

Written Testimony to the Subcommittee on National Security and Foreign Affairs.

“U.S. Promotion of the Afghan Economy: Impediments and Opportunities.”

*Room 2154, Rayburn House Office Building
10:00 a.m.*

July 14, 2009

**Submitted by:
Mildred Callear, Executive Vice President and Chief Operating Officer
Small Enterprise Assistance Funds (SEAF)**



Chairman John F. Tierney and Members of the Committee:

Thank you for inviting me here today to discuss the prospects for private investment—particularly investment in small and medium enterprises (SMEs)—in Afghanistan and what this means to the security and sustainable development of the country. It is evident that Afghanistan’s long-term security and economic development are deeply linked and mutually dependent. In order to experience long-term sustainable security in Afghanistan, socio-economic conditions have to be improved throughout the country, especially in the rural areas.

Jobs have to be created, income has to be generated, Afghan industry and products have to be improved and promoted, and the reliance on foreign assistance has to be reduced. More importantly, the international community has to coordinate more efficiently to implement quick impact projects that maximize returns and sustainable outcomes.

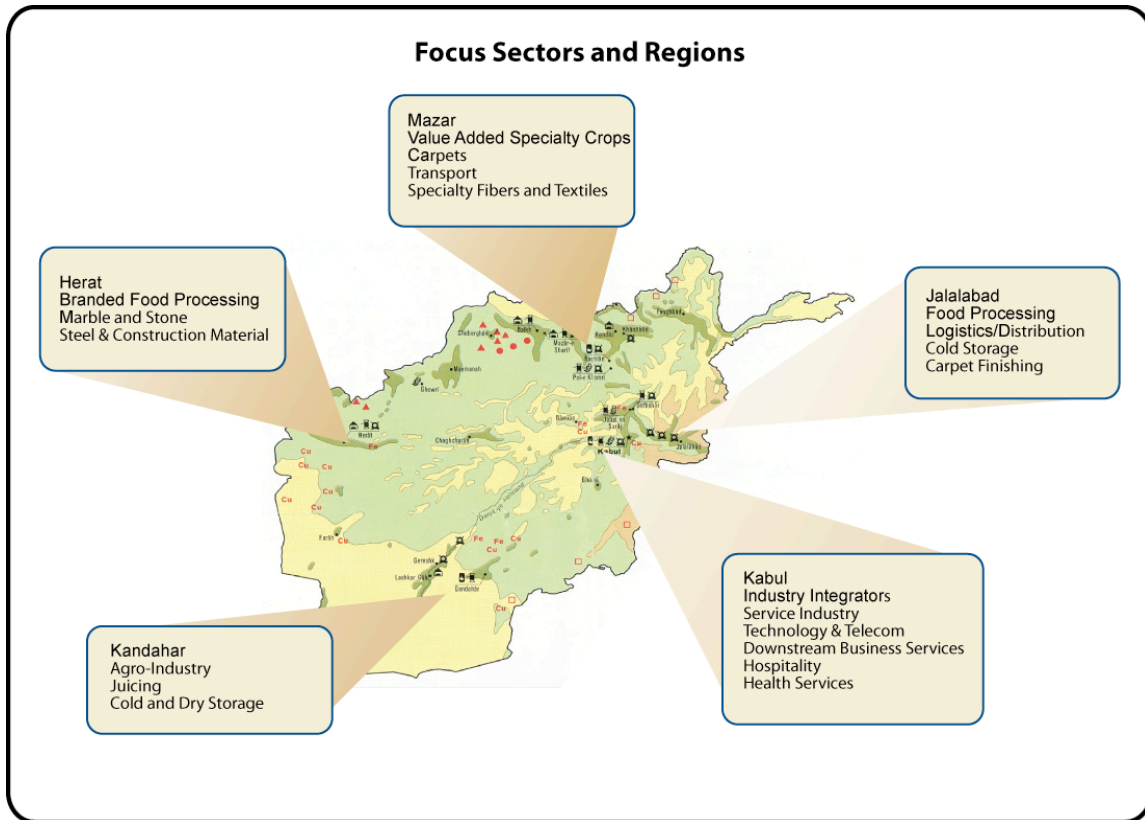
The mission of the Small Enterprise Assistance Funds (SEAF) is to further economic development by providing capital and needed technical assistance to create sustainable, for-profit small businesses in the emerging markets. SEAF’s experience in working on the ground in Afghanistan has reinforced our view that the best way to support economic development in Afghanistan is through direct investment in Afghan small and medium enterprises (SMEs). SMEs constitute the largest portion of the formal business base in Afghanistan and are the backbone of a growing and stable local private sector. The entrepreneurs behind these businesses could—and should—play a much larger role in development, but they are constrained by a lack of financing and technical assistance from both local and international sources.

Just over a year ago, SEAF created Afghan Growth Finance (AGF), a non-bank financial institution in Afghanistan, to focus on providing growth capital to SMEs in the country. With the support of the U.S. Government's Overseas Private Investment Corporation (OPIC), AGF has a USD 25 million lending facility that provides medium-term debt to growth-oriented SMEs in Afghanistan. We have seen first-hand that helping small companies grow by providing access to risk capital is a promising way to achieve sustainable development in Afghanistan by empowering the emerging private sector. AGF's success investing in Afghan SMEs demonstrates that SME investing not only leverages promising businesses, but also produces valuable economic and development returns to the local community, economy, and country.

SMEs are vital to the health and stability of Afghanistan as they constitute the largest portion of the employment base and provide the majority of available goods and services. Nevertheless, Afghan SMEs suffer from insufficient access to financing, crippling the small businesses from expanding their production and making a larger social and economic impact. While AGF currently meets a portion of the capital demands of SMEs in Afghanistan, there remains a large gap in access to structured debt financing for interested SMEs and no ability to access equity capital. Entrepreneurs seeking financing for their small businesses are up against the perception of local commercial banks that SMEs are too 'risky', for traditional loans as they lack sufficient collateral or connections, and yet they are too large for microfinance. This effective 'missing middle' in available financing drastically diminishes the prospects for sustainable development in Afghanistan by ignoring the necessity of cultivating a vibrant middle economy—a key element in job creation that is essential to poverty reduction, income equality, and general stability. In addition, SMEs need more than just lenders and capital—they need business partners. SEAF provides its portfolio companies with the technical assistance, access to markets and global knowledge they need to grow and succeed—all provided in a culturally sensitive manner using a local team that understands both the ways of local business as well as the potential for expanding well beyond the traditional ways to embrace the opportunities that globalization holds.

Since April 2008, AGF has committed approximately USD 5 million through ten loans to nine innovative and growth oriented Afghan SMEs, all of which received funding on market terms and are performing according to expectations. Investments range from USD 50,000 to 2 million with tenors of up to six years. AGF borrowers have used the funds to procure machinery, establish or create processing facilities, and fulfill their working capital needs. To date, AGF has invested in two construction component manufacturers, a licorice root and extract processor, a dried fruits and nuts processor, a raisin exporter, a media company, a printing and advertising firm, a technology and internet service provider, and a renewable energy corporation. An early assessment of the development and economic impact of AGF's investments has demonstrated that the benefit to the companies, employees, stakeholders and the local economy are consistent with results achieved

by and documented in SEAF investments in other parts of the world¹. Demand for our loans in Afghanistan is strong, as is the need for empowering local entrepreneurs to fill urgently needed products and services, providing sustainable employment opportunities, as well as creating economic success for entrepreneurs in a transparent manner.

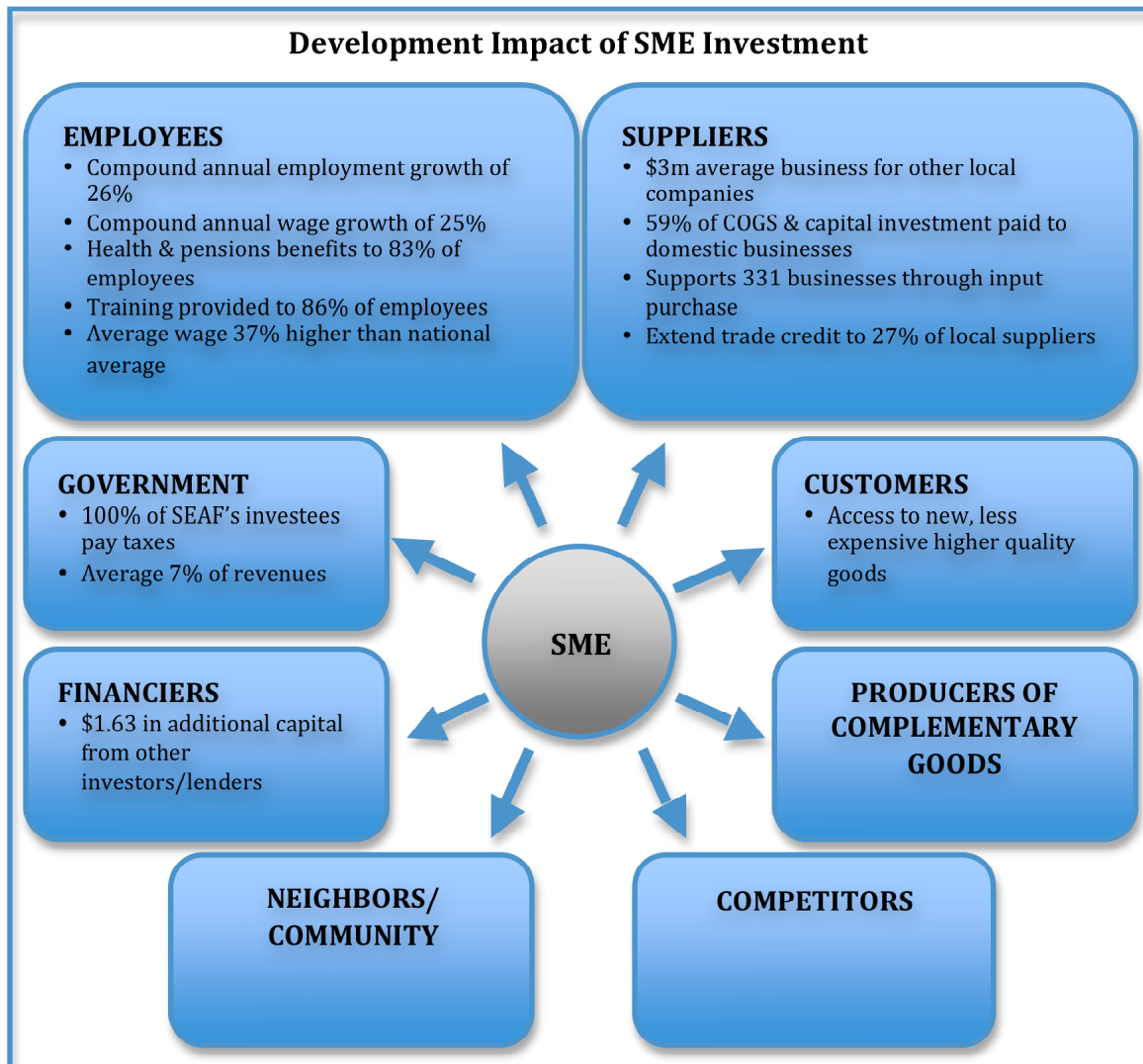


Over the past 20 years, SEAF has invested in nearly 290 SMEs in 30 countries through 25 managed funds and more than \$500 million in committed capital. SEAF's extensive experience has allowed it to identify and invest in promising companies that deliver both positive financial results, as well as significant economic and social benefits to their employees and their communities. Since 2004, SEAF has conducted in-depth analysis and produced a series of reports evaluating the development impact of our investments on a variety of community and government stakeholders.

We now have concrete evidence that growing small businesses create jobs for unskilled or low-skilled individuals who then receive training and see significant growth in their wages and overall benefits. In addition, each small company provides economic benefits to a host of other stakeholders—from its suppliers, customers, and competitors to local governments through tax payments and contributions to government social and pension schemes and to the local community through frequent philanthropic donations. SEAF's

¹ See SEAF's Development Impact Report, October 2007, on our website (<http://www.seaf.com/impact.htm>).

analysis shows that for every \$1 invested in a small and growing business, an additional \$12 in benefits redounds to the local society. With stable and secure jobs and growing incomes, for the first time families can begin to plan for their futures—investing in improved housing, preventive health care and education for their children that can end the cycle of poverty and build the base for a more stable and secure society.



In the case of Afghanistan, AGF’s portfolio companies have produced significant, measurable economic and social returns for the country, serving as a tool for poverty reduction and stability. Across the board, AGF’s SMEs have expanded their workforces by approximately 50%, increased employee wages by an estimated 30%, improved working conditions, extended non-salary benefits among their workforce, and offered training opportunities for unskilled or semi-skilled workers. AGF’s agro-processing SMEs have strong ties to over one thousand local farmers and input providers, to whom they provide consistent and reliable demand, assist in the extension of trade credit, bolster the market reputation for Afghan products, and encourage alternatives to poppy

cultivation for Afghan farmers. Two of AGF's borrowers manufacture construction components that have reduced the country's dependence on foreign imports by producing quality, locally manufactured products at lower prices that are then translated to the consumer and make local construction more affordable. AGF's media company disseminates important information throughout Afghanistan through public awareness programs and broadcasts to the United States and Europe, adding a locally broadcast perspective to the international dialogue on Afghanistan. AGF's renewable energy corporation is designing and building five renewable energy systems (wind and solar) for the border posts of the Afghan police, and, if successful, will expand this project to 70 other locations around the country. The success of this project can revolutionize the use of renewable energies in both on and off-grid regions throughout Afghanistan and the developing world. Finally, AGF's technology and internet service provider has expanded Afghans' access to more reliable and less expensive internet options, while making a deliberate effort to offer greater internet access to schools, hospitals, and government agencies.



As a result of the country's years of instability, compromised rule of law, and violence, Afghanistan faces a variety of unique challenges to sustainable development and greater stability. However, with the proper avenues for financing, SMEs have the potential to offer a promising solution to these challenges.

Afghanistan currently suffers from a lack of security that hampers foreign and domestic investment, compromises transportation and employee safety, and augments overhead costs. By virtue of their smaller size however, SMEs are more nimble, less visible and less attractive targets.

Years of instability in Afghanistan have led to poorly developed infrastructure for the country, including unreliable electricity and insufficient or poorly constructed roads. Inadequate infrastructure increases the costs of doing business, effectively reducing efficiency and competitiveness and deterring companies from starting or expanding operations in Afghanistan. SMEs typically begin their businesses locally, and as they expand, often make the localized investments in the infrastructure of their communities that are necessary for their businesses to prosper—clean water, improved access roads, lighting and improvements to the public spaces surrounding their businesses like parks, parking and playgrounds. In addition, a growing SME population means that more and more infrastructure development services can be provided locally rather than by foreign

contractors, effectively reducing costs to the government and bolstering community involvement.

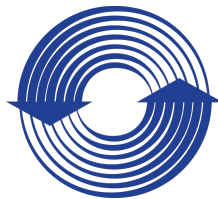
Corruption and bureaucracy are also major concerns for Afghanistan. Nuisance taxes and corruption are present at every level of the government, and an inconsistent application of laws and tax policy lead to a playing field that is not level for all companies. As formal enterprises, SMEs contribute taxes to local governments, in the form of corporate income tax, business receipts taxes, and other taxes. These taxes support the stability of the Afghan government, generate revenues for creating a social safety net and providing needed services and promote the establishment of a formalized Afghan economy. Additionally, formal SMEs encourage and demand greater regulation and transparency within their government and support greater equality in tax and other laws and regulations.

Instability and violence in Afghanistan has also left the country with depleted employment opportunities and a generally unskilled workforce. This makes it especially difficult for companies to recruit and retain qualified staff. Throughout the developing markets in which SEAF works, we have found that, on average, 87% of SME employees are unskilled or low-skilled workers. In Afghanistan, that number is likely even higher, but because SMEs are locally built and depend on their local workforce, these small businesses invest in their employees, promoting internally and providing training and skill-development that improves the skill level of the workforce. With increased skills, productivity and wages both rise and SMEs grow rapidly.

Rooted in their local communities, Afghan SMEs are positioned to identify unmet local consumer demands and, with proper access to financing, work with other stakeholders to address market deficiencies. Customers receive greater choice, improved quality, and lower prices and competitors benefit from demonstration, spillover effects, and improved reputations of local production. In addition, Afghan SMEs make valuable contributions to their surrounding communities. On average, each AGF portfolio company contributes USD 1,000 annually to charities and other local community causes. Such support has included contributions to local infrastructure and support for orphanages and community events. Finally, as formal enterprises, these companies contribute taxes to local governments, in the form of corporate income tax, business receipts taxes, and other taxes—averaging 5 percent of revenues in the year 2008. These taxes support the stability of the Afghan government and promote the establishment of a formalized Afghan economy.

There is little argument that Afghanistan will continue to need assistance from the international community to direct its country on a more stable, secure and sustainable path. SEAF's work throughout the world in conflict and post-conflict emerging markets has demonstrated that a key component of sustainable development is a thriving middle class, with formalized businesses, growing employment and greater ties to the international markets. Over the past year, AGF has proven that this type of risk capital investment can empower a company to overcome its country's challenges and produce higher value added and top quality products for both domestic and global consumers, while positively impacting the stabilization and growth of its community and country.

Access to capital is a key constraint to growth for promising Afghan SMEs, and while AGF is successfully meeting the needs of some of these businesses, the demand for both debt and equity capital exceeds the supply. SEAF applauds OPIC's willingness to partner with us to tackle the SME financing challenge in Afghanistan and we look forward to working with OPIC and others in the U.S. Government to expand the capacity of AGF to provide both the financing and technical assistance that SMEs need for growth and that Afghanistan needs to achieve its full economic potential.



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