Department for International Development

Low Carbon Study Fund 203134-101

Fund Management/ Administrator

Impacts on Investment

and Challenge Funds' Value for Money,

Efficiency and Results

Report

PO 40071245

Submitted by

LION'S HEAD

global partners

Contents

A. Glossary

Acronym	Expanded	Glossary
AECF	Africa Enterprise Challenge Fund	Investment and Grant Challenge Fund for RE and Agriculture businesses in East Africa
AfDB	African Development Bank	African MDB
AsDB	Asian Development Bank	Asian MDB
AUM	Assets Under Management	Total invested capital in a given fund
Capital	-	Financial assets, typically cash
CDC	CDC Group	UK Government Development Finance Institution
C-DEL	Capital Departmental Expenditure Limit	UK Government department investment in assets – fiscal for depreciable physical assets and non-fiscal for financial instruments
Concessional	-	Below rate available in commercial market
CP3	Climate Public Private Partnership	Donor funding initiative to create 2 PE fund of funds
DFI	Development Finance Institution	Alternative financial institution that provides equity, debt and guarantees for developmental projects and companies
DfID	Department for International Development	UK Government Department responsible for overseeing international aid policy and delivery
DOTs	Development Outcome Tracking System	IFC internal ESG monitoring and evaluation system
EAIF	East Africa Infrastructure Fund	A project debt fund within the PIDG
EEP-S&EA	Energy and Environment Partnership with Southern and East Africa	Grant Challenge fund for early stage low carbon project design and development
EIB	European Investment Bank	European bank that borrows on capital markets to finance developmental projects in/outside the EU
FCA	Financial Conduct Authority (ex FSA)	UK financial services regulator
Fund	-	A pool of capital managed and invested by a dedicated fund manager
GCPF	Global Climate Partnership Fund	Donor fund lending to projects and financial institutions to promote low carbon development
GNI	Gross National Income	Key indicator of a country's economic performance incorporating all economic activity including earnings generated abroad
GP	General Partners	Term for Fund Manager of a Private Equity fund
Hedge Fund	-	Fund applying an investment strategy that targets absolute return – i.e. long and short investments
HIF	Humanitarian Innovation Fund	The Humanitarian Innovation Fund is a challenge fund that provides grants to organisations and individuals to identify, nurture and share innovative and scalable humanitarian assistance solutions
IFC	International Finance Corporation	World Bank investment arm

Acronym	Expanded	Glossary
IRIS	Impact Reporting and Investment Standard	GIIN designed and hosted development outcome reporting system for impact investors and funds
IRR	Internal Rate of Return	Measure of financial return equivalent to the discount rate for a series of cash flows that creates an NPV of zero
KfW	Kreditanstalt für Wiederaufbau	German Government's Development Bank
KKR	Kohlberg Kravis Roberts	First and most established Private Equity firm
KW	Kilowatts	Measure of electrical output
Long	Going long	Purchasing a financial asset / making an investment on the assumption it will increase in value over time
LP	Limited Partner	Term for investor in an Private Equity Fund
MDB	Multilateral Development Bank	Alternative financial institution provided by a group of countries to provide financing (predominantly debt) and advising to governments and companies for a developmental purpose
Mezz	Mezzanine	Subordinated debt / preferred equity (i.e. ranking ahead of equity but behind project debt in terms in an event of default. Returns are typically higher than senior debt but lower than expected equity returns.).
MFI	Microfinance Institution	Financial institution lending money to low income individuals, households and cooperatives that are otherwise not served by commercial banks
Mutual Fund	-	Fund comprising capital pooled from a number of investors; each shareholder proportionately shares in gain or loss of fund. Usually long-only investment
NPV	Net Present Value	Measure of value for a financial asset. Sum of future cash flows occurring over the life of an investment. Each future cash flow is discounted with a rate reflecting its riskiness.
ODA	Overseas Development Assistance	Most recognised indicator of international aid flow measured by the OECD
OECD	Organisation for Economic Co-operation and Development	International organisation that promotes international economic development and trade
PE	Private Equity	Equity (i.e. ownership) investment directly in a company – not via a listed instrument that is publicly traded
PIDG	Private Infrastructure Development Group	MDB set up by the UK with partner governments that acts as an umbrella to a number of funds promoting private infrastructure investment in emerging markets
R-DEL	Resource Departmental Expenditure Limit	UK Government spending on operational expenses and grants (i.e. is consumed in specified period).

Acronym	Expanded	Glossary
SCAF	Seed Capital Assistance Facility	Grant/investment challenge fund / TAF supporting project equity funds to work in frontier markets on early stage project costs, hosted by UNEP
SEFA	Sustainable Energy Fund for Africa	The Sustainable Energy Fund for Africa is a bilateral trust fund administered by the African Development Bank to support small and medium clean energy and energy efficiency projects in Africa
Short	Short selling or going short	To generate a return by betting on the decline in value of a financial asset . Asset is sold and then repurchased.
SME/MSME	(Micro) Small and Medium Enterprise	Small scale business
SWF	Sovereign Wealth Fund	State-owned investment fund, often funded by commodity revenues or foreign exchange reserves
TA/TAF	Technical Assistance Facility	Pool of capital that provides concessional (often grant) finance to support investor/investee activities to support a particular developmental objective
UNEP	UN Environment Program	UN Agency coordinating environmental activities
VC	Venture Capital	High risk/high return investment in early stage businesses, projects, technologies

B. Executive Summary

DfID has a strong track record of achieving development results by leveraging the private sector.

DfID has become a leader in harnessing private sector solutions for public sector programs, delivering global public goods such as climate mitigation efforts in collaboration with the private sector. Notable examples include the Private Infrastructure Development Group (in particular the Green Africa Power initiative) as well as the AECF/REACT challenge funds.

Funds have become an established conduit for public & private capital into developing countries.

A large number of investment funds focusing on developing countries have emerged in the last decade. Donors and foundations have turned to independently managed investment vehicles to deliver development outcomes; simultaneously, private investors have used funds with a variety of investment strategies to tap into rapidly growing economies.

Investment funds can make development assistance more effective.

The investment fund model has a number of attractions and is complementary to traditional public sector strategies. It gives Donors access to private sector tools, creates new incentive mechanisms to achieve desired outcomes, attracts private sector co-financing, broadens the pool of management talent available to implement development programs and fosters a focus on long-term financial and developmental sustainability.

Funds are becoming an increasingly important tool for DfID.

Funds achieve two important purposes for DfID: (i) they engage the private sector to deliver development outcomes, and (ii) they are a response to the Government's desire to limit new borrowing without reducing its commitment to aid. As a larger group of DfID policy makers is exposed to, or tasked with designing investment funds, it becomes increasingly important to bridge the gap between public sector development thinking and private sector practices.

Delivering public sector initiatives through the private sector is complex and often leads to unintended consequences.

Donors are looking for solutions that have reach and scope, that are catalytic and innovative; private sector fund managers are often struggling with basic operational matters and to remain financially viable. The public sector wants value for money and is focused on safeguarding tax payers' money; fund managers are looking for appropriate compensation and in many instances performance-based pay-outs. Donors are accountable to the public and therefore ask for control, performance measurements and evaluations; the private fund managers want space to focus on their day to day job and flexibility to operate in a dynamic investment environment.

An effectively structured Fund meets the requirements of the market

In an effort to satisfy donor requirements, Fund structures often lose sight of the market. We want to draw attention on three core areas that are instrumental for the effectiveness of a private sector Fund:

- Alignment of Incentives
- Governance Mechanisms
- Structural Alignment

In all three areas, we frequently observe misalignment and unintended consequences borne out of the conflict between meeting government objectives and delegating authority to the private sector.

This study outlines the key principles and parameters of fund structuring and management.

Given the need for long term sustainability in all sectors of DFID's work, but especially in the climate space, the Low Carbon Study Fund commissioned a study on best practices, value for money, governance and other Fund related issues. The purpose of the study is to assist programme directors and policy makers in designing Funds and engaging with Fund Managers in relation to the management and administration of public funds.

In the following sections we will analyze how the cost of managing a fund is impacted by a focus on development outcomes. We will demonstrate that incentive compensation is effective for financial outcomes and that a lack of financial targets frequently results in higher costs. The study will furthermore explore how tight governance models impact decision making, lead to friction costs and sometimes misalign investors and fund manager. We will finally highlight the complexities of reconciling effective investment strategies with government objectives, such as non-fiscal spend, ODA and directives on tax havens.

In summary, funds are a powerful mechanism to deploy capital efficiently. However, achieving both development and financial outcomes in developing markets is challenging, especially for small funds or those that target small businesses. Successful funds take into consideration the 'human factor' – the way individuals react to often conflicting targets in a demanding environment. An understanding of Fund parameters, the relationship between strategy, compensation and Fund structure will contribute to better Fund design and more effective collaboration between the private and the public sector.

C. Introduction

Introduction

The development community in general and DfID in particular have committed and will commit significant amounts of capital to low carbon development projects. Increasingly, organizations like DfID are using funds as delivery mechanisms. As a result, fund structures can and should build on existing best practices.

Aims

This report aims to help policymakers understand the mechanics of commercial and non-commercial (grant) funds. In particular, we describe the most common management, compensation, governance and operating models. We also describe some of the approaches – and issues – that arise for funds and programs in the development sector, specifically, where commercial concepts are adapted to meet scrutiny by and demands of governments and tax payers.

Development funding is inherently complex; linking it to financial outcomes, even more so. This report identifies the best practices from the commercial fund sector and analyses how to integrate them with donor requirements (and constraints) as it relates to structuring, governance, value for money, and monitoring & evaluation.

Types of fund

"Funds" in this context is a broadly used, and sometimes misused, term. It describes the process of delegating authority for the deployment of capital to an independent management team. At a high level we distinguish between commercial funds – those that seek to maximize financial outcomes, and predominantly developmental funds, where development outcomes replace, or complement the goal of generating financial returns. . In this report, we also introduce the distinction between "funds" – investors hiring a fund manager to assume fiduciary responsibility for managing third party money i.e. the Fund takes legal ownership of the money (most investment funds) - and "programs" - governments hiring a third party to manage the selection process of grant recipients (most grant challenge funds). This distinction matters because with the former the fund manager acts as principal, whereas in the case of the latter program managers are simply contractors carrying out certain tasks on behalf of a donor.

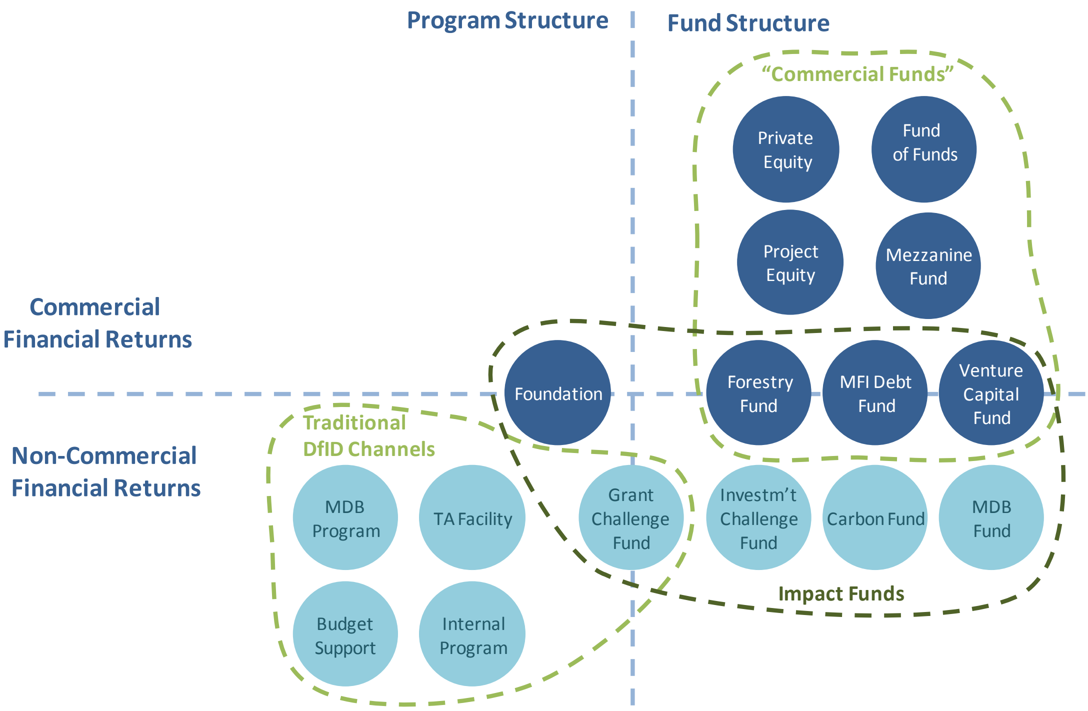


Figure 8 : Fund Types Matrix

Commercial Funds

The objective of commercial funds is to generate financial returns for investors. Funds' size and structure vary depending on their investment strategy and generalizations are difficult. This report focuses on funds wherein investors act as equity holders in the fund and uses Private Equity funds as the template for analyzing structure, compensation and governance. Private Equity funds make direct investments in companies and projects – typically around 8-12 investments over a 10-12 year fund life, targeting 15-25% returns across the portfolio. Venture Capital funds are a higher volatility equivalent with some structural changes due to the smaller size and higher risk profile of investments. Mezzanine and debt funds have the same basic structure as PE funds but some variation to accommodate different risk/return profiles, investment periods, sectors and management requirements.

Predominantly Developmental Funds

In the predominantly developmentally oriented sector, financial returns are complemented with specific development targets. Such funds typically accept higher risk or lower returns in order to achieve development outcomes[1]. In this category the term "fund" is often stretched, for example where it depicts programs or budgets that are spent on a defined activity (e.g. capacity building) – no capital is invested in an asset. Challenge and grant funds support developmental projects with concessional or free capital, generating no financial returns for the donor or investors. As such, a fund manager overseeing the selection process and disbursement is not making investments but rather overseeing a grant disbursement process.

Impact funds adopt some commercial fund approaches to channel concessional/philanthropic capital into businesses with high development impact, using financial instruments – debt and equity. Many of the more common strategies – such as carbon finance, forestry, microfinance and SME venture capital funds – target double bottom line returns[2] with development outcomes compensating for lower returns/higher risk.

Key Fund Characteristics

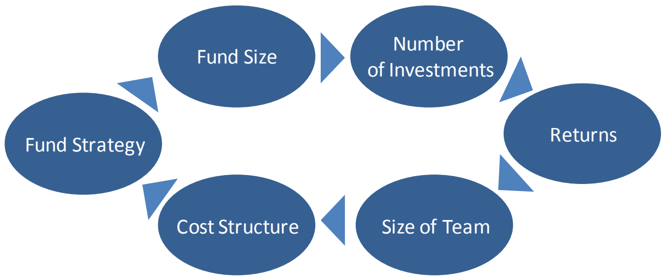
To describe and assess different structures, this report focuses on key fund characteristics. We analyse management structures – in terms of resources and compensation, - and governance structures. We then describe some of the key challenges that funds in this sector face in practice. Finally, we describe the additional structuring issues that are specific to DfID funds and propose some options.

Fund Management: Structure & Compensation

Fund management activities include fund raising, deal identification, investment structuring & execution and transaction monitoring & exit. In order to carry out these tasks, a fund manager needs a competent team and access to certain expertise. Fund size, strategy, team and costs are all interdependent. If a fund has a complicated or labour-intensive strategy to make and manage investments, it will tend to have a higher relative cost.

[1] For the purpose of this report we treat funds that target risk-adjusted financial returns and also deliver development outcomes as commercial funds. Arguably, almost every fund that invests in developing country has a development impact by virtue of increasing foreign direct investment.

[2] 'Double bottom line returns' refer to enterprises that are not solely profit oriented but rather target both financial and social/ developmental outcomes. The latter are not viewed as a positive by-product but are especially built into the business model. In the climate sectors, non-financial returns can include C02 savings, energy access for low income households, female employment, reductions to soil erosion, deforestation, etc.



Costs incurred by a typical fund are comprised of 'fund operating costs' (e.g. audit, establishment, fund administration) and 'fund manager costs' (i.e. salaries, expenses and, in some instances, profit share). The latter represents the majority of total fund costs.

There are four basic compensation models that reward the fund manager for executing its mandate:

1) *Mutual Fund:* Basic % of total assets under management
2) *Private Equity/Hedge Fund:* % AUM plus profit sharing (carried interest)
3) *Corporate:* Salary plus discretionary bonus
4) *Program Management:* 'Cost plus' charge for resources needed

The fund management fee is intended to cover basic salaries and fund manager operating costs (travel, office etc). Funds below a certain size incur fund management expenses that are too high to be covered by investment returns while still delivering returns to investors. Mutual funds tend to break even at $15-25mm (but by dealing in public equities, have much lower costs, not discussed in this report). Private Equity funds, however, tend to struggle to deliver commercial returns (>15%) at fund sizes below $75mm. Debt funds can be commercial at below $50mm, provided, however, that they lend on a very standardized basis[3].

Commercial funds need a balanced team to source, diligence, manage and exit investments; they also require resources for fund raising, investor communication general administrative (legal and accounting) support. Typical annual fees for investment funds range from 1% and 3% of funds under management.

Most private equity and hedge funds award managers a "carried interest" – i.e. profit participation. Carried interest is almost always set at 20% of profits generated after a given hurdle and repayment of all fees and costs. Carried Interest is designed to align the incentives of management and investors. It ensures that the fund

[3] These are gross generalizations and examples exist of small private equity fund that are very successful. However, these funds tend to operate in niche markets, make fewer deals or have the ability to invest capital in a very short period of time. The benchmarks herein refer to 'typical' funds that seek to make at least 8 – 12 investments and operate in a comparatively more challenging emerging markets context.

manager acts 'as a principal' alongside all other investors[4], and is motivated to maximize risk-adjusted returns.

By way of contrast, grant programs often have higher resource demands. In part, this is because they are aiming to support much more complex and demanding projects in challenging sectors/markets. Programs also have much higher administrative costs – to manage the additional due diligence and reporting burden associated with projects supporting social, economic and environmental development. As a result, donor and MDB programs typically have budgets in excess of 20% of the total allocated capital or annual fees as high as 4-7% of the donor committed capital. Because the program manager is not looking to generate a return, and does not share in the financial outcomes of the program, he is not incentivized to keep costs low. On the contrary, a Program Manager is judged by the quality of the 'execution process.' Better performance typically equates to 'more process' and therefore leads to more costs. As a result, Grant Challenge Funds have approximately 70-100% higher costs structures than commercial investment funds on an annualized basis.

The large spectrum of hybrid impact/commercial funds tends to have fees in between commercial funds and grant programs. Smaller size, higher transaction costs, immature markets require larger teams, increase the cost base and introduce higher risks.

Governance

Governance is a key component of both investment funds and development programs. Delegation of authority is highest for commercial funds (investors have limited step in rights[5]) and lowest for grant funds/programs (the fund manager acts as hired contractor operating under a strict mandate). Development oriented funds have adopted governance structures that separate fund management and investment committee. This structure introduces additional checks and balances. It results, however, in additional costs, and can have adverse unintended consequences (while the fund manager may be incentivized through the carried interest, the investment committee typically operates on a salary, or even pro-bono basis).

The main rationale for separating fund management and investment committee in donor funds is that tax payers require assurance that the fund is operating within stricter limits (preventing abuse rather than only having power to remedy). As a

[4] Carried Interest is paid after the fund manager has repaid all costs and fees. The Fund Manager is therefore also incentivized to keep costs low to maximize his profit share.

[5] Private equity funds are often referred to as 'black box' because investors have no say/involvement in the investment process. The fund management agreement regulates the activities of the fund manager. Non compliance can only be remedied by replacing the fund manager.

result, a non-commercial fund often has:

- very strict investment conditions imposed on the fund manager
- either an investment committee independent of the Fund Manager or populated by the investors directly
- additional technical/developmental committees with control over investments
- strict non-financial performance measurement, often by a 3rd party
- different managers for investing, monitoring and exiting investments

These additional governance structures have direct impact on the costs and performance of non-commercial funds. Additional layers of governance reduce flexibility, slow down decision making and reduce risk appetite[6]. To fund managers and recipients, these rigid and convoluted governance structures often appear to be unproductive meddling – exactly what DfID aims to avoid.

Measuring Performance

Financial outcomes can be measured and benchmarked. Financial capital is mobile and constantly seeks out the best risk adjusted returns. While not always absolutely scientific, a fund in Africa can be compared to one in the US and another one in South-East Asia. A global investor will allocate capital based on a relative value judgment about how effectively a fund manager will be able to achieve financial returns in a given market.

Development outcomes are often difficult to measure. Where they can be measured (e.g. kWh produced, tons of carbon mitigated) they cannot always be benchmarked against other projects. For example, the development metric of 'women employed' can be measured, however, passing judgment on such an outcome is often difficult, if not impossible (is employing 10,000 women better than preventing 100,000 ha from deforestation). As a result, value for money judgment in the impact investment realm remains an art rather than a science. In many instances the lack of relative performance metrics can lead to paralysis. The prospect of a potentially better deal – having to prove value for money – has slowed down disbursements of funds for some stand-alone TA facilities such as SEFA.

Ultimately, the data that fund managers report beyond basic financial performance is driven by the data investors want. A common complaint from fund managers is that multi-lateral/investor funds have too many different reporting requirements. Therefore donors should aim to use standard reporting templates. Fund managers are increasingly using a handful of standard measurement and reporting channels for development outcomes – namely IRIS and the IFC's performance standards/DOTS. CDC has also produced a simple, generic toolkit for fund managers

[6] An independent salaried investment committee hired for a limited period of time has no incentive to take risk – it does not get rewarded if risk taking pays off but faces reputational damage if the investment fails.

on reporting that allows managers to design their own systems.

Operational Impact

Fund operational efficiency is impacted by trying to marry commercial fund structures with non-commercial objectives. As noted above, it is impossible to scientifically evaluate and prioritise financial and developmental outcomes. It is (relatively) straightforward to maximize financial returns – much harder to agree on sacrifices to financial performance for the sake of non-commercial objectives. In most instances this tension results in higher cost, slower decision making or funds designed to meet donor objectives rather than market requirements.

In the case of climate finance, specific issues encountered include:

- Funds designed by investors/donors tend to underestimate the resources and demands of developing climate finance projects in immature, emerging markets;
- Fund tenure is too short for the timescale needed to get a project, business or similar operational and exited, especially in RE development, venture capital and sustainable agriculture or forestry investment;
- Non-commercial funds/programs deal with small and micro businesses and projects – meaning small investment amounts. For a large fund, this requires making a lot of investments to disburse capital – made more complex by the need to meet non-financial investment criteria.

Once the fund is structured, donors often require or aim for private/institutional investment alongside – but neglect fundraising issues such as:

- Private investors limit asset allocation in terms of total investment in a fund type, geography, sector; minimum investment size and % share in a fund;
- Private investors must comply with their fiduciary duty to maximize risk-adjusted financial returns before considering non-financial performance. The return profiles of proposed funds are often simply too low;
- Donor efforts to improve returns with downside protection often signal that the fund is making non-commercial investments – and therefore repels private investors. Managing towards below market returns is difficult and ambiguous, and therefore investors may worry that even with loss protection, the fund will underperform.
- Private investors are put off by donor demands in terms of investment oversight, reporting and capital calls – which often give donors disproportionate control and/or add costs.

Operational issues linked to non-commercial fund structures include:

- Funds remain uncommitted because the criteria are too limited, or the investment process too complex in order to include financial and non-financial performance.
- A disproportionate amount of capital is spent on fees, which results in the

harsher investment environment for climate finance in emerging markets
- Funds struggle to define catalyzing a given market and attribute benefits
- Reporting systems put too great a time/cost burden on the manager
- Investees avoid working with donor funds because of the additional requirements they must meet, and resulting time/costs.

Other Issues to Highlight

In addition to the demands of combining development outcomes with commercial fund models, DfID sponsored funds need to consider a range of internal government constraints and targets unrelated to development per se. The most notable include:

- DfID Accounting: an increasing percentage of funds have to be invested (non-fiscal C-DEL) rather than being given as grants (R-DEL)
- ODA Targets: the UK is committed to reaching its 0.7% of GNI ODA target. Achieving ODA credit for investments is often difficult and requires significant structuring complexity
- Fund Jurisdiction: the UK government is committed to reducing its use of jurisdictions considered tax havens. The fund industry however, for many acceptable reasons, relies on these jurisdictions to operate efficiently.
- FCA Regulation: Fund management of third party funds and marketing funds to other investors is a regulated activity. The FCA limits the activities of unregistered entities (such as DfID) in the fund industry.

Conclusions

For the DfID practitioner structuring fund there are a few high level guidelines that may be of use:

- Fund models are very diverse. There is no ‘one size fits all’;
- Fund structures have to take into consideration human behavior. Legal contracts and governance should be seen as a backing-up aligned business interests between manager and investor.[7] Proper incentives for all key parties is paramount;
- Most institutional investors struggle with small, illiquid investments in unproven markets. Risk / return considerations are only part of the decision making process;
- There is a limit to how many transactions a single fund can handle before it has to make trade-offs (e.g. AECF can handle a large number of transactions,

[7] We make this somewhat trivial point because this basic rule is being overlooked in so many development oriented funds. For example, the recent trend of installing independent investment committees is counterproductive in many instances. Anybody who joins such an investment committee on a salaried or pro-bono basis will have a motivation that is different to that of the fund manager (e.g. many IC members, while chosen for their commercial and/or political experience, do not get rewarded for making good investment decisions. The rational for joining the IC is often prestige, visibility, the desire to ‘give back to society’ etc… This creates asymmetric incentives where ‘being wrong’ has significant downside, while ‘being right’ limited upside).

however, at the cost of an 18 month investment process);

- Very small funds (<$75mm for private equity) are inherently less efficient;
- Too many funds are structured to meet donor requirements rather than addressing market needs;
- Not investing is almost always the worst investment. Financial performance of a fund suffers significantly if funds are deployed slowly; Grant challenge funds are generally more expensive than investment funds. This is due to complexity, over ambitious goals and a lack of incentive to operate efficiently.

D. Fund Structure Analysis

Topics Covered in this Section:

- What are the key characteristics common to investment funds?
- What is the genesis of the private equity model and what strategies have developed over time?
- How does one segment the market of donor fund options?
- Why are funds relevant to DfID?

D.1 Fund Trends in Climate Finance

The last decade has not only seen a renewed commitment to aid, including the UK's pledge of increasing ODA to 0.7% of GNI, but also witnessed a trend towards making aid flows more accountable by increasingly applying private sector principles. Not surprisingly, governance, efficiency and accountability are the key concerns of donor agencies.

This period of soul searching coincided with the spin-off of the UK's private sector development activities into Actis - in part driven by the view that professional private sector fund managers would be better incentivized and equipped to identify and manage investment opportunities in emerging markets. It also coincided with a cyclical outperformance of the private sector industry relative to other asset managers and a substantial re-allocation of funds, including from public pension funds, into the private equity industry. Especially in the middle of the last decade, the private equity model was seen as having not only an intellectual, but also structural advantage relative to other investment vehicles. The structural edge was manifested in a compensation structure that aligned incentives to long-term outcomes. The traditional mutual fund and pension fund management compensation model was built around a simple fee for service approach. Private Equity funds introduced a novel concept of profit sharing (carried interest). For a more detailed look at the private equity model, see Box 1 below.

Against this backdrop, the debate about reforming public sector aid spending (including through the private sector development arms of governments and Multilaterals) looked towards the private equity industry for inspiration. The (somewhat simplified) outcome of this review process was a marked shift towards funds (broadly defined) as the preferred avenue of donor engagement. CDC Group shifted from being a direct investor in assets, selling off much of its portfolio in the 1990s/2000s to adopting a Fund of Funds strategy. The African Development Bank and other MDBs created sizeable portfolios of private equity fund investments. The number of private equity funds investing in developing countries has increased significantly over the last 10 years; investors in these funds were largely DFIs and MDBs – who incidentally shifted their own business model to increasingly become private equity style investors themselves.

Once the concept of funds became understood and accepted within development circles, the application of funds broadened to encompass interventions that were previously funded through grants or concessional loans. It was argued that by tying financial rewards to development outcomes, rather than financial returns, the rigour and efficiency of the private sector could be applied to traditional developmental activities – the impact investment fund operating with double or triple bottom line was born. It is during that period that the Africa Enterprise Challenge Fund (AECF) and the Private Infrastructure Development Group (PIDG) were conceived and implemented.

Box 2: Overview of Key Features of Private Equity

The title given to this section is misleading but instructive of the confusion caused by trying to apply developed market concepts without distinction to an emerging market context. Private equity is either a very broad term given to investment activities that do not involve publicly listed securities, or it is the narrowly defined buy-out model described in the book 'Barbarians at the Gate', the story of the record size takeover of RJR Nabisco by a private consortium led by the first pure buyout firm, Kohlberg Kravis Roberts in 1989.

Origins of Private Equity

In the late seventies and throughout the eighties a new breed of investors demonstrated that the use of leverage, rigorous financial discipline and a long-term view can create significant economic value. They out-performed investors in publically listed companies who focused their energy on short term metrics for quarterly reports. Private Equity investors are able to take a longer term approach to the performance of a company – and are incentivised by realized returns at the eventual exit rather than short term market movements. The private equity practitioners argued that the high levels of debt used to acquire companies led executives to take better financial decisions. The process of financing company acquisitions with large amounts of debt and subsequent de-leveraging through restructuring, divestitures and turnarounds required dedicated and professional financial managers with operating experience, specific financial skills and importantly access to long-term capital. The typical private equity transaction from acquisition to exit lasted multiple years.

The key innovations of the private equity industry were:

- Private company ownership, detached from the spotlight and reporting requirements of public markets.
- An activist investment approach that involved taking controlling stakes in companies
- Highly geared acquisitions that created financial leverage which was the driver of outsized equity returns
- Long-term capital committed to a professional investment team, with limited or no liquidity until the end of the fund life
- Significant delegation of responsibilities and oversight to investment team for extended periods of time
- The investment manager becomes a stake holder in the business he acquires and therefore assumes certain operational responsibilities

Unlike traditional mutual funds and pension funds that looked to slightly outperform the stock markets, private equity fund managers promised significant 'alpha' or excess financial returns over longer period of times. Traditional institutional investors focused on listed stocks, were mainly passive and operated under a fixed percentage fee model. Private equity investors, on the other hand, were pro-active, had to go through the process of taking companies private, raising acquisition financing, in many instances installing new management etc. These activities required larger teams, significant transaction costs, time and effort. In addition, private equity fund managers successfully convinced investors that their superior investment performance warranted significantly higher remuneration. As a result, new compensation models had to be developed.

An additional differentiating factor between private equity and other investments – one that was considered critical in delivering operational and financial outperformance – was fund manager co-investment. Fund managers invested their own capital along-side investors and negotiated a 'carried interest' in the performance of their portfolio companies. This led to an important mind-shift in the attitude of fund managers. They were no longer just managing 'other people's money'. Companies they invested in were seen as 'their own businesses'. Investment outcomes were no longer just statistics, but had a direct tangible impact on their overall compensation.

Table 1: Key Characteristics of Private Equity Fund Model

Concept	Description	Other Investment Models
Long Term View	Private equity is a long-term investing approach with typical turn-around cycles of 7 – 10 years	Mutual Funds, Hedge Funds operate on a month to month or quarterly basis.
Absolute Returns	Private Equity Funds focus on delivering absolute returns, typically expressed as a multiple of capital invested (e.g. Fund achieved '2x' return)	Mutual funds, insurance companies often focus on percentage returns and outperformance of an underlying reference index
Committed Capital	Investors in Private Equity Funds are committing capital for up to 12 years (and longer for infrastructure funds)	Most financial investments can be liquidated momentarily or with short notice (e.g. 3 months for most hedge funds)
Delegation of Control	Investors in Private Equity Funds delegate control over their capital to the Investment Manager for up to 10 years. They typically have no say in how and when it is invested (within certain overall parameters)	Investors can withdraw capital at any time and therefore maintain ultimate control of its use
Skills/ Approach	Private Equity fund managers in most instances require financial but also operating skills in order to manage, and often turn-around, portfolio companies	No operational involvement
Co-Investment	Capital contribution by fund manager of at least 1%-3% is customary (i.e. $1-3mm for a $100mm fund)	Not required (other than hedge funds)
Compensation Model	Fee + carried interest	Fee only (except hedge funds)

Despite the successes of the AECF, PIDG and other interventions, the marriage of development initiatives and fund business models has not always been smooth. Funds, in particular private equity funds, have certain strengths but also clear limitations. As the development agencies continue to adapt to a world with rapid economic growth in developing countries and the 'fund approach' is stretched to include an ever bigger range of Donor activities, the shortcomings of the 'fund model' are increasingly starting to rise to the surface. Before we analyse in more detail these issues, we want to review the key structural aspects of the fund industry, in particular private equity which most development funds are modelled against.

D.2 Defining Types of Donor Programs/Funds

Donor finance has traditionally been deployed following four distinct models:

1) Donors define a strategy and implement it internally, using government resources. This approach allows complete command and control of how capital is spent and, due to the role and expertise of donor aid teams, focuses on grant finance for activities with a high developmental value and minimal commercial value. The main limitations of this approach are a lack of internal resources, the need to engage experts in a particular field and, more recently, a desire to leverage 3rd party finance and private sector expertise.
2) Donors transfer aid directly to recipient/target governments, commonly referred to as Budget support. Under this model, the capital can be tied to supporting a particular (public sector) activity, i.e. developing a PPP unit within a particular government. Alternatively, the capital can be provided unconditionally.
3) Donors outsource the implementation of grant or investment strategy to a recognized MDB, e.g. the AfDB or PIDG. These entities were established with robust governance structures in line with donor objectives. Their resources are significantly larger than those of DfID and their regional presence more extensive. As with in-house programs, however, outsourcing development initiatives to MDBs and similar organizations does not always ensure value for money. Their services are in high demand, as the World Bank's 1,000+ distinct trust funds[8] attests. In fact, MDBs charge significant, and mostly non-negotiable, administration and management fees, especially when compared with some smaller, leaner private sector operators. MDBs offer flexibility and have access to a larger variety of instruments – but tend to be better suited to disbursing grant and debt finance. The IFC has responded to some of the limitations outlined above by setting up a separately managed asset management arm, which combines private sector practices with MDB governance.
4) Donors use independent third parties to administer particular programs. The donor usually defines the scope of the program and issues a tender for prospective managers –ensuring value for money via competitive bids. These program managers are often specially formed teams within other consulting or non-governmental organizations – for example international non-

[8] World Bank 2012 Trust Fund Annual Report

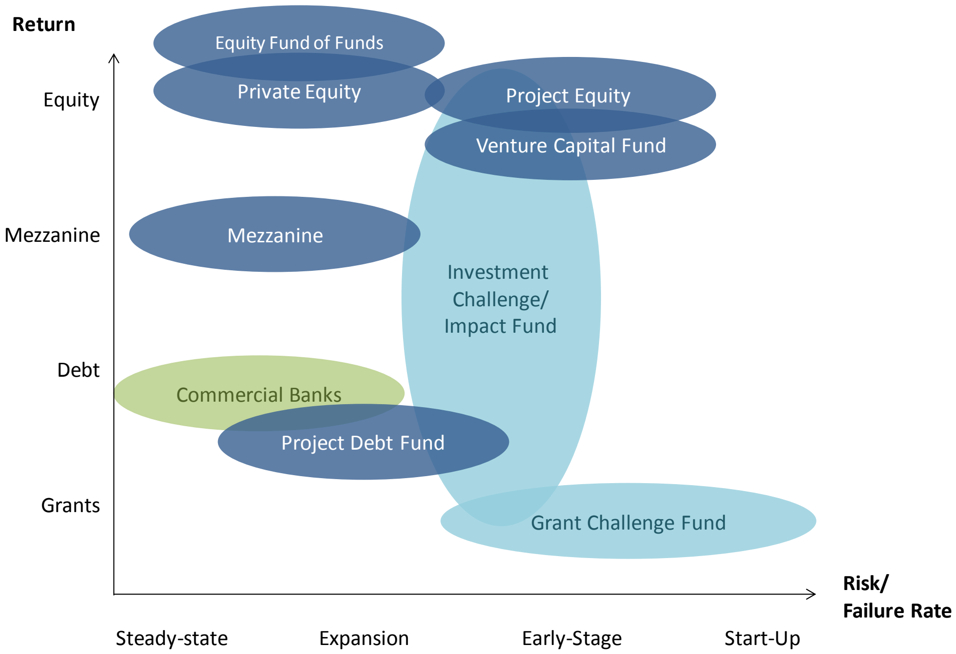
profits like Save the Children and Oxfam or "development advisory" sections of consulting and accountancy firms.

As donors shift their focus away from grant programs to investment management, new skills are required and a more market based approach to fund management is required. Professional investment managers such as Deutsche Bank (GCPF) or Credit Suisse/CFIG (Agvance/ CP3) and IFC AMC, and a host of smaller firms represent the new breed of fund managers investing in developing countries.

D.3 Defining Types of Commercial Fund/Fund Manager

Commercial investment strategies are varied and differ substantially from traditional grant programs or challenge funds. We believe 'Fund' is – all too often – a misused term. It gives the impression that fund structures are as homogeneous as other investment products such as shares or bonds. In fact, the term 'Fund' only describes an aggregation vehicle for investment capital. The spectrum of investment strategies that a fund can pursue is vast and requires different skills, infrastructure and investment teams. Figure 1 shows graphically how the universe of investments vary dependent on the investment instrument (grant/debt/ equity) and the stage at which investments are being made (start-up (angel)/early stage (venture)/expansion (growth equity)/steady state (buy-out). There are a myriad of funds that combine different investment products with various stages of business development – all differing materially in the way they deploy capital.

Figure 1: Fund Return profile relative to Interest depending on Fund Life and Performance



We have included Grant Challenge Funds in this table, although we believe that they fall into an entirely different category. They lack the 'investment' feature that is integral to all other fund models. Throughout this document we highlight how this distinction translates into different management models, compensation mechanisms and governance.

Table 2 describes in more detail some of the characteristics of funds that have evolved over time.

Table 2: Different Funds and their Key Features:

Type	Size (US$ mm)	Team/ Skills	Cost Structure	Number of Deals	Risk/Failure Rate	Returns	Comments
Buy-Out	100 -10,000	Small, focus on financial and structuring expertise. Complemented with operating experience	Very scalable; i.e. larger fund does not require pro-rata more resources	8-12	Low, total loss of investment is considered rare	13-15% on average over the long term; however, top funds consistently deliver 25%+ returns	Invest in stable, established going concerns. Looking for businesses with strong cash generation potential. Acquisition part financed through the use of leverage.
Growth Equity	80 – 500	Bigger than buy-out funds, more focus on operating experience and less financial structuring	Less scalable as each deal requires more ongoing focus. Also, transaction sizes generally smaller, therefore growth implies more deals and therefore larger team	8-10	Low, although occasional failure of business is expected (10%)	13-15%, top returns can be as high as 35%+ but more standard deviation in returns	Invest in fast growing businesses or turn-around situations. Investment mainly through equity (leverage low). Typically operate in small to mid cap segment.
Venture Capital	30 – 500	Small, focus on relationships, vision	Very scalable, can do more deals per deal partner. Although limited by market size	15-20	High, expect only 20-30% of deals to be successful (but with very high returns)	13-15% on average, however, top Silicon Valley VC funds have consistently delivered 25%+ returns. High standard deviations of returns	Invest only equity in early stage business (no debt capacity). Rather than picking winners, VC funds take a broad sector based approach. Only need 1 or 2 winners to deliver attractive returns. Model works best in highly scalable sectors such as pharmaceuticals, internet
Infrastructure Funds	500 – 5,000	Small, focus on financial engineering	Very scalable; looking for large transaction size	6-10	Very low. Invest in very stable, established businesses with stable, predictable	10-12% on average; top performers target 18-20% returns	Highly leveraged transactions. Looking at regulated industries (utilities, airports) with predictable, stable returns.

Type	Size (US$ mm)	Team/ Skills	Cost Structure	Number of Deals	Risk/Failure Rate	Returns	Comments
					returns		
Mezzanine Funds	500 – 5,000	Small, focused on financial engineering	Very scalable; team can execute larger number of transactions	15 – 20	Low; look to invest in stable, cash flow generating businesses	8-15%; target 15-20% project return	Mezzanine funds typically work in conjunction with buy-out funds.
Debt Funds	1,000 – open ended	Variable; small for specialist funds (e.g. project finance), large for more commercial loans	Variable; similar to debt funds for project finance funds; larger fixed cost base for commercial loan funds	Variable	Very low	8-12%	Most debt funds are in fact commercial banks. Some private funds exist in specialist areas such a project finance (e.g. EAIF)
Challenge Funds	5-50	Large teams required to process funding requests	High, given often small deal size and time intensity of disbursement /monitoring	10-50	High/NA; failure difficult to define when funds given as grants	No financial return; development returns	The term fund is misleading for most challenge funds as these pools of money are not investing money but rather administering programs through disbursements of grants or paying for certain services. AECF and AgDevCo run challenge funds are an exception as they invest at least a portion of their funds

Because their investment strategies differ significantly, their business models had to adapt. Different skills, team sizes, operating locations are required to make investments and manage portfolio companies. For example, while buy-out funds were moving towards ever bigger transactions, looking to generate returns by applying increasing amounts of leverage, venture funds were looking for smaller deals and more diversification. The former required financial engineering expertise, structuring and capital markets skills, the latter relied on providing operating support.

From investing equity for buy-outs, funds broadened their scope to include other forms of capital, in particular mezzanine and certain debt products.

Compensation models also adapted to the new breed of fund managers. The broader group of private equity funds maintained a fee plus carried interest compensation structure. Fees became more flexible to reflect the size of the fund and the investment strategy – larger funds accepted lower management fees, while smaller funds or those requiring larger teams negotiated fees in excess of the benchmark 2%. Carried interest on the other hand, remained fairly stable at 20% across the board (a possible exception being very large infrastructure funds accepting carried interest at less than 20%). Debt funds' compensation structures have become more nuanced over time. Some operate as 'traditional funds' charging 2+20% whereas others are charging commitment, underwriting and maintenance fees[9].

D.4 Relationship between Fund Management and Program Management

This study aims to capture how DfID funds and commercial funds are structured in the climate finance space. As we note elsewhere in this report, historically, DfID and other government agencies have channeled capital in one of four ways: via internal programs, via Budget support to recipient governments, via funds administered by MDBs and via outsourced or contracted funds (e.g. NGO programs and Challenge Funds). Commercial funds – whether or not the instruments they use are concessional – offer another option, and given the impetus on investing in financial assets, have an important role to play. Figure 2 highlights that once the barrier is crossed from focusing on development outcomes only to making financial returns and assuming fiduciary duty for entrusted funds, the fund manager morphs from acting as an agent on behalf of a Donor to becoming a principal.

[9] Typical bank charges in relation to making a loan and ongoing monitoring

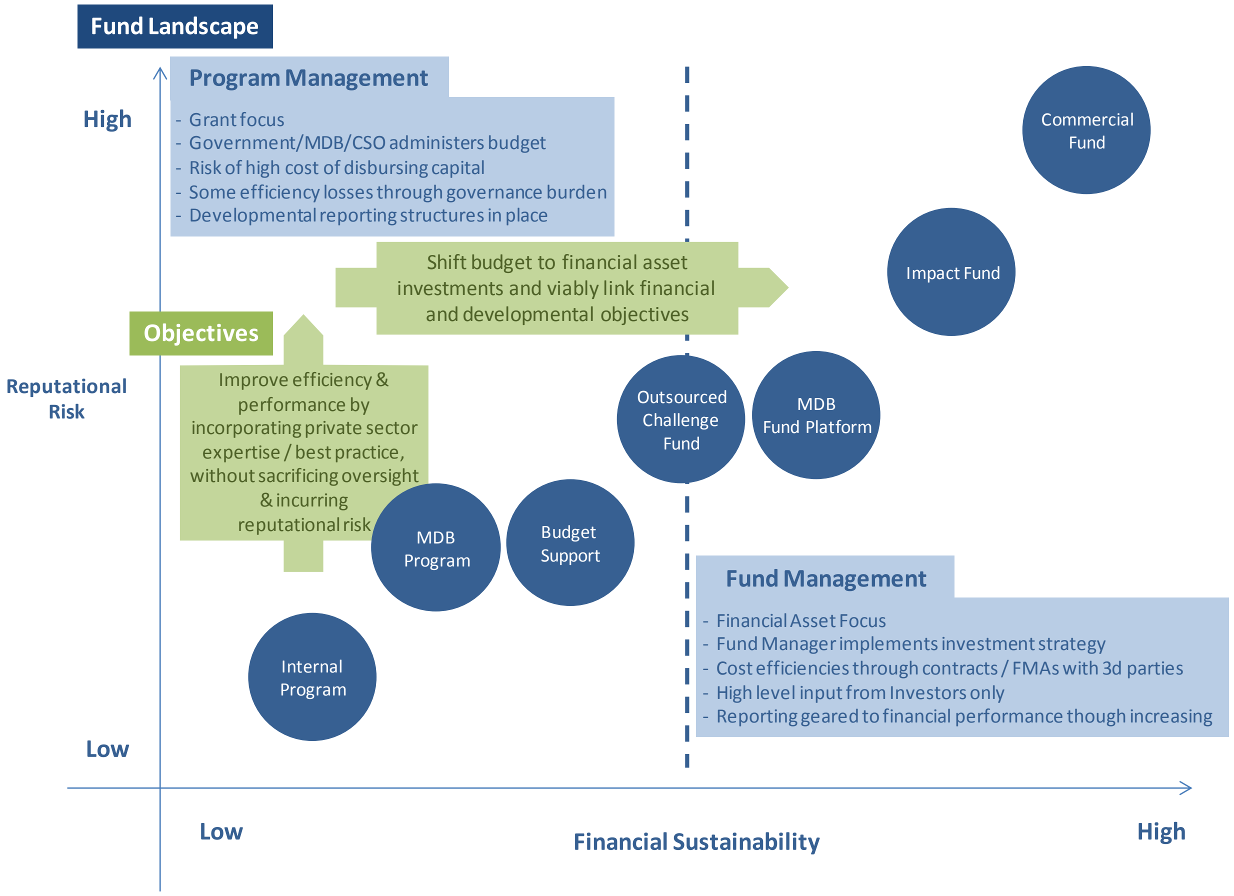


Figure 2: Simplified Fund Landscape and Objectives

Summary Conclusions:

- Funds are increasingly popular vehicles for Donor interventions. Their ability to tap into private sector expertise (and leveraging private capital sources) is viewed as an indispensable asset in delivering development outcomes.
- A key aspect of fund investing is the delegation of authority over a long period of time.
- Originally, funds focused on private equity; however, over the past years multiple fund strategies have developed focusing on different parts of the capital structure and branching out into new territories and industries.
- Key fund characteristics include:
  - Sector/ geographic focus
  - Type of instrument (equity, debt)
  - Fund size
  - Compensation structure
  - Return targets
  - Governance structure
- Donor focus on funds and new approaches pioneered by organisations such as the Rockefeller and Gates Foundations, has created new models including ‘impact funds’ seeking to deliver double bottom line outcomes as well as grant funds.

E. Management Resources and Compensation Structures

Topics Covered in This Section:

- What are parameters impacting the set up, size and compensation of a fund manager?
- Are there best practices that can guide fund design?
- What are typical fund compensation models and how do they vary between different fund strategies?
- Is the commercial fund compensation model appropriate for donor sponsored / initiated funds?

Because of the diversity of fund investment strategies there is no blue-print of a fund management model. Human resource requirements, operating strategy and compensation structure depend on the specific fund mandate and can therefore not be generalized. However, there are certain basic relationships that no fund can escape from. Fund size, number of investment professionals, cost structure and fund returns are all linked and cannot be determined in isolation.

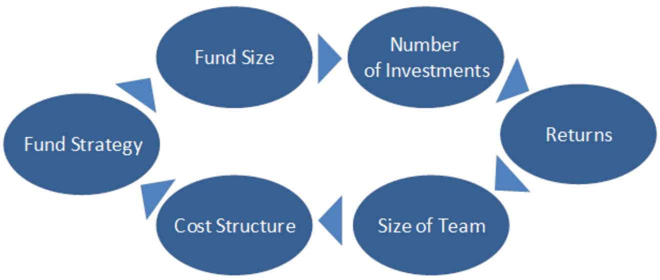


Figure 3: Relationship between Fund Parameters

What all funds have in common is that financial investors delegate authority over capital deployment to a third party. Human capital is the critical success factor. Assembling a team with the necessary skills and expertise is the core function of a fund manager. The size of the management team determines the fund's cost structure; the size of the fund is a driver for the fees available to pay the management team. The compensation structure has a direct impact on returns[10].

The size of a fund management team depends on a number of factors. At the most basic level, fund management requires investment and portfolio management expertise. A competent team will include investment professionals with sector and geographic expertise as well as a track record of investing capital. The manager needs access to a deal pipeline and the ability to evaluate, select and execute viable investment opportunities. In addition to financial skills, many fund management teams include industry experts or experienced operators. Investing in the climate change sector frequently necessitates expertise in project development (for power generation), carbon markets

[10] As described in more detail below, we distinguish between gross returns (prior to management compensation and fund costs) and net returns (post all costs). For a fund structured with a management fee and carried interest (i.e. most private equity funds) the difference between gross and net returns ranges from 7-10%. This is less for debt/impact funds that have smaller proportional incentive-based compensation.

(for CDM, REDD projects) or agriculture (for climate adaptation). Donor-sponsored funds often include experts in measuring and evaluating development outcomes.

A review of best practices shows that a typical deal execution team will include at a minimum a senior and a junior investment professional. A principal/senior manager will sponsor a transaction and take ultimate responsibility for the investment process and thereafter for portfolio oversight and exit. For small to medium sized funds, the fund manager will generally be able to field between two to four execution teams.

This investment team requires sufficient transaction support. This includes legal and accounting expertise to ensure that all documentation and contracting arrangements are sufficiently robust and that committed capital and annual financial performance is monitored. These services can be provided in-house, managed by third party contractors or some mix of the two.

Finally, funds often require specialists to manage ongoing fundraising, investor relations, reporting and other administrative tasks, such as general secretarial support. Whether these roles are staffed in-house or contracted out to specialists generally depends on the fund size.

The basic activities of deal generation, deal execution and deal exit apply to all investment funds. While the specific skills vary, there is no difference in approach between purely commercial and predominantly developmentally oriented funds.

E.1 Factors Determining the Composition of Management Teams

Generally speaking, we observe smaller teams for generalist private equity funds and debt investment vehicles and larger teams for impact funds and challenge funds[11]. Some of the reasons include the '2+20'[12] compensation structure used by most private equity funds, which encourages small teams to maximize overall profits. Many challenge funds and other very developmentally driven vehicles, operate under a cost plus model or receive significant additional technical assistance that provides funds for additional team members.

Grant challenge fund teams in particular are put together without the constraint of having to repay management fees to meet certain financial return targets. Their focus on reporting, M&E as well as a comparatively larger number of overall smaller transactions, requires bigger teams. While the management fee for a private equity fund ranges between 1.5-2.75% p.a., operating costs for grant challenge funds typically range between 3-4% p.a.[13]

Below we outline the key responsibilities of a fund manager driving team size, operating model and compensation structure.

---

[11] There are many exceptions: Voxtra, a $12 million agriculture impact fund has a team of 2 investment professionals, the $100 million Global Health Investment Fund (mezzanine), has 3 investment professionals.

[12] 2% management free / 20% carried interest

[13] This comparison is difficult insofar as investment funds have a 10 year life and repay management fees before any profit share to the management team. Challenge funds on the other hand have a 3-4 year lifespan (once funds are deployed their mission is generally completed). The aggregate fee they charge is comparable with that of a PE fund, but given the shorter lifespan, much higher on an annualized basis.

E.1.1 Investment/Activity Design, Policies and Processes

The resources required by a fund manager are principally a function of the fund's overall strategy. For investments in the low carbon sector, these core activities are described below.

Whether the platform is a commercial fund, a challenge fund, or a more direct program to support a particular low carbon activity, the management resources need to cover:

- *Fundraising*: commercial and philanthropic funds need to raise capital. For closed-end funds, including VC/private equity type funds (e.g. AfDB's African Renewable Energy Fund) and carbon funds (Terra Bella, BioCarbon Fund), the fund raising process takes place upfront. For open ended funds and charitable programs (e.g. Acumen, One Acre Fund, Root Capital) fund raising continues throughout. Fund raising skills are sometimes less relevant for funds that are initiated and funded by donors (e.g. EEP) or where donor investment facilitates capital raising by giving legitimacy to the fund.

- *Pipeline Development*: access to investment opportunities is critical for any fund, especially in developing countries where fewer intermediaries work to connect projects with investors. Most PE funds rely heavily on networks, word of mouth and a very active face to face marketing program (i.e. pipeline development in emerging economies is not a desk based exercise). Funds benefit from regional satellite offices in order to place team members closer to their market.

  Debt funds (EAIF, GuarantCo) typically do less primary solicitation and often rely on equity investors to bring them into a deal. They can therefore be more centrally managed.

  Donor programs, in particular challenge funds, tackle the difficult task of finding small scale, often very remote projects by streamlining the solicitation process into open tender competitions. Rather than going out 'looking for projects', they invite companies to 'find them'. This requires higher marketing effort and coordination, but has the potential to reach a much larger universe of potential investment candidates. Because proposals are not pre-screened, the administrative effort to select the final winner is significant.

- *Due diligence:* Due diligence is the process of screening and evaluating projects against financial, ESG and other criteria. Unlike publicly listed companies that are required to publish all relevant financial information, unlisted private businesses are often opaque. Investors have to devote substantial resources to getting relevant information on the company/project and its prospects. Challenge funds seek to manage this process by standardizing project solicitation and information requests; applicants are responsible for providing all relevant information themselves – though that information may not always be comprehensive or reliable. Private equity and debt funds engage in an iterative, two way process to analyze an investment opportunity. Additional resources may be required to complete environmental, social and governance due diligence associated with development investments. Fund managers generally apply the IFC performance standards to evaluate non-financial, legal or tax transaction terms.

- *Execution and Documentation:* Once a viable project has been identified the investment terms have to be agreed and implemented. For equity investments this includes a shareholder and a share subscription agreement, for debt investments a loan and various security agreements. In each case, investments have to be structured to comply with local laws and regulations. An important aspect of deal execution are structuring questions related to repatriation of cash, certain tax issues, and for DfID and other donors, ODA and C-DEL/R-DEL considerations.
- *Management/Operational Input*: The degree of operational input required by the fund manager depends on the investment strategy. Early stage equity investments and equity investments in small scale companies generally require significant in-depth management engagement. Challenge funds, especially those with a large number of investments, typically focus on oversight. Debt funds focus on monitoring compliance of covenants and on spotting early warning signals. In the climate finance space, most interventions are in immature markets and involvement by fund managers can be significant (e.g. during project development and execution of renewable energy power generation). Technical Assistance facilities such as UNEP's SCAF and PIDG TAF provide extra resources to funds to cover the heavy operating burden of tackling investments in emerging sectors/markets.
- *Reporting:* Another key activity for the fund manager is ongoing performance tracking and reporting. For some funds, this includes monthly updates from portfolio companies/projects to the fund manager, which then aggregate this information for their investors and other stakeholders. Reporting has become a major concern for private fund managers in charge of donor-sponsored funds. The need to audit the use of donor funds and to capture development outcomes (many of which are recorded differently amongst different donors) place a significant time and resource burden on the fund manager. Reporting is not only a cost issue but can significantly slow down or, worse, constrain the efficient running of fund activities. Despite recent efforts to produce standardize development reporting, e.g. the Impact Reporting and Investing Standards (IRIS) developed by the GIIN, fund managers struggle to comply with donor reporting requirements.
- *Exit:* The resources needed to exit an investment vary across fund strategies. For grant funds and programs, investment exit is not a concern. Debt investments are generally self liquidating, or the burden on refinancing lies with the equity sponsor. Private equity investors, however, *must* sell an asset on at some point in

order to realize its value. This sale may come through public or private offerings. Under either scenario, the investor needs financial expertise and resources to identify acquirers and manage the divestment process.

Box 3: Exit Considerations

Given the infancy of the funds market in developing countries, few data points exist about exits. For self-liquidating instruments, the exit itself is not an issue; however, judging by the high levels of non-performing loans in certain developing countries and anecdotal evidence from impact funds suggests that 30% or more of loans are in arrears or have had to be restructured. Exits for private equity investments come from sales to third parties or public listings. Here, the data is even less telling. The IPO market is limited; Umeme, the Actis owned Ugandan electricity distributor is a rare example outside RSA. The most common exit option is through trade sales to strategic investors (i.e. corporate buyers). For emerging market low carbon companies or projects, trade sales do happen but the viability of this option is untested - few funds have gone through a full investment and divestment cycle. Even the largest generalist funds such as Helios, who have successfully invested their first fund and are raising a second, have few, if any, completed exit transactions (Actis and GEF being notable exceptions). Those exits that have occurred are focused in relatively developed emerging markets – of approximately 600 PE exits in Africa from 2007 – 2012, 536 were in South Africa (KPMG, SAVCA).The theory that SMEs and venture businesses can be grown to scale that attracts strategic buyers or larger buyout funds remains unproven.

	Description	Example	Fund Raising	Pipeline Development	Due Diligence	Execution and Documentation	Disbursing Capital	Management/ Operational Input	Reporting	Exit
Grant Challenge Fund	*Grants for RE studies or business proposals via competitions*	*EEP HIF*	● Low	● High	● Low	● Low	● High	● Medium	● Medium	● Low
Investment Challenge/ Impact Fund	*Concessional loans or equity for projects and companies*	*AECF Acumen*	● Medium	● High	● Medium	● Medium	● High	● High	● Medium	● Medium
Technical Assistance Facilities	*Grants/concessional loans to funds and projects for developmental*	*SCAF PIDG TAF*	● Low	● Medium	● Medium	● Medium	● Medium	● Low	● Medium	● High
EM VC/Equity	*Early stage, high risk equity investment in new businesses*	*Embark Unitus*	● High	● High	● High	● Medium	● Medium	● High	● Medium	● High
Growth Equity	*Investment in existing businesses to finance expansion*	*ECP, Helios Carlyle*	● Low	● High	● High	● Medium	● Medium	● High	● Medium	● High
Mezzanine	*Subordinated debt or preferred equity investment (i.e. lower risk than equity, longer term than debt)*	*46 Parallels GAP*	● High	● High	● High	● Medium	● Medium	● Medium	● Medium	● High
Project Equity	*Equity investment into portfolio of project SPVs and/or developers*	*Actis Infra*	● Low	● Medium	● High	● Medium	● Medium	● Medium	● Medium	● High
RE Project Equity	*Equity investment into portfolio of RE project SPVs and/or developers*	*REAF*	● Medium	● Medium	● High	● High	● Medium	● High	● Medium	● High
Project Debt	*Project Finance Investment via loans to e.g. RE power project SPV*	*EAIF*	● High	● Medium	● Medium	● Medium	● Medium	● Low	● Medium	● Medium
MFI Debt	*Lending to established microfinance companies*	*DWM Blue Orchard*	● Low	● Medium	● Medium	● Medium	● Medium	● Low	● Low	● Medium
Debt Fund of Funds	*Loans to a portfolio of local Financial Institutions/Lenders*	*GCPF*	● Low	● Low	● Low	● Low	● Low	● Low	● Medium	● Low
Equity Fund of Funds	*Investment as LP into a portfolio of Private Equity funds*	*CP3 GEEREF*	● Low	● Low	● Low	● Low	● Low	● Low	● Medium	● Low
Carbon Funds	*Investment via ERPAs into projects for tCO2e credit resale/retirement*	*BioCF Terra Bella*	● Medium	● High	● Low	● High	● Medium	● High	● Low	● Medium
Forestry Funds	*Equity investments in forestry projects – 15-20year assets*	*GEF Africa New Forests*	● High	● Medium	● Medium	● Low	● Medium	● Low	● Low	● Medium

Legend: Resource Intensity: ● LOW, ● MEDIUM, ● HIGH

E.1.2 Number of investments

Investment size is typically not an indicator for the amount of work required to execute a transaction. Because the effort to make a $1mm investment is the same as completing a $100mm transaction, it is the number of individual investments that determines the size of the investment team. A fund that supports a larger number of portfolio companies or activities will tend to require a larger team in order to conduct due diligence on each target, prepare necessary transaction or program documentation and then administer the funds. In traded markets with high liquidity, significant low transaction costs mean small teams can execute a high transaction volume. Deal execution for private funds is time consuming and resource intensive. A private equity transaction can take between 4-8 months, debt investments 3-6 months. Private equity investments to develop a specific infrastructure project can take 6-24 months of high intensity work. Achieving financial close in project financings typically requires 12-18 months of intermittent work. When AECF started its challenge funds its turnaround time was approximately 3 months. Today, from start of competition to commitment is an 18 month process. The main reason for this long duration is the sheer volume of applications that have to be evaluated, a three step investment process (pre-screening, business plan selection, due diligence) and the complexity of arranging physical investment committee meetings as well as site visits.

It is a fact in all emerging markets analyzed that deal execution for private transactions takes up to 50-100% longer than in developing countries. This places additional demands on fund managers, limiting the maximum number of transactions that can be efficiently executed. The private equity market has tended to focus on 10-15 investments. Project finance equity funds and venture capital funds in emerging markets target a smaller number of deals – 6-8 – given the extra ongoing support given to portfolio companies. Grant programs and challenge funds often work with a much larger number, but smaller portfolio companies – 10-20 per year – and as a result require larger staffs and higher relative fees.

E.1.3 Geographic and Sectoral Scope

With the exception of large private equity funds such as Helios or Carlyle's new African fund, where deal sizes are larger and targets easier to identify, a broad geographic footprint generally speaking requires larger teams and offices in multiple locations. Single country funds tend to have smaller teams, given their narrow geographic focus. The ability to cover many very diverse markets diminishes as transaction sizes become smaller and for early stage strategies such as venture capital or green-field investments. Specialization and intimate knowledge of the local political and regulatory environment become paramount, forcing focus on fewer countries. Most challenge funds (with the exception of AECF), have a region- or country-specific strategy.

E.1.4 Transaction costs

Benchmarks from developed markets suggest that total transaction costs for private equity investments are approximately 1% and for debt, approximately 0.5%. However, in project financings, project development and transaction costs can be substantially higher. For carbon and sustainable land use, the direct costs associated with investing in a project can be as high as 10% of the total investment amount. Similarly, development costs for greenfield[14] renewable energy projects in emerging markets range from 5-7% of the total transaction size. There is no reliable data for transaction costs for smaller investments in emerging markets – and how efforts to reduce costs impact fund performance. In general, for transactions below $8-10mm it is virtually impossible to carry out proper legal, tax, accounting and, where applicable, environmental and social due diligence without trying to take short-cuts or otherwise incurring disproportionately high fees. Professional services for legal, tax, and accounting advice are charged on an hourly basis and range from $300 to $500 per hour. The cost for a fully negotiated shareholder agreement can quickly exceed $40- 50,000. A commercial bank will charge between 1.5 – 3.0% in fees on debt transactions (including commitment fees, legal fees, document preparation fees, collateral assessment fees, valuation fees, monitoring fee and a myriad of others). This figure excludes legal fees of the borrower. For small funds or funds doing many small transactions (such as many challenge funds) the only way to control costs is using off-the-shelf contracts and relying on investee representations in relation to environmental, accounting and tax compliance (e.g. AECF). However, this often means that fund managers are not able to conduct full due diligence on projects.

E.2 Compensation Structures

We distinguish between four compensation structures that are most prevalent for the range of investment funds observed in developing countries:

1. *The Mutual Fund Model*: The Fund Manager charges a fixed annual fee on the basis of total assets under management. This model is most common for funds that manage publicly traded financial assets, i.e. listed equity or bonds. Some impact funds and many debt funds (e.g. microfinance funds) operate under a similar % fee structure.
2. *Private Equity and Hedge Fund Model*: Most private equity investment models targeting absolute returns (rather than trying to beat a benchmark index) include an incentive mechanism in their compensation model. The most widely used structure is the '2+20' (2% management fee and 20% carried interest) model pioneered by private equity and since adopted by most private closed end equity investment vehicles. Hedge funds and listed private equity funds use a modified model with an annual compensation payment based on the current fund market value.
3. *Corporate Model*: Rather than the '2+20' private equity compensation scheme, investment professionals are compensated based on a corporate 'salary + discretionary' bonus structure. The model was pioneered by investment banks and is wide-spread for debt funds and certain impact funds. Many sovereign wealth funds have adopted this compensation scheme. The bonus mechanism can be pre-agreed based on a formula or determined by a board or compensation committee.

[14] A new development as opposed to an expansion project

4. *Program Management Model*: This model is the most common for deployment of donor capital. The Fund Manager is responsible for preparing and disbursing an annual budget. Compensation is pre-agreed to cover incurred costs plus a fixed profit component. The costs are most often determined based on a projected number of workdays and pre-agreed day rate. The fundamental difference of this model is that compensation is tied to work carried out rather than targets achieved.

There are of course numerous variations to each fee structure. In general, though, the first two compensation structures link the fund manager compensation with the size of the assets under management and with the performance of the fund. Compensation models 3 and 4 instead focus on the resources needed to manage and deploy the capital, with scope for bonuses but not necessarily directly linked to financial performance or specific outcomes.

Box 4: A History of Private Equity Compensation Models

E.3 Private Equity Compensation Model Reviewed

The typical private equity fund manager is compensated through an arrangement that consists of:

- a management fee: to cover salaries, operating costs and other overheads
- A carried interest: to reward outperformance and align incentives with fund investors

It is important to highlight that the logic behind this arrangement is to clearly and unambiguously separate compensation for certain pre-agreed activities (i.e. fund management) from a performance related bonus (carried interest). This implies that fund management fees in and of itself are not designed to generate outsized rewards for fund managers. (Because fund management fees are sticky, larger funds have been able to collect management fees that far outstripped their operating costs – investors have woken up to this phenomenon and negotiated substantially reduced fees for the largest private equity funds).

E.3.1 Sizing the Management Fee:

Management Fees for Private Equity Funds are typically set at 2% of committed capital. To understand why this figure has been set at that level we need to review the costs structure of a typical private equity fund. In the early days of private equity, funds under management ranged from $200 – 500 million, generating annual management fees of $4-10mm. In Table 3 below we outline the cost structure of a generic $350 mm private equity fund management team operating in the developed world:

The table, while generic, is reflective of average sizes for venture capital and buy-out private equity funds. It demonstrates the logic behind the 2% management fee benchmark that is widely used today. What is also worth noting is that the traditional private equity fund seeks to invest committed capital across 8-12 transactions. The fund manager is therefore able to field a relatively small, but high calibre team.

Since the 1980s and 1990s, private equity funds have grown in size. However, the targeted number of deals has remained the same, implying larger individual transactions. The work load for a $30mm deal is the same as for a $3bn deal (financial transactions are typically imminently scalable – in fact, often they become easier to execute as the deal sizes increase). Because management fees have remained very 'sticky' over the years, managers of growing funds found themselves in a position of collection management fees that vastly exceeded the running costs of the fund manager. The link between cost base and management fee was broken, and increasing fund sizes become a compensation maximizing strategy in itself. This trend continued largely unchallenged during the first decade of this millennium as markets remained buoyant and credit was readily available leading to outsized returns within the private equity industry. Only more recently, since the onset of the financial crisis, have investors started to question the lavish salaries that fund managers were receiving – while experiencing losses across their portfolios. Fees have come down, and are starting to be looked at in a much more differentiated way.

Category	**#**	**Cost**		**Total**		**Comments**
		low *($ '000)*	**high** *($ '000)*	**low** *($ '000)*	**high** *($ '000)*	
Team						
Partners/ Founders	2	800	1,000	1,600	2,000	Benchmarked against Investment Banking Salaries
Investment Professionals	4	250	400	1,000	1,600	Benchmarked against Investment Banking Salaries
Operating Partners	2	400	600	800	1,200	Benchmarked against partner salaries at strategy consultants
Legal Staff	2	250	400	500	800	Benchmarked against associate/ junior partner salaries at wall street law-firms
Support Staff	4	100	120	400	480	assitants and junior team members
Total Team	14			4,300	6,080	
Offices	2	200	300	400	600	
Insurance	1	100	150	100	150	Directors' and Officers' insurance
Travel	192	1	2	192	384	assumes 2 trips per month for deal professionals
Audit/ Book Keeping	1	80	120	80	120	
Third party consulting and non-deal legal fees	1	200	300	200	300	
Abort Costs	2	75	200	150	400	
Total Fund Costs				**5,422**	**8,034**	
Management Fees	*350*	*1.50%*	*2%*	*5,250*	*7,000*	Assuming Fund size of 350 m

Table 3: Management Fee Breakdown for typical Private Equity Fund

E.3.2 Understanding Carried Interest

The U.S. private equity index compiled by advisory firm Cambridge Associates LLC shows a net internal rate of return (IRR[15]) of 13.7% in the 10 years through September 30, 2012, compared with an 8 percent return by the S&P 500 Index. The top 25% of PE funds launched in 2001 boast IRRs of 36.5% per annum. Generating extra returns for investors justifies performance-based compensation – "Carried Interest". The Carried Interest is a profit sharing mechanism that enables the fund manager to receive a share of the money earned in excess of the initial invested capital. The rate at which this profit share is set is typically 20% - the genesis of this figure is unclear (it has been reported that the first use of a 20% carried interest was by Alfred Winslow Jones in 1952; his

[15] The average annual return generated from the day of investment to the day of realizing the investment (including all dividends)

company A.W Jones &Co was a pioneer of the hedge fund industry.)

20% carried interest has become a generally accepted amount. A study carried out by A. Metrick and A. Yasuda on the Economics of Private Equity Funds (2007) showed that of 144 buy-out private equity funds reviewed all charged a 20% carried interest, as did 89 of 94 venture capital funds (the remaining five funds range from 17.5% - 30% carried interest). There has been some pressure by investors to lower carried interest recently, but rather than reducing the 20% benchmark, investors have negotiated co-investment rights which allowed them to increase their exposure to a certain transaction without paying fees on extra invested capital (effectively reducing both management fee and carried interest across the entire capital commitment).

Carried interest is a back-ended compensation instrument. Pay-outs only occur once all investors have been repaid their initial capital contribution, including any expenses and fees incurred by the fund and the fund manager. Furthermore, the carried interest is usually paid out only after the fund has achieved a pre-agreed minimum performance threshold – called a "hurdle rate". The market standard hurdle rate ranges from 6-8%- once investors have been paid all expenses plus returns of 8% the fund managers is entitled to his profit participation. For a typical private equity fund with a 5 year investing period and 10 year total life, this typically means that the fund manager does not receive any carried interest payments for 7-8 years – at which point a well performing fund manager will receive his share of the overall fund performance as lump sum payments (i.e. while payments received often appear – and are – large, they have to be seen as the accumulated performance fee for the duration of the fund. For example, a $100 million fund that doubles its capital generates a $20 million carried interest (20% of $100 million capital gain). Spreading the total carried interest over 10 years and 6-8 investment professionals implies an annual performance based compensation of $280 – 330k per professional.

Table 4: Absolute Return depending on Fund Life and Performance; Carried Interest depending on Fund Life and Performance

Absolute Returns (Multiple of Invested Capital)			
	Average Fund Life		
IRR	5yrs	6yrs	7yrs
10%	1.6x	1.8x	1.9x
15%	2.0x	2.3x	2.7x
20%	2.5x	3.0x	3.6x
25%	3.1x	3.8x	4.8x
30%	3.7x	4.8x	6.3x

Annualised 20% Carried Interest (% of Invested Capital)			
	Average Fund Life		
IRR	5yrs	6yrs	7yrs
10%	2%	3%	3%
15%	4%	4%	5%
20%	6%	7%	7%
25%	8%	9%	11%
30%	11%	13%	15%

Table 4 above shows the money multiple achieved by a fund as a function of average annual IRRs and Average Fund Life (time on average between investing and exit). A 'typical' PE fund in the developed world would market to its investors a 25% IRR or a 3x money multiple (i.e. a $100 million fund would realize in total $300 million). Table 4 also shows the annualized carried interest based on the same scenarios (e.g. a 20% IRR over 6 years will generate an annualized carried interest of 7% of initial fund size: 3.0x money multiple = 2.0x capital gain * 20% CI divided by 6 years).

E.3.3 Impact of Management Fees and Carried Interest on Investor Returns

A private equity fund charging a management fee of 2% per annum will collect 15-20% of total committed capital in fixed compensation over the life of a 10 year fund (i.e. of $100 committed only $80-85 will be actually invested). Adding other fund expenses (ca 0.5% p.a.) and carried interest paid out to the general partner results in substantial leakage between project returns (gross returns) and money returned to investors (net returned). Dependent on the size of the fund, overall performance and other factors, such as speed of deploying capital, the different between gross and net returns can be as much as 7-8%. Therefore, in order to deliver a 20% return net to investors, a fund manager has to realize a 27- 28% project return.

E.4 Summary

An analysis of funds across the entire fund spectrum shows significant differences in management approach, and as a result in terms of cost/fees charged. For most commercially oriented private equity and debt funds, management and investment committee are staffed by the fund manager; only highly specialized services are outsourced to third parties.

Impact funds, especially those that have significant donor involvement, often separate fund management from the investment committee, the latter operating independently. Funds in this category focus on smaller deals and rely more heavily on technical assistance. Their teams are not only larger (relative to fund size) but also include experts in monitoring & evaluation, reporting and technology transfer, adding to the overall cost base.

The final funds, donor-driven challenge funds, select fund managers through competitive tender. The winning bidders are often large organizations (e.g. consulting arms of the big 4 auditing firms or specialist development consultants) that provide a platform, back-office and reporting lines to donors. In the past, these firms were reluctant to assume fiduciary duties in relation to invested capital. Instead, they committed to overseeing a specific pre-agreed execution strategy. The teams hired to carry out the fund strategy are often loosely assembled consultants brought together for a specific, time-limited task. This lack of cohesion is compensated by heavy emphasis on ongoing supervision, reporting and internal auditing. As a result, overall team sizes can be large and operating costs significant. However where funds are able to leverage 3rd party resources without incurring costs (e.g. the Humanitarian Innovation Fund[16]), management teams can remain small and flexible.

[16] HIF's Grant panel is reimbursed for expenses and has a small annual stipend – as a result, despite being larger than most investment committees (12 people), it is still much less costly than a standard commercial fund investment committee.

Figure 4 below presents a simple graphic of different fund compensation packages as a percent of total assets under management calculated in aggregate over lifetime of a particular fund or program.

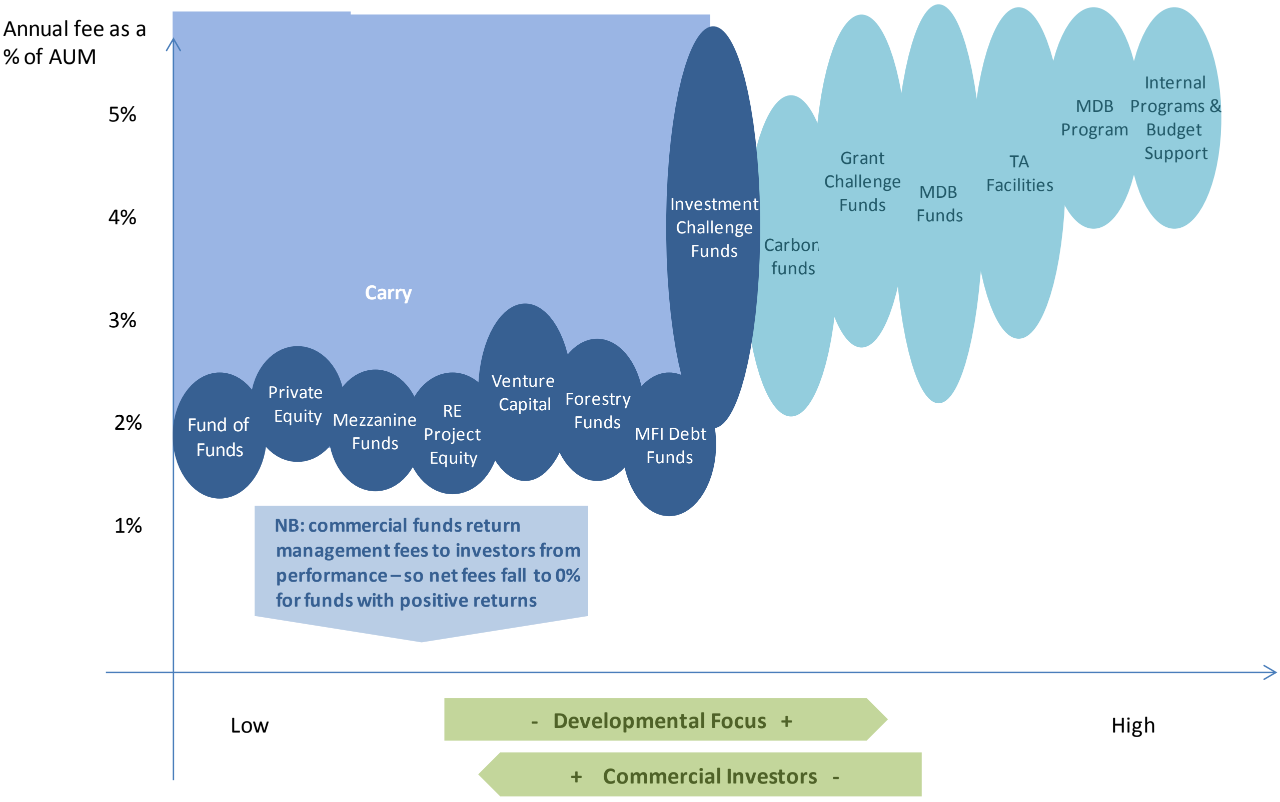


Figure 4: Fund Management Fee Comparison

Box 5: Difference between Fund Management and Program Management

We repeatedly refer to the difference between managing funds and managing a program. It is important to draw attention to this distinction:

- *The Fund Manager commits to safeguard the interests of the investor*. Unfavorable investment outcomes can create legal or at a minimum reputational liabilities. Understanding risks and responsibilities of managing third party funds is a regulated activity in most jurisdictions. A Fund Manager is measured by *outcomes*.
- Grant programme managers focus on strategies and delivery mechanisms. *The Program Manger commits to following due process and oversight*. Unfavorable outcomes do not necessarily imply that the program manager has not executed its mandate satisfactorily. A Program Manager is measured against *execution targets.*

While we include grant challenge funds in the analysis of fund models, they are fundamentally different to investment funds. As a result, many development consultants who act as program managers are reluctant to assume fiduciary responsibility for third party money, or establish separate vehicles (e.g. Dalberg Capital) that are licensed to carry out investment activities.

Summary Conclusions:

- Fund management compensation structure, fund size, returns and number/type of targeted transactions are interlinked and cannot be analyzed in isolation.
- Smaller funds struggle to cover costs without significantly impairing returns
- Dependent on investment strategy there is a limit as to how many transactions can reasonably be executed without compromising standards
- Development oriented funds tend to have a higher cost structure given the additional administrative reporting requirements and additional levels of governance
- 'Grant Funds' typically approach team structure and compensation from a different perspective. Pricing is often done on a cost plus basis

F. Governance

Topics Covered in This Section:

- What checks and balances exist to ensure fund managers exercise their authority in line with investors' expectations?
- Do donor sponsored funds require different governance structures?
- Where does one draw the line between maximum delegation of authority and regular, detailed oversight?
- What are the typical terms governing the management agreement between fund and manager?

One of the key principles underpinning the use of funds as delivery mechanisms for a specific investment strategy is that professional fund managers have skills and expertise as well as access to information and resources that providers of capital do not have. Employing a financial intermediary always implies a degree of *delegation of authority.* If independent decision making is curtailed too much, the fund manager becomes a contractor, or in the extreme, an outsourced employee.

With delegation of authority comes the need to establish governance procedures that allow capital providers to protect their interest. This is done three-fold:

- Set investment guidelines upfront
- Appoint representatives to protect the investor's interests on an ongoing basis
- Step-in rights to redress non-performance or make decisions that result in material changes to the underlying investment.

Governance mechanisms are well established in the corporate world. A share corporation, the most widely used 'investment vehicle' is governed by Articles and a Memorandum of Associations (i.e. upfront investment guidelines, a board (investor representation), and certain decisions that have to be delegated to the shareholders). The equivalent governance mechanisms for funds look as follows:

Governance Mechanism	Corporation	Fund
Upfront Guidelines	Memorandum and Articles of Association	Investment Memorandum/ Fund Management Agreement
Ongoing Representation	Board	Investment Committee
Step-In Rights	Reserved matters for shareholders	Right to relieve fund manager for cause or without cause

Similar to the role of the board for a public corporation, the investment committee is the executing organ of a fund. It directs the activities of the fund manager and approves investments in as well as divestments of portfolio companies. In order to analyze in more detail what tools DfID has to influence and control the activities of a selected fund manager, we are outlining the key terms typically incorporated in a fund management agreement. The table below describes the most important provisions of a renewable energy fund which is currently being established for Africa[17].

Key Terms	**Description**
Investment Guidelines and Restrictions	Outlines general strategy of the Fund, including: - region of operation, industry focus, nature of deals; - sets minimum / maximum fund size targets; - number of deals and average deal size - any investment exclusions
Legal Fund Structure	Domicile of Fund, legal form; including any parallel funds
General Partner (GP)	Legal Owner of the Fund with ultimate legal responsibility and liability
Limited Partner (LP)	Investor in the Fund
Fund Manager (FM)	Entity contracted by the General Partner to carry out day to day activities of the Fund; typically the same owners as GP but does not have to be (e.g. GHIF separates GP and FM; CP3 Asia GP is ADB/CFIG but FM is CFIG only)
GP Commitment	In order to align interest of investors with the GP, the GP is required to invest between 1-3% of the total fund size
Investment Period	Amount of time fund manager has to invest funds; thereafter, portfolio companies are readied for divestiture which has to happen within the maximum Fund Term (typically 10-12 yrs)
Restrictions/ Standards	Outlines performance standards that have to be met (e.g. IFC performance standards, World Commission on Dams, Biofuels Directive)
Reduction of Commitments	If certain investment targets are not met ,then investors have the right to reduce commitments (and with it the amount of fees they pay the FM)
Management Fee	Fee payable to FM to carry out day to day activities; typically ranges from 1% for fund of funds to 4% (for sub-scale funds). % is applied to commitments during investment period and can step down during harvesting period.
Fund Costs	Describes costs allocated to Fund, such as audit, administrators, certain deal costs and legal fees etc.
Abort Costs	Typically, the cost of due diligence and deal evaluation is charged to a successful transaction. Where such transaction is not successfully completed significant costs can accumulate ('Abort Costs'). Abort Costs are often charged to the Fund (albeit with a cap)
Transaction Revenues	In some instances, fund managers receive fees from providing services to portfolio companies. Such fees are typically shared between the Fund and the FM
Carried Interest/Hurdle	Amount of upside sharing for the GP. Typically 20% carry; hurdle rate sets out minimum return Fund has to generate before the GP is entitled to 'carry'. Note that carry is paid out <u>after</u> investors have recovered all FM fees and fund expenses
Distributions	Each Fund has a 'Distribution Waterfall' setting out how realized fund investment proceeds are paid back to investors. Typically: 1) investors are repaid their commitments 2) investors receive a minimum return 3) early investors receive greater returns for 'vintage years' investments, than later investors. 4) excess returns are split between Investors and GP based on Carried Interest %
Investment Committee	Sets out who is a member of the IC. This can be member of the FM only (IFC Catalyst Fund) or include third party members (AECF REACT)

[17] This fund is organized as a limited liability partnership (cf. CP3) with a general partner and limited partners. Other legal forms are also possible, such as incorporating the fund as a company (cf. GCPF).The terminology in the fund management agreement would change, but the essence of the provisions will remain the same.

Key Terms	Description
Investor Advisory Committee (IAC)	In the event changes have been made to the Fund Management Agreement, or the IC wants to approve a deal that lies outside the scope of the Fund, the IAC will have a final vote. The IAC also acts as arbiter on issues such as conflicts of interest and fund valuation (relevant for non-fiscal CDEL re-valuation).
Key Person	If individuals that are singled out as a 'Key Person' leave the FM, investors have the right to replace the FM
Co-Investment Rights	Many funds offer its investors rights to co-invest on a selected basis. Co-investments typically are free of fees /carry arrangements
Removal of FM with or without cause	FM can be removed if it breaches the terms of the fund mgmt agreement. In almost all instances the FM can be removed without cause by a super-majority of the investors (e.g. the FM fails to invest the money)
Reporting	Sets out minimum reporting obligations of the FM
Corporate Social Responsibility (CSR), Environmental & Social Management System (ESMS) etc	Beyond the generally accepted IFC Performance Standards, special CSR targets are often enshrined in the Fund Management Agreement.

F.1 Drivers/ Issues in Donor Sponsored Funds

A key difference between the traditional fund model and a Donor/DfID sponsored fund is the origin of the investment strategy. Most funds are launched by an experienced team which develops an investment proposition and looks for investors to back their strategy (e.g. REAF). Donor/DfID-sponsored funds, on the other hand, are initiated by the investor. DfID is the driver behind the Flexible Fund and has carried out considerable analysis to identify and define an investment strategy that meets its and the Government's climate goals. For the Flexible Fund or funds such as GCPF, the donor is procuring a fund manager with very specific objectives and guidelines. Where funds have 'double bottom line' targets, oversight and governance has to be particularly robust.

The objective of oversight has to be balanced with the need to empower the fund manager to apply its own expertise and judgment to the implementation of the Fund strategy and to avoid micro-management. Where oversight becomes too tight (committees, reporting etc), the administrative burden for the fund operations significantly slow down disbursement of funds (e.g. AECF) and overall running costs increase (e.g. PIDG).

The most common mechanisms to exercise ongoing control over the fund manager are the following:

Governance Alternatives	Description
Investment Committee	
Investors Participate on IC	Effectively, each transaction has to be signed off by investors. Ensures maximum control, however, slows down investment process due to investors' internal approval processes. In most instances impractical for DfID
Independent Experts employed by DfID constitute IC	Checks and balances between FM and IC. IC can be composed of experts who understand DfID's objectives. However, incentive misalignment between IC and FM can slow down deployment of capital (cf. eleQtra's desire to engage in agricultural infrastructure and InfraCo's (acting as IC) reluctance to extend beyond their board's expertise)

Governance Alternatives	Description
IC fully comprised of FM professionals with DfID observer rights	Most efficient model, relying predominantly on the FM incentive structure to result in desired outcomes (easier if solely commercially focused, more difficult for developmentally oriented funds)
Fund Management Agreement	
Very narrow definition of activities	Very difficult to define all outcomes upfront in a very dynamic and changing environment (especially over a 10 year fund life)
Periodic renewal of Fund Management Agreement	FM reviewed periodically and replaced if not performing (e.g. EEP). More difficult in funds where FM compensation depends on future outcomes (e.g. carried interest) – new FM responsible for old FM's performance payments
Separating investing period and harvesting period	Ability to secure teams with relevant skill sets (financial vs. operational). Same issues as above if compensation is tied to long-term performance
Reporting/ M&E	
By FM	FM knows activities best and therefore most efficient
By third party	Checks and balances. Ongoing review of FM performance by third party. Also M&E carried out by experts
Tiered Governance	
Separating Financial IC from Development IC	Pre-screening of potential investments to ensure development outcomes are met.

F.2 Governance Strategies Applied in Selected Funds

Governance mechanisms vary greatly between the fund models currently active. While there are individual differences, the biggest difference is between 'fund types'; i.e. challenge funds are managed very differently from impact funds and commercial funds. Table 5 provides an overview of selected funds and their governance mechanisms.

Table 5: Overview of Governance Mechanisms by Fund Type

Fund	Incentive Mechanism	IC	Reporting	Fund Mgmt Agreement	Other
Grant Challenge Funds (e.g. EEP)	Fixed fee; no performance mechanism	Independent IC	Dedicated reporting expert as part of team	Fixed period with specific termination clauses; FM is acting as agent rather than fiduciary	Not an 'investment fund'; moneys are disbursed as grants;
Investment Challenge Funds (AECF REACT)	Fixed fee with performance element	Independent IC	Substantial reporting for development and additionality outcomes	[Renewable periodically]	Financial outcomes secondary to development outcomes
Technical Assistance Facilities (SCAF II, PIDG TAF)	Fixed fee	Independent IC	Reporting responsibility lies with portfolio companies	Fixed period	Increasingly focused on returnable grants
Emerging Markets VC (e.g. Unitus, PEP, Embark)	Mgmt Fee + carried interest	Independent IC	Standard reporting requirements; i.e. no specific reporting to donors	Standard PE FM agreement (i.e. for life of fund)	Can also have corporate structure
Growth/Private Equity (Helios, ECP, Abraaj)	Mgmt fee + carried interest	IC managed by FM	Standard reporting requirements; i.e. no specific reporting to donors	Standard PE FM agreement (i.e. for life of fund)	Larger transaction sizes
Project Equity (Actis, AIIF)	Mgmt fee + carried interest	IC managed by FM	Standard reporting requirements; i.e. no specific reporting to donors	Standard PE FM agreement (i.e. for life of fund)	Larger transaction sizes
Renewable Energy (REAF, Evolution 1, D1 Frontier)	Mgmt fee + carried interest	IC managed by FM	Standard reporting requirements; including extensive SEMS	Standard PE FM agreement (i.e. for life of fund)	Provide development and construction equity. Mostly supported by TA
Debt Fund of Funds (GCPF)	% fee applied to AUM + annual performance bonus determined by Board	Board (independent with UK representative) and FM managed IC	Frequent reporting to board including annual business plan	To be renewed after three years; very prescriptive investment guidelines	Mostly investments in Financial institutions, some direct investments

Fund	Incentive Mechanism	IC	Reporting	Fund Mgmt Agreement	Other
Equity Fund of Funds (Agvance, GEEREF)	% fee applied to AUM + carry	Board (independent with UK representative) and FM managed IC	Standard reporting requirements; i.e. no specific reporting to donors	FM agreement for life of fund	Mostly investments in PE Funds, some direct investments
Project Mezz Fund (GHIF, GAP)	Mgmt fee as % of AUM + discretionary bonus	Independently managed IC, +/- additional charitable/technical committees	Multiple levels of reporting	Standard FM agreement (i.e. follows PE precedents)	Impact funds
Project Debt (EAIF)	Pre-agreed mgmt fee	Independently managed IC	Multiple levels of reporting	Standard FM agreement (i.e. follows PE precedents)	Infrastructure focused
MFI Debt (MWI, responsAbility)	Mgmt fee as % of AUM	Investment committee in-house	Monthly Financial Reporting, Annual Impact Reporting	Standard FM Agreement (i.e. follows debt precedents)	Some MFI funds offer investors liquidity on 3-6 months notice
Carbon Funds (Terra Bella, BioCF)	Fixed fee or annually agreed program management budget	IC managed by FM, Donor/Investor annual meeting	Annual financial reporting, with inherent climate metrics	Either Standard or program management contract with WB	Climate performance can be prioritized over financial performance (BioCF)
Forestry Funds (GEF, DfID Forestry Fund?	Pre-agreed mgmt fee	IC managed by FM, Annual meeting, Technical/Operational team	Annual financial reporting, with inherent climate metrics	Standard FM agreement or corporate structure	Long term investors – endowments, pension funds – but high risk

As a generalized observation, governance models for donor-sponsored investment funds exhibit more layers of control and fund management separated from the investment committee. This reflects the need for a more tightly-defined fund mandate that includes development targets in parallel with financial targets, but also the need to justify spending tax payers' money on private sector activities. The fund manager's focus is firmly on the financial outcomes since it is mostly recruited from the private/for-profit sector. Separation of fund management from investment decision making, and/or a two stage investment approval process (first developmental screening, secondly financial evaluation) does not only give donors more oversight, but also relieves the private sector fund manager from pursuing sometimes conflicting goals.

Because of the need to be accountable to tax payers, the reporting and auditing requirements for almost all donor-sponsored funds are stringent, and sometimes onerous. It is worth highlighting that reporting requirements and multiple layers of governance impose a significant cost on the fund manager. This cost is not just a 'nuisance' but has real implications on the ability of a fund manager to deliver its mandate and because reporting increases costs significantly, it is important that the fund design strikes the right balance between oversight/control and delegation of authority. Ensuring fund manager compliance with its mandate is paramount; however, excessive interference in day to day management to ensure best practice operations often has the opposite effect.

Summary Conclusions:

- There are three levels of control governing fund managers actions:
  - The fund management agreement
  - An investor oversight committee reviewing certain fund activities
  - Fund manager reporting
- Developmentally oriented funds, particularly those with a double bottom line mandate tend to have additional levels of control.
- Most common is the separation of fund manager and investment committee
- In many instances an additional committee is introduced to ensure investments meet mandated development targets
- Donor sponsored funds impose much more stringent reporting requirements
- An important distinction between investment funds and grant programs is the service they seek to deliver. The former commit to delivering optimal *outcomes*, the latter focus on implementing optimal *processes*.

G. Efficiency/Performance

Topics Covered in this Section:

- What are the common pitfalls that prevent donor sponsored funds from meeting their development goals?
- How can donor and fund manager interests best be aligned?
- Are funds an efficient vehicle to combine public and private sources of capital?

The use of the private sector to deliver development outcomes - in particular the use of investment funds - is motivated by the desire to improve efficiency and performance of donor programs. It is, however, important to understand that the fund model is not the silver bullet for all development activities. The private sector is not always the natural conduit for achieving development outcomes. Nor is the fund model a panacea for investments in developing countries.

G.1.1 Fund Structuring Considerations

Some of the most commonly encountered pitfalls are:

Mismatch between fund and asset lifespan

Most funds are closed end (i.e. they have a finite life). During the fund life investments have to be made and exited. Given an average fund life of 10 years and an investment period of 5 years, the average holding period for investments is 5-7 years. Certain asset classes, such as agriculture and infrastructure, in particular where Greenfield development is involved, require a long lead time (5+ years) before they reach a point in their lifecycle where they can be efficiently monetized. The extreme case is exemplified by re-forestation programs that can take up to 15 years before cash flows are generated. (Many re-forestation activities are therefore set up through corporate structures with permanent capital).

Appropriateness of investment strategy

Many new funds are set up with a 'private-equity' mindset. That is, they assume investments in existing/mature businesses with a track record and a history of profitability. The reality, however, often presents a different picture. Investment opportunities often involve start-up risks, and require growth capital (i.e. capital injection) rather than buy-out capital (i.e. acquisition of existing shares). The demands presented by investments into early stage and growing companies require specialist skills, and a high degree of operational experience (as opposed to financial engineering skills). The risk profile of growth and venture capital investments and project finance is significantly higher than that of buy-out transactions. Return expectations and blended returns need to take into account failure as well as the longer time period required to nurture investments to maturity.

Similarly, recognizing some of the risks associated with investing equity, many funds are structured to make loans instead. However, many companies in the climate space are not mature enough to borrow money.

Too many portfolio transactions

Operating in developing markets puts additional demands on fund managers. The combination of early stage investments, inefficient and immature markets and limited funds for company overheads, leads to much higher portfolio oversight requirements. Nurturing an early stage business in developing markets is time consuming. Funds that target in excess of 15 equity or 20 debt investments often find that they do not have the bandwidth to give each portfolio company the attention it deserves (and needs). As a result, performance suffers and best practices cannot be ensured.

Misalignment of incentives

Funds with a strong developmental mandate, impact funds in particular, sometimes struggle to appropriately incentivize management. The traditional fund model compensation is heavily weighted towards the carried interest. Fund managers are incentivized to deploy capital both quickly and prudently to maximize their share of profits generated. Funds that pursue strategies with higher risk, or lower overall return potential (e.g. many SME funds) are less likely to generate significant carried interest. Management fees become the principal component of compensation – carried interest is viewed as a low probability option. Fund managers operate less as stakeholders and investors and more like contractors. This creates perverse incentives, such as higher risk taking coupled with lack of urgency to deploy capital quickly.

The incorrect use of funds as delivery mechanisms for development initiatives can be costly. Not just because of the management fees that are incurred on allocated funds that are un-invested, but even more so because the opportunity cost of delaying investments is significant. (For example, the cost of not having access to the electricity grid can be as high as 20c/kWh. Therefore, the annual cost of delaying the installation of a £4mm 2MW solar installation can be as high as £300,000).

G.1.2 Fund Raising Considerations

Donor funds are an important component of financing green growth in developing countries. However, unless private sector capital can be mobilized, efforts by the development community will only ever have a marginal impact on the carbon footprint of emerging economies. A number of initiatives have been launched recently seeking to use Donor capital to leverage private sector funds into the sector. Successful examples include EAIF or GHIF; others - e.g. Agvance - are struggling to combine the requirements of private capital with donor objectives. Some very important lessons can be learned from past experience, especially as it relates to joint donor/private sector investment fund initiatives.

Many institutional investors have a fiduciary duty to maximize financial returns

Pension funds and insurance companies are managing money on behalf of their beneficiaries. Financial assets are managed to match financial liabilities (i.e. pension payments) and in most instances, risk adjusted return maximization is their primary objective. (In the US, pension funds are legally obligated to maximize financial returns). Double bottom line strategies, highly speculative strategies, entry into untested asset classes are often explicitly prohibited.

Furthermore, institutional capital is mobile. It can afford to take a global view and compare risk/returns of funds across various countries and jurisdictions. Some renewable energy and green growth strategies have limited return potential. For a (slightly generalized) example we can look at the economics of renewable power generation in developing countries. They are often constrained by high construction costs and low consumer purchasing power. As a result, project returns are unlikely to be substantially higher than in developed countries – risks, on the other hand, can be significant especially if government subsidies are required to provide some of the financial return to the investor. Unlike certain strategic investors (e.g. a renewable energy developer in Spain or Portugal), most international investors do not have to go to developing countries to grow their business.

Some private sector constraints are unrelated to risk/ return characteristics

The largest pool of private capital is managed by pension funds and insurance companies. In 2012, pension funds in the 13 largest markets are estimated to control close to $30 trillion in financial assets – while the total institutional investor base in the OECD is c$71 trillion. Pension funds, insurance companies and endowments have been the largest investors in private equity funds in the UK and US. Attracting only a fraction of funds under management to the developing world can easily dwarf the funds available to donors and development finance institutions.

Understanding how these organizations operate, and some of their constraints, is critical when marketing development focused investment funds to them. Specifically, given the large size of many of these institutions, their minimum investment size in illiquid asset classes, such as funds, is often >$50mm. At the same time rules limit their share in any fund to 15-20%. As a result, most small scale funds will not be eligible, irrespective of the investment proposition.

Asset allocation strategies, constraints and trends vary by market. Investments outside public equity and bond markets (alternative investments) are limited to an average of 20% of funds. Of this alternative asset allocation, private equity constitutes more than 10% (12.5% in the US), but can equally be substantially less than 5% - so in the UK, PE investments have been less than 1% of total Pension Fund assets as recently as 2009. Across a global sample set of institutional investors, the average asset allocation to private equity is growing year on year – shown in Figure 5 below.

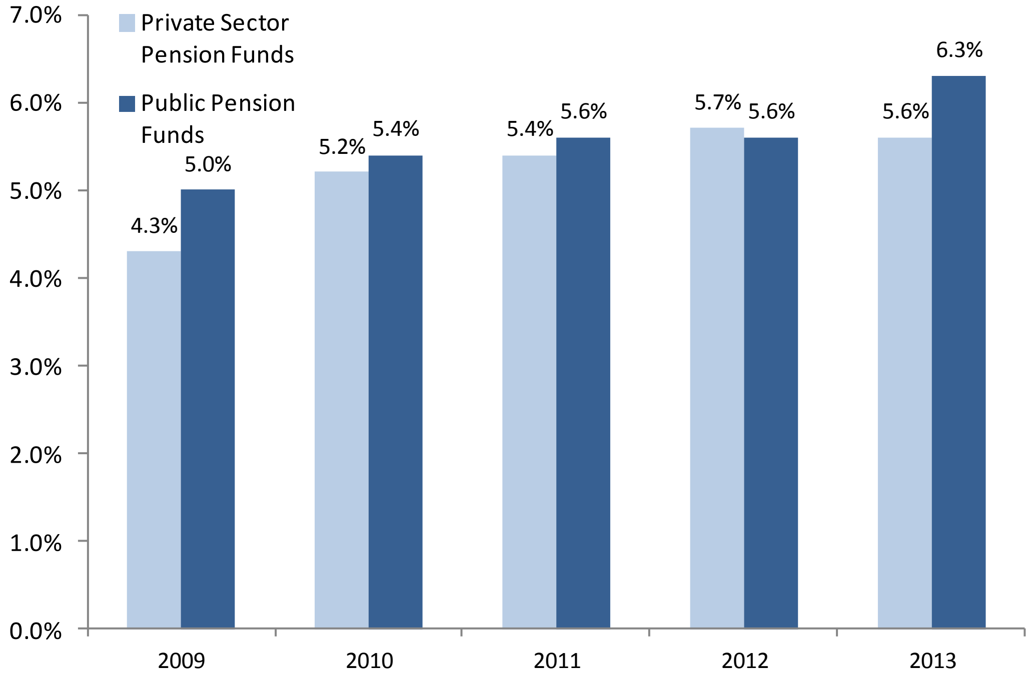


Figure 5: Asset Allocation to Private Equity by Pension Type, Preqin 2013

Downside protection/ tiered capital structures often send the wrong signal

Many funds are established with certain financial features that are intended to give private investors assurance that their downside risk is protected. While these mechanisms have a real risk mitigating effect, they often signal that these investments have limited return potential (hence the need to provide downside protection). A key attraction of entering new markets is the potential to earned outsized returns. Many developmentally oriented funds, on the other hand, offer moderate returns, albeit with downside protection. These returns, however, are often available in developed markets.

Private investors are concerned about the cost of reporting and M&E

Implementing a successful fund strategy and generating risk adjusted returns in the developing world is a challenge. For a typical private equity fund, the difference between gross and net project returns is around 7-8% (assuming a 2%+20% compensation structure). Reporting requirements, the need to carry out M&E, increases operating cost and slows down investment activities, both of which increase the delta between gross and net returns which can reach closer to 10% for many developmentally oriented funds. In an industry where returns are capped a reduction of net returns by 2-3% can tip the balance towards making a fund non-commercial for private investors.

All this is not to say that the public sector cannot play an important role in catalyzing private investment for climate change in developing countries. On the contrary, investor perceptions about risks and returns are best swayed by successful projects and increased industry activity; (hence the importance of action over deliberation). However, it is important to recognize that private investors have certain constraints and more importantly cannot be ‘talked into investing’. The private sector will not invest in order to improve the cost of capital, mitigate market failures, or correct perceptions of risk. However, the private sector will support investments that build assets, implement projects and demonstrate commercial viability.

G.2 Fund Operation Issues

A review of donor or IFI sponsored developmentally oriented funds operating in the emerging economies demonstrates that the marriage between the donor community and the private sector remains one of necessity rather than choice. Donors, guided by their public mandate, are weary of giving the private sector a blank cheque with taxpayers' money. Delegation of authority over a 10 year horizon is difficult for a public sector that operates on an annual budget. Donors want certainty and transparency. In developing markets, sub-Saharan Africa in particular, the private sector continues to rely on donor funds for most of its investment capital. Driven by the need to generate a profit for themselves and their investors, they only reluctantly accept outside interference which they feel compromises their ability to deliver their mandate. Table 6 highlights some of the key complaints voiced by Donors and Fund Managers

Table 6: Commonly Encountered Issues in Donor Sponsored Fund

Issues / Concerns	Description	Comments
Donor Concerns		
Committed funds are not invested	Many donor sponsored funds struggle to deploy capital. Fund managers collect management fees 'despite not doing their job'.	- Investment strategies are devised to meet donors' objectives but don't always reflect market realities (e.g. funds to invest in small scale agriculture struggle to find investable projects)
Fund management fees are too high	Mgmt fees for developmental funds are higher than average for the industry	- Funds are often sub-scale - Reporting and M&E requirements significantly increase cost base
Funds need to be catalytic	Donors want to invest in funds that make a difference – therefore look for scale and reach	- Fund managers struggle to be successful in their small niche and have no time to worry about the bigger picture
There are not enough local fund managers	Donors want to see more indigenous fund managers. Most funds, however, are managed by expats who prefer operating out of London or even the US	- More and more funds are setting up their base in their target markets - Local expertise is scarce, and where it exists, often too expensive (i.e. experienced local investment professionals have other options)
Oversight works 'on paper' but not in practice	Elaborate reporting systems are devised but don't deliver the information required by donors	- Information sought is often difficult to collect (especially where it is subjective) - Fund managers do not have the time to comply with all the reporting requirements

Issues / Concerns	Description	Comments
Fund Manager Concerns		
Donor due diligence is too time-consuming and expensive	Commercial investors would make a decision in principal before proceeding towards extensive due diligence. Donors have a tendency to carry out more extensive pre-screening before deciding whether to proceed or not	- Cost of due diligence is significant (time and money) - Many fund managers do not receive any remuneration while fund raising. Delays or long drawn out processes hit twice (cost of engaging and foregone income)
Reporting requirements are severely constraining fund managers' ability to operate	Quarterly reports don't seem overly onerous on the face of it. However, if they require significant upfront work and weeks of follow up, it can result in continuous reporting	- Fund managers struggle to invest money and are reluctant to divert resources towards bureaucratic activities - Reporting has real costs (direct expense of tying up resources and opportunity cost of not focusing on investing/ portfolio management)
Slow decision making hampering opportunistic deal making	In a rapidly changing environment, speedy decision making can be critical in securing a transaction	- Transactions in sectors such as agriculture are subject to extraneous factors (e.g. weather) that determine timing
Independent Investment Committees don't always operate in the interest of the fund	While fund managers' incentives are aligned with the interests of the fund, an independent IC is not subject to the same strict criteria. Fund managers often invest their own capital and receive performance linked compensation. IC members often receive fixed or nominal fees with limited accountability.	- The independent IC is not rewarded for risk taking (an essential part of investing). - Independent IC members may use the IC as a platform for their own interests rather than those of the fund.
Donors have a tendency to continuously 'change the rules of the game'	Donor interests, reporting requirements, and priorities change over time. Donors frequently seek to influence fund terms ex post (especially for challenge funds)	- Fund managers sign up to a management agreement which they expect to remain in place for the life of the fund
Investee Companies' Concerns		
Donor driven funds are too slow	Multiple levels of decision making, additional due diligence requirements slow down investment process	- Investees are increasingly viewing donor sponsored funds as a burden and adding to risk - This attracts investees with a more opportunistic attitude (i.e. sponsors are more likely to 'walk' from a deal if it does not work out)
Donor driven funds impose more stringent standards on investees but demand less strict conditions for themselves	For example, investors in an institutional private equity fund are obligated to fund within 10 business days of a draw down notice. Funding from the donor funded AECF often takes 2 months or more	- The working relationship between donor sponsored funds and investee companies can be severely strained if agreements don't apply equally to both sides

Issues / Concerns	Description	Comments
Donor driven funds (especially challenge funds) are too static	Many challenge funds manage investments against a business plan that was agreed upon upfront. However, over time, businesses and circumstance change requiring adjustments to business strategies	- If the investment process is too slow then the premise on which the initial investment decision is made may have changed by the time a transaction is executed. This often results in last minute deal changes or deals aborted after months of intense engagement
Donor conditions are viewed as unreasonable	The language of the IFC Performance Standards uses terms such as 'best practice'. These are difficult to define and sometimes lead to the most conservative; i.e. most stringent interpretation	- Best practices for EIAs may impose first world pollution standards designed for heavily populated areas on rural areas in Africa. - Investors are looking for a more differentiated, situation appropriate interpretation
Donor driven funds are viewed as lower quality investors	The 'strings attached 'are viewed as a real cost to doing business	- In the extreme this can result in 'adverse selection' i.e. only the weakest companies are attracted to donor sponsored funds

G.3 Analysis

A review of fund operations highlights a handful of key lessons:

1) Measuring impact is challenging
2) Many characteristics of these funds are new; benchmarking performance is difficult
3) The Fund Manager is the key driver of performance.

G.3.1 Measuring impact is challenging

Combining financial investment targets with developmental outcomes is not a new feature. Many funds, most notably Generation based in London, have been marketing a strategy that included negative screening for activities that are considered detrimental to good governance or responsible business practices and therefore financial returns. However, the last decade has seen a dramatic expansion of the interest and scrutiny that these investment opportunities offer and positive selection for development outcomes rather than negative screening has become the buzz word for many funds in developing economies.

Despite many years of 'double bottom line' investing, no government, MDB, DFI, NGO, corporate or investor has developed a consistent approach to evaluating non-financial performance. There are a variety of impact evaluation methodologies and a myriad of standards. Some have recently become de-facto standards seeking to standardize the many demands put on performance evaluation – most notably the GIIN's IRIS methodology, the IFC's Performance Standards and DOTs system and the UN's Principles for Responsible Investment.

The most successful models are transparent and easy to use – employing easily measured, unambiguous metrics (e.g. tCO2e reduced, MW power produced). However, donor investors, multilaterals and philanthropic investors often have their own independent investment objectives and constraints. As a result, most fund managers need to create a bespoke set of non-financial investment criteria and monitoring systems. This places a substantial burden on the fund manager as well as the investee – since each portfolio company/recipient has to supply the information. In selecting a broad framework, a fund manager is driven by the need to collect a set of information that overlaps most with each investor priority – and therefore have to supply the minimum possible amount of additional information.

Ensuring performance evaluation yields meaningful information and does not become a 'tick the box' exercise relies on the establishment of a baseline and prioritization of impact variables. Evidence suggests that unless targets are few and objectively measurable, the baseline analysis and subsequent data gathering becomes too complicated.

For all these challenges, Fund Managers are reacting to the growing investor demand for consistent reporting. Incorporating robust non-financial monitoring into fund operations usually entails hiring additional staff or using specialist consultants. Fund management fees for challenge funds and other programs reflect this burden, since they are calculated on a cost basis. Fund management fees tend not to factor this in – leading to an implicit profit reduction by the fund manager.

G.3.2 The Market is in its infancy and data of precedents scarce

For many of the key factors defining a successful fund, the fund market is too novel and investment targets too varied. As noted above, project development and transaction costs relating to particular investments vary enormously across instruments, countries, sectors and fund structures. Fund managers can struggle to control costs and meet scheduled milestones as a result. These challenges are compounded by the need to find out more detail on projects, with respect to the non-financial performance factors described above. Because double bottom line funds do not solely seek to maximize profits, their response to issues such as transaction costs is not uniform and therefore difficult to generalize.

The real issue, however, for development focused funds is the complexity of defining targets and interpreting those. Because metrics vary across investments they are difficult, if not impossible to benchmark. The concept of value for money implies that a specific intervention is preferable to its alternatives. For financial outcomes we look at relative risk adjusted returns which are (fairly) easy to establish and compare. How do we, however, judge whether employing [x] women is better than abating [y] tons of carbon. Because these questions are difficult to answer objectively, the targets used for many interventions are somewhat arbitrary. For example, the ICF projects that 1-5m people will have improved access to clean energy as a result of ICF programs. Leaving aside that these projections are often not very scientific, the more salient question is whether 1-5mm people is a good number or not (why not 10mm?).

Donors and fund managers have grappled with this issue ever since negative screening was replaced by positive selection for development outcomes. There is no consistently successful methodology for ranking or weighting non-financial and financial performance of a project or investment and the trade-off between the two. All of this does not mean that double bottom line investing is doomed and development metrics are meaningless. It does, however, imply that generalizing metrics and outcomes is difficult. Rather, each deal has to be evaluated on its own merits with a high degree of judgment.

G.3.3 Fund Manager's role in success

Most important to the success of a particular fund or program is the manager. Fund Managers need to be able to meet a number of challenges. Fund managers can succeed as a result of access to local or sector expertise without a defined team or presence – while funds with large teams and a robust presence struggle. For example, GAIN has been able rapidly to generate a large pipeline of projects for its Market Place for Nutritious Foods in 3 African countries without a large team, while AECF has substantial local presence but has faced serious challenges in disbursing capital (less than 50% of committed capital has been disbursed). Likewise, highly structured governance procedures do not always lead to improved results – in many instances, fund managers with more authority and less stringent oversight are able to execute strategies successfully. For example the successful HIF has only annual meetings with donors, but also benefits from direct, periodical access on an ad hoc basis. One key indicator of future success is the past performance of a particular fund team with respect to a particular strategy.

Therefore, as well as considering fund structuring options, it is important to identify management teams that can implement strategies effectively. An annex of possible fund managers with some exposure to low carbon investment incorporating development objectives is provided in the appendix, and further work on mapping expected after feedback from DfID.

Summary Conclusions:

- Donors are concerned about the number of funds that struggle to invest committed capital
- Fund managers complain about their heavy reporting burden and the slow response time of donors restrict their ability to 'do their job'
- Many frictions between donors, managers and investees arise for two key reasons:
    - The number of quality investment targets in sectors of interest to Donors is limited
    - Many funds are structured to meet donor requirements rather than optimized around their target market and investment strategy.

H. Other Structuring Issues

Topics Covered in this Section:

- What other constraints does DfID face when setting up funds to implement development initiatives?
- Is there a blueprint that ensures the most common pitfalls are avoided?

In the current fiscal environment, DfID is confronted with challenging, and sometimes conflicting demands in its effort to respond to HMG Treasury's guidelines related to development spending. On the one hand, the UK Government's commitment to meet its target of deploying 0.7% of GNI as ODA is pushing funding towards MDBs and/or grants. On the other hand, pressure is increasing to conduct development assistance without negatively impacting the national balance sheet and public sector borrowings. As a result, budget allocations for DfID are shifting towards an increasing proportion of non-fiscal C-DEL and lower R-DEL expenditures. Higher ODA spending and more non-fiscal C-DEL allocations coincide with a move by DfID towards more 'investment driven' development models and private sector partnerships to achieve its development goals. An increasing reliance on private intermediaries such as Fund Managers to deliver development outcomes adds an additional layer of complexity.

In this context, a range of program structuring and establishment issues related to DfID initiatives surface that need to be considered carefully. The rules governing structuring arrangements are nascent, and often untested and inconsistent. Some of them are set by the UK Government HMG Treasury, such as budget classifications, (C-DEL, R-DEL), financial regulation and jurisdictional constraints; others are implemented and supervised by the OECD (i.e. ODA eligible spending criteria).

The starting point is the DfID Budget mandated by Treasury. Understanding the different nuances and criteria of R-DEL/fiscal C-DEL vs. non-fiscal C-DEL is critical in order to ensure programs comply with allocated budget control totals. Once internal budget criteria are met, the focus can switch to ensuring DfID interventions are structured such that they count towards ODA.

Related issues that impact structuring decisions are the jurisdictional and regulatory restrictions that apply.

H.1 DfID Budgeting and Accounting

New budget and accounting rules are placing additional burden on program designers. In the past most of DfID funding for the private sector was disbursed as grants - for operating costs or to fund physical assets. (CDC had the mandate to make private sector investments, in particular investments in financial instruments). More recently, DfID is increasingly focusing on private sector strategies, in particular investment funds, to achieve its development outcomes. The government has created a new form of capital allocation, non-fiscal C-DEL, for investments into financial assets that are owned by the UK Government. Because each investment creates an asset, non-fiscal C-DEL expenditures are balance sheet neutral. It is worth noting that, while DfID's mandate if focused on delivering and measuring development outcomes, the UK Treasury only measures tangible financial assets (i.e. cash at hand or assets that at some point in the future can be converted into cash). If cash is spent to create an intangible asset (e.g. better governance, reduced carbon footprint) or extraneous assets (e.g. capacity building that leads to higher yields) this is not recorded by UK Treasury. The following table describes the characteristics of each form of DfID funding:

Funding Type	Description / Characteristic
R-DEL	- R-DEL expenditures are payments for services or operational expenditures that do not result in the creation of physical assets (e.g. a building) or an investment instrument (e.g. a loan, equity interest). - R-DEL expenditures are generally made in the form of grants (although not all grants are not necessarily R-DEL) - An R-DEL investment is a one-time expenditure. Once funds are transferred, DfID does not have any claims on these funds; i.e. there is no ongoing financial value to DfID (but they may have ongoing developmental value) - R-DEL expenditure funded by Treasury leads to an increase of indebtedness of the UK Government (either money has to be borrowed, or existing funds cannot be used to repay outstanding government debt)
Fiscal C-DEL	- Fiscal C-DEL expenditures are those that create a physical asset that is not owned by the UK government. (E.g. a grant made to build a warehouse owned by a third party or a school owned by the Gov't of Pakistan). - Fiscal C-DEL spending, just as R-DEL, represents a one-time expenditure. - From a budgeting perspective, fiscal C-DEL spending results in increased government debt and is treated similar to R-DEL. The distinction between fiscal C-DEL and R-DEL is therefore solely relevant for the allowed use of available DfID funding.
Non-fiscal C-DEL	- Non-fiscal C-DEL spending are short or long-term investments by the UK Government. Investments can be made through financial instruments such as loans or shares[18] - Non-fiscal C-DEL investments are <u>always</u> are made with the intention of earning a financial return. i.e. funding is made available in return for the promise of getting the money back (including in some instances a return on the initial capital through interest payments or dividends) - Non-fiscal C-DEL always creates an asset <u>owned</u> by the UK government. On day one it is expected that the value of the financial asset is equal to the investment amount, resulting in no deficit to the public sector borrowings requirement. The UK government therefore records an asset on DFID's balance sheet and a liability of equal size on the HM Treasury balance sheet. As a result, net government indebtedness does not increase. - Because every financial asset is risky (there is no certainty that the financial returns materializes) its value can change over time. This change in value has to be quantified and recorded on at least an annual basis, with impairments signifying a reduction in carrying value recognised through DFID's Annually Managed Expenditure budget.

[18] Theoretically, the UK government could make non-fiscal C-DEL investments in physical assets (e.g. real estate, forestry assets) provided these assets can be sold. In this paper we assume that all of DfID's non-fiscal C-DEL investments are made through intermediaries, and therefore in financial instruments

To summarize, as Figure 6 shows, from a Budgeting perspective, there are only two types of expenditures: 1) grants (R-DEL, fiscal C-DEL) to fund operating expenditures or the creation of a physical asset (owned by a third party) or 2) investments into a financial asset controlled by the UK Government.

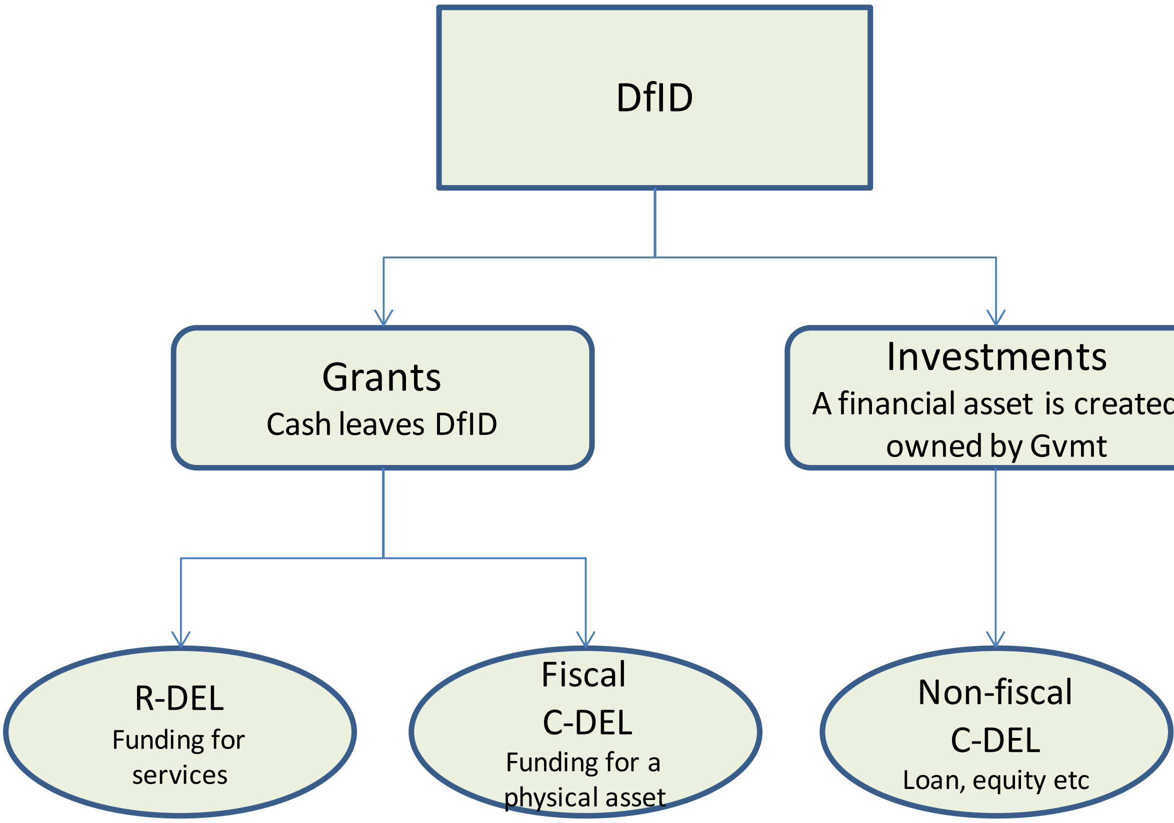


Figure 6: DfID Expenditure Framework

In the past, DfID's budget consisted only of R-DEL and fiscal C-DEL with no distinction set by HM treasury over fiscal and non-fiscal capital. Now, however, with the introduction of HMG Treasury imposed non-fiscal C-DEL targets, a significant portion of DfID's budget has very restricted permitted uses (i.e. it limits DfID's ability to structure non-returnable grant funds/programs) and, because the value of financial assets can change over time, brings with it a considerable increase in administrative effort (and a need for financial evaluation skills).

Structuring a DfID Intervention using non-fiscal C-DEL funds has to meet the following criteria:

- Funds have to be invested with a view to generating a financial return over 0% (i.e. targeting at least the return of the initial capital); therefore, grants are not possible, however reimbursable grants, loans, shares, preference shares, mezzanine instruments are possible.
- The financial return potential has to be contractually agreed upfront and has to stand up to independent scrutiny and international accounting standards rules on recognition of assets (i.e. it cannot be 'theoretical', discretionary or be contractually waived).
- The value of the financial instrument has to be quantified at the time of the investment and assessed annually. If the value is reduced, an impairment charge has to be recorded within DFID's Annually Managed Expenditure budget when first identified.

Determining whether an investment qualifies as non-fiscal C-DEL is straightforward and can be based on principles, although currently HMG Treasury are requiring that all DFID non-fiscal programmes be shared with them on a case by case to be confirmed by their Classifications team as meeting the rules set in defining non-fiscal spend . Additionally, because DfID non-fiscal C-DEL expenditure is by definition a 'double bottom line' investment, the intellectual and administrative complexity doubles as well.

	R-DEL / fiscal C-DEL	Non-fiscal C-DEL
Theory of Change	☑	☑
Development Impact M&E	☑	☑
Adequate Financial Returns		☑
Ongoing financial re-valuation		☑

Measuring development returns is difficult and fraught with challenges. Similarly, establishing the value of an investment requires judgment and financial skills. A description of the valuation frameworks used for financial assets would exceed the scope of this paper; however, in almost all instances it rests on an analysis of current assets and liabilities combined with projections of future cash flow generation potential. In the case of valuing an investment in a business, the ability of a business to generate cash in the future is the essence of its current value. The present value of future cash flow is a function of timing and risk; i.e. the opportunity cost of money and a quantification of the riskiness of those future cash flows. In practice, in most instances non-fiscal C-DEL will be investments in funds. DfID staff members will be able to take the value of DfID's share in the fund from the fund's own accounts and use that for the purposes of the non-fiscal C-DEL in the accounts. This will, however, require judgment in assessing the appropriateness of the basis of valuation used by the fund manager in determining the assets and liabilities. Additionally, where this valuation is subject to independent audit, DFID will also have to assess the skills and experience of the audit firm to establish if DFID can place reliance on their findings.

H.2 ODA Treatment

Reaching the 0.7% of GNI ODA target is an important objective for the current government, enabling the UK to fulfill the public declaration to achieve this spend level by 2013 ahead of the 2015 target for delivery set out within the UN Millennium Development Goals. Reconciling this target with the goal of increasingly investing into investment funds (now even more relevant given the increasing allocations to non-fiscal C-DEL) raises a number of issues. While grants for genuinely developmental purposes and to DAC country recipients always qualify as ODA when paid to an ODA eligible beneficiary, returnable capital investments, on the other hand, have to meet certain additional criteria to be classified as ODA. OECD DAC stipulates that *each transaction*[19]:-

a) is administered with the promotion of the economic development and welfare of developing countries as its main objective (*"Purpose")* and
b) is concessional in character and (for debt) conveys a grant element of at least 25 per cent (calculated at a rate of discount of 10 per cent) (*"Concessional Character"*)

The UK Government is not just concerned about achieving ODA treatment for its development efforts; it is also focused on being able to plan and project ODA expenditures. For the DfID staff planning a development initiative, two objectives arise: 1) obtaining ODA credit and 2) achieving predictability of positive and negative ODA flows.

Table 7: ODA Treatment for Different Types of Capital

	Grants (R-DEL / fiscal C-DEL)	Investments (Non-fiscal C-DEL)
Obtaining ODA Credit	Located in DAC country & contributes to economic development	Need to prove concessional nature of Investment
Planning positive ODA Flows	Depends on Intermediary	Depends on Intermediary
Planning negative ODA Flows	NA	Depends on type of investment

As Table 7 shows, meeting ODA treatment for grants is trivial. We therefore focus on the challenges that arise when investing in funds (as is increasingly the case given rising allocations to DfID's non-fiscal C-DEL budget[20]) and will along the way also cover issues related to recording ODA when disbursing grant money through an intermediary.

[19] Is it ODA? OECD DAC document: http://www.oecd.org/dac/stats/34086975.pdf

[20] It is important to note that ODA treatment and DfID's budgetary constraints (R-DEL/fiscal C-DEL vs. Non-fiscal C-DEL) are completely separate issues. However, because DfID is compelled to increasingly rely invest non-fiscal C-DEL funds and because ODA treatment is more complex for investments than for grants, ODA considerations are poised to become relevant to a broader audience within DfID.

The starting point for an ODA analysis is whether the investment instrument meets the ODA conditions as described above. Once this hurdle has been overcome, care must be given to structuring interventions such that ODA credit can be recorded as soon as possible and positive as well as negative ODA flows planned for.

H.2.1 Meeting ODA Criteria

The first criterion (*Purpose*) is relatively easy to demonstrate. Most activities in developing countries that DfID would ever undertake are likely going to pursue a developmental objective. While the bulk of investments by DfID typically are made directly to recipients in DAC countries, the ODA *Purpose* criterion does not stipulate that money has to be spent in DAC countries. For example, an intervention into firms operating in OECD countries, producing drugs for DAC countries could still meet the ODA *Purpose* criteria provided the entity is recognised by OECD/DAC as an eligible beneficiary.

Meeting the second criteria – i.e. the investment has to be concessional in character (*Concessional Character)* is somewhat more challenging and sometimes problematic. The OECD distinguishes between debt – for which it has established very rigid rules – and equity, for which it has only given loose guidelines. These rules are difficult to interpret for hybrid instruments (preferred equity, debt + warrants) and do not accommodate contingent support, such as guarantees. It is worth noting this is an area the OECD/DAC working group are consulting on, with a view to ensuring the funding mechanisms they currently recognize are still relevant and highlighting additional mechanisms which should be captured within the spend criteria. The fundamental principle of proving *Concessional Character* on debt is the concept of investing at 25% below market terms (i.e. 25% Grant Element). For debt instruments, the grant element is calculated by discounting future investment cash flows at 10% to calculate the Net Present Value (NPV). Investments with an NPV of less than 75% of invested capital are considered to be of concessional nature.

This condition creates distorted outcomes. In many instances, loans that have below market interest rates *cannot* be considered ODA because they do not meet the 25% grant hurdle. This results from loans that are short tenure or only marginally discounted. The table below shows the "grant" component of loans offered over a number of different periods and relative to a 10% discount rate. Even 0% loans fail to meet the concessionality hurdle

Table 8: Debt Concessionality Scenarios using 10% discount rate

		Maturity (years)									
		1	2	3	4	5	6	7	8	9	10
Interest Rate	0%	9%	17%	25%	32%	38%	44%	49%	53%	58%	61%
	1%	8%	16%	23%	29%	35%	40%	45%	49%	54%	57%
	2%	7%	14%	20%	26%	31%	36%	41%	45%	49%	53%
	3%	6%	12%	18%	23%	28%	33%	37%	41%	45%	48%
	4%	5%	11%	15%	20%	24%	29%	32%	36%	40%	43%
	5%	5%	9%	13%	17%	21%	24%	28%	31%	34%	37%
	6%	4%	7%	11%	14%	17%	20%	23%	26%	28%	31%
	7%	3%	5%	8%	10%	13%	15%	18%	20%	22%	24%
	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%

For equity investments, the ODA test is more qualitative resting mainly on the *Purpose* criteria. This would suggest that qualification for equity is easier to achieve and possible for investments that are clearly made with the intent of profit maximization (notwithstanding the developmental intent)[21].

The criteria used to prove ODA eligibility have a number of serious shortcomings, the most notable of which are summarized below:

Consideration	Comment
10% Discount Rate does not reflect changing market conditions	- The 10% discount rate, set by OECD/DAC, is a static figure in an environment of changing market interest rates. In a low interest rate environment (as in the past 10 years) commercial lending rates have dropped below 10% in almost all DAC countries. - As rates rise meeting the DAC test becomes increasingly difficult, even for loans that are clearly at below market terms.
Discount Rate does not reflect loan tenor	- Interest rates rise as loan maturities increase. A static 10% discount rate encourages short term lending, when in fact long dated debt is harder to obtain in the commercial markets. For example, in the current environment in many DAC countries it is difficult to obtain 10 year commercial funding. A 10 year loan at 10% interest rate would represent a 'below market' transaction, however, not be recognized by DAC as concessionary.
No consideration given to other 'below market' characteristics	- The below market nature of financial instruments is not simply determined by looking at the discount rate and tenor. Security arrangements, country, sector and political risk and subordination are all important components of an investment instrument. The current DAC evaluation framework (for debt instruments – see comments about equity below) does not give credit for flexibility on any of the above mentioned terms.
Defining 'Concessional Equity' is highly subjective	- It would seem that for equity the only requirements are that the developmental purpose test above is met and that the recipient is working in or based in an OECD DAC qualifying country.
Treatment of Dividends	- Dividends are not considered an ODA flow and are treated similarly to loan interest, being an OOF flow. The one exception to this is capital or stock dividends – i.e. shares awarded instead of cash. These are considered a negative ODA flow.
Limited in scope	- Cannot incorporate instruments that do not require deploying capital, but that are essential in supporting investment in development outcomes, e.g. guarantees, Guarantees only qualify as ODA when they are cashed in and not when they are issued. This makes it almost impossible for DfID to provide and budget for guarantees.

[21] For example, CDC's equity investments are credited towards ODA spending some of which are made into funds that have a profit maximizing strategy

It is worth noting that issues related to proving the concessional nature of an investment are not the only shortcomings of the current ODA regime. Calculation of positive and negative ODA favours weaker projects – an equity investment that is highly successful generating a significant return result in larger net negative ODA (in the future) than an unsuccessful project. This misalignment of incentives risks unintended consequences in project selection. Furthermore, ODA does not recognise contingent support, e.g. in the form of guarantees – unless and only when, guarantees are called (ODA only recognizes cash transfers/investments). Perversely, guarantees for weak projects are again rewarded. More importantly, though, the use of guarantees is greatly discouraged, despite the fact that as an investment instrument they are very powerful, highly leverage-able and a tool that donors are often inherently better suited to extend (for example, MIGA's success relies to a large degree on the leverage the World Bank has over a range of governments and SIDA's use of guarantees for SMEs has been very successful in stimulating an area that the multilaterals have neglected).

H.2.2 Planning ODA Flows

Qualification as ODA is not the only complexity related to DfID programs structured around returnable capital. Since non-fiscal C-DEL represents investments with the intention to recover some or all of the invested capital, and in some instances (e.g. equity) to realize a return on invested capital, ODA flows become negative as capital flows back to DfID. Negative ODA per se is not an issue. It increases available capital that can be invested to achieve development goals, providing DfID has forecast this income to HM Treasury who has permitted DfID to retain and recycle these proceeds. Negative ODA, however, can pose certain planning complexities – in terms of DfID's ODA target – where it is unpredictable, both in terms of timing and amount. Non-fiscal C-DEL in the form of debt investments is comparatively easy to administer. Timing and amount of re-flows are typically contractually set and pre-agreed. For equity or fund investments, however, reflows are subject to a variety factors outside of DfID's control. Fund investments are liquidated at the discretion of the fund manager, and as a function of the market environment, portfolio company performance, buyer appetite and others. The amount of capital re-flows is similarly dependent on market factors that are difficult to predict and/or influence. If the fund manager is contractually and practically able to reinvest within the calendar year then of course there is no negative ODA flow as OECD DAC ODA reporting looks at flows from and reflows back to the UK on an annual calendar year basis. As a result, funds that typically recycle capital may be able to mitigate this issue (as we discuss further below, more feedback is required from OECD DAC to understand whether funds 'warehoused' for recycling across year-end are considered negative ODA). However, for DfID to be able to reasonably have a claim on the underlying asset, funds cannot recycle/revolve indefinitely.

Box 6: Timing ODA and Budget Outflows for CDC

CDC offers a very relevant, but perhaps unique analogy to DfID's current fund structuring ambitions. CDC is the UK's Development Finance Institution (DFI) and is wholly owned by DfID. CDC makes equity and debt investments in businesses and projects in emerging markets, both directly and via fund intermediaries. While theoretically part of DfID, in practice, CDC operates independently and is financially self-sustaining. CDC's debt investments are not recognised as ODA since they are not sufficiently concessional, but instead are treated as OOF. ODA recognition for CDC's direct equity investments is made at the time of the transaction. ODA recognition for CDC's fund investments is deferred until the capital is received by the ultimate recipient. For example, an investment in a private equity fund, assuming it meets the ODA eligibility criteria, will only be recognized as ODA once the fund manager draws down capital in order to invest in a portfolio company. Returns are then recorded as negative ODA when the fund manager exits positions. CDC (and therefore DfID) as the provider of capital, however, has no control over the timing of these fund investments – and relies on the fund manager to appropriately report its investment activities (which, given that a typical fund has multiple sources of funds available for investments, such as dividends, fund generated from exits etc., complicates the determination of which funds have been used for a particular investment). This adds also significant reporting burdens for the fund managers back to DfID.

H.2.3 Summary

The shift from R-DEL expenditures to an increasing use of non-fiscal C-DEL for DfID programs is the new reality. DfID initiatives increasingly have to be structured as funds and be implemented through private sector intermediaries to achieve this objective. The test for non-fiscal C-DEL is relatively straight forward, providing principles can be established with HMG Treasury regarding classification approval. Unfortunately, it is not straightforward to structure programs that meet development objectives (many of which rely heavily on access to grants which are not allowed under non-fiscal C-DEL spending) while meeting the goals of ODA eligibility and predictable cash. Table 9 below, summarizes the key issues from the perspective of internal budgeting, ODA accounting and practical implementation:

Table 9: Key Issues

Accounting Considerations	ODA Considerations	Operational Considerations
- Balance sheet assets have to be revalued at least annually and, where necessary, an increase/decrease recorded on DfID's balance sheet - Provisions have to be recorded and absorbed within the Annually Managed Expenditure budget for expected losses related to non-fiscal C-DEL investments.	- Higher hurdles to demonstrate *Concessional Character* for ODA purposes - Repayment of investments result in negative ODA flows - Timing and amount of some negative ODA flows difficult to predict leading to pressure near the end of the calendar year to reinvest to retain an ODA neutral position.	- Fewer grants and more balance sheet-recognised investments - Increasing engagement with private sector intermediaries who will require to be recognised as ODA intermediaries - Increased planning and budgeting complexity as investment re-flows are difficult to predict - Longer planning times for projects, reflecting increased internal and external approval requirements - Higher administrative burdens as non-fiscal instruments require well-structured arrangements which need greater financial and legal review both at the outset and on an ongoing basis

H.3 ONS and Public Body Consent Rules

When DFID is creating a fund or trust which it is deemed to "control", it needs to be determined whether by doing so one might create a non-departmental public body (NDPB), an Agency or a Public Corporation, which is viewed as an extension of the UK Government. The classifications are determined by the Office for National Statistics (ONS) and HMT. Cabinet Office and ONS consent are needed for setting up such entities as there are staffing and other liability issues for UK Government.

NDPBs carry out a wide range of administrative, commercial, executive and regulatory or technical functions and are defined as "a body which has a role in the process of national government but is not a government department, or part of one, and which accordingly operates to a greater or lesser extent at arm's length from ministers". Additionally, NDPBs have varying degrees of operational autonomy and independence from ministers and the sponsoring department - but all work within a strategic framework set by UK Government Ministers. They usually do not employ their own staff but engage civil servants e.g. Environment Agency. Therefore it is unlikely that a fund would constitute a NDPB, due to the nature of its activities not being aligned to traditional government activities.

An Agency is similarly part of the Government. It carries out government functions and is again more arms length but staff may be other than civil servants. Again it is unlikely that a fund would comprise an agency unless it was carrying out some real public interest function.

A Public Corporation as is defined as 'a trading or market body which operates commercially and recovers most of their costs from fees charged to customers' and which is Government owned. The Government has less control over such bodies and they usually engage non civil servants. An example is Royal Mail before privatisation.

If the entity is classed as a Public Corporation then under HMT financial reporting requirements the total "value" of the entity will be reflected in DfID's accounts. This 'value' will initially reflect the cost of the transfers from DfID to the entity. These will subsequently be required to be re-valued to the lower of this cost or the assumed fair value of the entity. Fair value will be based on the net assets of the entity, which will predominantly be determined by the underlying investment assets. The annual audited accounts of the entity will determine the fair value of the net assets, but DfID would seek more regular valuations to ensure timely adjustment to the central budget to accommodate any required reduction in value. Such reductions would score out of DfID's Annually Managed Expenditure budget (AME).

If the entity is treated as being part of central government (agencies and NDPBs) then the balance sheet of the entity will be consolidated on a line by line basis with the rest of DfID's balance sheet (i.e. each individual balance sheet item will be added to the corresponding similar item in the DfID's balance sheet). This is in contrast to the treatment should the entity be treated as a Public Corporation, where it is only the total 'value' or net assets of the entity that is incorporated in the DfID accounts.

H.4 Financial Conducts Authority

Investment advisory, promotion as well as fund management all constitute regulated activities as defined by the Financial Conduct Authority (FCA). In the context of DfID's activities this means that anybody operating in the UK, either managing third party capital or raising money for an investment scheme (e.g. a fund) needs to have a license to do so, granted by the FCA. Breach of this FCA requirement may be a criminal offence and punishable on indictment by a maximum term of two years imprisonment and/or a fine.

In the context of setting up an investment fund, generally two regulated activities are carried out. Firstly, the fund manager, if located in the UK, requires a fund management license, irrespective of whether capital managed originates in the UK or abroad. Secondly, anybody seeking to raise third party private investments into the fund is also carrying out a regulated activity for which an FCA license is required. For the latter activity exclusions from FCA registration exist where financial promotion is approved by an authorized person. Rules and regulations about what constitute financial promotion are not entirely clear, but in essence, any activity that incites or invites a third party to invest in a regulated activity (e.g. a fund) is subject to regulation.

H.5 Jurisdiction and HMT consent

The choice of where to incorporate or base the fund entity is also important. Factors include:-

- Management costs, efficiency and flexibility e.g. in many developing countries matters such as issuing or transferring shares may take months and be expensive and there may be laws requiring joint ventures with locals or prohibiting extraction of returns and developing country laws can be uncertain. For this reason, many funds incorporate outside the developing country themselves.
- Regulation both in relation to the fund activity e.g. financial services and the fund itself. Some countries may have regulatory rules which are either excessive or inadequate for the nature of the fund or make the fund activity illegal. Funds relating to insurance therefore may prefer to base themselves in Bermuda. Singapore has specific rules that only permit a fund to be based there if there is a proper presence of staff.

  There may also be rules which require a fund to be based in a country e.g. India's own regulations. Certain types of funds in EU jurisdictions may fall within the EU Funds Directive.
- Competence and costs of fund administrators within the fund's jurisdiction. A fund administrator is an entity that manages the fund's corporate structure and reporting and sometimes even the financial accounting. Places such as the Cayman Islands or the Channel Islands are sometimes favoured because of efficient, reputable administrators. Costs can be higher in other places such as Luxembourg.
- Preferences of other donors or investors in the fund where the fund does not just include DfID. Institutional investors have particular preferences based often on their own tax position (see below).

- Taxation. Most investments will need to pay tax in the country of the final investment and often a withholding tax on profits that are withdrawn from that country. Private Investors (corporates or individuals) will then often need to pay tax in their home jurisdiction. Investors are therefore often concerned that there is not another layer of tax payable within the fund itself levied by the jurisdiction of the fund's base. The extent to which such investors can offset tax already paid elsewhere e.g. in the investee country or in the fund, varies according to their home country rules and the existence of double taxation treaties between the investee country or fund jurisdiction and the investor's base. For this reason it has become popular to establish funds in jurisdictions which do not tax entities which are using them only for through flow of funds or holding/management. UK Treasury has a preference, however, not to establish funds in such jurisdictions which are "low tax" or perceived to be "non-tax transparent" such as Cayman Islands, Mauritius, British Virgin Islands, Bermuda, Channel Islands, Isle of Man, Singapore, Switzerland, Luxembourg or Delaware. DfID has agreed to liaise and consult with HMT before choosing or establishing funds in such jurisdictions. This consultation should be done at a sufficiently early stage (preferably at design stage) of the programme and in close conjunction with the DfID Finance and Control Department.

H.6 Structuring Considerations:

H.6.1 Planning and Structuring of Non-Fiscal C-DEL Interventions

With a mandate to increase non-fiscal C-DEL spending, DfID's intervention will increasingly be delivered through private sector intermediaries, or intermediaries that apply private sector tools. The fund model, i.e. an investment vehicle managed by a dedicated fund manager to implement an investment strategy, is becoming increasingly common. An efficiently structured investment vehicle will consider strategies to mitigate issues related to:

- Ongoing non-fiscal C-DEL accounting complexity
- Qualification as ODA expenditure
- Timing of cash in and outflows back to DFID for ODA and budgeting purposes
- Reporting requirements and monitoring burden to verify valuation.

The most common structures to establish a fund are:

1) operating through a MDB owned trust fund account
2) setting up a new single purpose ODA-recognised entity (fund) to be managed by an independent fund manager

While the distinction between the two can be sometimes semantic, the two alternatives generally differ materially in terms of incentive structure, delegation of investment authority, oversight [and legal liability]. A newly established fund, in particular offers more tools to ring fence operations, bring in third party (including private) capital and specify operating procedures.

H.6.2 Multilaterals as Intermediaries

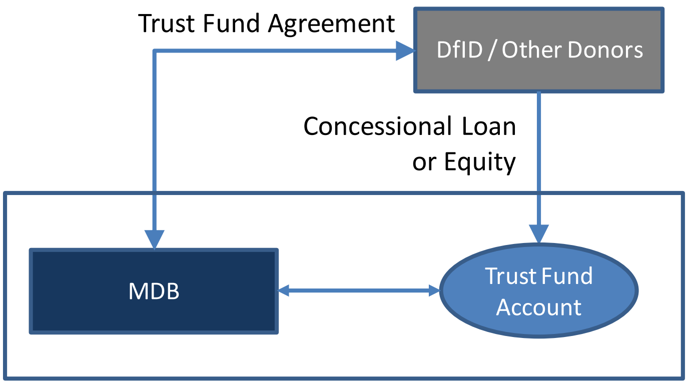


Figure 7: MDB Partnership

Traditionally, DfID and other Donors have partnered with ODA accredited intermediaries, such as IFC, PIDG, AsDB and the AfDB, investing funds into trust fund arrangements, using either debt with concessionary terms or equity into a fund administered by the MDB. Because the MDB intermediary is ODA accredited, the investment immediately qualifies as ODA expenditure, enabling DfID to record the entire notional as ODA on day one if the commitment is made by promissory note (even in the event of a delayed draw down)[22], DfID has the option to delay negative ODA reflows (e.g. by

[22] For example, DfID issues a promissory note for the benefit of a World Bank Trust fund that in turn provides capital to the IFC CP3 fund. The return of funds is governed by an account management agreement which determines repayment amounts and timing to DfID.

recycling capital to other ODA purposes that is returned from underlying projects or holding it within the trust fund).

The ODA accredited intermediary itself has significant flexibility to structure programs that meet DfID's development strategies without the same restrictions DfID faces under ODA rules. For example, the ODA accredited intermediary can invest funds received from DfID into a private equity fund without concerns about concessionality, timing of fund flows etc. On the flip side, however, acting through an intermediary often introduces an extra layer of costs and administration coupled with decreasing control by DfID (it is also not an appropriate funding mechanism for private sector investors). Also ODA intermediaries such as the multilaterals may be appropriate for infrastructure investments but are not always suitable for handling some private sector projects e.g. with start-up entities or small grants or where local knowledge is needed.

H.6.3 Special Purpose ODA Compliant Investment Vehicle

In those instances where intermediaries source funding from multiple sources (donor related or private), a special purpose funding vehicle, ODA accredited, can be set up. GEEREF, GCPF and EFSE are examples of entities that are currently acting as conduits for donor money. Often, these vehicles adopt the legal structure of a private investment fund, separating the legal fund entity from the capital providers and the management of the fund. Unlike the multilaterals, or larger ODA entities where DfID has a smaller stake, special purpose intermediaries can be set up with tighter safeguards imposed by DfID to ensure a narrowly defined development strategy (using an MDB as intermediary is often tied to accepting certain MDB policies and procedures).

Significantly, special purpose vehicles can be managed by a range of third parties, including the private sector (e.g. CP3 AsDB/CFIG, GCPF/Deutsche Bank) or an MDB (e.g. Catalyst Fund/IFC or GEEREF/EIB). A legal structure that follows the most commonly used investment fund models (e.g. a partnership –Figure 8– owned by a GP (fund manager) and funded by LPs (investors) or an investment company –Figure 9 – (e.g. a Luxemburg SICAV) with a variable share structure representing the interests of investors and fund managers) is suitable for both private and public investors pooling their capital for a specific investment strategy.

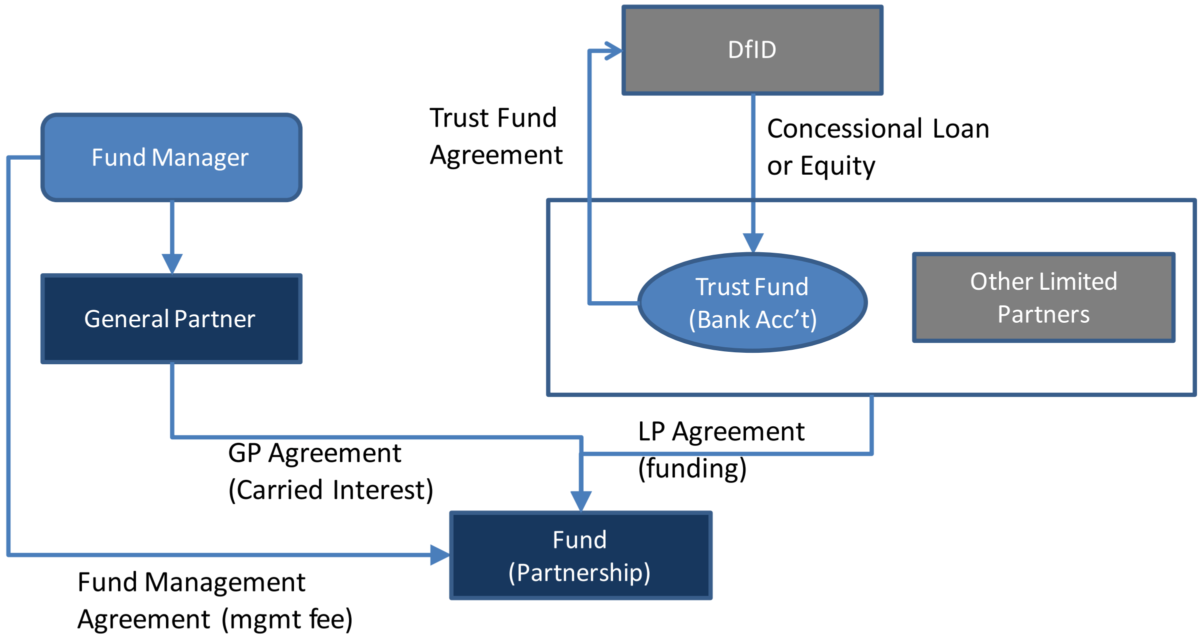


Figure 8: Sample Partnership Fund Structure

ODA accreditation of vehicles that include private capital, however, is challenging. The OECD DAC criteria are not clear but it would seem that they require some layer or element of concessionality within the special purpose vehicle to demonstrate the vehicle is contributing towards economic development in DAC countries. GCPF, GEEREF and EFSE all have an A share, B share, C share structure, with donors in one of these layers receiving 25% below market rate on the returns on shareholdings in the vehicle and/or assuming a first loss position (i.e. if there are losses in the vehicle the donors lose invested capital before the private investors do).

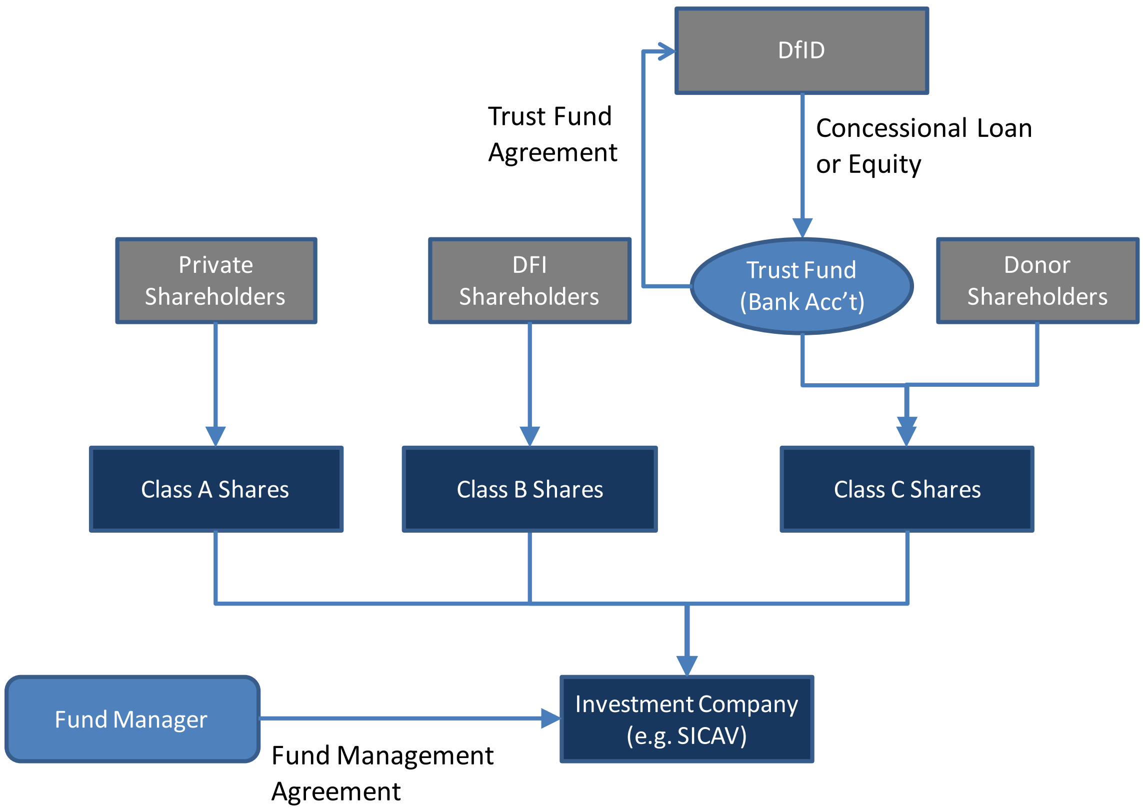


Figure 9: Sample Corporate Fund Structure with Different Share Classes

H.6.4 Investing in a Private Fund using ODA Compliant Instruments

A commercially oriented, private sector fund can act as conduit for ODA expenditures. Its legal structure would be substantially similar to that of the ODA accredited special purpose vehicle described above; however, without the ODA accreditation. In order to achieve ODA credit for funds deployed, the *Purpose* remains the key criterion. It is now the fund manager's obligation to demonstrate investments meet ODA criteria. Debt investments made by the fund have to meet the 25% grant value relative to a 10% discount rate. As a result of this, CDC's loans, which fail this test, are not recognised as ODA. Because the rules are more subjective for equity investments, getting ODA credit has to be argued on a case by case basis. The concessional *Purpose* requirement based on OECD-DAC rules is *prima facie* applied to each individual transaction. To what extent earmarking a certain % of available funds to Technical Assistance facilitates demonstration of concessional *Purpose* is unclear and will require direct discussion with OECD-DAC.

For all investments, however, ODA recognition is delayed until funds are invested by the intermediary (i.e. the fund manager). This places significant reporting and monitoring burden on fund manager and exposes DfID to the uncertainty of when ODA expenditures can be recognized.

H.6.5 Closed- versus Open-Ended Funds

The fund structures described above have a limited investment horizon. By the end of the fund life all investments are liquidated and capital returned to investors. The use of trust fund accounts allows DfID to delay capital re-flows (recording negative ODA) or redirect capital to other ODA accredited organizations or purposes. Further analysis is required whether Trust Funds set up in a DAC jurisdiction to warehouse cash received from non-ODA accredited fund vehicles can delay/ mitigate recording such funds as negative ODA.

An alternative to closed end funds are permanent investment vehicles; e.g. investment companies that attract permanent capital. Under this structure, DfID maintains control over when to record negative ODA flows; i.e. when shares are sold in the secondary market. It is important to reiterate that OECD-DAC has not given concrete guidelines as to the treatment of equity vehicles for the purpose of ODA accreditation or treatment. The examples above are indicative of structures that have been applied in the past and cannot be taken as a blue-print for fund structuring without seeking legal advice and OECD-DAC input.

Summary Conclusions:

- As an arm of the government, DfID activities have to meet the directives made by HMG Treasury and other government bodies. The most common ones to consider are:
    - ODA targets
    - Non-fiscal C-DEL allocations
    - Guidelines regarding the use of tax havens
- Moving from a grant to a fund model requires understanding of investor solicitation rules promulgated by the Financial Conducts Authority.
    - Most activities require a FCA license.
    - Rules become increasingly complex when targeting investors in Europe or the US
- DfID has developed structuring blue-prints that tackle many of the above mentioned issues. However, each case is different and requires input from lawyers, regulators and accountants.
    - ODA rules are not well defined for equity investments and often counter-intuitive for debt investments
    - Implementation of government directives is subject to exemptions on a case by case basis
    - For certain structures, in particular ODA compliance, only feedback from OECD DAC can give definitive answers.

.

I. Appendices

I.1 Interviews Conducted

Organisation	Interviewee
AECF	Hugh Scott
African Development Bank	Subha Nagarajan
Berkeley Energy	Alistair Vere Nicoll
BioCarbon Fund	Ellysar Baroudy
Cordiant	Bertrand Millot
Deutsche Bank Community Development Finance	Patrick Ball
Developing World Markets	Aleem Remtula
DfID	Kirsty McGinigal
DfID	Sam Kutnick
EEP	Georgina Ayre
Embark Energy Fund	Ellen Morris
Fenix International	Michael Lin
GEEREF	Gunther Fischer
Global Health Investment Fund	Labeeb Abboud
GVEP International	Andrew Reicher
HIF/Save the Children	Kim Scriven
IADB	Monica Pina Alzugaray
KfW	CEW/ Andrea Holzaepfel
LGT Venture Philanthropy	Oliver Karius
OECD	Julia Benn
Oxford Technology Mgmt (Enterprise Capital Fund FM)	Lucius Carey
Persistent Energy Partners	Dirk Muench
Prometheus Fund	Andrew Reicher
responsAbility	Patrick Huber
Sustainable Energy Fund for Africa	Joao Duarte Cunha
UNEP Frankfurt School	Martin Cremer
UNEP Seed Capital Assistance Facility	Eric Usher
Unitus Impact Fund	Samir Malviya

I.2 Low Carbon Fund Manager Landscape Index

Fund Manager	Fee Structure	Geographic Footprint	Fund Experience
3rd Party Programme Managers			
Coffey International	Fixed, cost basis	Europe, MENA	Multiple
Finance in Motion/Oppenheim AM	n/a	Europe, MENA	1 CT fund, 3 other (MFI/MSME)
Global Alliance for Clean Cookstoves	Fixed, cost basis	Global (US office, 6 countries)	Developing 2 VC funds, 1 WC Debt fund
GVEP	Fixed, cost basis	Global (UK, Asia, Africa office)	Multiple (e.g. Prometheus, IDEAS)
Harewelle International Management	Fixed, cost basis	Global, Africa Focus	Multiple (e.g. EEP (Bangladesh))
KPMG International Advisors	Fixed, cost basis	Global, Africa Focus	Multiple (e.g. AECF, EEP East Africa)
Save the Children/ELHRA	%AUM, cost basis	Global (UK)	HIF
SEAF	n/a	Global (ex Africa)	23 SME funds, 10 of which E. EU
SNV	Fixed, cost basis	Global	Multiple (e.g. Vietnam Business CF)
Triple Line Consulting	Fixed, cost basis	Global (UK)	Multiple (e.g. GPAF, Civil Society CF)
UNEP Frankfurt School	Fixed, cost basis	Global, Africa experience	Multiple (e.g. SCAF)
Foundations			
Syngenta Foundation	No	Global, Africa focus	Agriculture VC platform, 4 investments
Acumen Fund	Fixed, cost basis	Global, Africa focus	Large Impact VC portfolio - $150mm
Shell Foundation	No	Global, Africa focus	General Clean Tech
Calvert Foundation	NA, raise funding through retail notes	Global, Africa focus	General Impact Funds (& AM platform)

Fund Manager	Fee Structure	Geographic Footprint	Fund Experience
3rd Party Fund Managers			
Aloe Private Equity	% AUM, Carry	S. Asia, China, UK, Fr	3 Clean Tech (CT) Funds
AlphaMundi	1.5-2.5% AUM, Carry	Global	3 Impact Funds (attempt to raise a CT fund)
Bamboo Finance	n/a	Global	1 CT fund,
Berkeley Energy	1.5-2.5% AUM, Carry	Asia (Singapore), Africa (Nairobi)	2 RE Funds
Blue Orchard	<2% AUM	Switzerland	4 MFI Debt funds
Cordiant	1.5-2.5% AUM, Carry	Global (Canada Office)	3 EM Debt Funds managed
Deutsche Bank (Community Dev't Finance)	% AUM, Carry	Global	Growing US/EU Social Fund practice
Developing World Markets	<2% AUM	Global (US Office)	4 MFI Debt, 1 PE Fund
Frontier Investment Management	% AUM, Carry	Africa	1 RE/Carbon fund
Earth Capital Partners	% AUM, Carry	Global (UK office)	2 funds – RE and Timber
eleQtra	Fixed, Success, Carry	Global (UK office)	1 PIDG fund managed
Emerging Energy and Environment	%AUM, Carry	Latin America	2 CT funds ($30mm, $150mm)
FE Clean energy Group	% AUM, Carry	Global (US HQ)	2 PIDG funds managed
First Climate	%AUM, Carry	Global (Switzerland office)	3 Carbon Funds ($50mm-$150mm)
FMFM	% AUM, Carry	Global (UK Office)	2 PIDG funds managed
Generation AM	% AUM, Carry	Global (UK Office)	Multiple, including Africa Growth Fund
Global Environment Fund	% AUM, Carry	Global (Regional Office network)	Multiple, including Africa Growth Fund

Fund Manager	**Fee Structure**	**Geographic Footprint**	**Fund Experience**
Grassroots Business Fund	n/a	Global (Regional Office network)	1 $50mm fund
GroFin	n/a	Global (Local Office network)	7 Debt funds
Hermes GPE	% AUM, Carry	Global, UK	Environmental Innovation Fund (BIS)
Inspired Evolution	% AUM, Carry	Southern Africa (RSA Office)	Evolution One Fund
Jacana/InReturn	% AUM, Carry	E. Africa (Kenya Office)	1 RE fund
Lereko Metier	% AUM, Carry	Africa (RSA Office)	1 CT fund, PE platform (Lereko)
LGT Venture Philanthropy	0.5-2.5% AUM, Carry	Global (EU Offices)	1 Impact Fund, larger AM platform
LHGP AM (*NB Lion's Head sister co*)	0.5-2.5% AUM, Carry	Global (London, Nairobi offices)	1 Impact Fund, RE experience
Masdar Capital	% AUM, Carry	Global (MENA office)	DB Partnership, 2 funds
Persistent Energy Partners	2-3% AUM	E. & W.Africa (US, local offices)	1 RE fund
responsAbility	% AUM, Carry	Global, E. Africa	1 RE fund, multiple MFI debt funds
Terra Global	2-3% AUM, Carry	Global (US office)	1 Carbon fund
Wolfensohn	% AUM, Carry	BRIC + E. EU (US office)	1 CT fund
Real Infrastructure Capital Partners	% AUM, Carry	Latin America	1 RE fund
Unitus Impact Fund	1.5-2.5% AUM, Carry	Asia, (US Office)	1 Impact Fund

Fund Manager	Fee Structure	Geographic Footprint	Fund Experience
MDB Fund/Programme Managers			
AfDB	Fixed, cost basis	Africa	Multiple, e.g. SEFA
AsDB	Fixed, cost basis	Asia	Multiple
EIB	% AUM, Carry	Global	GEEREF, EIF UK Future Tech Fund (BIS)
IADB	Fixed, cost basis	Central and South America	Multiple, IDEAS Caribbean
IFC AMC	% AUM, Carry	Global (US Office)	Multiple, CP3
UNEP	n/a	Global	Multiple, SCAF
World Bank (Carbon Finance Unit)	Fixed, cost basis	Global	11 Carbon Funds
World Bank (Other)	Fixed, cost basis	Global	Multiple, e.g. CIF funds