



The New Missing Middle in Development Finance

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THE ISSUE

- The global micro, small, and medium enterprise (MSME) landscape faces a significant finance gap in the mid-late growth stage of innovation. This stage is critical as it is often the time when viable ideas turn into profit-making businesses. This financing gap is seemingly impenetrable for some of the current development finance actors who are unwilling to accept the marginally lower financial returns inherent to this critical stage of innovation.
- This brief looks at how blended finance tools can be used to structure an appropriate investment vehicle that can catalyze private capital and bridge the gap between the high-risk and low-risk stages of innovation.

INTRODUCTION

Over the past few decades, the economic landscape in the developing world has undergone a radical transformation. Net foreign direct investment inflows into the developing world constituted just 17 percent of the global investment share at \$34.65 billion in 1990; by 2014, that share had tripled, with developing economies receiving 51 percent (or \$685.29 billion) of total investment inflows.¹ During this period, per capita incomes expanded by nearly six times while the global poverty rate dropped by 72 percent, led by India and China, where hundreds of millions were lifted out of abject poverty. Despite this remarkable and unprecedented socioeconomic progress, the developing world continues to face significant challenges as it strives to catch up to wealthy and industrialized nations in the global economy.

International development practitioners have come to realize the value of the private sector on this journey. Development finance increasingly is seen as a critical complement to foreign aid that plays a more important role in the private sector as a country becomes more

developed. But within the development finance world, there is growing concern that something is missing. There are several stages of innovation, all of which require tailored financing: startup, early-mid growth, mid-late growth, scale, and expansion. The risk to returns on investment declines progressively with each successive stage. The developing world has some access to capital from angel networks, incubators, and crowd-funding institutions that can help sustain start-ups, which are inherently riskier investments. New pools of capital (e.g., philanthropy and crowdfunding) are supporting early-stage **start-ups**. Development finance institutions (DFIs), multilateral development banks (MDBs), and even private venture capital help bring businesses to **scale** with equity players and others available for **expansion** capital.

But do most businesses really go from startup to scale and then to expansion as previously thought? Some in the finance world agree that there is a necessary “early” (or “growth”) stage after the project starts up and before it goes to “scale.” This policy brief posits that the **growth** stage is critical and that getting it right will require different, more

blended finance tools and approaches than are typically offered.² Furthermore, the brief identifies two distinct sub-stages within the growth stage and discusses how blended finance can bridge an important resource gap.

Getting the right financing for the critical growth stage in the developing world will require different blended finance tools and approaches than the ones typically offered.

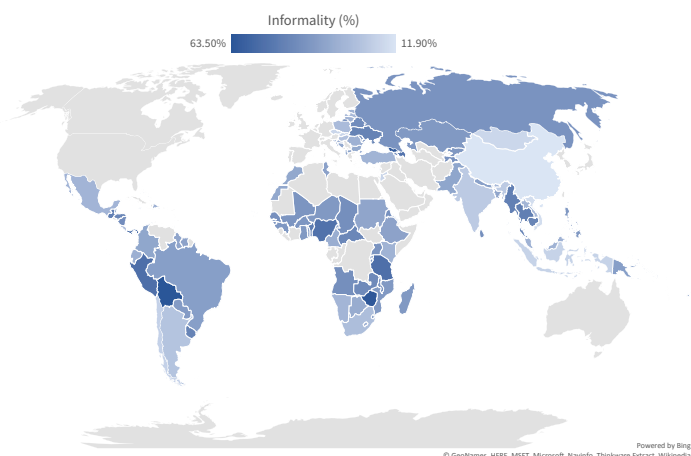
UNDERSTANDING THE CONSTRAINTS

Developing countries need financial resources to support economic growth and social progress. These resources can come in the form of external flows such as foreign aid (which includes concessional lending and grants), foreign direct investments, and commercial finance (debt and equity). Foreign aid is largely based on grants or concessional lending, which are made without an explicit desire for profits, whereas market returns are expected from commercial investments in emerging markets. Countries also rely on internal resources, such as taxes, savings, and fees.

However, private-sector firms in developing countries are constrained in mobilizing finances from non-foreign aid channels and are constrained in growth. Chief among these constraints is informality. More than 80 percent of the world's enterprises employing 60 percent of the global workforce operate in the informal sector.³ Nearly 1.7 billion adults conduct business outside the formal banking system and have few to no mechanisms to borrow from formal and regulated creditors. Informal credit can be available in some places, but these sources often come with unsustainably high interest rates, limited credit lines, lack of a clear and enforceable contract, limited means for arbitration and dispute resolution, and other significant risks. Institutionalized capital markets and local banking systems also can help channel savings from domestic and foreign sources into productive investments. Investors also need a functioning capital market to divest and exit the market without undue restrictions. Yet these markets remain highly underdeveloped, especially in low-income and fragile- and conflict-afflicted states.

Nearly 600 million new jobs will have to be created over the next decade to meet the needs of a growing labor force.⁴ Greater levels of financial inclusion—especially for women—and greater formality are prerequisites for the transformative

Figure 1: Informality in the Developing World



Source: "MSME Finance Gap," IFC.

economic growth needed for job creation. Although there are some "low-hanging fruits" that could use such capital today, many countries will reap the benefits discussed in this brief only when their economies formalize. Besides addressing these constraints, developing countries also will need to strengthen their institutions. This should result in a stronger rule of law and more robust enabling environments for businesses and investments, both of which are critical to private sector-driven economic growth.

The challenges posed in countries afflicted by fragility and conflict are more acute than other developing countries. Despite a fifth of the global population expected to continue living in such countries, their economies have deeper financing constraints underpinned by low state capacity, underdeveloped domestic capital markets, higher risks to investments, and a harsh investment climate.⁵ Fragile and conflicted-afflicted states will need more differentiated approaches to development than more established middle-income countries. These include:

- targeted financing for firms that have the capacity to foster increased social cohesion;
- supporting pioneer firms and complementary investments that can lead to investment clusters; and
- creating new financing instruments and development funds that serve as exclusive platforms for coordinating activities and investments that counter violent extremism.⁶

Simultaneously, domestic markets must be developed that can attract private capital investments at home and abroad. Micro, small, and medium enterprises (MSMEs) will need to assume a greater share of responsibilities to advance sustainable economic development. Innovation will remain

a critical component for all developing countries as they seek solutions to development problems. In this regard, the types and amounts of financing made available for company start-ups across different country contexts—from fragile to stable and everyone in between—must be increasingly tailored.

THE GLOBAL MSME FINANCING LANDSCAPE

MSMEs are critical creators of employment and drivers of economic growth. According to the International Labour Organization, approximately 35 percent of formal private enterprise employees worldwide worked in an MSME in 2016.⁷ Other estimates from the OECD put the number at 50 percent of global employment.⁸ Nonetheless, MSMEs in developing countries cannot grow, in part because they lack adequate financing instruments. Studies point out that the MSME financing gap stands at approximately \$5 trillion.⁹ More than three-fourths of this gap is localized to upper-middle-income countries, with lower-middle-income and low-income countries constituting the remainder (Figure 2).

Figure 2(a): Global MSME Financing Gap

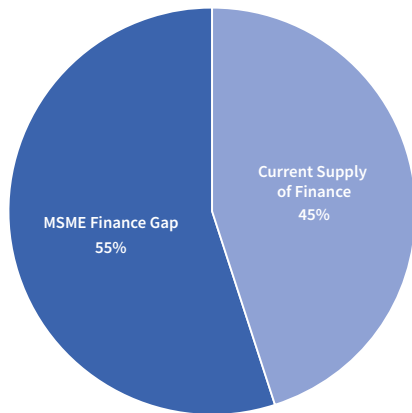
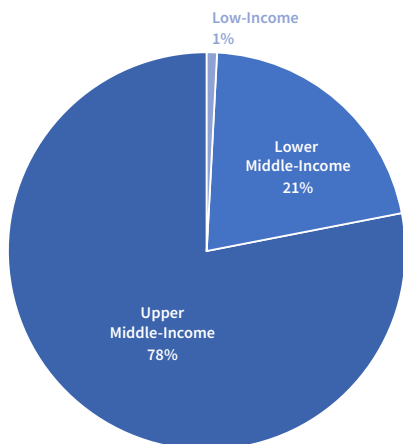


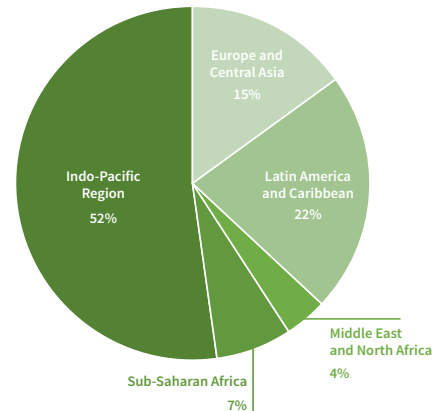
Figure 2(b): MSME Financing Gap by Countries' Income Level



Source: "MSME Finance Gap," IFC.

The Indo-Pacific region, which has 60 percent of the global population, is responsible for more than half of the global MSME financing gap.¹⁰ Meanwhile, Latin American and African economies account for 22 percent and 11 percent of the gap, respectively (Figure 3).

Figure 3: Financing Gap by Region



Source: "Population Division—World Population Prospects 2019," United Nations DESA/Population Division, 2019.

The inequities of the global MSME financing landscape are pervasive in other forms (Figure 4). For example, more than one-fifth of the MSMEs around the world that are fully or partially constrained for credit are women-owned businesses. Closing this gender gap could help empower women globally, adding an estimated \$28 trillion to global GDP over the next decade in the process.

Total MSME financing demand (currently estimated at \$8.67 trillion) is met by both formal and informal sources (Figure 5).¹¹

This brief focuses on the formal sources currently available to the developing world and will examine the strategies that stakeholders can pursue to bridge the MSME mid-late stage financing gap. It focuses less on how to mobilize more capital globally (which is in itself a constraint) and more on how existing capital can be blended or refocused on this key growth stage in an MSME's life. Aid agencies and DFIs both at the bilateral and multilateral levels have significant roles to play in making this happen.

The World Bank has undertaken numerous initiatives on this issue at the multilateral level, both through the International Finance Corporation (IFC) and through the International Bank for Reconstruction and Development (IBRD). As the World Bank's DFI, the IFC operates a group that focuses on venture capital investments in developing countries, making investments at earlier stages than most IFC programs. The portfolio of this group covers a range of sectors, including commercially viable projects, such as

Figure 4(a): MSMEs by Financial Constrains (out of total 314,990 total MSMEs)

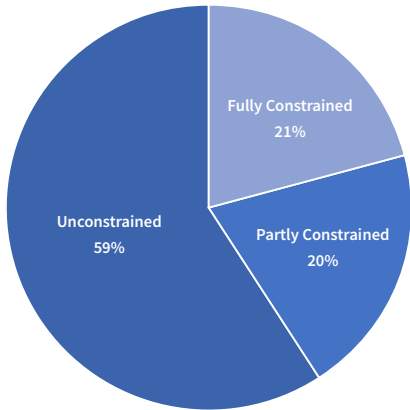


Figure 4(b): Fully Constrained MSMEs (by Gender)

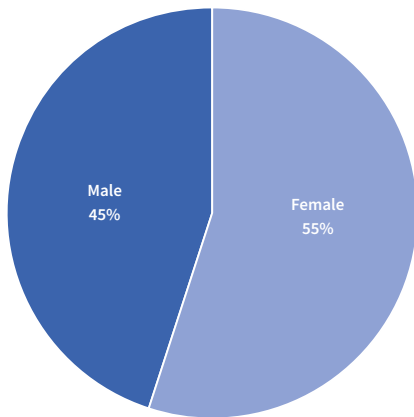
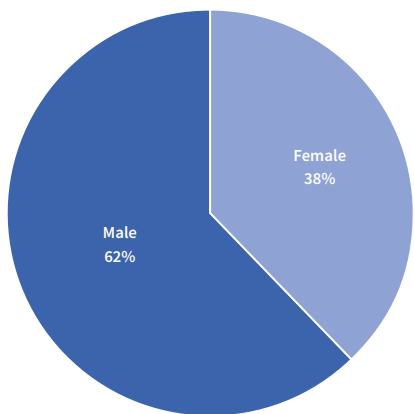


Figure 4(c): Partially Constrained MSMEs (by Gender)

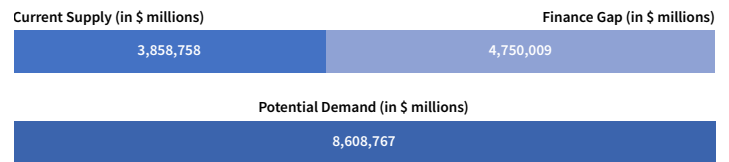


Source: "MSME Finance Gap," IFC.

e-commerce and telecommunication service companies, to social sectors, such as health and education technology.¹² The IFC also operates a unique program to assist early-stage start-ups to fill in the lack of seed capital in local economies, with the objective of connecting local start-

ups to global investors that could unlock more significant capital transactions from around the world. Furthermore, they can provide the enterprises with the advisory services that can help develop a credible and sustainable executive management capacity.¹³

Figure 5: Potential Financing Demand



Source: "MSME Finance Gap," IFC.

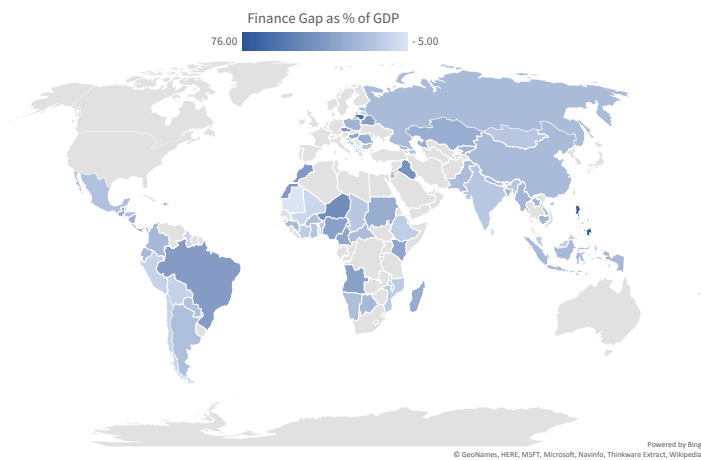
Other regional development banks have also put programs in place to support and scale innovation and MSME activity in various clusters of emerging economies. The Asian Development Bank (ADB), for example, has a High-Level Technology Fund that aims to support technological development in Asian countries. The targeted recipients for the fund have been enterprises that sought to increase durability, reduce environmental and social costs, improve access to service deliveries, and address climate risks.¹⁴

Meanwhile, the African Development Bank (AfDB) has supported entrepreneurial growth and innovation on the continent by providing direct financial support to countries' national funds, including Rwanda. The AfDB committed \$30 million to the Rwandan Innovation Fund to support and train technological entrepreneurs in business management and planning. The AfDB also supplied them with equity funds to help catalyze \$100 million in investments.¹⁵

The AfDB additionally created the Youth Entrepreneurship and Innovation Multi-Donor Trust Fund in 2017 as a platform to support young entrepreneurs with business incubators and advisory services. The bank has attempted to partner with research institutions to fund research on innovative solutions to youth entrepreneurship. The program, created in response to the burgeoning young population across the continent, empowers youth to harness the fourth industrial revolution and create inclusive economic growth through entrepreneurial ventures and innovation.¹⁶

The Overseas Private Investment Corporation (OPIC) and the European Investment Bank (EIB) also have initiated programs to address the constraints posed to developing world MSMEs. The Innovative Financial Intermediaries Program (IFIP), instituted by OPIC, allows lending to small equity funds, hybrid and debt funds, and non-bank financial institutions in developing countries that invest in SMEs focused on innovation.¹⁷ Concurrently, the InnovFin-

Figure 6: Finance Gap as a Percentage of GDP

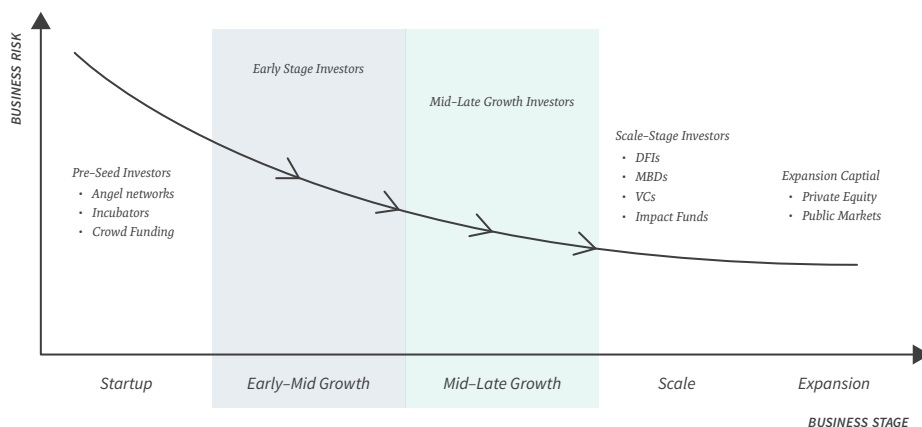


Source: MSME Finance Gap,” IFC.

EU program operated by EIB allows MSMEs, regardless of the volume of investment sought, to apply for financial support in the form of equity investments, guarantees, and direct loans that would facilitate innovation-research and development.¹⁸ Bilateral agencies also have collaborated to create special-purpose vehicles to confront the global financing challenge for innovation-based MSMEs. They include the Global Innovation Fund, which (along with private-sector partners) brought together bilateral agencies from Australia, Sweden, the United Kingdom, and the United States.¹⁹

These efforts and others have done much to support MSMEs in the developing world and should be supported and expanded. However, these funds only target companies that are in the “VVVV” stage. A significant gap exists in all these efforts: there is lack of financing in the growth stage and specifically on the difference between early-mid and mid-late growth.

Figure 7: Stages of Growth



Source: Churchill and Lewis, “The Five States of Small Business Growth.”

THE GROWTH GAP: A NEW MISSING MIDDLE

As discussed, there are several stages in the development of an enterprise: startup, growth, scale, and expansion. As the risk to returns on investment declines progressively and types and amounts of finance differ in each successive stage, enterprises need financing tailored to the stages (Figure 7).²⁰ In the developing world, startup MSMEs have some access to capital from angel networks, incubators, and crowd-funding institutions, which are inherently more risk tolerant.

Many MSMEs in developing countries finance their growth by relying on savings or overpriced loans from family or community-based informal lenders. The absence of formal credit severely constraints MSMEs and becomes particularly acute when firms attempt to enter the early-to-middle stage of investment, thus creating a “pioneer gap” that limits grant funding at the startup stage and later-stage private equity financing.

The pervasive gaps in capital markets largely are concentrated in the early-to-middle (e.g., seed and series A and B) and mid-late (e.g., series B, C, and beyond) stages of growth financing; the foreign aid and development finance communities must address these gaps to fully realize the potential of the private sector. At the early-middle stage, MSMEs typically seek investments worth \$20,000 to \$250,000, which is a challenge because of the lack of a meaningful financial and formal banking infrastructure.²¹ Microfinance institutions find such investments to be too large for their capacity, and DFIs rarely go into this territory. Meanwhile, MDBs often are under great pressure from their shareholders to maintain their top-grade credit-risk ratings. Consequently, they opt to make large, multimillion-dollar investments

in “safer markets” that practically guarantee them the returns needed to preserve their creditworthiness. These incentive structures are some of the biggest constraints on DFIs and MDBs, limiting them from making early-stage investments in riskier, smaller companies in low and lower-middle-income countries.²² As MSMEs in the developing world are inherently risky, DFIs do not find themselves naturally drawn to such investments. Other financiers, such as venture and impact funds, will engage in the early-middle

growth phase, but expectations of all financiers in this phase (e.g., returns within 5 years, commercial or near-commercial rates of return, and relative risk aversion) often do not align with the needs of MSMEs (e.g., patient capital of 10 or more years, concessional rates of return, and relative risk tolerance).

These challenges in the early-middle stage are real, but it would be wrong to assume that these are the only challenges in the growth stage. Businesses in the growth phase often will remain there for years before significant scale and expansion. It is during those years that they move from early-middle to mid-late, and as they move, their financing needs change. Though not yet ready for scale, these companies need financial products that are typically larger (in the millions of U.S. dollars) and are a mix of commercial and concessional debt and equity and, in some cases, first-loss guarantees and continued technical assistance.

Moreover, venture capitalists, philanthropists, and the few impact funds that operate in the mid-late growth stage usually do so in overly risk-averse ways, require increasing amounts of collateral (which, in the developing world, can be hard to come by), and typically expect higher returns in a shorter amount of time. So, they offer not quite the same expectations as financiers in the scale stage, but certainly not far off. Coming from the other end of the financing spectrum, those that engage in the early-middle growth stage (e.g., some angels, local venture capital, and philanthropies) find the mid-late stage needs too large. They also have limited types of capital and limited flexibility within them.

BRIDGING THE GROWTH GAP

Recognizing the catalytic impact of an unconstrained and thriving private sector on the developing world, it is imperative that the stakeholders of the development community address these growth stage gaps. Some businesses will succeed despite these challenges in the mid-late growth stage; however, it is likely that more MSMEs would move to scale and beyond if they had more flexible financing options. The answer is unlikely to be the creation of a new, heretofore unseen type of financing. The tools we need exist, and to a large extent, the types of capital needed for this sub-stage also exist. Thus, the answer is more likely the use of blended capital funds whereby those willing to accept riskier, below market rates of financial return are grouped with those able to provide larger amounts of capital. The OECD refers to blended finance as the strategic use of financial tools to catalyze mobilization of the private

capital needed to enable sustainable development. Blended finance is not a singular nor standard tool and should not be thought of as a silver bullet solution for financing challenges; however, some of the tools that offer flexibility for riskier projects (e.g., first loss capital, guarantees, junior equity financing, and technical assistance) have proven to be invaluable in mitigating risks in emerging markets. Although public grant resources have been critical to establishing blended finance as an approach and will continue to be important, a growing number of commercial and philanthropic investors are utilizing blended tools contingent upon the nature of risk covered and the terms and duration of investments.²³

Blended finance is neither a singular nor a standard tool and should not be thought of as a silver bullet solution for financing challenges.

Without the appropriate use of blended capital (i.e., a mix of non-profit grants along with debt and equity from commercial sources) to engage in this critical mid-late growth stage, many MSMEs will continue to struggle to reach their fully scaled potential. And without more MSMEs—the engines of job creation and economic growth worldwide—moving to scale, it is plausible that the SDGs will become harder and harder to achieve. Overcoming the growth stage gap will require development finance stakeholders to consider innovative ways to take more risks and to explore innovative investor partnerships across the financing spectrum. These partnerships will be critical for institutions to draw on their functional and regional strengths when developing their portfolios and to avoid an overlap in their activities.

Reform will not be easy. Over the past several decades, development finance stakeholders have established themselves along select areas on the finance spectrum and have become comfortable with predictable rates of return and high credit ratings. The business and shareholder accountability models that govern bilateral and multilateral agencies have made it seemingly impenetrable for them to invest in enterprises moving through different stages, even as they rue the lack of bankable deals. Nonetheless, it is important for donor countries to consider establishing special investment vehicles or funds that can cater to the early-middle and mid-late stages of MSME development while also supporting and enhancing existing platforms already venturing into this space.

There is precedent for such innovation: DFIs backed early pioneers in the late-1990s to catalyze emerging private equity markets.²⁴ Similarly, DFIs today could provide early seed funding and professional services for blended funds targeted at the gaps in the growth stage.

Despite their mandate to support and further economic growth objectives in developing countries, the structural incentives of DFIs limit them from functioning outside deals that are of low risk, high value, and yield immediate returns—three expectations that MSMEs cannot offer until they reach their growth stage. One way for DFIs to break this cycle and overcome the operational constraints is to engage with—and financially back—a platform that takes on higher risk and invests in smaller projects with growth potential and longer investment horizons. With the launch of the U.S. Development Finance Corporation (DFC) in 2019, the United States has an opportunity to rethink its modus operandi for development finance.

By strategically positioning itself as a backer of special purpose vehicles targeting mid-late growth investment gaps, the DFC could more effectively realize its mandate of transitioning developing countries from non-market- to market-driven economies.²⁵

Doing so will require the DFC and other DFIs to accept higher risk, lower returns, and longer time horizons. To address risk, financial institutions can use off-balance sheet financing models to protect their ratings. In particular, the use of securitization and synthetic securitization can allow institutions to take on riskier investments while off-loading the risk to the capital markets. For DFIs specifically, equity and debt have been the most easily deployed products; however, guarantees (especially when accompanied by policy reforms and technical advisory services) can be used in the growth stage. For example, a first-loss guarantee could crowd in private finance to a project that would otherwise not be considered because of risk-related reasons. DFIs also need to consider accepting longer-term time horizons as part of exploring more opportunities—either directly or via third party funds or other financial institutions—for impact in the growth stage.

Most DFIs are public institutions, meaning that citizens fund development finance programs through taxes. It is thus understandable why elected officials have difficulty supporting aggressive risk-taking and lower returns, particularly since the benefits of such investments are not reaped by taxpayers in the short time frame within which political outcomes are shaped. Donor country lawmakers also are wary of moral hazard, whereby financing terms

create perverse incentives that enable people (and governments) to take on unsustainable investments with no real risk nor consequences to the recipient country. There are broader concerns that DFI interventions could distort market dynamics adversely and crowd out the private sector. Alternatively, DFI investments could be redundant and a wasteful use of subsidies if they do not lead to additional mobilization of private capital.

The United States has an opportunity to rethink its modus operandi for development finance. . . Doing so will require the DFC and other DFIs to accept higher risk, lower returns, and longer time horizons.

However, the concerns should not be fodder for inaction. DFIs will have to figure out how to address these realities to bridge the growth gap. A good, and politically more feasible, first step would be to work toward the longer investment time horizons that are necessary for the growth stage. Blended finance then can be used to gradually increase risk tolerance and accept lower rates of return. If DFIs see greater development impact and crowding in of private capital over time, their case for continued reform becomes stronger. To track this impact, DFIs, MDBs, and other public institutions must prioritize impact assessments as part of any effort to scale or change activities. These public actors can seek new partnerships and collaborations with like-minded players in the philanthropic and private sector, where best practices on accountability, impact evaluation, and governance can be exchanged and adopted. Of course, public officials might also benefit from reminding constituents that donor countries spend only a small fraction of their gross national income on development efforts to safeguard long-term interests like security, trade, and increased commercial partnerships.²⁶

Throughout the reform process, the development finance community should stay true to the first word in its title: development. It too often focuses on the needs of shareholders—which often over-emphasize financial returns and strong credit outlook in the market—and forgets the other bottom line. DFIs and MDBs struggle with this, as the overwhelming desire for success and positive returns has led to some reluctance to engage with certain classes of countries, including frontier market economies and countries afflicted by conflict and fragility,

and along riskier parts of the investment spectrum. The impact assessments mentioned above must go beyond macroeconomic analysis into examinations of changes in quality of life and other social metrics. The development finance community should realize that often the trade-off for lower financial returns in the growth stage and beyond is higher social and development returns. ■

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ENDNOTES

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