Bridging the Gap: Unlocking Synergies between Private Sector Development and Development Finance
BRIDGING THE GAP

Unlocking Synergies between Private Sector Development and Development Finance

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INTRODUCTIONS

Commissioned by:

Supported by:

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(PSD)

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Research Study Co-lead
(Investment)
What types of work are you currently involved in? (Select all that apply)
AGENDA

1. Introduction
2. Findings and recommendations
3. Conclusions and way forward
1. INTRODUCTION
Rationale:

• BII and Gatsby Africa recognise that development finance and PSD often aim to achieve similar objectives around poverty reduction and sustainable growth in lower- and middle-income countries.

• Examples of approaches to reach these goals becoming less transactional and more transformational, with growing interest from both sides in supporting lasting, sector-wide change.

• Transformational change relies on multiple enabling factors – such as markets, investment, and policies – coming together to unlock growth.
  • In theory, alignment between development finance and PSD can support this, however in practice this did not appear to be happening to a significant extent.

Aims of the study:

1. Explore examples to better understand the drivers of / barriers to successful alignment
2. Provide recommendations for both sides that could strengthen alignment moving forward
3. Further dialogue and provide a springboard for action

Methodology:

• Study ran August – October 2021 and comprised a literature review, 38 interviews and a rapid survey, with a global scope
• Exploratory approach and few ‘model’ examples
DEFINITIONS: WHAT DO WE MEAN BY “PSD”?

• The study focussed on **market-shaping PSD** - initiatives that work to address **underlying, market-level constraints** to inclusive economic growth, including systemic barriers to responsible investment. Particular interest in high-impact sectors. Also looked at other types of PSD with transferable lessons.

• A variety of models with some common features:

  - Thinking systemically about development challenges
  - Understanding the root causes of underperformance
  - Developing context-specific solutions
  - Facilitative approach to build local ownership
  - Flexible, iterative delivery
  - Sustainable outcomes (beyond the period of intervention)
  - Large-scale impact

• A mainstream approach within donor PSD strategies (FCDO, USAID, Sida, SDC, etc.). Growing interest in applying the approach to challenges like economic transformation and youth employment.

• Increasing interest among DFIs (like BII and FMO) in thinking beyond transaction-level TA.
### INVESTOR TYPES

- **DFIs** (direct and indirect investment)
- **Impact investors** funded by DFIs or other concessional capital sources; focus on both impact and returns; ability to invest at “missing middle” ticket sizes
- **Investment arms** of foundations & other donor programmes making high risk, early-stage investments

### INVESTMENT PROCESS

<table>
<thead>
<tr>
<th>Origination</th>
<th>Due diligence</th>
<th>Structuring &amp; negotiation</th>
<th>Post-investment value creation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investors</strong>: Identify pipeline matching investment criteria, likely a mix of commercial &amp; impact criteria</td>
<td><strong>Investors</strong>: Conduct in-depth review of business performance, growth potential, management quality, ESG risk, etc.</td>
<td><strong>Investors</strong>: Decide investment instrument (e.g. debt, equity) &amp; structure, and other terms, e.g. valuation, investor rights</td>
<td><strong>Investors</strong>: Close transaction &amp; begin post-investment support to drive company growth &amp; value creation</td>
</tr>
<tr>
<td><strong>Companies / investment targets</strong>: Identify likely sources of financing</td>
<td><strong>Companies / investment targets</strong>: Prepare investment materials and respond to investor inquiries</td>
<td><strong>Companies / investment targets</strong>: Negotiate investment terms</td>
<td><strong>Companies / investment targets</strong>: Grow &amp; prepare for next round of investment (or exit)</td>
</tr>
</tbody>
</table>
DEFINITIONS: WHAT TYPES OF ALIGNMENT DID WE EXPLORE?

ALIGNMENT

Success: Defined as closed investment transactions, or the two sides working effectively towards this goal.

Types of alignment (strategic to tactical and ad-hoc):

- Systems change initiative that has created the underlying conditions for more / better-quality investment
- Project TA, and / or guarantees and other blended finance tools, that have been used to de-risk investment
- Matchmaking, deal-sourcing, information sharing (e.g. market studies, feasibility assessments, etc.), or similar arrangements

PSD
- Firm level TA – e.g. skills, technology upgrade, investment readiness
- Value chain TA – e.g. business advisory services
- Enabling environment – e.g. policy and regulation, infrastructure

INVESTMENT
- Direct debt and equity investments
- Funder of funds
- Firm level TA – e.g. management capacity, skills
2. FINDINGS & RECOMMENDATIONS
GENERAL OBSERVATIONS

• There was interest across the board in closer alignment:
  • “Many people say that there is money everywhere, but not enough good opportunities. It seems like market shaping programmes would be key to creating more opportunities.”
  • “The development world focuses on enabling environment and capacity building, but doesn’t have capital. DFIs have capital but aren’t doing market shaping. Bringing them together is a dream outcome.”
  • “The two worlds almost always miss each other. There are very few examples where efforts are joined up and aligned.”

• There was mixed awareness of the full offer of the ‘other side’, and some misconceptions (sometimes based on perceptions rather than experience).

• There were few ‘model’ examples i.e. market-shaping initiatives and development finance successfully working in unison.

• Coming out of the study, we are excited about the potential to support more alignment (under the right conditions).
OVERVIEW OF FINDINGS AND RECOMMENDATIONS

MODELS

IN-HOUSE OFFER
Developing both PSD & investment capabilities in-house

STRUCTURED COORDINATION
Development finance & PSD linked by program design

AD-HOC ENGAGEMENT
Opportunistic collaboration between DFIs / investors & PSD

SUCCESS FACTORS & CHALLENGES

STRATEGY & INCENTIVES
- Sectors and opportunities
- Timelines
- Incentives for alignment

CAPACITIES
- Knowledge and skills
- Awareness and perceptions
- Investment infrastructure
- Resources for coordination

OPERATIONAL MODELS & TOOLS
- PSD hurdles for investors
- Investor fund structures
- Collaboration toolbox

RECOMMENDATIONS

THEME 1: ALIGN STRATEGIES AND INCENTIVES AROUND COMMON OPPORTUNITIES

THEME 2: BUILD OR BUY CROSSOVER KNOWLEDGE, AND COORDINATION INFRASTRUCTURE

THEME 3: CLOSE THE GAP BETWEEN PRODUCT OFFERS
MODELS

Three broad models of alignment:

- **Model 1: In-house offer** refers to DFIs building expertise in market shaping technical assistance (TA), and PSD initiatives expanding beyond grants to provide returnable capital.

- **Model 2: Structured coordination** refers to a deliberate approach to linking development finance with PSD, with pre-defined investors either incorporated at design stage or formally engaged during PSD implementation.

- **Model 3: Ad-hoc engagement** – which involves more opportunistic collaboration between DFIs and PSD programmes – is the most common model.

• The research did not identify a single ‘best practice’ model. Each model has its advantages and disadvantages, and not all models are feasible for every actor interested in closer alignment.

• Further to this, the study highlighted that closer alignment should not necessarily be a default aim for every PSD initiative and development finance-related investment.
Current barriers to alignment:

- Different views on the role of the firm presented a key point of divergence (‘starting races versus picking winners’)
- Selecting common sectors and opportunities – different prioritisation of impact vs. commercial considerations – has been challenging
- Divergent timelines between investors with limited fund horizons & long-term PSD objectives; PSD implementation cycles can kill momentum
- Mismatched incentives for alignment on both sides

## HOW CAN WE DRIVE MORE ALIGNMENT?

### THEME 1: ALIGN STRATEGIES AND INCENTIVES AROUND COMMON OPPORTUNITIES

<table>
<thead>
<tr>
<th>Recommendations</th>
<th>For whom?</th>
<th>Quick win?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Develop sector and opportunity selection criteria based on both impact &amp; commercial viability</td>
<td>PSD donors</td>
<td>Implementers</td>
</tr>
<tr>
<td>2. Engage the ‘other side’ in setting investment strategies &amp; program design</td>
<td>PSD donors</td>
<td>Implementers</td>
</tr>
<tr>
<td>3. Increase focus on investment in PSD results frameworks, without creating perverse incentives</td>
<td>PSD donors</td>
<td>Implementers</td>
</tr>
<tr>
<td>4. Increase emphasis on market shaping as part of investment process; tie it to performance incentives</td>
<td>PSD donors</td>
<td>Implementers</td>
</tr>
<tr>
<td>5. Build exit strategy into PSD program design to maintain strategic alignment, including handovers of key investment-related activities</td>
<td>PSD donors</td>
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**Current barriers to alignment:**

- Mixed mutual perceptions & limited awareness of ‘other side’, particularly in terms of approaches, value proposition, & mechanics of engagement
- Lack of internal capacity around investment within PSD programmes, and vice versa, market systems thinking within investors
- Infrastructure specific to investment facilitation often needed
- Coordination critical but usually under-resourced

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<tr>
<td>6. Assign responsibility and resources for mapping of country-level economic development ecosystems</td>
<td>PSD donors: ✔️</td>
<td>DFI: ✔️</td>
</tr>
<tr>
<td>7. Recognise and support effective investor-PSD coordination initiatives at country level</td>
<td>PSD donors: ✔️</td>
<td>Other investors: ✔️</td>
</tr>
<tr>
<td>8. Pool DFI TA around joined-up initiatives</td>
<td>DFI: ✔️</td>
<td>Other investors: ✔️</td>
</tr>
<tr>
<td>9. Pilot cross-functional or cross-organizational secondments</td>
<td>PSD donors: ✔️</td>
<td>Other investors: ✔️</td>
</tr>
<tr>
<td>10. Implement training for donors, implementers, program teams, and investment personnel (investment 101, mini-CFA, market systems in practice)</td>
<td>PSD donors: ✔️</td>
<td>Other investors: ✔️</td>
</tr>
<tr>
<td>11. Utilise investment advisory &amp; facilitation expertise</td>
<td>DFI: ✔️</td>
<td>Other investors: ✔️</td>
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</tbody>
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### HOW CAN WE DRIVE MORE ALIGNMENT?

**THEME 3: CLOSE THE GAP BETWEEN PRODUCT OFFERS**

**Current barriers to alignment:**
- Real and perceived hurdles to engaging with PSD initiatives; many investors view donor engagement as resource-intensive & overly prescriptive
- Current investor fund structures & return expectations constrain investment ticket sizes & risk
- Investors most value technical expertise from PSD programmes, but both sides work from limited ‘toolboxes’ that constrain collaboration

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<td></td>
<td>PSD donors</td>
<td>Implementers</td>
</tr>
<tr>
<td>12. Build the commercial relevance of the PSD ‘offer’ to investors/ investees</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>13. Experiment with increasing use of RBF / pay-for-performance financing as part of PSD programmes</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>14. Re-align systems change terminology to resonate with investors</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>15. Proactively support first-time local fund managers &amp; experiment with new fund models</td>
<td>✓</td>
<td></td>
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Which of the recommendations resonated most clearly? (Please choose three)
3. CONCLUSIONS AND WAY FORWARD
CONCLUSIONS

• A complex challenge and a lot to take in.

• An encouraging level of interest from both sides through the research process and subsequently - most of us believe that more alignment is a desirable goal.

• Today’s conversation is a starting point: the next step is to start testing new approaches.

• We are interested to capture additional examples of alignment and identify partners interested in taking ideas forward: https://www.questionpro.com/t/ATYU6Zr2SY
DISCUSSION
THANK YOU FOR ATTENDING TODAY!

For more information, please contact info@marketlinks.org