Report

Investing with impact: how to make finance work in the most challenging places

Monday 6 – Wednesday 8 March 2017 | WP1538

In association with:

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Introduction

The re-negotiation of the international development framework in 2015, through the launch of the Sustainable Development Goals (SDGs) and the Addis Ababa Action Agenda, provides an urgent call to action as to how investment can work within the most challenging environments – delivering a transformative domestic and cross-border business agenda that creates jobs and improves livelihoods in the poorest places.

As developing economies grow and living standards continue to rise globally, increasingly the world's poorest people will be those living in fragile or conflict-affected states. Economic development is crucial to eradicating this poverty. However, businesses in the most challenging environments struggle to find the investment to grow as private sector investors are put off by higher levels of risk, including corruption and a lack of efficient infrastructure such as transportation networks and reliable power. This is evidenced by the fact that 70% of foreign direct investment (FDI) goes to only 10 developing countries.

With limited global aid budgets, private investment will play a critical role in realising the SDGs. The private sector is increasingly seen as a mechanism to stimulate inclusive growth by driving investment that targets the needs of the poorest or contributes to climate change mitigation, whilst still offering attractive returns.

Wilton Park convened this meeting in partnership with CDC and the Argidius Foundation, bringing together participants from the international finance, project development and policymaking communities from the Global North and South to investigate specific instances of investment in challenging environments, including fragile or conflict affected countries. The event sought to identify practical and workable solutions, working towards a strategy for facilitating sustainable development with the greatest impact in challenging environments.

Background: the investment gap to achieve the Sustainable Development Goals

Billions to Trillions

1. The Sustainable Development Goals present the world with a set of hugely challenging targets to achieve by 2030, and these challenges cannot be met with Official Development Assistance ODA) alone. The funding gap in developing countries to achieve the SDGs is estimated to be 2.5 trillion USD per year. The infrastructure gap globally has been estimated at between 57 and 90 trillion USD per year. Climate change presents an additional challenge, with some 13.5 trillion USD required by 2030. There is a growing international consensus that private sector investment will be critical to convert the billions of official development assistance to the trillions needed to support the transformational change that the SDGs demand.

"No country escapes poverty without a thriving private sector. International investments are vital in supporting business to grow and provide jobs in the world's hardest to reach and poorest places."

“The aid community needs to understand blended finance and what it means for development policy. We need to think strategically and take a tailored approach to try and understand what is the best financing mix for different SDGs at the country level”

Hard to reach places

2. Foreign Direct Investment (FDI) is overwhelmingly channelled to larger economies, with Sub-Saharan Africa receiving only 2% of global FDI. To achieve the SDGs, private investors need to balance financial incentives with development objectives in order to bring growth and jobs to the world’s poorest countries and help build sustainable economic environments for all.

Complexity and collaboration

3. The complexity and scale of the challenge is huge; issues such as climate change are ‘wicked’ problems that require collaborative solutions between multiple stakeholders: including governments, business and civil society; and support from a diversity of investors: including philanthropists, DFIs, impact investors and commercial players.

Challenges of the ‘missing middle’

Problem of scale

4. A key challenge is the lack of scalable investment opportunities in low income and fragile states. Constraints for the development of SMEs in low-income countries means that although there are many small businesses in need of investment, there is a ‘missing middle’ of bankable projects that are large enough to attract foreign investment.

Weak enabling environments

“If we are serious about meeting the SDGs, then we need to focus our efforts on the poorest 20% of the World’s population.”

5. In many country contexts the greatest barrier to investment is the weakness of the enabling environment for doing business, including the legal context and the predictability of the regulatory environment. Key challenges that often arise include securing access to land titles, lack of transparency in procurement processes, governance issues and corruption, weak labour standards and gender discrimination, as well as the physical and legal security of the operating environment. Governments have a vital role to play in attracting investors, there is a need to reduce uncertainty and the cost of doing business by ensuring adequate legislation and regulations are in place and consistently applied.

Perception of risk

6. International investors often do not have a thorough overview of the investment environment in fragile and low-income states, and are likely to perceive the degree of risk of investing in such contexts to be worse than the reality. It can be difficult to access reliable and timely information required to debunk such perceptions. Without sufficient information to build greater confidence, investors are unlikely to make “the last mile connection” to build more inclusive economic systems.

Problem of timing

7. It is often extremely difficult for early stage companies in fragile country contexts to gain the support they need to take off. For most businesses it can take a several years of market education and research and development to be able to gain momentum and thrive, and entrepreneurs usually have to be self-sustainable to survive this initial period. More investment needs to be channelled to promising early stage companies in challenging environments in order to support the development of a greater quantity and quality of bankable companies.

Problem of human capital

“We need to develop a more sophisticated view of what impact is and how investments can effect structural change in an economy”

8. Solving the issue of financing is insufficient to drive growth of successful companies. Often a lack of human capital can be as great a constraint for businesses to thrive as a lack of financial capital. Finding and supporting effective management teams that can build and drive companies forward can be a major difficulty in many challenging environments. Talent is very often absorbed by large multinationals, as such there is a limited pool of strong business leaders and teams working in SMEs.

Access to markets

9. An inhibiting factor for growth is access to markets. There is a need to channel investments to support increased access and connectivity, whether through physical infrastructure connections (roads, transport links) or high-speed internet connections. High-speed Internet connections have had a considerable impact on business development in Africa, with strong employment and income effects in areas that gained access compared with those that have not.

Measuring social return on investments

“Even when there is capital available, it is not tailored made to our needs. We need Blended, fixed for purpose funding for micro-enterprises”

10. A further impediment to effective impact investing is the lack of agreed standards and hard data available for the measurement of social returns. This is in part due to competing understandings of what the intention of impact investing should be – whether the overarching goal should be increased productivity and efficiency, job creation, economic transformation or environmental or social outcomes. There is a tendency to focus on aspects that are easy to quantify, such as job creation and economic growth, but which may provide a very limited view of social change. For example, it may be more relevant to look at the quality rather than only the quantity of employment that has been generated, or the broader system or supply chain effects that investments may stimulate. The SDGs can provide a meaningful framework through which we can conceive of and measure impact. However there is also the challenge of how to weigh up and compare impact between the SDGs, for example between health and climate change.

The reporting burden

11. Measuring the impact of investments is crucial but the reporting demands must not over-burden entrepreneurs to the extent that it hampers their ability to perform. Impact reporting can support an entrepreneur to perform better if they are well tailored to the context and business model. Too often though, reporting requirements are cumbersome processes and distinct for each investor. Practical and integrated reporting systems are needed that work around realistic timelines and provide meaningful information for all stakeholders.

Case studies and lessons learnt

12. Social entrepreneurs from Mexico, Haiti, Nepal and India presented their businesses and the challenges and opportunities they faced in launching their operations. Commons themes that emerged from the discussions were:

“I essentially have to run three companies: one for debts, for grants, one for equity. We need to be flexible in order to survive”

- Entrepreneurs felt a lack of understanding from investors of the particular challenges of the environments in which they are operating
- Very often social entrepreneurs in challenging investment environments are filling a gap in basic service delivery that the state is failing to provide
- It can be particularly difficult to source initial start-up capital, in many cases social entrepreneurs have to rely on their own savings, and on friends and family networks
- First mover costs are considerable, and usually underestimated by investors. In contexts where the regulatory environment may not even recognise certain business and financial structures (for example an on shore private equity fund), It may take years of lobbying the government to simply be registered as a legal entity.
- Finding meaningful ways to present the impact of these enterprises can be a real difficulty. A heavy focus on quantitative reporting gives a very narrow picture of impact, for example the number of direct employees may appear relatively small, but the qualitative impact on the lives of those people can be huge, or the impact of a social enterprise may relate to less tangible effects, such as developing self-respect and independence amongst vulnerable populations – which is very difficult to quantify.
- There are also risks of perverse outcomes of operating in such challenging

environments that need to be considered and addressed, for example an initiative that empowered women to work saw a spike in domestic violence in the community.

Recommendations

Blended finance

"Investors need to be looking beyond the deal by deal approach and understand the potentially transformational power their investments can make when the right social and political opportunities present themselves"

13. Different investors can play distinct roles in bridging the gap of the 'missing middle' through a blended finance approach: the strategic use of development finance and philanthropic funds to crowd in commercial investments. By providing early-stage investments, grant providers can help to de-risk investments, and increase the interest and scale of commercial investments in challenging environments. DFIs can play a catalytic role to play in demonstrating the possibility of achieving profitable returns, which should then remove the need for public subsidy. They key challenge to effective blended finance is ensuring each financing source is utilised to its maximum advantage, and that grant money is not simply replacing what private financing could achieve.

Supporting policy and regulatory change

14. Often businesses lack the knowhow or political capital to effectively lobby the government for the reforms they need in the policy and regulatory environment to operate effectively. In such situations, donors and investors can make strategic interventions to identify policy blockages and help businesses push for necessary reforms.

Accepting 'good enough' governance

15. There is a need to be realistic about the investment environments, and accept that structural problems within an economy may take decades to transform. A model economy with perfect physical and legal infrastructure is not required for investments to work. FDI specific regulation reforms can go a long way to support a more stable environment for investment. Strategic interventions by donors to support such reforms in a specific sector with high investment potential can be an important first step in transforming the market.

Beyond deal-by-deal approaches

16. Investors need to look beyond a 'deal-by-deal' approach, and take a longer-term and broader view of the potential impacts of their investments to transform norms, sectors and economies. Where smaller opportunities within one sector (health, energy, etc.) can be pooled together into investment packages, opportunities to crowd in capital and achieve impacts increase. By working collaboratively to create investment ladders, investors could help to address the challenges of the missing middle.

Measuring impact through the SDGs

"We need help to connect to the people who can provide money, but it goes beyond money, we need to connect with those who can provide mentoring, coaching, networks and on-going support to help our business thrive"

17. The investment community needs to think more strategically about how different investors, working in tandem with public sector and civil society actors, can contribute to transformative shifts towards the attainment of the SDGs. The SDG framework is a potentially useful lens through which to package opportunities for social impact investing, channel finance and measure results. Utilising the SDGs to take a more holistic approach enhances the likelihood of achieving and effectively capturing impacts at scale.

Additionality beyond finance

18. The added value of the partnership with an investor should extend to much more than provision of finance. Investors can provide access and support in terms of technical knowledge and capacity as well as soft skills, personal connections and professional networks that can prove invaluable to the development of early stage companies.

Investing in human capital

19. Greater efforts need to go into identifying and fostering talent in challenging business environments. One way to do this is through prizes and competitions; another way is through effective training programmes. It is important to note however, that training is not a silver bullet. Too often large sums have been invested in training programmes that have been shown to have minimum impacts.

Capturing and sharing learning

20. A cultural shift is required to increase the space for discussion and learning from investing in challenging environments. This can be challenging as there is significant pressure to portray the positive impacts of investments. The investment community needs to get better at capturing and sharing learning from difficulties and failures, as well as successes.

Advocating for change

"Investing in the hardest places will necessarily involve some negative outcomes. It requires a level of leadership to understand and handle these challenges, it's not simply a technical exercise. This requires real honestly, leadership, pragmatism."

21. Business working in partnership with civil society to advance advocacy agendas on the SDGs have been extremely successful in some instances. When companies come out in support of progressive action (for example on climate change or immigration) it can shift the terms of the debate. However, the fine line between lobbying and advocacy can be difficult to tread. Companies and investors need to be consistent in their messaging and business practices, open with regards to their advocacy agendas and work in partnership with credible organisations, in order to ensure accountability.

Intermediaries

22. Intermediaries and platforms that connect entrepreneurs with investors are a vital factor in bridging the 'missing middle' in challenging investment environments. They can serve as facilitators and translators, helping investors and investees to connect, speak each other's language and build understanding, trust and confidence from both sides. These functions are all too often under-prioritised and under-resourced.

Driving effective partnerships

23. More than bilateral funding relationships, what is required are transformative partnerships of diverse actors seeking to align their interests and resources towards a common goal. Meaningful partnerships and multi-stakeholder collaborations are not straightforward; they require time, resources, leadership and positive attitudes of like-minded people to work effectively. Partnerships ultimately come down to personal relationships, so fostering these is key. They should not be established for the sake of collaboration, but rather be built around concrete, continuously developed and mutually agreed outcomes. There is a great need to invest in the "multi-lingual" soft skills and leadership that is able to cross the boundaries of institutional cultures and world-views.

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