British
International
Investment

Our approach to investor contribution

2022 – 26 Strategy Period

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Our approach to investor contribution

British International Investment (BII) is the UK's development finance institution (DFI). Our objective is to have a positive impact on the sustainable development of the countries that we invest in, as articulated by the 2015 Sustainable Development Goals (SDGs) and Paris Agreement and in our 2022-2026 Strategy. As a UK taxpayer-funded DFI, we do that by adding to what private investors are doing. We would not achieve our objective if we displaced private investors, without making a difference to development outcomes, or if we allocated capital to businesses that are already impactful without increasing their impact.

The requirement for development finance to provide something beyond what the market offers and not crowd out private investors is usually referred to as "additionality".[1] Development finance must be additional for capital injections to qualify as Official Development Assistance, under OECD rules. Additionality means supplying inputs – financial and non-financial – that private investors would not. But whilst input additionality is necessary for impact, it is not sufficient. At British International Investment, we use the term "contribution" to refer to the difference that our additional inputs make to development outcomes.[2] The impact investing community has adopted the concept of investor contribution, and it is one of the six dimensions of our Impact Framework, which is based on the Impact Management Project framework.[3]

This note outlines our approach to assessing our contribution and its role in investment decisions.

Why 'additionality' and 'contribution' matter

- Contribution matters because it is necessary for development impact: we cannot have an impact on the lives of people in the countries where we invest if we are merely substituting for other investors, adding nothing. If we crowd out private investors, we risk inhibiting the development of private markets.
- We seek to understand our contribution to the impact of every investment, because our focus is on what we achieve, not on the inputs that we provide. We want to know *whether* we are additional and *how much difference* our additionality makes to development outcomes.
- For every investment, we require a contribution to development that is sufficient to justify the deployment of our capital and the time and effort of our staff.
- Our Investment Policy requires contribution (additionality) to be considered in every investment decision. The international rules governing the recognition of capital contributions to British International Investment as Official Development Assistance (foreign aid) require our investments to be additional.

1 Multilateral Development Banks' Harmonized Framework for Additionality in Private Sector Operations. World Bank Group. http://documents.worldbank.org/curated/en/839481540790602457/Multilateral-Development-Banks-Harmonized-Framework-for-Additionality-in-Private-Sector-Operations

2 The OECD uses the phrase "development additionality" to refer to the development impact of an investment that would not have occurred without the partnership between the official and the private sector.

3 The Impact Management Project is a practitioner forum for building global consensus on measuring, assessing, and reporting impacts on people and the natural environment.

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How contribution works alongside development impact

Contribution is one element of the larger development impact case for each investment. We assess the *impact of the investment*, which refers to the impact of the project or business plan that our investment would be supporting. This assessment has an implicit counterfactual of the project or business plan not going ahead. Then we assess our contribution to that impact as an investor, where the counterfactual is what would happen if we declined to invest (but another investor potentially does).

Our assessments of the impact of an investment is undertaken using our Impact Framework together with our portfolio-level impact scoring system that scores investments against our three strategic impact objectives of productivity, sustainability, and inclusivity.

The assessment of contribution as part of the overall development impact case covers:

a. The nature of our contribution.

b. Our confidence that we are doing something other investors would not.

c. The scale of difference that makes to expected development impact.

2.1 Who is responsible?

Our Investment Committee is ultimately responsible for the decision on whether our expected contribution to development is sufficient to justify the deployment of our capital and the time and effort of our staff. All members of our investment team are responsible for supplying the evidence and analysis required to enable an assessment of the nature, probability, and scale of our contribution.

2.2 Rating our contribution and its use in investment decisions

Contribution is not something that can be directly measured, because it requires a comparison of what happens if we invest against what would happen if we do not. Only one of those can ever be observed. Our approach to assessing our expected contribution is to ask ourselves the right questions and assemble the available evidence and analysis, so that we can arrive at a decision based on the balance of probabilities. Capital is scarce in the countries where we invest, and there is an urgent need for investment to create jobs and make more and better goods and services available at lower prices. Investment is about identifying and taking risks. We face the risk of making investments where we make no contribution to impact, and the risk of declining investments where we would have contributed to impact.

For decision making purposes we assign our expected contribution to four categories (none; low; medium; high). This rating reflects how we see the scale of contribution we expect to make to the impact of the investment, and our confidence that we are doing something others would not. Section 05 describes how these ratings are chosen.

Investment opportunities where we expect to make no contribution are rejected by our investment teams before being taken to Investment Committee. A low rating signals to the Investment Committee that our expected contribution as an investor is positive, but it requires careful consideration. The decision to invest is taken after considering the expected impact of the investment and our contribution rating together. The figure below illustrates how these elements are combined conceptually (note, no quantitative calculation is made):

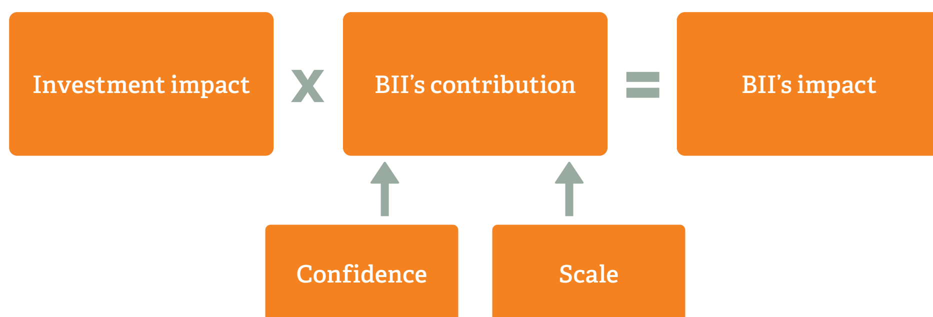

Figure 1: How we think about the impact of an investment and our contribution towards it.

Our impact as an investor is the product of the impact of the investment and our contribution to it. There are two reasons why we might apply a discount to the overall impact of the investment to arrive at our expected impact as an investor: confidence and scale. Sometimes we know that our contribution will only be responsible for a fraction of the impact of the investment. Sometimes, when an investment would probably go ahead without us, we cannot be sure how our contribution as an investor would differ from others. We place more weight on our contribution when we are surer of it.

Because our impact as an investor is the product of two things, the impact of the investment and our contribution to it, a low contribution should not be conflated with low impact. If the impact of the investment is small, then our impact as an investor is small even if we are responsible for all of it and our contribution is rated high. If the impact of the investment is very large, then our impact as an investor can be large even if we are responsible for a fraction of it and our contribution is rated low. A low rating is also not an evaluation of the performance of our investment team – sometimes putting together an investment where our contribution is rated high can be relatively straightforward, and an investment where our contribution is rated low can be extremely demanding and a great achievement. This implies that more activity does not mean more contribution. Some transactions can require a high level of support, but this does mean they should automatically be rated high.

The figure below illustrates how different combinations of the impact of an investment and contribution can produce a large enough expected impact to justify the decision to invest:

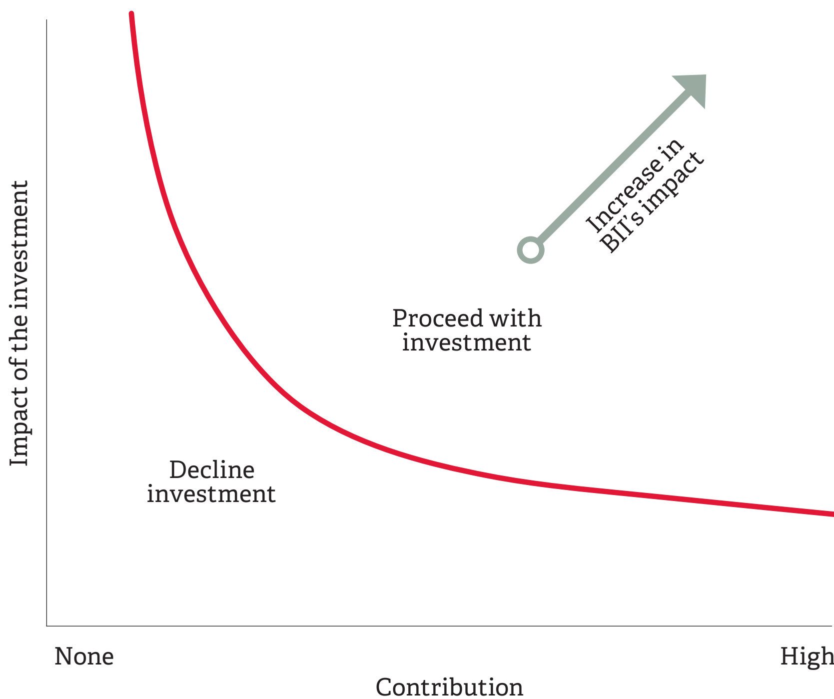

Figure 2: Conceptual illustration of the investment decision

Example

Suppose we are considering an investment of growth capital in a manufacturer that currently employs 500 people. After expansion, we expect it to employ 1000. The business is at full capacity and would experience no growth in the absence of the expansion, so the impact of the investment is assessed relative to that baseline. Our assessment of the impact of the investment would consider the quality of those jobs, who will get them, and what difference it will make to their lives. We would look at the environmental footprint of the expansion, any impact derived from the additional goods produced, and any other relevant impact considerations. We would also assess the risks that the realised impact of the investment might differ from anticipated. Alongside our assessment of the anticipated impact of the investment, we would rate our contribution to it:

- If we were confident that no commercial investor would provide suitable finance to the manufacturer, we would rate our contribution as high.
- If we think that a less ambitious expansion plan, perhaps employing fewer workers or serving different markets, would be undertaken if financed on terms available from private investors, we would rate our contribution as medium.
- If we think that there is some chance that expansion on a similar scale would be financed privately, but that without our involvement job quality would be lower and hiring practices would be less inclusive, we would rate our contribution as low.
- If we think that another investor would finance the expansion with no significant difference to the business plan or standards, we will rate our contribution as none and decline the investment.

The decision to accept or decline the investment would then be taken after considering the expected impact. of the investment and the nature of our contribution, alongside its financial profile.

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The nature of our contribution

Our contribution flows from the inputs that we bring to a transaction that a commercial investor would not. Our contribution can arise from either financial or value additionality, or both. Categories of financial and value additionality, as set out below, are recorded as part of the investment process. Mobilisation is a form of financial additionality (bringing private capital to an investment which would not otherwise be available).

Examples of where additionality can arise:

1. Financial additionality:
    a) Capital not offered at all
    b) Capital not offered in sufficient quantity
    c) Capital not offered on suitable terms
2. Value additionality:
    a) Processes and standards
    b) Management, skills, and human capital
    c) Job quality
    d) Gender
    e) Climate
    f) More developmental business plans
    g) Reputational improvement
    h) Knowledge and innovation
3. Mobilisation (a type of financial additionality)

3.1 Financial additionality

This refers to providing capital where it would not be offered at all by the private sector, or not in sufficient quantity, or not on terms which reflect the needs of the business. In some of the markets where we invest, long-tenor debt is unavailable, for example.

In uncompetitive and underdeveloped financial markets, financiers will offer only a limited set of products, and may also demand high returns and excessively strong rights and protections. As a result, the cost of capital is high and fewer projects that require external finance are viable, so the quantity of investment is lower. Lenders may also ration finance so that demand exeeds supply, in which case there will be projects that *are* viable at the prevailing cost of capital and yet cannot find finance.[4] In these situations, we can be financially additional by providing finance on commercial terms. In some circumstances, as justificed by the expected development impact, we may also offer finance on sub-commercial terms.[5] By providing flexible and patient capital, we can help enterprises achieve greater impact than would be possible when financed by purely commercial investors.

Terms of investment

By terms of investment, we mean the following attributes (not an exhaustive list):

- Interest rates (for debt) or enterprise valuation (for equity)
- Tenor of the loan (for debt) or intended investment period (for equity)
- Grace periods or flexible amortization schedules
- Mezzanine or innovative structures not otherwise available to the client
- Flexible collateral requirements

3.2 Financial additionality at a market level

Financial additionality is usually considered at a transaction level. But in market segments with a shortage of capital, meaning that some projects offering expected returns above a reasonable cost of capital cannot find finance, a DFI can have financial additionality at a market level even when displacing a private investor from an individual transaction. When the private investor displaced from a given transaction then deploys the money it would have invested in elsewhere in the same market, the overall quantity of investment in the market is higher, relative to if the DFI had not invested.

Even in markets where capital is scarce, there is often some competition for investment opportunities. Where the supply of capital falls short of demand, investors will make more opportunistic offers on less reasonable terms, they will more often fail to complete investments, and competitive fund-raising processes will fail more often. The likelihood of financial additionality is hard to assess in competitive fund-raising processes. The level of market activity and other signs of capital scarcity are some of the factors we consider when rating contribution. Although we would not assume our investments are always financially additional in frontier markets, the probability is higher, all else being equal.

4 There is a large body of theory and evidence concerning credit rationing when borrowers have private information. For an overview see Jaffee, D., & Stiglitz, J. (1990). Credit rationing. Handbook of monetary economics.

5 Guidelines covering the allocation of "blended concessional finance" were agreed by DFIs and MDBs in 2017. See https://www.ifc.org/wps/wcm/connect/a8398ed6-55d0-4cc4-95aa-bcbabe39f79f/DFI+Blended+Concessional+Finance+for+Private+Sector+Operations_Summary+R....pdf?MOD=AJPERES&CVID=npes1Dq

3.3 Value additionality

To simplify, if financial additionality increases the quantity of investment, value additionality increases its quality. We provide various non-financial inputs, ranging from our strategic advice and behaviour as a patient, impact-led investor, to a suite of services delivered on the ground, including those by our ESG, Climate, Gender, and Business Integrity teams.

As with financial additionality, we are concerned with establishing whether private investors would be likely to provide the same non-financial inputs, and whether what we do differently makes a material contribution to development outcomes. We may sometimes justify an investment solely because of our value additionality, but such cases require scrutiny to avoid crowding-out private investors on the grounds of value additionality that makes an immaterial contribution to development. The fact that we are engaged in a transaction and will require compliance with our minimum ESG standards does not necessarily in itself constitute a material contribution to development.

If we are investing alongside other public development finance organisations, our contribution may consist of what we add to the pool of non-financial inputs.

We can support investees to implement initiatives (e.g. job quality improvements or resource-use efficiency) which generate commercial returns that are appealing to the investee but which an external commercial investor would not pursue in our place. However, value additionality may sometimes create financial returns that a commercial external investor would pursue, in which cases we must carefully consider whether we are doing something others would not.

3.4 Mobilisation

In some cases, our contribution will include mobilising third-party investors. In such cases, the question of financial additionality extends to the participation of these investors: would they have offered finance in sufficient quantity and on acceptable terms, in the absence of our investment? The analysis of our contribution will extend to understanding how our investment, including non-financial inputs, contributed to the investment decisions of third-party investors.

In the context of assessing our contribution, consideration is only given to direct mobilisation, meaning capital invested by private investors as a result of our presence. We regard providing comfort to future investors as a form of non-financial additionality (reputational improvement), not mobilisation. Demonstration effects, whereby the success of our investments encourages private investors to make other similar investments (a form of indirect mobilisation) are considered as part of the impact of the investment, rather than our contribution.

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Special cases

The three variants of financial additionality (capital not available at all; not in sufficient quantity; not on suitable terms) apply generally, but some cases require further explanation:

4.1 Secondary transactions

A primary transaction involves raising fresh capital to be used by a business for investment and operations. In a secondary transaction – purchasing equity from existing shareholders or lending money that will be used to refinance existing debts – our capital is taken by previous investors and is not used to grow the business.

Secondary transactions are an example of investments where additionality is not sufficient to justify an investment. A secondary transaction may be additional, in the sense that no private investor would have done it, without making a difference to the impact of the enterprise. It can be more difficult in secondary investments to define what would happen if we do not invest. Our contribution will often rest on our ability to influence the strategic direction of the business to make it more productive, sustainable, and inclusive.

In the case of refinancing, if credit is not available elsewhere, rather than financing incremental growth, our contribution would consist of helping the business avoid the consequences of being unable to rollover its debts. Project finance transactions can be refinanced once operational at a reduced cost, which can deliver impact if passed through lower prices to customers.

A secondary transaction is sometimes combined with a primary fund raising, in which case the secondary portion can be seen as a price paid to participate in the primary. What matters is whether our contribution all told is sufficient to justify the total investment. In these, and other variants, what matters is the *difference* our investment will make to development outcomes. Changing a name on the shareholder register, does not in itself achieve anything.

In secondary transactions we do not consider any impact from the use of our funds by the previous investor who we are replacing.[6]

6 In the case of privatisations, licenses fees to governments may be considered as part of the businesses impact.

4.2 Co-investments, follow-on investments, and rights issues

In general, in these instances, the same questions should be asked: would finance be available in sufficient quantity and/or on suitable terms from private investors, and does our contribution justify the investment?

In some cases, commitments to follow-on investments will have been made in initial investment plans and should be honoured. Usually declining an investment comes at no cost to BII, but if we decline to participate in a funding round by an existing investee, that can sometimes result in a financial penalty. In those cases, a smaller contribution would be required to justify participation.

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Choosing a contribution rating

Choosing a rating necessarily involves making judgements, informed by data.

Our investment teams are responsible for asking themselves the right questions to test the likelihood of financial or value additionality, as appropriate in the context of the investment in question. Some potentially relevant questions are:

- Based on what we know about the availability of capital in the market—sector and geography—are there examples of recent private investments that resemble the investment under consideration, in the same market?
- Does the business require finance of a certain quantity or on certain terms to be viable or to meaningfully increase its probability of success? Do we observe finance on those terms available in the market?
- What do we know about the investee's efforts to raise finance from private investors?
- Does the investment in question have characteristics that explain why superficially similar businesses could attract private finance, but this business could not?
- Is the market in a down-cycle? (would the investment be counter-cyclical?)
- Is the investment part of a country's national investment or development strategy, where it has already been determined that capital is lacking and DFIs like BII are needed?
- Is the investment pioneering new markets or business models?
- What does the risk return profile look like? The more appealing the investment is as a commercial proposition, the less likely we are to be financially additional (all else being equal).
- How deep has our engagement been with the investee? Have we observed material changes in the business plan, ESG practices (or commitments), or other practices (perhaps relating to gender or climate), as a result of our engagement? Can we document that?
- How much influence do we really have over management (e.g. seat on board, on committees)?

- If we are offering non-financial services, do we have real expertise and a track record of delivery? Have we dedicated the resources needed to follow through?
- Do we have evidence the firm values our non-financial inputs, will there be meaningful consequences if they fail to implement what is proposed, will we receive reliable metrics to monitor implementation?
- How do the non-financial services that we propose to offer differ from those typically offered by commercial investors (who may also pay for ESG consultants, offer strategic advice etc.)?
- For funds, is our investment needed to get to a viable first close or a viable size? Have other investors in the fund expressly stated a desire to see BII commit? Have we helped educate inexperienced fund investors, or built the fund manager's capacity?

The assessment of contribution should be proportionate to the risks involved in the decision being taken. A case where there is signficant risk of crowding out private investors requires more consideration and evidence than a case where our investment is clearly additional. Our analysis of contribution is not intended to be exhaustive, but to capture the most significant things we are doing which make a difference to impact. These should be things we are commited to delivering and have agreed with the investee, not potential opportunities which may or may not arise during the course of the investment.

For further information:

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