Implementation Guide

Hybrid Financing: Combining Social Programming, Impact Investing, and Development Capital Structures

TOTAL IMPACT CAPITAL
JIM BULLION AND MICHAEL BROWNRIGG
APRIL 2018
The old models of aid and philanthropy—making grants and hoping for the best—no longer hold up in today’s world, especially for a new generation of leaders who seek sustainable solutions to poverty and insecurity, with the ultimate goal of helping people help themselves. As USAID Administrator Mark Green remarked upon taking office in 2017: “Aid should be striving to put itself out of business.”

Mobilizing private capital in coordination with government programs and philanthropy compounds the impact of social development initiatives and brings new approaches to old problems. This is the field sometimes called “impact investment” or “blended finance,” where many holders of capital come together to finance a project that will deliver both tangible (financial) and intangible (social or environmental) returns.

The promise of this approach is why Darren Walker, the President of the Ford Foundation, announced last year that Ford would place up to $1 billion of its corpus into mission-related investing over the next decade:

“We have come to believe that if we expect to overcome the forces of injustice and inequality, we need to expand our imaginations and our arsenals.”

As elaborated upon in our longer report, private capital flows to the developing world over the last decade, in aggregate, are more than double what the public capital flows have been. Moreover, private investment, if done well, is the gift that keeps on giving. It creates jobs, goods, services, taxes, and a higher standard of living. Taxes allow governments to establish their own social programs and priorities. Over and over again, whether it is in northern Afghanistan or western Virginia, policymakers understand the value of creating good jobs and the pride and stability that such jobs create for a community.

Clearly, the logic of impact investment as a way to support social objectives is a strategy that ought to inspire new thinking and tools among the development and foreign aid communities.

---

1 “I believe the purpose of foreign assistance should be ending its need to exist. … Each of our programs should look forward to the day when we can end it. And around the world we

2 https://ssir.org/articles/entry/unleashing_the_power_of_endowments_the_next_great_challenge_for_philanthrop.

And indeed, it has. USAID and the Aga Khan Development Network (AKDN), of which the Aga Khan Foundation (AKF) is a member, along with the Aga Khan Fund for Economic Development (AKFED) and nine other AKDN agencies, created two blended finance vehicles in 2013 and 2014 to tackle the immense development challenges in Afghanistan and Tajikistan, respectively. These novel public-private partnerships brought the aid expertise of both agencies together in coordination with the investment expertise of the AKDN, with the concept of investing in the regions that were the targets of foreign aid. The history and process by which these agreements came into being are described in our longer report.

The rationale behind each agreement was that the investments would give these communities something to work for and to believe in. With the expectation of profits, it was further agreed that a portion of all profits would support local grants and charity through a trust mechanism.

This document is meant to serve as a guide for organizations interested in designing similar blended finance partnerships, based on the lessons learned from these two AKDN USAID partnerships.

“Opportunities—the good ones—are messy and confusing and hard to recognize. They're risky. They challenge you.”

SUSAN WOJCICKI
CEO OF YOUTUBE

ENSURE A COMPATIBLE INVESTMENT STRATEGY BETWEEN ALL PARTIES

Impact investment makes lots of traditional operators uncomfortable: for the profit-first investor, it can feel like a breach of fiduciary duty if an investment is made that does not have an appropriate risk-adjusted rate of financial return, even if the social benefits might be profound. For the development officer or grant maker, putting taxpayer or philanthropic money into a profit-making enterprise raises concerns. This is exacerbated in a public-private partnership because of the added natural suspicion between the two worlds.

The benefits that can flow from such a blended or hybrid approach—think of the microfinance sector as pioneered by impact investor Muhammad Yunus—do not reduce the discomfort felt by participants in the moment.

Therefore, practitioners need to ensure that all parties are on board with the investment approach—including specifics on company size, sectors or stage of the investment, risk profile, return potential, and hold period. All of these factors lead to different choices about the style of investments to be made. There must also be clear understanding of different reporting and financial return requirements. For example, donors like USAID are obligated to report progress annually and have only a five-year window for most programs. Investors like the AKDN are more accustomed to taking more time when making investments in difficult markets and then to hold the investments for lengthy periods in order to grow them. This can lead to incompatibility in both vision and execution.
SOLUTION
Ensure all parties agree not just with the promise of investing with a social purpose, but with the related details: investment sectors, hold periods, management tools, sectors or stages of investment, and the path to liquidity. For agencies not familiar with these concepts, the easier decision may be to work with sister agencies who are comfortable operating in this space or to accept a very passive role in the investment process.

START WITH A PIPELINE OF INVESTMENT OPPORTUNITIES
Finding good deals is the greatest challenge for every investor. Frontier markets like Afghanistan make this hurdle even more acutely felt. Delays in identifying opportunities can cause loss of vital energy and goodwill or lead to skepticism and negative inertia. This lost momentum is especially problematic when senior leaders have invested their personal capital in the venture but can’t point to demonstrable results.

In reviewing the AKDN/USAID Global Development Alliances in Afghanistan and Tajikistan, the chief concern of all participants was the timeframe in which investments were made, which was exceedingly slow. After five years, the Afghanistan Multi-Input Area Development (MIAD) GDA has yet to conclude a single investment. The Tajikistan sister vehicle commenced with an investment in place: a significant investment in a microfinance bank that should have catalytic impact on enterprises in the region. That said, there is not a robust pipeline of opportunities behind it.

Deal flow is challenging to locate in many frontier markets due to weak merchant sectors, dearth of experienced managers and entrepreneurs, and small market sizes. In those markets or segments, additional investment or technical assistance grants may be required to build up the core of enterprises into which investment can be made. Several efforts globally that target frontier enterprises—the Transform Fund, an initiative of the UK’s Department for International Development (DFID) and Unilever, is one such example—consciously have a grant component and an investment component.

SOLUTION
To tackle this challenge, investors might consider partnering with sources that present solid startup opportunities and solid small enterprises, such as community banks (like First Microfinance Bank of Tajikistan) or accelerators/incubators (like Accelerate Prosperity or Endeavor’s entrepreneur accelerators). Consider creating grant components within the hybrid investment structure so that promising entrepreneurs can be assisted with grants and made “investment worthy.”

“In order to make 10 investments, the average venture capital firm reviews approximately 1,200 companies.”

SEAN JACOBSONH
EMERGENCE CAPITAL
TAKE RISKS, KNOWING SOME WILL FAIL

The fact that USAID and AKDN have spent 5 years in diligence to make a $1.5-million investment in an almond processing factory in Afghanistan is an example of significant risk aversion on both sides. Most standard venture funds, for example, make the bulk of their investments in the first 4 years, to allow time for growth and harvesting within their 10-year fund lifespans.

Risk aversion is not a great surprise: it is especially acute in government, where there is little celebration when risk taking produces positive results, yet potential serious career consequences if the endeavor is seen to have failed. This phenomenon is exacerbated when applied in conflict-affected or transitional countries like Afghanistan, due to the intense scrutiny from Congress that US officials working in the region receive. And it is further exacerbated by asking USAID officers to act outside their comfort zone or area of expertise when making investment decisions, or signing off on them. USAID insisted on maintaining this authority but had a hard time exercising it.

The importance of making decisions by taking calculated risks is critical when making early stage investments, especially in frontier markets. If the private sector were not willing to accept some level of failure, there would never be new drugs in the pipeline or self-driving cars.

SOLUTION

To ease execution with investment and risk taking, future public-private development partnerships that include investment strategies might become tripartite agreements—with USAID handling the development capital and Overseas Private Investment Corporation (OPIC) supplying the investment expertise or capital, given OPIC’s experience in assessing and investing in private sector development opportunities.

ENSURE AN EFFECTIVE INVESTMENT PROCESS

The investment process needs to work efficiently, which speaks again to a willingness to take risk.

USAID’s lack of experience or comfort with making investments was a challenge. The cultural divide between grant makers and investors, even within a single organization, is also found in many major foundations and philanthropies that are beginning to adopt impact investment as a core tool.

But there were delays and risk aversion also on the AKDN side, due in part to the small size and early-stage nature of the investment opportunities. The Aga Khan Fund for Economic Development (AKFED) is a successful investor in large part because it is a very careful investor, but that may not make it well suited to the
world of smaller, more nimble venture capital type investments in frontier markets. AKFED is also generally interested in making much larger investments and holding the enterprise for a long time.

One should be careful to marry the right investment managers to the opportunities. Investment expertise is specific to place, style, and size of investment. Teams who can make large-scale infrastructure investments are not generally the same teams who are good at small-scale, early-stage company investment, development, and management.

Take, for example, a rapidly growing and successful small enterprise, Rumi Spice, which stands in contrast to the aforementioned almond project. Founded three years ago by several young, Western-trained entrepreneurs, Rumi Spice is an Afghan-American company that grows, processes, and exports saffron. Today, it employs more than 1,900 women in Herat and exports its products globally. To this end, small enterprises can indeed be invested and gain success, but the execution has to be swift and the tolerance for risk has to be extant.

SOLUTIONS
Partner with or engage early stage investment experts who can identify motivated entrepreneurs, provide them with seed capital, coaching, contacts and other support, and allow them to build businesses and to demonstrate success (this is, essentially the venture capital model adapted for frontier markets and impact investing).

TRUST AND CONTRACTS
In launching the MIAD GDA in Afghanistan, USAID needed legal support to allow them to participate, if indirectly, in investments into private enterprises. While a “work around” was engineered and approved by USAID General Counsel, it proved to be somewhat fragile and subject to political winds. This then exacerbated officials’ caution around the innovative approach.

Even more than the legal contracting, trust is a crucial element for parties to work together. The two agencies had a lot of mutual respect but had not operated together on the commercial side. While trust was established at the most senior levels, it did not filter down to the working levels as easily.

SOLUTION
The legal framework on the government side must be rock solid and institutionalized. But there should also be a dedicated investment team created between the two agencies (assuming the government agency does not want a passive position), so that the government officials can be brought along on the investment diligence and structuring process—building trust and mutual competence and awareness.

“Wherever you see a successful business, someone once made a courageous decision.”

PETER DRUCKER
“When I got to Afghanistan, there was no coordination between agencies, which led to instability at the community level, which then created vacuums the Taliban were all too willing to fill. As we learned in Colombia, it was not building a soccer field that helped the community... It was building a soccer team and getting them uniforms and having the town be proud of them and root for them that built community cohesion. So we appreciated this hybrid development approach with the AKDN and its emphasis on taking an overall community-centered and integrated approach.”

KEN YAMASHITA
USAID FIELD OFFICER, AFGHANISTAN

CONCLUSIONS
Private investment that leverages a base of social development can create sustainable economic growth and support communities to become increasingly more self-reliant, which is the clear goal of both AKDN and USAID agencies, as well as development agencies and impact investors around the world.

While the first generation of the MIAD GDA accomplished many objectives, the investment plank did not perform to expectations. However, there are important lessons here that USAID, AKDN, and other organizations can learn from and build on for future projects that seek to “put aid out of business” and bring true prosperity, security, and hope to people in some of the most challenging and insecure areas of the world.