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The Catalytic Effect – Learning Deep Dive

**Dutch Good Growth Fund track 2
Financing Local SMEs**

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In 2014, the Dutch Ministry of Foreign Affairs (MFA) set up the **Dutch Good Growth Fund (DGGF)** to help entrepreneurs realise their international ambitions in emerging markets and developing countries and offer financing and support for development-relevant investments and exports. DGGF has three tracks: Track 1: Loans for investments by Dutch SMEs (Invest International). Track 2: Financing Local Needs; and Track 3: Export credit insurance and finance for development-relevant exports (Atradius Dutch State Business).

SMEs are an important source of economic growth and job creation. However, many SMEs – the so-called ‘missing middle’ – **face a financing gap** when they are too big to qualify for microfinance but are too small or risky for conventional financial market players or lack the growth or return on investment sought by traditional venture capital players. Yet, these firms are essential for economic growth, especially in the context of developing countries.

To address this issue the second track *Financing local SMEs* of the Dutch Good Growth Fund (DGGF) was established in 2014. This track uses a fund-of-fund model, which means that DGGF supplies capital to Investment Funds (IF) and Financial Institutions in developing countries. DGGF invests in a wide portfolio, divided over different continents, containing several types of financing such as private equity, debt and venture capital. These different types of financing cover different ‘missing middle’ SME-subsegments that all have different (financing) needs¹.

A consortium of Triple Jump and PwC is responsible for managing the Dutch Good Growth Fund track 2 ‘Financing local SMEs’ on behalf of the Dutch Ministry of Foreign Affairs. DGGF has nearly committed total fund size of €470 million incl. Investment Capital & Seed Capital and Business Development (SC&BD), is active in 49 countries, over 14,000 SMEs have been financed, nearly 19,000 jobs have been created and more than 110,000 jobs have been supported.

The objective of this Deep Dive is to define the concept of Catalytic Effect and assess the ability of IFs to stimulate Small and Medium Enterprise (SME) investment beyond the Investment Fund's initial investments. The Catalytic Effect is still a novel concept and has not yet been widely

¹ High-growth ventures, Niche ventures, Dynamic enterprises and Livelihood-sustaining enterprises. From: DGGF, the Omidyar Network, and Dalberg Advisors (2018). *The Missing Middles: Segmenting Enterprises to Better Understand Their Financial Needs*.

studied and applied in monitoring exercises. As reflected in the 2019-2020 external evaluation of the complete DGGF portfolio, there is currently limited evidence collected to assess how these investments have generated catalytic outcomes for SMEs. The Deep Dive therefore investigates how the catalytic effect at the SME-level manifests itself, where it originates from, and how large it is. The Deep Dive:



Defines the **Catalytic Effect**;



Identifies the **Catalytic Effect**;



Focuses on **best practices** for Investment Funds.



Unpacking the Catalytic Effect: Definition and Mechanisms behind the ability to secure catalytic investments

As the concept of Catalytic Effects is rather novel – both in the context of DGGF track 2, but also in general – an important finding of the study is the definition and the mechanisms driving the ability to attract additional capital at the SME-level. Understanding this provides insights in how to achieve and amplify the Catalytic Effects envisioned by DGGF Track 2 Theory of Change. We define the catalytic effect as follows:

“the ability of invested SMEs to raise additional funding (from sources outside the investment fund itself) because of the IF’s presence and/or activities”.

Based on the desk study and key stakeholder interviews, we propose a **conceptual framework** as depicted in the Figure below that explains the catalytic effect in the context of DGGF’s activities. The conceptual framework highlights two mechanisms; the **cornerstone role** and the **professionalisation** mechanism.

The **cornerstone role** highlights the positive signal the investment of the IF in a specific SME sends towards other investment funds (**passive**), while it also reflects that the IF can take an active role in the additional fundraising activities of the SME (**active**).

Similarly, the **professionalisation** mechanism refers to the active role an IF has on ‘improving’ the fundamentals of the investee through specialised support or guidance, training opportunities and other activities. SMEs can also professionalise due to specific requirements of the IFs (e.g., adhering to certain accounting standards). Finally, the **context** of the investment of DGGF (and the IFs), specifically the ecosystem, the IF and the SME, is crucial.

It is important to distinguish the Catalytic Effect based on the timing of the additional investments, as attribution effects across activities and timeframes differ. Therefore different types of catalysed funding should therefore not be aggregated. We divide the Catalytic Effect into a **primary catalytic effect** (within one year of the initial investment by the IF) and a **secondary catalytic effect** (after one year of the initial investment).

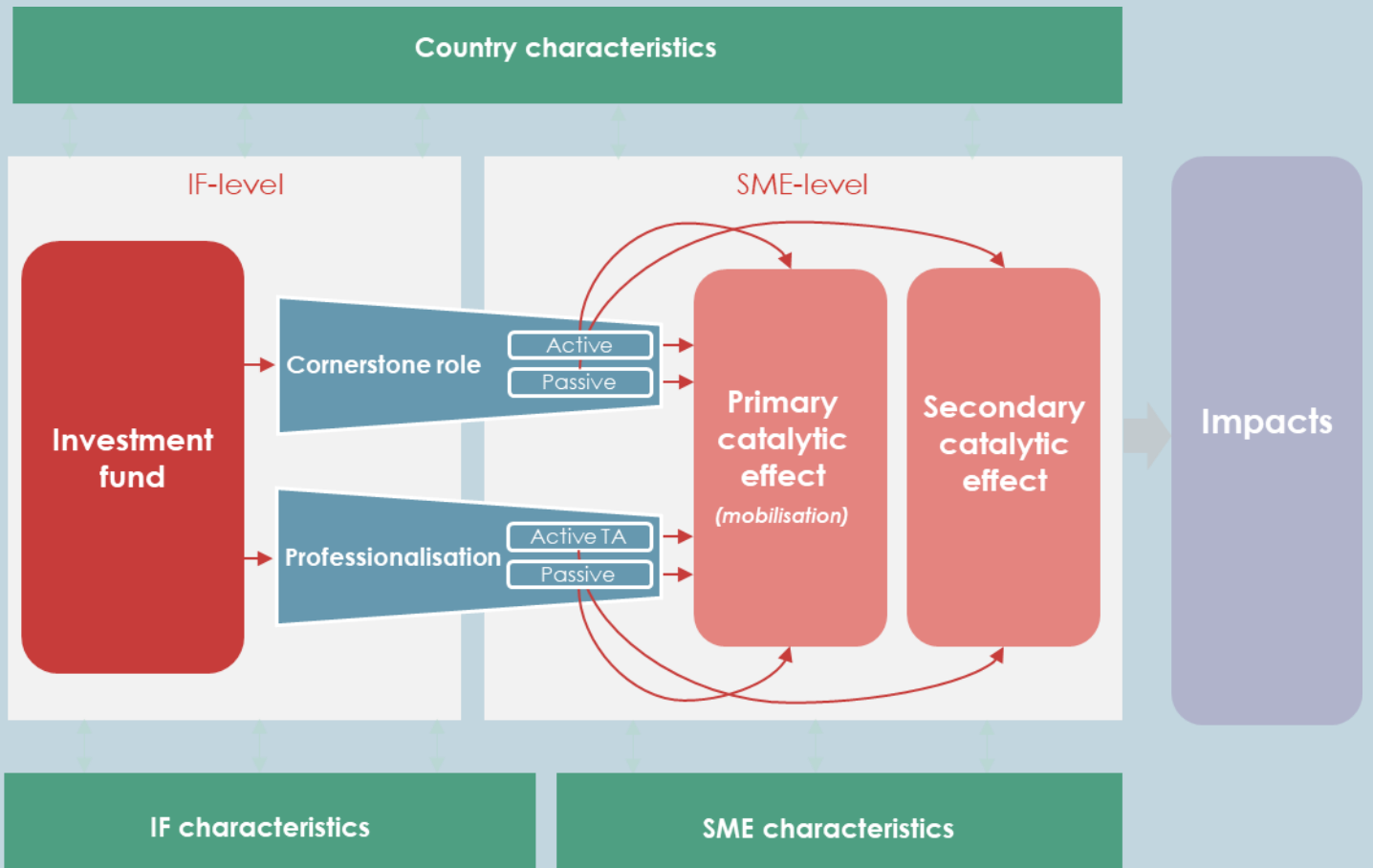


Figure 1 DGGF Catalytic Effect Conceptual Framework





Demonstrating the DGGF Catalytic Effect at the SME-level: Analysis results and identifying the Catalytic Effect

The analysis of the surveys shows that SMEs of DGGF-supported IFs are successful in attracting additional capital after the initial IF investments. A large share (95.5%) of the Investment Funds indicated that (part of) their portfolio companies were successful in attracting additional funding following the initial IF investment. Similarly, 42% of the SMEs responded to the SME survey that they were able to attract additional funding at the same time or within one year after the investment from the IF (20% of all respondents) or after one year (24% of all SME respondents). Only 5% of the respondents indicated that they were unsuccessful in securing additional funding. The rest had plans to do seek additional funding in the future or did not seek additional funding at all.

The analysis shows that the multiplier of the Catalytic Effect on average is 2.76. Using the survey results of 21 IFs, we find that 55.7% of the SMEs supported by the IFs are successful in raising additional funding and 44.3% are not successful, do not look for funding or have gone bankrupt (30.8% of the SMEs fail). It should be noted that the Dutch Good Growth Fund is not the only investor into its supported IFs. The investments of DGGF accounts for about 19.8% of the IF's total investments on average.

Figure 2 After receiving the investment from the Investment Fund into your company, were you able to secure additional funding from other sources? Please select all that apply. (n=115)

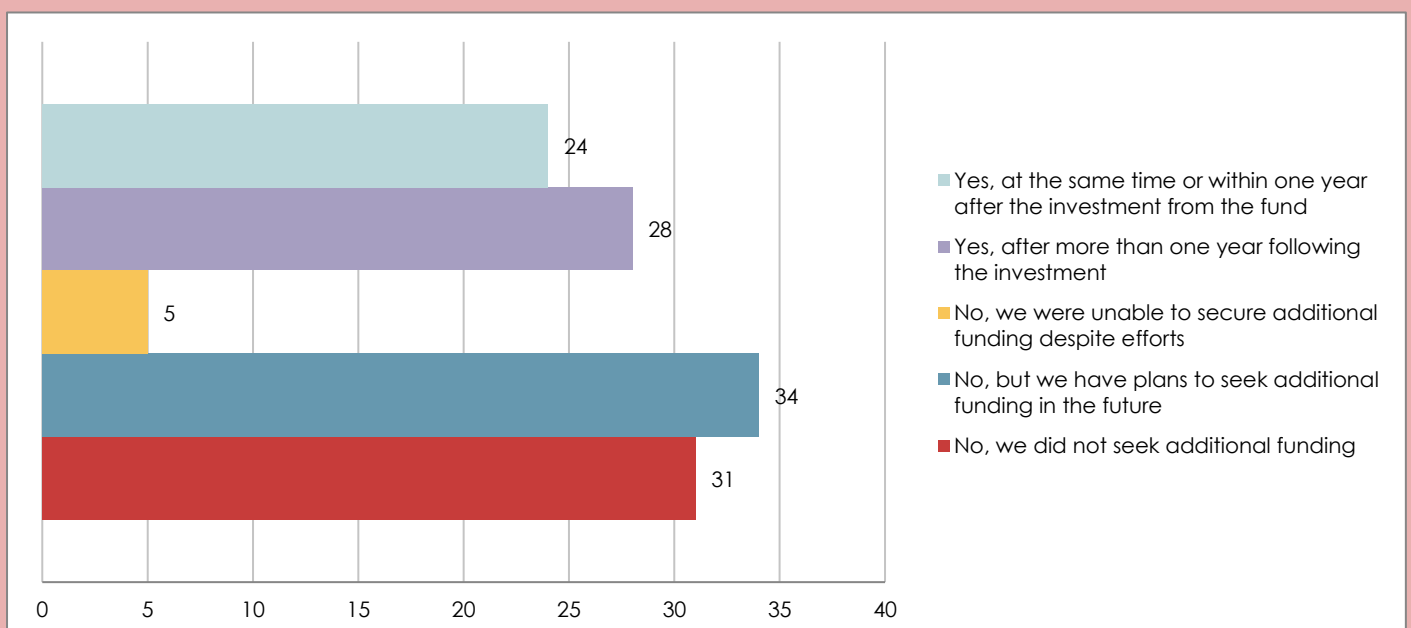
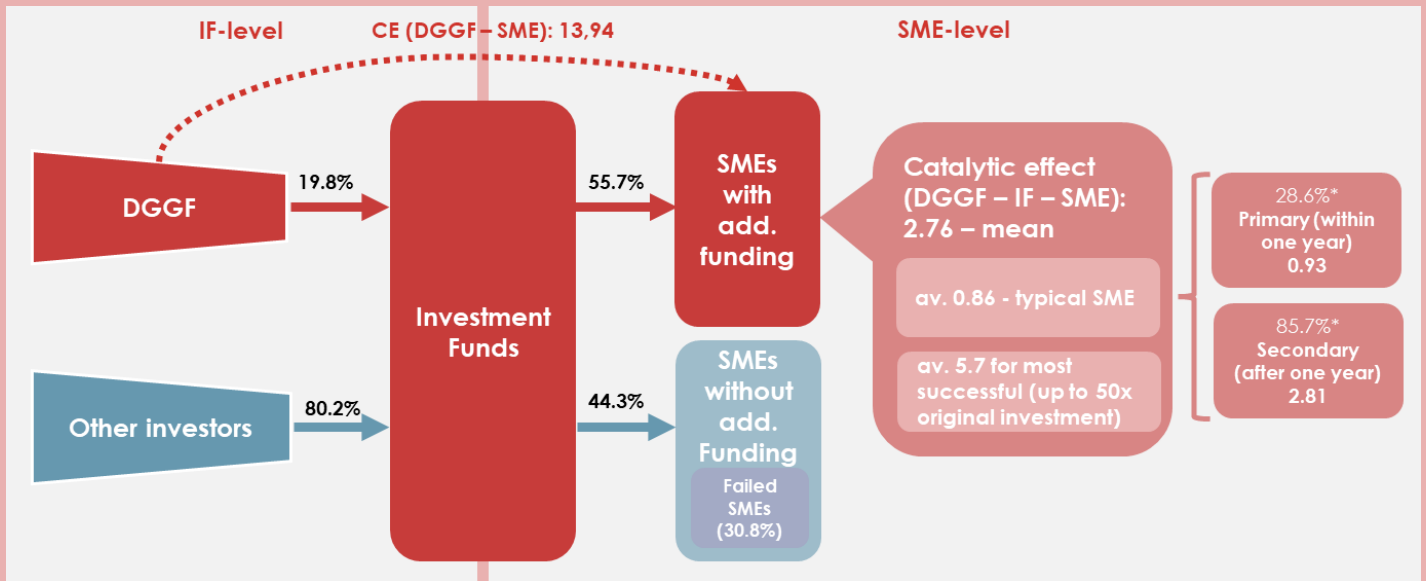


Figure 3 Catalytic Effect in the DGGF portfolio



This average number hides large differences between SMEs, and the extent to which they have been successful in raising additional funding. **The analysis shows that few SMEs account for a major share of the total Catalytic Effect.** Once an SME is successful in collecting new funding, it is likely to secure more in the future. The typical SME shows a multiplier of 0.86, and the most successful SME raises on average 5.7 times the initial investment (up to 50 times the initial investment). Finally, only 28,6% of the SMEs that are successful in attracting additional capital do so within one year after the initial investments, whereas 85.7% of the SMEs are successful after one year of the initial investment. This additional capital mostly consists of international venture capital, followed by loans from local banks and local venture capital.





Facilitating the Catalytic Effect: the drivers and barriers

We clearly observe that the Catalytic Effect is induced by a decreased SME risk, either as perceived by other investors or due to improved fundamentals. We find strong evidence that both the professionalisation activities fostered through the involvement of the IFs as well as their cornerstone role are important for local SMEs in their ability to attract additional funding after the initial investment of the IF. As shown in Figure 4, almost all Investment Funds provide support to their investees to professionalise, enhance their operations, access further funding or assist in this process.

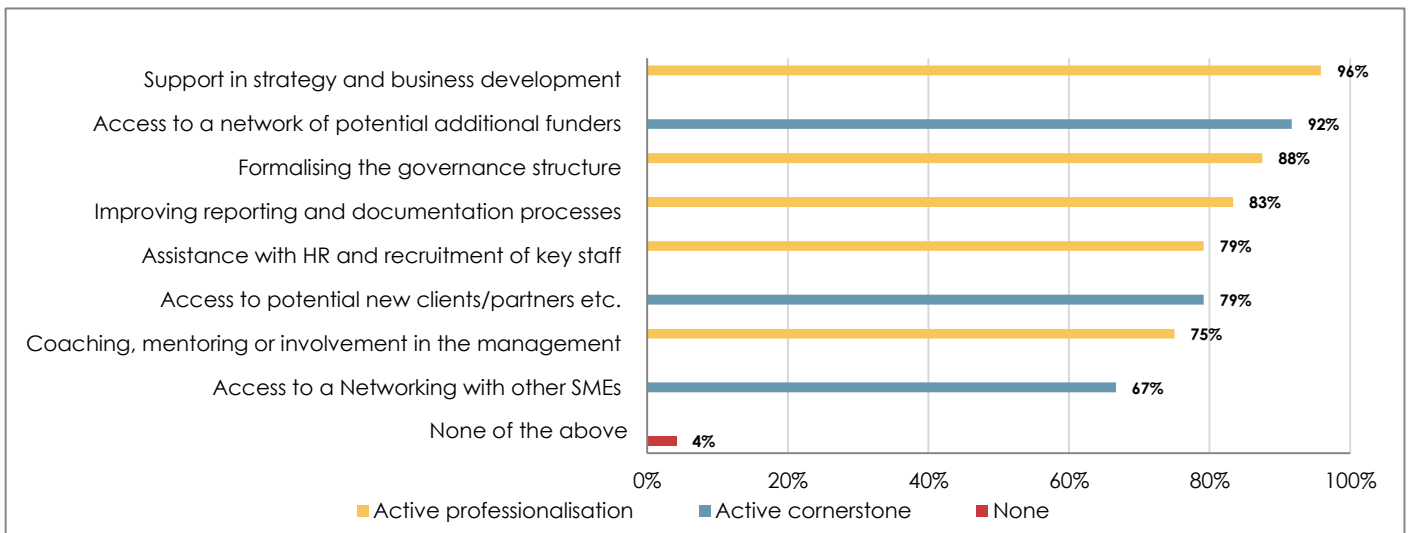
The investment by the IF is often one of the first large investments by an institutional investor the SME receives. The investment of the IF therefore acts as a seal of approval for other investors. It decreases the risk of investing in these SMEs, both as perceived by the investor but also because of the improved balance sheet of the company. IFs are often also very actively involved in their portfolio companies. Many IFs interact regularly with the SMEs both informally but also more formally in committees or the board of the company. The IFs help to shape the strategy of the SME this way. This shows that both the cornerstone and professionalization role are important.

We find that the IF actions (e.g., related to the cornerstone and professionalization) are well-aligned with the Catalytic Effect. Value creation and non-financial support is at the core of the VC and PE models of IFs, as the investments of the IFs have a direct relationship with their own returns and reputation. The specific involvement of the IF critically depends on the type of investment, with especially venture capital and private equity funds more involved. SMEs also differ greatly in terms of their development and IFs note that some need more guidance than others.

Other important drivers of the catalytic effect are:

- **The Catalytic Effect materialises over time.** We observe a flywheel-effect and the '*winner takes all*' perspective that is also well-reported in the entrepreneurship literature..
- The **leading role** many DGGF-supported IFs take in additional fundraising rounds. Their (international) network, local reputation, the demonstration they have caused in the local ecosystem and their activities related to the cornerstone role and professionalisation are key.
- **Local presence** of an IF provides context and expertise which is of vital importance – not only for the SME-level, but also at the ecosystem- and IF-level.
- The hands-on approach and **active involvement** of IFs is valued by SMEs (and IFs). Especially, when it comes to developing a clear strategy for the SME that provides strategic and financial milestones for the investment period.

Figure 4 What types of support did you (IF) provide to the portfolio companies? (n=24)



In addition to that, **an important indirect driver of the Catalytic Effect is the IF selection** (and their investment thesis) and **the DGGF investment thesis** that indirectly foster the cornerstone role and professionalisation mechanism. Similarly, the selection of potentially interesting SMEs is an essential role of the IF, they are likely to be able to do this more successfully given their local knowledge. Many IFs are in close contact with the founders even before the investment in their company. Going even one step further DGGF also selects the specific IFs to invest in. Finding the right IFs with this local knowledge and an active attitude towards developing the ecosystem enables the investments of DGGF to be impactful and generate a catalytic effect.

Finally, the context matters. Catalytic investments do not occur in isolation. As mentioned before, DGGF and the IFs have an extremely heterogeneous portfolio. The country an IF is situated in is an important factor determining how they can assist SMEs. The startup and financial ecosystems of some countries are way more developed than others and play an important role in enabling SMEs to grow. However, especially in the countries with underdeveloped ecosystems, the IFs can provide additionality. Other contextual factors such as the availability of talent and the ease of doing business are important.

How the Catalytic Effect feeds into the overall DGGF Impact

We find evidence that confirms the main assumption from the DGGF Theory of Change, namely that economic activities would not have taken place at the same level without the presence of DGGF-activities. Evidence from this Deep Dive shows that catalytic investments and the IFs activities aimed to foster them indeed have an effect on job creation and economic development. Attracting talent or creating jobs can be the direct result of the investments of the IF (and the subsequent catalytic investments). Similarly, it is likely that there is effect on economic development. However, given the timeframe of this Deep Dive, it is likely that previously achieved impact is not fully captured as impacts following catalytic investments will be visible after a longer timeframe.



Key recommendations

Based on the findings and lessons learned presented in this deep dive, we present nine recommendations for action. The first five are strategic recommendations; the last four are recommendations for the DGGF monitoring.



Recommendation #1 – Foster Catalytic Investments through aligned IF selection criteria: several best practices emerged from the analysis. Various IFs indicate that a local team that understand the context and has local expertise and a network is of vital importance. Similarly, IFs and SMEs accentuated that they value a hands-on approach (in terms of developing a strategy, professionalisation, and the process of securing additional funding). The potential to foster the catalytic effect can be improved by aligning IF selection criteria with the best practices.



Recommendation #2 – Continue to amplify the passive cornerstone effect by ensuring an effective DGGF branding and visibility strategy and a reflection on how to improve it, to make sure that key follow-up investors are aware of it as a high-quality fund-of-funds, allowing the IFs in their turn to more easily tap into investors for next rounds.



Recommendation #3 – Continue to further promote peer-to-peer learning between IFs: Fund managers indicated to be interested in peer-to-peer learning or community of practice activities related to the catalytic effect. Activities supported through the DGGF Academy facilitate this.



Recommendation #4 – Promote further thinking and learning on the Catalytic Effect by sharing the insights generated in and through DGGF with other similar funds and key policy stakeholders (such as those stakeholders involved in the Publish What You Fund campaign).



Recommendation #5 – Provide guidance and support to public funding opportunities: We found fund managers are generally well aware of further private funding opportunities (PE/VC primarily), they are not always optimally aware of the different public funding support instruments, such as grants and loans as well as soft measures (e.g. acceleration support, internationalisation support), offered by the Dutch government (e.g. DHI partnership projects), other bilateral donors, or multilateral actors (e.g., MFIs, instruments of Eureka). The DGGF secretariat could provide a short guidance document providing a (yearly updated) overview of the main opportunities for hard and soft support, thereby supporting the IFs in faster active professionalisation as well as active secondary cornerstone effects.



Recommendations related to DGGF monitoring

We see that in many cases information on the Catalytic Effect already is available at different sources. Depending on the preferences and willingness to report at the IF-level, different approaches to track catalytic investments can be used. These can be used in parallel to each other or individually:



Recommendation #6 – If feasible and desired, integrate the tracking of catalysed investment monitoring in the DGGF Impact Monitoring: Providing a standardised framework on how to report catalysed investments will make it easier for the IFs to report on it and will help to get insights into the overall Catalytic Effect at the portfolio-level.



Recommendation #7 – Monitor external databases to get insight into the Catalytic Effect



Recommendation #8 – Include qualitative questions on the Catalytic Effect and mechanisms in the DGGF Impact Monitoring



Recommendation #9 – Setting up a contact database of SMEs supported through DGGF would greatly facilitate the ease of data collection at SME-level, allowing for more granular insights on the Effect.

Limitations

This Deep Dive is subject to a number of methodological limitations. These limitations stem from the relative novelty of studying the catalytic effect, as well as data limitations. The **conceptual limitations** relate to the **heterogeneous portfolio** (both at the IF- and SME-level), as the wide variations in SME size, maturity, and sector makes it difficult to isolate attributes contributing to catalytic effects; the **attribution challenge**, as a range of external factors beyond the involvement of the investment funds influence the additional investments; the **Block III constraints** – as the dynamics, reporting requirement and internal data gaps limit the comparability and completeness of the data. The practical limitations include: **data gaps**: the absence of access to historical IF data means that the study reflects a present-day snapshot; **survivor bias**: SMEs that failed or exited the portfolio prematurely are underrepresented in the sample, potentially skewing findings toward more successful cases; and **data matching challenges**: Data matching proved difficult due to inconsistent company naming across different data sources.



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