

At the nexus of investment and development: lessons from a 60-year experiment in SME impact investing

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Mennonite Economic Development Associates (MEDA) was launched as an investment club in 1953 when a group of North American Mennonite business people joined together to support the development of communities in Paraguay, Uruguay, and Argentina. With their business background, this group of early 'impact investors' determined that they would provide loans to small to medium enterprises (SME) in order to catalyse sustainable economic growth. They offered the loans as high-risk venture capital and mitigated the risks with the provision of business coaching and technical assistance. Since those early days, MEDA and the SME investment fund managers which it has co-founded (Microvest and Sarona Asset Management) have continued to make impactful investments and to work towards a common development goal, 'to help people help themselves' (Fretz, 1978 : 19). This paper presents a case study of the 60-year 'MEDA experiment', (Fretz, 1978), describes specific activities and innovations, and identifies MEDA's learnings that have emerged from this SME investment experience.

Keywords: impact investing; SMEs; PSD; global; nexus of investment and development

Introduction to impact investing

Modern impact investing has its roots in the development finance institutions (DFIs) that were formed after World War II to aid reconstruction efforts in Europe, most notably the World Bank (at that time the International Bank for Reconstruction and Development) and the International Finance Corporation. Other international and regional development and investment banks followed over the next 50 years, and these have deployed and continue to offer significant sums of debt and equity to growing businesses, while supporting countless development initiatives with the goal of poverty alleviation.

Today, there are many types of investment funds – private and public – that offer impact investments. According to the Global Impact Investing Network (GIIN), impact investments are

investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return.

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<http://dx.doi.org/10.3362/1755-1986.2014.028>, ISSN: 1755-1978 (print) 1755-1986 (online)

Impact investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending upon the circumstances (GIIN, 2014).

These investments share the characteristics of intentionality, defined expectations on returns from among a set of return expectations and asset classes, and a commitment to impact measurement. According to the Monitor Group, the number of impact investment funds grew rapidly in the 2000s, with assets of about US\$50 billion in 2009 and projections that the industry could grow to \$500 billion over the following 10 years (Freireich and Fulton, 2009), although this would still be a relatively small portion of the trillions of dollars invested worldwide.

In addition to the funds themselves, a diversity of actors offer a host of services to funds and businesses of all sizes and stages, across regions and sectors, with varied needs and development objectives (See, for example, Rockefeller Foundation, 2013 and Jones and Turner, 2014). For example: business incubator and accelerator programmes help SMEs to adopt viable business models that can be scaled, build competent management teams, be environmentally and socially sustainable, and become connected to investor networks. In addition to development finance institutions, bilateral donors are assisting investment programmes with direct support or the upgrading of financial ecosystems: DFID, USAID, DFATD (formerly CIDA), Norad and others. Further, an increasing number of consulting firms and membership associations offer training and coaching to SMEs in both financial and social areas. Finally, impact measurement is being refined and documented by associations (e.g., the GIIN, ANDE, East Africa Venture Capital Association), multilateral organizations (e.g., UNPRI), investment funds (e.g., SEAF, Abraaj) and even individual programmes such as MEDA's Evaluation and Learning Group (ELAG) that is made up of industry leaders including B-lab, UNPRI, Sarona Asset Management, the GIIN and others.

This section has offered a high-level overview of the impact investment field to provide context for this paper. (Further reading can be had from the references already noted as well as excellent overviews of the field by the World Economic Forum (2013), the Rockefeller Foundation (2013), and the Omidyar Network (Bannick and Goldman, 2012).) The rest of this paper examines the 60-year long 'MEDA experiment' (Fretz, 1978), relates this experience to trends in private sector development and impact investing, describes key learnings, and concludes with a discussion of the nexus of investment and development, and what roles the various stakeholders in impact investing can take to advance the industry and achieve development outcomes.

The MEDA Story: the first two decades – from investment club to NGO

In 1953, a group of successful North American Mennonite entrepreneurs decided to take positive steps to help those in need in less developed countries, putting into action the business practices and principles that they believed would lead to sustainable change (Fretz, 1978). They formed an investment club – established as

an Ohio chartered corporation – with eight founding members. The membership grew to 126 by 1971, and today, is the non-governmental organization MEDA (Mennonite Economic Development Associates), which has over 3000 supporters. Initially, the investment group focused its efforts on Mennonite communities in Paraguay, Uruguay, and Argentina, aiding groups of people who had been displaced by World War II and were struggling to achieve economic security. This was reflective of the larger global scene where post World War II reconstruction was taking place in Europe, and monies were flowing to countries and communities in need of rebuilding.

The early MEDA members deployed high-risk venture capital into a range of enterprises: for example, farms, dairies, and various factories in Paraguay as well as a creamery in Uruguay and a chicken hatchery in Argentina. Along with venture capital, investors offered business and technical support (best practice promoted by many today: for example, see Proparco, 2011); and they considered the enterprises to be a success when the local owners bought out the investors and continued to operate as viable independent enterprises. Many modern businesses in Paraguay can trace their roots to these early investments both directly through investment and indirectly as target sectors and local economies grew: for example, the initial dairy investment in 1953 spawned the modern dairy industry that eventually served 70 per cent of Paraguay's national market as well as export markets (Pries, 2014). Soon investment efforts were extended to non-Mennonite communities, based on the belief that 'mutual sharing and foundation-building ... and ... the development of self-reliance' are fundamental to economic growth (Fretz, 1978). And, shortly thereafter, MEDA's work began to expand around the globe so that by 1977 MEDA had assisted in 422 projects, 261 of which were still active (Fretz, 1978).

A key principle that was stressed by these early venture capitalists – when queried at the time about not taking a more traditional charity-based approach to supporting community development as did other Mennonite organizations – was that investment was required for local businesses to flourish. Although the good works of organizations like the Mennonite Central Committee were recognized as valuable contributions, the investors emphasized that charitable organizations are not set up to provide capital and direct business support (Fretz, 1978). Furthermore, the investors felt inspired to share their skills and expertise, and to contribute first-hand to economic advancement of less fortunate communities, while respecting the knowledge and experience of the enterprises in which they invested and listening to their expressed needs (reminiscent of today's 'Human-Centered Approach' to development which is becoming popular in market development and microfinance initiatives. See IDEO, 2009).

With the establishment of USAID in 1961 and CIDA (now DFATD) in 1968, new funding opportunities arose, and MEDA shifted to non-profit status in 1973 (MEDA, 2003) becoming what is now called a non-governmental organization (NGO). After much discussion (and dissent) around this change, MEDA decided it could continue with its business approach to development while taking advantage of resources to

help strengthen local organizations (MEDA, 2003). MEDA moved forward with the mandate to

- 1) offer counseling services to the third world, with or without a credit component; 2) provide education management support and services thereby developing in-country human resources; and 3) orient the program to the needs of the lower 30 per cent of the population. (reported on MEDA website, 2014)

Throughout the 1970s, 1980s and 1990s, MEDA continued its commitment to this mandate and developed the mantra 'from project to program to business' (MEDA, 2003) indicating the desire to achieve sustainable local businesses that serve their communities and beyond from development dollars.

Establishing an appropriate investment practice within the NGO

As an NGO, MEDA experimented with a variety of approaches to investments in developing countries over the early years – initially, they were small investments led by local MEDA country offices that often lacked the necessary investment expertise to properly select, assist and sell the companies. And as a result, many were unsuccessful in building stronger companies that could result in high impact in terms of job creation, and improved products and services. Despite this, there was continued interest from MEDA's entrepreneurial staff, its business-minded board of directors, and private supporters to continue with an investment mandate as part of MEDA's programming. MEDA experimented with private sector approaches such as micro-credit and revolving loan funds, microenterprise development, trading companies, monetization, cooperative formation, agricultural development and consulting services – with financial industry innovators Chuck and Sue Waterfield (known for their work in microfinance and particularly Microfin) leading MEDA programmes in Haiti and Bolivia, and Calvin Miller (a respected FAO expert and author in agricultural finance) heading up rural programming in Bolivia.

Learning from these experiences, by the mid-1990s, MEDA had begun steps towards institutionalizing an investment vehicle which could be expanded and deployed more widely. These efforts culminated in the establishment of what is now the Sarona Risk Capital Fund (SRCF) – a MEDA-owned fund not to be confused with the independent Sarona Asset Management that is described below – a fund that invests both debt and equity in SMEs, including microfinance institutions, in Latin America, Asia, Africa, and Eastern Europe. In the early days of SRCF, investments were opportunistic and lacked a cohesive strategy, and as a result, although many of these businesses did well, opportunities to create broad impact were not maximized. Today, SRCF investments, totalling over \$20 million, are aligned with MEDA's economic development programming, resulting in increased leverage and impact.

This adjustment in the focus of the SRCF reflects MEDA's learning that the combination of finance and technical assistance (including sector development) advances more opportunities than either one of these components could on their own (See also Proparco, 2011). For example, in Tajikistan, with a grant from the

Canadian Government, MEDA invested in the horticulture sub-sector through value chain development for farmers, traders, input suppliers and other stakeholders, and the creation of a horticulture-focused investment fund managed by the Association of Business Women of Tajikistan (ABW). Today, ABW has transformed to IMON – the largest microfinance lender in Tajikistan – with a loan portfolio of over \$128 million of which 35 per cent of recipients are women and 62 per cent are rural. The success of the rural lending portfolio would not have been possible without technical support including coordination with agricultural specialists in assessing early loan applications and designing the overall portfolio terms and composition (See Jones and Pasricha, 2007).

As in the case of Tajikistan, from the early 2000s, MEDA's work had become more 'systems-oriented', and the organization was at the vanguard of the value chain/market development movement along with other industry leaders such as ACDI/VOCA, CARE, Technoserve, and Practical Action (Jones and Miehlebradt, 2009). This systems orientation enabled MEDA to take a more strategic approach to its investments: facilitating the development of entire sectors and value chains as currently promoted by the Omidyar Network (Bannick and Goldman, 2012) and documented by USAID (for example, Field and Schiff, 2011). During the same time period, in 2003, MEDA co-founded Microvest with CARE, allowing MEDA to focus more programming efforts on its core competencies as technical service provider and programme facilitator, while externalizing investment support for the microfinance industry.

For example, in 2008, the global financial crisis threatened the livelihoods of farmers in a MEDA agriculture project in Ukraine by drying up the capital that had been available to smallholders. MEDA responded by partnering with local entrepreneurs to create a leasing company called Agro Capital Management (ACM). Leveraging investment from MEDA's risk capital fund, ACM offered access to tractors, greenhouses, irrigation, and other agricultural inputs to affected farmers, shoring up the horticulture sector in targeted regions. By the middle of 2013, ACM had provided over \$7 million worth of leased products to more than 1,000 clients – 37 per cent of whom are women – and grew from a value of \$1.2 million to more than \$2.6 million. A buyout was negotiated and closed in 2014.

Separating commercial investments from development activities

As MEDA was adopting a systems approach to development programming, MEDA's SRCF investment team began to see strong potential and appetite for private equity funds that could offer market returns while strengthening the environmental, social, and governance (ESG) outcomes of the companies in which it invested. However, the SRCF investment team realized that in order to grow the fund and expand impact, there was a need for a revamped ownership structure – a privately owned management company that would have more appeal to institutional investors who were uncomfortable with a company owned by an NGO (MEDA, 2011).

The new structure would also be better positioned to attract and retain the high quality experienced talent required to substantially grow assets under management, since: i) NGO salaries were not attractive to investment professionals; and ii) did not allow them to invest their own resources in the funds they were promoting, which would boost confidence of potential investors. Therefore, in 2011, a management buyout occurred, with MEDA taking 10 per cent ownership of the new corporation – Saronas Asset Management. The MEDA board of directors stated at the time ‘we believe that this change is a necessary step in creating an industry-leading impact investment company that MEDA will be able to point to with pride’ (MEDA, 2011).

Saronas Asset Management (known widely as ‘Saronas’ in the impact investing community) quickly evolved to a fund of funds model based on the recognition that local funds can be more effective since their managers know the prevailing language, culture, business networks, and regulatory environment, and also have knowledge of investment opportunities. Equally important for a fund of funds is that in the current environment of increased competition in private equity markets, funds are under pressure to create value through improved operating performance of portfolio companies (McKinsey & Co., 2014). Local fund managers are in a better position to provide this regular hands-on support.

Saronas’s model is representative of a new approach that is emerging – an ‘impact’ investor that can operate in a fully commercial manner and deliver top quartile returns while improving ESG standards (Rockefeller, 2013). This points to the merging of the bifurcated world of impact versus profit and the increasing realization that businesses that are run more ethically can do better financially. This is supported by the practical knowledge of business owners and investors, as witnessed by the Forbes leadership section on ‘doing well by doing good’ (Forbes, 2014).

Putting learnings into practice: a new partnership for impact investing

Building on these and other similar programme successes – e.g., creation of investment funds that support microfinance institutions and SMEs in frontier markets, strengthening of sectors through strategic investments, individual investments that have led to improved value chain functioning – MEDA decided to launch a department specifically aimed at SME/Investment in mid-2013. MEDA had concluded that there is a need for a broad set of technical support services that can be offered by an NGO in partnership with donors, investors, and other organizations. Needs that have been identified can be categorized by the demand (investee) or supply (investor) side of transactions as well as according to requirements of the industry (ecosystem level) (see Table 1 on next page).

Table 1 Technical support needs in SME impact investing**Investee companies**

- Investment readiness;
- Business management capacity building;
- Environment, social and governance upgrades;
- Monitoring and reporting;
- Innovation to include smaller, more remote, rural enterprises.

Investment funds

- Opportunity pipeline development;
- Due diligence;
- Business management capacity-building;
- Fundraising;
- Environment, social, and governance upgrades;
- Monitoring and reporting;
- De-risking of investment.

Impact investment ecosystem

- Sector assessment and development;
- Identification of investees on a sector-basis;
- Strengthening of the sector to de-risk individual investments (including infrastructure, value-chain relationships, producers of raw materials, and other suppliers).

MEDA's SME/Investment department has formed a strategic partnership with the Government of Canada (DFATD) to launch a global SME investment programme – Impact Investing in Frontier Markets (INFRONT) – that offers finance and capacity-building to targeted funds and SMEs. As programme lead, MEDA is collaborating with Sarena Asset Management and the MaRS Centre for Impact Investing to reach 5,050,000 women and men in emerging/frontier markets with improved products and services that are delivered more effectively and by more socially responsive firms. Central to this initiative is Sarena's Frontier Markets Fund 2 LP (SFMF), a fund of \$150 million that will invest in 12 to 18 local funds for onward investment in approximately 130 SMEs that have potential for high development impact. DFATD provided a \$15 million catalytic first loss contribution and OPIC contributed inexpensive debt finance to launch the fund and attract private investors who may otherwise be hesitant to place capital in emerging and frontier markets.

Complementary to the financing component of INFRONT is a technical assistance facility comprised of (i) a Social Innovation Grant Fund to provide economic incentives to investee SMEs that present practical and locally designed plans to create more jobs, reach more marginalized communities, and to be more socially and environmentally responsive; (ii) the Global Fund Manager Mentorship Programme, which matches seasoned North American venture capital and private equity managers as mentors with inexperienced managers in frontier and emerging markets; and (iii) an enhanced monitoring and evaluation system that will assist funds and SMEs (and the larger industry) to report on impact with a streamlined approach (with the participation of industry experts on the ELAG committee referenced in the introduction). INFRONT combines the expertise of Sarena with two not-for-profits with complementary expertise that adhere to business principles.

Key lessons learned

Drawing on MEDA's six decades of involvement in impact investing, including early lessons from the INFRONT programme, the eight most important lessons learned for achieving development objectives through impact investing are (with contributions from Pries, 2014):

1. There is value in combined Technical Assistance and investment

SMEs often require both financial and non-financial inputs in order to grow, increase productivity, improve quality and operate in an efficient and responsible businesslike manner while contributing to development outcomes such as job creation and supply chain outreach. There are different areas in which growing businesses require technical support: business management and governance, technical knowledge that is sector specific, investment readiness and fundraising, and capacity-building ESG areas. Such technical support, when combined with appropriate investment, leads to both financial and social returns for the businesses, their investors and other beneficiaries including employees, suppliers, and consumers. For example, in MEDA's original investment club, investors not only provided finance but worked closely with businesses on operational issues to ensure their success. This led to the expansion of small businesses, more decent employment opportunities, and the growth and upgrading of targeted sectors.

2. Development agencies need to adhere to business principles and practices

When an NGO is involved in an impact investing programme or partnership, it needs to be clear on the business model and undertake actions that promote sustainable outcomes, rather than falling back on outdated charitable behaviours that encourage dependency. This means it is important to let markets drive business development, allowing commercially viable businesses to be selected and not interfering with the due diligence or investment decisions of finance partners. In MEDA's INFRONT programme, Sarona makes all investment decisions while MEDA provides technical support in ESG and enhanced monitoring and evaluation. MEDA may introduce a potential investee or suggest investments in particular regions, but it is at arm's length from the actual investment process. As a result, Sarona has a strong portfolio that offers above market returns, while at the same time SMEs have access to technical assistance from MEDA and the ongoing business support of fund managers further enhancing the development results related to SME development.

3. There is room for multiple actors (investors, donors, NGOs) but roles have to be clear

Impact investing initiatives can involve multiple stakeholders, but the roles need to be well-defined in order to avoid working at cross purposes or clashing over decision-making processes or areas of responsibility. In MEDA's INFRONT programme, the Canadian Government (the donor), Sarona (the investor), MEDA (the TA provider), and MaRS (subcontracted to offer specialized

coaching to fund managers) all have defined roles that are set out in contracts and mutually agreed upon plans. Even so, it is important to have regularly scheduled meetings and discussions on an as-needed basis to ensure smooth functioning of the project and amicable relations among partners. Further discussion on roles in areas that require more development assistance is included in the following section.

4. SME investment can promote systems change

Investment in SMEs, if strategic, can contribute to systems change. For example, MEDA's investment in a leasing company in the Ukraine at a critical time when finance was not available enabled the continued development of the horticulture sector. This required partnership between local business people and MEDA, as well as the support of investors. Through such partnerships (and other examples described), systems change is possible, and many new models are emerging in a rapidly changing investment landscape.

5. Funds managed by local managers can be more effective than those managed remotely

Local fund managers know their business environment, are aware of potential investee firms, have networks of contacts, and are available to their investees on an ongoing basis. Local funds repeatedly stress that concerns around too few good businesses in the pipeline stem from remote or outsider funds that do not know the local environment and cannot provide regular business support. Sarona consciously took the decision to be a fund of funds and to support fund managers who were committed to their region and to give investees the hands-on support that they often need to grow. Other investment funds – SEAF for example – set up offices in country with local staff and, therefore, provide appropriate support by localizing their operations.

6. Social returns and financial returns are not a zero sum game

There is still a perception among many investors and development agencies that social and financial returns are at odds, and that greater social benefit means reduced financial return and vice versa. However, practical experience is showing that both are needed for long-term sustainability and ongoing returns. In the short term, it may be possible to cut back on ESG returns to gain financially but this can ultimately lead to a degraded environment, a non-inclusive (and, therefore, limited) workforce, and corrupt or careless management and boards. For example, the CEO of Mountain Lion Agriculture (a SRCF investee) in Sierra Leone recently reported to MEDA that the success of his rice processing operation is dependent on the health of the supply chains and the good practices of rice producers. Without support for them in social and environmental areas, the business will not be robust.

7. Development of impact measurement is essential to impact investing

While financial returns are straightforward to measure, the evaluation of social impact is much more complicated. Certainly the measurement of jobs created, incomes increased and products reaching the bottom of the pyramid

are important indicators of success, and such measures are set out in current standards (IRIS and GIIRS). But, as the Stanford Social Innovation Review (SSIR, 2014) has recently reported, this tells us nothing about the social value of those jobs (benefits to employees). In impact investing, understanding the social outcomes and impacts requires additional qualitative reviews that are not currently widespread. MEDA's ELAG committee, described above, plans to contribute to the advancement of monitoring and evaluation for impact without creating onerous reporting requirements for fund and SME managers.

8. Development finance mechanisms are in a time of rapid change

While MEDA's history is unique for an NGO, we recognize that we live in times of rapid change when innovations in financial mechanisms are ongoing. For example, investors such as OPIC (Overseas Private Investment Corporation) are introducing new models to reach smaller investment funds and businesses while opportunities like crowdfunding are proving to be effective forms of fundraising from individuals (e.g., Homestrings and Indiegogo). Additionally, social finance bonds, blended finance, repayable contributions from bilateral donors, harnessing of diaspora investments, new forms of trade finance and guarantees, and more are creating a complex landscape of investment options.

Next steps for impact investing – at the nexus of investment and development

SMEs of all kinds have the potential to offer development benefits: larger businesses have the potential to employ high numbers of people, provide on-the-job training and benefits packages, and thereby contribute to healthier and more stable societies – e.g., the employment of young people across India in the burgeoning airline and call-centre industries; medium-sized businesses may not hire as many people, but can be especially adept at creating innovative niche products and services that serve a lower strata of consumers – e.g., mini packs of seeds distributed to women market gardeners across regions of Bangladesh, low-cost water purification systems operational at the village level in Brazil, distribution of affordable bednets in Tanzania; and small businesses that are on a growth trajectory can be a source of employment for less skilled workers and provide market linkages for small-scale producers in, for example, eco-tourism enterprises in Madagascar and Mexico, and among construction contractors in growing cities around the world.

However, within this SME spectrum, a 'missing middle' has been identified (ANDE, 2012) – small and growing businesses (SGBs) that are at the lower end of the spectrum, requiring between \$20,000 and \$2 million in investment. In terms of development objectives, SGBs appear to be uniquely positioned to spur growth among lower-income communities, attract more women and youth, integrate disadvantaged communities, and ensure that private sector development has more equal benefits for all (Jones and Turner, 2014). This means that while across the continuum of SMEs there are development benefits, SGBs have strong potential to offer both inclusive economic growth and poverty reduction. However, SGBs are

more costly for investors to reach and support, and more risky in terms of financial returns. In order to make them attractive to impact investors, there is a greater need for interventions from donors and development agencies. Certainly, most of MEDA's work has focused on this end of the spectrum although this is not the case for INFRONT which has been described here (and of course opens the debate around the value of job creation versus SGB growth).

As noted already, clarity on the role of stakeholders will be key to advancing the SGB sector. From MEDA's experience we recommend the following (See Jones and Turner 2014).

- NGOs can play an important role in coordinating programmes and developing the capacity of local service providers, SGBs, and investment fund managers in business, technical, ESG, and impact measurement areas.
- Donors and philanthropists should de-risk private investments through various mechanisms including technical assistance grants, funding for financial ecosystem development, and financial instruments including catalytic first loss capital, debt guarantees, and other forms of blended finance.
- Incubators and accelerators can offer support to promising enterprises to advance to a suitable level of investment readiness and link them with investors if sustainability issues are resolved.
- Impact investment funds need to develop business models for investing in the SGB sector; some will be happy with lower returns (e.g., Grofin), while others will seek funding for technical assistance (e.g., BPI), and yet others will focus on specific sectors (e.g., Root Capital).

Conclusion

In this paper, we have offered practical learnings from MEDA's 60-year 'experiment' in SME impact investing. As the impact investing field matures, industry organizations such as ANDE and the GIIN, socially conscious investors like Sarona, and NGOs including MEDA will contribute to our body of knowledge of what does and does not work.

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