The Role of Investors in Getting Inclusion Right

Money flows with great force toward places where it is most effectively deployed, so investors shoulder a responsibility ensuring that the undeserved are benefiting as well.

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Across emerging markets, we are in the early stages of a digital financial revolution that promises to upend the status quo while vastly expanding services to people who were previously un- and underserved. As investors, we believe we can play a catalytic role in ensuring that digital innovations have the opportunity to be market tested, refined and ultimately scaled.

This essay considers the role of investors in responding to the opportunities offered by the digital financial services revolution and bringing about financial inclusion. The comments here reflect the view from Quona Capital. Quona manages the Accion Frontier Inclusion Fund, the first global fintech firm for the underserved, and its successor, the Accion Quona Inclusion Fund. We believe that Quona brings a unique perspective with a view across a wide range of countries, business models and investor types – all focused on getting financial inclusion right.

Fintech Innovators Are Creating an Enormous Opportunity

In emerging markets today, financial institutions enjoy robust profits, with returns on equity in Africa well above 20 percent and in Latin America in the high teens. Incumbent banks are doing well by serving the well served, including corporate and government clients.

At the same time, there is a radical expansion of technology that changes the way financial services can connect to the underserved, and this has bred a new generation of entrepreneurs. These entrepreneurs are leveraging technology to, firstly, dramatically reduce delivery costs to enable services to groups that were previously too costly to reach, and, secondly, better understand – and therefore serve – customers who were previously hidden from view. These opportunities exist at both consumer and small business levels.

And the opportunities are enormous. In the U.S., even with its relatively well-developed financial sector, the alternative lending market for small business loans has gone from a market that barely existed ten years ago to one serving a projected **16 percent of the market in 2018**. If this kind of opportunity exists in the U.S., it is even greater in emerging markets where small companies are much less well served. With the advent of technologies like cloud services and smartphone apps, entry barriers are lower, and this is a great equalizer – both for fintech startups (who wish to compete with incumbents) and for the lower end market (no longer as disadvantaged relative to the middle class). The two biggest opportunities arise in lending to small enterprises and individuals and in digital payments. The payments and lending opportunities go hand in hand, as digital payments provide the data footprint that supports credit underwriting.

There are green shoots popping up in insurtech, too. The vast majority of the innovations in these areas are coming from startups that directly serve customers, though we also see partnerships with incumbent financial institutions, such as models in which banks provide capital while fintechs do loan origination and underwriting.

We also see opportunities in adjacencies to traditional financial services that bring together technology and finance. For example, we considered investing in a company offering an Uber-like motorbike ridesharing service in an African country. This thesis around mobility-linked financial services was appealing in part because transportation is an important economic enabler which financing can further unlock. As an added benefit, this company insisted on the use of helmets, bringing greater safety to an often precarious occupation.

The New Wave of Fintechs Need Capital and Support

The innovation we are talking about is not driven by traditional financial institutions. Innovative companies are reaching out to specialized investors, which are essential for enabling them to obtain the financial lifeblood they need to thrive and grow. They need capital that is prepared to take on the level of risk involved with companies that are startups, using innovative technologies, to serve segments at the base of the economic pyramid in frontier and emerging markets. Each of these attributes carries heightened risk and therefore necessitates specialized, risk-bearing sources of support. Impact investors like Accion's Venture Lab and Quona are willing to provide the risk capital to get promising companies up to a level at which they can mature and scale.

In addition to capital, our investees need a wide range of support to meet the various challenges involved with building young businesses. Probably our most fundamental role in that regard is as coaches for the leadership of companies. We are in a position to have open conversations with them about confronting and overcoming challenges, including external – macroeconomic shocks, regulatory surprises – and internal challenges – personnel, systems, etc. We aim to help them problem solve in a very quick and agile way – in keeping with the necessity for rapid response that these young companies face.

Part of what we can bring to these companies is knowledge of what's going on in similar companies in other parts of the world. Because we review hundreds of opportunities every year, we gain insight into a great cross-section of key sectors, something that is difficult for business builders to obtain, with their laser focus on shorter-term execution. We can make connections. For example, we recently connected two companies, each working in supply chain finance, on different continents. One was good at the finance end of the business, while the other was good at the logistics – each looking to learn from each other as they scaled their operations.

We urge our companies to move beyond executing to building. As startups that are beginning to scale, they often focus on short-term execution – making it all work and reaching the next set of targets. A slightly longer term perspective is needed if they are really going to scale – because they often need not just incremental growth but significant leaps.

Talent is another of the most important areas to support. The technical talent these companies need exists, but is often not available locally in emerging and frontier markets. We often encourage our portfolio companies to hire outside their familiar networks so that they can bring in diverse new ideas and knowledge. We assist them to explore the unknown in a disciplined way, neither staying in their comfort zone nor leaping into the dark.

Companies may need assistance to broker important relationships, such as those very important, but sometimes difficult, relationships with regulators. It is tempting for Fintech companies to "fly under the radar" so that regulators do not notice them until they are well established. But this is not smart: regulators need to be informed about how the market is evolving so that they can evolve their own regulations and avoid surprising companies later on. We can often make a difference by bringing experience from other countries into the dialogue. Recently in one country with a highly pro-incumbent regulator, we were able to discuss the rapid progress made in countries where regulators took a different view. Such conversations require nuance and political understanding, and it helps to have been through them in multiple contexts.

Similarly, companies may need assistance brokering relationships with mainstream institutions with which they seek partnerships. Partnering with existing financial institutions may be one way for companies to make the leaps we mentioned above, but they are not easy to establish. As brokers, we have worked to enable both parties in negotiations to see the mutual benefit that can come if they partner effectively.

The Gamut of Investors

As companies grow from their earliest stages, they work with different types of investors that are equipped to shepherd investee companies through specific points in their lifecycle. Many of the earliest investors are incubators, including some funded by mainstream banks. Accion's Venture Lab is a seed stage fund that comes in as the main elements of the business model have been developed, even before the business has broken even. Quona's work comes in as companies are well-tested and beginning to scale. Quona seeks to catalyze the next wave of capital, including technology venture capital firms, mid-market private equity and buy-out firms, and financial institutions. These are the kinds of groups we look to as co-investors, new investors at later stages, and ultimately, buyers of our companies.

Mid-market private equity companies like General Atlantic (a $20 billion, New York-based fund), Advent (a $30 billion fund based in Boston) and Temasek (a $300 billion investment fund based in Singapore) have the ability to invest in amounts ranging from $50 to $300 million, taking a proven business model to significant scale. Ideally, we would like to have General Atlantic (or the like) look at one of our investee companies and say, "Wow, this company is capturing a good business opportunity and they're executing well. We can provide the capital they need to scale."

This is what happened recently with Clip, a company that makes it easy for small merchants to accept digital payments. This company, in which Accion's Venture Lab invested at the seed stage, is working in the enormously untapped market of small merchants in in Mexico. General Atlantic came into Clip's Series C in a big way, allowing it to scale dramatically.

Technology venture capital funds, especially local ones, are often co-investors with us. In addition to capital, they bring experience in digital marketing, technology development and local markets, while we add the specialized lens of social impact, as well as specific fintech expertise. Also we see banks backing startups by setting up accelerators and funds.

Impact investors also play an important role: in reminding both investors and fintechs of the important goals underlying the work. In smaller and less developed markets, social impact investors more often take the lead. In bigger and more advanced markets, these investors had an important catalytic impact early on and are now able to cede some of the financing to more commercial players. In both cases we find that impact investors help companies to develop broader and longer-term vision, especially around market opportunities that might otherwise be overlooked.

And that brings us to an important point. Both mainstream and impact investors play essential roles in scaling companies. Accion Venture Lab identified promising early stage companies like Konfio – a digital lender for small and micro businesses in Mexico. Quona came in to provide growth capital followed by mainstream investors like QED and Vostok. Access to mainstream capital allowed Konfio to scale and capture a growing share of the Mexican SME financing market. But building companies is as much about vision as it is about capital. At Quona, we often say we're practicing venture and private equity the way it was invented – around business building and value creation. Investors focused on financial engineering or looking for quick and easy returns lead to more zero sum outcomes, rather than creating greater value for the company, shareholders, and the ecosystem at large.

Theory of Change and Impact

Our theory of change is about creating a demonstration effect. Though we aim for our investees to grow and prosper, we know that they will not transform markets alone. Sector-wide change will happen when other businesses are drawn into the same markets and services when the success of our portfolio companies opens their eyes to the business opportunity. Sometimes the demonstration effect includes directly applying business models in new markets – or even as competitors to our own investees. All this is good.

We observe that in places where innovations are driven by startups we tend to see greater innovation in mainstream banking. The entrepreneurs bring new models to market, and that sparks a response from existing institutions.

The demonstration effect requires proven business models in order to draw in the interest of other investors. In many countries, this effect is already kicking in for the fintech sector. In fact, we are seeing fintech-oriented companies receiving an increasing share of all early stage venture capital in emerging markets – as much as 25 to 40 percent. Many of these companies are aiming directly at the previously underserved market segments as more investors recognize the opportunity to expand the market by reaching these new customers. We see investors shaping their own in-house expertise to be better equipped to support such businesses. Right now this activity is concentrated in a subset of markets – generally the larger and more advanced of the emerging markets, including Southeast Asia and countries like India, Brazil, Mexico, and South Africa.

As this shift toward more mainstream investors proceeds, concerns are sometimes raised about mission drift. We try to identify companies that are squarely focused on the underserved, whose entire business model is built around innovative ways to serve these segments. Such companies are not likely to move away from their impact focus as they grow. However, we also work with some companies that did not begin exclusively with the inclusion segment, and our role is to help them see the opportunity in inclusion and bring them tactical knowledge about reaching these segments.

We also think of the investor role not just in terms of building individual businesses but also in terms of building an ecosystem. In this regard, investors and often investee companies need to cooperate to make a market that works well and need to move beyond a winner-take-all mindset. Of course companies must consider their own needs in terms of confidentiality, intellectual property and competitive advantage, but it is often better for companies if there are multiple businesses establishing a new market in a given country.

Part of what needs building is the investor ecosystem itself. Investors need to contribute to a positive environment through knowledge sharing and talent development. One part of the ecosystem we would especially like to support is the market for debt. Our portfolio companies face extreme shortages of access to debt, and so we are happy to work with people and organizations who are putting debt mechanisms in place. Experienced impact and early stage investors can help new-to-fintech investors learn more about the sector through deep dives with their teams on a subsector or a region.

A Concluding Thought

As technology crosses borders, capital and talent flows to all corners of the globe. Money flows with great force toward places where it is most effectively deployed. This is an exciting and encouraging process to watch and even more to take part in. As investors, we have a great opportunity and responsibility to be proud of the world we are building.

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The Center for Financial Inclusion at Accion (CFI) is an action-oriented think tank that engages and challenges the industry to better serve, protect, and empower clients. We develop insights, advocate on behalf of clients, and collaborate with stakeholders to achieve a comprehensive vision for financial inclusion. We are dedicated to enabling 3 billion people who are left out of — or poorly served by — the financial sector to improve their lives.

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