Independent Commission for Aid Impact

CDC's investments in low-income and fragile states

A performance review
Approach paper

May 2018

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1. Purpose, scope and rationale

CDC is the UK's development finance institution, wholly owned by the UK government. It plays a key role within DFID's Economic Development Strategy. CDC invests in businesses, both directly as well as through commercial funds, and supports the growth of these businesses. CDC invests using 'development capital', seeking to generate both positive development impacts (with a focus on job creation for local people, stronger local economies and an enhanced investment climate in target countries) and a financial return. Financial returns are then recycled into new investments.[1]

CDC's net assets more than doubled over the period 2006-16 (to £4.8 billion, with investments in 1,245 businesses).[2] A significant new capital injection of £735 million was received from DFID in 2015 – the first investment in CDC in 20 years.[3] Since 2012, CDC has sought to better align its portfolio of investments with DFID's priorities. It has increased its focus on Africa and South Asia, particularly in low-income and fragile states where the private sector is weaker and financial risks are greater. CDC's net assets are set to increase further, to above £8 billion by 2021, as a result of earnings and additional capital commitments from DFID.

ICAI has decided to conduct a performance review of CDC's investment activities. The review will focus on how effectively CDC has adapted its strategy and operations to help meet DFID's economic development priorities and drive growth in low-income and fragile states. It will look at whether CDC's investments are achieving their intended development impact, including meeting social and environmental goals, while still delivering an overall financial return on its portfolio. It will generate lessons for DFID and CDC, which will inform CDC's ongoing scale-up and greater focus on development impact. A performance review is appropriate because this is not a new area of work; at the same time, CDC's new strategy and enhanced approach are not yet mature enough to warrant an impact review.

The review will cover a sample of the 345 new investments made in companies since 2012, with a particular focus on CDC's progress in building its portfolio in more difficult investment markets.[4] The review will also consider CDC's piloting of higher-risk investment strategies designed to maximise development impact. The review will cover both direct investments in companies and investments through intermediary funds. This review will complement previous reviews of CDC.[5]

2. Background

One of the four key objectives of the 2015 UK aid strategy is to "promote global prosperity". As part of this objective, DFID is committed to helping partner countries improve their investment climate and to increasing its own use of development capital to create jobs and stimulate the private sector. This was also a major part of DFID's 2017 Economic Development Strategy.[6]

Development capital is public investment made in the private sector to achieve development objectives. It seeks financial return alongside delivering development impact.[7] CDC, as the UK's development finance institution,[8] is the primary vehicle through which DFID invests development capital. DFID's periodic investment in additional shares in CDC is treated as ODA expenditure in the year of investment.[9]

1. *Investing to transform lives: Strategic framework 2017-2021*, CDC, link.
2. The total amount held by CDC in equity and debt in private firms and investment funds, along with the financial returns it had made on such investments, minus any outstanding liabilities. *Annual Review 2016,* CDC, 2017, link.
3. *News: Annual Review 2015 shows CDC growing in ambition and impact*, CDC, 20 July 2016, link.
4. CDC measures the investment difficulty of countries (and Indian states) by applying an equally weighted index combining five indicators: (i) market size, (ii) income level, (iii) credit to the private sector, (iv) 'Doing Business' rankings and (v) a composite measure of fragility designed by DFID. CDC then categorises the countries and Indian states in which it invests as A, B, C or D (see Figure 1). This ICAI review will focus on investment in A and B countries and Indian states. See CDC's document explaining its screening tool for investments, link.
5. The National Audit Office conducted a review of CDC in 2016, focusing on DFID's strategy for and oversight of CDC, CDC's performance and CDC's approach to managing its business. The report was positive about CDC's performance in securing a return on public funds and its increased level of alignment with DFID priorities, but raised questions about its ability to measure development impact. To complement the National Audit Office review, our focus will be on CDC's capacity to deliver results. See *Department for International Development: investing through CDC*, National Audit Office, November 2016, link. Other recent reviews include: *The future of CDC*, International Development Committee, February 2011, link.
6. *Economic Development Strategy: prosperity, poverty and meeting global challenges,* DFID, 31 January 2017, link.
7. *Development capital - catalysing investments to benefit poor people*, DFID, 15 July 2015, link.
8. CDC is a public limited company, wholly owned by the UK government, and DFID is the sole shareholder. However, while its objectives are set by DFID, CDC operates autonomously in respect of investment decisions.
9. *DAC High Level Meeting Communiqué,* OECD, 19 February 2016, p. 6, link. Donor capital contributions to ODA-eligible development finance institutions can be reported in full as ODA in the year that they are made. DFID uses this approach. The OECD-DAC is developing a process for certifying individual institutions and nominating what proportion of their work counts as ODA. In the case of CDC, 100% of its work counts as ODA.

CDC aims to "support the building of businesses throughout Africa and South Asia, to create jobs and make a lasting difference to people's lives in some of the world's poorest places".[10] It invests capital in businesses either directly (by investing equity or providing loans and other debt finance) or indirectly (by investing through commercial funds), through a structured process of investment selection and portfolio management.

CDC's current strategic priorities and intended development results are set out in Box 1.

Box 1: CDC's priorities and intended development impact

Under its 2017 strategy, CDC summarises its priorities as follows:

- **developmental:** embed development throughout CDC to maximise impact
- **responsible:** invest responsibly and persuade others to follow suit
- **innovative:** address key development challenges in new ways
- **enduring:** grow in response to market need, ensuring value for money for the UK taxpayer.[11]

DFID anticipates that its investments through CDC will generate development results in four ways:

1. job creation in portfolio companies and their suppliers
2. fostering technical change in portfolio companies
3. boosting access to affordable goods and services
4. building investment markets by demonstrating the viability of investments in the poorest countries and 'crowding in' additional finance.[12]

There have been significant and ongoing shifts in CDC's approach over the period covered by the review, bringing closer alignment with DFID's development priorities. In 2012, DFID and CDC agreed a new investment strategy,[13] which changed CDC's geographic and sectoral focus and its mix of financial instruments.[14] Before 2012, CDC invested in a wide range of developing countries, including many middle-income countries such as China and Brazil, where financial returns are easier to achieve. From 2012, CDC has only made new investments in more difficult markets in Africa and South Asia (see Figure 1). By the end of 2016, CDC had invested £1.8 billion in 653 businesses in Africa and £1.3 billion in 342 businesses in South Asia. £0.7 billion remained in legacy investments outside of these regions.

Figure 1: CDC's categorisation of countries in which it invests by investment difficulty (A = most difficult, D = least difficult)[15]

	A			B	C		D
Countries	Afghanistan	Congo, Rep	Mauritania	Angola	Algeria	Namibia	Mauritius
	Benin	Djibouti	Niger	Côte d'Ivoire	Bangladesh	Maldives	Morocco
	Burkina Faso	Eritrea	São Tomé and	Equatorial Guinea	Bhutan	Rwanda	South Africa
	Burma	Ethiopia	Príncipe	Laos	Botswana	Seychelles	Tunisia
	Burundi	Gambia	Sierra Leone	Libya	Cambodia	Senegal	Vietnam
	Cameroon	Guinea	Somalia	Mozambique	Cape Verde	Sri Lanka	
	Central African	Guinea-Bissau	South Sudan	Nepal	Egypt	Zambia	
	Republic	Liberia	Sudan	Nigeria	Gabon		
	Chad	Madagascar	Togo	Pakistan	Ghana		
	Comoros	Malawi	Uganda	Swaziland	Kenya		
	Congo, DR	Mali	Zimbabwe	Tanzania	Lesotho		

10. *Investing to transform lives: Strategic framework 2017-2021*, CDC, link; *Investment Policy 2012-16*, CDC, link.
11. *Investing to transform lives: Strategic framework 2017-2021*, CDC, p. 10, link.
12. *DFID Business Case: Capital increase to CDC, the UK's development finance institution*, link.
13. *CDC Strategy 2012-16*, link.
14. These strategic shifts were in line with recommendations from the UK Parliament's International Development Committee in 2011, link.
15. See CDC's document explaining its screening tool for investments, link. This index will be re-calculated at five-yearly intervals for the duration of the Investment Policy. Figure 1 does not include Indian states, which CDC categorises from A to D individually.

Since 2012, CDC has also increased its number of direct investments (rather than investing via funds), in order to create the flexibility to target and manage its own investments and increase development impact.[16] In 2016, 55% of CDC's portfolio constituted investments through funds (compared with almost 100% in 2012), and 75% of new commitments made were in direct investments.

From 2012, CDC began to target the seven sectors it considered most likely to create jobs and attract investment: agribusiness, construction, financial institutions, infrastructure, manufacturing, health and education. It also began basing its specific investment choices on a 'Development Impact Grid score', a composite measure derived from the business sector and locations of operation. In addition to this, CDC committed to a greater focus on measuring development impact alongside financial performance and environmental, social and governance issues.[17] The shift in strategy over this period to managing direct investments, coupled with an increased focus on development impact, has required a significant scale-up in CDC's staff capacity.

This trajectory was reinforced with the publication of CDC's 2017-21 strategic framework,[18] which incorporated the following developments:

- CDC has developed a range of 'market-building' strategies, which take a higher-risk approach to investment in order to help address market failures,[19] accelerate sector growth and generate greater development impact.[20]
- CDC is looking at further ways to help mobilise capital markets (beyond simple demonstration effects) in order to deliver impact 'at scale' and help meet the Global Goals.
- Whereas over 2012-16, success for CDC was judged largely in terms of job creation, financial return and investment in more difficult markets,[21] in the new framework, CDC is committed to achieving and measuring a broader range of impacts. These include sector impacts, women's economic empowerment, addressing climate change, business skills and leadership, and job quality.[22]
- CDC updated its internal Code of Responsible Investing, which sets the parameters for CDC to add value to individual investments and help businesses grow and impact positively on their workers, the environment and communities.

By 2017, DFID's aggregate investment in CDC stood at £1.5 billion. The UK Parliament recently quadrupled the cap on DFID's potential stake to £6 billion (with the option to increase this to £12 billion); DFID announced annual capital injections of up to £703 million over the next five years. The commitment represents just under 8% of forecast ODA spend for that period.[23] CDC's investment portfolio is therefore set to increase significantly. Based on its economic modelling, DFID expects this additional investment in CDC to generate 2.4 million jobs over the next 15 years and additional socio-economic benefits worth £5.8 billion.

This review is therefore extremely timely – CDC is scaling up its operations significantly while attempting to deliver on a new and challenging strategy; its performance in relevant areas since 2012 will help to provide an assessment of whether its current strategy and activities are fit for purpose.

16. *The Future of CDC*, International Development Committee, 2011, link.
17. *CDC Strategy 2012-2016*, link.
18. *Investing to transform lives: Strategic framework 2017-2021*, CDC, link.
19. CDC is still required to deliver a minimum of a 3.5% return on its 'commercial portfolio', but can take additional risk on the new higher-risk investment strategies.
20. These market-building strategies include and build on a £75 million impact fund and £40 million impact accelerator introduced in 2013 and 2015 respectively.
21. Since 2012 DFID has set CDC performance targets for the minimum annual return on its portfolio (3.5%) and the extent to which new investments have targeted the geographies and sectors with the greatest potential development impact. These targets do not apply to the new higher-risk investment strategies.
22. *DFID Business Case: Capital increase to CDC, the UK's development finance institution*, link.
23. *DFID Business Case: Capital increase to CDC, the UK's development finance institution*, link.

3. Review questions

This review is built around the criteria of **relevance**, **effectiveness** and **learning**. The relevance question explores whether CDC has a credible strategy and set of approaches and the capacity to deliver development impact, at scale, in low-income and fragile states. Under the effectiveness question, we will explore whether CDC is successfully sourcing and managing investments, and whether these are generating the expected results as well as contributing to CDC's broader growth mission. The learning question will explore whether CDC learns from its own experience, research and peer organisations, and whether it puts this learning into operation internally and as part of its external leadership role. Review questions and sub-questions have been developed for each of the above criteria (Table 1).

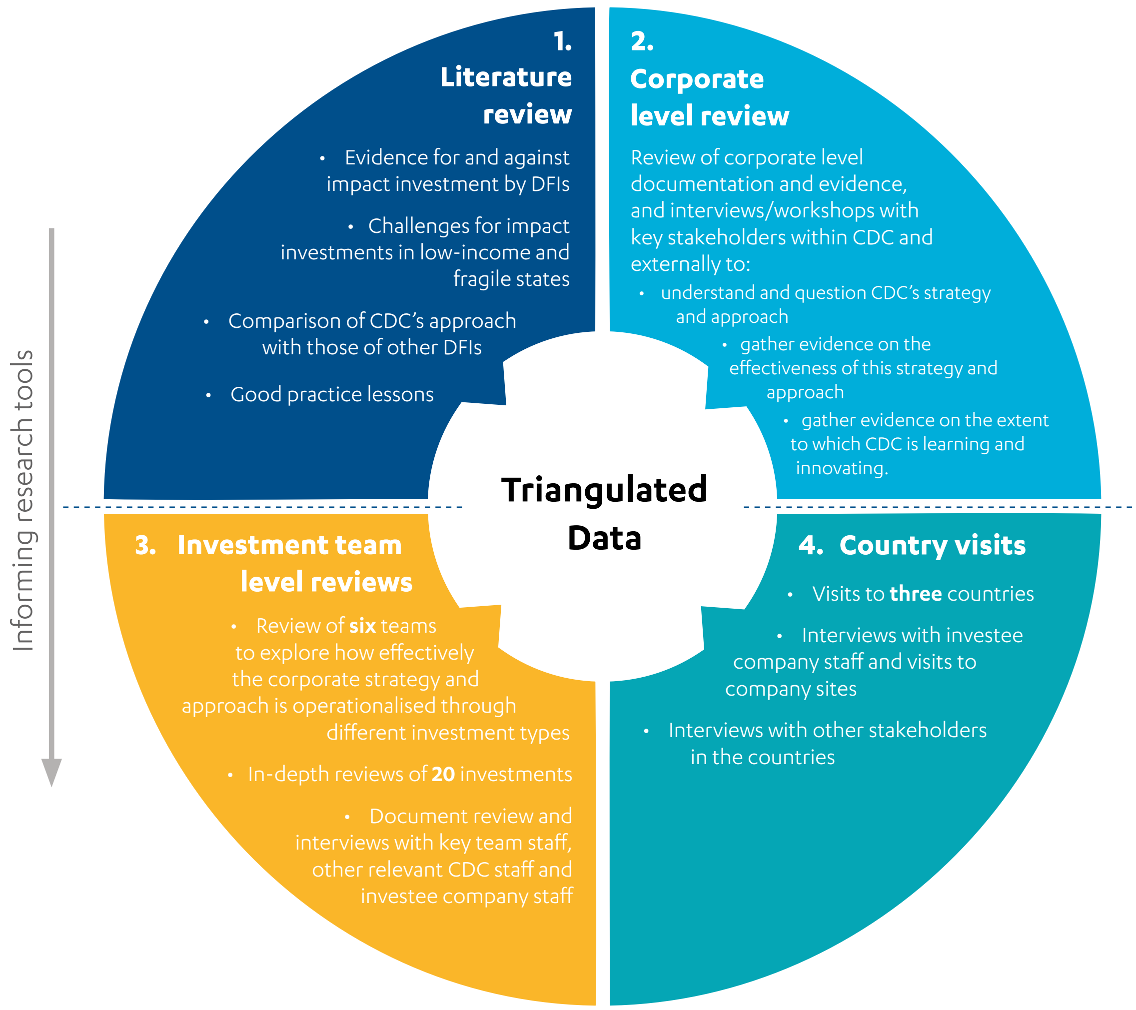
Table 1: Our review questions

Review criteria and questions	Sub-questions
1. **Relevance:** Does CDC have a credible approach to achieving development impact and financial returns in low-income and fragile states?	• What progress has CDC made towards establishing an appropriate and coherent strategy for achieving development impact at scale in low-income and fragile states? • How well has CDC adapted its ways of working to invest in more challenging markets while managing a rapidly growing portfolio?
2. **Effectiveness:** How effective are CDC's investments in low-income and fragile states?	• How well does CDC select, manage and exit investments in low-income and fragile states? • How effectively does CDC balance delivering development impact for local people and communities (including direct and indirect job creation and other impacts) with securing an acceptable overall financial return? • How well does CDC add value to individual companies, support their inclusive and sustainable growth and meet responsible investment commitments? • How effectively does CDC contribute to establishing and expanding investment markets in low-income and fragile contexts?
3. **Learning:** How well does CDC learn and innovate?	• How well has CDC learned from global evidence on impact investment in difficult markets? • How well do CDC's monitoring and evaluation processes drive learning within the organisation? • How well is CDC sharing learning (in support of a leadership role within the investment industry)?

4. Methodology

The methodology for the review involves four mutually reinforcing components, sequenced to allow the literature review and corporate level review to inform the subsequent investment team level reviews and country visits. This is summarised in Figure 2.

Figure 2: Overview of the methodology



- ***Component 1 – Literature review:*** We will conduct a review of academic articles and publications from relevant academic experts, civil society organisations, donor organisations and development finance institutions. This will inform our understanding of the challenges for impact investment in low-income and fragile states and existing debates on impact investment by development finance institutions. We will draw a set of lessons from the literature on what works, in areas including promoting development impact (through job creation and influencing other investors) and monitoring and evaluation. This will inform our ability to critically assess CDC's approach, shape the research tools and help identify key stakeholders to interview as part of the corporate level review. It will also help us contrast CDC's approach to impact investing in these difficult markets with the approaches of other institutions.

- ***Component 2 – Corporate level review:*** We will review CDC's corporate level documentation and evidence, and conduct interviews with key stakeholders within CDC and externally. This will allow us to understand CDC's strategy and approach for achieving development impact in more difficult markets (alongside return on investment) and to gather evidence to assess the relevance and effectiveness of this approach. This will include looking at which countries and sectors have been targeted, how prospective development impact is balanced with financial return, and how performance data is gathered, validated and aggregated. We will also consider the effectiveness of CDC's evaluation and learning mechanisms, from the perspectives of internal and external audiences.

  We will conduct key informant interviews with relevant CDC staff at all levels (including those focusing on environmental and social responsibility and development impact). We will also interview key staff within DFID's economic development team to explore the relevance of CDC's approach to DFID's strategy, and how the two agencies are working together to help address constraints and catalyse investment in developing markets and promote inclusive growth. While we do not propose formally to benchmark CDC against other development finance institutions, given the significant differences in mandates and areas of focus, we will interview staff from other institutions to learn how they deal with similar challenges. We will convene workshops for academic and development practitioner experts, as well as experts working in impact investment, to draw on their knowledge.

- ***Component 3 – Investment team level reviews:*** CDC's investment teams select, manage and monitor CDC's investments (with support from other specialists within CDC, for example on development impact). The investment teams are structured around CDC's three main product lines (direct equity, funds and debt) and then further broken down by sector and region.

  We will review six CDC investment teams in depth to explore how, in more difficult markets, CDC's approach to achieving financial returns, development impact and added value for firms and communities is operationalised. This will include assessing CDC's capacity and the effectiveness of processes for sourcing, screening and managing credible investments, including ensuring additionality, quality support and estimating and measuring development impact (direct and indirect). We will then review a sample of investments as well as decisions not to invest, in order to assess how the investment criteria (including the Development Impact score) and Code of Responsible Investing are being applied and operate in practice. For direct equity and debt investments, we will look in depth at the sampled company. For indirect investments through funds, we will undertake both a portfolio review of CDC's investment in the fund and look at the fund's investment in one selected company (where we will investigate performance and the extent of CDC influence).

  For the selected teams and investments, we will review CDC's documentation, including its investment papers, action plans and monitoring reports, and interview a number of stakeholders, including the investment lead and environmental and social responsibility and development impact leads at CDC, and staff from investee funds and companies. Some of these interviews will be conducted remotely. For investments in countries that we visit, we will conduct these interviews face to face. For all sampled investments, we will assess evidence of their development impact, including the quality of CDC's assessments of *potential* and *achieved* development impact, as well as relevant equity and sustainability issues.

  This evidence will be gathered, analysed and triangulated using an assessment framework for each investment team, and an assessment framework for each investment, designed to enable systematic assessment against the review questions.

- ***Component 4 – Country visits:*** We will visit three of the countries in CDC's two higher categories of investment difficulty (categories A and B) over the review period. This will expand on the evidence collected through the corporate level review and the investment team level reviews. We will investigate a sample of investees in each country (those included in the sample reviewed as part of the investment team level reviews, and others as appropriate). Country visits will allow us to conduct interviews with a broader range of stakeholders than for investments reviewed remotely, including stakeholders beyond CDC and investee staff (such as sector experts in that country, investors and DFID economic advisers). Visits will also allow us to meet with investee companies to help verify the reported development impact of CDC's investment, as well as CDC's contribution to responsible investing and generating other added value. Evidence on particular investments will feed into the assessment frameworks for the investment team level reviews described above.

  In addition to investigating the sampled investments further, country visits will allow us to look at issues beyond the individual investment level. These include the challenges for impact investment in the particular country contexts and the relevance of CDC's approach in light of these challenges, as well as the strength of links with DFID's other private sector development and work on inclusive growth in that country. In particular, country visits will allow for a deeper assessment of whether CDC is helping to develop or accelerate particular sectors in the country, and mobilise investment by other donors and by the private sector to help deliver impact at scale.

5. Safeguarding

The protection of aid beneficiaries and the public from exploitation or harm in connection with aid programmes (commonly referred to as 'safeguarding') has recently become a subject of heightened public concern.

Safeguarding is an area of potential risk for CDC, for example through investing in companies that may employ people on exploitative terms or in unsafe conditions. We will explore what systems and processes CDC has in place to manage this risk. Our analysis will include:

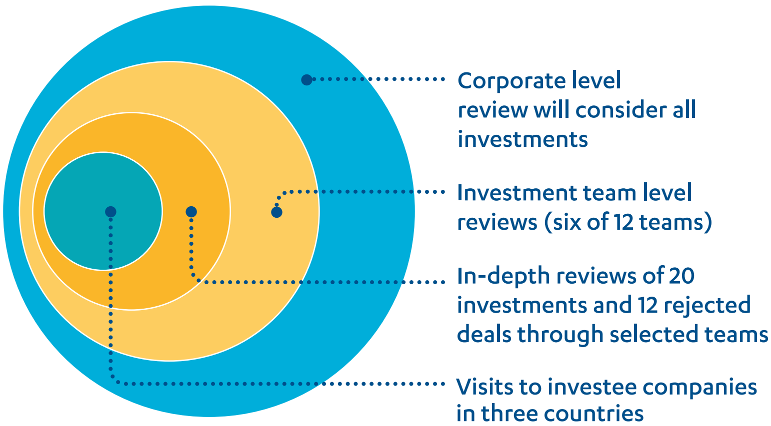
- through the literature review and key stakeholder interviews, exploring standards and good practices across development finance institutions on safeguarding
- assessing how CDC addresses safeguarding risks as part of its approach to responsible investing and associated investment criteria
- assessing what support CDC provides investee companies to improve their labour practices and address employee and public safety.

6. Sampling approach

We have selected a sample of six out of 12 investment teams to review in detail (a further three will be looked at more broadly). These were chosen purposively based on:

- the level of CDC investment made through the team in difficult markets
- the need to cover direct and indirect investments as well as CDC's 'market-building' strategies.

Figure 3: Overview of different sampling levels



We have also selected 20 investee funds and companies to review in depth, from a sample population which included all investees in low-income and fragile states that CDC has invested in under commitments made since 2012. This sample size and composition is based on:

- the need to include a range of investments from each of the investment teams selected, including from the countries that we will visit
- the need to reflect the scale of investment through each investment team in the relative focus given to it within the sample.

We will also select up to 12 rejected deals for review, in order to further explore CDC's decision-making processes and criteria for making investments including CDC's risk threshold, and interview companies and funds that are aware of CDC but have not applied for funding (through the country visits).

The countries we have selected to visit are all low-income and fragile countries. Together they have a reasonable number of CDC investee companies and provide us with an opportunity to visit investees across the range of investment types and country contexts.

Some investees sampled for in-depth review will be in countries with substantial CDC investment (including the country visit countries), but others will be located in countries where CDC has less of a presence. This will allow us to compare CDC's performance in these different contexts.

7. Limitations to the methodology

Assessing effectiveness – Some of CDC's market-building strategies, as well as approaches to promoting and monitoring development impact, were only adopted in 2017. It may therefore be premature to assess the effectiveness of some aspects of CDC's approach. In these circumstances, the review will focus on likely effectiveness, based on analysis of the strategies and approaches being pursued, and early evidence of performance. This will be triangulated with external evidence of what works and with expert stakeholder opinion, to arrive at a judgment.

Small number of investments reviewed in depth – We have selected a sample of 20 investments in low-income or fragile countries (including some through funds) to review in depth, from the 345 investees that CDC has invested in under commitments made over the review period.[24] While the sample will not be fully representative of CDC's activity in difficult markets, it will allow us to triangulate findings from our corporate level review and investment team level reviews. We will also investigate investment types not covered through investment team level reviews through interviews and document reviews as part of the corporate level review, so that we are able to make informed judgments about the portfolio as a whole.

8. Risk management

Risk	Mitigation and management actions
Positive bias in sample because some sampled investees choose not to participate	Investee companies are under no obligation to participate in this review. It is possible that companies whose performance is less positive will be less willing to participate. We will work closely with CDC to encourage firms and funds to share information, while protecting commercial confidentiality. We have also selected a 'backup' sample of investees. If an investee does not cooperate, we will replace it with a similar investee from the backup sample.
Difficulty in engaging companies that CDC has invested in indirectly through funds	We will work closely with the sampled funds and investee companies to get their buy-in to the review. If a sampled company that has been invested in via a fund does not cooperate, we will replace it with another company from the backup sample that the fund has invested in.
Potential absence of performance data, particularly development impact data and data for newer investees	We have ensured that some older and some newer investments are included in the sample to mitigate this risk. Aggregated development impact data will also be explored as part of the corporate level review. For newer investments, the effectiveness questions will also test the rigour of selection criteria and projected development impact.
ICAI review does not pick up on any existing safeguarding issues among investees	Relevant judgment criteria and evidence collection methods have been included in the review framework.

9. Quality assurance

The review will be carried out under the guidance of the ICAI commissioner Richard Gledhill, with support from the ICAI secretariat. The review will be subject to quality assurance by the service provider consortium. Both the methodology and the final report will be peer-reviewed by Charles Kenny, senior fellow and director of technology and development at the Center for Global Development.

24. These 345 investees are all of CDC's new investments under commitments made in the review period, not just those in low-income and fragile states.

10. Timing and deliverables

This review will be conducted over a period of around nine months, beginning in February 2018.

Phase	Timing and deliverables
Inception	Literature review: March to May 2018 Approach paper: May 2018
Data collection	Corporate level review: May to July 2018 Investment team level reviews: June to July 2018 Country visits: July 2018 Evidence pack and emerging findings: September 2018
Reporting	Final report: Winter 2018-19

This document can be downloaded from www.icai.independent.gov.uk
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