

Bridging the Gap

Unlocking Synergies between
Private Sector Development
and Development Finance

OVERVIEW

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We believe there is untapped potential for greater transformational impact if private sector development (PSD) programmes, development finance institutions (DFIs) and other impact investors collaborate more strategically.

At Gatsby Africa, we have seen first-hand how strategic investments in businesses, alongside broader market-shaping and ecosystem work, can have a transformative impact on sectors.

PSD programmes, DFIs and impact investors often have similar goals around inclusive economic growth and job creation in lower- and middle-income countries. While their strategies and toolkits are different, they could be very complementary if incentives were more aligned and if organisational cultures started to recognise the potential value of collaborating.



PSD programmes can benefit DFIs and impact investors by providing technical assistance at the value chain and sector enabling-environment levels to increase chances of success for sectors and investee firms, as well as by working with investors to buy down transaction costs and risks of investing in specific target firms. In addition, PSD programmes can help investors with broader development objectives to identify those firms that can have a catalytic impact on the entire value chain or sector.

On the other hand, DFIs and impact investors can complement PSD initiatives by providing the investment capital needed to catalyse large-scale growth and transformation of sectors. Investors increasingly provide targeted advisory support to firms to improve chances of successful growth, with some investors also working on upstream pipeline building activities, and many incorporating efforts to expand business outreach and impact. These efforts could be more transformational for the economy by considering more deliberately how an investee business might help to change the wider system, for instance by demonstrating the viability of a new business model or providing evidence for financial institutions of returns.

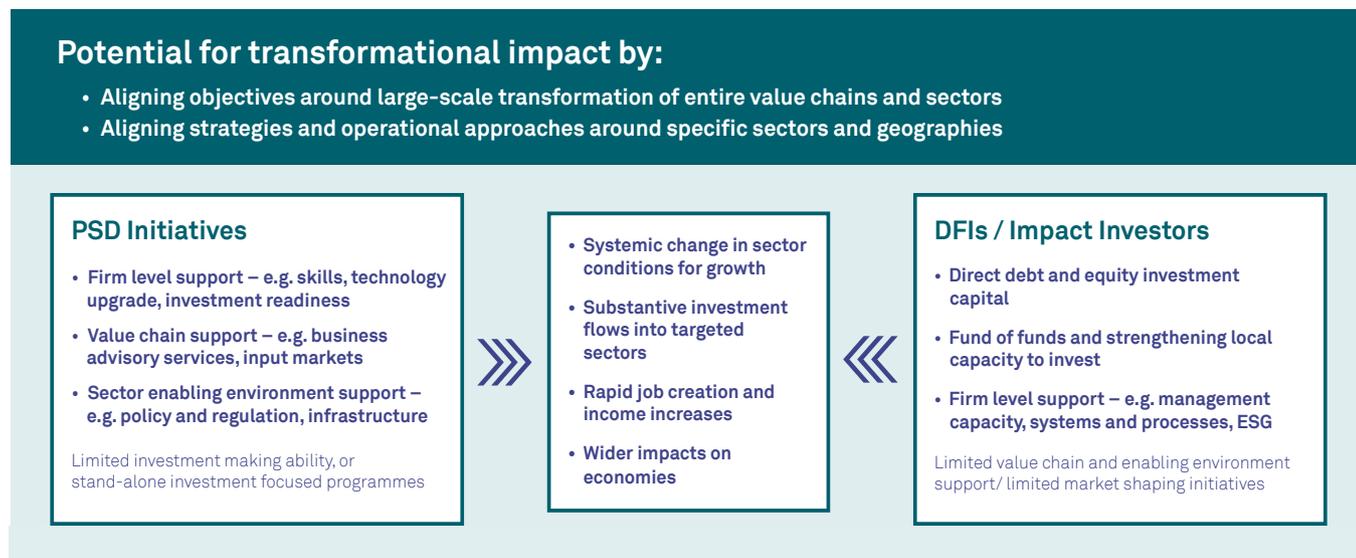


Fig 1. Opportunities for PSD programmes and investors to bring together complementary approaches

Case-study

Gatsby Africa's investment in the aquaculture sector in East Africa to catalyse wider sector transformation

East Africa's aquaculture sector is at a very early stage. In 2016, there were no large size fish farms (>2,000MT p.a.) in the region and the existing SME farms were not evidently and consistently profitable. The sector was also not a priority for regional governments, but our analysis showed that there was real potential for growing a competitive industry. We felt that what was needed to kickstart the growth was demonstration of commercially viable farms to prove the business case and help spur the local demand for improved fish farming services that could enable a vibrant industry to develop.

So how did we use investment as a strategic tool to catalyse momentum in the sector?

Gatsby invested \$2.5 million (debt) in a pioneering firm with scope for extremely rapid growth, Victory Farms. While commercial investors were interested, they could not justify an investment in an EBITDA negative, capital-intensive start-up in an unproven industry with a weak supporting ecosystem of inputs, services and regulation.

Since our investment in August 2018, Victory Farms has shown strong year-on-year growth. In late 2019, the business achieved EBITDA break-even and has since secured over \$7 million in additional funding. The industry has seen the entry of 3 other larger farms possibly partially attributable to the success and demonstration of Victory Farms.

In addition, the growth of Victory Farms and other firms following its lead has created a demand pull for improved fish feed, which is a major determinant of competitiveness. In 2021, Gatsby co-invested, alongside Victory Farms and an international feed company, in a globally competitive fish feed mill in order to supply high-quality and competitively-priced inputs not just for Victory Farms but for the wider East African industry, thus making the industry much more attractive for the small and medium farm segment.



“The development world focuses on enabling environment and capacity building, but doesn’t have capital. DFIs have capital but aren’t doing market shaping. Bringing them together is a dream outcome.”

DFI Investment Manager
(interviewed as part of the GA-BII study)



We recently partnered with British International Investment (BII) on a study that found that while there is appetite from PSD programmes and development finance practitioners for greater collaboration, there is limited strategic alignment in practice.



The joint Gatsby-BII study ‘Bridging the Gap: Unlocking synergies between private sector development and development finance’ found that there is already a high level of interest in the topic, and numerous examples of attempts to bridge the gap between the PSD and the development finance communities. However, these are largely ad-hoc and tactical, and not yet systematic in linking the agendas of the two sides in a more strategic manner.

The study finds that there are broadly three models of alignment currently being demonstrated :

IN-HOUSE MODEL	STRUCTURED COORDINATION	AD-HOC ENGAGEMENT
<p>DFIs building expertise in market-shaping technical assistance, and PSD initiatives expanding beyond grants to provide returnable capital.</p> <p>Recent examples include BII and FMO developing market shaping/ ecosystem initiatives, PSD implementers launching investment arms (e.g. DAI Capital, Palladium Impact Capital, and ACDI/VOCA’s AV Ventures) and organisations such as Gatsby Africa, Financial Sector Deepening Africa and Fundación Chile, which invest alongside their market shaping work.</p>	<p>Deliberate approach to linking development finance with PSD, with pre-defined investors either incorporated at design stage or formally engaged during PSD implementation.</p> <p>An example is the Dutch Fund for Climate and Development, delivered by a funder-implementer consortium comprising FMO (the Dutch DFI), SNV (Netherlands Development Organisation), WWF (World Wildlife Fund) and Climate Fund Managers.</p>	<p>Opportunistic collaboration between DFIs and PSD programmes. This is the most common model found by the study.</p> <p>Programmes such as USAID INVEST and FCDO’s Manufacturing Africa are two examples of this model in practice, and have been successful in identifying investors for specific opportunities and closing transactions.</p>



It is important to note that the research does not suggest a single 'best practice' model. Each model has its advantages and disadvantages. But what is clear from the research is that there are several structural challenges that make it difficult for the two sides to collaborate.

The challenges are categorised under three themes in the study:

- **Misalignment of strategy and incentives**

e.g. considerations of which sectors and firms are prioritised for support, incentives related to risk appetite and expectations of returns and timelines within which impact is expected.



- **Lack of understanding of the other side and coordination**

e.g. considerations of level of knowledge of what the other side offers, perceptions of the other side, language and terminology barriers and staff capacity to effectively engage.



- **Lack of compatibility between the operational models and products**

e.g. considerations of extent to which PSD programmes tailor their offer to investment criteria, investor ticket sizes and fund structures and extent to which these are compatible with needs of PSD initiatives.



Ending on a more positive note, our study identifies a number of practical recommendations for how greater collaboration between PSD programmes and development finance can be encouraged.



The recommendations in the study are structured under the three aforementioned themes, and include some 'quick wins' that organisations can pilot relatively easily to begin bridging the gap.

It is worth recognising that donors are often funding both types of organisation and are responsible for setting the parameters within which they operate. Hence donors have a critical role to play in facilitating greater collaboration between PSD initiatives and DFIs as the shared link between the two.

	Strategies and incentives	Cross-over knowledge and coordination	Operational models and products
Donors, PSD programmes and DFIs	<ul style="list-style-type: none"> ✓ Develop common sector selection criteria • Engage the 'other side' in setting strategy 	<ul style="list-style-type: none"> • Strengthen ecosystem mapping • Support coordination at country level ✓ Pilot cross-organizational secondments ✓ Implement training (e.g. mini-CFA) 	<ul style="list-style-type: none"> ✓ DFIs proactively support first-time local fund managers & experiment with new fund model, with PSD programmes potentially reducing transaction costs and risk
PSD programmes only	<ul style="list-style-type: none"> • Increase use of smart investment indicators in PSD results frameworks • Strengthen handover and exit strategies to maintain momentum 	<ul style="list-style-type: none"> • Utilise specialist investment advisory and facilitation expertise 	<ul style="list-style-type: none"> ✓ Build commercial relevance of PSD offers • Re-align systems change terminology • Experiment with results-based/ pay-for-performance financing
DFIs only	<ul style="list-style-type: none"> • Increase emphasis on market shaping as part of investment screening 	<ul style="list-style-type: none"> • Pool DFI TA around joined-up initiatives 	

✓ = represents quick wins

Gatsby Africa is excited about the possibilities that greater collaboration will open up, and we hope this report proves useful to the PSD and development finance communities. Please download the full report [here](#).

We invite donors, implementers and development finance institutions who are interested in discussing the topic or exploring opportunities to collaborate to reach out to us.

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A note on terminology:

Donors: Refers to bilateral or multilateral donors and foundations funding inclusive economic initiatives in low- and medium-income countries.

Private Sector Development (PSD) programmes: Refers to the sub-group of development programmes that aim to engage with the public and private sectors to promote business-led pro-poor growth.

Development Finance Institutions (DFIs): Refers to institutions, often majority owned by national governments, that operate with the stated purpose of providing finance in low and middle-income countries to promote positive social and environmental outcomes.

