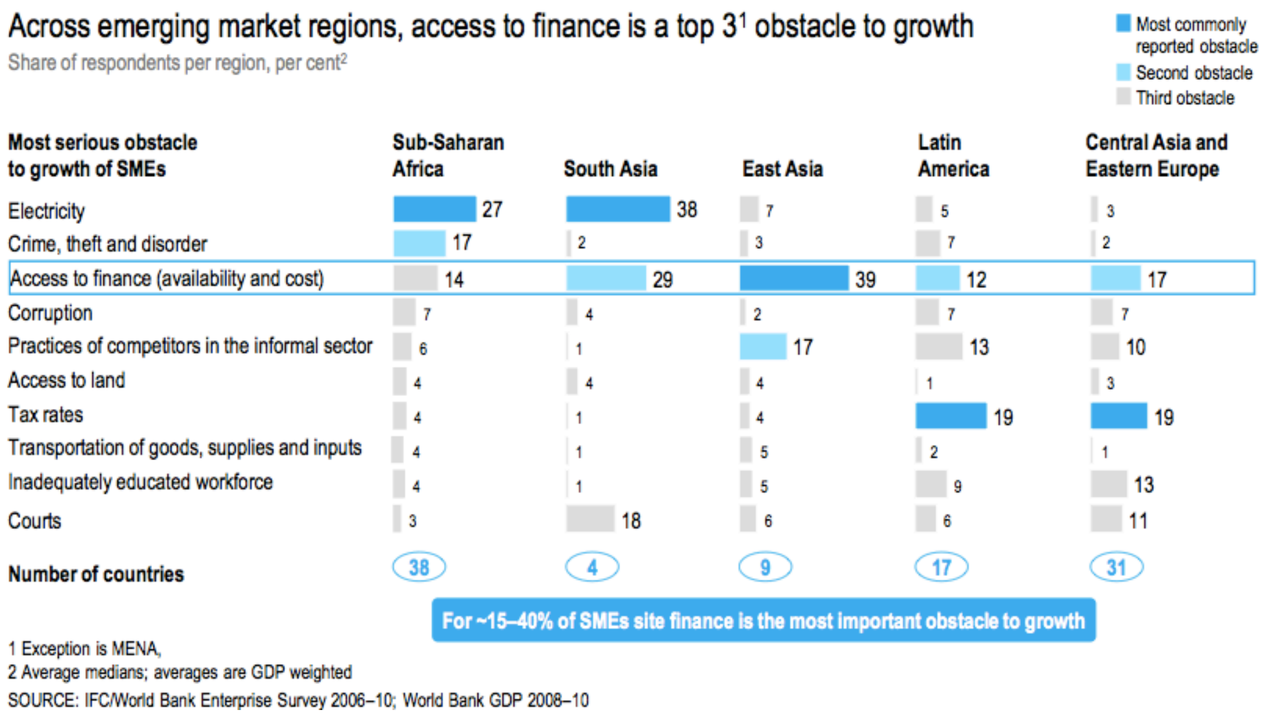
[30] Interview with Karl Skare (Stanford Graduate School of Business MBA '13) on October 30, 2013.
[31] Interview with Sandhya Hegde (Stanford Graduate School of Business MBA '13) on November 20, 2013.

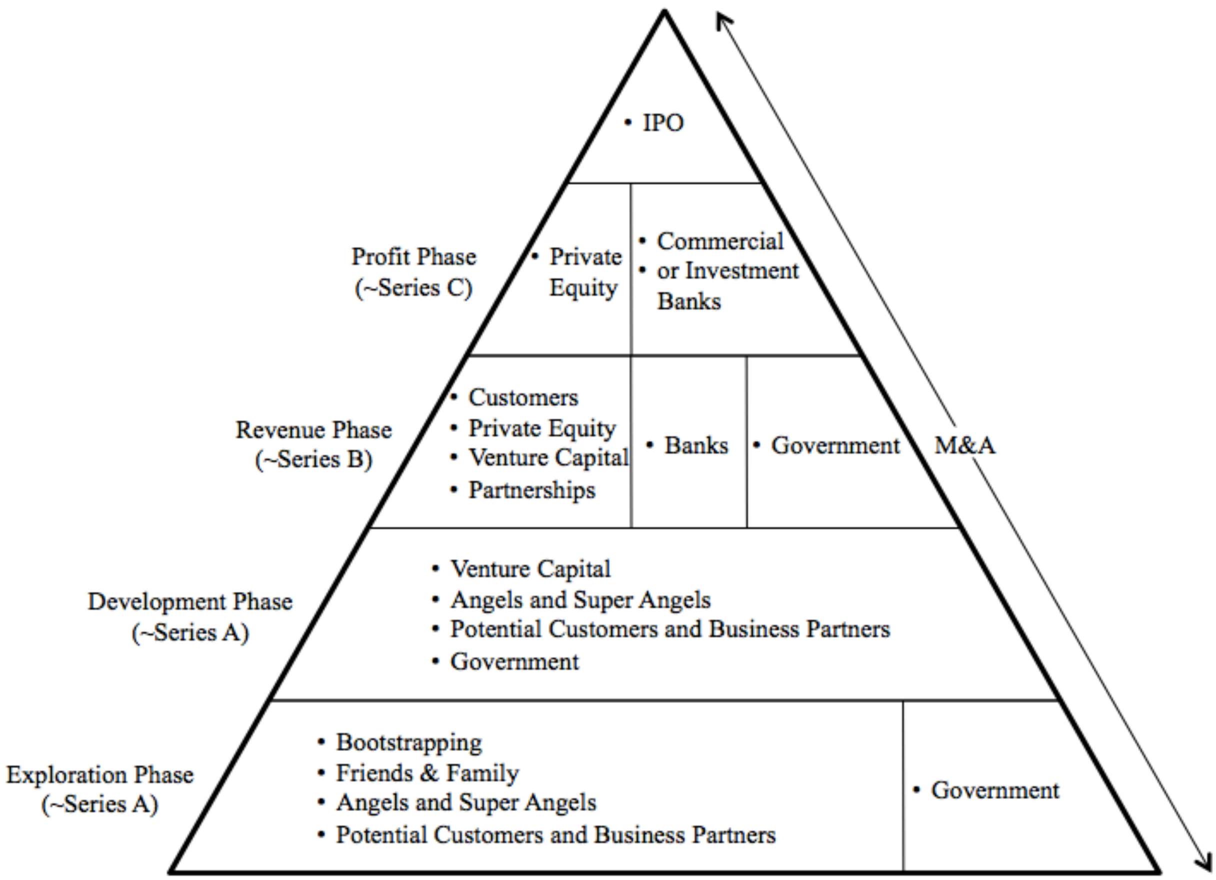
entrepreneur can formulate and execute a strategy customized to the dynamics of his or her specific financing environment.

Exhibit 1
Obstacles to Growth for Start-ups in Developing Economies



Source: "Micro-, small and medium-sized enterprises in developing economies: how banks can grasp a $350 billion opportunity," McKinsey & Company, 2012.

Exhibit 2
Four Stages in a Venture and the Associated Investor Interests



Source: Graphic created by authors.

Exhibit 3
Entrepreneur Resources: Research and Databases

CROWDFUNDING

- **The World Bank document evaluating the crowdfunding ecosystem:**
  *info*Dev, "Crowdfunding's Potential for the Developing World," 2013, http://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf (accessed January 3, 2014).

- **A comprehensive list of the number of crowdfunding platforms worldwide:**
  Statista, "Number of Crowdfunding Platforms Worldwide in 2012, by Country," http://www.statista.com/statistics/251573/number-of-crowdfunding-platforms-worldwide-by-country/ (accessed January 3, 2014).

- **Global database of crowdfunding platforms:**
  Thecrowdcafe, "Crowdfunding Platforms: Global Database," http://www.thecrowdcafe.com/crowdfunding-platforms/database/ (accessed January 3, 2014).

- **List of more than 500 crowdfunding platforms:**
  CrowdFunding Conference and Seminars, "List of CrowFunding Sites,"http://www.crowdfundingconferenceseminar.com/media-libarary-crowdfunding_planning-Conference-cloud_based_business_planning-crowdfunding_softwarecrowdfunding-crowdfunding_exchange/List-of-crowd-founding-sitess (accessed January 3, 2014).

INCUBATORS

- **Start-up Chile website:**
  Start-up Chile, http://startupchile.org/ (accessed on January 17, 2014).

- **The National Business Incubation Association database of incubators:**
  The National Business Incubation Association, "Find a Business Incubator Near You," https://www.nbia.org/links_to_member_incubators/ (accessed on January 3, 2014).

- **List of over 100 incubators in Asia:**
  The Bridge, "Where are the Startup Incubators and Accelerators in Asia? Here's 100 of 'em," June 6, 2013, http://thebridge.jp/en/2013/06/startup-incubators-accelerators-asia-pacific (accessed January 3, 2014).

- **List of incubators in Africa:**
  Mawuna Remarque Koutonin, "Top Business Incubators in Africa," Silicon Africa, February 3, 2013, http://www.siliconafrica.com/top-business-incubators-in-africa/ (accessed January 3, 2014).

BUSINESS ANGEL INVESTORS

- **List of business angels, angel groups, and angel databases in Africa:**
  Mawuna Remarque Koutonin, "Top Business Angels and Investors in Africa," January 8, 2013, Silicon Africa, http://www.siliconafrica.com/top-business-angels-and-investors-in-africa/ (accessed January 3, 2014).

- **List of business angels worldwide:**
  AngelList, https://angel.co/people/investors (accessed January 3, 2014).

Exhibit 3
Entrepreneur Resources: Research and Databases (continued)

BUSINESS ANGEL INVESTORS (CONTINUED)

- **The Keiretsu Forum website:**
  Keiretsu Forum, http://www.keiretsuforum.com/ (accessed January 17, 2014).

BANKING INSTITUTIONS

- **The German Federal Ministry for Economic Cooperation and Development's publication on credit guarantee schemes:**
  German Federal Ministry for Economic Cooperation and Development, "SMEs' Credit Guarantee Schemes in Developing and Emerging Economies, July 2012, http://www.aecm.eu/servlet/Repository/?ID=1302 (accessed January 3, 2014).

- **The World Bank's review of credit guarantee schemes in the Middle East and North Africa Region:**
  The World Bank, "A Review of Credit Guarantee Schemes in the Middle East and North Africa Region," http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-5612 (accessed January 3, 2014).

INTERNATIONAL FINANCIAL INSTITUTIONS

- **List of the International Finance Corporation member countries:**
  The World Bank, "IFC Members," http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/ORGANIZATION/BODEXT/0,,contentMDK:20122863~menuPK:64020025~pagePK:64020054~piPK:64020408~theSitePK:278036,00.html (accessed January 3, 2014).

- **Portal to International Finance Corporation's investment services:**
  International Finance Corporation, "IFC Investment Services," http://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/what+we+do/investment+services/investmentservices (accessed January 8, 2014).

NATIONAL AND MULTILATERAL DEVELOPMENT BANKS

- **List of the Inter-American Development Bank member countries:**
  The Inter-American Development Bank, "Member Countries," http://www.iadb.org/en/about-us/member-countries,6291.html (accessed January 3, 2014).

- **List of the African Development Bank member countries:**
  The African Development Bank Group, "Countries," http://www.afdb.org/en/countries/ (accessed January 3, 2014).

- **List of the Islamic Development Bank member countries:**
  The Islamic Development Bank, "Member Countries," http://www.isdb.org/irj/portal/anonymous?NavigationTarget=navurl://750e51a0219adf78e6329e889512714e (accessed January 3, 2014).

Exhibit 3
Entrepreneur Resources: Research and Databases (continued)

MICROFINANCE INSTITUTIONS

- **Comprehensive source of information on the microfinance industry, as well as a complete database of microfinance institutions worldwide:**
  Mix Market, http://www.mixmarket.org/ (accessed January 3, 2014).

VENTURE CAPITAL

- **List of venture capital and private equity institutions worldwide:**
  Venture Choice, "Venture Capital and Private Equity Directory," http://www.venturechoice.com/vcdir.htm (accessed January 3, 2014).

- **List of venture capital institutions worldwide:**
  "Venture Capital Companies," Bloomberg Markets, http://www.bloomberg.com/markets/companies/venture-capital/ (accessed January 3, 2014).

- **The Latin American Private Equity & Venture Capital Association:**
  The Latin American Private Equity & Venture Capital Association, http://lavca.org/ (accessed January 13, 2014).

PRIVATE EQUITY

- **List of developing economy private equity companies worldwide:**
  Emerging Markets Private Equity Association, "List of Members," http://www.empea.org/members/list-of-members/ (accessed January 3, 2014).

- **List of legal systems (e.g., common law) employed in countries worldwide:**
  The Central Intelligence Agency, "Field Listing: Legal System," https://www.cia.gov/library/publications/the-world-factbook/fields/2100.html (accessed January 3, 2014).

CAPITAL MARKETS

- **List of global stock exchanges**
  World Stock Exchanges, "List of Stock Exchanges Around the World," http://www.world-stock-exchanges.net/ (accessed January 3, 2014).

Exhibit 4
The Number of Crowdfund Investing Platforms in Selected Countries

Country	# of CFI Platforms	Country	# of CFI Platforms
Australia	12	India	10
Belguim	1	Italy	15
Brazil	17	Netherlands	34
Canada	34	Russian Federation	4
China	1	South Africa	4
Estonia	1	Spain	27
France	53	UAE	1
Germany	26	United Kingdom	87
Hong Kong SAR, China	1	United States	344

Source: *Crowdfunding's Potential for the Developing World*. 2013. *info*Dev. Financing and Private Sector Development Department. Washington, DC: World Bank.

Exhibit 5
Global Private Equity Penetration

Source: "Q3 2013 EM PE Industry Statistics," Developing Economies Private Equity Association, http://www.empea.org/research/data-and-statistics/q3-2013-em-pe-industry-statistics-public-summary (December 3, 2013).

Exhibit 6
2013 Global IPO Regional and Exchange Breakdown

Regional Breakdown - (US$ Billions)

	2011			2012			2013		
Region	**#**	**$**	**% of $**	**#**	**$**	**% of $**	**#**	**$**	**% of $**
Asia Pacific	200	$69.4	50.3%	90	$41.7	41.8%	91	$44.9	32.8%
Europe	32	$27.8	20.2%	15	$9.9	10.0%	46	$26.9	19.6%
Latin America	18	$6.0	4.4%	12	$6.4	6.4%	16	$12.1	8.8%
Middle East and Africa	2	$0.2	0.2%	6	$1.5	1.5%	2	$1.4	1.0%
North America	87	$34.4	25.0%	80	$40.1	40.3%	145	$51.7	37.7%

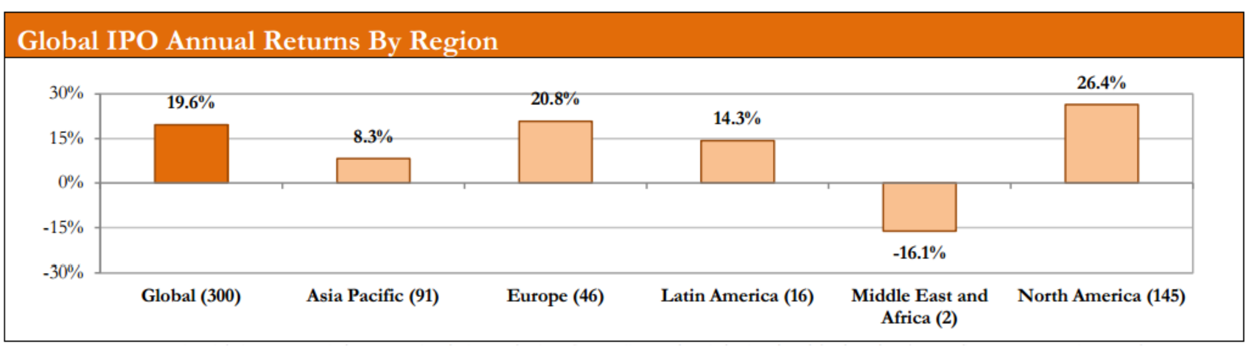
Source: Renaissance Capital. Global statistics include IPOs with a deal size of at least $100 million and exclude closed-end funds and SPACs. Data as of Dec. 18, 2013.

Exchange Breakdown - (US$ Billions)

	2011			2012			2013		
Exchange	**#**	**$**	**% of $**	**#**	**$**	**% of $**	**#**	**$**	**% of $**
NYSE	56	$26.4	19.1%	62	$19.7	19.7%	95	$39.8	29.0%
Hong Kong Exchange	35	$22.4	16.3%	17	$9.7	9.8%	38	$18.1	13.2%
LSE Main	10	$15.7	11.4%	7	$4.4	4.4%	19	$11.5	8.4%
NASDAQ	28	$7.3	5.3%	13	$19.4	19.4%	40	$9.7	7.1%
Bovespa	11	$4.0	2.9%	3	$2.1	2.1%	9	$7.6	5.6%
Tokyo Stock Exchange	2	$1.3	0.9%	7	$11.5	11.5%	7	$6.9	5.0%
Australian Securities Exchange	1	$0.2	0.2%	0	$0.0	0.0%	13	$4.2	3.1%
Singapore Exchange	5	$7.0	5.1%	5	$1.6	1.6%	9	$4.1	3.0%
Frankfurt Stock Exchange	7	$1.8	1.3%	2	$2.2	2.2%	4	$3.9	2.8%
New Zealand Stock Exchange	1	$0.3	0.2%	0	$0.0	0.0%	3	$3.6	2.6%

Source: Renaissance Capital, "Global IPO Market Bounces Back in 2013," December 18, 2013, http://www.renaissancecapital.com/ipohome/review/2013globalreview.pdf (accessed January 8, 2014).

Exhibit 7
2013 Global IPO Annual Returns By Region



Source: Renaissance Capital, "Global IPO Market Bounces Back in 2013," December 18, 2013, http://www.renaissancecapital.com/ipohome/review/2013globalreview.pdf (accessed January 8, 2014).