British International Investment

Insight

Investing for impact in African private equity funds

Practical thinking on investing for development

Insight is a series of practical and digestible lessons on the issues of private sector investment and development. They're based on our experiences, knowledge and research and are aimed at investors, businesses, development professionals, and anyone with an interest in private sector development.

Published: September 2024

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Executive summary

Development is stifled when businesses cannot access the capital they need. Different firms have different needs at different times, and the efficient way of investing to meeting those needs depends on the nature of the finance being supplied. That is why BII invests across the capital spectrum, both directly and via a range of different intermediaries.

This paper is about private equity funds, with a focus on Africa, and their importance to our mission of promoting productive, sustainable, and inclusive development. It explains the importance of equity for development, why we use intermediaries, and it describes some of the impacts that fund managers have achieved. It also discusses some of the challenges of fund investing, the recent financial performance of African funds, and how lessons learned have helped shape our current strategy.

Equity is a form of risk-bearing capital. Loans create vulnerability because debts must be paid come what may, whereas firms only pay dividends to equity investors when they are in a position to do so. Private equity has a chequered reputation in advanced economies, often linked to the practice of leveraged buyouts. The fund managers that we support do not typically borrow to finance acquisitions and generally seek financial returns from successful companies becoming more valuable as they grow, not from dividends. Fund managers do more than provide capital to help firms grow, they also professionalise management teams and introduce better practices to improve performance.

Risk-bearing capital is especially important for development because it is needed to finance pioneering and ambitious business plans. It helps young companies become credit worthy, and it cushions lenders against risk. Equity is in short supply in Africa. In many African countries, companies have few options for raising equity from external investors, other than from the private equity funds backed by development finance institutions (DFIs).

The role of equity in financing more ambitious, higher risk business plans is borne out by the data, which shows that both average growth rates, and the variance of growth rates, are significantly higher among the companies in our private equity (PE) fund portfolio than among typical businesses in Africa.

PE funds give investors access to local investment origination and management capabilities, and allow them to pool resources to diversify risk. Without PE funds, our capital could not reach so many businesses in Africa, especially those too small for us to invest in directly. But fund managers are more than just a means of deploying capital, they also play a critical role in Africa's development, as the part of the continent's financial system most capable of investing risk capital in the real economy.

In less developed markets, or when the fundamental problem is a lack of risk capital across the board, we will sometimes support generalist fund managers that invest across a range of sectors. These managers have found highly impactful investments in sectors such as manufacturing and business services, and they are also a source of co-investment opportunities that we choose based on impact considerations. In more mature markets, we often find managers that specialise in high impact sectors, such as inclusive finance, forestry, agriculture, and climate technologies. In all cases, we look at impact across the manager's portfolio, recognising that some individual investments will be higher impact than others.

The development of robust in-house capabilities at fund managers, including impact and environmental, social and governance (ESG) management systems, is crucial to our objective of creating sustainable investment businesses that can attract investment capital and invest it responsibly. At BII, we can help fund managers raise money by giving them a vote of confidence and anchoring their funds with our capital, but our support for capacity-strengthening can be equally important.

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Acknowledgements
The authors gratefully acknowledge helpful comments and suggestions from Duncan Green, Martina Castro, Fadi Bassir, John Owers, Andrew Brown, Emanuele Colonnelli, Ezgi Kiris, Guy Alexander, Craig Gifford and Adam Boros.

Our legal agreements with fund managers require them to comply with our Principles of Responsible Investing. These cover business integrity (corporate governance and anti-corruption) and environmental and social risks. One of the most important ways in which DFIs have a positive impact on development is by working with companies to bring their business practices up to international standards, and beyond, sometimes starting from unfavourable initial conditions. We want the fund managers that we support to do the same.

Delegating investment decisions to fund managers is integral to fund investing. We, along with other investors in a fund will agree to its strategy, which includes defining excluded categories of investment, but managers have independence subsequently. As with any delegation of responsibility, things sometimes go wrong. Our role is to select the right fund managers, help them develop their capabilities, and then try and spot problems early and take active steps to resolve them.

The financial performance of fund managers matters. We want them to be sustainable financial institutions that are capable of attracting capital and investing it responsibly. African fund managers have faced an extremely challenging macroeconomic environment in recent years, with currency devaluations making it harder to generate competitive dollar returns. In many African countries, financial markets are at a relatively early stage of development. This means it takes more time for fund managers to find and transact investments, to help companies reach their potential, and to find buyers. These hinderances often make it harder to generate returns that compete with those available in other markets. But the same could have been said of India a couple of decades ago, when the market was similarly immature. With the support of DFIs, the Indian PE industry is now thriving.

Our strategy towards African PE has evolved over the years, in the light of what we have learned. Those lessons are summarised in section 8.2 of this report. Our view is that the African PE industry would benefit from a period of consolidation with growth tilting towards new funds from established managers, although we will support some first-time managers where the impact case justifies it. African companies do not have an adequate supply of risk capital from commercial sources, meaning we still see a general need for DFI capital across the PE market. We are not yet at a stage where DFIs can concentrate on the frontiers of the industry, as we can in India. We allocate our capital by considering three categories of fund manager: ‘strategic funds’ that often target larger firms in core sectors such as manufacturing, consumer goods and business services, and where we look for access to impactful co-investment opportunities; ‘impact-aligned funds’, which are explicitly targeting impact outcomes that fit with our impact priorities while seeking commercial returns, and ‘catalyst funds’, where we are willing to face risks without fully compensating expected returns, for the sake of impact.

The supply of risk-bearing capital to young firms and older firms with expansion plans is tremendously important for the development of African economies, as is the support that investors provide to improve management practices in those firms. Growth-oriented and impact-aligned PE funds are indispensable partners to us, both because they enable us to reach more firms than we could directly, and because they are important in their own right to Africa’s economic development.

1

Introduction

Developing economies typically consist of a few large firms, more medium firms, even more small firms, and many more microenterprises. For example, the Kenyan economy comprises around 1.4 million micro, 110,000 small, 11,000 medium, and 200 large enterprises.[1] These diverse collections of firms have very different needs, not just in the quantity of finance they require but also the nature of that finance. At BII, we see opportunities for impact in firms of all sizes. That means we want to find efficient and effective ways of investing to ensure that all businesses with the potential to grow and contribute to development get the type of finance they need.

The *type* of financing needed by these firms is important for development, because development involves the growth of more productive firms, to create better jobs and produce new or improved goods and services, and firms often need patient and risk-bearing capital to finance growth. Vibrant economies that create jobs and pathways out of poverty require entrepreneurs to try new things and firms to pursue ambitious business plans. Economic development has famously been called a process of self-discovery through experimentation, to learn what can be produced profitably, and how.[2] Experimentation requires the right type of capital that rewards risk-taking. Equity is risk-bearing and enables firms to handle the uncertainties of more pioneering business plans.[3] Conversely, debt requires predictable cash flows. It creates fragility because it needs to be repaid regardless of how a business is faring. African economies need risk-bearing capital to help companies scale-up and become credit-worthy.

1 SME Finance Forum MSME Economic Indicators, available here: https://www.smefinanceforum.org/data-sites/msme-country-indicators and S&P Capital IQ.

2 See Hausmann & Rodrik (2003) *Economic development as self-discovery*, and also Kerr et al (2014) *Entrepreneurship as experimentation*.

3 See Meki (2024) for an introduction to the role of equity financing.

New firms often turn to equity financing when they are loss-making or lack assets that can be used as collateral. For businesses with the potential to scale rapidly, often technology-enabled, venture capital (VC) funds specialise in backing high-growth start-ups. But equity financing is suited to early-stage businesses of all kinds. Traditional private equity focuses on older, more established companies that they can help to expand and increase their impact. We want to reach all types of companies that need risk-capital, and we work with all varieties of fund managers that are looking to generate returns for their investors through the growth of the businesses they invest in.

This paper is about our investments with those fund managers. Investing via funds enables us to pool our resources with other investors to reach places we couldn't reach ourselves. Without PE funds we couldn't make as many equity investments in small and medium-sized firms.[4] But fund managers also find more investment opportunities in larger firms than we could alone.

We also want to help fund managers build their own institutional capabilities and adopt responsible investment practices, because deepening Africa's financial sector, and improving how business is done on the continent, will mean more domestic and foreign capital invested in Africa's real economy.

PE funds can be seen as a solution to a general shortage of risk-bearing capital in Africa, but in deeper markets with sufficient investment opportunities, fund managers can pursue more targeted strategies and specialise in certain sectors, such as financial services, infrastructure, agriculture, or climate technologies. These specialist fund managers can help us meet particular impact objectives.

The most important way in which PE funds have an impact is by providing growth capital to firms that want to finance expansion. The equity finance raised by firms can used to construct buildings, acquire equipment and technologies, expand production or distribution, develop new products and services, fund acquisitions, develop intellectual property, or to pay for working capital (inventories of inputs and finished goods) and cover other operating overheads.

But providing finance to firms is not the only way in which PE funds can achieve impact. Fund managers also often bring management expertise with them. This expertise can help companies develop their strategies, strengthen their management teams, bring sectoral or thematic knowledge, build capacities and improve their governance, and fund managers' business networks can help firms find suppliers and customers.

PE funds will also often acquire businesses from previous owners, without injecting new capital into them – known as a secondary transaction.[5] In those cases, fund managers can add value and achieve impact through non-financial means. The introduction of outside shareholders is sometimes accompanied by the transition of a business from being founder or family run to being run by a team of professional managers that can take the business to the next stage. A lesser degree of delegation to 'outside' managers is a striking difference between firms in developing and advanced economies, and contributes to lower firm productivity in the former.[6] However, the PE fund managers that we and other DFIs support in Africa generally do not practice leveraged-buyouts and other means of extracting financial returns through financial engineering.[7] Instead, their incentives are to generate returns by improving productivity and delivering growth.

4 Our Insights paper *How and why we finance SMEs*, available here: https://www.bii.co.uk/en/news-insight/insight/articles/how-and-why-we-finance-smes/ describes how we supply capital to SMEs in the form of loans and mezzanine products. It also includes a summary of the evidence concerning the development impact of SMEs, which is omitted from this paper.

5 Some transactions have both primary and secondary components, where new funds are raised for the business and previous owners are wholly or partially bought out.

6 Akcigit et al. (2022) explore how a lack of managerial delegation can explain why firms in poor countries are small, with important aggregate consequences

7 A leveraged buyout is the acquisition of a company that is financed largely through debt that is often collateralised by the assets of the company being bought, and the debt effectively becomes the liability of the business that has been acquired. When this high-risk tactic goes wrong, it can result in bankruptcy and job losses. Press coverage tends to focus on buyouts with bad outcomes, but a more thorough examination of the track record of all PE buyouts finds more mixed results, with increases in firm productivity and employment following buyouts on average, in some circumstances. See Davis et al. (2021)

We do more than provide capital to fund managers. By working with fund managers, we can help them to refine their strategies and strengthen their responsible investing practices and corporate governance. By helping them build operating capacities we can have a lasting impact beyond the life of our direct relationship as an investor in their funds. We explain in Section 4 how our Policy on Responsible Investing applies to fund managers. As well as working directly working with fund managers to improve their systems during and after investment, we also offer open training workshops on topics like impact management, business integrity, environmental and social risk management, climate, and gender diversity. These workshops aim to influence business practices beyond our immediate investments. In turn, fund managers can influence the way their investees do business, for the better.

Fund managers are responsible for their own investment decisions and portfolio management. We, along with other investors, approve the fund strategy and set boundaries for managers and agree information reporting requirements.[8] To build lasting and self-sufficient financial institutions capable of attracting capital from multiple investors and investing it successfully, it's essential that fund managers make independent decisions and develop strong internal systems. But as with any delegation of control, things can go wrong when decisions taken deviate from the agreed strategy and the flow of information breaks down. When we invest, we need to be confident of impact alignment, commercial abilities, and integrity, but sometimes that confidence is misplaced. This is one of the risks of fund investing that we manage, and highlights the importance of fund manager selection and building the capacity of fund managers.

Like all DFIs, and as with our direct investments in firms, we sometimes support intermediated investments that face higher risks and offer lower prospects for generating financial returns than purely commercial investors would accept. Moreover, we will not invest in funds that can attract all the capital they need from commercial investors. For this reason, the financial performance of our entire fund portfolio is not necessarily informative for commercial private investors, who may take different fund selection decisions. Many fund managers report their financial performance, with the permission of their investors, to industry bodies – we cite that data in Section 8.1 of this report.[9]

PE fund investments in emerging and developing markets have outperformed other asset classes in other regions in the past (Cole et al., 2020) and African PE funds saw periods of strong financial returns in the 2000s and early 2010s, driven by more favourable macroeconomic trends (Devine et al., 2021). More recently, returns have underperformed benchmarks. Asset classes in different regions naturally overperform or underperform each other over different periods, and while the last few years have been very difficult on the continent and problems remain, over the longer-term Africa has much to be optimistic about. Section 8.1 discusses financial performance in more detail.

We invest through funds so that our capital can reach firms that need it, but funds are also an instrument for mobilising more private finance in Africa. They offer a combination of investment origination capabilities and portfolio management expertise, as well as the means of pooling funds with other investors and diversifying risk. This makes them an ideal entry point for private investors that want exposure to Africa and want to allocate capital where it can have the most impact, but may be unfamiliar with African markets.

8 These boundaries include, but are not limited to, the excluded activities listed in our Investment Policy, available here: https://assets.bii.co.uk/wp-content/uploads/2021/12/14080613/investment-policy-2022-2026.pdf

9 As one Limited Partner among many, we also typically do not have the right to disclose the financial performance of individual funds.

There are many different types of private investor. Some impact investors are willing to tolerate elevated risks and take a more long-term view of a developing market, but we believe there are identifiable strong commercial performers in the African PE market that should be attractive to traditional commercial investors that take decisions based on a competitive risk/return and diversification considerations. Our current approach towards asset allocation to funds is intended to optimise the impact and mobilisation potential of our funds portfolio. We categorise funds in three groups:

1. **Impact-Aligned Funds** that offer a compelling risk/return profile and are strongly aligned with our impact objectives.
2. **Strategic Funds** that also offer a compelling risk/return profile, supplying much-needed equity to African firms and also generate co-investment opportunities we can select on impact criteria. The number of relationships we want with such fund managers is limited.
3. **Catalyst Funds** that are pioneers with a higher risk profile, enabling us to explore new ways of shaping nascent markets and building more inclusive and sustainable economies.

All our fund investment decisions are taken to maximise our impact across a portfolio that respects the risk/return parameters set by our shareholder. Our portfolio combines different fund managers with different impact, risk and return profiles. Not every fund manager is as explicitly impact focused as we are, but it is incorrect to presume that only impact investors have impact. We want to encourage the development of the commercially-oriented financial sector in Africa, and there is ample evidence of how important that is for development (see Section 5).[10] This strategy – discussed further in Section 8.3 – reflects our experience over the decades as one of the largest investors in African PE funds.

This report is intended to give readers the background to our support for PE funds and why they are so important to our development mission. It is written both for readers who are unfamiliar with the workings of PE funds and for those who know private equity well. We use the term 'private equity' broadly to refer not only to the purchase of 'ordinary shares' in a business, but also hybrid instruments ('structured equity') that may include some debt-like repayments. The word 'private' means investments that are negotiated directly with firms and not made by purchasing instruments traded on a public market, such as a stock exchange. A narrower definition would distinguish traditional private equity from other models, such as venture capital, but we intend to refer to all varieties.

We start in the following section with a short history of PE in Africa, where the industry is yet to follow the trajectory seen in India. We then compare our PE portfolio against the African PE industry more generally, and against our direct equity investments. Section 3 explains why the risk-bearing nature of equity is important, and how it differs from debt, seen from both the firm's and investor's perspectives, before describing what PE funds are and how they operate. Readers already familiar with different financial instruments and the operations of fund managers may skip this section.

Section 4 tackles the question of why we invest via funds rather than only investing in equity directly, explaining how investing through funds allows our capital to reach more firms in more countries than we could otherwise, enables us to influence how business is done in Africa, and mobilises private investors.

We then turn to the evidence that equity is important for development in Section 5, which is supported by comparing revenue and employment growth rates in our fund portfolio against those of African firms more generally. Section 6 discusses how we look at fund investing through three lenses: the age of firms, the sectors the funds invest in, and the impact objectives they help us achieve and Section 7 looks at how we monitor impact. Section 8 explores the historical financial performance of funds, what we have learned about how to invest in funds successfully, and how this has informed our current approach to asset allocation through funds.

10 Our blog Why the financial sector matters for development, available here: https://www.bii.co.uk/en/news-insight/research/why-the-financial-sector-matters-for-development/ presents some of the evidence.

2

An overview of PE funds in Africa and Asia

Over the last few decades, our primary markets of Africa and South Asia have been on different trajectories. Panel b) of Figure 1 of Figure 1 shows the PE industry in South Asia – dominated by India – has seen explosive growth, but the African market has not. Panel a) shows that the growth of PE investing has been accompanied by growth in the value of the economy-wide quantity of private capital (buildings, machinery etc.) per person in South Asia.

We were an early supporter of pioneering PE funds in South Asia. As that market matured, first with the entrance of local institutional investors and then global commercial private investors, our strategy has evolved. We no longer support generalist PE funds in India, and we now focus on venture capital and impact-aligned fund managers operating on the boundaries of commercial appetites. Rising investment in India, and to a lesser extent Bangladesh, has delivered rising living standards. That is not to say the battle is won – these countries still have very large populations living in poverty and therefore remain priorities for us.[11]

Africa is a different story. It is a continent of 54 different countries, thousands of languages, and over 7,500 cities so generalisations can be misleading.[12,13] However, looking at the continent-wide aggregates, African economies have seen hardly any capital deepening, and the PE industry is yet to take flight. The African PE market is at a much earlier stage of development, with fewer well-established fund managers with demonstrable commercial track records, more early-stage managers, and more active support from DFIs. Private equity is an industry that benefits from virtuous circles; the better it performs, the more firms will seek equity finance and the more exit options there are for managers (see Section 8.1.2). African fund managers are operating in a less conducive environment than those in India.

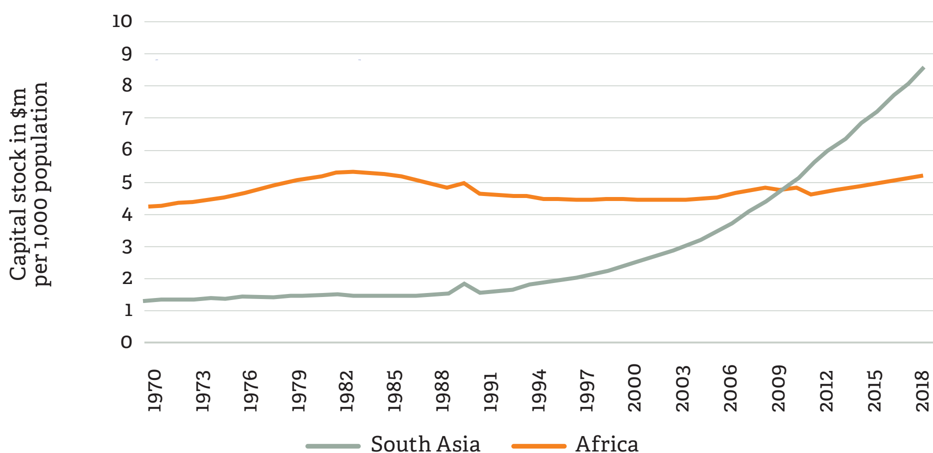
11 See our Insights paper Investing for Impact in India, available here: https://www.bii.co.uk/en/news-insight/insight/articles/investing-for-impact-in-india/#:~:text=We've%20been%20a%20long,is%20valued%20at%20%242.2%20billion for an overview of our investments.

12 The African Language Program at Harvard, https://alp.fas.harvard.edu/introduction-african-languages

13 African Development Bank Group, https://www.afdb.org/en/documents/africas-urbanisation-dynamics-2022-economic-power-africas-cities

But there are encouraging structural parallels between Africa today and South Asia decades ago: a young, ambitious and rapidly growing population, rapid urbanisation and an emergent middle-class, and with the process of structural change underway but at an early stage. Many African economies remain dominated by small informal businesses, and with much of the population still working in small-scale agriculture. Some new considerations are also evident. For example, there is much potential for digital technologies to transform economies and connect firms with workers and customers in ways that were previously not possible. Many African countries are also endowed with renewable energy resources that offer the promise of relocating energy-intensive economic activity to the continent. While the focus of this paper is on Africa, we introduce some lessons from our experiences in South Asia where relevant.

a) Private capital stock per person, 1970-2019



b) Total private equity investments ($m), 2008-2022

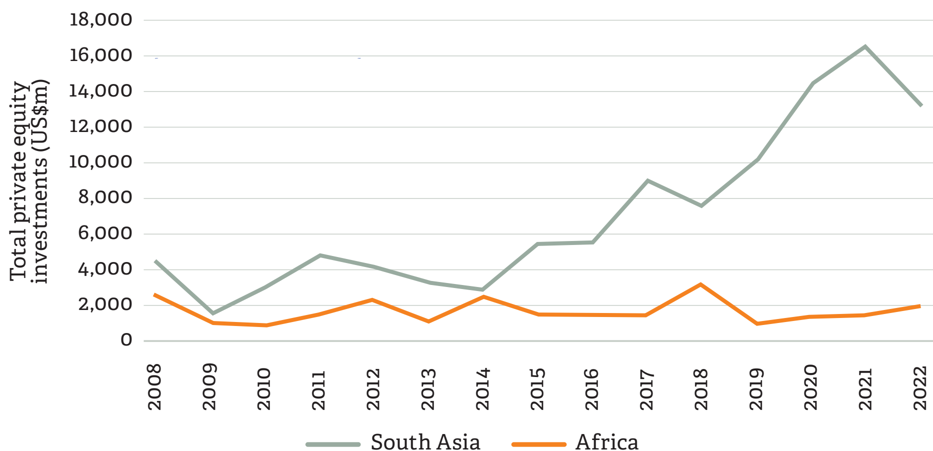


Figure 1: Private equity investment and capital accumulation on different trajectories in Africa and South Asia
Source: IMF Fiscal Affairs Department's Investment and Capital Stock Database, World Bank World Development Indicators, and GPCA.

2.1 A short history of PE in Africa

Private equity is “as old as capitalism itself”, but the modern era of PE funds emerged in the US in the 1980s.[14] The birth of PE in Africa came later in the 1990s, and, unlike in developed markets, DFIs were the parents. Those pioneering Africa-focused fund managers could engage with African corporates and help them develop the experience and skills needed to drive growth. This, in turn, helped create capacity for new private equity practitioners to enter the market and build upon their achievements (AVCA, 2018). DFIs backed some of the earliest fund managers that appeared in South Africa, and helped see the industry grow – from 12 fund managers in 1997 to around 140 two decades later.[15] Early South African fund managers included Ethos, founded in 1984, Emerging Capital Partners, founded in 1990, and Horizon, founded in 1996. South Africa dominated the African industry in its first decades, but we also established some single country funds elsewhere in Africa, including the Ghana Venture Capital Fund and the Acacia Fund in Kenya, “at a time when no one else was making this kind of bold commitment” (Brain & Cable, 2008). In 1997, Takura Ventures launched its first fund, managed and anchored by BII, which successfully invested in Zimbabwean businesses in challenging macroeconomic circumstances.

Africa still accounts for a tiny proportion of the global PE market (Figure 2).[16] Between 2013 and 2021, there were an average of 21 funds raising money per year, raising a combined average total of $1.9 billion.[17] Over the same period, the average annual amount raised globally was $427 billion, meaning Africa accounts for less than 0.5 per cent of the market.[18] The US dominates, typically accounting for around half of the total, and in recent years its share has risen. There has been a global trend towards a concentration of commitments to large funds, with smaller and newer managers finding it more difficult to raise capital (McKinsey & Company (2023)).

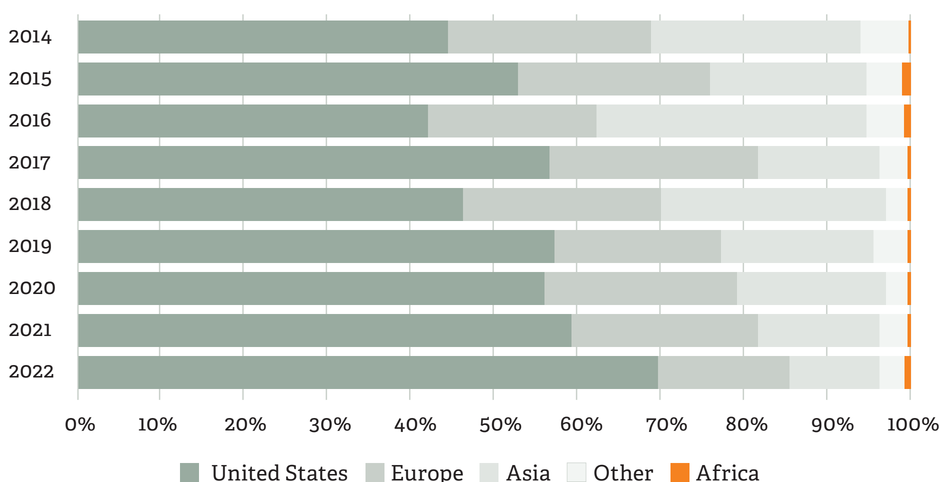


Figure 2: Share of PE fundraising by region, 2014-2022
Source: Pitchbook, data download 21 November 2023.

14 *The Wall Street Journal* (2012), ‘A Short (Sometimes Profitable) History of Private Equity’ by John Steele Gordon, available here: https://www.wsj.com/articles/SB10001424052970204468004577166850222785654

15 AVCA (2016), Guide to Private Equity in Africa, available here: https://www.mfw4a.org/publication/guide-pe-africa

16 The discussion in the previous section focused on Africa and South Asia, BII’s primary markets. Here we present data on the global PE picture, and ‘Asia’ refers to all Asian markets, including major East Asian economies such as China and Japan.

17 GPCA (2023). Data as of 30 September 2023.

18 Pitchbook (2023) Global Private Market Fundraising Report Q2 2023.

Figure 3 shows that the gap in fund raising (as opposed to investment) by General Partners (GPs) between Asia and Africa has grown – based on the averages over 2006-10 and 2018-20 the gap has more than doubled from $15.6 billion to $36.1 billion.[19] PE fundraising in Asia has grown fairly consistently – with the exceptions of 2009 and 2020 (the onset of the Global Financial Crisis and the Covid-19 pandemic). In Africa, it has flatlined. Figure 3 also reveals that the average size of Asian funds has grown consistently over this period, while in Africa there has been a moderate decline. The average fund size across all regions increased from $386 million in 2015 (948 funds) to $609 million in 2022 (1,305 funds), in Asia it increased from $338 million (65 funds) to $512 million (61 funds), and in Africa it declined from $152 million (21 funds) to $45 million (17 funds).[20]

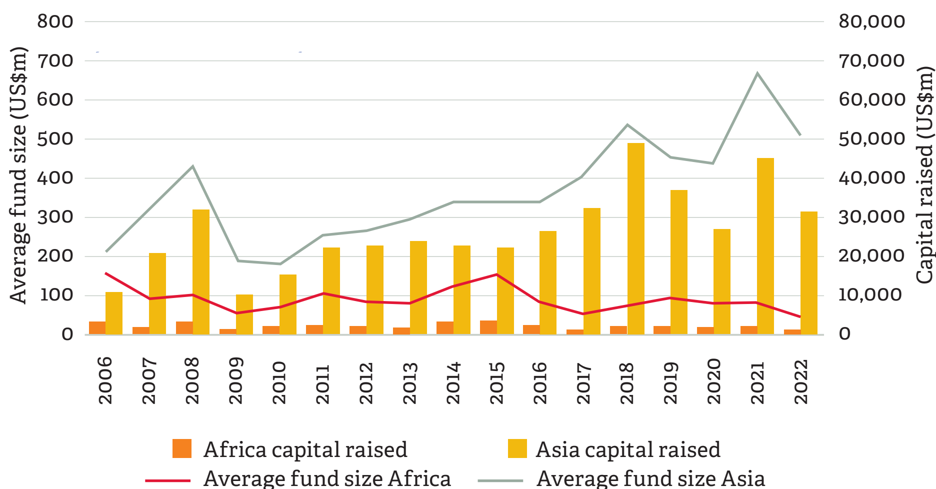


Figure 3: PE in Africa and Asia: Total capital raised and average fund size, 2006 to 2022
Source: GPCA.

PE in Africa has historically been highly concentrated in a few countries. South Africa still accounts for almost a third of average flows between 2008 and 2022. Egypt, Kenya, Morrocco, and Nigeria account for another third.[21] Figure 4a shows African countries' shares of the value of country-specific PE investments compared to that country's share of African gross domestic product (GDP). Figure 4b shows the same thing for our fund investment. Countries in dark orange received more PE investment relative to the size of their economies and dark grey received less. Mid-tones receive investment proportionate to GDP and white indicates no data.

The African PE market is small and most funds have received support from DFIs. Therefore, there is no room for DFIs to deviate too far from the market's overall pattern, but our portfolio is clearly more weighted towards lower income countries. First, there are several countries in which our funds have invested where the Global Private Capital Association (GPCA) reports no PE investment, such as the Democratic Republic of Congo (DRC), Burundi and Somalia.[22] Second, we are underweight in South Africa, compared to the overall PE industry. Nigeria – the country in Africa with the highest absolute number of people living in poverty – is a major destination for PE investments in absolute terms, but still receives disproportionately little investment relative to its GDP. By contrast, our portfolio is more in proportion to the size of its

19 The right-hand panel of Figure 1 showed investments by PE funds and there can be a long lag between fund raising and deployment

20 GPCA, data as of 30 September 2023

21 GPCA, data as of 30 September 2023

22 Not every fund reports its activities to organisations that collate data, hence some funds in our portfolio do not appear in GPCA data. The countries with no BII fund investments are Sudan, Libya, South Sudan, Central African Republic, Equatorial Guinea and the Republic of Congo.

economy. We have a disproportionately large presence in Kenya, and are also overweight in Ghana, Cote d'Ivoire, Uganda, Mozambique and Zimbabwe. Kenya is the investment hub for East Africa and Africa more broadly, particularly for venture capital – Kenya represents 3 per cent of the African economy but hosts 10 per cent of mainland Africa's VC fund managers.[23] A large number of fund managers have a presence in Nairobi, including TLcom Capital (VC), Adenia Partners (PE), Ascent Capital Africa (PE), Helios, Metier, Pembani Remgro, TRG and Africinvest.

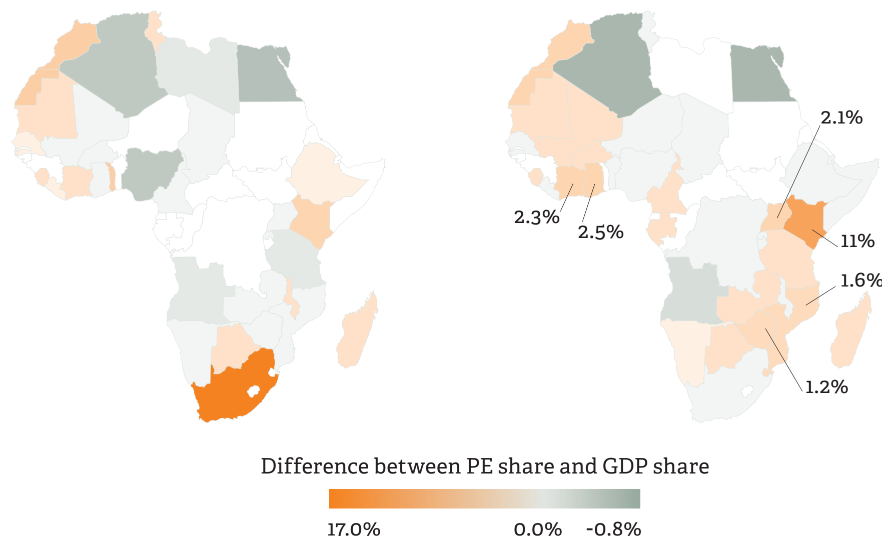


Figure 4: Share of country-specific PE in Africa relative that country's share of African GDP, 2008 to 2022 average[24]
Source: GPCA; World Bank Group; BII internal data.

Table 1 compares BII-backed funds in Africa against the wider PE market by World Bank country income groups. Our funds are weighted towards low- and low-middle income countries (84 per cent of the portfolio) compared to overall PE investments (63 per cent), despite us having invested in a majority of African PE funds. DFI portfolio allocations by geography should be analysed relative to GDP, because most low-income economies are very small (they have low income per person, but also relatively small populations), whereas some lower middle-income countries are very large, most notably Nigeria, which is home to almost a quarter of a billion people. Our portfolio in lower middle-income countries is proportionate to their share of African GDP, and we are noticeably underweight in upper-middle income countries.

	Total PE market	BII funds	Share of African GDP (USDm)*
Low income	11%	13%	9%
Lower middle income	52%	71%	71%
Upper middle income	36%	16%	20%

**Based on GDP in constant 2015, $, averaged between 2008 and 2022.*

Table 1: Share of total PE market investment and BII-backed funds by income group
Source: GPCA; World Bank Group; BII internal data.

23 Pitchbook, accessed 7 March 2024. Pitchbook list 522 VC fund managers headquartered in mainland Africa, of which 51 are in Kenya.

24 The country-specific nature of the data means it does not capture regional or pan-African PE deals.

Equity investing is about making firms grow, which tends to be harder in smaller markets. Therefore, equity investing is drawn towards larger domestic markets, such as South Africa, Kenya and Nigeria, or those able to trade, either with their neighbours or internationally. It is harder to find buyers for equity in smaller markets. Our PE funds, often regional funds, have sometimes invested successfully in low-income countries, but because equity investors can only make returns when a successful exit is possible, it is not always the appropriate instrument in the most fragile low-income countries where there are very few buyers. Self-liquidating instruments (like loans) can be more appropriate.[25] Some funds may offer 'mezzanine' products that combine the self-liquidating characteristics of debt with the risk-bearing characteristics of equity.

2.2 BII and PE funds

Throughout our history, we have had a relatively strong focus on equity financing (see Figure 5), and historically have been the largest fund investor in Africa.

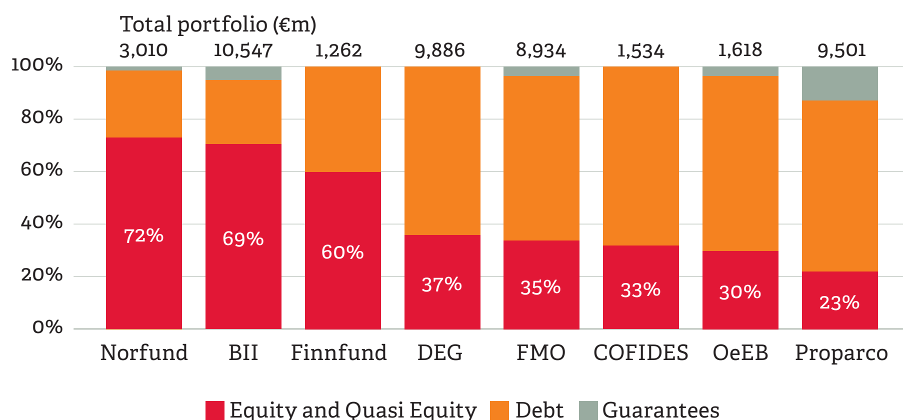


Figure 5: DFI portfolios by financial instrument
Source: EDFI.

We made our first fund investment in 1996. The fund manager Aureos was founded as a joint venture with Norfund in 2001, while in 2004 the fund manager Actis was spun out of BII, at which time we were reconfigured to only invest through funds. Since we reintroduced direct investing in 2012, annual funds commitments have been reasonably consistent in absolute terms, but have decreased as a proportion of overall annual commitments (from 100 per cent of annual commitments in 2011 to 23 per cent in 2022). The result has been a major shift in the balance of our portfolio over the last decade (see Figure 6).

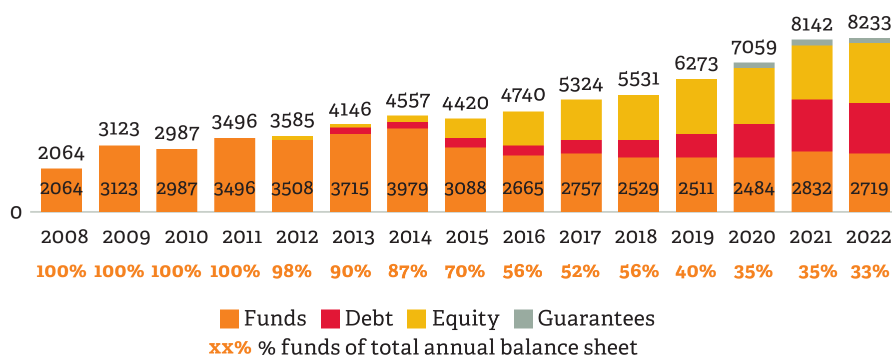


Figure 6: BII portfolio balance by product type ($m)
Source: BII data.

We remain committed to the African private equity sector. Funds are an indispensable tool for investing for impact. Our strategy has evolved in response to how the market has developed and what we have learned over the years. Section 8.3 describes our current fund strategy in more depth.

25 Some low-income countries, including larger ones like Ethiopia, have also historically lacked the legal and regulatory environment needed for foreign investors to buy and sell equity in domestic companies via funds structures.

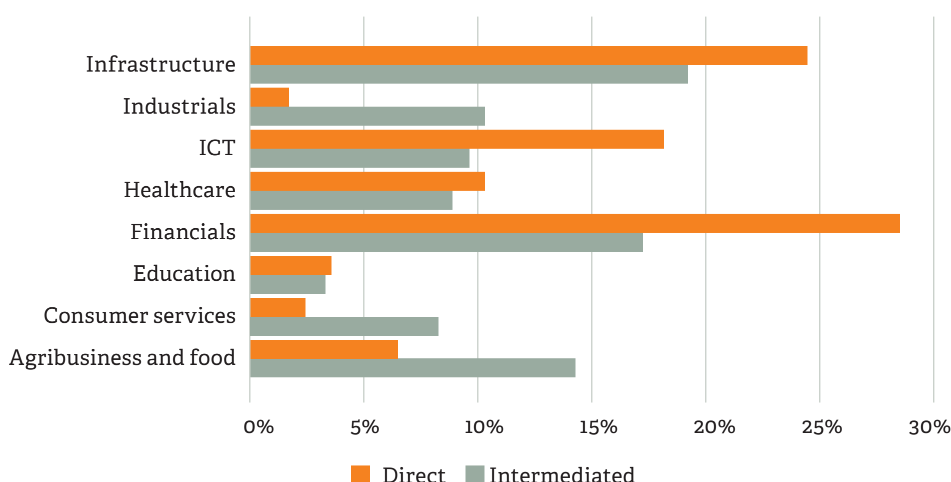
2.3 BII portfolio by sector

Figure 7 shows our direct and intermediated equity investments by sector. Between 2014 and 2023, BII-backed funds invested an average of $157 million each year of BII capital in Africa, with the largest sectors being infrastructure ($29 million), financial services ($26 million), and agriculture and food ($22 million). This compares with $379 million average annual investment directly.

DFIs and impact investors have adopted the United Nations Sustainable Development Goals (SDGs) as a shared vision of development. Some of the 17 SDGs have sectoral focus, such as SDG 3 (Health), SDG 4 (Education), and SDG 7 (Energy). In isolation, however, we do not view sector as a useful indicator of impact, as investments can be found with high and low impact in every sector. Our impact management system is oriented around our strategic impact objectives and an understanding of who investments have an impact upon, in what ways, and by how much.[26]

As a rule, we don't think it is possible to infer how impact-oriented an investor is by observing sectoral allocations alone. However, some sectors are especially important for development goals. Infrastructure, manufacturing, agricultural modernisation and financial services are essential for the economic transformation that lifts countries out of poverty.

Compared to our direct investments, PE funds have much greater reach into the industrial (including manufacturing), consumer services, and agribusiness and food sectors. This is noted in the recent independent impact evaluation of our industries, technology and services (ITS) portfolio, which states that multi-sector funds have "filled gaps" in key sectors.[27] Businesses in those sectors are often relatively small, and not suited to larger direct equity investments. This illustrates the importance of PE funds to the achievement of our impact objectives.



Note: BII data shown here is based on our disbursements

Figure 7: Average share of total BII capital invested by sector, 2014-2023

26 See What does impact mean to us? An overview of how we manage impact' for an introduction to our impact management processes, available here: https://www.bii.co.uk/en/news-insight/insight/articles/what-does-impact-mean-to-us-an-overview-of-how-we-manage-impact

27 BII (2024), Evaluating the Impact of BII's Industries, Technology and Services (ITS) Portfolio, available here: https://assets.bii.co.uk/wp-content/uploads/2024/03/13082720/BII-ITS-Evaluation-Full-Report.pdf

3

What is equity and what is a PE fund?

Investment comes in different forms. For a company looking to grow and needing external finance, debt and equity are two ways of raising money. Debt financing involves borrowing money with a commitment to make interest payments and (typically) repay the loan by a set date in the future.[28] Equity financing involves a firm raising money by issuing new shares, which are purchased by an investor. The company will then use that money to create value and increase future earnings. The cost to existing shareholders is that their ownership is diluted, and consequently their share of any future dividends paid, or proceeds from selling the business, is reduced. Each instrument has its advantages, and the two work in tandem – equity can be seen as a cushion that reduces the risk taken by lenders, while debt can work to enhance the returns to shareholders. This section considers equity from the perspective of firms and investors.

Ultimately, equity is vital to our development mandate because it helps businesses do things they couldn't otherwise. Risk is inherent to any business plan in any market, but risks are often higher in emerging and frontier markets. Lenders are reluctant to back unproven businesses and entrepreneurs will also have less appetite for risk if reliant on debt financing. The management and shareholders of even a large corporation can be unwilling to embark on an ambitious expansion without the ability to share risk with new equity investors, while lenders to large projects want to see equity invested to absorb risk.[29] As a result, the supply of risk-bearing capital is especially important for development (see more in Section 6 below).

28 Debt also comes in the form of revolving credit facilities, where a business borrows on an ongoing basis. Loans can be scheduled with repayments of the principal spread over time, so that the outstanding debt falls over time, or with with interest payments made over time and the principal repaid at the end of term, sometimes called a 'bullet' structure.

29 Lenders sometimes set limits for 'coverage ratios', the ratio of cash flows to debt servicing costs. The less equity in the capital structure and the more highly leveraged it is, the lower that ratio will be, and the less willing lenders will be to lend.

Equity from the firm's perspective

Equity is risk-bearing. It typically does not create financial obligations on a business, because dividends need only be paid when the cash to do so is available.[30] In contrast, debt creates claims on cashflows regardless of circumstances, and that can create vulnerability – the more indebted a business is, the less capacity it has to survive a downturn in fortunes.

But while equity finance makes a business more resilient when things go wrong, sharing risk means sharing rewards. Debt financing, on the other hand, amplifies returns for existing shareholders when things go to plan. The cost of capital is easy to observe for loans (it's the interest rate) and is less clear for equity – it consists of the dilution of returns for existing shareholders – but because equity is risk-bearing, equity investors want higher returns, making it usually a more expensive form of capital, from the point of view of a business owner.

Corporate finance theory has stated that the mix of debt and equity is irrelevant in the sense that the value of a firm should be independent of its capital structure. In other words, the size of the pie is unaffected by the blend of debt and equity in its filling. However, this only holds true in the rarified world of theoretical economics. With 'perfect' markets, where everyone can fully diversify risks, there are no transaction costs, no taxes, no bankruptcy costs, etc. (Modigliani and Miller, 1958).[31] But once these considerations are accounted for, there are reasons to want different combinations of capital in different circumstances. Debt and equity each have advantages and disadvantages, and development demands an adequate supply of both.

When a firm takes out a loan, the debt contract specifies that repayments must begin at a certain date. Lenders can sometimes offer grace periods, but as a rule they are impatient to see cash returned. In some less developed financial markets, long-term loans are very hard to obtain. Equity comes with no such demands. Of course, equity investors expect to realise returns at some point, but because equity investors can realise returns from capital appreciation when they sell their shares, provided the business is growing and creating value, it makes sense for the firm to reinvest its internal cashflows rather than pay dividends. The need to service debts is particularly ill-suited to early-stage firms that are not yet profitable and which should be reinvesting cashflows for growth.

Entrepreneurs are themselves often looking to make returns from capital appreciation, so the incentives of firm owners and outside equity investors are aligned. Equity is *patient* capital – it is well suited to long-term investments that finance businesses or projects requiring time to mature. That said, the traditional PE fund structure is not endlessly patient. The typical PE fund structure is a closed-end fund of ten years, with perhaps two one-year fund life extensions. Fund managers make investments in the commitment period of a fund (usually the first five years) and then seek to sell those investments over the remainder of the fund life, looking to return capital and make a return for their investors within that ten-year lifespan.[32]

30 Preference shares can create a financial obligation of fixed dividend payments. 'Mezzanine' finance refers to financing products that share characteristics of debt and equity and sit between the two in the capital structure.

31 A full exposition of the benefits of debt vs. equity in the context of impact investing is beyond the scope of this paper, but for more information see Tirole (2010).

32 Commitment period of a fund can also be referenced to a certain percentage of the fund being drawn or invested

In addition to diluting the financial returns to existing shareholders, raising equity from outside investors may be unappealing to business owners because it comes with control rights and complicates governance. Once external shareholders own more than 50 per cent of the business, they typically have effective control, although minority shareholders may still have certain key rights, and the controlling shareholders may still continue to delegate operational decisions to owner-managers.[33] Whether this is a bargain worth making, from the point of view of a firm's owners, depends on circumstance. It is quite normal for the founders of start-ups to end up as minority shareholders, particularly if they needed external equity investors to fuel the growth of the business.

We have found that even with businesses where equity would be the most suitable form of financing, owners may be reluctant to seek equity because they find it harder to understand all the implications. Debt is simpler. We sometimes support national market-building programmes which help to educate firm owners about what taking on equity investment involves. For example, our Ghana Investment Support Programme (GHISP) helps owners understand the suitability of equity financing for their businesses (such as through the GHISP 'SME Toolkit').[34]

Equity from the investor's perspective

Loans come with an agreed interest rate, and once the loan has been made, all that matters to lenders is the downside risk of not getting repaid.[35] There is no upside. If the firm stagnates, doubles in size, or grows by multiples of ten, it's all the same to lenders, so long as they are repaid. To make investments that share in the value created by growing firms requires a stake in the firm's equity. As already mentioned, equity investors usually hope to make money from capital appreciation by selling the stake in the business after it has increased in value.

For example, let's say Facebook had issued a $1 million, ten-year bond at a yield of 5 per cent in 2012. At maturity it would have returned $1.5 million to the investor that bought it. But, if the investor purchased $1 million of Facebook shares (equity) when it went public in the same year, the investor would have an equity stake worth over $13 million as at March 2024.[36] Of course, that is what happens if you invest equity in a firm that goes on to be very successful. There are many cases of share prices stagnating or falling, while lenders are still getting paid. It is not unusual for equity investors to lose half of their investment, a rarity for debt investors.[37]

From an investor's point of view, lending is usually much simpler than PE investing.[38] The volume of information required, and the need to form a subjective view of a firm's prospects, is lower. In many cases, lenders rely on third-party credit rating agencies to do the work for them.[39] There are lenders that operate in segments where decisions are based on a careful in-house assessment of a business' growth prospects, but as a rule the question of "am I likely to be repaid" is easier to answer than "what are the future earnings of this business and how much will someone else pay for it?"

33 Typical minority protections may include protecting share-class rights (e.g., the right to vote, right to participate in dividends, right to participate in new share issues).

34 See https://ghisp.org/

35 So-called mezzanine capital has characteristics of debt and equity. Loans can be structured with payments conditional on the underlying performance of the business.

36 In this case we are talking about public equity, whereby shares are traded on public stock exchanges, in contrast to private equity, which is equity capital invested in private companies. Public equity is less relevant to developing economies where stock exchanges are less prevalent, and those that do exist are small and in a nascent stage.

37 Default rates on investment grade bonds are extremely low. See https://corporatefinanceinstitute.com/resources/fixed-income/investment-grade-bonds/

38 Although it is easy to lose money, buying shares listed on liquid public markets is easy to do.

39 A security is said to be information sensitive if the benefit of producing costly private information about it outweighs the cost. See Deng et al. (2020).

To complicate matters, PE investing involves much more than deciding whether to extend a loan at a market interest rate. It involves negotiating a valuation with existing shareholders. Both the outside investor and the existing shareholders will have a view on the likely future earnings of the business, and its likely future value. A current valuation acceptable to all parties must be found. Holding expected future earnings and the required quantity of investment constant, a lower valuation implies higher returns for the new shareholders and greater dilution for existing shareholders.[40] There are market valuation benchmarks in equity investing too, but because these come in the form of multiples of earnings and revenues, estimates of which can be very subjective, valuations can be very subjective too.

As already mentioned, PE fund managers often add value through non-financial means, through active involvement in the strategy and management of the businesses they invest in. From the investor's point of view, that can be demanding in terms of time and the level of expertise needed. Being an active equity investor requires much more work than being a passive lender.

Private equity is also more demanding of investors from a portfolio management perspective. Debt investing generates highly predictable cashflows, and the returns usually start flowing quite soon after the initial disbursement of funds. For a DFI such as BII, that recycles its capital and reinvests the returns from historical investments for impact, that brings predictability, which in turn makes it easier to manage investment pace. The amount and timing of cash returned by investments in PE funds is much harder to predict.[41]

3.1 Private equity funds

PE funds are pools of capital used to make equity investments in private companies. The capital is provided by multiple investors, known as limited partners (LPs). The management of this pot of money is taken by the fund managers, known as general partners (GP). LPs are therefore the asset *owners* while GPs are the asset *managers.* The fund manager (GP) is responsible for identifying, assessing, negotiating, and committing to investments in individual companies, all according to legal covenants agreed with the investors.[42] These covenants are shaped by the motivations of the investors, and would, for example, reflect country, sector or single-deal limits, but the LPs do not take investment decisions.[43]

Figure 8 shows a simplified model of a typical PE fund arrangement. The fund manager will raise capital from investors, hoping to reach its target size. Funds might undershoot (or overshoot) their target, though it must meet a minimum viable size in order to proceed. Fund raising will usually consist of several 'closes', some of which may overlap with the investing period. The 'first close' refers to the point at which the fund has secured sufficient capital to begin actively investing. The 'final close' represents the point at which no further LPs will be admitted. LPs make commitments to the fund, but they do not give the money to the GP up front. Rather, the GP sources the deals and then 'calls' capital from the LPs when needed. A single GP may at any one time be raising and executing more than one fund, but they should only ever be investing one fund per strategy (unless LPs have given specific permission otherwise). Successful GPs may introduce different types of funds with differentiated strategies as they become bigger.

40 Our Insights paper, Risk, Return and Impact discusses how equity investors value companies. See https://www.bii.co.uk/en/news-insight/insight/articles/risk-return-and-impact/

41 This is also true of our direct equity investments.

42 The legal structure of PE funds is typically a limited liability partnership (LLP), hence the nomenclature of GPs and LPs.

43 This is an important legal construct in funds investing, and ensures the LP's liability is limited to the size of its commitment.

After first close, the GP sources deals and makes investments until the fund has reached the end of its commitment period.[44] They seek to manage and improve the portfolio (ideally within three to five years per investee, but may take longer) and, eventually, 'exit' these investments, in other words, sell their stake (timescales vary, see Section 8.1.2). The sale proceeds are then returned to LPs. GPs usually charge an annual fee for managing the fund (typically 2 per cent of total of what they have comitted and then invested) plus a proportion of the fund level realised profits (typically 20 per cent) if the fund's realised profits exceed a 'hurdle' rate (this profit share feature is called 'carry' and is designed to align incentives between GPs and LPs).[45] On the impact side, an investor like ourselves will build provisions into the terms of the fund. These are designed to ensure the GP makes and monitors investments in accordance with our environmental, social and business integrity policies, and also reports sufficient data for us to be able to monitor the fund's impact. The GP is equally responsible for managing these aspects of the portfolio and delivering impact returns (see Section 4.3).

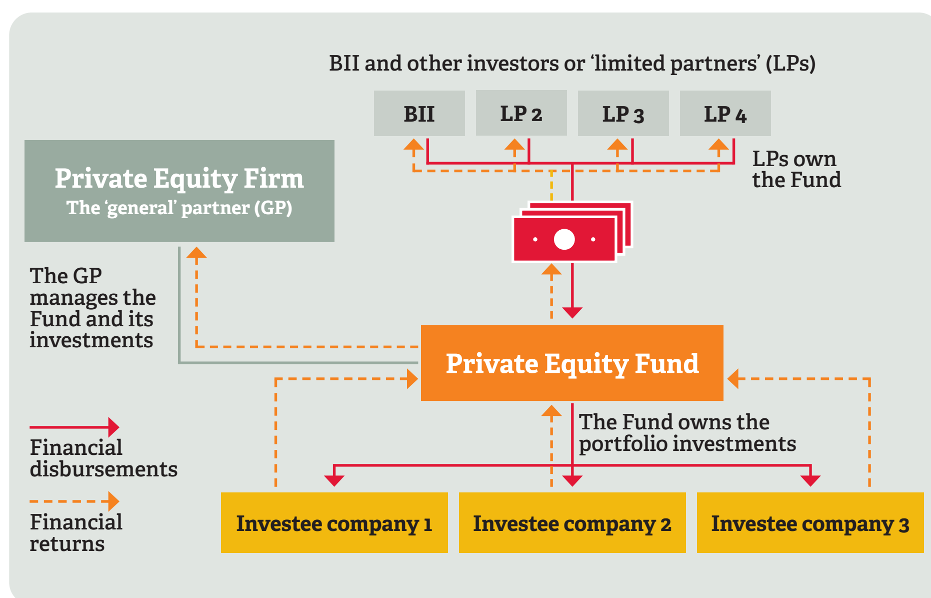


Figure 8: A simplified model of a private equity fund

While Figure 8 explains the basic mechanics of a PE fund, it cannot explain how and why we use them to deliver on our development mandate. That is the purpose of this paper.

44 To note, the capital is only transferred from LPs to GPs when it is called upon.

45 Management fees can vary according to fund size (larger funds reducing the fee percentage, smaller funds increasing it). This is known as the typical 'two and twenty' structure of a PE fund. The share of returns aligns incentives by enabling the GPs to benefit from high performance. If the GPs are solely paid through fees, they have less reason to worry about the returns for LPs. GPs have an incentive to deliver high returns for LPs if they want to attract investors into future funds, but that might not always be the primary concern of individual GPs. GPs can also invest their own money alongside LPs in their funds (known as GP commitment) which further aligns their interests.

Box 1: Funds and offshore financial centres

Because funds take money from investors in different countries, and often invest in multiple countries, it is unavoidable that their domicile is 'offshore', meaning the fund is domiciled in a different country to where it invests and to where it raises capital from. Offshore financial centres (OFCs) are often used in these situations for their stable financial, legal and regulatory environment. Being legally domiciled in an OFC does not prevent a fund manager from having local offices and expertise in the countries where they invest.

OFCs are not always islands. London, Luxembourg and Amsterdam are among global finance centres that specialise in providing legal domiciles for investment funds. Some OFCs have a reputation for enabling tax evasion and avoidance, which can raise concerns when PE funds are legally domiciled in these locations. These concerns are largely misplaced and are often based on a misunderstanding of how funds operate. In particular, the legal domicile of a fund may affect the taxation of investors' returns, but usually does not have implications for taxes paid by the businesses they invest in. Many African PE funds are domiciled in the African country of Mauritius but their relocation to London, for example, would generally not result in higher tax revenues for African governments, because the UK has an extensive network of bilateral tax treaties (see Carter (2017) for discussion). OFCs such as Mauritius usually offer lower fees for professional services than European financial centres, and an efficient and trusted process, which makes it easier to attract capital than if domiciled in a territory with unfamiliar and unstable legal and regulatory practices. Tax evasion and avoidance are risks that DFIs must actively manage. At BII, we only invest through funds domiciled in OFCs where needed for genuine commercial, legal or regulatory reasons – never to avoid the payment of taxes or to conceal information.

4

Why PE funds?

Our motivation is always creating impact, whatever instrument we use. This section explains why we allocate some of our capital through PE funds.

PE funds allow us to extend our reach, to make *more* investments (impacting more people), access *more* markets (including the more difficult to reach), and reaching *smaller* companies. People in the poorest countries are more likely to work for smaller companies and depend on them for access to goods and services.[46] Accessing a broader range of countries/sectors and enhancing our reach to SMEs are key justifications for the ITS Portfolio Evaluation Report's recommendation that we continue to invest in funds.[47]

4.1 Reaching more, smaller companies

The large-scale investments necessary for poverty reduction, such as infrastructure projects, call for direct investments of tens or even hundreds of millions of dollars. We have invested $220 million through two equity investments in Liquid Telecom, to build fibre-optic cable networks across Africa, for example.[48]

We use PE funds as intermediaries to reach more small and mid-sized companies.[49] But why can't we invest in those same companies directly? If a team at a fund manager can successfully deploy $100 million across ten investments in mid-sized firms, and generate sufficient returns to cover their costs and deliver net returns for LPs, why couldn't that same team work in-house for us?

46 IFC Jobs Study (2013); Altenburg and Eckhardt, 2006; United Nations Commission on the Private Sector and Development; 2004; World Bank, 2002

47 Holzman et al. (2024)

48 See https://www.bii.co.uk/en/story/liquid-telecom/

49 PE funds tend to serve the larger end of the SME spectrum. There are more than 1.6 million SMEs in sub-Saharan Africa alone (see https://www.smefinanceforum.org/data-sites/msme-country-indicators). Our recent paper 'How and why we finance SMEs', available here: https://www.bii.co.uk/en/news-insight/insight/articles/how-and-why-we-finance-smes/ has further information.

Investment businesses must cover their overheads (mainly staff costs) from the returns they make. Technically, GPs cover their costs from the fees they charge on the capital they raise, but ultimately everything comes from returns on investment. If returns don't exceed fees, LPs lose money and the whole thing falls apart. Because equity investing is risky and involves long-term commitments, most GPs aim to deliver net internal rates of return (IRRs) of around 15-20 per cent for their LPs. All investment businesses try to generate a positive return net of costs for the investors whose money they are investing. In our case, those returns are recycled into new investments, because we do not pay dividends or return capital to our shareholder.

If a fund can invest $100 million across ten businesses and generate positive returns net of costs, then in theory we could bring that team in-house and make those investments directly (assuming we could recruit and incentivise those same individuals, which may not be the case). But that would require us to supply the full $100 million of capital ourselves, and therefore we would need to want that much exposure ($10 million each) to those ten businesses. If we would only want $1 million of exposure to each of those businesses, for a total investment of $10 million, that would not work in-house. The returns on $10 million would not cover the costs of making those ten investments directly. That is because the staff costs, legal and other third-party fees involved in making a small investment are not much lower than the cost of making a large investment (see Box 2).

Box 2: Resource-intensive equity investing and maximising reach

The making, managing, and exiting of investments is a complex and labour-intensive process. Before an investment is even made, hundreds of questions need to be answered: How is the company impactful? Does its management team align with our values and standards? Does it have robust governance? What is its current capital structure? How has revenue been growing? Ensuring our investments adhere to robust standards in line with our Policy on Responsible Investing demands substantial resources prior to investment, with further resources required during management and exit stages of the investment lifecycle.[50]

We have over 200 investment employees (not including portfolio management). Around 16 per cent of whom are focused on funds. In 2022, BII-supported funds in Africa made 108 investments. In the same year, we made ten direct equity commitments. So, roughly 18 per cent of our investment team managed over 90 per cent of the total number of 2022 equity commitments. If we tried and make the same number of equity investment directly, it would require a dramatic increase in the size of our investment teams.[51]

We can only allocate a finite quantity of capital to equity investments in mid-sized firms in Africa.[52] Were we to invest $100 million directly, that could look something like ten investments of $10 million. We could not make 100 investments of $1 million, the costs would be far too high. Instead, if we spread $100 million across ten funds, and in each fund our $10 million is pooled with $90 million from other investors, we can make 100 investments of $1 million and the returns generated by each $100 million fund should cover transaction costs.

50 See https://assets.bii.co.uk/wp-content/uploads/2022/01/25182701/Policy-on-Responsible-Investing-1.pdf

51 Assuming a proportionate increase in the number of staff per investment

52 This is a simplification. Some funds invest in large firms, so our allocation for large firms is split between direct investment and funds.

Smaller firms tend to be more vulnerable than large firms, so a portfolio of few relatively large investments in smaller firms would be concentrating risk. Because funds ensure greater diversification, DFIs and other investors are willing to allocate more capital overall to equity investments in mid-sized firms than they would if constrained to only doing so directly. Many LPs lack the capacity to invest directly, so an intermediated approach in their only option. The overall quantity of risk capital available for African businesses is therefore greater, thanks to the existence of the fund model allowing investors to pool their capital, share costs, and diversify risks.

4.2 Reaching more places

Box 2 shows that more direct investments would demand more investment employees. However, it is not just a question of headcount, but *where* there are enough transactions to justify locating staff to originate investments, if investing directly. Funds give us greater geographic coverage. The countries in which we have invested via funds in recent years include Burundi, Madagascar, Niger – some of the poorest nations in the world. Figure 9 compares the geographical spread of our direct and intermediated equity by value of total country-specific investments between 2013 and 2022. Note, the map only depicts investments that are direct or via funds; it excludes any investments that fall into both categories (for example, co-investments with funds), so does not represent the entirety of our portfolio. The underlying BII funds data is the same as that used for Figure 4b. However, in this instance it shows value in US dollars, not relative to GDP share.[53]

The maps show that investments via funds reach double the number of countries (36 vs. 18), are less concentrated (see Figure 9), and reach smaller economies. We do find some larger direct investments in smaller countries, or investments into firms with regional operations that include them, but as a rule it is difficult for us to reach smaller, lower income countries with direct investments.

Effective equity investing requires the ability to operate in local markets to originate and exit investments, and with hands-on management to ensure their success. This calls for experienced investors with local contacts and understanding of context. In-depth coverage of every SME investment opportunity across 54 African countries would not be viable in-house. This can be particularly true of smaller lower-income countries, which are a priority for our capital but where investment opportunities are few and far between. Funds like African Infrastructure Investment Fund III enable our capital to reach small and/or fragile markets like Benin, Burkina Faso, and Mali, where it wouldn't necessarily make sense for BII to have a local presence. The ITS Portfolio Evaluation Report notes that "multi-sector funds have been instrumental in increasing the number and breadth of investments into geographic areas where BII has no or few direct investments in ITS."[54]

However, in other markets we have an important role to play more directly. Our in-house Africa Coverage Team, whose local presence is essential to both direct and intermediated investments, has primary operating hubs in Cairo, Lagos, Nairobi, and Johannesburg, as well as smaller offices in other key markets.

53 As with Figure 4, the data shows only country-specific funds.

54 See Holzman et al. (2024)

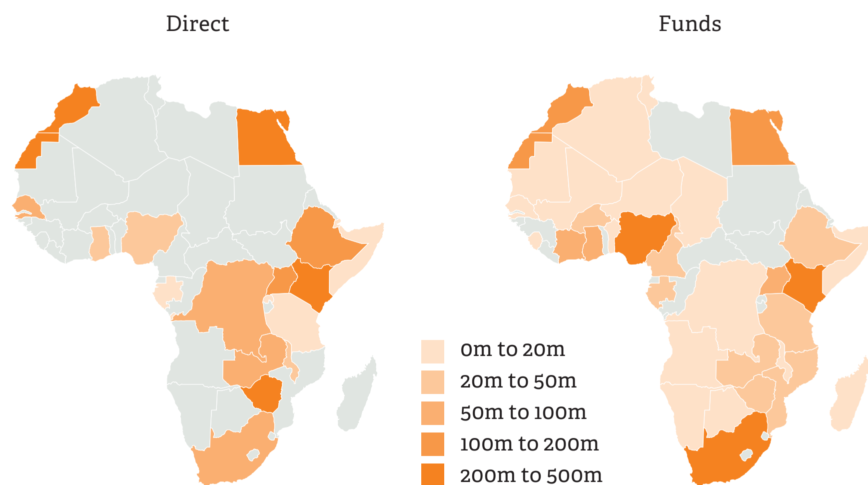


Figure 9: Total value of country-specific equity investments directly and via funds, 2013-22 (USDm)

4.3 Shaping how business is done in Africa

Our impact isn't just about enabling businesses to grow, but about shaping the way business is done. That means strengthening corporate governance, encouraging diversity in management and the workforce, and raising ESG standards. Our in-house teams work with firms we invest in directly, but helping PE fund managers propagate good business practices in the companies they invest in means we can help shape how business is done in Africa on far greater scale than we could alone.

Commercial and social objectives are often aligned here – there is evidence that more responsible business practices tend to improve long-run profits and achieve higher valuations.[55] Better practices create better exit opportunities because prospective buyers have more confidence they are acquiring a responsibly run business, less likely to have 'skeletons in the closet'. For example, fund manager Adenia credited improvements in job quality, especially health and safety, at the paint manufacturer Mauvilac with helping it to secure a higher valuation on exit.[56] There is even some evidence that better ESG practices by firms are associated with better macroeconomic performance (Zhou et al, 2020).

A report by the African Private Equity and Venture Capital Association (AVCA, 2018) finds African PE fund managers "ahead of the curve" in the adoption of ESG standards compared to other markets, thanks to the historical support of DFIs. The survey suggests most fund managers have adopted either the International Finance Corporation (IFC's) Performance Standards, or use our ESG toolkit for fund managers.[57] All our fund investments must comply with our Policy on Responsible Investing, including legally binding commitments with the fund manager.[58]

The places most in need of progress on the SDGs – our priority markets – are also the places with the most work to be done on ESG. According to Global Risk Profile's ESG Index, seven of the ten countries with the highest ESG risks in the world are in Africa. Proactive management of ESG risks is therefore particularly important in an Africa context, where fund managers often invest in smaller, family-run businesses that face inherent challenges. This means we must be willing to bear ESG risks to have the opportunity to influence how businesses operate in countries at earlier stages of market development.

55 See IFC (2018), Yu et al. (2018), Friede et al. (2015), Devalle et al. (2017), Eccles et al. (2014) and Transparency International UK (2022).

56 EMPEA (2021), Investing for Growth Deal Book, available here: https://www.globalprivatecapital.org/app/uploads/2021/03/Deal-Book-2021-NEW-03.29.21.pdf

57 See https://toolkit.bii.co.uk/

58 When investing via a fund, legal requirements are placed on the fund manager (not the fund's portfolio companies) because that is who our contractual relationship is with. However, fund managers are also legally required to develop their own processes, capacities, and governance systems to enable them in turn to implement appropriate standards in their portfolios. See https://assets.bii.co.uk/wp-content/uploads/2022/01/25182701/Policy-on-Responsible-Investing-1.pdf

We provide bespoke and in-person ESG and business integrity (BI) training to GPs across Africa, giving practical and actionable guidance on managing ESG and BI risks at the fund and in the companies they invest in. Since 2020, BII has trained over 1,000 staff from fund managers across a variety of topics, such as gender-based violence and harassment (GBVH) risks. We run follow-up surveys to monitor the introduction of new practices by GPs. Our ESG Toolkit for Fund Managers had around 1,000 monthly users in 2023. This toolkit covers guidance on integrating ESG at different stages of the investment cycle; the design of policies and procedures; guides to typical risk and opportunities in different sectors; advice on anti-corruption and anti-money laundering and on specific ESG topics. Those topics include animal welfare, community health, disability inclusion, gender-based violence and harassment, human rights, labour standards and many more.[59] We work with fund managers to help to embed best practices early in firms' development.[60] We help GPs establish ESG-sub-committees, for which we have seen strong adoption by fund managers that are active in sectors with higher contextual risks, such as infrastructure.

One of the positive developments we have seen in the PE industry is that fund managers now typically employ a number of technically skilled ESG 'front office' staff actively involved in investment decision-making and management, as opposed to 'back office' ESG reporting. We have also been promoting Operational Due Diligences (ODD) across the PE industry in Africa. ODD is now institutionalised as a fund-raising tool used by LPs to assess and strengthen the GPs' governance structures. In the African market, we are seeing more GPs commission ODD reviews to meet governance best practices and manage regulatory and fraud risks.

A recent independent evaluation looked at the evidence of how our fund investing has supported mobilisation, using four funds – in Nigeria, India, and Bangladesh – as case studies (hereafter the "Funds Mobilisation Evaluation Report").[61] It found that our support to fund managers "helped set the tone for PE" in India and Nigeria. Illustrating the alignment of impact and commercial motivations, evaluators found that a BII-backed fund in Nigeria (CAPE IV[62]) sold one high-profile investment at a high valuation, partly because of the 'ESG premium' it helped the firm to build.

59 See https://toolkit.bii.co.uk/esg-topics/

60 See our Venture Capital Toolkit, available here: https://toolkit.bii.co.uk/sector-profiles/venture-capital/

61 Itad (2024)

62 See https://www.bii.co.uk/en/our-impact/fund/capital-alliance-private-equity-iv-cape-iv-investment-01/

Box 3: Responsible investing

Our Policy on Responsible Investing sets out the environmental, social and business integrity requirements that our investees are expected to meet after an investment is made. It also presents recommended practices on emerging issues we believe are increasingly important.[63] This policy is part of our legal agreement with every fund manager we invest in. It includes our exclusion lists – investments we will not permit – and also numerous requirements, such as compliance with core International Labour Organization (ILO) labour standards. The assessment of the manager's ability to apply our policy is part of the due diligence for every fund investment.

We want to improve how business is done across Africa and Asia. Rather than ask our fund managers to invest only in firms where ESG practices are already best in class, we want fund managers to work with firms that have missing or sub-standard procedures, helping them to improve over time. Our goal is for fund managers to approach responsible investing as we do when we are investing directly. That means combining some 'red lines' with identifying and assessing the ESG risks associated with each investment. Then, through a process of prioritisation, action plans can be agreed with companies to tackle the issues identified.

We ask our fund managers to invest where risks can be high, so incidents of various forms are inevitable. We ask for annual ESG reports, and timely serious incident reporting with a special emphasis on safeguarding issues. Fund managers must have grievance procedures in place. Although incidents can be the result of poor ESG practices, higher levels of incident reporting can be a signal of good practices. It can signify that the fund manager has good monitoring systems in place, engages well with communities, and is not trying to conceal problems – especially when reporting near misses.

We also prioritise our oversight of fund managers. With new managers, we may sit on their ESG committees and review their due diligence of each investment in greater depth than we would with more established managers. If we discover that a fund manager is not properly implementing our Policy on Responsible Investing our first method of intervention is simply dialogue, and we would look to resolve issues in a collaborative spirit. With more problematic cases, we can require fund managers to appoint third parties (specialist consultants) to resolve an issue, and we can raise issues with other LPs. The ultimate sanction is for LPs to replace the manager and refusal to support follow-on funds.

The delegation of responsibility always comes with risk, and there have been occasions where fund managers have not conducted themselves as we require, and incidents have occurred at portfolio companies that we were unaware of at the time and should have been made aware of. We learn from these occurrences and are always working to strengthen our internal systems and those of our fund managers. Incidents are inevitable, however. Our view is that incidents in our funds portfolio should not be interpreted as a reason not to invest via funds. With the support of DFIs, fund managers are a powerful means of spreading responsible investing practices across Africa and raising standards within businesses across the continent.

63 See https://toolkit.bii.co.uk/working-with-bii/policy-responsible-investing/

4.4 Mobilising private investment

An important part of our current strategy – and those of our peers – is mobilising commercial capital into impactful investments in Africa and Asia.[64] So-called 'alternative assets', which includes private equity, private credit and infrastructure loans, have become as important to major investors as the traditional asset classes of listed equities and investment grade bonds. Even a minor rebalancing towards Africa would make a huge difference.

Many impact investors have a particular interested in supporting active fund managers that provide growth capital in markets where it is short supply, as opposed to passive investing in liquid markets – because that is where their capital can make a real difference. But PE funds provide an entry point for investors looking for exposure to Africa for purely commercial reasons too.

Investors taking their first steps into a new market need the local origination and portfolio management capabilities that fund managers offer, and a fund structure offers diversification. Different fund managers also offer a range of distinct investment strategies, as will be discussed in Section 6, so investors can find something suited to their preferences.

DFIs can help fund managers attract private investors by refining their fund proposals to enhance fundraising prospects, supporting the development of their impact and responsible investing strategies during fundraising, supporting recruitment efforts (e.g. for ESG professionals), and by being an 'anchor investor' – the first to make a substantial financial commitment to a new fund. Other investors are aware of the depth of the DFIs' experience and the breadth of proposals we see before making our selections., Our due diligence is respected and the LP agreements we negotiate are perceived as high quality. Acting as an anchor investor can be particularly important in a challenging fundraising environment, when GPs are struggling to attract private capital. For example, the Funds Mobilisation Evaluation Report found that "BII's presence as an anchor investor provided confidence at a difficult time, which led to a number of limited partners (LPs) deciding to invest in India Value Fund III."[65]

Our goal is to build a private equity ecosystem in Africa consisting of strong fund managers with good commercial track records and proven capabilities, that are also sufficiently aligned with our impact goals (particularly through co-investments) and those fund managers that offer more niche and or unproven strategies with high growth and impact potential. This can help drive 'locally-led' development – a priority for the UK Government (our shareholder) and international development actors more broadly.[66]

Ultimately, we expect African PE to follow the trajectory of India towards higher volumes of investment with financial performance that attracts commercial investors. However, as Section 3 shows, the market is still at an earlier stage of its development. The continent has also suffered from recent global economic shocks, macroeconomic crises in several countries, and the general withdrawal of capital from emerging and frontier markets in response to global monetary tightening, so fund raising activity has been muted in the last couple of years. Total Africa PE fundraising fell from over $3 billion in 2015 to under $800 million in 2022, though saw a partial recovery to $1.6 billion in 2023.

64 Available here: https://assets.bii.co.uk/wp-content/uploads/2022/01/06170001/2022-2026-technical-strategy-2.pdf

65 ITAD (2024), Analysis of mobilisation in four BII-backed funds, available here: https://assets.bii.co.uk/wp-content/uploads/2024/03/19095026/Analysis-of-mobilisation-in-four-BII-backed-funds.pdf Also see https://www.bii.co.uk/en/our-impact/fund/india-value-fund-iii-investment-01/

66 UK Government (2023). International development in a contested world: ending extreme poverty and tackling climate change. A White Paper on International Development, available here: https://www.gov.uk/government/publications/international-development-in-a-contested-world-ending-extreme-poverty-and-tackling-climate-change

There are different types of investors, who will invest in different fund managers for different reasons. Some are simply looking to maximise dollar returns and are shopping for investments globally. The weakness of African currencies recently has made it difficult to attract those investors. Examples of African private equity funds in which we have invested alongside globally active institutional investors include African Development Partners III Fund,[67] which has attracted pension funds such as the Chicago Teachers' Pension Fund and the Philadelphia Municipal Retirement System, Helios Investors II[68] where we are invested alongside the Alaska Permanent Fund, a sovereign wealth fund, and Amethis,[69] which has a substantial private investors base.[70] Other investors want to gain experience in Africa for longer-term strategic reasons, some have developed expertise in African markets, and others are investing for impact. Foundations with an impact mandate, such as Shell, Mastercard and Allied Climate Partnership are also important sources of capital.

African investors, including pension funds and sovereign wealth funds, do not face the same exchange rate risks. In India, local institutional investors were behind the scaling up of the PE industry after the initial phase of DFI support, and global dollar return-seeking investors have only entered India relatively recently. We work with African fund managers to attract local investors, such as pension and sovereign wealth funds. That can involve helping institutional investors who are unfamiliar with private equity investing, and sometimes requires a change to their investment mandate and regulations. An evaluation of mobilisation in BII funds found that our investment in CAPE IV in Nigeria in 2015-16 influenced the GP to launch a local-currency-enabled vehicle, which was "directly responsible for attracting local pension funds to invest".

New fund managers can face a 'chicken and egg' problem: to attract capital they need a track record but to build a track record they need capital. First-time African fund managers are often very reliant on DFIs but can attract private investors into their subsequent funds. For example, BII helped to seed the Nigerian fund manager African Capital Alliance (ACA) via their first fund Capital Alliance Private Equity I, which reached close in 1998 with $35 million total capital raised. By their fourth fund (CAPE IV) they raised $570 million with LPs including General Electric Pension Trust and New York State Common Retirement Fund. This is an example of a more general pattern, noted by Cole et al. (2022), where impact investors are often replaced by 'traditional' private investors as funds and companies seek additional rounds of financing.[71]

This is not always a linear process, and as investor sentiment towards Africa ebbs and flows, some managers have needed more DFI support in their later funds than in their earlier funds. Although DFIs have historically backed many first-time managers to help create the African PE industry, we are now in a new phase of market development, with more emphasis on new funds from established GPs (see Section 8.3).

67 See https://www.bii.co.uk/en/our-impact/fund/african-infrastructure-investment-fund-iii-investment-01/

68 See https://www.bii.co.uk/en/our-impact/fund/helios-investors-ii-investment-01/

69 See https://amethis.com/en/

70 Co-investors drawn from Pitchbook data, accessed 28 February 2024.

71 See our blog Do impact investors do things differently? for further discussion of this paper, available here: https://www.bii.co.uk/en/news-insight/research/do-impact-investors-do-things-differently/

Box 4: Blue Earth secondary transaction

This year, we announced a pioneering secondary transaction in which we sold partial stakes in three PE funds: Aavishkaar Goodwell India Microfinance Development Company II, Novastar Ventures Africa Fund II and Adenia Capital Fund IV, to Swiss impact investor Blue Earth Capital (BlueEarth). These funds have all, to different degrees, already deployed most of their capital, so Blue Earth is buying a known portfolio of assets rather than putting money into a blind pool, which can be more attractive for investors taking their first steps in an unfamiliar market. In this way, a secondary transaction supports BlueEarth's fundraise for its new fund, as investors will have visibility of the portfolio companies. Secondary transactions such as these help us to realise capital from our fund investments sooner, while remaining invested in each fund, but that is not our main motivation. We want to introduce investors like BlueEarth to strong fund managers in our markets, with which they will have a continuing relationship by investing in their new funds. Secondary markets are commonplace and regarded as important to the functioning of the PE market in the US and Europe. The creation of a secondary market in Africa, for positions in funds that have largely deployed their capital, would give LPs more exit options, making them more willing to invest in the first place.[72]

72 See: https://www.bii.co.uk/en/news-insight/news/british-international-investment-and-blue-earth-capital-complete-landmark-secondary-transaction/

5

The evidence that equity matters for development

The importance of equity for development stems from its risk-bearing characteristics, as discussed above, which enables entrepreneurs and firms to do things that would be difficult or impossible without it, and the fact that equity is in short supply in Africa. Equity is also appealing from a development perspective because it increases resilience, whereas debt financing leaves firms more vulnerable to economic downturns.

In smaller and lower-income African countries, there are very few places for firms to obtain equity finance, outside of PE funds supported by DFIs or direct investments by DFIs. Some firm owners will be fortunate enough to receive equity investments from wealthy family members or friends. Foreign and domestic firms also sometimes buy stakes in, or inject fresh equity into, other firms. But otherwise, PE funds are often the main source of risk-bearing growth capital for firms in Africa.

We commissioned a market mapping exercise that found all but two equity transactions in Tanzania between 2018 and 2022 involved DFI-backed PE funds.[73] At the other end of the scale, in Africa's largest market Nigeria, some fast-growing technology companies have attracted finance from global VC firms, and while there are also some large one-off transactions, such as a Chinese state-owned bank investing equity in a port development, DFI-backed fund managers are still the dominant source of risk-capital. As Section 3 shows, the PE industry in Africa is tiny by global standards. Even in the largest markets of Morocco, Egypt, Nigeria, Kenya and South Africa, where the volumes of investment by PE funds is greatest and there is more capital available from commercial investors, firms do not benefit from the depth of financing options available in advanced economies.

73 The market mapping was conducted by Asoko Insights, whose local researchers search for deal announcement in the media, on corporate websites and in regulatory filings. This method may miss transactions that were not disclosed. Of the two equity transactions in Tanzania that did not involve a DFI-backed fund, one was a merger of two companies that operate petrol stations, and the other was the acquisition of a telecoms business by another, that was itself back by DFIs.

Because there is so little equity investing in Africa, much of the empirical evidence about its importance for economic development comes from elsewhere. Peter (2021) studies Eurozone economies and finds that the inadequate supply of equity does much more harm to economic performance than debt constraints.[74] Interestingly, Peter also finds that more equity financing is associated with lower inequality, despite the fact that "more access to equity financing allows entrepreneurs to run larger businesses with higher revenues." That's because equity financing results in the ownership of firms being distributed more evenly across society, whereas debt financing encourages highly concentrated ownership.

There is a substantial body of theory and evidence that connects the risk-bearing nature of equity to the rate of innovation and hence growth. Gorodnichenko and Schnitzer (2013) ask why poor countries do not catch-up with rich countries and find "unambiguous evidence that financial constraints restrain the ability of domestically owned firms to innovate and hence to catch up to the technological frontiers." Risk-bearing capital is especially important for firms that are attempting to 'leapfrog' to the latest technologies. Robinson (2021) argues that incomplete financial markets constitute a "missing market for entrepreneurial risk". Michelacci and Schivardi (2013) and Chen et al. (2010) also evidence the importance of non-diversifiable entrepreneurial risk for growth.

Some of the most exciting and highest-impact investments involve innovative technologies that offer new solutions to development problems and can scale rapidly. Kremer et al. (2021) demonstrate the incredibly high social returns generated by just a handful of firms financed by USAID's Development Innovation Ventures. Impact investors often speak of the desire to find investments that have a 'transformational' impact. Caggese (2019) models firms as choosing between incremental or radical innovations, with the latter resulting in much faster growth but requiring risk-bearing capital. Colonnelli (2024) surveys African start-ups and finds a strong preference for equity financing. Investments in new technologies and other innovative business models are primarily the domain of VC funds, and there is a great deal of evidence about the importance of the VC industry for growth – see Akcigit et al. (2022) for example. But it is worth noting that once innovative business models have proven themselves, they can still require additional risk-bearing capital to expand, and that experimentation is not always about new technologies. It can be risky to introduce business models and technologies, which have been proven elsewhere, to new markets.

5.1 Evidence from our funds portfolio

We can investigate the idea that equity is important for development because it allows firms to undertake riskier and more ambitious business plans, by looking at the performance of the businesses that have sought equity investments. In this section we present the distribution of revenue and jobs growth rates, among the businesses in our PE funds portfolio. We want to see whether average growth rates and the variance of growth rates are higher than in the general population of African firms.

The impact of a business has two aspects: what it produces, and how it is produced. Both aspects are central to our impact objectives of promoting productive, sustainable, and inclusive development. Revenues are a measure of the value of the goods and services produced by firms. On the other side of the coin are the jobs created to produce them. We want to know whether revenue growth has been accompanied by jobs growth.

74 Her exact phrasing is: "Quantitatively, I find much larger output effects from equity frictions: harmonising them across countries would lead to nearly five times larger output effects compared to debt frictions, removing them would increase aggregate output by more than twice as much.". Friction is economics jargon for anything that prevents the efficient allocation of capital.

We compared firm data from our funds portfolio against firm data from Orbis, a database containing information on over 400 million companies globally. The data covers 2012 and 2021.[75] This comparison is not proof of impact. There is nothing here resembling an experiment in which equity was made available in some markets and denied to others, so that we can observe the impact of equity. Our goal is merely to show how the distributions of revenue and job growth rates at companies in our PE fund portfolio differ from the distribution in the general population of African firms, over the same period. However, we do know that around half of firms in sub-Saharan Africa report being partially or fully credit constrained, and that equity is generally at least as hard to obtain as long-term debt, so it is reasonable to believe these equity investments often have a causal impact on firm growth compared to a counterfactual with no PE funds.[76] The data we use from our PE portfolio cannot distinguish between primary and secondary transactions (growth capital or buyouts) so the growth rates we observe here are the outcome of both financial and non-financial contributions by fund managers.

The analysis shows that **the median BII PE fund investee company grew faster than the median African company, both in terms of jobs and revenue**. Table 2 shows that the averages and the variance of growth rates is notably higher in the BII sample than in the Orbis data. Figure 10 shows the two distributions, for jobs and revenues. Jobs growth rates are somewhat lower than revenue growth, but the contrast between the Orbis sample and PE funds companies is greater in the case of jobs, informally suggesting that PE funds are financing relatively jobs-rich growth.

	Orbis	BII
Revenue		
Median CAGR	2.7%	8.7%
Mean CAGR	11.4%	22.7%
CAGR standard deviation	0.8	1.9
5-year aggreagte change	-7%	6%
Jobs		
Median CAGR	1.6%	7.3%
Mean CAGR	2.4%	20.5%
CAGR standard deviation	0.2	0.7
5-year aggregate change	5%	37%

Table 2: Summary statistics of jobs and revenue growth comparisons

75 Our sample includes fund investees from 39 African countries where the initial investment falls between 2012 and 2021. The ORBIS sample is drawn primarily from company accounts of both private and listed African-headquartered firms from the same 39 countries with employee and revenue data within the equivalent time period. Revenues are converted to USD at market rates. Calculation of compound annual growth rates (CAGR) was based on the first and last year each firm appears in our sample. The sample was limited to those firms with at least three years of jobs and revenue data. To test the effects of firm size, we re-ran the analysis including and excluding firms by size, using IFC definitions (micro and small, medium, and large). We also excluded firms that would be outliers relative to the BII firm size distribution (removing those in the smallest and largest deciles). Our sample is weighted towards more recent years, whereas the Orbis sample has more even coverage over time. We split the same into two periods (2013-17 and 2018-21). CAGRs were compared under each of these tests (median, mean, and standard deviation), and in none of them do the results qualitatively change.

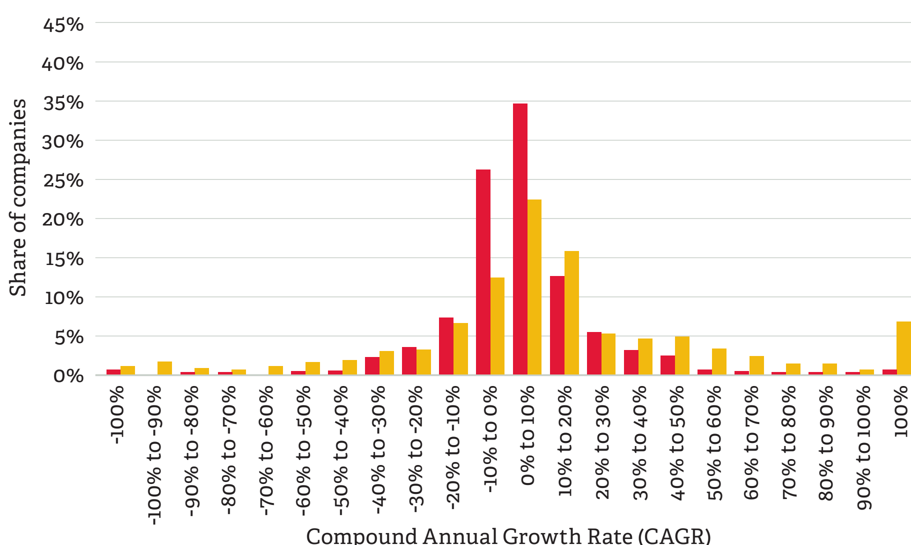
76 World Bank Enterprise Survey data, accessed 15 December 2023, and Olomi & Mori (2015), available here: https://www.enterprisesurveys.org/en/data/exploretopics/finance

Table 2 also reports 'aggregate changes' over five years, computed by summing all firm data for each year before calculating the percentage change. This is to test how firm size is affecting the results: it is equivalent to a weighted average, weighted by firm size. We excluded one very large, fast-growing outlier – one investee had initial revenue of $798 million in 2013 that grew to $6.9 billion in 2021. Excluding that company, the aggregated median and mean growth rates are somewhat lower than the unweighted averages, suggesting smaller firms are growing faster in percentage terms, as one would expect. The aggregate revenue growth in the Orbis sample is negative, reflecting larger companies in the sample that shrunk.[77]

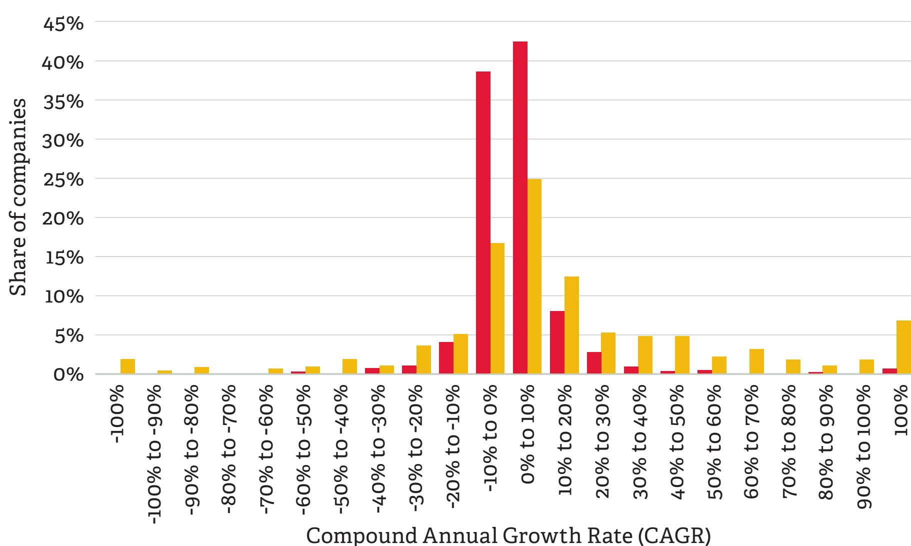
A closer look at the distributions reveals further insights.

1) **BII PE fund investees are more likely to grow extremely fast.** Roughly 7 per cent of BII fund investees more than doubled revenue annually, with a similar proportion (6 per cent) doing the same for jobs. Of these fast revenue growers, 80 per cent started as micro/small, 12 per cent medium and 8 per cent large. The equivalent in the Orbis sample is less than 1 per cent for both jobs and revenue.

a) Revenue



b) Jobs



Orbis BII investees

Figure 10: Distribution of revenue and jobs growth: BII-supported fund investees in Africa vs. other African companies, 2013-2021

77 Jobs did not fall proportionately in those large companies, resulting in positive jobs growth. This may be linked to many large companies being based in South Africa and the relatively rigid employment laws there. South Africa has historically scored very low on labour market flexibility in the World Economic Forum Global Competitiveness Report available here: https://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf, particularly in terms of hiring and firing practices.

2) **This variance is greater for BII right across the distribution, not just at the extremes.** Most companies sit between -20 and 20 per cent revenue growth, with both distributions peaking in the 0-10 per cent group. However, the distribution for BII investees is flatter throughout: over 80 per cent in Orbis are between +/-20 per cent compared with 58 per cent for BII funds. This picture of variance is important because we have little confidence in reported -100 per cent growth rates. Although both datasets contain some zeros, we suspect data is missing for many firms that failed. We would expect to see much more bunching at -100 per cent, given widely reported high VC fund failure rates, which implies the standard deviations we report are inaccurate.

Given that part of our rationale for using funds to reach smaller firms, we reran the analysis looking at SMEs only, according to IFC revenue and employment definitions.[78] Figure 11 shows similarly shaped distributions to the overall sample, based on their size in the first year we have data. The BII sample is drawn from the portfolio of all funds, not just those that self-describe as SME-focused.

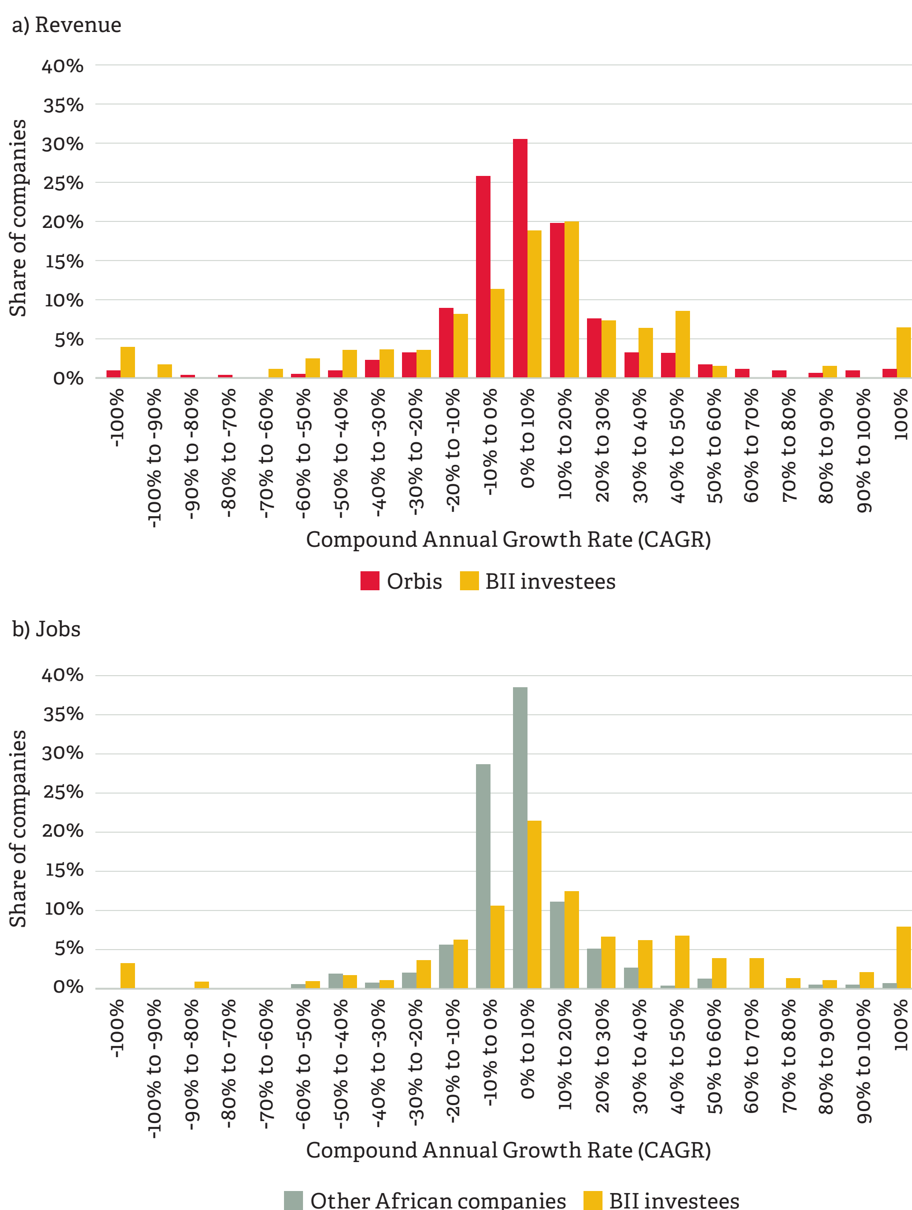


Figure 11: Distribution of revenue and jobs growth: SME investees support via funds vs. other African SMEs, 2012-2022

78 See IFC's Definitions of Targeted Sectors for the classification criteria, available here: https://www.ifc.org/en/what-we-do/sector-expertise/financial-institutions/definitions-of-targeted-sectors

One key difference is that, in comparing BII and Orbis data, the gap between the share of 'superstar' firms (100 per cent-plus) is even wider. In terms of revenue, 0.9 per cent of the Orbis sample are superstars, compared with 6 per cent of the BII funds portfolio. At 9.6 per cent, the median CAGR for BII SMEs is greater than the overall sample, though the mean is lower at 16.6 per cent. This suggests that a focus on SMEs shifts the overall distribution towards higher CAGRs, but the failures bring down the mean.

The findings of this analysis are consistent with the idea that PE funds are helping small and mid-sized African firms with ambitious expansion plans.

6

How we use funds: stages, sectors and impact objectives

The PE funds market can be approached in different ways and for different purposes. Our funds strategy, described in Section 8.3, describes our approach to asset allocation. The overall objective is to direct our capital towards our impact objectives, where our capital is additional. It places fund managers into three categories, according to their commercial track record and risk/return profile, the potential for them to offer impactful co-investment opportunities and their overall impact orientation. There are other ways of cutting it. Some funds are generalists while others focus on specific sectors. Some specialise in early-stage companies while others look for more mature businesses with growth opportunities. And some focus on control deals, whilst others are more likely to take minority positions. And from our point of view as an impact investor, we might also look at funds in terms of the impact objectives they help us achieve – our strategic impact objectives are termed Productivity, Sustainability, and Inclusion.[79]

That all makes for a multi-dimensional strategic matrix that would defeat even the most talented PowerPoint slide designer. Our fund investment decisions are informed by all these considerations, because sometimes we are thinking about how we can use funds to reach certain sectors, to reach firms at different stages of their lifecycle, or to achieve our impact objectives. This section will look through three of these lenses – stage, sector, and objective – and gives examples of each. These examples will focus on early-stage investing, on the infrastructure sector, and on the objective of inclusion.

79 These objectives are defined in Section 2 of our 2022-2026 Technical Strategy, available here: https://assets.bii.co.uk/wp-content/uploads/2022/01/06170001/2022-2026-technical-strategy-2.pdf

6.1 Funding the corporate lifecycle

A business has a lifecycle similar to that of a person. It is born, grows, matures, and it dies (see Figure 12). Of course, not all businesses pass through all phases. Businesses are acquired, merged, spun-out, and reconfigured in various ways. Many die young, others find ways of rejuvenating themselves. But the form of finance a business requires does depend on where it is in its lifecycle.

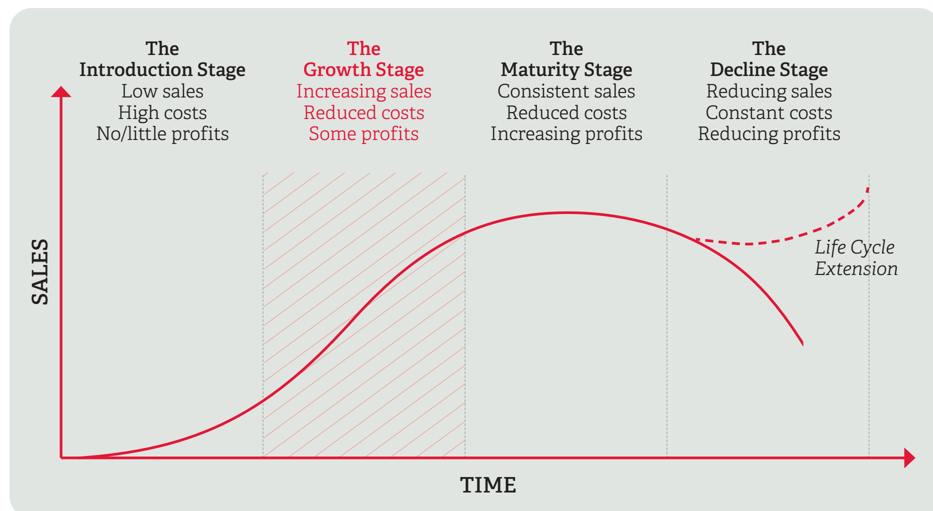


Figure 12: The business life cycle

Figure 13 shows the average amount of capital invested in firms at different stages of development, as reported by Pitchbook at the global and Africa levels. Not surprisingly, young firms tend to start with small sums and those succeed require greater volumes of financing as they expand. Uber's first major fundraise was $1.3 million in 2010. Years later, it was still financing its growth with ever-larger equity fundraising rounds in the tens of billions. Now it issues corporate bonds.

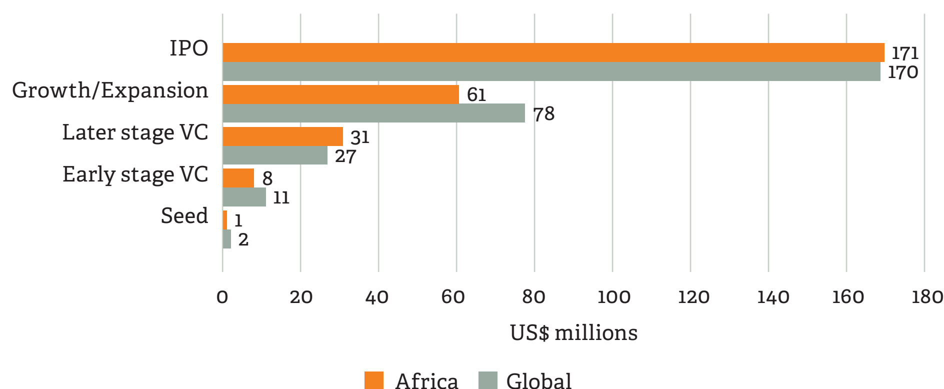


Figure 13: Mean capital invested across different stages of VC and PE, 2014 to 2022[80]
Source: Pitchbook

Most start-ups fail. Estimated failure rates vary – some are as high as 90 per cent.[81] That means a fund targeting start-ups must be able to make very large returns from the few that succeed. VC funds, therefore, look for companies with the potential to scale very rapidly.

80 Categories according to Pitchbook definitions. Seed = financing for a new enterprise at the earliest stage of development; Early stage VC = a Series A to Series B round that occurred within five years of the company's founding date; Later stage VC = a Series C to Series D round, or a round that occurs more than five years after the company's founding date; Growth/Expansion = when a PE firm makes a non-control, equity investment in a company (cash is received by the company and not the selling shareholders); Initial public offering (IPO) = a public investment open for the general public or retail investors.

81 VC Café (2023), Startup death rates spike, available here: https://www.vccafe.com/2023/09/28/startup-death-rates-spike-as-we-approach-q4-2023/

A focus on firm growth is another aspect in which commercial and development impact goals can be aligned. Globally, over 3.5 billion people still live in some form of poverty. That implies we want to find solutions to development problems that succeed *at scale*.[82] Innovative companies introducing new technologies can reach millions of people.[83] Africa is an entrepreneurial continent, and its nascent VC industry has continued to attract investment even as the global VC market has cooled.[84] Innovation for impact is needed generally, but it is especially important to our sustainability objective. Transforming the nature of the global economy – so that it is no longer contributing to global warming and is adapted to the reality of higher temperatures – will require a great deal of innovation and experimentation. Some of the technologies we need may not even exist today, and many new technologies need to see cost reductions before they can be adopted at scale, and for the emergence of business models capable of deploying them profitably. VC investing in climate technology is booming globally.

It would be difficult for DFIs to support early-stage companies directly for the reasons already outlined, but local knowledge and specialist expertise is even more important when assessing the prospects of unproven business models. When the frequency of failure is so high, we need to make many small investments, rather than a few big bets.

Success for a young company does not rest on a single funding round, but rather multiple rounds to finance expansion. Within the VC industry, there are some funds that specialise in the earliest rounds and others somewhat later. As more money is needed by successful start-ups as they grow, we can also invest directly alongside our fund managers (known as co-invests).

Box 5: VC funds and climate

We have supported a number of climate-focused fund managers in South Asia, and exclusively climate-focused funds are started to appear in Africa as well. However, generalist VC funds have also made highly impactful investments in climate technologies.

Novastar Ventures is a Nairobi-based VC fund manager that we have supported since 2014. It has backed BasiGo, the only company deploying e-buses with a 'pay-as-you-drive' revenue model in Africa. Novastar backing will enable the scaling-up of an innovative business model with the potential to transform Kenya's low carbon urban transport industry.[85] Novastar was also an early supporter of MAX.Ng, Africa's largest vehicle subscription platform for low-to-zero emission vehicles. MAX is helping to make motorcycle ride-hailing services greener and safer for drivers and passengers in Nigeria.

Equator is a Nairobi-based VC firm with a tighter focus on climate tech. Equator has supported the scaling of SunCulture, which provides smallholder farmers in Africa with solar-powered irrigation systems, making it simpler and cheaper for farmers to grow higher value crops and increase yield, while reducing water usage by around 80 per cent. SunCulture's products help farmers adapt to changing climate conditions while also reducing greenhouse gas emissions by replacing diesel-emitting fuel pumps.

82 See the World Bank Poverty and Inequality Platform, available here: https://pip.worldbank.org/poverty-calculator?src=EAP,SAS,SSA,LAC,MNA,ECA,OHI,WLD&pv=6.85&oc=pop_in_poverty&on=Population%20living%20in%20poverty&os=millions&od=Population%20living%20below%20the%20poverty%20line%20(2011%20PPP)&tab=table&ppp=2017. This is based on total global population living under $6.85 per person, per day (the typical national poverty line in upper-middle-income countries)

83 This is why digital transformation is an important pillar for our current strategy, available here: https://www.bii.co.uk/en/our-2022-2026-strategy/

84 See Why Africa is defying global trends in VC funding, available here: https://qz.com/africa/2175765/the-big-deal-vc-funding-in-africa-is-up-150-percent-from-q1-2021-to-q1-2022

85 Transitioning towards a low-carbon transport system is one of the priority mitigation activities outlined in Kenya's climate action plan (NDC) for 2030.

VC funds and stakeholder impact

To what extent does the growth of early-stage companies really change lives? Our VC portfolio includes companies like **Moniepoint**, a leading Nigerian fintech that supports financial inclusion, particularly focused on low-income women operating microenterprises. **Trade Depot** uses technology to address inefficiencies in the informal supply chains that serve low-income informal retailers.

Interviews with over 200 TradeDepot customers showed two-thirds are from low-income households and 73 per cent are women. Of the customers surveyed, 88 per cent and 98 per cent, respectively reported that TradeDepot and Moniepoint had improved their lives, with seven in ten reporting life had "very much improved" for the latter (see Figure 14). Three-quarters of customers reported an increase in the number of paid employees and 85 per cent of women users reported increased feelings of empowerment, both attributed to Moniepoint.

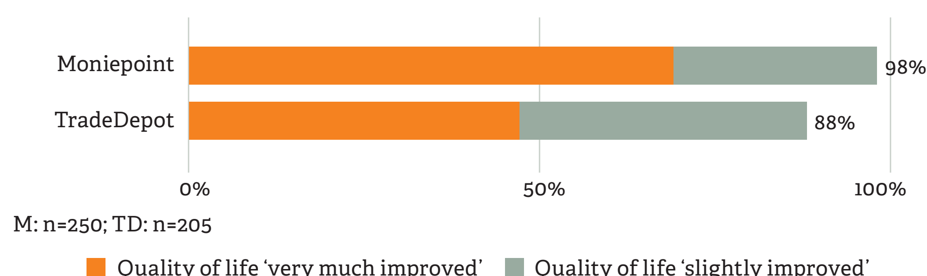


Figure 14: Quality of life: how (and by how much) it has improved for Moniepoint and TradeDepot customers

6.2 Sectors

Fund managers sometimes specialise in a specific sector. We approach investment from a sector perspective – our three business groups are Infrastructure & Climate, Financial Services and Industry, Technology and Services. Each will deploy a set of instruments, including direct equity, equity funds and debt, to best achieve our impact objectives.[86] Investments in sector-specific funds are made under the umbrella of sector impact strategies. It is easier for fund managers to specialise in larger, more sophisticated markets, with more depth.

6.2.1 Generalist funds

Some funds, however, are generalists. Where there is a widespread lack of suitable financing available to firms in African economies, we are interested in improving its overall supply. SMEs, for example, lack access to credit so many of our investments through financial intermediaries are motivated by improving supply to SMEs across the board.[87] Generalist funds typically have portfolio construction limits which will place thresholds on their exposure to any single sector, deal size and (other than single-country funds) country exposure, but placing too many restrictions on a generalist fund would often make it too difficult to find enough investments to operate successfully, running counter to our wider objective of developing local financial markets and mobilising capital.[88] This is often the case in shallower markets, such as smaller and lower-income countries, where there are fewer investment opportunities all round. However, we always define some excluded sectors in which we will not allow GPs to invest our capital as they fall outside our investment policy.

Before my shop was small but now it has increased in size and in stock.

TradeDepot customer (42, Female)

The network allows me to serve many customers and earn enough to take care of my family and when needs are met in the home, everyone is happy.

Moniepoint customer (33, Male)

Providing for myself and family is no longer an issue for me.

Moniepoint customer (41, Female)

86 Our Financial Services Group also invests in credit funds as well as equity funds.

87 See How and why we finance SMEs which shows how often we work with sector agnostic lenders, available here: https://assets.bii.co.uk/wp-content/uploads/2024/01/22173748/How-and-why-we-finance-SMEs.pdf

88 This point is noted in the ITS Portfolio Evaluation Report, which states "...particularly in Africa, the depth and development of the market is such that there are not many sectors where the market opportunity is large enough to merit a sector-specific strategy."

These generalist funds often make investments that are aligned with our impact objectives. Many of the investments in manufacturing and agribusiness and food, shown in Section 3.3, were made by generalist funds. But they will also invest in businesses that we would not prioritise when investing directly, such as certain consumer services segments (non-essential goods, retail, entertainment, etc.). African economies still benefit when such firms have access to capital to grow, create jobs and pay taxes. External observers sometimes highlight investments made by generalist funds for criticism where they appear inconsistent with our mission as a DFI, but those observers may fail to appreciate the role generalist funds play in overall market development, and that we are concerned with impact of the fund's whole portfolio.

Generalist fund managers are also sources of impactful co-investment opportunities. When GPs find investment opportunities that exceed the capital that they can allocate to the transaction, they can ask individual LPs to invest directly alongside them. We make co-investment decisions based on the same impact considerations as our other direct investments (see section 8.2 for more detail).

Our appetite for generalist funds is limited, forming part of an overall strategy that prioritises more impactful sectors and is tied to the stage of market development. Once the market in a country or region is sufficiently well developed and commercial capital is readily available, we would stop supporting them, as we have done in India.

6.2.2 Infrastructure funds

No country can escape from poverty without substantial investments in physical infrastructure. Public investment is better suited to some types of infrastructure, but others better lend themselves to private sector involvement.[89]

Infrastructure is critical to tackling the climate crisis. The sector is responsible for 79 per cent of all greenhouse gas emissions (energy, transport and building sectors being the highest emitters) and 88 per cent of all adaptation costs (Thacker et al., 2021). According to the United Nations Environmental Programme (UNEP) (2023), closing the gap on climate financing for infrastructure – estimated at $56 billion per year this decade – necessitates private investment.

Equity is particularly important for development and construction phases of infrastructure projects (Kim et al., 2022). Because many infrastructure projects are large, we can invest in them directly, but specialist infrastructure funds also help us reach projects we could not invest in alone. Sometimes this is a matter of expertise. Our recent investment in The Urban Resilience Fund enables us to harness the expertise of a specialist in urban infrastructure, including mass transits, waste management and electrical vehicle charging, markets which are at a very early stage in Africa and where we have little track record.[90] Part of the infrastructure-specific challenge that demands this expertise is that there are often not easily identifiable revenue streams, and it can be difficult to transplant business models from other sectors and places. Infrastructure investments are, by their very nature, 'big ticket' items. From an impact and risk perspective, the diversification of investing through funds enables us to support more infrastructure projects than we could do directly.

89 Different countries take different approaches to the appropriate role of public and private investment in infrastructure, with decisions on the balance between wholly public, wholly private, or a public-private partnerships, ultimately in the hands of governments.

90 See: https://www.bii.co.uk/en/news-insight/news/british-international-investment-commits-eur-20-million-to-the-urban-resilience-fund/

The importance of fund managers adhering to our Policy on Responsible Investing is especially important for infrastructure, where ESG risks can be high. According to the ILO, construction is one of the world's most dangerous sectors for workers.[91] In Africa, sector and country risks interact. The International Trade Union Confederation (ITUC) reports "no guarantee of workers' rights" in 12 African countries, and "systemic violations of rights" in a further 22.[92] Such risks highlight the need for bringing about a shift in standards (see Section 5.2). Critically, when we contribute a portion of a fund's capital, our standards apply to the whole fund. In other words, even if we only commit 10 per cent of the capital, our Policy on Responsible Investing applies to 100 per cent of the capital. This matters across our portfolio, but is particularly important in high-risk sectors like infrastructure.

Case study: Evolution II – Mubuga Solar PV Park Burundi

In Burundi, only one person in every ten has access to electricity – the second worst rate in the world.[93] The development need is great, but so are the investment challenges. The country has experienced macroeconomic and political instability. In such environments, where projects often take very long time to reach financial close or fail to progress from the development stage, specialist fund managers can help get projects over the line.

The Mubuga solar photovoltaic (PV) project – a portfolio company of Evolution II, a fund in which BII has a $20 million investment – started operating in April 2021 and now provides more than 10 per cent of Burundi's electricity capacity. It is the first grid-connected solar PV project development by an independent power producer in Burundi and represents the largest international private investment in Burundi's electricity sector in nearly 30 years. Evolution's strategy of partnering with established developers with whom they have long-term relationships was important to closing this deal.

6.3 Objective: inclusion

Inclusion is one of our three strategic impact objectives, because sustainable development requires that the fruits of economic growth are shared across society. Financial inclusion is a major part of that, both as an end in itself, because access to financial services improves lives, and because economic growth tends to be more inclusive where the financial sector is too.[94]

Our impact objective of building more inclusive economies, through investing in a more inclusive financial sector, obviously overlaps with investing in the financial sector in general, but they are not the same thing. Not every financial institution is an equally effective agent of inclusion. Some PE fund managers help us pursue our inclusion objective because they specialise in emerging financial technologies that can reach across society in a way that traditional banking does not.

91 See: https://www.ilo.org/resource/focus-most-vulnerable-workers

92 ITUC Global Rights Index (2023), available here https://www.ituc-csi.org/IMG/pdf/2023_ituc_global_rights_index_en-v2.pdf

93 See World Bank DataBank indicator EG.ELC.ACCS.ZS

94 See our Insights paper How and why we finance SMEs for the evidence on that point.

Over the last decade, the number of bank branches per person in sub-Saharan Africa has stagnated (4.12 per 100,000 adults in 2014 and the same in 2021), yet account ownership has increased from around one-third of people aged 15+ to more than half.[95] This progress has been driven by innovation. According to the UN, "digital finance paves the way for the Sustainable Development Goals".[96] Despite some well-publicised examples of African fintechs, such as M-Pesa, Africa receives a tiny minority of global fintech investing – just 0.76 per cent in 2021.[97]

Many of our most inclusive financial investments are through funds. Again, the importance of the risk-bearing nature of equity for innovation, and the ability of funds to reach smaller businesses, explains why. Apis Partners is a good example of a fund manager with specialist expertise in digital finance.[98] Deep sector knowledge helps Apis anticipate trends and capitalise on impactful sub-sectors, while foreseeing and avoiding risks in others. Specialist fund managers build networks that can contribute to successful exits, thanks to relationships with strategic investors. Apis has supported its investees with product strategy, customer introductions, improved credit underwriting practices, and geographic expansion.[99]

Case study: DPO

One example of an Apis investment is DPO – a company that enables African companies to make digital payments with a particular focus on micro and small enterprises that are excluded from traditional banking. An independent evaluation found Apis gave DPO access to a greater level of knowledge about the payments industry and connections to other market players, as well as supporting DPO's inorganic growth strategy (i.e., growth from acquisitions).[100] This led to a dramatic expansion in DPO operations, including entry into Nigeria and francophone Africa. Since Apis's investment, the number of countries with active DPO merchants has grown from 35 to 89. Apis' investment in DPO has not only enabled it to reach more customers, but has also had impact in *depth* – 72 per cent of merchants reported improved profitability since using DPO services.

95 World Bank Databank. See indicators FX.OWN.TOTL.ZS and FB.CBK.BRCH.P5. Account ownership includes accounts at a financial institution or with a mobile-money-service provider.

96 UNSGSA (2018)

97 See the World Bank's Global Findex Data Dashboard and Ruddenklau (2022)

98 See https://apis.pe/

99 For more information on Apis and its investments, see evidence submitted to the International Development Committee: https://committees.parliament.uk/writtenevidence/117674/pdf/

100 Khurana et al. (2023)

Case study: Apis and Sun King (Greenlight Planet)

The potential for off-grid technologies to bring electricity to excluded households is well-known. In sub-Saharan Africa, the International Energy Agency (IEA) estimates that private sector off-grid is the lowest-cost option for 75 per cent of the future connections needed to meet SDG 7 (affordable and clean energy) (IEA, 2017).

Financing is an underappreciated part of the story. Large upfront payments are extremely difficult for credit-constrained low income households, and their willingness to pay for money-saving technologies is low.[101] Pay-as-you-go (PAYGO) models have made off-grid energy more affordable to the poorest: the daily payments can be less than spending on kerosene. Gertler et al. (2023) find that PAYGO offers consumers large welfare gains.

In 2017, Apis invested in Sun King (formerly Greenlight Planet), a vendor of off-grid products including solar panels, battery storage and appliances, with a focus on finance. Apis helped Sun King pilot and introduce stronger credit underwriting policies, and helped it raise local currency debt financing to reduce foreign exchange (FX) risk. Sun King has expanded into new geographies following Apis Fund I's investment, including direct sales in Zambia, Mozambique, Myanmar, and India, and more in partnerships.

In a survey of over 275 Sun King consumers in Nigeria, more than three-quarters of them were from low-income households, more than 86 per cent reported 'first time access', and only 7 per cent reported being able to easily find a good alternative. More than four of five respondents reported Sun King products were either 'somewhat inexpensive' or 'very inexpensive'.

Sun King also provides predominantly unbanked consumers with their first access to formal financial services, which creates a credit history that can help customers gain access to cheaper financial services in the future.

They made the payment system whereby even a poor man can afford your product.

Sun King customer (52, Male)

The solar gadgets have been very useful to us in my house and the payment is not too much... it is not a burden on me.

Sun King customer (56, Female)

6.4 Gender-smart investing

Gender is a central pillar of our inclusion objective, as stated in our 2022-26 Strategy and accompanying Position Statement.[102] Across the global economy, women are underrepresented and undervalued. In 2021, over 1 billion working-age females were outside the labour force in low- and middle-income countries, compared with less than 600 million men.[103] These inequalities degrade the lives of women, and the wasted potential is also a source of economic inefficiency (Chiplunkar & Goldberg, 2021). We are a founding member of the 2X Initiative to mobilise gender-lens investing that provides women in emerging economies with access to leadership opportunities, quality employment, and products and services that enhance their economic participation and inclusion. In the last year (2022-23), almost two-thirds of the fund managers we invested in met 2X qualifying criteria, some of which were smaller funds, so the proportion by value was 38 per cent.

101 Berkouwer & Dean (2020) found on average low-income Kenyan households were willing to pay $12 for a cookstove that saved around $120 per year in fuel costs. Access to credit doubled willingness to pay.

102 Available here: https://assets.bii.co.uk/wp-content/uploads/2022/02/02182247/Gender-and-Diversity-Finance-Position-Statement-2022-26-1.pdf. More broadly, "putting women and girls centre stage" is a priority of the UK Government's White Paper on International Development (2023), available here: https://www.gov.uk/government/publications/international-development-in-a-contested-world-ending-extreme-poverty-and-tackling-climate-change

103 World Bank, World Development Indicators, accessed 31 August 2023.

Working with PE fund managers means we can support the adoption of gender-lens investment across Africa. Our Gender Masterclass was started in 2018 to build understanding of gender-smart investing (GSI) practices among fund managers, and tools that GPs can use to adopt GSI approaches. In a recent set of independently conducted interviews across a sample of African fund managers, they reported the Masterclass had helped them to:[104]

- Refine approaches to negotiating gender action plans with their investees.
- Update their gender due diligence to help promote equity in workplace policies and human resource practices.
- Adapt their own workplace policies, such as putting in place a parental leave policy that helped retain women employees.
- Make progress towards integrating Gender Action Plans into broader Impact Plans.
- Consider how products and services offered by their portfolio companies could be geared to women customers, thereby unlocking new market opportunities.

104 Case Study on BII's Gender Masterclass: Outcomes Achieved & Lessons Learned.

7

Impact monitoring

We invest via funds because they are an effective conduit for our capital to reach highly impactful businesses at scale. We monitor the impact of fund investments by collecting impact metrics that funds reports to us, and through site visits and commissioning evaluations and surveys. Funds increasingly publish their own impact reports, but some of what they report to us GPs would regard as commercially sensitive.

Some impact metrics, such as jobs and revenues, can be collected from funds and aggregated for reporting purposes. Those metrics are important, but they only provide a partial indication of impact. A more complete picture of impact means understanding the specifics of what a business does and the context in which it operates. Richer qualitative impact studies are challenging for fund managers, particularly for smaller and less deep-pocketed funds with stretched teams, because they are resource intensive. It can also be intrusive for the management of businesses with many demands on their time.[105]

For intermediated investments, with so many underlying investments in our fund portfolio, our approach to impact monitoring necessarily differs from our approach where we have a smaller number of relationships with the businesses that we have invested in directly. We have a responsibility to understand how our capital is being used, and funds are covered by our evaluations and learning programme (see below), but monitoring the impact of fund investments ourselves would not make sense. The best solution for us, and for the market, is for fund managers to develop their own impact reporting systems, and be accountable to all their investors for understanding, maximising and communicating the impact they are creating. This forms part of our efforts to support the creation of sustainable fund managers with all the in-house capabilities they need. We are seeing an increasing number of fund managers publishing impact reports, either as a standalone document or as part of a broader 'ESG & Impact Report'. We also encourage the fund managers we work with to consider adopting (and ideally becoming a signatory to) the Operating Principles for Impact Management a framework for investors to ensure impact is meaningfully and purposefully integrated throughout their investment process.[106] Signatories are subject to third-party verification of impact management practices.[107] Finally, we frequently run impact management training sessions with GPs, in addition to the courses we run on business integrity and ESG, to help strengthen their monitoring capabilities.

105 Impact Frontier is leading an industry-wide effort to define impact reporting norms, see https://impactfrontiers.org/work/impact-performance-reporting, to establish shared expectations for impact reporting by GPs. Dichter & Bourke Why investment funds don't have enough high-quality impact data, SSIR 2024, discuss the problem of resourcing impact monitoring at GPs, see: https://ssir.org/articles/entry/impact-investing-high-quality-impact-data

106 See https://www.impactprinciples.org/

107 A list of OPIM signatories can be found here: https://www.impactprinciples.org/signatories-reporting

Box 6: Adenia Capital's impact reporting

Adenia Capital is an OPIM signatory and in 2019 it introduced a systematic Impact Management and Measurement (IMM) framework to report against two long-term impact targets aligned with SDGs: i) the improvement of job quality and diversity (SDG 5 and 8); and ii) the increase in sustainability of operations (SDG 9 and 13).[108] Every investment undergoes pre-acquisition due-diligence against these objectives, alongside the exploration of other specific impacts investees may deliver, and relevant indicators are monitored at the investee and fund level.

Figure 15 provides a visual representation of Adenia's portfolio-level impact. The expansion from the red triangle (impact assessment at the point of acquisition) relative to the orange triangle (assessment at the end of 2022) indicates progress against the impact goals. Different investees have different impact profiles. For example, Kanu Equipment, a construction and agricultural plant distribution company working across Sub-Saharan Africa – focuses on job quality and diversity. Employees are paid on average almost ten times the legal minimum wage, and there is a strong focus on gender equality and professional development via technical training. Eastcastle Infrastructure, a communications company working in DRC, Nigeria and Cote d'Ivoire – focuses on enabling access to poverty-reducing services that rely on and build upon mobile technology. Adenia also reports local involvement in its companies' supply chains. This includes the value of the purchases of goods and services from domestic suppliers, and, where relevant, the number of farmers inked to the client of company.

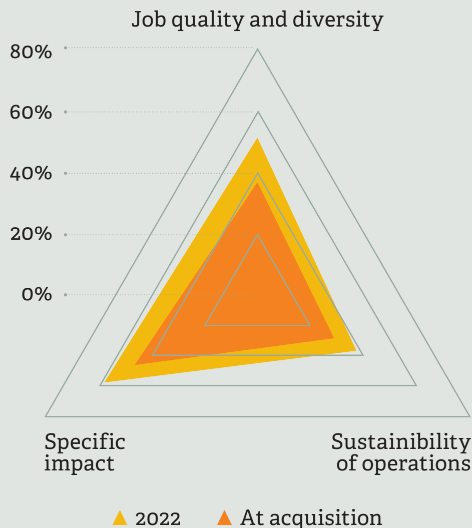


Figure 15: Representation of Adenia IV's portfolio-level impact

Impact reporting is constantly evolving, so the information requirements we make of fund managers today are more extensive than those we agreed with managers years ago. Because funds are so long-lived, the information we receive from managers in our portfolio also varies depending on when our investments were made. In addition, impact reporting requirements are agreed to suit the nature of the fund.

108 See Adenia Parnter's 2022 ESG and Impact Report, available here: https://www.adenia.com/media/tw1kps2r/adenia-partners-esgi-report-2022.pdf

For generalist funds, it is difficult to identify 'standard' impact metrics that will apply across the fund's portfolio given the broad range of companies and sectors invested in. For such funds, we typically use revenue and jobs growth rates as rough proxies for impact. If revenue and jobs are growing, we can usually be confident the positive impacts that a business has on society are growing as well. These standard metrics are often complemented by company-specific metrics for certain sectors (e.g., improvement in student performance for an education investment).

For sector-specific funds, we usually collect additional standard impact metrics across the portfolio. For agriculture funds, this might relate to the number of farmers reached or increase in total output (volume/value) of crops. For financial inclusion funds, this might include number of loans disbursed (disaggregated by client income or SME size) or total number of customers reached with a new financial service (disaggregated by different categories, such as whether or not they had previous access to such a service).

Some of our more recent fund investments include financial renumeration tied to delivery against impact objectives.

Impact metrics, such as the number of loans made or the demographic characteristics of a businesses' customers, are indicators of performance. However, really understanding the difference a business makes to people's lives usually requires a more in-depth evaluation. Alongside annual monitoring, our fund investments also fall under the FCDO–BII Evaluations & Learning Programme, which consists of independent third-party evaluations commissioned by FCDO. These evaluations consist of two phases – overall assessments of the portfolios of each of our three business groups (financial institutions, infrastructure and climate, and industry, technology and services) and more in-depth looks at sets of individual investments, some of which are fund investments.[109]

We also commission in-house evaluations and surveys, sometimes as pre-investment due diligence, which sometimes cover fund investments.

We recently surveyed over 4,100 stakeholders of 19 BII investees in Nigeria and Egypt, including companies we have invested in directly, as co-investments, and via funds.[110] This is a relatively small sample, and not necessarily representative, but our fund investments appear to reach a wider range of stakeholders than our direct investments and the overall percentage of stakeholders we classify as low-income was higher at fund investments and co-invests (see Figure 16). Stakeholders of fund investments were also more likely to rate the investee highly on a measure of satisfaction. Fifty-five per cent of fund investee stakeholders were considered 'promoters', compared with 49 per cent of directs and 42 per cent of co-investments.[111]

109 The second phase of the financial services sector evaluation includes two fund investments, DPO (fund manager Apis) and Arohan (fund manager Aaviskaar) available here: https://www.bii.co.uk/en/news-insight/insight/articles/whats-the-impact-of-our-financial-services-portfolio/. A recent evaluation of gender investing covered funds, available here: https://www.bii.co.uk/en/news-insight/insight/articles/how-does-investing-in-companies-and-funds-with-gender-diverse-ownership-and-leadership-support-positive-outcomes-for-women/

110 Stakeholders can include a range of persons affected, depending on the impact thesis of the investment. Here they are placed into four groups: customers, suppliers, contractors, and employees. We recently conducted a similar exercise for our India portfolio – see Understanding who we reach: a deep dive into our portfolio in India, available here: https://www.bii.co.uk/en/news-insight/insight/articles/understanding-who-we-reach-in-india/

111 Based on the Net Promoter Score (NPS), a widely-used measure to gauge views on a company. Stakeholders were asked on a scale of 0-10 how likely they were to recommend the company, product or service to a friend or family member. 'Promoters' were assumed to be those with a score of 9 or 10, while 'detractors' are assumed to be those with a score of 0 to 6.

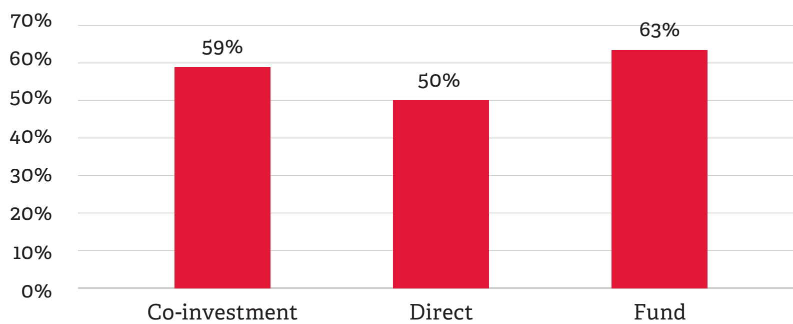


Figure 16:

We also asked stakeholders to describe how businesses have impacted them, in their own words. Respondents were asked: "Has your quality of life changed due to Company X?" Two-thirds reported their quality of life had improved, with 30 per cent reporting no change and 4 per cent reporting it had become worse. They also had the opportunity to explain how in a follow-up question. Responses most frequently referenced improved incomes and better access to food for their families (but do not always say quality of life has improved). For example:

*"I now get everyday **money** which guarantee[s] my feeding and other domestic bills like school fees and health bills."*

*"It has been **improved** as I have a stable job with a specific net salary each month which is hard to find a job with this nowadays so I can afford my house needs."*

*"It is hard to say I am even seeking a **better** quality in the meantime. My life is just stable and so is my quality of life, the company is a main contributor to that as my salary is fixed and so are the working hours, but quality of life is the same."*

Impact case studies

This section presents three short case studies, to give a flavour of the variety of ways in which the businesses our funds have helped grow have an impact, in agriculture, renewable power and manufacturing.[112]

Case study: Coscharis Farms

Rice is a staple in Nigeria, but domestic production is often from small and unproductive farmers. BII-backed Fund for Agricultural Finance in Nigeria (FAFIN) has invested in Coscharis Farms in Anambra State. Coscharis covers the rice value chain from cultivation, milling, storage and marketing. As of June 2020, the farm was growing on 1,300 hectares and was developing an outgrower scheme expected to reach 4,500 farmers. It has built a rice mill and contracted local storage facilities. A survey of 200 Coscharis farmers found that 96 per cent are estimated to be low income, around two-thirds said that their quality of life had improved, and 82 per cent reported having no alternative access to the services Coscharis Farms provides.

There is improvement because I had a better yield, which means more money for me... I paid my children school fees from that money, you know the way things are difficult in this country but I was able to make profit out of my farm as a result of Coscharis Farms.

Coscharis Farmer (49, Male)

They encouraged me to do this rice farming. Now food is on my table. I have money and I can solve problems that arise in my life because I make more profit now.

Coscharis Farmer (28, Female)

They have removed the stress of me looking for buyers and I have made profits from this farming, I have increased my farmlands and I have started to process the rice so now my business has expanded, I am able to send my son to the university just last year, thanks to Coscharis Farms.

Coscharis Farmer (52, Female)

112 Case studies are often conducted opportunistically and do not follow a selection process designed to produce a representative sample.

Case study: PRIF commerical and industrial solar power

Pembani Remgro Infrastructure Fund (PRIF) is managed by an experienced team based in South Africa. BII is a major LP alongside Remgro (a South African publicly-listed investment holding company).

PRIF has invested in GridX Africa, which develops and finances solar and energy storage solutions for businesses across, and has operating projects in Kenya, Tanzania and Mozambique, and pipeline projects in the DRC, Zambia and South Africa. It specialises in financing the development of solar power for commercial and industrial (C&I) customers, without the need for upfront payments. One of its biggest projects is at the Two Rivers in Nairobi, a mixed-use development integrating retail, commercial and residential properties. Its solar panels already contribute peak of 11 per cent of power needs to the site, and GridX plans to reach an annual average of 24 per cent of peak demand. The same fund manager has also invested in Solar Saver, another developer of C&I solar generation that does not require customers to put up any capital or financial guarantees. SolarSaver now runs the largest fleet of self-financed C&I solar in Southern Africa – over 450 installations operated under long-term rent-to-own and power purchase agreement (PPA) contracts in South Africa, Namibia and Botswana. The impact of these investments consists of the avoidance of carbon emissions and businesses benefitting from lower-cost power.

Case study: Garment manufacturing in Ghana

Verod Capital is a generalist PE firm based in Lagos and Accra that invests in Nigerian and Ghanaian SMEs. Verod has invested in the expansion of Do the Right Thing (DTRT), West Africa's largest apparel manufacturer, founded in 2013. DTRT has large clients in the US and EU, and using raw materials sourced from Asia, its manufacturing is carried out in two sites in Ghana, in Accra and Tema. DTRT has approximately 5,000 employees in Ghana, over 70 per cent of which are women, mainly aged between 18 and 35. DTRT says each employee supports an average of three to five dependents, and that entry level staff earn twice the Ghanian statutory minimum wage on average. They also receive additional support for transport, meals and medical care. DTRT has a gold-level certificate from the Worldwide Responsible Accredited Production (WRAP) organisation, verifying its commitment to ethical manufacturing and employment practices. The company retained all its staff during Covid-19. DTRT is planning an expansion of its Tema site and a move into more complex designs, to grow its customer base.

Since Verod's equity investment, DTRT has raised additional debt funding from the IFC to develop West Africa's first sustainable, water-free fabric mill, and is looking to attract fibre extrusion and farm spinning companies to supply the mill, included from recycled materials. The impact of DTRT consists primarily of the jobs it has created, but like many African countries, Ghana sometimes experiences damaging foreign currency shortages, so export industries are of macroeconomic importance.

8

BII and African funds: history, lessons learned, and our strategy

This section presents our current approach towards the African PE market, which builds on our decades of experience as the largest single LP in this market. Our focus is on what we have learned about the African PE funds market from an investor's perspective: what explains the relative performance of the African market and different fund managers within it, and finally what that implies for us and other investors.

We start with an overview of the financial performance of African PE funds, and some of the challenges fund managers have faced. The financial returns delivered by fund managers are essential to achieving our impact objectives. We want the African PE industry to succeed and raise more capital to invest in African economies without being overly reliant on DFIs – following the trajectory we have seen in South Asia.

For that, two things must happen. Investors must see a reasonable prospect of positive macroeconomic trends on the continent, and they must see that PE fund managers are capable of delivering returns. That is not quite the same thing as saying that African PE fund managers must first deliver financial returns that are in line with or above benchmarks before the African PE industry can grow, because forward-looking investors will be willing to adjust for an adverse macroeconomic past if they think the macroeconomic future will be brighter. But a strong financial track record is the first thing potential fund investors look for, nonetheless.[113] Investors want to know PE fund managers can invest successfully, despite the elevated risks in many African countries. Our experience has taught us there are identifiable fund managers that have demonstrated they can achieve this.

113 The Funds Mobilisation Evaluation Report concludes that "the most important demonstration effect a fund can create is through financial performance." (Itad, 2024)

We also care about the financial returns from our PE fund investments because we want to recover capital to recycle into new impactful investments. The approach to funds investing presented below is designed to maximise our impact while staying within the financial performance parameters set by our shareholder.

Like all DFIs, we have a mandate to be additional, which means we are willing to invest where the combination of risks and expected return is not attractive enough for commercial investors. But we also want the funds we support to attract private investors, which means we must operate on the frontier of commercial appetites. We would not invest in funds that can raise all the capital they need without us, but there are many examples of funds that can only find part of the capital they need from commercial investors. GPs report their performance with the consent of their LPs to industry bodies such as Cambridge Associates, which supplies data to the African Private Capital Association (AVCA) and the GPCA.[114] The following section will refer to financial performance data reported by GPs to Cambridge Associates.

8.1 Historical financial performance

The African PE industry has experienced periods of outperformance. Figure 17 shows how the early days of PE in Africa – which consisted largely of South African funds in the mid-1990s to early- to mid-2000s – saw comparable or better performance than other emerging markets. Cole et al. (2020) show that emerging market PE has outperformed global benchmarks historically, based on data from the IFC's PE investments, and that some of the highest returns in its portfolio came when funds were early into frontier markets that went on to experience positive macroeconomic trends. In addition to entering a frontier market at the right time, another way to make good returns is to pick the right time to re-enter a market after it has underperformed, when valuations are still low (the other way of making good returns is having the ability to identify better-than-average fund managers).

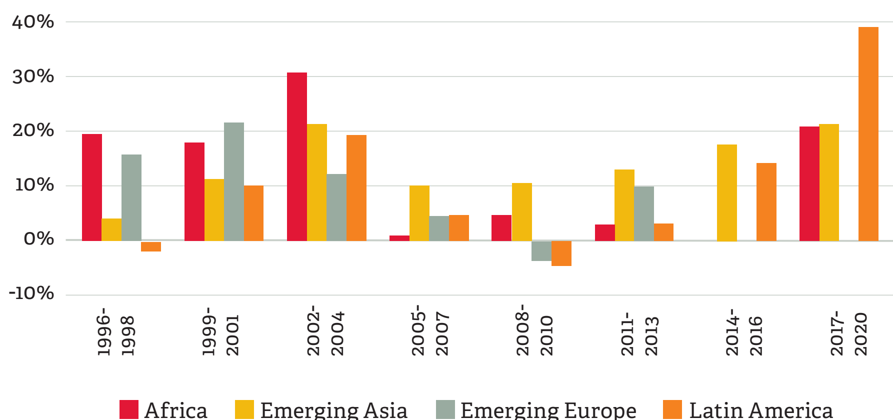


Figure 17: Pooled net internal rates of return (IRRs) by vintage year groups in Africa and other emerging markets, 1996 to 2020[115]
Source: Cambridge Associates LLC.

114 Because our fund selection differs from that of a commercial LP, and we have excuse rights that sometimes means our returns differs from other LPs, we do not regard our portfolio performance as indicative. Potential investors in African funds seeking to understand the performance of our portfolio can engage directly with our funds teams.

115 One of Cambridge Associates benchmarks representing dollar-weighted net IRRs – as reported by individual fund managers in their quarterly and annual audited financial reports – pooled together across fund managers and years in which their funds began making investments (vintage).

8.1.1 Macroeconomic challenges

In recent years, global financial markets have been dominated by the extraordinary dollar-denominated performance of the US market. That reflects both the strengths of the US economy and of its global corporations, and the series of crises that more negatively affected other regions of the world. Within that, PE has also outperformed other asset classes.[116] As table 3 shows, in recent decades, the US PE and VC industry has dominated other regions.

Index	1-year	3-year	5-year	10-year	20-year
Africa PE & VC	4.27	8.92	3.95	4.54	9.85
Africa/Pacific Emerging PE & VC	2.27	6.63	8.69	12.20	12.23
Europe Emerging PE & VC	10.19	12.51	5.69	1.96	9.12
US PE & VC	3.68	15.50	15.46	15.06	15.01

(Fund index summary: horizon pooled return, net to LPs)

Table 3: Comparative PE and VC end-to-end returns by region, Q3 2023[117]
Source: Cambridge Associates LLC, data as of 30 September 2023

The relative macroeconomic fortunes of countries are reflected by exchange rate movements. Investors usually care most about returns once translated back into their home currencies, but the global investment market defaults to measuring returns in dollars. The revenues and earnings of the businesses that PE funds invest in, which underpin the valuations of those companies, are usually denominated in local currencies, unless they are exporting. Local currency inflation can offset nominal exchange rate depreciation, but – as a rule – when there is 'real' devaluation, the dollar value of PE investments in those countries falls. Cross-border PE investors are usually taking unhedged currency risk.[118]

In the last decade, African currencies have almost universally depreciated against the US dollar, by a median of 31 per cent (see Figure 18). Hence, even fund managers that have been successfully investing growth capital in businesses, seeing revenues and earning grow, and selling those businesses for a high return in local currency, have struggled to deliver attractive dollar returns to LPs.

116 In theory, investment markets should equalise the risk-adjusted returns on different asset classes. The mechanism is arbitrage: prices should adjust as investors move money to chase returns. But differences can persist for some time. Investors may be slow to react, or they may overreact, and too much money may push up prices and hence push down future returns. For decades, the global PE industry had touted superior returns, and the sums of money allocated to it ballooned. The evidence suggests that on a risk-adjusted basis, global PE returns are now in line with other asset classes, and it is quite common to read investors expressing concerns that too much money has flowed into PE, which may presage below-market returns in the future. The FT article Is Private Equity Actually Worth It? available here: https://www.ft.com/content/55837df7-876f-42cd-a920-02ff74970098 is an excellent survey of the issues.

117 The Cambridge Associates benchmark shown in this table pools funds managers' returns into an index, with performance assessed (as an IRR) between two points in time. So, according to this index, as at 30 September 2023, pooled cash flows from African PE and VC funds yielded a net return of 4.27 per cent to LPs over the preceding one-year period, 8.92 per cent over the preceding three-year period, etc.

118 It might be possible to hedge the currency exposure of a PE portfolio in high income countries with deep FX markets, but exit time horizons of equity investments are difficult to predict, and long-term currency hedges are very expensive and not available at any price for most African countries.

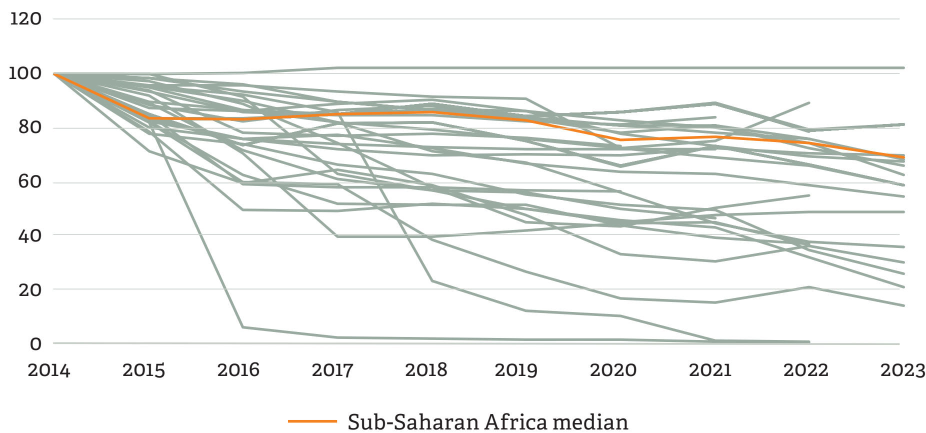


Figure 18: African currency depreciation against US Dollar, nominal exchange rate annual average, 2014 to 2023 (2014 average = 100)
Source: IMF, International Financial Statistics.

The last couple of years have seen some very sharp depreciations in some major African economies, such as Egypt and Nigeria. Many countries are struggling with excess debt and may require International Monetary Fund (IMF) programmes and debt forgiveness. If these macroeconomic problems can be resolved, and once currencies find a level consistent with dollar liquidity in the FX market, equity investors in Africa should see better days.[119]

By some accounts, the 'Africa rising' narrative that took hold in 2011 resulted in a volume of capital flowing into African PE funds that exceeded the supply of good investment opportunities. This contributed towards lower returns as funds competed for deals and overpaid, but more modest levels of fund raising since then is helping the market find an equilibrium (according to AVCA, fund raising peaked in 2015).

8.1.2 Microeconomic challenges

Compounding often difficult macroeconomic circumstances, African fund managers also face a set of challenges in their markets that can make it harder to deliver returns to LPs, even if successful fund managers have developed the capabilities to overcome them.

Some of these challenges are self-reinforcing. For example, a lack of exit opportunities pushes down valuations, and low valuations raise the cost of capital to firm owners, making equity less appealing and investments harder to find. Whereas when capital markets are thriving, a vibrant secondary market makes for a vibrant primary market. Easier exits make entry easier. Also, small fund sizes make it harder to achieve good returns, but good returns are needed to help raise larger funds. Should the African PE market follow the trajectory of South Asia, we should see these dynamics stop working against fund managers and start working for them.

When finding and exiting from investments is harder, everything takes more time and – the aphorism is apt here – time is money. As described in Section 4.1, fund managers typically charge a 2 per cent annual fee *of the committed capital of the fund*. The longer they are charging fees without having investments in their portfolio that are gaining value, the worse net returns to LPs will be. African fund managers need to spend more of their time fund raising, but they operate in a thinner market so investments and exits are harder to find, and other aspects of deal making can take longer – for example when regulatory approvals are required. Since 2012, in the US, the median time between closing a fund and its first deal is almost 0.7 years.[120] While it is difficult to provide comparable figures for Africa due to the relatively small number of funds, our experience has revealed slower investment pace which has been further slowing over time.

119 'One swallow does not make a summer', but at the time of writing, Bloomberg was reporting Billions Pour Into Nigeria as Tinubu's Reforms Start to Pay Off, available here: https://www.bloomberg.com/news/articles/2024-03-08/billions-pour-into-nigeria-as-tinubu-s-reforms-start-to-pay-off

120 Pitchbook as of 10 September 2023

That said, 2022 was a record-breaking year for exits in Africa, with 82 private capital exits reported, almost double the 2012-19 average.[121] AVCA (2023) suggests this may relate to global macroeconomic uncertainty leading to fund managers prioritising disposal of assets, as well as finalising exits that were postponed due to the effects of the Covid-19 pandemic. Generally, the time that elapses between a fund making and exiting investments is rising globally.[122] This is showing up in the amount of time funds hold onto assets. Figure 19 reveals that in Africa, the average holding period of individual PE investments has increased from 5.7 years in 2013 to 7.1 years in 2023. The increase, linked to fewer exit opportunities, is also apparent in other markets, though holding periods are consistently higher in African PE.[123]

Across our portfolio of funds whose fund raising was at least ten years ago, the average fund took around 12 years to fully return our initial capital, as measured by "distributed to paid-in capital" (DPI).[124] The top quartile funds return capital after around eight years.

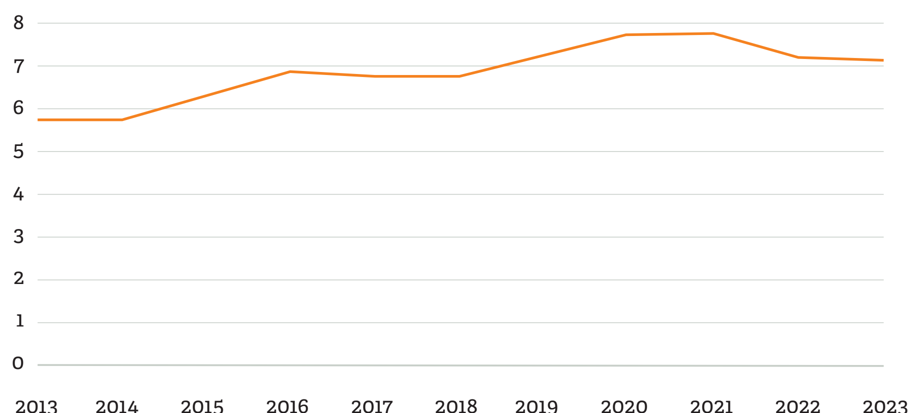


Figure 19: Average Holding Period in PE exits in Africa, 2013 to 2023 (three-year rolling average)
Source: AVCA.

PE fund managers have three main exit options: an initial public offering (IPO) on a stock market; selling the business to another business; or selling the business to another investor. IPOs are rare in Africa and, as shown by Figure 20, have become increasingly rare recently. Outside of South Africa, the continent's stock markets are very inactive and the lack of liquidity means it can be difficult to exit via a listing. In Africa, selling to secondary/financial buyers has grown from almost nothing to being one of the most common type of exit alongside strategic buyers (acquisition by a firm). By comparison, IPOs have been a consistently frequent exit route in Indian PE, with its relatively active stock market.

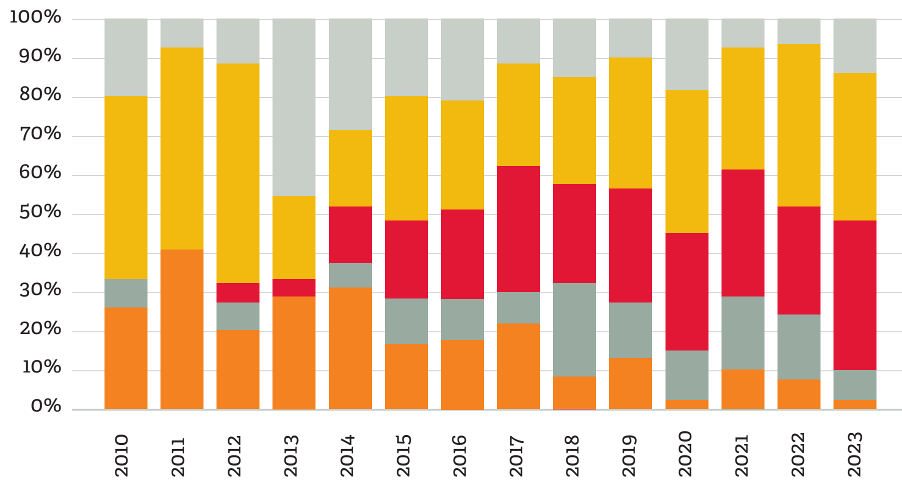
121 AVCA (2023) 2022 African Private Capital Activity Report, available here: https://www.avca.africa/data-intelligence/research-publications/2022-african-private-capital-activity-report/

122 According to McKinsey & Company (2023), the ratio of exits to investments as of Q3 2022 fell to 0.38, the lowest level since 2008.

123 See Pitchbook (2023) What's in store for fundraising in 2024? Here are three predictions, available here: https://pitchbook.com/news/articles/vc-pe-fundraising-predictions-2024

124 Distributed to Paid-In Capital (DPI) is a measure of the total capital that a fund has returned to its investors, relative to the amount initially paid in. Time taken to fully return capital refers to the year when DPI reaches 1.0x. It does not imply the fund has fully exited its investments and paid out – a positive return for investors implies a DPI of above 1

a) Africa



b) India

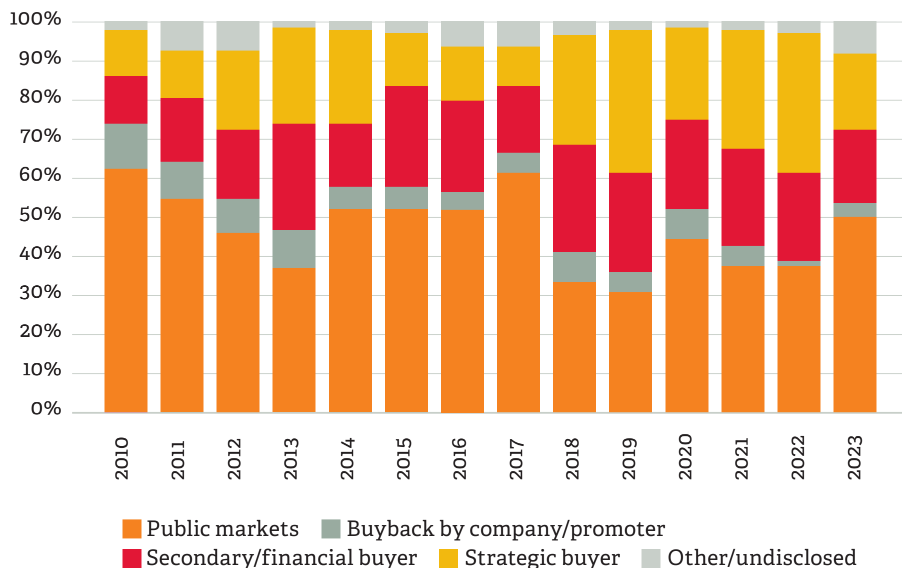


Figure 20: Share of annual exits by transaction types (number of deals), 2010 to 2023
Source: GPCA.

Holding periods in Africa may also be longer because in more challenging economic contexts, it can take more time for fund managers to add value to investees, by helping them develop better business plans, find operational efficiencies and new avenues for growth. Sometimes fund managers will acquire businesses from other fund managers. If valuations rest on fund-to-fund sales, financed by new capital supplied by LPs, there is a risk of valuations becoming unmoored from what anyone would pay, should the flow of new capital dry up. But there can be legitimate reasons for fund-to-fund sales, when the first fund has run out of time or funding to support an acquisition by the investee, or has used all its levers for value addition, and the new owner has different capabilities and can continue to add underlying value.

The cost of longer holding periods makes itself felt in the gap between the fund's gross returns and the net returns to LPs, because more LP capital is being allocated to paying the fund's management fees.

Difficulties finding buyers, and the longer periods of time needed to add value to firms, have contributed to an upward trend in the share of African PE investments, by value, that are classified as buyouts. Figure 21 shows the dollar value of buyouts has recently converged on the value of growth equity, although in terms of the number of investments, growth equity still dominates. Not all of these buyouts will be from other GPs, although as Figure 20 showed, sales to other investors are rising. Some investments categorised as buyouts will also include some primary investment alongside the secondary.

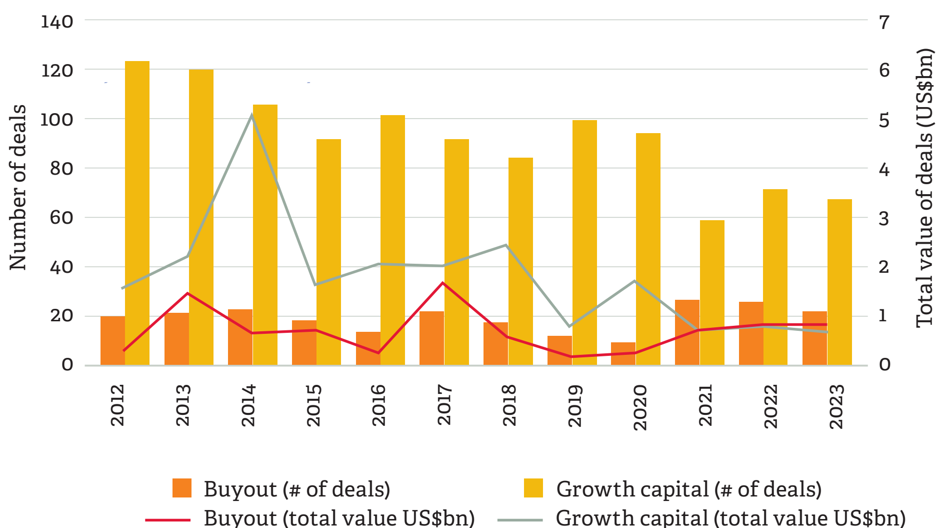


Figure 20: Growth vs. buyout capital in African PE, 2012 to 2023
Source: GPCA.

Figure 14. Growth vs. buyout capital in African PE, 2012 to 2023

Leverage

In rich countries, private equity is synonymous with leveraged buyouts (LBOs), whereby a company is acquired using borrowed money that later becomes a liability of that company. From the point of view of equity investors, leverage amplifies returns when things go well. Buying a company with £40 million of equity and selling it for £60 million is a 50 per cent return on equity. Buying it using £5 million of equity and £35 million of debt, and selling it at an enterprise value of £60 million, which values the equity at £25 million, net of debt, the return on equity would be 400 per cent (£20 million profit divided by £5 million).[125] Some of the most infamous examples of LBOs have been very highly leveraged, although in 2023 the US average share of equity finance in LBOs was reportedly 50 per cent.[126]

As an impact investor, we are interested in PE fund managers that create value by growing underlying companies, by either supplying growth capital or by non-financial interventions. We are not interested in generating returns through financial engineering alone. The African PE fund managers we invest in generally do not use debt to acquire companies and focus on driving growth and improving margins to deliver a financial return.[127] However, because African PE managers often cannot use leverage to amplify their returns on equity, it makes it all the harder for them to deliver absolute returns that compares favourably to those offered by PE funds in rich countries, that do. African PE managers must rely on underlying value creation and, if they are fortunate, multiple expansion.[128]

125 This is a simplification that ignores the cost of servicing debt. A sale price implying a £60m enterprise value would not be assured.

126 See the FT article Debt-fuelled dividend recaps prop up private equity, available here (paywall): https://www.ft.com/content/b33cb3b0-a90a-41f1-adfe-99261088d53e

127 Companies that have received equity investments from PE funds may of course also borrow money too. The distinction between and LBO and borrowing for growth lies in the use of funds, and whether the GP takes cash out of the business to repay debts taken on to acquire the business.

128 Companies are often valued on a multiple of earnings. Sometimes valuations rise because the multiples investors are willing to pay increase, sometimes because earnings increase, sometimes both.

Fund scale

Because GPs are paid a fee based on the percentage of fund size, the managers of larger funds have more money to invest in their internal systems and expenses, staff that source and manage investments, and on diligence and some other transaction costs. Because the returns to LPs are net of a fee that varies with fund size, their returns do not benefit from economies of scale as they would from a business with fixed costs, but LP returns may benefit from GPs being better resourced. The GPs themselves, however, need to cover fixed costs and a smaller fund size makes it harder for them to pay staff and operate profitably. Funds sometimes fail because the GP has been unable to invest sufficiently in building out a team that is capable of executing the investment strategy.

This can be a self-fulling problem. Smaller funds can find it harder to make good returns, but good returns make it easier to raise large funds. Although many factors explain the differences between IRRs across regions, there is correlation between fund size and median IRRs across regions, as show in Figure 21.

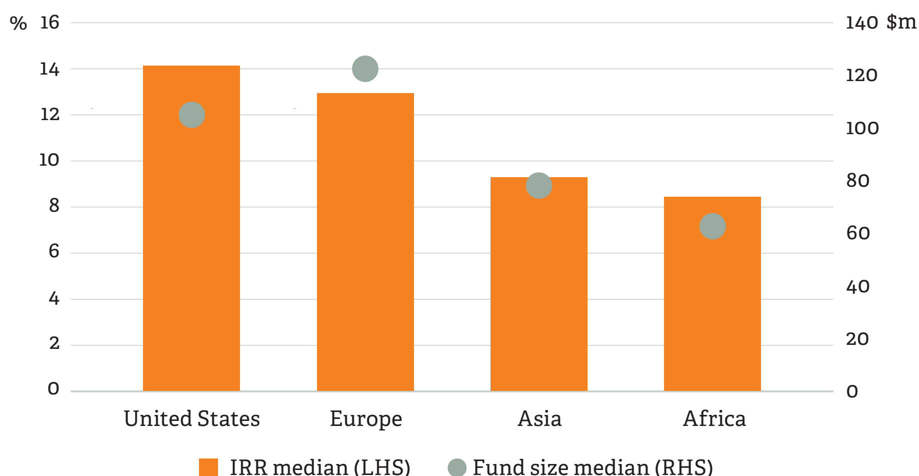


Figure 21: PE fund size and median net IRR by region, 2000 to 2022
Source: Pitchbook, data accessed 16 June 2023.

Box 7: Measuring performance: the mechanics of IRRs

Measuring the financial performance of a fund that is deploying and receiving funds at different points in time is not easy. One way to look at performance is the 'cash multiple' (or multiple on invested capital (MOIC)) – that compares how much money you generated at exit with how much you initially invested. That is simple and intuitive, but it does not take account of how long it took for returns to materialise.

The figures reported in Table 4 show the PE industry's favoured performance measure, the internal rate of return (IRR). An advantage of IRRs is that they represent an annualised rate of return, which a cash multiple does not. In PE, as with other financial assets, money is worth more when returned sooner rather than later. Annualising returns is helpful but there are a number of issues with the calculation of IRRs – here we look at its sensitivity to the timing of investments.

Table 4 provides two simplified examples. Both are £100 million funds that are fully invested in Year 0. After five years, Fund 1 has returned £150 million to investors, while Fund 2 returns £200 million, both reflected in the last column (MOIC). However, the timing of disbursements differs. Fund 1 sells one asset in Year 2 (for £140 million) and another in Year 5 (for £10 million). The IRR is calculated as 21 per cent. In Fund 2, the GP sells its whole portfolio in Year 5, for an IRR of 8 per cent.

Fund 2 doubled its investors' money, and Fund 1 increased it by 50 per cent, but the IRR suggests Fund 1 performed better. Why? The reason is the mechanics of IRRs. An IRR is defined as the discount rate that implies the net present value of the fund's cash flows is zero. A large return received in the near future would require a very high discount rate to cancel it out. For an IRR to be interpreted as an annualised rate of return experienced over the whole lifetime of the fund, that would only hold if assuming all inward cash flows are reinvested at that *same IRR for the remaining life of the fund*.[129] That is not likely to be true, and it is particularly misleading when a very high return investment is realised early in a fund's life. In this example, the high annualised return generated by Fund 1 in Year 2 feeds into this re-investment assumption, resulting in a high IRR over the life of the fund.

The time-value of money is important. LPs would prefer to have that £140 million back early so they can recycle it into other investments – and IRRs capture this. But if we only rated the performance of Fund Manager 1 and Fund Manager 2 based on the IRRs, we would not know which fund returned more money to its investors over its lifetime.

Cash flows (£m)								
End of year	0	1	2	3	4	5	IRR	MOIC
Fund 1	-100	0	140	0	0	10	22%	1.5x
Fund 2	-100	0	0	0	0	200	15%	2.0x

Table 4: Example fund cash flows and IRRs

As discussed in Section 5.1.2, PE investing can be a slower business in Africa than elsewhere. This affects the time profile of returns and therefore the IRRs that funds report, even if the fund may ultimately perform well in cash multiple terms. For more about IRRs see Brown and Volkmann (2023), Phalippou (2008) and Howard Mark's *You can't eat IRRs*, available here: https://www.oaktreecapital.com/docs/default-source/memos/2006-07-12-you-cant-eat-irr.pdf

129 This can be illustrated. If the $140 million from the sale of the investee is reinvested for three years (Year 2 to Year 5) at a rate of return of 21 per cent, it grows to about $248 million by the end of Year 5 (plus the $10 million from the other investment in the portfolio). Calculating a geometric average return over a five-year period starting with $100 million and ending with $258 million: (258/100)^1/5)-1 = 21 per cent.

8.2 Lessons learned

This section presents lessons we have learned from our experience of fund investing in Africa. Some of the following considerations may verge on the self-evident, but our goal here is not novelty.

Get the basics right. GP selection starts with alignment, commercial capabilities and integrity. There are a number of considerations beyond those:

- We look at the quality of the investment pipeline because we want the manager to be ready to deploy at the point of our commitment
- We want to see fund managers that make investments with a good idea of how they will exit from them when they make the initial investment, and be working towards that.
- We want to pay fees that are sufficient for the GP to implement their strategy, but no more.
- The fund manager must have sufficient scale, resources and capabilities, and the fund must be of sufficient size, to execute the strategy.
- Fund managers need the right balance of investment and operational skills to add value – the skills needed to find investments, manage investments, and deal with crises are not often all found in a single individual.
- Fund managers must be acutely price conscious and not overpay for investments.

Impact. We have not observed a straightforward correlation between impact and financial performance. There is an association between risk and impact, as we assess it, but capital markets tend to demand higher returns for investment in riskier assets, and of course businesses have greater impact when they succeed and grow, and growth also tends to generate returns on equity.[130] We think there are fund managers in Africa that can execute a genuine impact investing strategy while also investing on commercial terms. That said, some high impact strategies, such as a focus on smaller companies or primary agriculture, are harder to execute successfully. We have seen real enthusiasm for strengthening impact management and monitoring processes from Africa-focused GPs, from both intrinsic and instrumental motivations (it helps them raise capital). We think the Operating Principles for Impact Management are a particularly important evolution for the industry.[131] A growing number of African GPs have signed-up to these, which requires regular and independent third-party verification of their implementation and public disclosure of alignment.[132]

Fund manager selection and delegation. Our goal is to support the creation of capable PE fund managers with strong internal systems, that can attract capital and invest it responsibly. For that reason, we want to delegate investment decisions and portfolio management to fund managers – within guardrails we set. As a DFI, we require compliance with our Policy on Responsible Investing, and we can offer GPs assistance on strategy development, ESG and impact management.[133] We learned the importance of due diligence in manager selection the hard way: the collapse of the fund manager Abraaj was a painful experience for all involved. It was regular scrutiny of its activity that uncovered malpractice at Abraaj, and we have since deepened our diligence of fund managers.[134]

130 For a deeper look these questions, see our Insights paper Risk, Return and Impact, available here: https://www.bii.co.uk/en/news-insight/insight/articles/risk-return-and-impact/

131 See https://www.impactprinciples.org/

132 Our 2023 OPIM disclosure statement is available here: https://assets.bii.co.uk/wp-content/uploads/2023/08/01164544/OPIM2023_Disclosure_Statement_BII.pdf

133 See: https://toolkit.bii.co.uk/working-with-bii/policy-responsible-investing/

134 For more, see: Lessons from fund investing: What did we learn from investing in Abraaj?, available here: https://www.bii.co.uk/en/news-insight/insight/articles/lessons-from-fund-investing/

A successful fund manager must build a team with a range of skills and an organisation that can survive staff turnover. Running a fund is about more than finding and completing investments, managing, and then selling them. A GP must have proper systems and processes in place to manage and promote staff, and encourage them to stay, and effective administrative support functions. Changes of leadership (whether voluntary or forced) will inevitably create disruption. Planning on long time horizons and thinking through succession at all levels of the business (clear pathways on promotion, and what it entails to get to each level) are important. Investors will look for a core team that has experience of working well together over the full deal cycle. The risk of team disintegration is heightened considerably in new teams.

Some observers argue that direct investing is preferable because we would have more control over how our money is used. But we do not regard delegation as a trade-off we grudgingly accept for the sake of greater reach. We want to develop the capacities of local financial sectors, and not try to do everything ourselves. Localisation is a theme across development. As the UK Government's recent White Paper on International Development noted, development "will be more sustainable, when we partner with those who best understand local needs and realities, and when they determine their own development."[135] But however much care is taken when selecting GPs, delegation inevitably involves the risk that our partners will fail to honour agreements, and that relationships will break down. We cannot always prevent that from happening, but we can try to spot it early and find solutions. In 2023, we created a dedicated Fund Solutions team whose responsibilities include managing BII's funds that have fallen outside of our strategy for various reasons, including those funds where there is misalignment between BII and as GP, when there are difficult situations and an LP-led intervention is needed to safeguard the investment.

Market building and first-time fund managers. Building the PE funds industry in Africa necessarily involves supporting first-time managers. Between 1992 and 2013, we invested in 182 separate funds globally, over half of which (56 per cent) were first-time managers. Our backing of first-time fund managers helped increase the number of Africa-focused PE firms from 12 in 1997 to 140 in 2016, but for the last couple of decades the amount of capital raised has been mostly flat. Established fund managers can accumulate organisational capabilities and a deep bench of experienced investment professionals, which are advantages first-time managers can lack. Our current view is that the African PE market would benefit from some consolidation, with future growth tilting more towards new funds launched by established managers and fewer first-time managers. Of course, it remains important to support exciting new managers with high impact potential, and we retain the ability to do so in our Catalyst Portfolio (see Section 8.3 below).

Currency and instruments. Exposure to exchange rate risk is inevitable when trying to generate dollar returns for investors by investing in firms that earn revenues in local currencies. But GPs can undertake FX risk assessments, anticipate the possibility of devaluations, and take some steps to mitigate their effects. For example, they can look for some investments in firms that have some export revenues, and when firms that are reliant on access to FX to import inputs, they can take steps to build supply chain resilience. Similarly, GPs in markets where exit risk is elevated, with the agreement of LPs a fund's strategy can allow for risk-bearing but self-liquidating 'mezzanine' investments, which resemble loans with repayment flexibility. These can sometimes be denominated in hard currency, when that is suitable for the company, and when local common equity holders are comfortable taking the exchange rate risk. We have learned that GPs can usefully adapt transaction structures to the nature of market risks.

135 UK Government (2023). International development in a contested world: ending extreme poverty and tackling climate change. A White Paper on International Development, available here: https://assets.publishing.service.gov.uk/media/6560874b0c7ec8000d95bdcf/international-development-in-a-contested-world-ending-extreme-poverty-and-tackling-climate-change.pdf

Patience. Investors in African PE funds must either be especially patient, or look for fund managers with a track record deploying and returning capital relatively quickly. In our experience, many African fund managers have taken more than ten years to return our capital – the likely timing of returns is an important element of portfolio construction, and our funds strategy takes account of the fact that the larger fund managers tend to deploy and return capital more quickly. But we have also learned that a closed-end fund structure is not patient enough for some development challenges, which is why our latest SME financing vehicle Growth Investment Partners is an open-ended 'permanent capital vehicle', as is our African Forestry Investment Platform, and AgDevCo.[136]

Co-investment. When a GP encounters an investment opportunity that calls for more capital than the fund is willing or able to deploy, it can ask its LPs to invest directly alongside the fund. This is known as a co-investment. For many LPs, the attraction of a co-investment is that the directly invested portion does not attract either a management or a performance fee, the LP is usually well aligned with the fund making the investment (in respect of investment terms) and the GP will do much of the monitoring of the investment without therefore creating too much additional portfolio management burden for the LP. For us, co-investments are a useful method of originating more impactful investments, as well as enhancing the overall returns from our funds portfolio (because of the lack of fees). We take co-investment decisions based on impact, and by signalling to GPs what we look for, we can tilt our exposure to their portfolios in a more impactful direction.

Mobilisation

Mobilising private investors into a fund involves both selecting the right fund manager and targeting the right investors. Some private investors seek to maximise absolute dollar returns and are shopping in a global investment market. These investors are not likely to invest in all but the strongest African fund managers with proven track records, until there are expectations of better macroeconomic conditions on the continent. Other investors are still commercially oriented, but they have strategic motivations for entering Africa and may consider GPs that the first category of investor would reject, or they may have developed local expertise which leads them to believe they can invest successfully. There are some private investors with an impact mandate, perhaps targeting specific impact themes, that are willing to look beyond purely financial performance. Impact and ESG is proving to be increasingly important in fund raising, which is why our work to help fund managers developed their in-house capabilities can be equally as important from a mobilisation perspective as our ability to anchor funds with our capital. Industry initiative such as OPIM, the Global Impact Investor Network and its impact reporting metrics and frameworks, and the impact reporting norms developed by Impact Frontiers, are important for this reason too. We think the African PE industry would benefit from a secondary market in fund positions, to give LPs more options of for entering and exiting funds, other than by coming in at the start and staying to the end. We hope to repeat our recent pioneering transaction with Blue Earth.

136 For more about Growth Investment Partners, see our blog A new platform for SME finance, available here: https://www.bii.co.uk/en/news-insight/research/a-new-platform-for-sme-finance/ and for more on AFIP, see our Insights paper Investing for Impact in Forestry, available here: https://www.bii.co.uk/en/news-insight/insight/articles/investing-for-impact-in-african-forestry/?fl=true

8.3 Our funds strategy

This section presents our current funds strategy, which reflects the lessons we have learned from decades of fund investing, and our view of the African PE market and economic outlook.

This is an asset allocation strategy. We have defined three segments of the PE market to construct our portfolio from, so we can decide how much capital we wish to put in each. We call these 'impact-aligned', 'strategic', and 'catalyst'. As Section 6 above described, this is not the only way we look at funds. Our overall approach to maximising our impact through fund investing incorporates our view on what stage of the corporate lifecycle a fund serves, which sectors it invests in, and which of our impact objectives it furthers. Our fund investments are assigned a portfolio-level impact score and investment decisions are taken after anticipated impact is assessed through our impact framework and impact dashboard, as with all our investments.[137]

Our choice of labels for these three categories raises the question of why we do not only invest in impact-aligned and catalyst funds. Those are our priorities, but we see the need for DFI capital in all of these categories. The supply of risk-bearing capital to African firms that want to finance expansion is inadequate and even some of the largest names in African PE still require support from DFIs to reach their minimum and target fund sizes. The fund managers we have categorised as 'strategic' have made some highly impactful investments, even if the fund managers themselves do not meet our definition of 'impact-aligned'. This should not be surprising – these funds invest in sectors that are vital for development, such as infrastructure, manufacturing, pharmaceuticals, food and agriculture. These more commercially-oriented fund managers are also important from a mobilisation perspective, because they can attract private capital. We can take elevated risks in our Catalyst portfolio, but any losses there must be offset by gains elsewhere to stay within our financial parameters. These larger funds also help us manage our investment pace, because they tend to deploy and return capital relatively quickly.

1. Impact-aligned funds

Impact-aligned funds are those that are most strongly aligned with our impact objectives, but that also have a compelling risk/return profile. An impact-aligned fund is expected to demonstrate:

1) Clear impact intentionality, with targeted impact objectives that are strongly aligned with our own strategic objectives. This is a fundamental and 'non-negotiable' criteria for an impact-aligned fund.
2) Strong impact performance, with a proven tracked record of delivering impact through investments. There must be some evidence of delivering meaningful impact for a fund to be impact-aligned – intentionality alone is not sufficient.
3) The use of effective impact systems, whereby impact is screened throughout the investment process, there are clearly defined impact metrics that are actively monitored, etc. We will work with fund managers to develop their systems as required.

We are continuing to play an important role in the emergence of this type of fund manager. We expect these fund managers to play a critical role in the future of impactful PE investing in Africa and elsewhere, and will therefore be where our fund investing is primarily focused going forward.

137 For an overview of how we manage impact, see our Insight paper What impact means to us, available here: https://www.bii.co.uk/en/news-insight/insight/articles/what-does-impact-mean-to-us-an-overview-of-how-we-manage-impact/

2. Strategic funds

A local financial sector that supplies a range of different financial services at competitive prices is extremely important for development. However, that does not imply every impactful financial intermediary must meet the definition of an impact investor. There are PE and VC funds in Africa that have a more commercial orientation but which we regard as effective channels for investing our capital with impact.

Strategic funds are those which do not meeting our definition of impact-aligned, but we nevertheless consider a valuable part of our portfolio, particularly because of financial performance and the opportunity to co-invest (in high impact transactions) alongside them. We will limit the number of relationships we have with such funds and set targets for impactful co-investment to ensure the fund relationship *as a whole* meets our impact objectives.

3. Catalyst funds

We invest through our Catalyst funds portfolio to shape nascent markets and build more inclusive and sustainable economies. Our Catalyst funds portfolio allows us to apply a flexible risk appetite in pursuit of pioneering impact where few benchmarks or precedents exist, where investments would not meet the risk/return profile we require in our Growth portfolio.[138] Catalyst investments must meet a higher bar for impact.[139]

Catalyst funds are a core area of focus for us. They are fundamental to our strategic objectives because they enable us to significantly deepen our inclusion and/or have transformational climate impact. In the context of PE funds, they give us the ability to support first-time fund managers or those operating in more challenging but higher impact segments, such as smaller companies in lower income countries, and primary agriculture.

Our funds portfolio is being built around this typology. This is merely the next step in our evolution rather than a fundamental shift. We will direct our capital towards developing new markets through first-time fund managers only where our role in getting the manager off the ground is particularly meaningful and the market's potential impact is high. In the current phase of market development, we do not see increasing the number of fund managers as an objective in its own right and see growth tilting towards new funds from established managers. We remain committed to PE funds, and within the capital allocated to funds we are: (i) primarily focusing on Impact-aligned funds and (ii) rebalancing between what we invest via fund stakes and what we invest via co-investments.

138 See Assessing impact and risk when deploying catalytic capital, available here: https://www.bii.co.uk/en/news-insight/insight/articles/assessing-impact-and-risk-when-deploying-catalytic-capital/

139 See Our approach to enhanced development impact, available here: https://www.bii.co.uk/en/news-insight/insight/articles/investing-for-enhanced-development-impact-what-does-it-mean/

9

Conclusion

The UK Government is clear that private sector development finance "is a central part of the UK's means to address the SDGs" and that a "multipronged approach" is necessary to mobilise private capital at scale and achieve these Goals.[140]

In this context, we have decisions to make about how we allocate our resources. The diversity of places, people, and needs demands different tools. PE funds are indispensable partners for development finance institutions because they allow us to channel risk-bearing capital to a greater range of highly impactful firms than we could reach otherwise. They are also an indispensable element of the financial ecosystem that is needed to efficiently allocate African domestic savings towards the growth of the real economy in African countries.

Our mission is to deliver positive impacts for people and planet. PE funds in Africa are financing climate innovation, promoting financial inclusion, creating employment and contributing towards building productive, sustainable and inclusive economies in numerous ways. Our approach towards fund investing will continue to evolve in response to how these markets develop, but we remain fully committed to investing in the future of the African continent with our PE fund manager partners.

140 UK Government (2023). International development in a contested world: ending extreme poverty and tackling climate change. A White Paper on International Development, available here: https://assets.publishing.service.gov.uk/media/6560874b0c7ec8000d95bdcf/international-development-in-a-contested-world-ending-extreme-poverty-and-tackling-climate-change.pdf

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