Department for International Development

UKaid from the British people

Development Capital

Catalysing investments to benefit poor people

July 2015

Development Capital – catalysing investments to benefit poor people

Development Capital is public investment made in the private sector to achieve development objectives. *It is a tool used by DFID to catalyse investment that benefits poor people. Development Capital follows a double bottom line approach: We seek modest financial return alongside significant development impact. Returns will be redeployed into development programmes, making UK aid better value for money. This paper sets out the context and drivers of Development Capital and how DFID will deploy it.*

The private sector as driver of growth and development

The UK government's vision is to help poorer countries achieve a secure, self-financed and timely exit from poverty. Inclusive economic growth[1] is core to achieving this vision. No country has been able to eradicate poverty without economic growth, and no country will graduate from aid without it. Economic growth has helped lift 700 million people out of poverty in the last two decades and has led to a boost in human development across the globe. Private investment has been a key ingredient of this success.

The private sector is not only the engine of economic growth but it also directly supports the livelihoods of poor people:

Creates jobs – Over 90% of jobs in developing countries are in the private sector and poor people see getting a job as the most promising path out of poverty[2].

Provides access to infrastructure and services – In Africa, the private sector accounted for over 80 % of total production over the period 1996-2008. This includes the building of key infrastructure and access to drinking water, health and education.

Increases innovation and competitiveness – The private sector can provide innovative and sustainable solutions that address a wide variety of social and economic problems affecting those at the base of the pyramid[3].

Contributes to government revenue – Firms and their activities are the principal sources of tax revenue for governments. The taxes fund public services and money transfers to poor people.

Leads to better standards and working conditions – Promotion of an organised private sector and improved standards in investee companies will lead to improved compliance with labour, environmental and governance standards[4].

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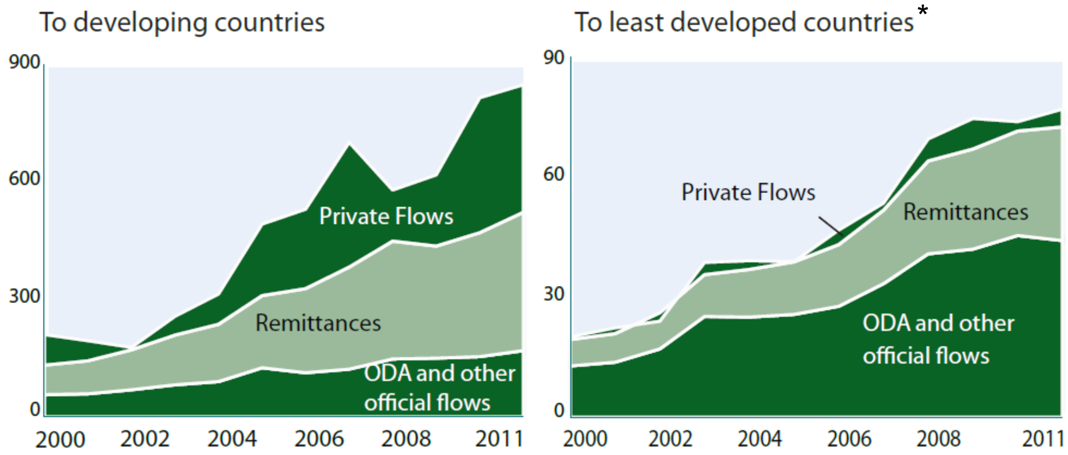
[1] In 2014 we set out how we will achieve this vision in our strategic framework – "Economic development for shared prosperity and poverty reduction".
[2] World Bank (2005), World Development Report / Voice of the poor study
3 CK Prahalad (2004), Fortune at the base of the pyramid,
[4] ILO (2004), A Fair Globalization. Creating opportunities for all, Report of the World Commission on the Social Dimension of Globalization

More private capital is needed to support development

Investment financed by private capital is the foundation for wider private sector activity and the benefits that follow. It is also instrumental to achieving economic growth.

Private capital including Foreign Direct Investment, debt and portfolio equity to developing countries has been outstripping Overseas Development Assistance (ODA) flows in the years since 2003 (figure 1). Increased inflow of private finance is associated with countries growing out of poverty. However, the poorest countries are missing out (figure 1), remaining dependant on aid and remittances. Similarly, private investment in African businesses has increased substantially with an average annual volume of $3 billion. However, 90% of investments are made in only four countries.

Figure 1: Least developed countries rely disproportionately on ODA and remittances

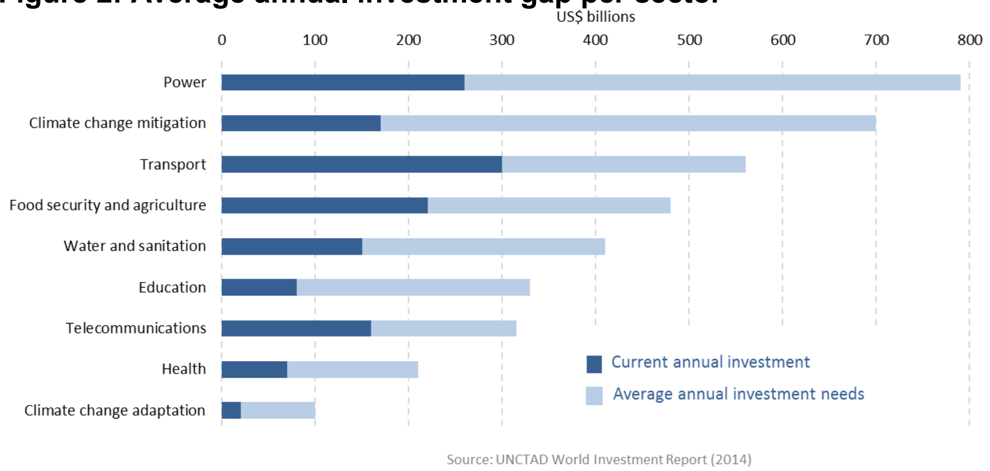


* 48 poorest countries as defined by the World Bank

Source: UN (2014), Intergovernmental Committee of Experts on Sustainable Development Financing

The finance needed to achieve the Sustainable Development Goals to be agreed this year is estimated at approximately $2.5 trillion every year[5] but current investment levels are less than half of that (figure 2). The private sector arm of the World Bank, the International Finance Corporation (IFC), estimates the financing gap for Small and Medium Enterprises (SME) in emerging economies to be up to $2.5 trillion[6], implying their job creation and innovation potential is not being realised. Public resources alone will not be sufficient to address such high financing needs in developing countries. They will need to be used increasingly as a catalyst to attract private finance, especially to sectors that can transform developing economies.

Figure 2: Average annual investment gap per sector



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[5] UNCTAD (2014), World Investment Report

[6] IFC (2010), Two trillion and counting: assessing the credit gap for micro, small, and medium-sized enterprises in the developing world

Catalysing private capital for development with Development Capital

DFID's Economic Development Strategic Framework[7] sets out the strategic objective to catalyse increased private investment in developing countries as an important driver of economic growth and contributor to human development.

DFID has programmes in place that help its partner countries with improving their investment climate. An insufficient legal and policy environment is often a key obstacle to attracting private investment. However, investors may overestimate risk even in promising policy environments, or there maybe weaknesses in the financial and capital markets that prevent feasible projects from being implemented. In such situations public intervention can play a positive role by making pioneering investments that yield direct benefits, taking risks to attract regular investors as well as crowding in by demonstrating success. Even well-functioning markets like the UK[8] have publicly funded programmes to catalyse investment and spur innovation. Well-designed public interventions, especially in key sectors, can transform developing economies, which lack the domestic resources or capacity to undertake similar programmes.

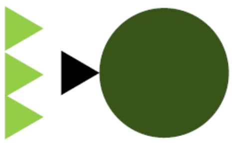
DFID is responding by using Development Capital as a catalyst to make pioneer investments in developing countries. Development Capital is public investment made in the private sector to support development objectives. It is not grant funding, meaning that we treat Development Capital investments as an asset on our balance sheet. While the objective is not profit, we consider this an important indicator as only successful investments will be able to attract additional private finance and transform markets.

Development Capital is an additional instrument in DFID's toolkit that complements rather than replaces our other approaches. Traditional grant aid will continue to play a critical role for example in improving policy and building state level capacities for delivering services.

Development Capital will benefit poor people in two ways. First through the investment itself which will be focussed on meeting the needs of the poor whether it's through creating jobs, improving infrastructure, or bringing better access to services. Secondly, where investments are successful, they will help by demonstrating to commercial investors the feasibility of private investment in geographical areas and sectors key to generating inclusive, sustained growth, improving access to services and/or tackling climate change. Box 1 sets out three ways in which Development Capital can help attract more private investment to developing countries.

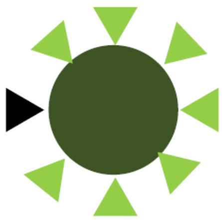
Box 1: Development Capital catalyses private finance

Leading the way



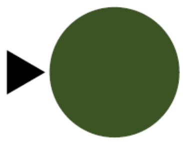
Development Capital can lead market participants to follow suit if the investment was successful

Crowding in private investment



Development Capital can "crowd-in" private investment by sharing some of the risk of an investment, encouraging others to co-invest

Overcoming access to finance barriers



Development Capital can provide capital in shallow markets where no other capital is willing to go

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[7] https://www.gov.uk/government/publications/economic-development-for-shared-prosperity-and-poverty-reduction-a-strategic-framework

[8] HMG recently developed a Pensions Infrastructure Platform that will facilitate investment from British pension funds in public infrastructure projects backed by the UK Treasury.

In deploying Development Capital we will adopt a double bottom line approach, seeking modest financial return alongside significant development impact. We will be taking risk and correspondingly, share the returns. These returns will be redeployed into development programmes, making UK aid better value for money. We will prioritise development impact over financial return, whilst always taking into account that only successful businesses create sustainable impact.

Development Capital is a flexible instrument that can be tailored to specific contexts. We identify investments in line with our development objectives and to maximise development impact we need to be able to make a range of interventions – from small scale and risk capital supporting start-ups to larger investments that enable companies to reach scale and employ more people. Development Capital also addresses a gap in the spectrum of development finance (figure 3). DFIs and development banks often deploy their capital with the goal of commercial or near commercial return. Other tools, e.g. grant aid and technical assistance are disbursed with no expectation of return. Between these instruments there are only a limited number of impact and blended finance investments that target returns that are significantly below commercial rates. We have identified this middle ground as target area for Development Capital while maintaining a range of instruments we can draw on to achieve development impact.

Figure 3: Development Capital fit in development finance landscape

DFID's relationships with partner countries and analysis of country specific growth opportunities will allow us to reflect local priorities and needs in our investments. Our focus on poverty reduction, partnership with committed, expert institutions and ability to take managed risk allows us to support investments that other investors may overlook, and to implement safeguards to ensure that these investments are conducted responsibly.

DFID relative strengths in ensuring that Development Capital is put to the most effective use are:

- the willingness to take and manage higher financial risk on its investment compared to fully commercial actors as well as many Development Finance Institutions (DFIs)
- complementary grant funding and the network of country offices that can help to improve the policy environment, build local capacity and facilitate design of investable projects
- expertise at strategic level on the role of the private sector across economic, human development and climate change
- engagement with international policy development, as active member of the G7 and G20
- strong partnerships with Multilateral Development Banks (MDBs), as shareholder and through direct project related funding
- untied aid, ensuring that developing countries can reap the full benefit of our investment
- legal mandate and convening power with businesses to hold businesses to account, for example UK anti-bribery Act, mechanisms such as the Extractive Industries Transparency Initiative (EITI).

Cape Verde – Cabeolica Wind Power

In 2010 the UK and other shareholders of the Private Infrastructure Development Group[9] (PIDG) invested £5 million in a 28 megawatt wind farm on the Cape Verde islands. Before this investment the local government had failed to secure bids from commercial investors and turbine providers. The PIDG investment allowed this project to achieve financial close and catalysed an additional £45 million from private investors.

Today the wind farm is providing 425,000 people with cheaper and cleaner power – that is 95% of the population. The cost of generating power is now much cheaper and as a result of this investment Cape Verde was able to reduce its oil imports considerably – saving the country more than £5 million a year. This money can now be spent on key public investments and services.

PIDG is providing cheaper and cleaner power in countries across Africa and Asia

Photo credit: InfraCo Africa, a PIDG Facility

[9] The Private Infrastructure Development Group (PIDG) mobilises private sector investment to assist developing countries in providing infrastructure vital to boosting their economic growth, and combating poverty. http://www.pidg.org/

Development Capital will respond to market needs

We will focus our investments where Development Capital can be a key driver of growth and in projects for which regular private investment is not available. These can include, for example:

- sharing risk to facilitate longer term and local currency finance for local businesses, deepen insurance and local capital markets to increase financial inclusion and resilience;
- develop physical infrastructure, including power and transport directly; or through investing risk capital in infrastructure funds;
- provide early stage, growth stage and working capital to SMEs in manufacturing and agriculture becoming part of global value chains;
- tackle the massive investment gap in climate finance, low carbon or renewable energy, commercial initiatives that improve land use and forestry;
- provide risk capital to innovative solutions in service delivery, for example in health by developing and marketing new technology that addresses health challenges facing the poor

The design of Development Capital investments will ensure strong alignment with cross-cutting priorities such as fragile and conflict affected states and girls and women. Differentiated approaches will be worked up for each country context, taking account of the drivers of fragility. Tailored operating models and careful sequencing will be needed to ensure a positive impact.

Development Capital can be a driver of girls' and women's economic empowerment, by increasing opportunities for employment in decent jobs, improving access to financial services, improving mobility through better infrastructure; and by encouraging female entrepreneurship, which can lead to knock-on effects of influencing social norms by providing positive role models to girls. Investments in certain sectors could have disproportionate impacts on women, providing services that free up time from unpaid domestic chores, e.g. efficient cook stoves and clean water; investments in better lighting and staffing, and improved public transport to make public spaces 'safer'.

African Risk Capacity (ARC)

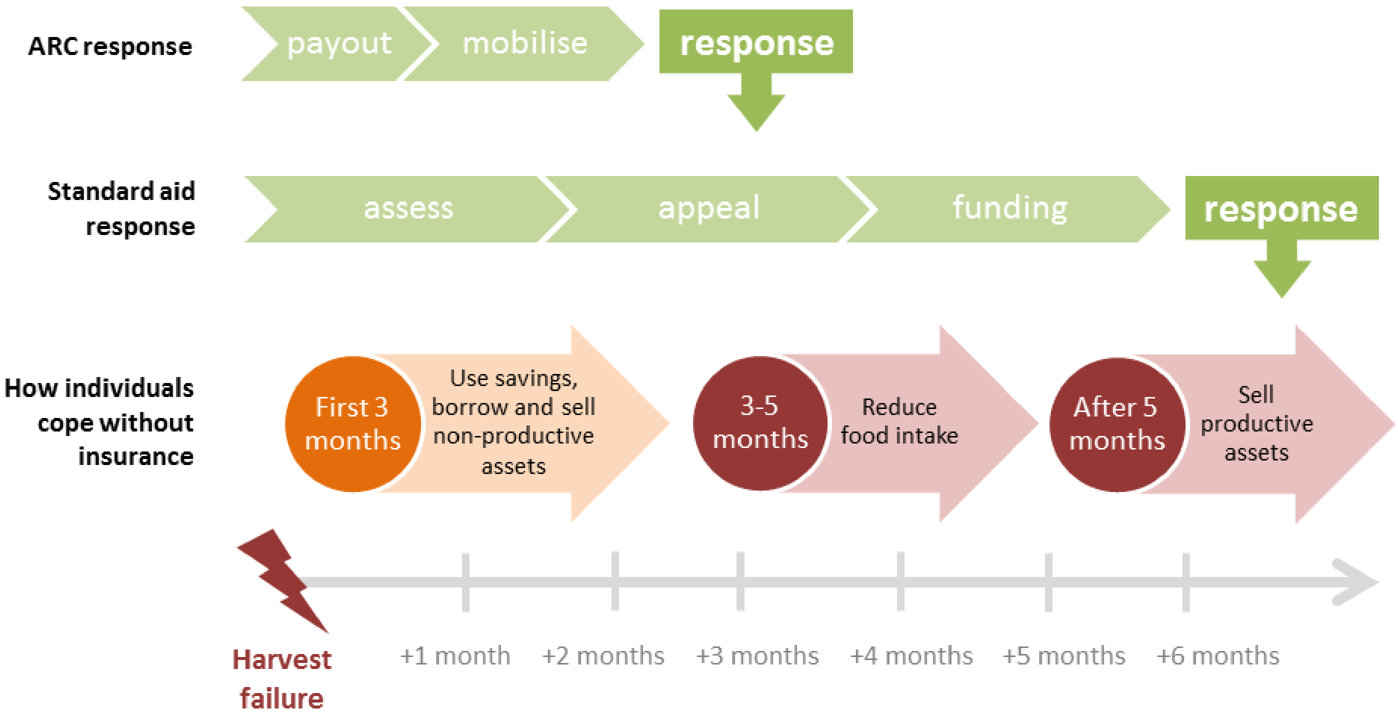
UK Development Capital helped set up this African climate risk insurance pool and early response mechanism. ARC enables African governments to insure themselves against natural disasters and respond early when their citizens experience harvest failure. Early response is key to avoid families having to sell assets to survive and losing their livelihoods.

Rice ready to be distributed as part of the emergency packages in Senegal
Photo credit: ARC

In early 2014, the UK agreed a Development Capital investment of up to £90 million, as well as a grant of up to £10 million for technical assistance and evaluation. Of this, an initial £30 million (matched by Germany) was paid in to capitalise ARC Insurance Company Ltd and allow it to offer insurance. Four African countries purchased drought insurance, with Senegal, Mauritania and Niger receiving pay-outs totalling £17 million after poor rains. Some are already putting this money to use and have started the delivery of emergency packages including food supplies to local beneficiaries which will benefit 1.3 million people across the three countries.

A further five countries should be eligible for insurance in 2015, and other African countries are interested too. Coverage is also being expanded to include floods, tropical cyclones and other hazards. In addition to UK and German support, ARC also receives grants from Sweden, Switzerland and the Rockefeller Foundation.

How ARC is making households more resilient to natural disasters



Employing Development Capital

CDC, the UK's development finance institution, will remain the most important vehicle for catalysing investment. Based on the new strategy agreed in 2012, CDC is now focussing more sharply on the poor countries in Africa and South Asia, to deliver development impact alongside financial returns. CDC now invests directly as well as through funds.

However, CDC cannot be expected to tackle the entire challenge on its own. DFID will partner with other expert partners selected based on their expertise, development track record and fit with our objectives to develop complementary investments that can respond to need.

There is a set of risks that need to be actively managed. These include development impact risk, such as crowding out regular capital, which will be mitigated by ensuring that investments are well targeted, demonstrate additionality and are rigorously monitored. Environmental, social, governance and political risks of investments will be monitored through independent due diligence.

Development Capital means that we are making investments that are outside the comfort zone of commercial investors. We want to drive innovative business models that can make a real difference for poor people. This will lead to some cases where our investment does not provide a financial return. Learning from such pioneering investments is a vital part of the Development Capital approach.

Export Trading Group (Pan-African Agribusiness)

Export Trading Group (ETG) is a pan-African agribusiness that procures at the 'farm gate', provides support to farmers through the sale of fertilisers and farming equipment, as well as logistics support through transportation and warehousing of agriculture commodities. In recent years ETG has diversified from solely a trader of farm-gate commodities to a processor and distributor of agri-products, providing African farmers with an expanded market for their produce.

ETG is helping farmers in poor countries like Malawi
Photo credit: CDC Group

CDC invested US$32.5 million in the company in 2012. At the time of investment, the company provided 5,000 direct jobs and the investment aimed to support further growth in employment. ETG also provides a route to market for smallholder farmers in African countries which are difficult to invest in.

Two years since CDC's investment, direct employees have grown to 8,000 people in more than 30 African countries. Aside from direct jobs, approximately 3 million people benefit more widely from ETG – the company employs people to cover seasonal warehousing peaks and provides income to many smallholder farmers. In many countries, women make up 40% of ETG's local workforce.

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leading the UK government's fight against world poverty.

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