AID EFFECTIVENESS REVIEW:

Submission regarding the creation of an

Australian Development Finance Corporation

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Introduction and Summary

Proposal

That Australia considers creating a sovereign Development Finance Corporation (“DFC”) in order to engage in the growing market for impact investing that is revolutionizing overseas aid.

Discussion

Australia has recently moved to increase its foreign aid budget to 0.5% of GDP (an estimated doubling from $4.3 billion in 2011 to over $8 billion in 2016), thereby joining the global donor leadership in both percentage and actual dollars contributed.

It is paramount that the foreign aid budget is deployed with maximum effectiveness and efficiency, and that is the driver behind the review of aid effectiveness. This submission proposes the addition of impact investment through a DFC to augment future aid activities.

Among other major country donors it is common to supplement grant-making and capacity building activities with one or more social investment vehicles. This is the case even where they hold active roles in multi-lateral development banks or funds.

These countries (see sample list below) have concluded that strategic investment for specifically targeted social outcomes is an effective – and efficient – approach to complementing and enhancing their humanitarian aid activities. Such investment acts on different levers within the recipient country’s economy, seeking to leverage its impact by stimulating market forces to release dormant or under-utilised resources already present to maximize the effect of the invested funds.

The best social investment catalyses sustainable economic activity or infrastructure sufficient to repay the invested funds over time, as well as to continue to generate a surplus going forward. Thus the impact remains and grows well beyond the direct period of donor intervention. Investing (versus grant-making) preserves the donor country’s capital, enabling it to be recycled for multiple uses over time. This is a unique benefit over pure aid.

This approach, known as impact investing, is well-proven, and most OECD countries have opted to use structures such as development banks, development finance corporations or investment funds to deliver desired outcomes.

Therefore, it is submitted that the establishment of an financial institution such as an Australian Development Finance Corporation ("AusDFC") should become a key element in Australia's global aid presence and development influence for the next decade.

<u>Interim Action</u>

While it is likely that the establishment of a fully-fledged AusDFC will take some considerable planning (and possibly new legislation), it is possible for DFAT to take some immediate steps toward that goal.

This submission examines the benefits of and contains a proposal to create an Australian Sovereign Social Investment Fund ("AusSIF"), as a precursor to a fully-fledged DFC.

The establishment of AusSIF will enable DFAT:

- to move immediately into the impact investment space;
- to apply the increase in the aid budget most effectively;
- to begin the process of establishing co-sponsor and co-investment relationships; and
- to use the learnings as a foundation for planning the Australian DFC.

Once the AusDFC is established, we would propose to roll the AusSIF into the new structure.

What is Impact Investing?

Recent Trend

In recent years there has been a global trend of moving development policy towards increasing commercial investment and leveraging private capital flows to supplement development assistance. Microfinance – pioneered by groups such as Opportunity International (founded by former Senior Australian of the Year, David Bussau) and Grameen Bank (founded by 2006 Nobel Peace Prize winner, Mohammad Yunus) - is one of the early examples. Other sectors that have expanded in this way include housing, health care, renewable energy, water/sanitation, physical infrastructure and rural development.

These types of investments to promote development and their funds have many names, such as triple-bottom-line, venture philanthropy and social-impact investing. However, each form of "impact investment" has the common goal of achieving a development result as well as a financial return.

Impact investors operate in the space between Overseas Development Assistance (ODA) and commercial investment. They are seeking to address problems through market-based, for-profit models that provide both a social benefit and the positive financial return necessary to generate a self-sustaining revenue stream and achieve scale.

Growth in Impact Investment

Some of the countries in which such an approach has been successful include Taiwan, South Korea, China and many parts of Eastern Europe. Whilst most of these markets can now access mainstream foreign direct investment – in no small part due to the leads taken by impact investors – it is now the more challenging emerging markets of poorer Asian countries, the Pacific and Africa that are the frontier markets for such funds.

The growth of impact investment can be best gauged by the numbers of vehicles: Within a decade the numbers have grown from virtually zero to the more than 125 funds and foundations now claiming to do some form of impact investing. Estimates from the Monitor Group[1] suggest that impact investing could mobilize A$500 billion annually within the next 10 years.

Whilst still a small amount compared to total global managed assets of approximately A$50 trillion, or even global socially screened and shareholder advocacy investing at A$7 trillion, it would be a significant increase in resources targeted directly toward social causes. It would certainly be massive compared to current ODA, being more than four times the global amount of just A$120 billion in 2008.

Such social enterprises have a key need for funding, particularly at the early stages when traditional forms of debt will not be available as cash flows are insufficient to service loans.

[1] Jessica Freireich and Katherine Fulton, "Investing for Social and Environmental Impact: A Design for Catalyzing an Emerging Industry," The Monitor Institute (2009), at www.monitorinstitute.com/impactinvesting

Moreover, whilst such enterprises will seek commercial returns, they will be less than the levels demanded by traditional venture capital.

<u>Returns from Social Investment</u>
It is rather early in most sectors for reliable data to be available. However, microfinance is one sector with a reasonable history of investment. Leaving aside the spectacular returns made by certain investors in some Microfinance Institutions, such as Compartamos (Mexico) and SKS (India), the latest annual returns achieved by Microfinance Investment Vehicles (MIVs) range from 1.5% to 7.5%.[2]

Success in other industry sectors has been achieved by The Small Enterprise Assistance Fund (SEAF), with its series of investment facilities over the past 20 years that have achieved double-digit returns. The key common point between the MIVs and SEAF is that their funds have used large amounts of public funding from development finance institutions or DFCs, including USAID, DEG (Germany), FMO (Netherlands) and Proparco (France) and others that are funded by many countries such as the ADB and the IFC.

Who is Involved

<u>Development Finance Corporations</u>
Virtually every OECD country has established a DFC and/or sovereign development funds. In addition to those already mentioned, other countries with DFCs include the UK, Switzerland, Belgium, Denmark, Finland, Norway, Austria and Spain: see Appendix I for examples.

The British Government has long been active in the field, through CDC and its predecessor organisations. In the last year, the UK Coalition Government has established a new Private Sector department to focus to an even greater extent on this area. As stated on its website[3]:

"CDC's objective is to invest in a commercially sustainable manner in the poorer countries of the developing world and to attract other investors by demonstrating success. CDC's capital is focused on the private sector as the engine of growth."

CDC is limited to investing in funds: 134 of them as at the end of 2009 with a total CDC portfolio value of Stg1.4bn (A$2.25bn). Other DFCs have wider mandates that include actual enterprises.

<u>Impact Achieved</u>
DFCs that invest in funds, such as CDC, measure their impact in the following way:

"These funds now back around 800 portfolio companies in 71 different countries. The CDC portfolio companies employ over a million people and support the lives of millions more."[4]

[2] CGAP, "2010 MIV Survey Report", August 2010, at www.cgap.org
[3] www.cdcgroup.com
[4] www.cdcgroup.com/key-facts.aspx

Other DFCs can invest directly into projects, for example the French DFC Proparco: Appendix II contains examples of its projects, which are typical. The project impact measurement tool it uses includes more detailed assessments of:

- current public revenue;
- net currency effects;
- employment;
- technology and know-how transfer;
- extension and improvement of basic service supply;
- improvement of performances thanks to private operators;
- social effects (health, education, continuous training, etc);
- compliance with environmental standards; and
- positive environmental impacts from greenhouse gas mitigation measures, the use of renewable energies and energy saving. [5]

As a result, Proparco can boast that, between 2007 and 2009, its financing and co-financing helped to:

- Connect 345,000 people to an electricity supply network;
- Connect 43 million people to a telecoms network;
- Boost state revenues by **€**650m (A$884m);
- Secure or create one million direct or indirect jobs; and
- Save 1.5 M teq CO2 of greenhouse gas emissions annually.

These sorts of significant impact could also be achieved by an Australian DFC.

Conclusion

It is estimated[6] that there are at least 200 potential for-profit impact investments across the developing world. With clearly established social and financial outcomes, private investment capital devoted to social causes will quickly dwarf aid and other assistance efforts.

Sectors such as finance have been proven to be viable, and some such as clean energy and technology may have more potential for commercial returns. Whilst not all will be appropriate for impact investment, such as education, there is a real role for the Australian Government to join other OECD countries in becoming involved in the sector.

[5] www.proparco.fr/jahia/Jahia/site/proparco/lang/en/Les-outils-de-mesure-des-impacts
[6] John Simon and Julia Barmeier, “More than Money: Impact Investing for Development”, Center for Global Development (2010)

Near Term Initiative: Australian Sovereign Social Impact Fund

Purpose

The AusSIF would be designed to complement the current efforts of AusAID, through the use of market mechanisms to stimulate positive economic and social outcomes that benefit the poor and marginalised communities in recipient countries.

The Fund will operate outside of bilateral channels as a direct investment fund. In this way, it would be similar to the Enterprise Challenge Fund and other such vehicles already established by AusAID, i.e. under the government's auspices but with an external manager. Its parameters could include:

- clearly defined and measured social objectives, along with economic return targets;
- the aim to be a prime example of an economic model where social and market principles operate side by side; and
- seeking to stimulate and set an example for commercial enterprises to operate in a continuum where negative social impact is no longer acceptable, and the delivery of both social benefit and commercial profit drive enterprises, as opposed to profit maximisation only.

Objective

The objective would be to generate significant positive development impact, to begin to grow Australia's presence in international impact investment (defined by Monitor Institute 2009 as 'profit generating investment for social and environmental good'), to build a sustainable operation, and ultimately to preserve and return the Government's capital.

As such, the Fund would channel aid funding in a way that could have significant impact on poverty alleviation, without imposing any additional burden on the resources of AusAID.

Assistance provided by the Fund

It would be possible for the Fund to make grants, provide debt and invest equity into enterprises and projects. Other forms of funding could also be provided, such as hybrid instruments including convertible debt. Social enterprises may also need access to guarantees to assist in raising debt from wholesale financiers.

Management and Governance

An external management team would be appointed.

Governance for the Australian Sovereign Social Impact Fund should also include an Advisory Council of independent experts, each having extensive experience in international development and in social and commercial investment management. This Council will act in an advisory capacity, and as an Independent Investment Committee, approving each investment of the fund.

Appendix I: National Development Finance Corporations

Name	Sponsor Country	Mission / Description	Fund Size / Website
CDC Group (formerly the Commonwealth Development Corporation)	United Kingdom (owned by Department for International Development)	CDC's objective is to invest in a commercially sustainable manner in the poorer countries of the developing world and to attract other investors by demonstrating success. CDC's capital is focused on the private sector as the engine of growth.	Stg1.4bn (in 134 funds managed by 65 managers) www.cdcgroup.com
Proparco	France (owned by French development agency, AFD)	PROPARCO promotes private investment in emerging and developing countries with the aims of supporting growth, sustainable development and the Millenium Development Goals. Projects include infrastructure (eg roads, telcos, energy), financial inclusion and climate change.	www.proparco.fr
Swiss Investment Fund for Emerging Markets (SIFEM)	Switzerland - for State Secretariat for Economic Affairs and other public and private investors	Finance to promote equity funds (eg South Africa Vantage Mezzanine Fund) and FIs investing in SME sector in emerging markets	US$409m www.sifem.ch
Development Bank of Southern Africa	South Africa (and SADC)	Accelerate sustainable socio-economic development by funding physical, social and economic infrastructure, eg water, RE	R37b www.dbsa.org
KfW Banken Gruppe	Germany	Climate change, education, energy, FIs, health	Eu400b (assets) www.kfw-entwicklungsbank.de
DEG	Member of KfW group	Finance investments by private sector in emerging economies	Eu3.5b www.deginvest.org
Belgium Investment Company for Developing Countries (BIO)	Belgium	Support MFIs funding businesses and SMEs, also infrastructure and funds, eg RE	Eu500m www.bio-invest.be

Netherlands Devt Finance Corporation (FMO)	Netherlands	Entrepreneurial development bank, providing capital and advice to promote the private sector, eg housing, energy, FIs, food	Eu4.6b www.fmo.nl
USAID Credit Guarantee Fund	USA	Guarantee up to 50% of private sector lending to sectors such as water, energy, health and agriculture	US$130m[7] www.usaid.gov
Finland Fund for Industrial Cooperation (FinnFund)	Finland – projects that involve a Finnish interest	Loans and risk capital for profitable projects in emerging markets, eg medical, environment, mills (steel, paper), RE, aviation	Eu$188m www.finnfund.fi

[7] 267 partial credit guarantees have facilitated over $2.3 billion of private capital debt

Appendix II: Project Examples[8]

Scaling up nutritional autonomy in developing countries

Project start-up: **2010**

Financing: **€2m convertible bond issue**

Partner: **Nutriset**

Context

Child malnutrition affects 195 million children and kills almost 3 million under-fives every year. There are an increasing number of ready-to-use products to combat malnutrition, but the coverage rate continues to be extremely low.

Nutriset, a French SME founded in 1986 and based in Normandy, has developed a highly innovative range of products for the ready-to-use therapeutic food market, including Plumpy'nut, a flagship product created in 1996. This nutritive paste is distributed by international organizations and NGOs and has revolutionized the treatment of severe acute malnutrition.

Since 2005, Nutriset has been transferring part of the manufacturing of these products to the countries of the populations concerned, *via* a network of franchised companies.

Project objective

PROPARCO's investment concerns the geographical expansion of this network of partner companies and aims to:

· Increase local production;

· Give the most vulnerable populations easier access to these products;

· Strengthen agribusiness industries in the countries concerned.

PROPARCO also wishes to support a French company which is a model and market leader in its industry.

Project description

The international network of local manufacturers today counts 11 members on 4 continents. PROPARCO has allocated €2M of convertible bonds to Nutriset to help it expand this network. This project is also supported by other commercial banks and will last 7 years.

Impacts

Thanks to the increase in local production capacities:

- Almost 5 million children suffering from severe or moderate malnutrition will be treated (against 1.3 million in 2009) ;
- 750 additional jobs will be created in the next five years and 3 new production units will be opened every year;
- Local and regional agricultural industries will be supported (groundnuts, sugar, oil, etc.) with spillover effects estimated at €105m over the next five years; and
- The agro-industry and quality control laboratories will be developed

Nutriset also ensures that skills are transferred to developing countries by training its staff to use production tools (partnership with an engineering school in Burkina Faso)

[8] These and many other projects can be seen at: www.proparco.fr/jahia/Jahia/site/proparco/lang/en/Projets_PROPARCO

Boosting African SMEs

Project start: **2009**

Financing: **Equity investment of $10M with technical assistance**

Partner : **GroFin**

Context

GroFin is a multi-national specialist SME finance and development company offering an innovative combination of risk capital and business development assistance to viable enterprises.

The Growth Finance sector is a niche market providing risk finance for small and medium businesses in emerging markets, focusing on the ability of the business to make a profit year after year. Entrepreneurs in this sector are often unable to access finance from traditional finance institutions as they lack the necessary track record or collateral. Microfinance, although flexible and development orientated, is restricted to supporting individuals and small entities. Private Equity offers management input and long term involvement, but is confined to assisting larger, more mature companies. Venture Capital offers the seed funding so desperately needed by start-up businesses lacking a track record, but is confined to early stage, high growth businesses.

GroFin, as a leading supplier in the Growth Finance sector, offers a solution which integrates flexible finance with business support, serving entrepreneur-owned businesses. GroFin has established itself as one of the leaders in the market by raising five funds dedicated to SMEs between 2004 and 2007.

GroFin Africa Fund, the 6th fund managed by GroFin's team, is a mezzanine fund of $170M and is the biggest multi-countries fund raised by the group, with a presence in seven countries in sub-Saharan Africa: South Africa, Uganda, Tanzania, Kenya, Nigeria, Ghana and Rwanda. It is also the largest fund targeting the Growth Finance sector.

Project objective

FISEA's equity investment in GroFin Africa Fund aims at taking part in the development of the private sector and the strengthening of SMEs in sub-Saharan Africa. Beyond its equity contribution, FISEA's intervention through technical assistance aims at improving the standardization and performance of GroFin's financial offering in several countries throughout sub-Saharan Africa. FISEA's contribution aims to provide financing and operational support to the "intermediary marginalized sector" of African SMEs in order to create a virtuous circle benefiting local economies.

Project description

The financing offer provided by GroFin materializes in a financial package -mezzanine loans (average amount of $350 000), performance based incentives, with technical support- tailored to each entrepreneurs' needs and cash flow' risk profiles. The standardization of tools and methods enables the organization to reach a scale effect that could be comparable to that of the banking network.

Impact

According to GroFin forecasts, more than 13,000 jobs should be created or conserved thanks to the investments of GroFin Africa Fund. Around 92,000 people should benefit from it (through the creation of indirect jobs).