Vas-Y: Public-private-partnership model for unlocking private investment for fragile states

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PRIVATE INVESTMENT IS CRUCIAL TO ACHIEVE DEVELOPMENT GOALS, ESPECIALLY IN FRAGILE CONTEXTS

Traditionally, international development policies pursue global development objectives through official development assistance (ODA). However, the 2030 Agenda revealed the shortcomings of ODA in implementing the Sustainable Development Goals (SDGs). Given an annual ODA budget of USD 162.779 billion, there is an estimated USD 30 trillion shortfall in funding for achieving the SDGs.[1] Policymakers stress the necessity for private investment in developing countries. A number of prominent initiatives reflect this argument. This includes the UN's SDG Impact initiative and the heavyweight Compact with Africa, launched under the German G20 Presidency in 2017. Today's role of ODA is therefore not limited to fixing global challenges directly, but it should pave the way for large private investments to do so.

Private investment is of particular importance to contexts of fragility, conflict and violence (FCV).[2] Two arguments are striking: (i) FCV contexts have a comparably high need for funding, yet only a low share of ODA and private investment. (ii) The impact of private investment in FCV economies can make an enormous contribution towards resilience, stability, and sustainable development.

Let us unpack these arguments: fragile states appear to be among the top beneficiaries of funding. ODA to FCV countries increased 26% from 2009 to 2016.[3] Yet, a closer look at this number unveils a noteworthy distortion. The high amount is due to an enormous increase of humanitarian assistance. The humanitarian share in ODA is about 25% for all FCV contexts and about 50% for the 15 extremely fragile contexts. Reserved for immediate crisis response, the humanitarian budget does not provide the resources for long-term development and SDG achievement. If we look at more SDG-oriented spending, we find in 2016 that only 10% of total ODA was in fragile contexts. The small amount of ODA de facto aimed at SDG efforts in fragile contexts shows the importance of support mechanisms that attract private capital for development in areas affected by FCV.

»Private investors are more agile and innovative than the slowly moving development tankers.«

A second argument for private sector engagement in fragile contexts is that private investors are valuable implementing agents for the SDGs, complementary to development agents. Private investors are more agile and innovative than the slowly moving development tankers, injecting not only capital, but also supporting the development of companies and hence economies as a whole. Successful development agents in FCV contexts (esp. in economic development) must adapt to local market dynamics shaped by more institutions and powerbrokers than the state alone.[4] This requires a certain flexibility that we find more with private sector investors than politically loaded development organizations.

»Volatile security and political uncertainty are a major constraint to investment.«

POTENTIAL AND CHALLENGES TO PRIVATE INVESTMENT IN EMERGING AND FRONTIER MARKETS

Emerging markets are characterized by low local debt, fast-growing GDP, somewhat developed equity markets and market exchange. Yet, these markets are not subject to elaborate regulatory standards and do not have sufficient market efficiency. Investors need to be aware of possibly insufficient infrastructure, and of political and monetary uncertainties. In FCV contexts, investors face even less mature frontier markets. Frontier markets face a very low level of diversification in the financial sector, are comparatively small, less liquid and rather affected by volatility. Investors are confronted with the infrastructural and political characteristics of a developing country and with a greater lack of information about investment-relevant processes.

At present, fragile states receive less than 10% of all FDI. Considering the great need for private investment this raises the question of how to improve incentives for private sector investment in fragile states. FCV countries hold growth potential unmatched by saturated developed markets. In addition, fragility serves as a natural "market protection" for companies equipped to deal with the volatility of these markets. Yet, these incentives are usually overshadowed by the considerable risks of FCV.

Naturally, volatile security and political uncertainty are a major constraint to investment. Yet there are additional reasons that are often not addressed adequately by technical assistance:

First, private investors require more than an investment pipeline and knowledge of the potential of frontier markets to build a viable case for investment at an acceptable level of risk. Despite improving business environments and GDP growth, investors struggle in frontier markets because of the lack of effective market institutions, e.g. end-to-end logistics companies or market research firms.[5] Moreover, investors often perceive frontier markets as unattractive due to their high share of low-income consumers.[6] Investors mostly target large and "high end" medium-sized enterprises, because smaller companies are usually not considered investable. To absorb investments, smaller companies require additional – cost-driving – support that is disproportional to the investment, e.g. managerial expertise and access to networks or synergies with other investees.[7] Most companies in fragile states classify as small- and medium-sized enterprises (SMEs), hence the number of companies attractive for investment is limited. The general low level of investments in FCV contexts is additionally constrained by the low level of investment in SMEs. This implies a further barrier to sustainable development, as SMEs are crucial for creating jobs and sparking innovation.

VAS-Y! UNLOCKING PRIVATE CAPITAL FOR DEVELOPMENT IN FRAGILE STATES

Vas-Y is a public-private partnership model for development agencies and private equity investors, which is looking to address the challenge of raising private capital for development. It refers to the French phrase "vas-y", or "go ahead", reflecting the need for development cooperation actors, investors and small companies to break new grounds for economic prosperity. Unlike existing models, Vas-Y's idea is to trigger investment with two main gears: (i) it supports investors to build profitable investment cases in frontier markets at predictable risks and costs; (ii) it channels investment to SMEs that account for the largest development potential.

The partnership approach: Vas-Y builds on the understanding that investments always consist of a capital injection and technical assistance in forms of skills and knowledge transferred to the investee. While the capital injection fuels the investee's economic growth, technical assistance ensures its sustainable operational performance. Separating financial investment from technical assistance (TA) allows private equity investors to focus on the former and allows development organizations to support the investor in providing the latter, valuing the complementary strengths of each actor. Investment managers have the capability to raise funds for injecting capital in the investees, manage the investments through active engagement, and implement exit strategies. With TA as their core business, development organizations are able to provide the technical resources needed to build a viable case for an investment in these high-growth markets at an acceptable risk in close cooperation with or through the investor.

Targeting SMEs: Investments in SMEs contribute to growth and stimulate ripple effects in entire markets, as they are the backbone of most frontier economies. Yet, while larger firms may find access to finance, SMEs remain underserved by financial institutions, which is one of their biggest constraints. Frontier markets lack the institutional context and resources to provide access to different forms of financing, such as equity financing – in particular, private equity.[8] Private equity investments, unlike debt financing, do not require investees to provide guarantees or collateral to investors, but rather shares of the company. Through this arrangement, investors and investees align their goal: sustainable growth of the company. Vas-Y addresses the financing gap and taps into opportunities to foster economic growth. Providing technical assistance resources helps private equity investors to build a business case for investments in SMEs. This drives down the management costs of investment funds, guarantees the investees will improve business performance and provides the platform to offer complementary support.

THE GRASSROOTS BUSINESS PARTNERSHIP

Although Vas-Y offers a new institutionalized approach to unlocking private capital for development in fragile contexts, the core components of this approach – distinguishing technical assistance from financial investments – have been tested: In 2004, the IFC set up the "Grassroots Business Initiative" to tackle issues of financing and provide support to companies with a positive economic and social impact. In 2008, the initiative became an independent non-profit spin-off from the IFC named "Grassroots Business Partners Inc" (GBP), operating under the brand name "Grassroots Business Fund" (GBF). In 2011, GBP launched the "Grassroots Business Investors Fund I LP" (GBI-I), a private mezzanine investment fund, working in conjunction with GBP, to provide quasi-equity investment capital and targeted business advisory services. The GBF aims to grow viable, sustainable and inclusive businesses that generate earnings or cost savings for people. It identifies high-impact businesses in developing countries and grows them to amplify their social and economic impact. The cooperation between GBP and GBI-I is successful. GBP has conducted more than 450 business advisory service assignments, enabling investments by GBI-I of USD 42.7 million in 33 high-impact companies since 2011. The number of indirect beneficiaries reached globally amounts to 5.3 million people.

HOW DOES VAS-Y WORK?

Vas-Y is built around a non-profit technical assistance facility (TAF), which serves as platform to manage the partnership between development organizations and private equity fund managers (orange bubble). The TAF is founded and managed by one or more investment managers (dark green oval circles), interested in extending their investment portfolios to fragile and SDG-relevant markets. The purpose of this TAF is fourfold:

- It provides financial and logistical support for identifying and doing the due diligence of potential investee companies. As such, it matches the development organization's knowledge of local markets with the due diligence capabilities of investment managers.
- Once potential SME investees (light grey oval circles) have been identified, the TAF provides, manages and coordinates the technical assistance that accompanies financial investments by private equity fund managers. This technical assistance is needed to ensure a sustainable development of the benefitting companies and hence to de-risk the investments of fund managers.

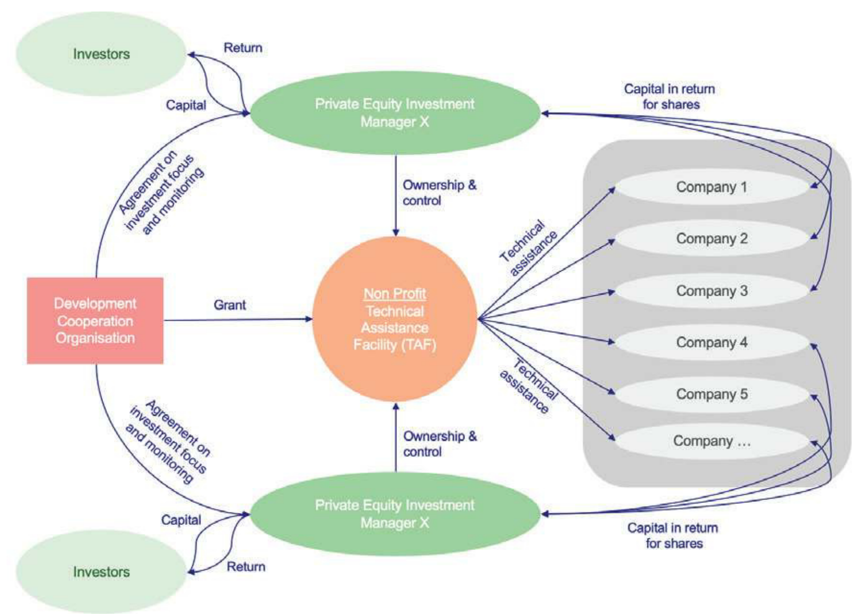
»There is ample reason to consider embedding Vas-Y in a broader programmatic approach.«

- It develops and applies a standardized SDG-sensitive evaluation and monitoring system, to measure the social and environmental impact of the investment portfolio.
- It represents a platform for investment managers to coordinate and represent their interests toward donors or governments, helping to further improve investments in fragile countries.

It is crucial that the TAF is managed by investment managers participating in the scheme. Fund managers are accountable to their own shareholders. Investors therefore must have the managerial freedom to design and implement the technical assistance according to their own choice. Further, the investment managers often have more detailed knowledge of business administration and economics for responding to the needs of the investee companies.

The structuring as a non-profit entity allows development organizations, development banks and other actors (see red box) to financially support the TAF through grants or other financing schemes like public-private partnerships – often the only direct financing instruments available

Figure 1: Vaz-Y: Public-private partnership model to leverage private equity investment for frontier markets



Source: authors

to these organizations. Through financially supporting technical assistance, development organizations drive down the costs of investment managers and set incentives to engage in SDG- relevant markets.

»An effective partnership is required to drive a company's growth and a nation's economic prosperity.«

To benefit from the support that development organizations channel through the TAF, private equity investors must commit to focusing their investments in SMEs in fragile countries and SDG-relevant markets and agree on respective monitoring systems. Furthermore, fund managers must demonstrate their ability to raise funds as well as verify a track-record of successful investments, in order to prove the ability to fulfill their role in the partnership.

Considering the decades of experience development organizations have in fostering conducive business environments on the meso (i.e. helping to form business associations) and macro levels (i.e. advising national governments on trade policies), the model foresees the support in these areas as encapsulating the investments in a suitable environment. Hence, while Vas-Y could be designed and implemented as a stand-alone solution as part of any private-sector development initiative, there is ample reason to consider embedding it in a broader programmatic approach.

PROVIDING SUPPORT AND INVESTMENT TO SMES IN THE TOUGHEST MARKETS: THE CASE OF INFRONTIER

Afghanistan is considered one of the most challenging environments for investment. InFrontier is the only private equity investment fund in Afghanistan. It has a portfolio of over USD 30 million, including investments in an insurance company, a broadcast technology provider and an agri-processing company. The London-based fund has offices in Afghanistan, Pakistan and Uzbekistan. The local proximity is key to its success. One of the biggest challenges was to convince financial backers that the fund will succeed in a fragile context. Yet, according to co-founder Felix von Schubert, the increased risk is expected to pay off through risk-rated returns. Another challenge is the search for qualified personnel for its portfolio companies. Companies often lack management capacities or basic financial and operational systems. Schubert stresses the importance of the InFrontier teams presence on site and the technical assistance it provides to its companies. Through the deployment of experts and customized capacity development, investees are equipped to introduce new products, establish new partnerships and expand regionally. Such measures are not a special characteristic of investments in fragile contexts but substantially more challenging to implement. The lack of local service providers, such as auditors, certification companies or payment providers, are another major hurdle that often must be sourced from neighboring countries. InFrontier measures its impact through its concept of "Whole Sector Impact", describing its impact of investing in market leaders that transform entire sectors. InFrontier does worry that development organizations often lack an understanding of how private investors operate and the value they provide to companies. For that reason, von Schubert stresses that an effective partnership is required to drive a company's growth and a nation's economic prosperity.

[1] UNDP. (2018). UNDP launches 'SDG Impact' to help unlock investment in Global Goals. [online] Available at: https://www.undp.org/content/undp/en/home/news-centre/news/2018/UNDP_launches_SDG_Impact_to_help_unlock_investment_in_the_UN_Global_Goals.html [Accessed 5 May. 2019].

[2] Our understanding of context of conflict, violence and fragility (FCV) refers to the concept of fragility suggested by the OECD. 2016: 16. States of Fragility 2016: Understanding Violence. OECD Publishing Paris, https://doi.org/10.1787/9789264267213-en

[3] All numbers in this paragraph refer to OECD. 2018. States of Fragility 2018. OECD Publishing. Paris. https://doi.org/10.1787/9789264302075-en

[4] Minoia, Giulia and Urs Schrade. 2018. "No more standard programming: economic development in fragile settings. Lessons from Afghanistan". Overseas Development Institute (ODI). SLRC Policy Brief. London.

[5] Khana, Tarun, Palepu, Krishna G. and Jayant Sinha. 2005. "Strategies That Fit Emerging Markets." In: Harvard Business Review, Vol. 83(6), p. 63-74.

[6] Bhaumik, Sumon Kumar and Stephen Gelb. 2005. "Determinants of Entry Mode Choice of MNCs in Emerging Markets: Evidence from South Africa and Egypt." In: Emerging Markets Finance and Trade, Vol. 41, Issue 2, p.5-24.

[7] A good example in this regard is InFrontier, the only private equity fund based in Afghanistan. InFrontier placed an investment in the Insurance Corporation of Afghanistan (ICA), the country's largest insurance company and a pioneer in developing health care insurance in Afghanistan. To accompany the capital injection and secure a sustained growth, InFrontier recruited a new management team for ICA, helped to improve accounting and risk management systems, introduced new standards, developed customer feedback policies, and more.

[8] In India, for example private equity investors focus on companies with an annual revenue between 2 and 500 million USD and in Vietnam, private equity investors prefer a company size of 10-20 million USD annual revenues.