OCT 17, 2014 @ 04:31 PM

Development Finance Institutions Come of Age

Daniel Runde , CONTRIBUTOR
I cover the opportunities for the US coming from the developing world.
Opinions expressed by Forbes Contributors are their own.

Bangladesh now has 117.6 million mobile phone users, and Afghanistan has 21.6 million - both upwards of 70 percent of the population. Fifteen years ago there were essentially no cell users in either of these countries, yet a handful of entrepreneurs and investors in each decided they could create a telecom market in the heart of the developing world. Similarly, Sudanese born engineer and entrepreneur Mo Ibrahim founded African telecom giant Celtel in 1998, at which point Africa was the most underserved telecom market in the world. Today, Africa is the world's second largest cellular market and is projected to hit one billion cell users in 2015, or about 90 percent of the continent's population.

These examples illustrate that, even in the world's most underdeveloped regions, there are significant opportunities for successful business and investment, yet financiers often write these ideas off as crazy. In many instances, capital is a coward. Even when opportunities exist, somebody needs to prove there is money to be made in these exotic markets by leading the way.

Celtel advertising in rural Uganda

These "somebodies" are often development finance institutions (DFIs), and the successes mentioned above could not have happened without investments and the "good housekeeping

seal of approval" from these institutions. DFI is an umbrella term for the alphabet soup of somewhat obscure organizations that include: the International Finance Corporation (IFC), European Bank for Reconstruction and Development, the Overseas Private Investment Corporation (OPIC), CDC Group, PROPARCO, FMO, and DEG that share financial risk, provide loans, take minority equity investments, support emerging market equity funds and provide advice to both companies and government in the developing world.

THE POWER OF PRIVATE CAPITAL

Fifty years ago, the development "industry" relied almost solely on foreign aid– loans and grants– given to governments and NGOs. In 1970, official development assistance (ODA) accounted for more than two thirds of financial flows to the developing world, but today global ODA is approximately $135 billion against roughly $1 trillion in FDI heading to the developing world. In 2012, for the first time, developing economies absorbed more FDI than developed counterparts.

Attracting this capital will be necessary for effective development policy in the 21st century. Even in Africa, foreign direct investment now exceeds ODA. Perhaps the most critical role for private enterprise comes in job creation, which is a massive need for developing countries seeking economic progress and stability. Population growth will drive the need for 600 million new jobs by 2020, and in the developing world, 9 out of 10 employment opportunities are created by private enterprise.

Various leaders of international development agencies understand that their role has changed, including World Bank President Jim Yong Kim, who recently acknowledged that without robust private sector growth and private sector investment foreign providers alone, "won't fund the critical investments needed to create enough jobs for the poor or to meet developing countries' growing infrastructure needs."

One way OECD governments are seeking to share risk and encourage private enterprise has been to create and expand the use of DFIs. While DFIs have been part of the global aid infrastructure for decades, their use has exploded in recent years. Total annual commitments from DFIs to the private sector have quadrupled since 2002, from just over $10 billion to about $44 billion in 2012, yet this number still drastically undervalues the role of DFIs on a range of issues including project design, technical assistance, and the ability to leverage additional funds. Every G7 country but Canada now has a DFI, and Canada (along with Australia) are considering creating one.

WHAT IS A DFI?

Development Finance Institutions make investments, operate on market principles, and in theory, invest in sectors or countries that would otherwise be unable to attract capital. Generally, DFIs seek to maximize profit and "development impact", an ethos

encapsulated in the key term "additionality", or unique value provided by DFI involvement. Additionality is typically described along 4 parameters:

Demonstration additionality comes when a DFI makes money in an emerging sector or region, prompting private enterprise and investment to follow. Financial additionality can come in the form of longer loan periods, which allows investment into projects such as infrastructure, which require longer loan tenors to get done. DFIs also offer design additionality; a DFI works on 50 food processing plant investments (or water, or roads, or microfinance) and they bring that global expertise to an investment in, say, Tanzania. Finally, DFIs provide policy additionality because they can accelerate reform through the deals they finance. DFIs can put a project in front of policy makers and say: "if you make this change in policy, we can make this investment, and 1000 private sector jobs will be created."

As DFIs have grown in relevance, they have had to evolve. IFC, the DFI attached to the World Bank Group, began operations with a clear focus on Latin America in the context of the Cold War 1950s; OPIC, the US DFI spun out of USAID in the early 70s, started as a provider of political risk insurance; CDC (not the Atlanta based health organization dealing with Ebola– the other one) developed agriculture in the former British colonies. Most DFIs have major or even majority portfolios in Africa, and their shareholders are asking them to go into some of the world's most difficult environments. IFC, OPIC, and CDC (along with the other DFIs) have grown into new regions, new business lines and products. Some of these trends have included:

- Establishing the Emerging Markets Private Equity Industry: DFIs helped establish private equity markets in the developing world and the Emerging Market Private Equity Association(EMPEA) (set up by IFC) now has over $1 trillion in assets between 300 member institutions.

- Outside Investors: Africa50 initiative is a planned $10 billion AfDB fund aimed at mobilizing private capital for infrastructure investment in Africa. IFC Asset Management Company mobilizes third party funds, with about $4.5 billion under management.

- Investments in Conflict and Post-Conflict Zones: The success of mobile telephony in Afghanistan over the last decade is an example of DFIs pushing into places where there is active conflict or where the fighting has only recently stopped.

- Moving into "Frontier Markets": This means an increased focus on Africa as well as on the poorest regions of places like Brazil and China.

DILEMMAS AND OPPORTUNITY

With increased DFI expansion, criticisms have also emerged. One serious question is, why do we need DFIs when private banks like HSBC and Citibank can provide financing in emerging markets? This criticism has grown as several dozen developing countries have become

investment grade over the last decade. This critique has been curtailed somewhat, however, by post-financial crisis regulations, including Dodd-Frank and Basel III, which placed greater restrictions on the large banks. Another ongoing tension is whether DFIs should prioritize profits or development outcomes. The DFIs would answer "both" but the pressures on them are great at the investment officer level as well as at the institutional level to "book" increased investment volumes every year. Given this reality, extending a low risk high return project finance loan for a luxury hotel in Brazil will always be tempting.

One more valid concern is, when a DFI invests in a struggling or low income country, are we rewarding bad policy decisions by developing country governments? One response to this is to say that in a place like Afghanistan, we can either wait for reforms to happen or we can use a proposed investment in the telecom or mining sector to help force a constructive conversation with local policymakers.

Each of these criticisms contains more than a grain of truth, and reflects tensions fundamental to the missions of these organizations–tensions that can be managed but not "solved." In a world where private enterprise drives jobs and prosperity, DFIs expand the frontiers of what is viewed as a profitable investment opportunity around the world.

DFIs at their best can "prime the pump", supporting revolutionary businesses like Celtel, and opening economies to global trade and investment. DFIs at their worst invest in sectors and countries they should have exited years before in order to reap the profits to justify their continued existence. Based on the other tools available, as well as the changing world confronting policy makers, expect DFIs to be utilized more not less.

Where are DFIs looking next? DFIs are investing in water, sanitation, education, healthcare and energy. Could there be a "cellphone revolution" equivalent in the areas of toilets, vocational technical training, or micro utilities delivering water or power? If any of those breakthroughs happen, I am betting that organizations like IFC, CDC, or OPIC will be early stage investors.