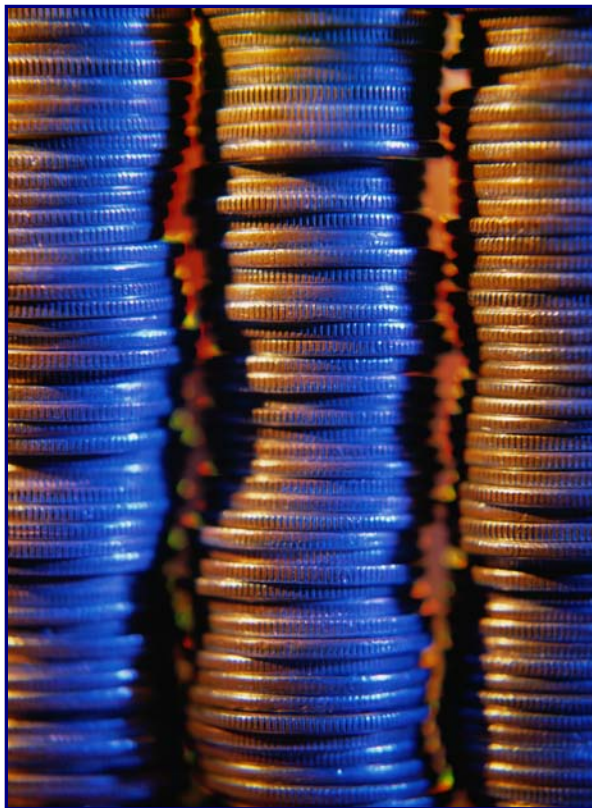


Challenge funds as private sector development tools: progress and potential¹

In recent years, challenge funds have emerged as an innovative way to engage the private sector to promote pro-poor economic growth and community development. The challenge fund model began in the 1990s as a British domestic policy instrument to identify the best project ideas for inner city regeneration, inviting private businesses and social enterprises to bid for public support. The model has since evolved through application by donors in developing countries to support private sector-led development work.



Philanthropists around the world are increasingly recognizing the importance of engaging with the private sector. Poverty cannot be eliminated unless jobs are created and wealth increased through economic growth and private investment. But poor people are not always included in the benefits from investment. In Africa, donors are addressing these points through inclusive market development initiatives, which have already demonstrated substantial impact. However, these programmes take a necessarily long view on development. Things like reforming regulations, building service sector capacity, reducing trade barriers, patching holes in value chains and increasing access to markets and information can take years, if not decades.

Enter – the challenge fund. Challenge funds provide an interim mechanism that can leverage the current capacity and creativity of the private sector to quickly reach poor communities. The idea is to encourage businesses to pursue innovative, commercially viable ventures that benefit the poor. Challenge funds have taken on a number of forms, with the common theme of providing risk-sharing finance that allows private

¹ This is one of a series of short pieces from KPMG IDAS Advisors designed to show forward thinking based on our extensive experience, that covers general development topics, fragile states, private sector development, governance, assessment and organisational development, renewable energy and adaptation to climate change. The series is edited by Julio Garrido-Mirapeix, Head, and Abijah Kanene, Manager – Market Intelligence Learning and Knowledge, IDAS Africa. This paper was written by Rachel Keeler, IDAS Impact and Evaluation Manager.

sector firms to test new pro-poor business models and technologies that might otherwise be dismissed as too risky.

How can we extend affordable electricity to poor, rural communities? Bring healthcare services to vulnerable people? Put more girls in school? Ensure smallholder farmers have access to quality seeds and markets to sell their goods? If these puzzles are solved by ventures that demonstrate commercial success, other businesses may follow suit, creating a crowding in effect. In this way, challenge funds are able to support economic growth and improve livelihoods in the near term, by channelling private sector capital, skills and creativity toward more inclusive activities.

This innovative approach offers a powerful development tool that can be applied at the community, national and regional levels. Challenge funds have been effective in sectors closely tied to poor communities, such as agribusiness and financial services, as well as through private provision of social services including health and education.

1. How does it work?

Pose A Challenge

The key distinguishing feature of a challenge fund is the challenge. Contests must be marketed widely with clear eligibility and selection criteria in order to generate a large pipeline of qualified applicants. The hope is to solicit a variety of clever and unexpected solutions to development problems from the private sector.

Look For... Pro-Poor Innovation + Commercial Viability = Social Impact

Challenge funds seek propositions that are innovative, because innovation disrupts the status quo and can instigate systemic change. They seek commercially viable businesses, because profitability promotes scale and sustainability. Add innovation and scale to a pro-poor business model, and you have the potential to impact a lot of poor people. The challenge is about leveraging existing capacity, so funds look for capable management teams. They also look for companies that engage with poor communities at the core of their business models – this can lessen conflict between the pursuit of social and commercial returns down the line.

Provide Additional Risk Capital

A challenge fund's main function should be to buy down risk on innovative projects to the "go ahead" point for private investors. In order to avoid market distortion, challenge grants should not compete with or displace available commercial capital. Fund managers must ask: "Would [not could] the project be funded without donor support?", and aim to provide the minimum amount of money required to make a project happen that otherwise would not.

2. What are the benefits?

A challenge fund's main comparative advantage is as a lean and transparent funding mechanism that can stimulate the private sector to test business models for which the risk-return profile is unknown, and by doing so unearth powerful new ways to make markets work for better the poor.

Posing a challenge to the private sector creates space for unexpected solutions. It searches for serendipitous outcomes, and recognizes that sponsors do not have all the answers. Challenge funds capture one of the private sector's greatest strengths: the ability to generate and test new ideas, the flexibility to rapidly abandon the failures, and the motivation to scale success.

When managed well, they can complement and partner with other impact investors and commercial financiers. They can also catalyse systemic change, either on their own or through synergies with other market development and investment climate reform programmes.



3. What have we learned?

The UK's Department for International Development (DFID) began experimenting with pilot challenge funds focused on financial deepening and business linkages in developing countries just over a decade ago. These first funds were limited in size and scope, but they produced some important lessons. DFID and other donors have since gone on to support a variety of funds covering everything from the Asian garment sector to construction in Nigeria and innovation in Malawi and the Caribbean.

The largest of these second generation funds is the Africa Enterprise Challenge Fund, a special partnership initiative of the Alliance for a Green Revolution in Africa (AGRA) and funded by several donors. The AECF² targets businesses working in agriculture, financial services, renewable energy and adaptation to climate change in Africa. AECF was launched in 2008 with an initial capitalization target of US\$34m. It has since grown into a US\$200m multi-window platform with 133 approved grantee projects and operating in 22 countries. Through this rapid expansion, AECF has tested and built on a number of the lessons learned through past challenge funds:

- **Sector focus:** Early challenge funds incorporated a variety of sectors in their investment theses. The model was subsequently refined to focus on a few specific industries closely linked to poor communities, such as agribusiness and financial services. This approach works well. Positive results have also been achieved by focusing on private provision of social services, namely health and education.



Sector- and country-specific windows can also bring productive focus within a larger challenge fund and promote systemic change.

- **Systemic change:** Experience has shown that if a fund manager selects projects strategically – especially when projects are clustered within a single country or sector – the portfolio can begin to develop value chains, improve market access for low-income groups, and even address legal and regulatory hurdles.³ This offers particular impact potential for philanthropists with specific interest in a single market or sector.

² The AECF is managed by KPMG IDAS. The AECF is funded by the UK's Department for International Development (DfID), the Australian Government Aid Programme (AusAID), the Ministry of Foreign Affairs of the Netherlands, the International Fund for Agricultural Development (IFAD), the Consultative Group to Assist the Poor (CGAP), the Danish International Development Agency (Danida), and the Swedish International Development Cooperation Agency (Sida)

³ Note AECF portfolio project examples: Introduction of innovative systems by AECF grantee, Biolands has improved market access and prices for cocoa farmers in Sierra Leone and is replicating this process in Ivory Coast. Together, AECF portfolio projects Protrade, Paperhole, and Kencor are transforming the agricultural inputs market system in Zimbabwe. And in Mali and Burkina Faso, grantee AGF Afrique Allianz is working to amend regional regulations on micro-insurance through the demonstration of innovative index-based crop insurance for smallholder farmers.

Funds can also work as part of, or in tandem with, larger business enabling environment programmes to propel market development.

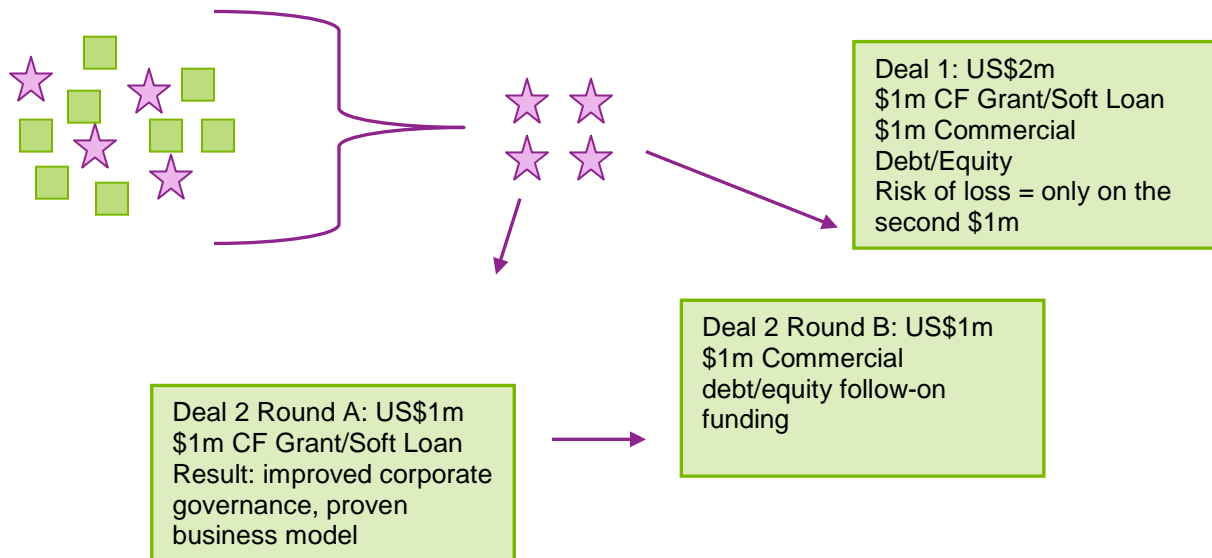
- **Strong fund management systems:** Generating and managing a large portfolio of relatively small grants can be costly. Batch funding requires strong systems in place to process a large number of applications quickly and efficiently. Assessment of applicant business plans and subsequent verification of grantee reports and impact research, which may often require travel to remote locations, must be as streamlined as possible to be rigorous, verifiable and cost-effective.

- **Matching funds:** Many challenge funds require grantees to match or exceed the grant amount with their own investment. This mechanism is meant to share risk, leverage private sector resources and promote value for money. However, defining what constitutes a matching fund can be quite tricky, and the requirement may disqualify otherwise qualified applicants who lack capital. While matching funds have long been a challenge fund mainstay, new funds such as DFID's ambitious £300m Girls Education Challenge fund are abandoning this requirement. A good alternative way to leverage private sector capital is to seek partnerships with commercial financiers.

- **Public-private funding partnerships:** The challenge fund platform invests a significant amount of time and resources into soliciting and vetting private companies (and/or in some cases CSOs and NGOs) in search of finance. This pipeline may be of interest to commercial investors, who often find it hard to locate good deals in emerging markets. In Africa, for example, the AECF has partnered with the Soros Economic Development Fund, a commercial impact investor, to co-finance companies in Zimbabwe and other fragile states. In these public-private partnerships, challenge fund grants can act as a sort of "first loss" subsidy to buy down risk and make a deal more attractive to a commercial partner such as an impact investor, private equity fund, debt lender, or even banks. The key to making these partnerships work is in aligning investment strategies, due diligence requirements, and valuations. Because they require certain corporate governance standards from their grantees, challenge funds can also identify and prepare companies for follow-on investments from private partners.



Companies apply to CF competition.... Pipeline of Vetted Deals



- **B2B Linkages:** Thanks in part to its large fund size, the AECF has been able to foster many productive business-to-business linkages between its portfolio companies. These connections are especially strong within country and sectoral windows. Fruitful connections have also been made between grantees working within the same value chains across the continent. Demand from grantees for B2B links has been clearly demonstrated and enhanced by the forum created by AECF for interaction between a select group of businesses all looking in some way at inclusive models.
- **Risk appetite:** A challenge fund must accept failure. By design, these funds seek innovative business ventures that are necessarily high risk. Some of these investments will likely be in start-ups, which carry a traditional failure rate in western markets of anywhere from 25-90%, depending on the metric.⁴ Should a challenge fund invest in start-ups? Novel ideas often come in the form of new businesses. However, most challenge funds are not set up to be active value-adding investors (like an equity holding venture capital investor would be). This is why they look to leverage existing capacity. In some cases, start-up management teams will have this capacity. In other cases they won't.
- **Repayable grants:** AECF is one of the first challenge funds to experiment with interest-free loans in addition to grant funding. Loans can promote value for money, build more flexibility into funding

⁴ Research released in September 2012 by Harvard Business School lecturer, Shikhar Ghosh, found that three-quarters of venture-backed startups in the US fail to return investors' capital. Slightly more optimistically, VC industry rule of thumb says that about three to four out of every 10 startups fail completely, while three to four break even on the original investment, and just one or two produce substantial returns. In emerging markets, a slightly higher failure rate might be expected due to the higher risk environment. See The Wall Street Journal, "The Venture Capital Secret: 3 Out of 4 Start-Ups Fail", 19 September 2012.

mechanisms, and help prepare portfolio companies for commercial funding down the line. It is too early to tell how successful this approach will be. Early experience suggests that a repayable element helps applicants to think beyond 'just applying for grant money'. However, loan management can pose substantial challenges related to monitoring and repayment enforcement where legal jurisdictions are weak.

- **Learning:** How best to monitor, evaluate and learn from a challenge fund has posed a host of questions for fund managers: How to measure social return on investment? How much impact is quantifiable and attributable to your work? What kind of reporting can you reasonably expect from grantees? How can you share lessons and encourage replication of business models without jeopardising individual business growth and profitability?
- **Challenge Fund as Impact Investor?** Basic challenge fund design began as a light touch instrument to provide matching grants for assets and small projects. It is easy to fund and monitor the outcome of say, a tractor purchased to benefit smallholder farmers. The mechanism has since evolved to support larger projects and entire businesses that show pro-poor promise. This approach increases the potential for impact, but begins to blur the line between challenge funds and commercial impact investors, resulting in some confusion regarding fund structure and where challenge funds fit in the financial ecosystem. What kind of investor should a challenge fund be? How can they be both cost effective and achieve maximum impact? How should they partner with other impact investors? These questions remain open for debate.

4. Limitations and complementary requirements



Challenge funds can be a powerful tool for private sector development. But they also have their limitations. To achieve both efficiency and impact, challenge funds rely on existing business capacity. In countries where the private sector is weak and the pool of qualified business applicants is shallow, other PSD approaches or a “challenge fund plus” programme may be more appropriate.

For example, in developing countries where agriculture dominates the economy but viable agribusinesses are scarce, nucleus

farm grant schemes can be an effective way to engage with the sector. These schemes support

smallholder outgrowers through a commercial farm hub. In other cases, nascent industries can be nudged along with the help of a technical assistance (TA) facility attached to the challenge fund mechanism. TA funds are also an option for donors that hope to engage with smaller, locally-owned or women-owned firms, which often require some form of support (particularly, financial management capacity). Experience has shown that technical assistance can be effective if it is flexible, carefully managed, and given to winning companies after their grants are contracted, in order to maintain a level playing field.

Many challenge funds are not set up to engage in business development. However, this may ultimately limit their ability to test the most innovative ideas or dig deeper into emerging markets. Companies in emerging markets often fall short on business fundamentals: they may lack experienced management teams, understanding of sound corporate governance, or rigorous financial systems. New ideas often come in the form of start-ups that require incubation support. And while some businesses can help address holes in the market system, others will remain helplessly constrained by them.

Recognizing these constraints, challenge funds must continue to explore ways to partner with value adding investors, make better use of TA facilities, exploit synergies with other market development programs and work with businesses to address the challenges they face while at the same time tackling the challenge of poverty reduction.

5. Lasting impact

In markets where challenge funds have an opportunity to flourish, they can have a lasting impact.

Amongst their grantees, challenge funds help to instil best business practice. In order to receive grant funding, companies must maintain good corporate governance and transparent financial management. Many winning bidders use grant funds to bring their internal systems up to par. They also learn the importance of community engagement through adopting environmental, social and governance (ESG) principles. This makes for better business, prepares entrepreneurs to engage at a higher level in global markets, and facilitates more interest from foreign investors who have strict standards for the businesses with which they will work.

Challenge funds also encourage new ways of thinking about markets and people. The real challenge is for businesses to take on a different mindset about dealing with the poor. Ultimately, demonstration of commercially viable, pro-poor innovation expands the private sector's concept of what is possible in regard to low-income markets.

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