

ISSUE BRIEF

The Future of Development Finance

NOVEMBER 2018 AUBREY HRUBY

Rising competition from China in emerging markets has finally shaken the United States out of its complacency towards development finance and commercial diplomacy, creating a welcome new willingness on the part of US policy makers to innovate in enhancing the tools available to support US corporate success in fast-growing foreign markets.

The Better Utilization of Investments Leading to Development (BUILD) Act of 2018, which passed into law in October, is an important first step towards rebalancing US commercial diplomacy. It establishes a new government agency, the United States International Development Finance Corporation (USDFC),¹ that will subsume the Overseas Private Investment Corporation (OPIC) and authorizes the transfer of some facilities from the US Agency for International Development (USAID), namely the Development Credit Authority (DCA), the Office of Private Capital and Microenterprise (OPCM), and enterprise funds.² While both OPIC and enterprise funds have generated healthy returns for the Treasury, an updated approach that streamlines efforts and combines more flexible financing options will help boost commercial returns and support US national security interests.³ Smart power⁴ programs that generate economic activity can support conflict-prevention efforts while providing economic opportunities in emerging markets.

The USDFC will allow US policy makers to formulate a twenty-first-century free market approach to development finance. It will continue to focus on helping US businesses invest in low-income and lower-middle-income

The Africa Center promotes dynamic geopolitical partnerships with African states and shapes US and European policy priorities to strengthen security and promote economic growth and prosperity on the continent.

- 1 The name of the agency was established by the BUILD Act, but the agency's acronym has yet to be determined.
- 2 Christopher M. Vaughn, "Better Utilization of Investments Leading to Development Act of 2018: A Bill to Establish the US International Development Finance Corporation," *Lexology*, April 30, 2018, <https://www.lexology.com/library/detail.aspx?g=ce217d35-c913-466d-a47f-8895cd7b0c94>; The DCA helps businesses in underserved markets gain access to local private capital through risk-sharing agreements. Established in the early 1990s to support the development of fledgling private sectors across Central and Eastern Europe, enterprise funds are essentially the use of state funds to make private equity investments in emerging markets.
- 3 US Agency for International Development, *The Enterprise Funds in Europe and Eurasia: Successes and Lessons Learned*, September 12, 2013, https://www.usaid.gov/sites/default/files/documents/1863/EE_Enterprise_Funds-LessonsLearned.pdf.
- 4 Joseph S. Nye Jr., "Get Smart: Combining Hard and Soft Power," *Foreign Affairs*, July/August 2009, <https://www.foreignaffairs.com/articles/2009-07-01/get-smart>.

economies, but will do so more effectively than OPIC has done by expanding current capabilities in five ways:⁵

1. Raising the contingent liability cap to \$60 billion over the next five years, which represents a doubling of OPIC's current \$29 billion lending cap.⁶
2. Permitting minority equity investments of up to 30 percent of total equity in any given project (the USDFC has a total limit of 35 percent equity of the agency's total investments).
3. Providing technical assistance and grants for advisory services, project studies, and project promotion.
4. Allowing products to be denominated and repayable in a foreign currency, not just US dollars.
5. Replacing the "US nexus" with a "US preference" allowing for more flexibility for the USDFC to invest in innovative structures and market-interested players.

These new capabilities will provide greater support to US companies and investors seeking opportunities in historically risky markets. Nowhere is this more critical than in Africa.

Sub-Saharan Africa is the second-fastest-growing economic region globally (after South Asia), and many countries have made steady progress in addressing some of the key socioeconomic challenges. But growth is continually undermined by a huge unmet demand for infrastructure—particularly for energy and transport, consumer goods, and services in education and healthcare. Fortunately, most development finance institutions (DFIs) and foreign investment agencies, especially those in Europe and Asia, have already woken up to these trends and are helping the private sector to take advantage of the opportunities they present. African markets currently constitute 27 percent of OPIC's portfolio and that share is slated to rise given the growth trends on the continent and the expanded USDFC budget cap.⁷ The ability to provide loans in local

currencies will also enable the USDFC to be more in tune with local economic conditions, provide lower cost capital, and take a more long-term position in the markets.

This issue brief provides a snapshot of the DFI competitive landscape within African markets, discusses the key components of development finance, outlines the future challenges for DFIs, and offers recommendations to US policy makers charged with making the new USDFC a reality.

A SNAPSHOT OF DEVELOPMENT FINANCE INSTITUTIONS IN AFRICA

Emergence of DFIs

Modern DFIs evolved from one of the central pillars of the Marshall Plan: addressing a clear market failure with government-provided insurance to private US investors to protect against the risks faced in post-war European markets. This political risk insurance was expanded in the 1950s to cover a larger spectrum of risks, from currency convertibility to expropriation.⁸ By the late 1960s, US policy makers had recognized the need to form an agency specialized in political risk insurance in an ever-expanding set of countries; they created OPIC in 1971.

For almost fifty years, OPIC and its sister institution, the US Export-Import Bank, have been central vehicles for US commercial diplomacy. OPIC was established with an initial portfolio of \$8.4 billion in political risk insurance and \$169 million in loan guarantees under the Richard Nixon administration, with a mandate to help US firms invest in sound business ideas in emerging markets with weak institutions.⁹ By participating alongside the private sector in accessing high risk-high return opportunities, OPIC, at its core, has been self-sustaining. It has returned almost \$4 billion back to the US Treasury in deficit reduction over the last ten years, supported over \$80 billion in US exports, and created 280,000 American jobs.¹⁰

5 Vaughn, "Better Utilization of Investments Leading to Development Act of 2018."

6 James M. Roberts and Brett D. Schaefer, "House and Senate Revisions Have Not Improved the BUILD Act Enough to Warrant Conservative Support," The Heritage Foundation, July 24, 2018, https://www.heritage.org/sites/default/files/2018-07/1B4890_0.pdf.

7 "Connect Africa," OPIC, accessed October 10, 2018, <https://www.opic.gov/opic-in-action/connect-africa>.

8 "The Political Risk Insurance Industry: A View from the Supply Side," in *World Investment and Political Risk*, ed. Multilateral Investment Guarantee Agency, 2010, https://www.miga.org/documents/flagship09ebook_chap3.pdf.

9 "OPIC History," OPIC, accessed October 10, 2018, <https://www.opic.gov/who-we-are/opic-history>.

10 "Better Utilization of Investments Leading to Development (BUILD) Act of 2018 (H.R.5105/S.2463)," The Borgen Project, accessed October 10, 2018, <https://borgenproject.org/wp-content/uploads/BUILD-Summary.pdf>.

Table 1 **The Portfolios of the Best-Known DFIs**

DFI	Commitments 2012-16 (USD millions)	Commitments 2012-16 (USD millions)	Total Number of Investments	Mean Project Size (USD millions)	Median Project Size (USD millions)
CDC Group	\$4,447	136	\$32.70	\$22.78	49
DEG (German Investment Corporation)	\$2,307	120	\$19.89	\$16.70	24
FMO (Netherlands Development Finance Company)	\$8,115	711	\$11.41	\$7.59	33
*Proparco	\$5,629	305	\$18.46	\$15.18	35

*In the case of Proparco—a development finance institution owned in part by the French Development Agency—data were pulled from the 2016 annual report.

OPIC does this by providing firms with risk-mitigating tools, such as political risk insurance and debt investment in private equity (PE) funds. But, while relatively large in capitalization, OPIC was built with limitations that have hamstrung its capacity to innovate and made it unable to effectively compete with its developed country counterparts. These limitations include its dependence on debt investments and dollar-based lending. Still, despite these constraints, OPIC has delivered benefits to the US economy and paid development dividends abroad.

With the exception of Britain, which formed its Colonial Development Corporation (CDC Group) in 1948¹¹ to help advance agricultural development in the wake of World War II, many European countries also created their DFIs in the late 1960s and early 1970s. A combination of Cold War thinking, post-independence colonial patronage, and a desire to be part of the East Asian growth story of the 1970s motivated the formation of over a dozen DFIs and microfinance organizations in this period. Across the board, these institutions typically provide credit, equity, and a wide range of capacity-building programs to companies, small businesses, and early-stage funds whose financial needs are not sufficiently served by private banks or local capital markets.¹²

DFI Finances

Most DFIs are funded through annual contributions from national governments, which ensures their creditworthiness. At their core, most DFIs are lenders with debt dominating their portfolios. The great exception is the United Kingdom's CDC Group: 70 percent of its commitments have been in equity.¹³ To date, DFIs have generally focused on finance and infrastructure projects. OPIC provides the most financing for utilities (largely the result of the Barack Obama administration's Power Africa initiative).¹⁴ A breakdown of the portfolios of the best-known DFIs is shown in Table 1.¹⁵

DFIs' Role in Africa's Growth Story

African projects and deals claim the largest regional share of DFI portfolios. Between 2012 and 2016, sub-Saharan Africa received the most commitments (\$14.2 billion), followed by East and South Asia (\$10.5 billion) and Latin America (\$10.2 billion).¹⁶ The \$14 billion allocated in 2016 was nearly six times the amount allocated in 2005, and the proportion of funds allocated to Africa in overall DFI portfolios has also been growing. In the last fifteen years, it has risen from less than a quarter to roughly a third of the European DFIs' consolidated portfolio. OPIC is also

11 In 1963, the Colonial Development Corporation was renamed the Commonwealth Development Corporation, which remains its formal name today.

12 José de Luna Martínez, "The Role of Development Financial Institutions in the New Millennium," *World Bank Blogs*, September 27, 2017, <http://blogs.worldbank.org/eastasiapacific/the-role-of-development-financial-institutions-in-the-new-millennium>.

13 Charles Kenny et al., "Comparing Five Bilateral Development Finance Institutions and the IFC," Center for Global Development, January 17, 2018, <https://www.cgdev.org/publication/comparing-five-bilateral-development-finance-institutions-and-ifc>.

14 Ibid.

15 Ibid.

16 Charles Kenny et al., "Comparing Five Bilateral Development Finance Institutions and the IFC."



OPIC President and Chief Executive Officer Ray Washburne celebrates US investments in Kenya with Kenyan President Uhuru Kenyatta, US Secretary of Commerce Wilbur Ross, and other high-level Kenyan and American officials. *Photo Credit: OPIC.*

very active in the region: In 2017, sub-Saharan Africa accounted for 27 percent of its portfolio. The current portfolio is \$6.1 billion across 128 projects.¹⁷

Comparing the development finance activities of non-European countries with those of the traditional DFIs is difficult given the vastly different approaches taken by the newer cadre of investors in sub-Saharan African markets (including China, India, Turkey, Morocco, and Israel). What these new players have in common is their aggressive use of financial activities as central to their commercial diplomacy and foreign policy.

No country has invested more in commercial diplomacy over the past decade than China. Fueled in large part by its desire to find natural resources and to sustain corporate profits, China has over the past two decades transformed its formerly negligible economic ties to Africa. It is now the continent's biggest financier, accounting for 14

percent of Africa's total debt stock.¹⁸ (This figure understates China's hold on Africa's fastest-growing economies: Beijing, for example, holds over 72 percent, or \$5.32 billion, of Kenya's bilateral debt).¹⁹ Through the China-Africa Development Fund and export-import banks, China has supported the development of over three thousand critical infrastructure projects.²⁰ At the most recent Forum on China-Africa Cooperation, held in September, Beijing announced an additional commitment of \$60 billion over three years to African countries.²¹

By offering debt that often does not meet the Organisation for Economic Co-operation and Development's concessionality terms, China has been able to fill gaps left by multilateral financial institutions and Western DFIs, which often have stringent economic, social, and governance criteria. China's aggressive approach has produced dra-

“No country has invested more in commercial diplomacy over the past decade than China.”

matic increases in the number of Chinese firms doing business in Africa; annual two-way trade is now over \$200 billion.²² McKinsey & Company, a global consulting firm, estimates that there are now over ten thousand mainly private Chinese companies of all sizes operating in all sectors of African markets.²³ While China makes a show of announcing new programs and additional funds to support Chinese companies in Africa at a pageant-like triennial summit, US commercial diplomacy has stagnated. It still relies on the African Growth and Opportunity Act

17 “Connect Africa,” OPIC.

18 Wenjie Chen and Roger Nord, “Reassessing Africa’s Global Partnerships: Approaches for Engaging the New World Order,” in *Foresight Africa* 2018, ed. The Brookings Institution, January 11, 2018, https://www.brookings.edu/wp-content/uploads/2018/01/foresight-2018_chapter-6_web_final.pdf.

19 “Sh534bn China Debt Now 72pc of Bilateral Loans Pile,” *Business Daily*, July 2, 2018, <https://www.businessdailyafrica.com/economy/Sh534bn-China-debt-now-72pc-of-bilateral-loans-pile/3946234-4642122-743gtxz/index.html>.

20 Witney Schneidman and Joel Wiegert, “Competing in Africa: China, the European Union, and the United States,” The Brookings Institution, April 16, 2018, <https://www.brookings.edu/blog/africa-in-focus/2018/04/16/competing-in-africa-china-the-european-union-and-the-united-states/>.

21 Yun Sun, “China’s 2018 Financial Commitments to Africa: Adjustment and Recalibration,” The Brookings Institution, September 5, 2018, <https://www.brookings.edu/blog/africa-in-focus/2018/09/05/chinas-2018-financial-commitments-to-africa-adjustment-and-recalibration/>.

22 Schneidman and Wiegert, “Competing in Africa: China, the European Union, and the United States.”

23 Kartik Jayaram, Omid Kassiri, and Irene Yuan Sun, “The Closest Look Yet at Chinese Economic Engagement in Africa,” McKinsey & Company, June 2017, <https://www.mckinsey.com/featured-insights/middle-east-and-africa/the-closest-look-yet-at-chinese-economic-engagement-in-africa>.



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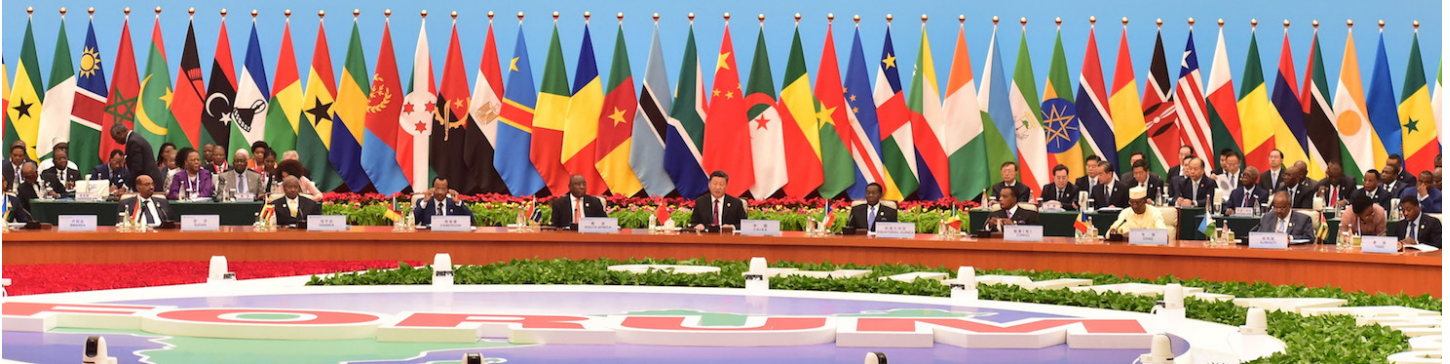
The 2018 Beijing Summit of the Forum on China-Africa Cooperation

Sommet de Beijing 2018 du Forum sur la Coopération Sino-Africaine

3-4 September 2018

2018年9月3-4日

3-4 Septembre 2018



Chinese President Xi Jinping chairs the 2018 Forum on China-Africa Cooperation in Beijing, with 49 African heads of state or government in attendance. *Photo Credit: The Presidency of the Republic of South Africa.*

(a nonreciprocal trade agreement granting duty-free access to the US market for certain products), a hamstrung Export-Import Bank, and OPIC (which is limited to using only debt tools) as the foundation of its commercial relationship with Africa. The creation of the USDFC throws open a new door to innovation in development finance for the United States and will finally begin to level the playing field.

KEY FUNCTIONALITIES AND BEST PRACTICES

DFIs are pivotal catalysts of growth in underserved economies, but they also promote the interests of their own governments and domestic businesses.

The BUILD Act articulates three main principles that will guide USDFC activities: additionality, meaning that DFI interventions must not crowd out private capital; the need to be catalytic by leveraging the capacities of the private sector and partnering with like-minded institutions; and alignment with US foreign policy strategic objectives.

Tool of Commercial Diplomacy

The United States has had a history of purporting to align its commercial interests with developmental and national security goals, but mostly falling short of creating robust commercial diplomacy capacities. A few bright spots—the Marshall Plan and US support provided to the fledgling private sectors of the former Soviet Union—demonstrate how measured capitalism can help foster democracy and political stability.

USDFC Principles

- **Additionality:** Projects should invest in underserved geographies, sectors, and segments, helping private sector actors overcome clear market gaps and be first-movers in less developed economies.
- **Catalytic Effect:** Interventions should mobilize additional capital, foster knowledge sharing, and reduce risk for investors.
- **Advance US Strategic Interests:** Projects should be consistent with and guided by US foreign policy, development, and national security objectives.

A core pillar of the Donald Trump administration's National Security Strategy (NSS), and its America-first focus, is focused on regaining economic competitiveness as a basis for US power going forward.²⁴ The NSS makes explicitly clear what has long been intrinsically understood—that economic strength is the foundation of geopolitical strength—and calls for upgrading “diplomatic capabilities to compete in the current environment and embrace a competitive mindset.”²⁵ Through its ability to generate economic activity in underserved markets, the newly created USDFC has an important role to play in smart power programs that help prevent conflict, create jobs, and deliver returns for the domestic economy.

Risk Mitigation in Underserved Markets

The USDFC will prioritize activities in less developed countries, as defined by the World Bank.²⁶

There is no doubt that DFIs—by acting as first-movers and providing tools to reduce risk and unlock private capital flows—play a catalytic role in underserved markets.

DFIs are evolving away from the monoline provision of political risk insurance and increasingly seek to provide a comprehensive tool kit that is still aimed at mitigating political and regulatory risk, but also addresses counterparty credit risk and currency risks.

Currencies in emerging markets are often volatile and suffer from double-digit inflation. Resolving foreign exchange risks is vital for unlocking private equity flows into emerging markets by ensuring returns are not erased at exit when profits are translated back into dollars. According to the African Private Equity and Venture Capital Association's review of private equity in Africa, 63 percent of fund managers found currency fluctuations to be the most important macroeconomic risk when investing in African markets.²⁷ DFIs have an important role to play by developing cost-effective ways to support investors in managing currency risks.

The four main risk mitigation tools relevant to African markets are summarized in Table 2.²⁸

Seeding Private Equity Funds

DFIs have played a central and catalytic role in the creation of the African private equity industry. In the late 1990s, European DFIs, along with the IFC, began helping to seed private equity funds focused on African markets with equity. As one of the first to move in 1995, FMO started actively working with local partners and commercial banks to create small and medium-sized enterprise (SME) funds via the Dutch government's Seed Capital Fund.²⁹ Technical assistance was also provided to train local investment managers. In that way, the DFI capital started to unlock other pools of money, including from institutional investors and private individuals looking to invest in African funds.

It is hard to overstate the importance of DFIs to the private equity industry. In 1997, there were twelve funds with

24 Colin Dueck, “Trump's National Security Strategy: 10 Big Priorities,” *The National Interest*, January 9, 2018, <https://nationalinterest.org/feature/trumps-national-security-strategy-10-big-priorities-23994>.

25 Peter Feaver, “Five Takeaways from Trump's National Security Strategy,” *Foreign Policy*, December 18, 2017, <https://foreignpolicy.com/2017/12/18/five-takeaways-from-trumps-national-security-strategy/>.

26 US Congress, Senate, *Better Utilization of Investments Leading to Development Act of 2018*, S 2463, 115th Cong., 2nd sess., introduced in Senate February 27, 2018, <https://www.congress.gov/bill/115th-congress/senate-bill/2463>.

27 “African Fund Managers Continue to Capture Opportunities Amidst Rising Currency and Geopolitical Risk,” African Private Equity and Venture Capital Association, December 7, 2017, <https://www.avca-africa.org/newsroom/avca-news/2017/african-fund-managers-continue-to-capture-opportunities-amidst-rising-currency-and-geopolitical-risk/>.

28 Belgian Investment Company for Developing Countries, *Annual Report 2016*, 2016, <http://www.bio-invest.be/library/annual-report.html>.

29 African Private Equity and Venture Capital Association, *An Untold Story: The Evolution of Responsible Investing in Africa*, April 2018, http://financedocbox.com/Mutual_Funds/77901840-An-untold-story-the-evolution-of-responsible-investing-in-africa.html.

Table 2 Risk Mitigation Tools Relevant to African Markets

DFI Risk Tool Kit		
Risk	Example Tools	Case Studies and Benefits
Political Risk	<ul style="list-style-type: none"> Political risk insurance protects firms from disruptions due to civil unrest, expropriation, restrictions on currency conversion, and transfer of earnings 	<ul style="list-style-type: none"> Available via OPIC for all US companies looking to make both large and small investments across 160 low-income and post-conflict countries
Currency Risk	<ul style="list-style-type: none"> Local-currency funds Development of emerging market-focused hedging products 	<ul style="list-style-type: none"> The partial local currency guarantee of the International Finance Corporation (IFC) for the public transportation system in Guatemala City OPIC's partnership with the African Development Bank and the German Development Bank to support the development of local currency corporate bond markets in Africa, focusing on agriculture, housing, and small and medium-sized enterprises
Counterparty Credit Risk	<ul style="list-style-type: none"> Syndicated loan guarantees 	<ul style="list-style-type: none"> The IFC negotiates loans with borrowers and maintains some of it (A loan) while selling the rest (B loan). B participants benefit from the IFC's preferred creditor status while the borrower is introduced to new potential banking relationships. USAID's DCA has made close to \$5 billion in private financing available through over 500 guarantees between USAID and financial institutions, supporting over 2.45 million entrepreneurs globally and providing protection to investors against certain sovereign risks, including failure to honor international arbitration awards, confiscatory changes in law, currency convertibility, and more.
Project Rediness and Sustainability	<ul style="list-style-type: none"> The New Partnership for Africa's Development Infrastructure Project Preparation Facility/Service Delivery Mechanism 	<ul style="list-style-type: none"> Support at the pre-feasibility/feasibility level can be crucial to de-risking projects by facilitating project structuring and ensuring government buy-in. Incorporating high environmental, social, and governance standards is critical to the ultimate implementation of responsible policies.

a total of \$1 billion³⁰ and today there are well over two hundred managing upwards of \$35 billion in assets.³¹ Over 50 percent of private equity funds in Africa have DFIs as early investors, and DFIs helped to create a pool of professional fund managers deeply steeped in sustainable investing practices.³² The United Kingdom's CDC Group has invested \$4.1 billion in eighty-two private equity funds operating across the African continent, which in turn have

invested more than \$50 billion in more than 570 privately owned and managed companies in sixty-five countries.³³ By comparison, OPIC has made just thirty-six investments in emerging market private equity firms.³⁴ This is, in part, due to OPIC's inability to invest equity, and the reluctance of European DFIs to invest equity alongside OPIC debt.

30 Amar Bhattacharya, Peter J. Montiel, and Sunil Sharma, "How Can sub-Saharan Africa Attract More Private Capital Inflows?" in *Finance and Development*, ed. International Monetary Fund, June 1997, <https://www.imf.org/external/pubs/ft/fandd/1997/06/pdf/bhattach.pdf>.

31 Aubrey Hruby, "The Missing Middle in African Private Equity," *Financial Times*, October 24, 2016, <https://www.ft.com/content/6e2e0a7a-504a-3ac1-bd83-e68f21090d5b>.

32 "Reviving DFI Funding in Africa," *CNBC Africa*, May 15, 2014, <https://www.cnbc.com/news/2014/05/15/reviving-dfi-funding-in-africa/>.

33 "Our Investments," CDC Group, accessed October 10, 2018, <https://www.cdcgroup.com/en/our-investments>.

34 "Current List of Investment Funds," Overseas Private Investment Corporation, September 30, 2016, https://www.opic.gov/sites/default/files/files/IFD_FundList_fy2016.pdf.

In 2017, \$453 billion was raised for private equity globally, adding to a stock of current uninvested capital of over \$1 trillion.³⁵ The amount of money raised for African private equity was less than 1 percent of the global raise. The United States is home to seventy-seven of the one hundred top global limited partners and of these, 42 percent are public or private-sector pension funds. There is a huge amount of capital that could be unlocked for emerging and frontier markets by the USDFC through seeding more funds and other Africa-focused intermediaries. Nowhere is this more needed than in African countries.

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Though ten million people are coming of age and joining the African labor market every year, the continent is only creating 3.7 million jobs per annum. American counter-extremism and security interests will be advanced if the USDFC can figure out ways to unlock more latent capital in the United States to help advance job creation in African countries.³⁶

Direct Investments

In addition to seeding private equity funds, DFIs started making direct investments in African companies in the early 2000s. Direct investments give DFIs the opportunity to support company growth in situations in which PE firms cannot invest, or in which the investment has strategic significance in terms of either return, impact, or both.

Because DFIs have different thresholds for economic returns, they can often absorb more risk and be more patient over time. Also, the thorough due diligence conducted by DFIs sends valuable market signals to other investors. When DFIs invest in an African corporation, family offices, private equity funds, and international and local institutional investors take note and often piggyback on the DFIs' diligence work. DFI equity investments therefore have the potential to be valuable far beyond their face value through their de-risking catalytic effect and ability to unlock private capital.

But it is important that such investments remain catalytic and do not instead crowd out private interests. Many DFIs have stipulations in their mandates that prevent them from competing on bids where the private sector has also bid.³⁷

DFIs OF THE FUTURE

The creation of the USDFC presents US policy makers with a strategic opportunity to innovate and shape a development finance institution wired to support US companies in rapidly growing, ever-changing low- and lower-middle-income countries. As the 120-day period articulated in the BUILD Act for creating the new agency unfolds, policy makers should focus their efforts on ensuring that the USDFC is equipped to do the following:³⁸

- **Operate in informal markets.** Informal markets are the loci of economic growth in most low-income countries. The informal sector produces an estimated 40 percent of Latin American and 35 percent of South Asian gross domestic product, and employs 65 percent of the workforce in some sub-Saharan African countries. In Kenya, the informal sector accounted for 90 percent of the jobs created in 2016. Scarce data, immature governance structures, fragmentation, and fluidity make investing in informal businesses extremely difficult for DFIs. The traditional due diligence requirements of major DFIs either make it impossible for informal sector companies to survive—due to a lack of proper doc-

35 Christine Idzelis, “Everything about Private Equity Reeks of Bubble. Party On!” *Institutional Investor*, July 22, 2018, <https://www.institutional-investor.com/article/b195s0y2vfl169/everything-about-private-equity-reeks-of-bubble-party-on>.

36 Siddarth Chatterjee and John Dramani Mahama, “Promise or Peril? Africa’s 830 Million Young People by 2050,” United Nations Development Programme, August 12, 2017, <http://www.africa.undp.org/content/rba/en/home/blog/2017/8/12/Promise-Or-Peril-Africa-s-830-Million-Young-People-By-2050.html>.

37 Thomas Dickinson, *Development Finance Institutions: Profitability Promoting Development*, Organisation for Economic Co-operation and Development, accessed October 10, 2018, <http://www.oecd.org/dev/41302068.pdf>.

38 Per the BUILD Act, a “reorganization plan” must be submitted within 120 days of the Act’s enactment by the president of the United States to the relevant congressional committees.

umentation and corporate compliance, and the limited bandwidth of the entrepreneurs—or are cost-prohibitive on a return-adjusted basis for DFIs to embark on given the small size of the deals.

DFIs of the future cannot ignore the opportunities in the informal sector and must find a way to reduce the associated transaction cost. Companies operating in African markets that straddle the formal and informal markets such as cars45 in Nigeria and Brookside Dairie in Kenya should be studied to understand how they make informal businesses more efficient and the constraints to growth. These “straddling” businesses could be targets of direct investment as they carry outsized development returns by creating entire ecosystems of SMEs.

Additionally, DFIs could begin investing in companies that provide crosscutting business support services aimed at getting early-stage businesses investment ready. This space has traditionally been left to non-profit players that lack the return incentive of DFIs, such as USAID’s joint program with leading consultancy firm Open Capital Advisors,³⁹ which makes \$600,000 available through an investment readiness program to catalyze \$3.5 million in investment into East African businesses; or Mastercard Foundation’s \$1 million investment to support the African Entrepreneur Collective, an East African-focused SME incubator working to develop small businesses in Rwanda.⁴⁰ Such support, while valuable, often comes with a limited timeframe and therefore lacks the ongoing benefit a private investment would deliver. The flexibility to give technical assistance and make direct debt and equity investments into these service companies helps to formalize informal markets, and allows DFIs to be developmentally catalytic.⁴¹

- **Fast-track the development of business ecosystems and trust.** DFIs of the future will also be able to use investments to get outsized development returns by reducing the cost of doing business, fostering trust within the market, and serving as a bridge for institu-

tional capital. While DFIs have been helping to shape business ecosystems since the creation of the first enterprise funds in Central and Eastern Europe after the collapse of the Soviet Union, the needs of fast-growing companies in undercapitalized markets will require a blurring of the lines between traditional DFI products. A movement towards more flexible and customized funding structures (blended finance) will ensure that businesses get the capital necessary through various stages of growth. Part of additionality is ensuring that firms are responsive to customers rather than DFI processes. The increase in local debt facilities backed by DFIs is a positive development reducing the risk of debt financing for growing SMEs in emerging markets.

- **Make the fundraising process more efficient for private equity firms and intermediaries.** Given their unmatched importance to private equity funds operating in African markets, DFIs should dedicate some of their resources to improving the efficiency of the fundraising process. The average African private equity firm takes over three years to raise money, independent of its size. A great deal of this time is spent meeting with the two dozen main DFIs, tweaking presentations, and going through each DFI’s highly individualized application process. DFIs of the future can draw inspiration from the best practices in incubators and accelerators and apply them to the fundraising process, experiment with panel-type interviews and processes, and employ shared tech-based screening and due diligence procedures. By establishing even more standard rules and consistency in how they themselves operate, DFIs have an additive role to play in helping the entire development finance sector ecosystem evolve.

DFIs are more relevant than ever in the face of global growth patterns. With over 80 percent of future growth emanating out of emerging markets, US companies will require a competitive boost. Under the right leadership, mandate, and structure, DFIs can create new channels to crowd-in the private sector. Moreover, they can play a catalytic role by generating new knowledge, convening

39 “Open Capital Advisors, USAID, and Four Investor Partners Launch Investment Readiness Program,” Open Capital Advisors, accessed October 10, 2018, <https://opencapitaladvisors.com/open-capital-advisors-usaid-and-four-investor-partners-launch-investment-readiness-program-2/>.

40 “Mastercard \$1 Million Grant Set to Ignite Business Growth in Rwanda,” Mastercard, April 26, 2017, <https://newsroom.mastercard.com/meal-press-releases/mastercard-1-million-grant-set-to-ignite-business-growth-in-rwanda/>.

41 Tom Groenfeldt, “IFC and VCs Want to Take Emerging Market Microfinance to Mobile,” Forbes, April 4, 2018, <https://www.forbes.com/sites/tomgroenfeldt/2018/04/04/ifc-and-vcs-want-to-take-emerging-market-microfinance-to-mobile/#23fd6ac47a39>.



Alistair Group, established in 2007 with just two trucks, used a seven million OPIC loan in 2012 to expand its operations. The company now offers shipping and logistics services for major mining, oil, and gas companies as well as global relief organizations across the African continent. *Photo Credit: OPIC/Raymond Kasoga.*

stakeholders, and providing technical assistance to build capacity in both the private and public sectors.⁴²

The New USDFC

In addition to expanding the budgetary cap, the BUILD Act has endowed the new USDFC with equity power and a consolidated set of tools.

First, the USDFC will help put US development finance on a par with other countries at a crucial time. A recent estimate is that between 2002 and 2014, annual commitments made by DFIs grew from \$10 billion to \$70 billion. In addition, the DFIs of the other G-8 nations have been growing and doing development finance in more flexible ways, improving tools, and investing much more aggressively than the United States. For example, in 2017, the United Kingdom committed to quadrupling the limit on

support it gives to its development finance portfolio.⁴³ The USDFC will also improve US competitiveness against China, which is making ever-larger investments through its development finance institutions.⁴⁴

Second, the USDFC's ability to invest equity in addition to debt makes the agency even more catalytic. With equity, it will be able to more effectively seed private equity funds and intermediaries focused on African markets. Under the old system, a private equity firm that was fundraising and had received an OPIC commitment would have to go to the European DFIs to get investments in order to unlock the OPIC debt money. European DFIs were reluctant to make these types of investments, however, because OPIC's debt would be senior to their equity in the event of a bust scenario. Funds were thus often forced to choose between OPIC and European DFIs, and most chose the Europeans, whose long-standing equity products could

42 De Luna Martínez, "The Role of Development Financial Institutions in the New Millennium."

43 Henry Mance and Jim Pickard, "UK eyes move to divert billions in aid to private equity arm," *Financial Times*, November 22, 2016, <https://www.ft.com/content/bbc9717e-b0a6-11e6-a37c-f4a01f1b0fa1>.

44 Adva Saldinger, "Support for New US Development Finance Bill, Even as Some Details Are Questioned," *Devex*, March 1, 2018, <https://www.devex.com/news/support-for-new-us-development-finance-bill-even-as-some-details-are-questioned-92220>.

truly anchor funds. Now the USDFC will be able to do the same and that power will create more US funds that invest abroad.

Finally, the USDFC will streamline the fundraising process by bringing a consolidated tool kit to aid efforts in US commercial diplomacy. It will consolidate some agency activities and federal development programs into one full-service, self-sustaining institution.⁴⁵ By creating a flexible menu of lending, first-loss capabilities, equity, local currency debt, and grants for technical assistance, the USDFC will be able to better deliver blended capital to a company or fund that is appropriately calibrated to its stage of growth. It will be the first time that policy makers will be able to speak about grants and returns, capacity-building and private equity in a single conversation unmarred by interagency divisions and communication slowdowns. It could become a role model for other DFIs.

RECOMMENDATIONS

The bipartisan nature of the support for the USDFC is inspiring in a time of deep divisions in Washington. The Trump administration has transformed the potential for the United States to buttress African economic development, while helping American companies succeed in new markets. Expanding a government agency, recruiting additional staff, and developing a viable pipeline of opportunities will all take time and create new bureaucratic, technical, and political challenges. During this formative 120-day reorganization period, US policy makers should consider the following recommendations:

1. **Double down on areas of US competitiveness.** The United States is a service-based economy and excels in sectors such as finance, technology, entertainment, and professional services.⁴⁶ Home to the world's most well-established hub of venture capital and tech entrepreneurship, the United States has an opportunity to shape the new USDFC in areas of competitive differentiation and to offset recent Chinese advances. Chinese tech companies such as Huawei, Tecno, ZTE, and others have taken a deep interest in African markets over the past ten years and, recently, Tencent and Alibaba have started making investments in countries from Nigeria to

Kenya. The USDFC should create special initiatives around financial technologies, venture capital, and crosscutting business services that can reduce transaction costs in lower-income economies. The preference given to American companies under the USDFC should be strongly enforced in areas of US competitive advantage.

2. **Focus on key performance indicators.** To do smaller, more impactful, and catalytic deals, especially in the informal sector, the USDFC should identify and prioritize key performance indicators such as the cost of transactions, standardization of due diligence standards, and time to commitment. Partnering with the European DFIs to standardize and harmonize due diligence and contracting processes can help the USDFC do more deals, more quickly. Additionally, the USDFC should incorporate technology in deal origination, data collection/analysis, and due diligence.
3. **Cultivate a risk-taking mentality.** While having a development mandate to work in low-income economies, many DFIs shy away from riskier deals because of concern about credit rating, the inability to drive down transaction costs, and the difficulty of creating meaningful incentives for employees on deal origination, vetting, closing, and exiting. The USDFC can explore structural innovations like seeding special purpose vehicles to create pools of patient off-balance sheet money from DFIs for higher risk deals.
4. **Invest in ecosystem players for efficiency.** To create a robust pipeline of deals and reduce transaction costs, the USDFC should prioritize investing in companies that function as the critical infrastructure of market assessment, deal origination, and vetting. These include tech companies in the data space and deal platforms such as Fraym and Asoko Insights.
5. **Mobilize deep private sector expertise.** Inspired by the Marshall Plan and early enterprise funds' successes, the USDFC should create a program for private sector secondees, volunteers, and retirees to serve in advisory council roles on specific funds, deals, and sector deal teams. The Dutch provide a

45 "Better Utilization of Investments Leading to Development (BUILD) Act of 2018 (H.R.5105/S.2463)," The Borgen Project.

46 Aubrey Hruby, "Escaping China's Shadow: Finding America's Competitive Edge in Africa," Atlantic Council, September 7, 2018, <http://www.atlanticcouncil.org/publications/issue-briefs/escaping-china-shadow>.

viable model. PUM Netherlands Senior Experts is a nonprofit organization that receives most of its funding from the Dutch government to develop small and medium-sized enterprises in over thirty emerging markets.

6. **Prioritize equity investment in funds and other financial intermediaries.** The vast majority of the USDFC's equity power should go to funds—general partners of the funds are specialists closer to the ground with greater incentive to close and successfully exit deals. Outside of seeding and growing equity funds and permanent capital vehicles the USDFC should consider making equity investments in platform companies that have outsized and scalable development impact (such as renewable energy companies, financial inclusion technology, and mobile-first education). It is important to have a clearly defined policy around the use of equity to ensure additionality and to prevent the USDFC from competing with the very funds it seeds.
7. **Create the positions of senior innovation officer and institutional liaison to educate and mobilize the US private sector.** Since the mobile revolution has transformed the landscape of frontier markets, and technology will be critical for driving down transaction costs, the USDFC should establish a position of senior innovation officer to engage with tech-first parts of the US economy and forge partnerships with tech innovators in emerging markets. The innovation officer will be important in outreaching to tech companies and Silicon Valley venture funds and incorporating new technology internally in the USDFC. Additionally, the USDFC should hire an executive tasked with engaging with US family offices and institutional investors, educating US companies and mobilizing domestic interest in priority deals.
8. **Create a deal corps for MBA graduates.** Forging a partnership with the Peace Corps, the Africa Business Fellowship, Bizcorps, US banks, and leading US business schools, the USDFC should create a two-year program for master of business administration (MBA) graduates to work in deal teams based on the continent. These teams, reporting into USDFC, could be involved in deal origination, initial due diligence, and post-deal monitoring. Top MBAs could be incentivized through loan forgiveness, the

prestige of working with a US government agency, and a living wage stipend. Through this program, the United States can enhance its competitiveness by creating a whole cadre of future business leaders with first-hand experience in emerging markets.

9. **Allow for regional enterprise funds.** Given that the African continent is divided into fifty-four countries, many small and economically challenged, regional efforts become critical for sustainability. Encouraging regional integration has been a pillar of US foreign policy in African markets and the enterprise funds outlined in the BUILD Act should also operate with a regional mandate to reinforce African economic integration progress. The Millennium Challenge Corporation was given a mandate to make regional compacts earlier this year and the new USDFC should also have this capacity.

CONCLUSION

The USDFC presents a once-in-a-generation opportunity for the United States to create robust and strategic commercial diplomacy and remain competitive in the global market. The next four months will be critical in laying the groundwork for a DFI suited to the challenges of twenty-first-century emerging markets. By incorporating lessons learned and innovative thinking, the USDFC can create a new standard in development finance, and in doing so, strengthen US global competitiveness.

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