Final Policy Paper: Exploration of Social Impact Bonds for SME Development

April 3, 2014

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Abbreviations

ASIB – African Social Impact Bond
BBBEE – Broad-Based Black Economic Empowerment
BDS – Business Development Services
CSI – Corporate Social Investment
ED – Enterprise Development
GDP – Gross Domestic Product
SIB – Social Impact Bond
SME – Small and Medium Enterprises
the dti – Department of Trade and Industry

Acknowledgments

The coalition wishes to give thanks to the many organisations, firms and people for their contribution to this project; with particular thanks to all the BDS providers, investors, government representatives, professionals and other stakeholders engaged with for their valuable insights, discussions and support on this project.

The coalition would also like to express their sincere gratitude to the Bertha Centre, and support staff for their assistance in the administration and operations aspect of the project.

Last, special thanks must be given to the funders of this report, namely National Treasury and Flanders, without whom this research would not have been possible.

Introduction

Background of Project

In September 2013, The Bertha Centre (located within University of Cape Town's Graduate School of Business), Genesis Analytics and Social Finance formed a research coalition and were awarded a grant to explore the applicability of Social Impact Bonds (SIBs) as a financing instrument in South Africa. In particular, the initial scoping study sought to assess issues relating to the design of, and gauge the level of interest of key stakeholders in, a SIB providing business development services (BDS) to small and medium enterprises (SMEs) so as to generate economic growth and job creation.

During the course of the research, the coalition held discussions, interviews and workshops with (i) local business development service providers; (ii) national, regional and local authorities; (iii) community groups and NGOs interested in facilitating SME growth; (iv) potential investors; and (v) potential outcomes funders. Additionally, the coalition brought together a broader group of stakeholders in an African Social Impact Bond (ASIB) Advisory Group with representation from: (i) provincial and national government departments; (ii) the financial sector; (iii) business organisations and/or; (iv) international funders. Workshops and interviews with these stakeholders and the Advisory Group comprised a significant portion of the project and their feedback is incorporated throughout this document.[1]

Introduction to SIBs

'Social Impact Bonds are an innovative method of financing social programmes in which governments partner with service providers and private sector investors to fund social programmes. Investors are repaid if and when improved social outcomes are achieved. Thus, government pays only if the services are successful at meeting the needs of its citizens.'

- Kippy Joseph, Rockefeller Foundation, 2013

Global action on SIBs, which aim to improve the effectiveness of interventions that tackle social problems, has surged over the past few years. SIBs are an outcomes-based contract where private funding is used to scale-up services and test innovations, and the government pays only for success. In the four years since the first SIB was launched by Social Finance in 2010, targeted at reducing reoffending rates among ex-offenders leaving Peterborough prison in the UK, more than twenty SIBs, raising in total approximately US$100 million, have been launched globally. Market growth is accelerating with progress on policies to set aside significant funding for SIBs, such as the £60 million of funding allocated by the UK Cabinet Office and Big Lottery Fund, and the proposed US$300 million allocation in the White House FY2014 budget. In turn, a growing number of organisations are involved in developing SIB policy and transactions, including the Taskforce on Social Impact Investment established following the G8 Social Impact Investment Forum in June 2013, the UK's Centre for SIBs and the US' Harvard Kennedy School SIB Lab. As the market has expanded, the application of SIBs has spread to issues that range from homelessness to early childhood education and grown to as large as a US$27 million[2] capital raise for a single SIB.

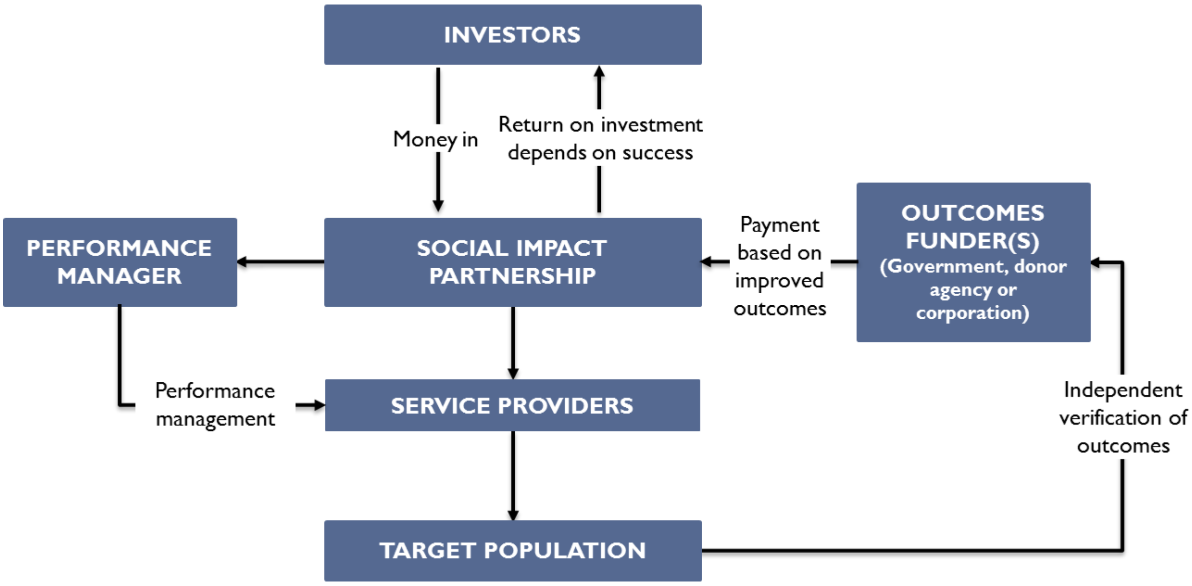
SIBs are instruments that are designed to help governments explore and expand effective social programmes among a pre-defined target group. A SIB focuses on specific, pre-agreed, social outcome(s) and clear metrics for measuring success. Investors provide the upfront funding of a programme that is designed to achieve the target outcomes. Specialised service providers carry out the programme itself, and investors are repaid by an outcomes funder – usually government – if (and only if) independently verified evidence shows that the programme has been successful

[1] See further detail on the research process conducted in Appendix 1 – Detailed Description of Research Process.

[2] Johnson, H. (2014).

in delivering the pre-agreed outcomes. The return to investors for sharing this performance risk typically varies according to the results achieved, subject to an overall cap on the return. A typical SIB structure is represented below in Figure 1.[3]

Figure 1: Typical Structure of a SIB



Source: Social Finance

Potential in South Africa

The research conducted for this project has confirmed that SIBs hold particular promise to improve service delivery in South Africa through:

- *Rigour*: SIBs bring greater focus on agreeing the outcomes desired by a programme up front, and then measuring the effectiveness of delivery in order to decide payment
- *Innovation*: SIBs transfer risks to socially-motivated investors who have a greater appetite for testing innovation and funding new models
- *Flexibility*: SIBs create incentives to put in place the necessary feedback loops, data collection and performance management systems required to learn from local circumstances, resulting in a bottom-up, client-centred, and potentially more effective, approach to service delivery.

SIBs also provide further benefits to key stakeholders compared to traditional contracting models:

- For *service providers*, SIBs provide upfront funding paired with extensive data collection and analysis, which allows providers to expand their services and at the same time adapt and learn from the data to improve their programmes and achieve greater impact;
- For *outcomes funders*, SIBs can transfer outcomes risk through payment only for results;
- For *social investors*, SIBs can provide an opportunity to invest in outcomes related to important social issues with the possibility of recycling their capital; and
- For *target beneficiaries*, SIBs can facilitate outcome-focused service delivery from evidenced based interventions.

[3] An intermediary organisation – not represented in the diagram – also plays a critical role in SIB design and development. The role of intermediaries is laid out in further detail later in the report.

Identifying Strong Opportunities for SIBs

While SIBs represent a powerful opportunity for governments to address key issues across sectors, experience has shown that SIBs add the most value in situations where:

- a *pressing social problem* has been identified which is a priority for both outcomes funders and investors;
- a *target group* has been identified with sufficient clarity, to whom the intervention can be delivered and for whom the impact of that intervention can be measured;
- *evidence-based interventions* are available which have been shown to be effective in mitigating the problem among a population which is comparable to the target group;
- *robust outcomes metrics* to which success can be attributed can be identified and are able to be measured, using reliable data sources;
- a *viable investment proposition* can be developed, which excites investors – typically socially motivated – to invest; and
- there are *willing outcomes funders* who will pay for the identified outcomes if they are delivered.

It is particularly important for a country launching its first SIB to consider these criteria, as the first SIB will provide an oft cited and deeply scrutinized example for further development of the market. This paper will explore each of these criteria in depth in relation to a potential SIB that provides BDS for SME development. It should be noted that BDS has not to date been the subject of any SIBs. There are however SIBs which are currently operating in the UK and the Netherlands which are focused, directly or indirectly, on employment or employability of young people. [4]

Due to the breadth of the focus of the project – the term 'BDS' covers hundreds of types of interventions across nearly all sectors of the economy – the broad answers to these criteria do not always reflect the individual realities for specific sectors and types of interventions. Nonetheless, when assessing the broad BDS space, our research found that:

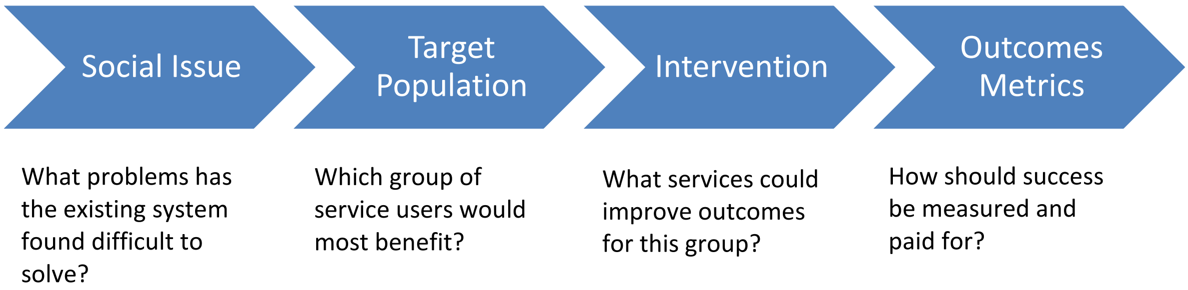
- Unemployment is identified as one of South Africa's most pressing social and economic challenges. As such, the facilitation of BDS focused specifically on catalysing economic and employment growth is a high priority area for outcomes funders and investors alike.
- A target group of SMEs will likely share some combination of geographical location, business sector and business stage so as to enable a clear definition of target impact and to increase successful attribution of outcomes.
- Although there are a large number of BDS providers in South Africa, there is limited evidence on what types of interventions are effective. In particular, it may be challenging to attribute an increase in employment to the effective delivery of BDS, given the number of external factors that drive increases in employment and the potentially non-linear link between the success of SMEs and number of jobs created (e.g. SMEs may need to reduce jobs in the first instance in order to get onto a path of sustainability). It is suggested that several BDS providers could be contracted under simplified tariff-based SIBs in order to test the effectiveness of different types of services, given the current lack of robust evidence on which models might be most effective.
- A basket of outcome metrics or a mix of output and outcome metrics could be used to capture the wider impact of an intervention. For example, metrics such as sustained SME survival and revenue and profitability growth could potentially be used as proxies for the strength of SMEs and therefore the potential to create jobs.
- A market of SIB investors does exist, and whose interest would need to be further tested when a specific proposal is developed.
- Initial interest from outcomes funders has been expressed, but the next step of designing a bond should not proceed without firmer commitment.

[4] See Appendix 4 – Case Studies on Relevant International SIBs for further detail on these SIBs.

The overall recommendation of the coalition is to test several different forms of BDS interventions in parallel through a simplified tariff-based SIB structure so as to determine the effectiveness of different types of BDS. This approach is discussed in more detail below.

Framework for Developing a SIB Concept for the BDS Sector

Developing a SIB concept requires an in-depth analysis of key factors, which are laid out along the development framework below.[5] A clear, analytical understanding of each of these elements is essential to designing robust SIB concepts. This framework guided the work of this research project and is reflected in the following sections of this report.



Defining the Social Issue

SMEs as an Engine for Growth and Job Creation

South Africa's unemployment rate is currently at 24.1%.[6] The country is also known to have the world's third highest unemployment rate for people between the ages of 15 to 24, with more than 50% of young South Africans unemployed.[7] High unemployment, poverty and inequality are a triple challenge that South Africa is continuing to try address.

Estimates from the United Nations Industrial Development Organisation show that more than 90% of private businesses are SMEs and are responsible for more than 50% of employment and gross domestic product (GDP) in most African states.[8] In South Africa, a study conducted in 2010 by Abor and Quartey[9] corroborates these findings, estimating that 91% of formal business entities in the country are SMEs and that these enterprises account for approximately 55% of GDP and 61% of employment. In 1995, the South African government released a White Paper on the National Strategy for the Development and Promotion of Small Business in South Africa, emphasising the point that "Small, medium and micro enterprises represent an important vehicle to address the challenges of job creation, economic growth and equity in our country".[10] In short, potential exists to generate employment opportunities and economic growth through a vibrant and well-functioning SME sector.

The 2012 Global Entrepreneurship Monitor report estimates that only 2% of South Africans own businesses that have been established for over three and a half years, indicating a high failure rate among South African start-ups.[11] This compares to a global failure rate of approximately 50%

[5] See Appendix 5 – Process for Developing a SIB for an outline of the overall process for completing a SIB transaction.
[6] Vollgraaff, R., and Mbatha, A. (2014).
[7] James, W. (2014).
[8] UNIDO (1999).
[9] Abor, J. and Quartey, P. (2010).
[10] Department of Trade and Industry (1995).
[11] SBP (2009).

within 5 years.[12] The reasons for failure are variable: the 2010 Finscope South Africa Small Business Survey found that 39% of respondents cited money-related issues, 34% strategy related issues and 17% infrastructure-related issues as obstacles to growth[13]. The survey also revealed that 42% of small business owners do not use any type of financial products but rely on family and personal capital. In addition, the Global Entrepreneurship Monitor report supported by the Branson Centre of Entrepreneurship[14] revealed that many young entrepreneurs do not have any business mentors to turn to for advice. One aim of BDS is to address these obstacles so as to decrease the chances of business failure.

BDS Landscape in South Africa

BDS is defined as "services that improve the performance of the enterprise, its access to markets, and its ability to compete."[15]

Various forms of BDS are available to help address obstacles faced by SMEs. Details of the main types of BDS commonly offered in the South African context are given in the table below:

Type of BDS	Description	Examples
Market access	Identification of and assistance in problem areas with regards to market access	• Market research • Advertising • Subcontracting and outsourcing
Infrastructure	Provision of infrastructure and other physical business requirements	• Storage and warehousing • Internet access • Office space
Training	Provision of general training on business management	• Financial and tax advice • Management training • Mentorship
Technical Assistance	Provide assistance on issues that are specific to the type of business and its offering	• Business incubators • Investment readiness services • Technical expertise
Technology and product development	Facilitation of technology transfer and commercialisation	• Link with technology suppliers • Quality Assurance programmes

The overall challenge facing the BDS sector is the need for sufficient high quality services that achieve measurable impact for SMEs in need. Findings from stakeholder engagement suggest that there are approximately 9,000 registered BDS providers in South Africa[16] which, coupled with the estimated 6 million small businesses,[17] does not suggest that quantity of demand or supply of services is the main obstacle. However, the quality of services offered has been identified as a challenge. It appears that the ease of access to funding created by South Africa's unique Enterprise Development (ED) and Broad-Based Black Economic Empowerment (BBBEE) environment, has

[12] Bouri, A., Breij, M., Diop, M., Kempner, R., Klinger, B., Stevenson, K. (2011).
[13] These include lack of access to telecommunication infrastructure, electricity, roads etc. (Grundling, I. and Kaseke, T. (2011).)
[14] Branson Centre of Entrepreneurship (2011).
[15] UNDP (2004).
[16] See Appendix 7 – BDS Environment in South Africa for further detail.
[17] See Appendix 8 – List of BDS Providers in South Africa for the long-list of BDS providers considered by the scoping team.

led to a large supply of BDS providers who deliver services that do not address the needs of SMEs. On the demand side, BDS providers have reported that they are unable to find high-potential SMEs to service, despite the large number of SMEs. This is likely due to two reasons; i) BDS providers are offering services that are not in demand by SMEs and ii) there has been a failure to create a pipeline of high-quality SMEs due in part to low-quality BDS provision. A further challenge is that BDS providers with strong track records often limit the provision of their services to those who can pay – typically larger SMEs or corporates using ED funds to provide BDS to SMEs in their supply chain. This has in turn inhibited access of smaller SMEs to these high-quality providers and thus the pipeline of high-potential SMEs.

Value and Purpose of SIB Intervention

SIBs hold great potential for improving the quality, and thereby impact, of BDS delivered to SMEs. SIBs, by making payments only for outcomes, can bring a greater focus to defining and measuring the objective of BDS. This can improve impact achieved through creating incentives to put in place the necessary data collection systems to create bottom-up, client-centred, and thus more effective BDS delivery. For the broader market, SIBs will generate data about which BDS providers, and when different types of BDS, are effective. This information can then inform and improve the efficiency of future funding.

The aim of a SIB focused on providing BDS to SMEs would be to strengthen SMEs so as to improve the environment for economic and employment growth. The exact focus of a SIB would be shaped by the outcomes that the funder wishes to see and is willing to reward. For example, a SIB that aims to improve the climate for job creation in a specific region may focus on providing BDS to small labour-intensive businesses, such as financial services firms that are concentrated in the region and typically unable to afford high-quality BDS. One challenge of a BDS SIB, however, is that effective BDS is associated with, but not directly linked to, job creation.

The implicit logic of a BDS SIB to reduce unemployment runs as follows:

1. Unemployment rates are too high;
2. A SIB funds BDS services for SMEs;
3. Survival and growth rates of SMEs should improve;
4. More SMEs are likely to hire more people in the medium-term; and
5. This will help to reduce unemployment.

The BDS SIB therefore involves establishing a number of steps in the logic chain to justify payment by an outcomes funder. It also needs to consider wider issues, for example, if the aim of a SIB is to directly generate job creation, it needs to have a tightly and carefully defined target group so as to ensure job creation is likely, but will also need to consider whether the success of target group SMEs might adversely affect employment in non-target SMEs. Other metrics in addition to job creation will also have to be used to measure the wider impact of the SIB. Finally, some outcomes funders may be willing to pay for intermediate, as opposed to definitive, outcomes such as success in strengthening SMEs, as evidenced through growth and survival rates, on the basis that this is likely to be correlated with job creation in the longer term.

Defining the Target Group

A key component of a SIB is that it seeks to have some defined, measureable impact on a specified target population or group. Developing a SIB concept therefore requires consideration of the people or organisations for which the desired impact is intended. This will help ensure that a suitable intervention is identified that caters to the specific needs of that target group and will make it easier to assess the relevance of the evidence-base that exists for that intervention – i.e. if there is strong evidence that an intervention has worked well for a specific target population in the past, then that evidence is relevant where the SIB is targeting a population with similar characteristics.

Key aspects of defining the target group also include an understanding of the groups that outcomes funders are seeking to benefit, and also the interest of investors in investing in the outcomes of that group.

Geography

SIBs are typically focused around a particular location, where target beneficiaries share common characteristics, so as to facilitate the definition of desired outcome metrics. Consideration needs to be given to ensuring there would be a sufficient volume of beneficiaries who could be reached efficiently and which are not too widely dispersed, as this would increase transaction costs.

There are several SME "hubs" in South Africa on which a potential SIB could focus. Nearly a third of South African SME owners are located in Gauteng, followed by Kwazulu-Natal with roughly a fifth. Limpopo, the Western Cape and the Eastern Cape were each home to ~10% of SME owners in 2012. Some specific geographies have concentrations of sub-sectors, such as the case of ICT start-ups in Western Cape. Selection of the target location will depend on the size of the "hub" and impact the SIB aims to achieve.

Sector

There are concentrations of South African SMEs in specific sectors that exhibit shared characteristics in terms of employment and growth level. The trade and hospitality sectors (including retail, wholesale and restaurant enterprises) attract the greatest number of SMEs, representing ~45% of all SMEs in South Africa (included in this sector are franchises). From an employment perspective, manufacturing and financial/real estate services employ the highest number of workers on average, namely ~22, versus an overall private sector average of ~13 staff. In terms of growth, the construction, transport and communications sectors have grown rapidly (by number of SMEs) over the three years to 2012 (double digit growth) whilst sectors such as agriculture (mainly primary) have contracted (over 20% decline by number of businesses, and net profit margins of less than 5%). Accordingly, there are several sectors that have a high concentration of SMEs and employ high numbers of workers or are experiencing fast growth. Selection of a sector for a SIB would depend on the social impact a SIB would aim to achieve.

Business stage

The type of BDS provided and the outcomes it is likely to achieve will depend on the business stage of an SME. For instance, as outlined above, most South African businesses fail in the first three and a half years due to money-, strategy- and infrastructure-related issues. Specifically, almost half of SMEs rely solely on family and personal capital. Accordingly, the provision of investment readiness services in the first 18 months of a SME's life (known as the 'tipping point' for success or failure) could have a large impact on SME survival rates, and could be a focus for a potential SIB.

In conclusion, the social impact a SIB aims to achieve will guide the selection of the target group. A target group will likely share location, sector and business stage characteristics so as to facilitate clear attribution of outcomes. For instance, if outcome metrics were set as an improvement of survival rates then the target group would need to be sufficiently narrow so that the appropriate threshold survival level can be established relative to the average level of the target group. Otherwise the SMEs served may already have survival rates that exceed the threshold level and in turn, outcome payments would be made without SIB interventions actually having any real impact. Conversely, SMEs served may have survival rates that are in reality significantly lower than the assumed threshold, which increases the risk for investors and raises the possibility that they would not be rewarded even if the SIB intervention had a significant, positive impact on survival rates.

Defining the Intervention

An intervention is the service or set of services that will be provided to the target group under a SIB. Services will depend on the outcomes that a SIB aims to achieve and the needs of the target group. Accordingly, it is necessary to establish the likelihood of the intervention having an effect on target outcomes. This is dependent on two considerations:

- The degree to which interventions are well understood and their effectiveness is evidenced with sound data.
- Whether there is a gap or scarcity of service provision to the target group such that the SIB is likely to lead to a significant change in desired target outcomes.

To answer these questions, an assessment should be undertaken of interventions under consideration for the target group that includes: reviewing the qualitative and quantitative evaluations available on the interventions; interviewing service provider staff members and target beneficiaries; and, mapping out the theory of change for the interventions and analysing how these interventions are likely to meet the needs and improve the outcomes of the target group.

Intervention of BDS SIB

There is a large range of possible interventions that a SIB focussed on strengthening SMEs to generate economic growth and job creation could deliver. As discussed, the exact intervention or set of interventions selected would depend on the needs of the specific target group. For instance, a SIB could provide the following types of BDS to relevant groups of SMEs:

- Business strategy and investment readiness services for 18-month-old SMEs aimed at overcoming the 'tipping point' for success or failure and consequently improving SME survival rates and therefore employment levels.
- Training focused on people, financial and management skills for fast-growing enterprises in the construction sector aimed at formalising their systems and processes and improving profitability, thereby increasing future growth and employment potential.
- Incubation and infrastructure services for ICT start-ups in Western Cape aimed at increasing the revenue growth of enterprises and enabling the development of a competitive "hub" that would eventually generate economic growth and employment.

There are likely to be many service providers interested in delivering these services under a SIB. Many well-respected BDS providers that were interviewed expressed interest in participating in a SIB, primarily for two reasons: i) to increase access to working capital that would improve the sustainability of their own operations, and ii) to increase their focus on outcomes that would enable them to improve the impact of services delivered. Accordingly, despite the large pool of BDS capital available in South Africa, well-respected providers are likely to be interested in participating in a SIB.

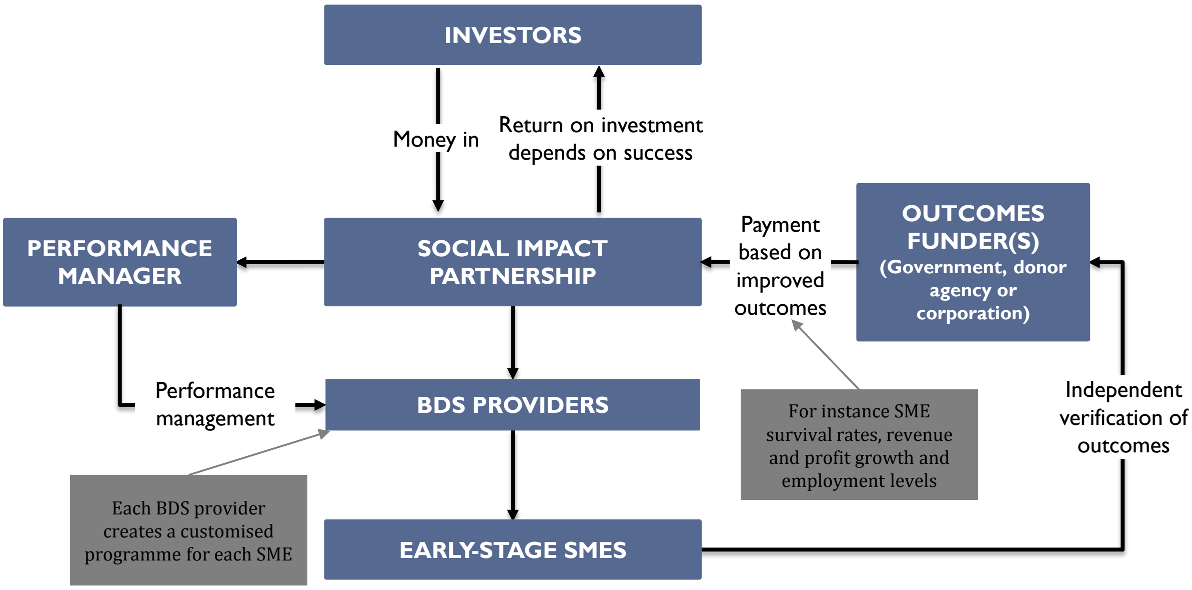
As outlined above under 'Defining the Social Issue', the BDS sector is a functioning and active for-profit market - not an underfunded social economy sector. However, sufficient levels of and procedures for ensuring accountability appropriate to the high level of investment being made into BDS are currently absent. There is also little understanding of what types of interventions achieve the greatest success in any particular circumstances and what types do not. In a well-functioning market, these learnings would be generated by the natural workings of the market over time. An important function of a SIB could therefore be to test what types of BDS are effective in order to better direct the high levels of funding currently directed at the market through regulatory capital, based on the generation of important learnings through the operation of the SIB for the BDS market (which would simultaneously inject rigour into outcomes definition and measurement within the market).

BDS SIB Structure

Two models for development of a SIB in the BDS space have emerged in the course of our work. One – the traditional model – is primarily focused on building an intervention and measurement framework designed to improve the quality of a particular category of BDS services and, through performance management and a rigorous approach to capturing and responding to data, build up the evidence base for an intervention which is effective to deliver the target outcomes. The second – potentially simpler approach – would be to pilot a number of SIBs across the spectrum of different BDS services (but targeted at comparable outcomes and target groups) to determine what type of BDS is most effective at delivering those outcomes.

The first of these – the traditional SIB model – is most appropriate where there exists a relatively well-defined intervention with some track record of delivering desired results, and where the SIB structure could help improve the quality of intervention delivery. Investors' interests and the interest of outcomes funders are both aligned to outcomes achieved. In order to drive performance, the intermediary appointed by investors would manage performance of service delivery by BDS providers. It would collect real-time data and use this information to guide improvements in service delivery to enable achievement of outcomes. Figure 2 outlines how a SIB providing BDS services to early-stage SMEs adopting the traditional structure operates.

Figure 2: Structure of traditional SIB providing BDS to early-stage SMEs



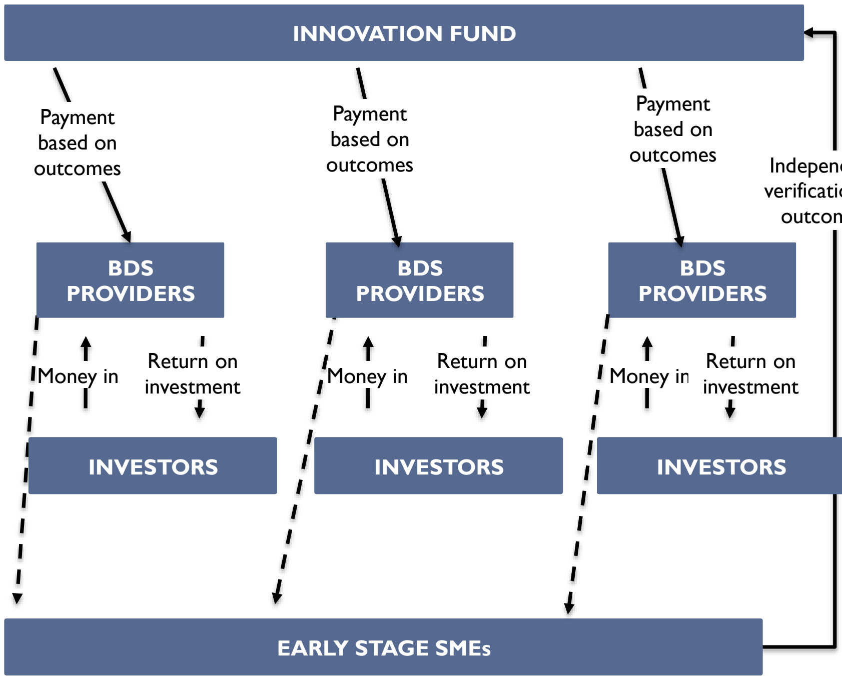
The simplified tariff-based SIB model is potentially preferable in cases where there is a lack of robust evidence on what might be most effective, and where the objective is to test out different types of BDS to see which have the most impact on target outcomes among comparable target intervention groups.

Under this simplified tariff-based model, the outcomes funder would set aside a challenge (or innovation) budget, which specifies what outcomes they are willing to pay for and the maximum tariff they are willing to pay for each outcome achieved. BDS providers would then be invited to tender. BDS providers interested in participating would bid, outlining their proposed intervention and the tariff they wish to be paid for the relevant outcome(s) – not exceeding the tender maximum. Clearly, it would be necessary at the outset to know that there is appetite from investors to support service providers with working capital under a simplified tariff-based SIB, and this will need to have been considered by the outcomes funder during the design phase of the tender. The outcomes funder would select several providers, enabling different projects to be piloted in parallel and enabling it to develop a view on the most effective providers and types of

BDS. This simplified tariff-based SIB model has been used by the UK's Department of Work and Pensions, under its Innovation Fund – which is targeted at programmes for disadvantaged youth, and is outlined in Figure 3.

Given the lack of evidence that exists in the BDS space on what types of interventions are effective, our recommendation would be to pilot several different forms of BDS under such a simplified tariff-based SIB model.

Figure 3: Structure of Simplified Tariff-Based SIB providing BDS to early-stage SMEs



Defining the Outcome Metrics

Outcome metrics form the foundation of the contract between the outcomes funders and investors in a SIB as they determine what outcomes are rewarded, which in turn provides a flow of income that enables investors to be repaid. The most important criterion for the identification of outcome metrics is whether the metrics incentivise a service that improves outcomes for those who use it. Once the outcome metrics are defined, a system of measurement that all stakeholders trust must be developed in order to provide objective measurement of the degree to which the SIB intervention has achieved the target social outcomes.

Developing appropriate outcome metrics: An outcome metric must be objective and improvement in the metric must be desirable, measurable and achievable within a reasonable timeframe.

SIBs should also be carefully structured so as to avoid the creation of perverse incentives. For instance in the Peterborough SIB, which focused on reducing re-offending, there was a need to mitigate against the 'cherry picking' of those least likely to reoffend and to ensure that providers are encouraged to work with those offenders who are responsible for the highest volume of crime. Accordingly, a frequency metric was adopted, based on the 'number of reconviction events' for members of the target group. This was preferred to a binary metric, such as whether an individual has re-offended or not, as there would not be an incentive to continue to work with an individual once he had reoffended, and in consequence little incentive to work with the most prolific offenders who are responsible for the most crime. Various other terms were included within the contract, also with the purpose of mitigating against the risk of perverse incentives – for example, forbidding the use of funding to provide direct monetary incentives to the target group.

A combination of output metrics, which measure whether services have been delivered, and outcome metrics, which measure the impact achieved by these services, can also be used in appropriate circumstances. Allocating some payment for outputs enables capital to be returned to investors sooner than if payments are only made for outcomes which are only measureable a long time after service delivery. Where there is a strong relationship between service delivery and achievement of outcomes but a long delay before measurement of outcomes it may be desirable to use a mix of output and outcome metrics. It should be acknowledged, however, that payment for outputs has the disadvantage that there is likely to be less flexibility for service delivery and also has the risk that some payments may be made for activities that do not lead to outcomes.

Establishing a measurement framework: The measurement framework sets a benchmark against which SIB outcomes are compared. The benchmark reflects outcomes in the absence of SIB interventions, enabling the calculation of benefits generated by the SIB-funded interventions. There are three common ways of generating a benchmark:

- *Historical benchmarks for an equivalent population*: Outcomes achieved for the SIB target group are measured against historical data for a similar target group.
- *Pre- and post- intervention for the target group*: Outcomes for beneficiaries in the SIB target group prior to the intervention start date are compared to a point after they have received the intervention service.
- *Control group or live baseline*: Outcomes achieved for the SIB target group are compared to a contemporaneous control group that is monitored during the period of intervention.

The advantages of the historical benchmark and pre- and post- intervention approaches are that they do not exclude individuals or organisations from receiving the SIB intervention and are simpler to apply. However, they are less able than the control group approach to identify and take into account the impact of external factors on the outcomes achieved by the SIB intervention. Accordingly, the selection of a benchmark will depend on the outcome metrics and preferences of stakeholders.

Outcomes metrics for BDS SIB

A SIB focused on providing BDS to SMEs would aim to strengthen SMEs, so as to increase the potential of SMEs to address the social issues of economic growth and employment creation. Examples of possible outcome metrics for such a SIB include: growth in SME survival rates; revenue and profitability; number of employees; and tax paid by SMEs. These metrics could also be overlaid with empowerment credentials, such as the proportion of black-owned and managed SMEs. The outcome metrics selected for a SIB would ultimately depend on the agreed aims, target SMEs and interventions applied.

Overall, it was determined that SME survival rates and revenue and profitability growth are desirable metrics for a SIB, although it is recognised that there is potential complexity both in measurement and in attributing any change to the BDS support provided under the SIB. SME survival, combined with revenue and profitability growth provides an indication of the health of SMEs, which is in turn loosely correlated with job creation and economic growth.

By contrast, a simple metric that directly focuses on job creation was considered potentially difficult since, while there may be broad correlation between job creation and profitability in the longer term, in the short term creating new jobs typically has an adverse impact on profitability. BDS providers also acknowledged that support focused on profitability growth frequently involved restructuring or job losses, albeit with a view to stronger businesses and sustained employment in the long term.

Increase in tax paid was also suggested as an alternative basis on which to measure success, due to the alignment this variable has with a growing payroll and increased profitability. However, this is felt likely to be unduly complex as a primary metric, not least because most businesses are keen to take advantage of deductions and allowances to minimise their tax liabilities.

As specific SIB concepts in the BDS sector are developed, these tensions would need to be addressed, and satisfactory and robust metrics, either directly measuring impact or 'proxy' metrics which are appropriate and valid indicators of impact, would need to be developed.

While it is important to ensure that a SIB's metrics are as simple as possible, one option is to consider whether some of the measurement challenges outlined above could be addressed by either (a) setting a 'basket' of outcomes with different metrics triggering smaller individual outcomes payments; or (b) using a mix of output and outcome metrics.

Under the 'basket' approach, for instance, if a SIB aims to increase sustained employment opportunities through reducing SME failure at the 18-month "tipping point", multiple metrics may be required. The main outcome metric would be an increase in SME survival as a result of the SIB. A secondary metric could be the increase in sustained employment as a result of the SIB. A lower weighting may be appropriate for the secondary metric, given the potential for job reduction which may be necessary for business survival, making this metric alone particularly risky for a SIB targeting business survival.

Metrics that focus on both outputs and outcomes place weight on incentivising successful interventions (the outcomes element), but also remunerate provision of the underlying service (paying for doing, regardless of success). Whether or not this approach is appropriate will depend on how comfortable outcomes funders are to pay for outputs, given the current lack of evidence between BDS provision and its effectiveness in achieving desired outcomes such as job creation.

The outcome metrics of a potential SIB will also need to be measured over a long enough timeframe to capture the impact of the intervention. In the case of a SIB concept focused on reducing SME failure at the 18-month "tipping point", outcome metrics could be measured when the SME has reached a lifespan of three to four years. Measurement at this point would be appropriate as this is the time by which the majority of SMEs that pass the "tipping point" have failed. This is also a reasonable timeframe for a SIB, which needs to run for long enough to demonstrate sustained change and build resilience into the delivery model so that there is clear evidence of the effectiveness (or not) of the intervention. The terms of SIBs which have been launched to date vary from two years to just under ten years, although the longer-term SIBs incorporate some early repayments based on intermediate outcomes or outputs such that capital can be recycled to fund later years of the SIB programme.

Finally, it is also important that selected outcome metrics for a BDS SIB minimise the risk of perverse incentives as outlined above. For instance, a metric such as job creation may create incentives for multiple hirings, but on short-term contracts or recruitment of lower skilled workers when the optimal requirement is for skilled workers. To combat this, the chosen metric would need to be one focused on the creation of sustainable new jobs – for example, a requirement that a job be held for a minimum period and that contracts be based on a minimum number of hours per a week.

Measurement framework for BDS SIB

Setting a defendable benchmark for success will require rigorous analysis to counteract the current absence of impact measurement within the BDS space in South Africa. The eventual outputs of work currently being conducted by J.P. Morgan and Dalberg focused on designing ratings tools for measuring the impact of BDS[18] will be helpful both in identifying outcome metrics and setting benchmarks.

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[18] C4G (2013).

Although there would be considerable challenges in doing so, it would be possible to attribute outcomes in a BDS SIB through creating a control group. Use of a control group is a typical approach to attribution in a traditional SIB. The primary challenge in setting a control group is to identify the key characteristics of the target group, which should be matched with members of the control group. Another challenge with a control group in the BDS space is that SMEs in the control group might themselves receive services from providers not involved in the SIB. As a result, the measurement framework would need to be defined so as to measure outcomes achieved through BDS provision under the SIB relative to those achieved by SMEs receiving BDS provided outside of the SIB. Unavoidable variation in the type and impact of the BDS that is provided outside of the SIB will create further uncertainty in the setting and pricing of outcome metrics, which would need to be overcome. Another consideration is whether SMEs in the control group, who do not receive BDS under the SIB, will be willing to provide the required data on an on-going basis for the duration of the SIB. This could potentially be overcome through the provision of small financial or non-financial incentives to control group participants.

An alternative approach could be to make payments for outcomes achieved regardless of attribution. This is the approach to outcomes measurement that is typically used in the simplified tariff-based SIB structure. Under this approach, a tariff for outcomes would also be set. This tariff would be informed by a variety of data including the social value of the outcomes, the historical results for an equivalent population of SMEs, past results of participating SMEs and predictions on the impact of external factors on outcomes. While this approach reduces the complexity of measuring outcomes achieved, it does introduce further risks and thus may deter outcomes funders and/or increase investor returns required to achieve buy-in. For instance, under this model, outcomes funders risk making payments for outcomes achieved due to external factors, and not the intervention itself, and investors face the risk of external factors preventing the achievement of outcomes and consequently, preventing the disbursement of payments. Overall, whether or not this is a preferable approach will depend on the respective requirements of outcomes funders and investors.

Role of Investors

Investors provide up-front financing for the intervention programme and bear the risk of programme effectiveness. Investors in SIBs are typically motivated by both financial return and social impact. Accordingly, investors will require a return proportionate to the level of investment risk and their assessment of the social impact that outcomes will deliver. A relatively limited investment term is typically required. Investors may include development finance institutions, high net worth individuals, impact investment funds and charitable foundations. In general, engaging investors throughout the design of the SIB process is encouraged, so as to ensure development of a proposition that fits the mandates of investors.

The alignment of investors' financial returns to the achievement of social impact under the SIB structure means that there is a strong incentive for investors to manage delivery risk. In the first instance, the investor manages this risk through due diligence of the proposed intervention. Second, the risk is managed through the discipline and rigour of performance management and impact measurement. Investors could undertake performance management and coordination or, as more often occurs, hire a third party intermediary. The intermediary uses qualified personnel and robust systems to capture real time data, which informs the management of service providers to ensure target outcomes are achieved. Regardless of the model of performance management chosen, it is essential that a robust governance framework be in place, which ensures financial matters are properly balanced with the social objective.

Finally, an independent third party monitoring and evaluation organisation that is contracted to report on the outcome metrics should be selected with input from both outcomes funders and investors, so that both parties are confident in the impartiality of their findings.

The coalition has established, through exploratory meetings with potential investors and prior research conducted by the Bertha Centre,[19] that there is strong investor interest in funding a SIB. In particular, investors are attracted to SIBs both as a means to test the effectiveness of different types of BDS (through the simplified tariff-based SIB model) and also to scale-up services that have an evidence base (through the traditional SIB model). The following recommendations arise from investors' input on what would make a SIB proposal a compelling investment.

Level of risk transfer

At the heart of a SIB is the transfer of risk to private investors. Underlying risks could include among others, intervention risks, operational risks and demand-side risks. Depending on the types of risk being transferred to investors, different metrics and incentives will need to be considered in order to achieve a suitable alignment of interests between the various SIB stakeholders.

Multiple options exist for the adjustment of risk transfer. For example, adjustment can be made to the term of a SIB or a basket of metrics for which outcome payments are made. The term of a SIB needs to balance having a longer period that enables time for learning and adaption to improve outcomes and measurement of the impact of the intervention, and a shorter period that would typically have a lower funding requirement and reduce the exposure of investors. SIB durations can vary significantly, with advantages and disadvantages in each case. Contracts longer than seven to ten years, for example, may be too lengthy for investors; whilst a two year period may be insufficient to produce enough data to measure intervention results and allow for learning and mid-course corrections. As discussed above, a combination of output and outcome metrics can be used to ensure capital is returned to investors sooner and to reduce the risk of the investment.

Risk transfer can also be adjusted through reforms to the structure of an investment. Where SIB investors have significantly different preferences in terms of risk/return, or where the capital requirement for the SIB is so large that there may be a need to attract more commercial capital, a layered structure can be considered in which some investors opt for a higher risk/return profile and others a lower risk/return profile. In some cases, a first-loss guarantee, which helps ensure partial or full return of principal to investors with lower risk appetite, can be considered to help crowd-in more commercial capital. For example, in the New York State SIB announced in December 2013, which focused on training and employment of formerly incarcerated individuals, the Rockefeller Foundation provided a guarantee facility to the project covering 10% of investors' principal. This facilitated a transaction comprising over 40 investors and was the first SIB offering distributed via a leading wealth management platform (made available to qualified private and institutional investor clients of Merrill Lynch and U.S. Trust).

Where service providers have sufficient financial strength, it may be appropriate that they also share in risk - for example, accepting that a proportion of their service fees are dependent on achieving target outcomes. It would be important, in such a case, to ensure that this did not cause misalignment of incentives or compromise the SIB's overall objectives.

Investors will also consider whether there could be risk associated with changes in government, for example the risk that a successor government will not wish to continue the SIB or will prefer budget allocations for outcomes payments to be directed to other priorities. The primary consideration is to ensure government buy-in across departments and at a high level, including relevant finance or treasury departments.

CSI, Social Investment Capital and Enterprise Development Funding

Historically, the focus of Corporate Social Investment (CSI) has been funds distributed rather than outcomes achieved. Through investment in SIBs, large South African firms can use their ED spend

[19] Research conducted under the supervision of the Bertha Centre on investor sentiment is included in Appendix 9 – Investigation of Investor Interest in SIBs in South Africa.

to build-up competitive SMEs in their supply chains that also meet BBBEE code compliance. The coalition believes that these funds have the potential to be used at both the investor and outcomes funder level. Several workshop participants noted that SIBs could be an effective instrument through which to channel ED spend towards specific impact areas and ensure impact is achieved with this investment. Discussions with legal experts on whether ED funding and CSI spend could be used to invest or pay for outcomes for SIBs are on-going and clarity from the National Treasury would expedite this process.

Role of Outcomes funders

"Unless there is an outcomes funder with real commitment and willingness to pay for outcomes, and the budget and authority to make it happen, it's just an interesting conversation"

- David Hutchison, CEO, Social Finance

Outcomes funders are critical to a SIB, as they ultimately determine what behaviours and outcomes they want to incentivise and are willing to pay for, which in turn provides the revenue stream which will repay investors their upfront funding for service delivery, together with a return on capital.

Outcomes funders are typically motivated to participate in a SIB to improve outcomes achieved and the efficiency of spending through payment only for results. Investors in a SIB are paid by the outcomes funder if (and only *if*) independently verified evidence proves that the programme or intervention has been successful. Accordingly, outcomes funders will need to be comfortable with their role as primarily one of providing financing, rather than specifying and managing the delivery of services. Outcomes funders will also need to have the flexibility and mandate to allocate future budget to pay for outcomes if and when they occur.

Outcomes funders play an essential role in determining the direction and focus of a SIB by signalling their willingness to pay for particular outcomes. Several organisations expressed interest in the role of outcomes funder in a potential SIB providing BDS to SMEs and a commitment from these organisations would enable tailoring of the SIB design to suit their objectives. Potential outcomes funders exist across multiple groups and include:

- South African Government, including Departments, such as the National Treasury, the Department of Trade and Industry (the dti), the Department of Economic Development, the Department of Labour and provincial government departments and public sector agencies such as SEFA.
- Private sector foundations with a focus or interest in innovative finance mechanisms, such as the Ford Foundation, the Rockefeller Foundation, Citi Foundation and the MasterCard Foundation.
- Donor agencies and international development banks operating in South Africa and especially organisations with stated missions to support SME development, such as Flanders government who provided funding for this study. Representative organisations that fit these criteria include UNDP, GIZ, the World Bank, Europe Aid, AFD, DFID, and USAID, although in some cases donor agencies may only be able to provide loans rather than grants, which would exclude them from being outcomes funders.

In particular, the objectives of several South African government departments could be advanced through funding a SIB focused on BDS. The National Treasury's National Jobs Fund targets employment creation by offering matched funding for several types of initiatives including those related to BDS provision. In addition, the National Budget Speech, presented by the National Treasury on 26 February 2014, has indicated an allotted budget of R6 billion to be directed toward SME development. A SIB focussed on BDS provision could also aid the objectives of the dti to broaden participation in the economy to strengthen economic development, and provisional governments, such as Western Cape, to increase employment in the regions they govern. A SIB providing BDS has the potential to advance the objectives of these departments through improving outcomes achieved and the efficiency of public spending through payment only for results. It would also increase evidence available on effective provision of BDS enabling further scale-up of such services through traditional grant-making approaches or further SIBs.

For South African government departments to become outcomes funders, rules governing how budgets are set may need to be revised. SIBs require government departments to agree in advance to make payments that align with outcomes achieved and therefore make payments of an uncertain value. Current budget rules typically require the application of a penalty when more or less than allocated funding is distributed, and consideration will need to be given whether such rules will need to be adjusted for departments to fund a SIB. In some jurisdictions, similar concerns have been addressed through legislation which ensures that the government can make multi-year commitments under a SIB. For instance, in the US Massachusetts has passed legislation that creates a Social Innovation Financing Trust to hold outcomes payments for the life of the Impact Bond.[20]

Role of Intermediaries

If development of the BDS SIB concept were to continue, specialist intermediaries would have an important role in designing and implementing the SIB. As highlighted throughout this report, successful development of a SIB requires both in-depth knowledge of the SIB structure and extensive stakeholder management. Intermediaries typically perform three roles:

- **Help bring together SIB parties to make transactions happen**: Intermediaries can help represent parties not in the room and support the negotiation of an agreement that fits the needs of all those engaged in the process. The experience of developing the SIB market has shown that specialist intermediaries play a critical role in getting transactions off the ground.
- **Support SIB design and implementation**: Particularly in early SIBs, intermediaries play an important part in supporting SIB design and implementation, beyond the role of intermediation. In particular, intermediaries can provide support to SIB parties in: feasibility assessment, contract development, capital raising, due diligence, performance management, service commissioning and capacity building.
- **Share learning and help further understanding of SIBs**: Markets are generally emerging with intermediaries helping to further the understanding of SIBs as a public good, through publications, knowledge sharing and partnership working.

Experience has shown that those markets with effective intermediary capacity have progressed more strongly than others. We would recommend that intermediaries be used to guide the development of any SIBs providing BDS to SMEs in South Africa.

Conclusion

This conclusion sums up our findings around a pilot BDS SIB in South Africa.

The research process for this paper has demonstrated that SIBs could be applicable and useful in SME development in South Africa. As a country characterised by many social problems, as well as the need for cost-saving private or NGO interventions, stronger accountability between spending and results, and a mechanism to combine private and public efforts, the research coalition believes that South Africa could also benefit from the application of SIBs in social issue areas beyond SME development.

It should be noted at the outset that as the BDS project is one of the first to explore a pilot SIB in South Africa, there is extraordinary pressure to "get it right", in that the use of a pilot SIB

[20] Shah, S. and Costa, K. (2013).

inappropriately or where it fails, introduces for the proponents a real risk of harming the reputation of the model.

The specific question that has been answered for this paper is whether a SIB is a mechanism worth pursuing in respect of BDS? While some of the criteria for a traditional SIB are in place and there is enthusiasm from many stakeholders, there are issues over attribution and measurement, and there is a lack of evidence on what types of BDS are effective and in what circumstances. Accordingly, our recommendation for the BDS sector is that simplified tariff-based SIBs are explored to test the effectiveness of different types of BDS and measurement options in parallel.

Experience shows that at least six criteria should be in place to improve the chances of a successful SIB:

A pressing social problem must be identified: That South Africa's most pressing social and economic challenge is unemployment is universally accepted. This provides a strong rationale for the pilot – a pressing problem, acknowledged by all that requires partnership and innovation to solve. However, as providing effective BDS is only associated with, but not directly linked to job creation, job creation cannot be the sole target outcome of a SIB. To address this issue it would be important to narrow the target group (e.g. youth unemployment in a certain geography) to increase the likelihood that a SIB achieves job creation. One would also need to define the intermediate outcomes that potentially lead to job creation, for example the achievement of above average survival or growth rates of SMEs, on which a proportion of payments could be based and which outcomes funders trust to be inherently good for society.

Summary: A valid social problem can be identified, although the link of BDS interventions to job creation is more tenuous than ideal for a SIB.

A target group must be identified: The SME sector is large and diverse in sector, geography and business stage; therefore a narrowing process based on the social impact a SIB aims to achieve would be essential.

Summary: A target group will likely share some combination of location, sector and business stage so as to enable a clear definition of target impact and to increase ability to attribute outcomes.

An evidence-based intervention is required: The research shows that there are thousands of BDS providers in South Africa, thus locating a group of willing service providers would be relatively easy. Furthermore, participation in a SIB was enthusiastically received by many of the well-regarded BDS providers who attended the workshops. Instead the major challenge of launching a traditional SIB in the BDS market is that there is limited evidence on what types of interventions are effective. Accordingly, we would recommend using a simplified tariff-based SIB to create important data about the outcomes achieved by different types of BDS.

Summary: Several BDS providers could be contracted under simplified tariff-based SIBs to deliver interventions to SMEs in order to test the effectiveness of different types of services.

Robust outcomes metrics must be identified and success must be attributed to the metrics: While job creation may be the objective of a SIB it is a challenging metric to use, as often the first intervention adopted to make SMEs more sustainable is to *cut* jobs. However, metrics such as sustained SME survival and revenue and profitability growth can be used as proxies for the strength of SMEs and therefore the potential to create jobs. Attribution of outcomes can be made relative to the outcomes of a control group or on a tariff basis. Both approaches would be imperfect and require application of assumptions to set target outcome levels and payment values. In a simplified tariff-based SIB, payments that fit with objectives and operation of the instrument would be paid on a tariff basis.

Summary: A basket of outcome metrics or a mix of output and outcome metrics could be used to capture the wider impact of an intervention and in a simplified tariff-based SIB, payments would typically be made on a tariff basis.

There are willing investors, who will share risk: There is no shortage of willing investors in the BDS market. The national emphasis on SME development, not least through the ED element of the BEE scorecard, has created extra supply of investment in SMEs. The research suggests there are investors who are willing to sponsor a SIB if it improves the success rate of SMEs.

Summary: There is a market of SIB investors and their interest would need to be further tested when a specific proposal is developed.

There are willing outcomes funders: Initial interest from outcomes funders has been expressed, but the next step of designing a bond should not proceed without firmer commitment, including willingness to consider the approach to output/outcome metrics, and the tariff methodology, identified above.

Recommendations for an Outcomes Funder: Potential outcomes funders should be aware that a number of material challenges would need to be overcome to launch a traditional SIB in BDS. There is also a risk that early transactions with limited success will damage the nascent growth of SIBs, a promising instrument. Accordingly, we recommend that outcomes funders explore setting up a structure for simplified tariff-based SIBs or supporting the development of SIBs in another topic area.[21]

If an outcomes funder were to proceed with a simplified tariff-based SIB structure, the first steps would be to identify a set of outcomes and values for which to ascribe to those outcomes that represent value for money for the outcomes funder in line with the objectives that are to be incentivised. It's important that outcomes are designed with input that ensures they meet the requirements for an investible SIB proposition. The outcomes funder would then invite BDS service providers to tender for outcomes-based contracts. Service providers would be responsible for securing the investment to fund the contracts, using the SIB structure. An independent monitoring and evaluation firm would be appointed to report on the outcomes achieved.

If an outcomes funder were interested to support the development of SIBs in other sectors, the first step would be to commission specialist intermediaries to complete feasibility studies on the applicability and design of SIBs in a particular focus area. A coordinated approach to market development might also be considered, such as the $5.3 million programme to test SIBs in Latin America and the Caribbean announced by the Multilateral Investment Fund in March 2014.[22]

Recommendations for National Treasury: If the National Treasury is interested in catalysing the development of SIBs as a funding mechanism across South Africa, we recommend the following:

- ***Issue a directive that SIBs could be a vehicle for national, provincial and local governments to evaluate as a funding mechanism for social services.*** Throughout this research project, the coalition found significant enthusiasm for exploring SIBs by members of government agencies and departments provided National Treasury sanctioned the use of these alternative forms of financing.

- ***Issue a directive that ED spend could be channelled through a SIB.*** As discussed in this paper, corporates presented themselves as a key potential investor group in SIBs during this research. If government were to affirm the possibility of using ED funds to support SME focused SIBs, this could mobilize a large pool of capital towards outcome focused funding.

[21] See Appendix 10 – Other Sectors Possibly Suitable for SIBs for more detail.
[22] Multilateral Investment Fund (2014).

- ***Explore tax relief for social investors.*** In the March 2014 budget speech in the UK, a 30% tax relief for social investment was announced. This tax relief is expected to generate £480 million in social investment over the next 5 years. Similar legislation could be catalytic in its effect around social investment in South Africa.

The research coalition firmly believes that SIBs represent an exciting opportunity to shape the flow of private and public capital in South Africa. During the course of this research project, momentum around SIBs has grown both substantially on a local and global level. Within South Africa, the coalition has been impressed by engagement and enthusiasm of multiple provincial and local governments to explore SIBs as well as dozens of private funders. We expect this momentum to only increase with the publication of this report. Globally, SIBs were at the top of the agenda for the G8's Social Impact Investment Forum in 2013 and the value of funds set aside to catalyse the growth of SIBs in both the developed and developing world continues to rise.
Whether in BDS or other key social issues, this research coalition believes the timing is ripe for South Africa to commence designing, commissioning and implementing SIBs.

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Appendix 1 – Detailed Description of Research Process

Approach to key design issues of BDS SIB

Defining the Social Issue

As a basis of our understanding of the SME and BDS sectors in South Africa, Genesis Analytics created an overview of the sectors that is attached to this report in Appendix 7 – BDS Environment in South Africa. Social Finance also led a literature review of research pertaining to the results of BDS in supporting SMEs. The full review is included in Appendix 6 – Key Lessons from Literature on BDS to SMEs.

Defining the Target Group

Social Finance developed a list of criteria to identify the target group for a SIB. Selection of the geography, sector and business stage of the target group was an iterative process that required desk research and stakeholder engagement to complete.

Defining the Intervention

To identify the potential interventions a SIB could address we conducted a stakeholder engagement process with BDS providers.

Defining the Outcome Metrics

Identifying the right outcome metrics is critical to the success of SIBs. Outcome metrics have to be clearly defined and measured accurately. We have identified a number of possible outcome metrics for a potential BDS SIB – these have been developed through internal conversations and feedback from stakeholders.

Overview of Outcomes Funders

In order for a SIB to be effective, its outcomes need to align with those of potential funders. Accordingly, we have surveyed the objectives/goals of potential outcomes funders. Genesis Analytics then provided an overview of which potential Outcomes Funders are likely to be interested in participating in a SIB.

Stakeholder engagement conducted on BDS SIB

The purpose of stakeholder engagement with BDS providers was multidimensional. Not only did the stakeholder involvement further clarify the problem that a SIB would seek to address, it helped to narrow the potential candidates that could be a part of a SIB structure.

We began this process by creating a long-list of service providers that includes government-sponsored programmes, innovative start-ups, non-profit and for-profit entities, youth-focused institutions, and sector specific organizations. We sourced the organizations from our own databases, desk research, and references.

Before starting interviews, we prioritized the order of our outreach efforts using a few key criteria:

- Reputation
- Track record
- Willingness to engage with the working group
- Strength of existing relationship

We started stakeholder engagement with BDS service providers via a short telephonic interview. For those that were interested in further engagement or demonstrated unique appeal for a potential SIB, we have progressed with a longer interview where possible. The interview captured the following select aspects of each service provider:

- Geographic and/or sector focus
- Target group

- Type of business development service provided
- Overview of intervention model (duration, intensity, etc.)
- Definitions of success
- Measurement and evaluation systems
- Current funding strategy

From these initial interviews, a select few BDS providers were chosen for further consultations.

Establishment of the African Social Impact Bond Advisory Group

In order to ensure broad understanding, engagement, and support of Impact Bonds in the South African context, we have established the African Social Impact Bond (ASIB) Advisory Group. The purpose of the ASIB Advisory Group is to advise on the scope, scale and realism of potential SIB opportunities. It will explore the use of SIBs in areas as diverse as healthcare delivery, BDS, education, and Early Childhood Development (ECD), amongst others. It will provide context for the development of SIBs, drawing on members' experiences in government, corporations, financial institutions, NGOs, development agencies and philanthropic organizations in Africa and throughout the world to provide valuable and essential insight into potential issues and opportunities.

The ASIB Advisory Group will advocate for the development of SIBs where there is opportunity to support interventions that are effective, supported by data, more beneficial than existing services, scalable, reproducible, and meet the needs of a number of beneficiaries.

A long-list of potential members for the ASIB Advisory Group was drafted and the working group has engaged potential candidates in our first Advisory Group meeting, held on 28 January 2014, in Johannesburg (see Appendix 3 – List of Meeting and Workshop Attendees).

We expect this group to expand slightly as this work continues.

The Advisory Group is focused on the development of SIBs in Africa broadly, with its application for BDS in South Africa as its first project.

For individual SIBs, the ASIB Advisory Group will council on:

- **Instrument**: is a SIB the best instrument available?
- **Value for money**: are the outcomes and costs correctly valued and estimated?
- **Structure**: is there an optimal allocation of roles and responsibility between investors, service providers and outcome payers?
- **Investibility**: is this a proposition that would be legitimately attractive to investors?
- **Implementation**: does it follow best practice, what are potential pitfalls? Are the best available technologies/techniques/approaches being employed?
- **Flexibility and responsiveness:** does the SIB project structure allow for real time tracking of progress and as-needed adaption of project structure and implementation modalities?
- **Outcomes**: do the metrics measure the targeted outcomes, and are they measurable with the needed precision?
- **Evaluation**: is the outcome evaluation methodology sufficiently rigorous (i.e. is it likely to generate the desired standards of precision)?
- **Reporting**: Is the proposed reporting sufficient and timely? Is there adequate openness and transparency?
- **Risk:** what are actual and reputational risks?

On January 31st in Johannesburg, we held the first ASIB Advisory Group meeting. Their feedback is included throughout this document. Lists of attendees of the ASIB Advisory Group meeting are included in Appendix 3 – List of Meeting and Workshop Attendees.

Workshops with Key Stakeholders
To compare intervention models and get feedback from other stakeholders operating in the BDS space (consultants, researches, funders, etc.), we hosted workshops in the last week of January in Johannesburg and Cape Town. In these workshops, we presented preliminary findings and asked for feedback on select questions. All three parties mediated the workshops: Bertha, Genesis Analytics and Social Finance. The feedback and insight from the interviews and workshops directed much of our research and can be found throughout this document. Lists of attendees of the workshops are included in Appendix 3 – List of Meeting and Workshop Attendees.

Meetings with Potential Investors
Throughout our research process we interacted with potential investors for SIBs including corporations, private investors, CSI fund managers, foundations and high net worth individuals. There was displayed enthusiasm for the concept, but clarity around scorecard points and tax implications, as well as greater detail regarding the structure of a bond itself are needed to accurately assess investor appetite. Research from the Bertha Centre on investor sentiment is included in Appendix 9 – Investigation of Investor Interest in SIBs in South Africa.

Launch of Scoping Report and Policy Brief
The final report and this policy paper were presented on April 3rd to government and other key stakeholders.

Appendix 2 – Scoping Team

The Bertha Centre for Social Innovation and Entrepreneurship
The Bertha Centre for Social Innovation and Entrepreneurship is a catalyst for social impact and for dialogue that promotes social and environmental change agents that find new solutions for emerging markets in Africa. The Centre invests in the next generation of social innovators through scholarships; practical, rigorous teaching, exposure and debate; and a focus on applying leading research to responding to challenges that are immediate and critical to the fabric of Africa's social and economic future – many of which sit on its geographic doorstep. A partner to international and local entities, the Bertha Centre is located at the UCT Graduate School of Business and was established in partnership with the Bertha Foundation.

Dr Francois Bonnici
Director, Bertha Centre for Social Innovation & Entrepreneurship, UCT Graduate School of Business

The Founding Director of the Bertha Centre, Dr Francois Bonnici, has worked in the field of social innovation for almost a decade, published in social innovation, health and development and was the contributing editor to the MIT journal's special edition on "Social Innovation in a Post Crisis World", launched in Davos. Originally trained as a physician in South Africa, he also read for a Master's degree in Public Health (London) and a MBA (Oxford) as a Rhodes Scholar. As a Global Leadership Fellow of the World Economic Forum, he worked on developing public-private partnerships and innovations for development, later heading up the Forum's own Schwab Foundation work in social entrepreneurship in Africa and the Middle East. He co-founded the African Social Entrepreneurs Network and with colleagues established an award-winning social enterprise building low-cost medical devices in low-resource settings.

Aunnie Patton
Social Finance Fellow, Bertha Centre for Social Innovation & Entrepreneurship, UCT Graduate School of Business
Dean's Fellow, Saïd Business School, University of Oxford
Aunnie Patton is a Fellow at both the University of Cape Town and the University of Oxford and the Co-Founder of Insight Capital Partners. She spends her time across three areas: consulting to a range of organisations including start-ups, financial intermediaries, investment funds, family offices and foundations on social investment strategies; researching the social investment market and the integration of social and environmental impact into valuation methodologies, and lecturing in finance. She has experience in both the mainstream and the impact oriented venture capital and investment banking sectors in North America, the UK, Africa and Asia. Aunnie has a B.A. in International Political Economy from DePauw University and an M.B.A. from the University of Oxford's Saïd Business School.

Lucy Hoffman
Lucy Hoffman was most recently the Head of Operations at Nexii, an impact investing advisory firm credited with developing the world's first social stock exchange. She works with a number of social businesses to develop their capital raising strategy and access impact investment. In 2012, she advised on a White Paper to the National Treasury on creating an enabling regulatory and tax framework for social business and SMEs in South Africa.

Alex Rodrigues
Alex Rodrigues has worked in finance throughout Africa, including positions in corporate finance at Standard Bank and in SME impact investing at Injaro. During his MBA, he co-founded Africa's first Net Impact Chapter. In addition to work at Bertha, Alex lectures finance, statistics and maths.

Genesis Analytics
Genesis Analytics is a Johannesburg-based research, economic policy, and strategy consulting firm that advises governments and investors on development and fund design. Genesis works with all leading companies in South Africa as well as donors across the world and government departments in South Africa. Genesis is the designer and advisor to National Treasury on the R9billion Jobs Fund, and has previously worked with Treasury on the design of a national development bond, and advised the GEPF on design of a developmental investment strategy.

Ryan Short
Partner, Genesis Analytics (in economic development practice)

Ryan Short is a development economist specialising in the economies of Southern Africa, notably in policy design, private sector development, responsible investment, impact investments and strategy. In addition to having advised many multinational firms on policy and strategy including Anglo American, De Beers, Standard Bank, Sasol and Liberty, Ryan is an advisor of government departments such as the South African National Treasury, Presidency, and Department of Trade and Industry, as well as the international donor community, including the World Bank, IFC, African Development Bank, and UK government. He designed the investment strategy for the National Treasury Jobs Fund and the developmental investment policy for the GEPF. He has also worked with National Treasury to test the viability of a national development bond, and currently advise the pension industry on introduction of responsible investment per Regulation 28.

Bridget Fury
Associate Consultant, Genesis Analytics (Business in Development practice)

Bridget Fury is an independent consultant with more than 15 years' experience advising Government, NGOs, the private sector and donor community on strategies to maximize social and development outcomes. She works between South Africa and the UK and has a wealth of experience in and understanding of the SME sector. She is currently advising the South African National Treasury on its R9 billion Jobs Fund on the specific use of concessionary and hybrid financial structures which support enterprise development. She has worked with a number of major South African and international NGOs including TechnoServe on developing their SME strategies. Additionally, Bridget has advised some of the leading multinational companies on responsible business practices, co-ordinates the activities of two philanthropic foundations in the UK and has set up two donor-funded research centres at major International Universities.

Social Finance Ltd.
Social Finance pioneered Social Impact Bonds, and currently co-leads with the Center for Global Development a Working Group on Development Impact Bonds. Social Finance was established in 2007 to improve the quality and quantity of finance available for achieving social impact. The organization developed and launched the first Social Impact Bond in 2010, focused on funding rehabilitation services for short-sentence prisoners released from Peterborough Prison, and has experience developing and structuring Social Impact Bonds in a range of social issue areas.

Jane Newman
Jane joined Social Finance in 2012 as International Director. She leads work on developing an international network of impact investment intermediaries to develop Social Impact Bonds. She joined from The Social Investment Business, the UK's largest social investor, where she was Director of Governance and Company Secretary; prior to which she was a senior corporate partner at a leading international law firm, Simmons & Simmons, where she advised a wide range of clients across the commercial and financial sectors. She has broad international experience, leading transactions in a range of jurisdictions, and also held positions as managing partner of Simmons & Simmons' German operations and as head of its Mainland China office.

Peter Nicholas

Peter has over 25 years of management and project experience at the World Bank, including serving as Director of a five country Department in Southern Africa. He has focused on delivering projects with measurable and sustained impact, and on results-based country strategies. His experience ranges from environmental assessments to budget management, and from community-based social projects to the fiscal impact of mining investments. He has worked with countries in Africa, South Asia and the former Soviet Union, specialising in the development challenges of low-income and fragile states. He is also a Trustee of BRAC UK. Peter holds an M.Phil in Economics and a D.Phil in Philosophy from Oxford University.

Diane Mak

Diane joined Social Finance in June 2010. She is mainly involved in the development of Social Impact Bonds in the areas of children and families and international development. Prior to joining Social Finance, Diane worked at the International Growth Centre at the London School of Economics, which offers independent advice on economic growth to countries in Africa and Asia. She also worked as a financial consultant at the Ministry of Finance in Liberia. Before that, Diane worked in the Policy and Research team of Transparency International, where she was the contributing editor of the organisation's flagship publication, the Global Corruption Report. Diane started her career in the investment banking division at Citigroup Global Markets. Diane holds a Master in Public Administration in International Development from the Harvard Kennedy School, and has a BA in Economics from Trinity College, Cambridge.

Andrei Xydas

Andrei joined Social Finance in November 2013 as an Associate. She works on advancing the Development Impact Bond model. Andrei previously worked as a consultant at The Boston Consulting Group, where she had a focus on strategy in technology and the financial services sector. Andrei has also developed five-year country assistance strategies for the Pacific Islands at The World Bank and investment opportunities in social enterprises in India at Acumen. Andrei holds Bachelors of Laws and Commerce from The University of Melbourne. During her time at university, she successfully expanded Live Below the Line, then a pilot online fundraising campaign and now a multi-million dollar fundraiser, into the corporate sector.

Appendix 3 – List of Meeting and Workshop Attendees

BDS Workshop Attendees (Johannesburg)

Company	Representative
Awethu	Rob LeBlanc
Endeavor South Africa	Palesa Makanda
Growthpoint Properties	Shawn Theunissen
Optima	Michael Lombard Dr Johan Badenhorst
Raizcorp	Allon Raiz
SEDA	Lusapho Njenge
Start-Up Cherry	Paul Smith Justin Coetsee
the dti	Mzwanele Memani
Thomson Reuters Foundation	Nicholas Glicher
Tshikululu	Samantha Braithwaite Mpadi Makgalo

BDS Workshop Attendees (Cape Town)

Company	Representative
ANDE	Jenny Everett Nompu Ntsele
ASPEN	Jenny Everett Nompu Ntsele
Bridge Project	Camilla Swart
Business Bridge	Tom Parry Janine van Tonder
Business Partners Ltd	Nikita Mfenyana
Edge Growth	Greg McFarlane
Greater Capital	Bridget Evans
Impact Amplifier	Max Pichulik
Rand Trust Financiers	Jason Nicol
Relativ Enterprise Development	Gabrielle Habberton
Raymond Ackerman Academy	Elli Yiannakaris
Shanduka Black Umbrellas	Donavon Goliath
TSiBA	Adri Marais
Western Cape Economic Development Partnership	Phindile Tshabangu Christian Gable
Wize Impact	Alex Lemille

ASIB Advisory Group Meeting Attendees

Company	Representative
BLSA	Kirsten Kennedy
GIZ	Gavin Watson
SECO	Markus Schrader
Standard Bank	Justin Prozesky
the dti	Mzwanele Memani
Vumelana Advisory Fund	Brian Whittaker

Appendix 4 – Case Studies of Relevant International SIBs

UK: Preventative interventions targeted at disadvantaged youth

In 2012, the Department for Works and Pensions (DWP) in the UK commissioned ten social investment pilots to support disadvantaged young people aged 14 to 24. The programme's objective is to foster targeted and preventative interventions aimed at supporting young people into education, employment and training. The pilots are led by teams of investors and service providers who are paid tariffs for the following outcomes as they are achieved:

- Improved attitude, behaviour and attendance at school earn £700-1,400 per person
- High school and vocational qualifications earn £900-3,300 per person
- Entry into and sustained employment earn £2,000-3,500 per person

The programmes which are being delivered as pilots under this initiative include, e.g. a programme which offers professional mentoring to 1,750 young people for an intensive period of 6-12 weeks followed by on-going support through volunteer mentors and residential activity courses; a programme which pairs 1,152 young people in a supportive relationship with a disadvantaged pre-school child, designed to help the young person gain interpersonal skills and emotional literacy as well as qualifications.

New York State, USA: Re-entry into employment by offenders

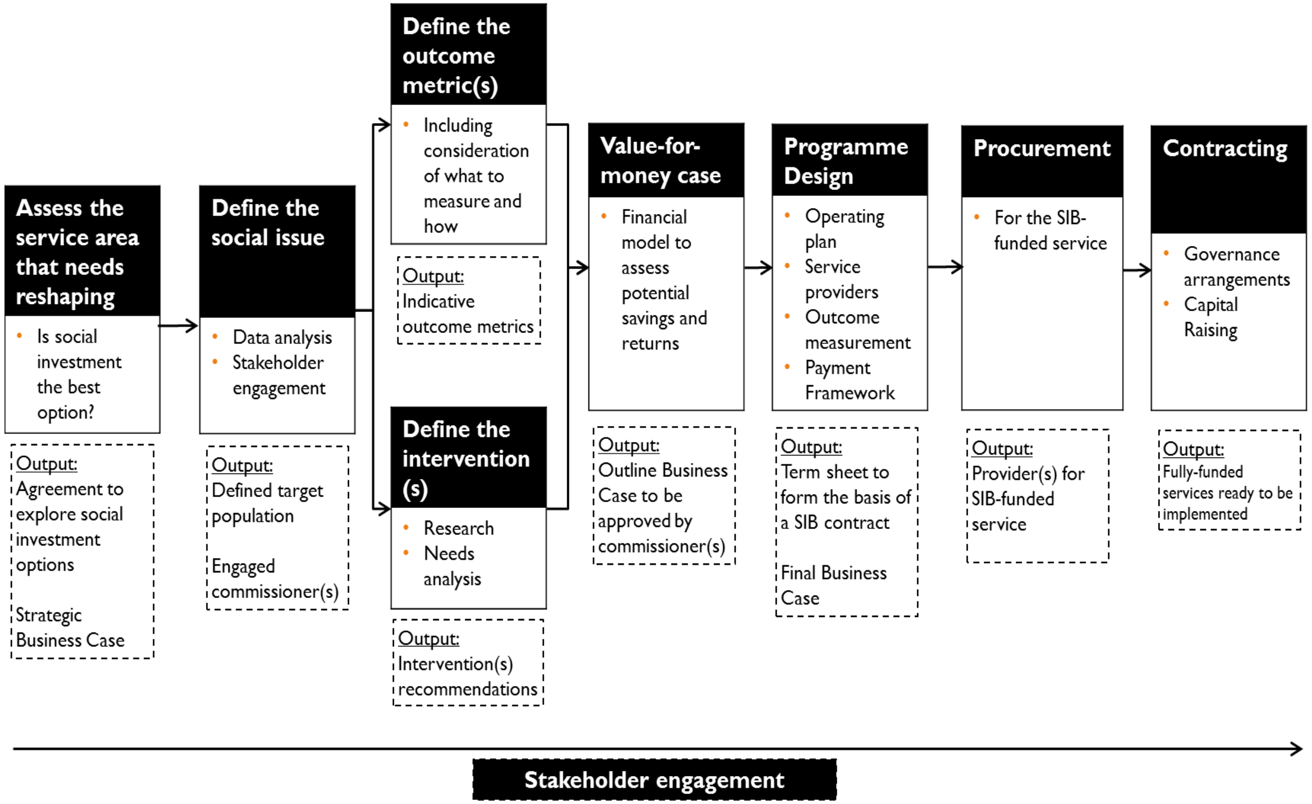
In December 2013, New York State launched a $13.5 million SIB to pay for comprehensive re-entry employment services for 2,000 ex-prisoners. Services include life skills, employment and retention support to be delivered over a four-year period, with the objective of breaking the cycle of recidivism while obtaining gainful employment.

Over 40 private and institutional clients of Merrill Lynch and U.S. Trust's wealth management business and other impact investors have invested in the SIB. All capital beyond a first-loss guarantee of 10 percent of total capital is at risk. For investors to be repaid the project must reduce recidivism by at least 8 percent or increase employment by at least 5 percent as established through a randomized control trial. If the programme performance exceeds this threshold, investors will earn a return that is proportionate to the savings and benefits achieved by the public sector. It is estimated that if the project achieves the highest anticipated performance level, the public sector would realise US$7.8 million in savings.

City of Rotterdam, The Netherlands: Reduction in youth unemployment

In December 2013, the City of Rotterdam raised £680,000 for a SIB focussed on reducing youth unemployment in the region. Over three years, the programme will provide mentoring and skills development to 160 unemployed young people who are disadvantaged in seeking employment (i.e. no high school diploma, criminal record, etc.). The City of Rotterdam has agreed to pay the investors, ABN AMRO and Start Foundation, a return for a reduction in time taken for young people to gain stable work, education or business ownership, compared to a baseline. The rate of return is capped at 11.3% per annum and has been developed to reflect a sharing of savings in unemployment benefits, which would otherwise be paid by the City of Rotterdam.

Appendix 5 – Process for Developing a SIB



Source: Social Finance

Appendix 6 – Key Lessons from Literature on BDS to SMEs

Entrepreneurial skills, measured by the education of business owners and their participation in training, explain a large share of the differences in productivity across firms and regions in developing countries. But entrepreneurs often do not recognize the relevance of management expertise (for example only 3 percent of Brazil's owners of micro- and small enterprises see management as a binding business constraint). And free markets fail to nurture entrepreneurship training, because knowledge spillovers allow some of the returns to acquiring/developing new managerial ideas to accrue to others.

Entrepreneurship can be fostered by direct exposure to advanced management practices and technologies (e.g. eight-month visits by Bangladeshi garment managers to Korean garment factories).

Imparting managerial capacity through management training is more difficult. While management training improves financial literacy and basic management skills of business owners, the impact is less robust in improving business outcomes and job creation.

Results improve if entrepreneurs are selected who have the highest potential and relatively better access to financial resources. The potential to absorb management practices differs greatly among beneficiaries,[23] and there are therefore significant returns to identifying in advance the highest potential businesses. This can be achieved through survey questionnaires designed to capture abilities, attitudes, and management scores of potential trainees.

Key lessons from recent experiments with management training are:

- Management training should be kept simple
- Vocational and business training work better than financial training
- Good teaching materials need to be readily available, and the total duration of the training program matters (100-200 hours seems optimal)
- Classroom teaching should be combined with instructors' visits to trainees on the job
- Training on maintaining control of production pace is crucial[24]
- Skills training combined with financing[25] has larger impacts on employment than skills training alone
- For women entrepreneurs the largest effects come from providing better access to credit

[23] For example, a study by Tokyo's Graduate Institute for Policy Studies concluded: "In earlier studies, the estimated training effects [of management education] were economically large but statistically insignificant or only marginally significant. Our results [in Kumasi, Ghana] suggest that such weak estimates come from large variations among the participants in terms of their own inherent abilities and education levels and their workers abilities and motivation. Probably, entrepreneurs' managerial abilities are more difficult to improve than workers' skills. Unlike vocational training, a management training program may improve the managerial abilities of only a few participants.

[24] A study by Sonobe, Higuchi and Otsuka concluded: "… particularly important for MSEs is to keep control of the production pace because wild fluctuations in production make the expansion of employment size highly risky and cause overproduction and other wasteful uses of resources. For MSEs, it should be useful to teach the importance of record keeping and pricing based on the analysis of records and basic knowledge of marketing and workshop housekeeping."

[25] Financing being one or more of: (micro) credit for business; consumer loans; cash and in-kind grants; and access to financial products such as saving accounts.

- Work experience in large productive firms may the best form of management training

Training programs can be implemented and provided by private providers, but governments have a role to play as long as there are knowledge spillovers and the importance of management expertise is undervalued. Randomized experiments in Ghana, Tanzania, and Vietnam indicate that the benefit of training programs generally outweigh the cost.

The intangible quality of entrepreneurship is critical. As the study by Sonobe, Higuchi and Otsuka[26] puts it:

> "The provision of basic management training is not enough to help firms grow dynamically so that they can create ample job opportunities. Dynamic firm growth is a result of multifaceted innovation led by entrepreneurship. Thus, it is important to nurture entrepreneurs' innovative capacity. Compared with managerial capacity, innovative capacity in general is probably more elusive and accordingly more difficult to teach to entrepreneurs. Nonetheless, our review of dynamic cluster development suggests that there is a common pattern: dynamic clusters in different sectors in different countries have shared similar experiences of a series of innovations starting with product quality improvement followed by branding, improvements in marketing, strengthening relationships with suppliers, and improvements in management of labor, inventory, and finances. This finding brings new hope: entrepreneurship relevant to industrial development in low-income countries may be taught."

Improvements in profitability and output from management training do not necessarily result in net job growth. It is worth quoting the results of a management training RCT in Mexico in full:[27]

> "Our results suggest that lack of managerial skills constitutes a significant constraint to firm growth and the ability of micro, small, and medium enterprises to withstand economic shocks. The effects of the study are large. On average we find an increase in sales and profits of 80 and 120 percent, respectively, for the treatment group compared to the control group. However, we believe that the magnitude of the impact is not unreasonable given that many enterprises in the sample had not received any formal management training prior to our intervention. The sales and productivity improvements seem to be brought about primarily by improvements in marketing and financial controls. Consultants also appear to have helped enterprises to set clear goals and define a strategy for how to achieve these goals.
>
> "In contrast, we do not see any significant impact on employment generation or the number of employees. One can only speculate whether the scope of the intervention was not long or significant enough to affect employment, or whether the decision to hire additional workers would have to be preceded by even larger or more sustained increases in output. Alternatively, some recent studies suggest that there is large heterogeneity in the willingness of small businesses to expand which may be due to variation in the owners' objective function (see for example Hurst and Pugsley 2011)…Overall our results suggest that managerial inputs have a large and important impact on firm performance. However, there is still much to learn about the way this information affects firm performance as a whole and more specifically how it interacts with the marginal productivity of inputs such as labor and capital. In addition, while there may be a lot of heterogeneity in effects our sample is not large enough to allow us to look at all the firm level interactions that might be of interest, such as competitive nature of the industry, age and gender of the owner, owner's ambition level, risk taking ability, or general skill levels. We believe this is a critical area for further research."

[26] Sonobe, T., Higuchi, Y. and Otsuka, K. (2012).

[27] Bruhn, M., Karlan, D.S. and Schoar, A.S. (2012).

Appendix 7 – BDS Environment in South Africa

SME Landscape of South Africa: Overview

Defining SMEs

The National Small Business Act of 1996 categorises small businesses in South Africa into four distinct groups: survivalist, micro, small and medium. This has evolved into the term 'SME' i.e. Small, Medium and Micro-Enterprises when referring to only formal businesses i.e. registered tax entities. The table below details broad definitions of SMEs:

Table 1: SME Definition according to National Small Business Act

Enterprise size	Number of employees	Annual turnover (ZAR)	Gross assets, excluding fixed property
Medium	Fewer than 100 to 200, depending on industry	Less than R4m to R50m, depending on industry	Less than R2m to R18m, depending on industry
Small	Fewer than 50	Less than R2m to R25m, depending on industry	Less than R2m to R4.5m, depending on industry
Very small	Fewer than 10 to 20, depending on industry	Less than R200,000 to R500,000, depending on industry	Less than R150,000 to R500,000, depending on industry
Micro	Fewer than 5	Less than R150,000	Less than R100,000

Source: National Credit Regulator, Literature Review on Small and Medium Enterprises' Access to Credit and Support in South Africa, 2011

Although the terms 'SME' and 'SME' (Small and Medium Enterprises) are used interchangeably in South Africa, this research project will focus on the latter, excluding survivalist micro-enterprises. Survivalist enterprises are generally considered to be pre-entrepreneurial, exhibit substantial, complex factors of failure and have owners who would prefer formal employment.

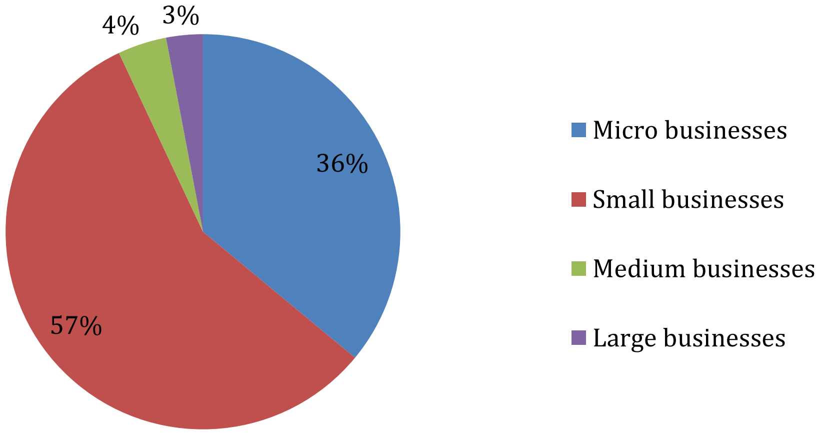
Size of the SME sector in South Africa

According to a recent FinScope *Small Business Survey*[28], there were 5,979,510 small businesses, accompanied by 5,579,767 small business owners[29], in South Africa in 2010.

A 2008 report by the dti cites the following breakdown of the number of enterprises by size:

[28] Grundling, I. and Kaseke, T. (2011).
[29] These are individuals aged 16 years and older.

Figure 4: Number of enterprises by size (2007)



Source: The dti, Annual Review of Small Business in South Africa 2000 – 2007, 2008

The report also states that over the 2004-2007 period, the SME sector grew by 27%. From these enterprises, medium-sized businesses grew by 208% while micro enterprises decreased by 5.6%.

Potential

The Finscope survey reports estimates that, excluding entrepreneurs themselves, small businesses have the potential to create a further 6 million jobs. A 2007 National Credit Regulator report, states that the South African SME sector contributes 39% to GDP, with 22 SMEs for every 1,000 people.[30] While in many developed countries informal businesses are considered marginal in their contribution to employment and GDP, in South Africa these informal and micro-enterprises are key to the livelihood and survival of millions of people[31].

Note: for the purposes of the SIB pilot it is best to focus on formalised businesses with established track records so as to facilitate evidence-based analysis for validation of the model.

Sector Distribution

The table below shows the different sectors, and percentage size, across formal and informal businesses.

[30] Mahembe, E. (2011).
[31] Mahembe, E. (2011).

Table 2: Difference in sectors by formal and informal SMEs

Formal sector			Informal sector		
Sector	**Examples of SMEs**	**% of total SMEs**	**Sector**	**Examples of SMEs**	**% of total SMEs**
Financial Intermediation, Insurance, Real Estate and Business Services	• Accounting firms • Real estate agents • Financial advisers • Insurance agents	44%	Retail trade	• Traders in agriculture raw materials, food, beverages and tobacco • Motor vehicle repairs • Electrical repairs • Take-away counters • Caterers	52%
Wholesale and Retail Trade, Repairs, Hotels & Restaurants	• Auctioneers • Traders in agriculture raw materials, food, beverages and tobacco • Motor vehicle repairs • Electrical repairs • Guest lodges • Restaurants • Take-away counters • Caterers	23%	Manufacturing	• Textile processing (Cut, Make and Trim) • Agricultural processing (meat and dairy products) • Baked goods • Furniture and carpentry businesses	12%
Manufacturing	• Production and processing of meat products • Manufacturers of canned products • Dairy processors and packagers • Manufacturers of baked goods • Telecommunication manufacturers and providers • Textile preparation and finishing • Publishing and printing businesses	11%	Community, Social and Personal services	• Waste collectors • Taxi drivers • Home-based care workers • Hairdressing services • Beauty services	10%

Source: Genesis Analytics, and the dti, Annual Review of Small Business in South Africa 2000 – 2007, 2008

Geographical focus

Most SMEs are found in *four provinces* in South Africa: Gauteng, Western Cape, Kwa-Zulu Natal and Eastern Cape.[32] While Gauteng accommodates high numbers of both informal and formal enterprises, the Western Cape cites more formal businesses with the latter three dominated by more informal enterprises. In particular, a high prevalence of entrepreneurs is located in North-West, Free State, Eastern Cape and Northern Cape.[33]

To be discussed: will the SIB focus on businesses or entrepreneurs (or both) as beneficiaries? This is a crucial distinction as it will inform the selection criteria for service providers and the outcomes metrics which we use.

Barriers and Failure Rates

According to 2013 data,[34] South Africa stands at 53 in the ranking of 185 economies for the ease of starting a business. While this is better than Turkey, Thailand, Botswana and Nigeria, there is definitely still room for improvement. This is particularly the case in the SME sector that, in general, is characterised by high failure rates.

The 2012 Global Entrepreneurship Monitor report estimates that only 2.3% of South Africans own businesses that have been established for over three and a half years, indicating a high failure rate among start-ups.[35]

The reasons for failure are variable: the *2010 Finscope South Africa Small Business Survey* found that 39% of respondents cited money-related issues, 34% strategy related issues and 17% infrastructure-related issues[36] as obstacles to growth. The survey also revealed that 41.8% of small business owners do not use any type of financial products but rely on family and personal capital. In addition, the Global Entrepreneurship Monitor report[37], supported by the Branson Centre of Entrepreneurship, revealed that many young entrepreneurs do not have any business mentors to turn to for advice.

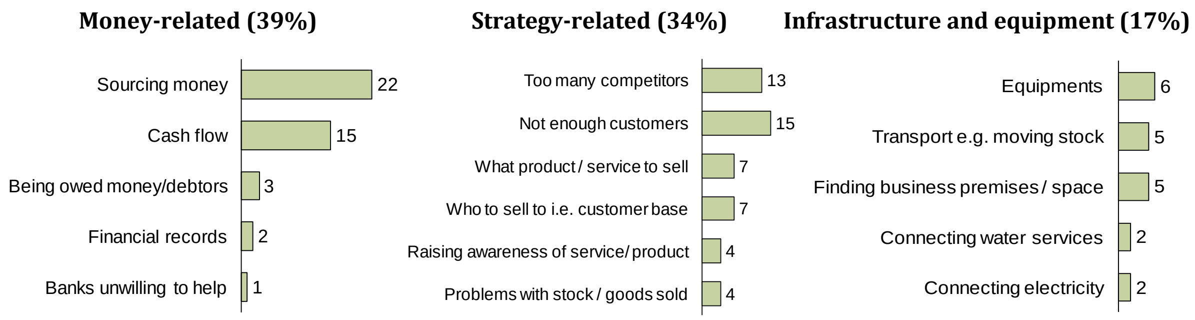
Box 1: Entrepreneurship and competitiveness

Entrepreneurship is a precondition for any business. In this regard, South Africa is an underperformer. The latest report by the Global Entrepreneurship Monitor shows how far behind its peers South Africa has fallen. As a developing country, its entrepreneurial uptake should exceed some 10% of the adult population. But as things stand, its entrepreneurial uptake is closer to that of a poorly performing developed country. Only around 7% of South Africa's adult population is involved in early-stage entrepreneurship – in other words, with start-ups and young firms. Another 2% is operating firms that have been in existence for more than three and a half years. The latter figure places it in last place in the entire study, sharing this spot with Panama and Russia. Against this, around 15% of Brazilians are in early-stage entrepreneurship, while another 15% operate established firms.

Source: SBP Alert, Issue Paper 1, 2013

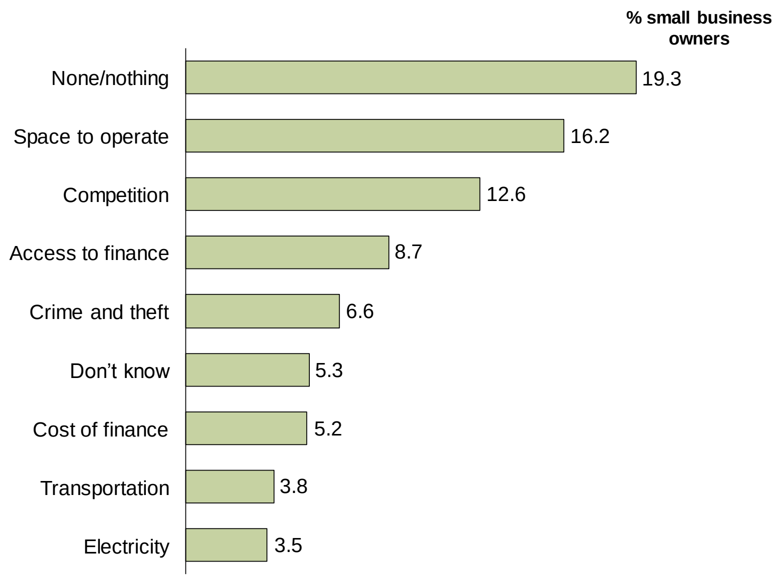
[32] Department of Trade and Industry (2008).
[33] Grundling, I. and Kaseke, T. (2011)
[34] The World Bank and IFC (2013).
[35] SBP (2009)
[36] These include lack of access to telecommunication infrastructure, electricity, roads etc.
[37] Branson Centre of Entrepreneurship (2011).

Figure 5: Major obstacles faced by small business owners in South Africa



Source: FinMark Trust, Finscope South Africa Small Business Survey, 2010

Figure 6: Other obstacles faced by small business owners in South Africa



Source: FinMark Trust, Finscope South Africa Small Business Survey, 2010

The sectors with the highest shares of liquidations in the 2006-07 period were wholesale and retail trade (31%) and financing, insurance, real estate and business services (40%). This is likely due to low barriers to entry and high rates of competition, as well as adverse market conditions in the property sector (for real estate agencies).

BDS Landscape

BDS is defined by the 2004 UNDP 'BDS How-to guide' as

> *"... services that improve the performance of the enterprise, its access to markets, and its ability to compete. The definition of 'business development service' includes an array of business services (such as training, consultancy, marketing, information, technology development and transfer, business linkage promotion, etc.), both strategic and operational."*

Various forms of BDS are able to address obstacles faced by SMEs. Details of the main types of BDS commonly offered in the South African context, are given in the table below:

Table 3: Types of BDS offered in South Africa

Type of BDS	Description	Examples
Market access	Identification of and assistance in problem areas with regards to market access	• Market research • Advertising • Subcontracting and outsourcing
Infrastructure	Provision of infrastructure and other physical business requirements	• Storage and warehousing • Internet access • Office space
Training	Provision of general training on business management	• Financial and tax advice • Management training • Mentorship
Technical Assistance	Provide assistance on issues that are specific to the type of business and its offering	• Business incubators • Investment readiness services • Technical expertise
Technology and product development	Facilitation of technology transfer and commercialisation	• Link with technology suppliers • Quality Assurance programmes

Source: Adapted from UNDP, BDS How-to Guide, 2004

BDS typically focuses on services but financial support to SMEs does often accompany BDS and can include debt and equity financing or capital guarantees.

There have been two schools of thought to BDS:

1. ***Traditional Development approach:*** Here a BDS organisation, through public subsidies, provides BDS directly to SMEs at no or very low cost. Intervention occurs as a direct provision by a single institution. Intervention is often provided in the form of direct financing. The aim is for SMEs to become financially sustainable as financing or funded BDS is withdrawn. Reality has shown this is rare and can result in serious market distortions for existing service providers.

2. ***Market Development approach:*** This is a relatively newer approach where an organisation facilitates a more *sustainable* increase in demand and supply of BDS. In this

case, organisations are encouraged to provide services to SMEs on a commercial basis, as opposed to public or donor subsidies. The ultimate goal of this BDS approach is to enable SMEs to buy services of their own choice from a wide array of products offered; thereby ensuring BDS services are appropriately structured and priced. In addition, service providers are held accountable to the needs of the purchaser and not a third party financier.

Government initiatives often follow the Traditional Development approach with large amounts of subsidised funding on offer. Facilitated by the dti and associated organisations, examples include:

- the Centre for Small Business Promotion
- the Small Enterprise Development Agency (SEDA)
- National Youth Development Agency
- Khula Enterprise Finance
- the National Empowerment Fund
- the Industrial Development Corporation SME Support Programme
- the Land Bank
- the Tourism Enterprise Programme[38].

However, research has found that many SME's are unaware of such Government initiatives. The quality of these free services also remains questionable.

Private not-for-profit initiatives that deliver BDS through the traditional approach include:

- Anglo Zimele
- Mondi Zimele
- Sasol Chem City
- SAB Kickstart Foundation.

Such private initiatives are generally integrated into larger corporations' CSI plans. These programmes often offer linkage opportunities to SMEs through preferential procurement policies such as set-asides, early payments and premium prices.

The following table details the types of services offered using the Traditional Approach in South Africa.

[38] *Boosting small businesses* (n.d.).

Table 4: Traditional model: Selected BDS Providers in South Africa

Business Development Services						Financial support	
Service provider	**Market access**	**Infrastructure**	**Training**	**Technical Assistance**	**Technology and product development**	**Grant support**	**Alternative financing[39]**
SEDA	✓	✓	✓		✓		
Khula Enterprise Finance Ltd.		✓	✓				✓
National Youth Development Agency			✓				✓
Anglo Zimele	✓		✓	✓		✓	
Sasol Chemcity		✓	✓	✓	✓		✓
PPC Ntsika Fund			✓	✓			✓
SAB Kickstart			✓			✓	

Source: Genesis Analytics and the dti, National Directory of Small Business Support Programmes, 2010

[39] This includes debt and equity financing as well as alternate financing such as capital guarantees

The Market Development approach in South Africa has gained momentum in recent years. For-profit BDS providers include Raizcorp, Edge Growth, Aurik, Shanduka Black Umbrellas and Bandwidth Barn. Typically, these organisations operate on a for-profit basis with commercially based prices and/or returns. Alternatively, they extend preferential procurement policies alongside BDS to SMEs who may be integrated into a corporate supply chain. In line with the market development approach, grant support is often not a feature.

Table 5: Market Development model: Selected BDS Providers in South Africa

	Business Development Services					Financial Support	
Service provider	**Market access**	**Infrastructure**	**Training**	**Technical Assistance**	**Technology and product development**	**Grant support**	**Alternative financing[40]**
Raizcorp[41]	✓		✓				✓
Edge Growth	✓	✓	✓		✓		✓
Aurik	✓		✓	✓	✓		
Shanduka Black Umbrellas	✓	✓	✓	✓	✓		
Awethu	✓	✓	✓	✓	✓		✓

[40] This includes debt and equity financing as well as alternate financing such as capital guarantees.
[41] Approximately 86% of Raizcorp's partner companies have a growth rate in excess of 15% per annum. Over a period of 1 to 2 years, Raizcorp has managed to increase the turnover and profitability of over 95% of its partner companies. (C4G (2013).).

Without considering the growth stage of an SME, BDS intervention may be misplaced and inappropriate. Formal SMEs often follow the following progression with differing BDS needs accompanying each phase.

Table 6: Stages of business growth

Stage	Critical development area	Overriding objective
Start up	Market and product development	Proof of business concept
Expansion	Resources and operational systems	Scale up
Professionalisation	Management systems	Transition to professional management
Industry lead	Replication of cycle	Diversification
Maturity	Revitalisation	Exit or restart growth

Source: Genesis Analytics, adapted from Management Systems, Stages of Organisational Growth, 2012

Concluding note

Initial research suggests that any SIB would most likely be structured around formal SMEs who are fast growing, with some track record in a sector that is characterized by a sufficient number of SMEs and demand-driven growth.

The appropriate cohort will be identified in the research.

Appendix 8 – List of BDS Providers in South Africa

Note: This is not a comprehensive list of BDS providers in South Africa.

ABSA Enterprise Development Centres (EDCs)
Accel Enterprise Development Programme (Part of Bandwidth Barn)
Ackerman Pick 'n Pay Foundation
Anglo Zimele
Ashoka Innovators for the Public
Aurik
Awethu
Black Business Suppliers Development Programme (part of dti)
BLSA (Beyond Advocacy)
Brain (Business Referral and Information Network)
Branson Centre of Entrepreneurship
Business Bridge
Business Partners Ltd (formerly Small Business Development Corporation)
Business Partners Mentors
Business Place (The)
Cape Agency for Sustainable Integrated Development in Rural Areas (CASIDRA); Red Door
Cape IT Initiative (CITI)
Clothing Bank (The)
Coega Development Corporation
De Beers Zimele
Deloitte Success Campaign
dti
East London IDZ
Eastern Cape Development Corporation
Eastern Cape Tourism Board
Edge Growth
Enablis Financial Corporation SA
Endeavor South Africa
Enterprise Room (Large number of bluechip clients including Hollard, Discovery, Mnet, MTN, Telesure)
Entrepreneurs Organisation
Founders Institute
FRAIN (Franchise Advice and Information Network)
Free State Development Corporation (FSDC)
Gauteng Economic Development Agency
Gauteng Enterprise Propeller (GEP)
Goldman Sachs 10 000 women (delivered by GIBS)
Government Support for Women in Construction (WIC)
Gro-eScheme
Human Initiative Restructures Society (HIRS)
Impact Amplifier
Industrial Development Corporation SME Support Programme
Institute for Business Advisors
Isivande Women's Fund
Ithala Development Finance Corporation (KZN)
Job Creation Trust
Khula Enterprise Finance (now known as SEFA)
Khutaza Women in Housing
KZN Trade and Investment (TIKZN)

Landbank
Limpopo Business Support Agency (Libsa)
Limpopo Economic Development Agency
Limpopo provincial department of Economic Development and Tourism
Limpopo Tourism Authority
Maadima Foundation (Construction)
Matiegemeenskapdiens
Mondi Zimele
Mpumalanga Economic Growth Agency
Mpumulanga - Support for SMEs
MTN South Africa Foundation
Namac Trust (National Co-ordinating Office for Manufacturing Advisory Centres)
National Business Initiative (NBI)
National Empowerment Fund
National Productivity Institute
National Youth Development Agency
Ndiza
New Partnership for Africa's Development (NEPAD): Spanish Fund for African Women Empowerment
North West Development Corporation
North West Invest
North West Parks & Tourism Board
Northern Cape Department of Economic Affairs and Tourism
Northern Cape Economic Development Agency
Oceana Enterprise Development
Old Mutual Masisizane Fund
Optima
PPC Ntsika Fund
Productivity SA turnaround programme & workplace challenge
Raizcorp
Raizcorp ARIZE Enterprise Development Program
Red Door
Risk Capital Facility Program
Royal Bafokeng Enterprise Holdings (RBIH)
SAB Kickstart/Foundation
Sasol Chemcity
SEDA (Small Enterprise Development Agency)
SEFA (Small Enterprise Finance Agency) - merger between Khula Enterprise Finance Ltd. and small business activities of the IDC
Shanduka Black Umbrellas
Shell Live-Wire
Sirolli Institute (US)
Siyakhula Business Consulting
Sizanani
South African Women Entrepreneurs' Network (SAWEN)
South African Women in Construction (SAWIC)
South African Women in Mining (SAWIM)
Soweto Centre for Small and Medium Enterprise Development
Spinnaker Consulting (Growth Partners)
StartUp Cherry
Teba Development
Technology for Sustainable Livelihoods
Technology for Women in Business
Technology Innovation Agency (TIA)

THETHA (Tourism, Hospitality and Sport Education and Training Authority)
Tourism Enterprise Programme
Transformation and Entrepreneurship Scheme
Transnet Canteen Project
Transnet Enterprise Development Hub
Transnet Foundation (The Dept of Public Enterprises)
Transnet Itireleng Fund (with GEP)
Transnet, SEDA Supplier Development
Transnet, Shanduka Black Umbrellas Incubation
Tshumisano Trust (Technological Innovation Agency entity)
TSiBA
UCT Centre for Innovation and Entrepreneurship
Umsobomvu Youth Fund (rolled up into NYDA)
VisionSpring
Vodacom Community Phone Project
Woesa (Women in Oil and Energy) SA
Women in Construction (WIC) - Government Support
Women in IT Forum
Women's Enterprise Development initiative of South Africa (Wedisa)
Women's Development Business

Appendix 9 – Investigation of Investor Interest in SIBs in South Africa

Written by Sue de Witt

Context and research questions

The study has been conducted in the light of the critical state of global public finances, the growth of the SIB market around the world and the growing interest in SIBs in South Africa. South Africa has context specific determinants that preclude directly extrapolating from similar studies undertaken on the UK and USA on impact investors generally and SIB investors specifically (Godeke Consulting, 2012)(ClearlySo, 2011)(World Economic Forum, 2013).

Private primary investors assume all or most of the financial risk so it is essential that SIBs be priced correctly in order to attract investment. Price discovery is complicated by the calculation of cashable government savings and the lack of a secondary market. Cashable savings include cross sector and long-term gains. By enhancing our understanding of what South African investors value, governments and intermediaries will be in a much better position to structure the instrument in a way that will attract capital.

The research questions were designed to unearth those values and preferences.

- What returns do primary investors hope to achieve?
- What risks are primary investors most concerned about?
- What reservations are there around pricing a new instrument?
- What other factors will influence primary investor interest in SIBs?
- What trajectories will the SIB market follow and what purpose are they likely to fill in public sector finance in South Africa?

Research methodology

Semi structured interviews were conducted with 19 potential primary investors and 6 current stakeholders. During analysis of the data three groups of investors emerged according to their priorities and the South African legislation that most affects their investing decisions. These groups were labelled Foundations, Corporates and Commercial Investors. Foundations include private and corporate foundations, trusts, philanthropists and those providing financial, legal and due diligence services to these investors. Corporates include private companies, ED fund managers and CSI strategists. Commercial Investors include pension funds, asset managers, impact investors and those responsible for investing the endowments of foundations or trusts. The findings were ordered according to prevalence of opinion for each question.

Findings and recommendations

Foundations

Foundations primarily seek social impact and mission alignment when it comes to grant making and most are happy to collaborate with the government to increase their footprint. Impact investing is relatively new in the space although foundations are eager to participate especially as transactions are made easier by the presence of philanthropy focussed service providers. They are unlikely to make impact investments from endowment capital. The main risk identified was that of potential project failure. Adequate due diligence and strong personal relationships were cited as possible mitigation strategies. They are unlikely to be intimately involved in the pricing process. There is degree of uncertainty around how SIBs will be treated by SARS although they are to be added to an application on behalf of philanthropists to alter prohibitive tax laws.

Recommendations

- Investor education
- Provide capital guarantees to attract commercial investment to increase footprint
- Pool funds to spread risk
- Create tax incentives to attract more capital or at least streamline current legislation to simplify process

Corporates

Any SIB investment on the part of corporates is likely to be made in an effort to gain BBBEE points. An interesting exception to that prevailing opinion may be mining houses that are required to spend over and above the scorecard requirement and could invest in an initiative that had a tangible direct benefit for the company. SIBs are likely to feature in this spend only if they comply with the dti requirements and if they are as simple to invest in as current investment options are. The main risks identified were those of accountability within the partnership and sustainability of the intervention in the long term. Corporates expressed a desire to sit in on the pricing process.

Recommendations

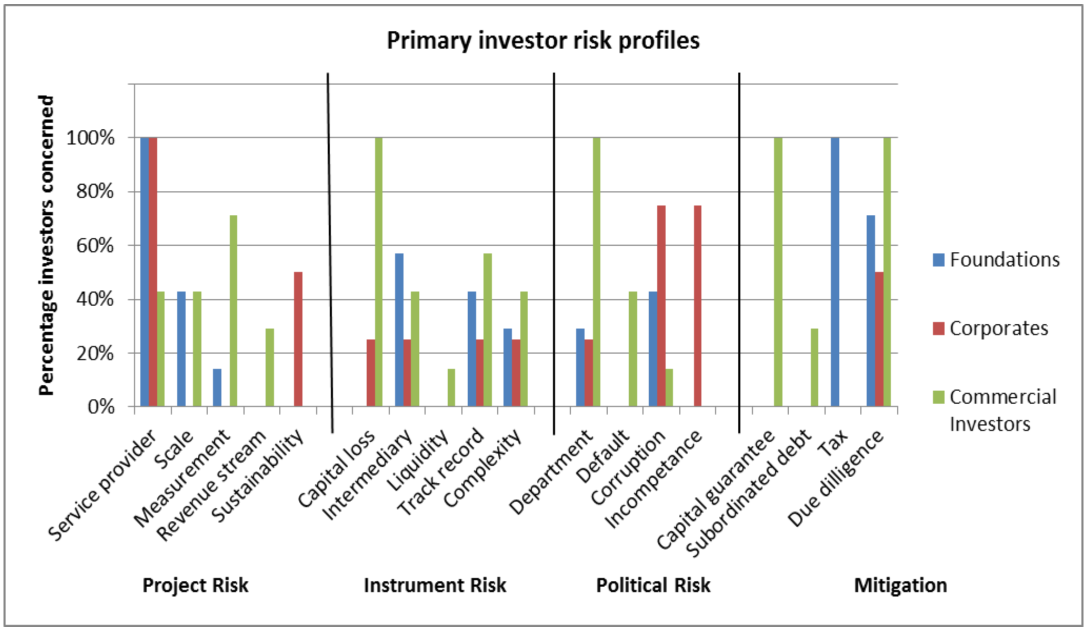
- Ensure BBBEE compliance
- Simplify investment process
- Suggest plausible business case where SIB intervention will directly impact bottom line

Commercial Investors

Fund mandates and fiduciary duties are of paramount importance to institutional investors. Regulation 28 has delivered on its promise to limit risk in retirement portfolios by diversifying assets but is yet to catalyse the impact investment market. All commercial investors desire a risk adjusted market related return from a SIB investment. All those interviewed would place the asset in an existing SRI fund structure. The overriding risk identified was that of capital loss as an indirect result of the SIB structure, a direct result of project failure or a failure of government to pay out. Credit enhancement and track record are essential to buy in as are accurate outcomes measurements, strong service providers and intermediaries and National Treasury backing. Most commercial investors are used to complicated finance structures and would most likely be involved in the pricing process.

Recommendations

- Provide credit enhancement in the form of capital guarantees and subordinated debt structures
- Create government outcomes fund to ring fence payments
- Create risk and incentive sharing structures within SIBs that include the service providers and intermediaries
- Outsource due diligence to local experts


Primary investor risk profiles
Percentage investors concerned
100%
80%
60%
40%
20%
0%
Service provider
Scale
Measurement
Revenue stream
Sustainability
Capital loss
Intermediary
Liquidity
Track record
Complexity
Department
Default
Corruption
Incompetance
Capital guarantee
Subordinated debt
Tax
Due dilligence
Project Risk
Instrument Risk
Political Risk
Mitigation
Foundations
Corporates
Commercial Investors

Appendix 10 – Other Sectors Possibly Suitable for SIBs

Based on the criteria outlined in this report for developing SIBs, initial assessments of the Early Childhood Development, Education and Health sectors reveal potential attractiveness for SIBs.

Early Childhood Development

- From both international and South African research, significant evidence around the effectiveness and long term outcomes of specific Early Childhood Development related interventions
- Early Childhood Development is a high priority issue for national and provincial governments and has substantial interest from international and local donors
- Early Childhood Development centres and non-centre based interventions are routinely underfunded and South Africa currently lacks a comprehensive Early Childhood Development design at both the provincial and national levels

Education

- Evidence from around the world shows that the returns from education are significant, with properly educated and trained individuals earning as much as 58% more than those with poor schooling (e.g. as is the case with Ghana's Technical and Vocational Education and Training program)
- Education is a key area for the South African government to improve, with unsatisfactory maths and science standards in particular (a recent ranking places South Africa second last in the world, after Yemen, in this regard[42])
- Outcomes such as improved literacy and numerical skills, exemptions as well as job readiness can be measured through standardized testing and benchmarked, whilst outputs such as time spent in class (attendance) can be useful proxies to monitor intermediate progress and efficacy of interventions

Health

- Health interventions are historically reliant on evidence-based practice and could potentially lend themselves to SIB structures. The link between preventative interventions and cost savings (from reduced acute treatment) is particularly evident for health outcomes
- There is significant political will and economic incentives to combatting health challenges in South Africa, particularly among diseases such as HIV / AIDs and Tuberculosis
- For some interventions, measurement of results may be particularly problematic based on a lack of benchmark data, yet there has been substantial work done internationally on data collection in health interventions
- Despite state resources, health interventions are often underfunded with traditional donor funding to South African NGOs continuing to decrease as the country develops

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[42] Evans, S. (2013).