INSIGHT
Bridging the Gap: Unlocking Synergies between Private Sector Development and Development Finance

Strategic investments in businesses, alongside broader market-shaping and ecosystem work, can have a transformative impact on sectors. Photo credit: Gatsby Africa.

*Aligning strategies, incentives, and activities can drive lasting, sector-wide change.*

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Introduction

There is untapped potential for greater transformational impact if donor-funded private sector development programs, development finance institutions (DFIs), and other impact investors collaborate more strategically. They 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 organizational cultures started to recognize the potential value of collaborating.

British charity Gatsby Africa has seen first-hand, through its work in the East African aquaculture and forestry sectors for example, how strategic investments in businesses, alongside broader market-
shaping and ecosystem work, can have a transformative impact on sectors.

Programs that support business-led pro-poor growth can benefit DFIs, which are often majority-owned by national governments, and impact investors. They can provide technical assistance to improve the enabling environment at the value chain and sector 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 target firms. In addition, these programs can help investors with broader development objectives to identify those firms that can have a catalytic impact on the entire value chain or sector.

**Figure 1: Opportunities for private sector development programs and investors to bring together complementary approaches**

DFIs = development finance institutions, ESG = environmental, social, and corporate governance standards, PSD = private sector development.

DFIs and impact investors can complement initiatives to develop the private sector by providing the investment capital needed to catalyze 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.

**Case Study: Victory Farms**

East Africa’s aquaculture sector is at a very early stage. In 2016, there were no large size fish farms (>2,000 metric tons per annum) in the region and the existing small and medium-sized farm enterprises 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 (earnings before interest, taxes, depreciation, and amortization) 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 three 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-sized farm segment.

Three Models of Collaboration

Gatsby Africa recently partnered with British International Investment on a study that found that while there is appetite from private sector development program and development finance practitioners for greater collaboration, there is limited strategic alignment in practice.

The 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. 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:

1. **In-House Model**

DFIs build expertise in market-shaping technical assistance, and private sector development initiatives expand beyond grants to provide returnable capital.

Recent examples include British International Investment and Dutch development bank FMO developing market-shaping/ecosystem initiatives, implementers of private sector development programs launching investment arms (e.g., DAI Capital, Palladium Impact Capital, and ACDI/VOCA’s AV Ventures), and organizations, such as Gatsby Africa, Financial Sector Deepening Africa, and Fundación Chile, investing alongside their market-shaping work.

2. **Structured Coordination**
Taking a deliberate approach to linking development finance with private sector development programs, with pre-defined investors either incorporated at design stage or formally engaged during program implementation.

An example is the Dutch Fund for Climate and Development, delivered by a funder-implementer consortium comprising FMO, SNV (Netherlands Development Organization), World Wildlife Fund, and Climate Fund Managers.

3. Ad-Hoc Engagement

Opportunistic collaboration between DFIs and private sector development programs is the most common model found by the study.

USAID INVEST, which is an initiative of the United States Agency for International Development, and Manufacturing Africa, a program of the Foreign, Commonwealth and Development Office of the United Kingdom, are two examples of this model in practice and have been successful in identifying investors for specific opportunities and closing transactions.

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 categorized under three themes in the study:

- **Misalignment of strategy and incentives** – e.g., considerations of which sectors and firms are prioritized 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 private sector development programs tailor their offer to investment criteria, investor ticket sizes and fund structures, and extent to which these are compatible with the needs of private sector development initiatives.

**Practical Recommendations**

The study identifies a number of practical recommendations for how greater collaboration between private sector development program and development finance can be encouraged.

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

It is worth recognizing that bilateral or multilateral donors and foundations are often funding both types of
organizations and are responsible for setting the parameters within which they operate. Hence donors have a critical role to play in facilitating greater collaboration between private sector development initiatives and DFIs as the shared link between the two.

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<tr>
<th>Strategies and incentives</th>
<th>Cross-over knowledge and coordination</th>
<th>Operational models and products</th>
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| Donors, PSD programmes and DFIs | ✓ Develop common sector selection criteria.  
• Engage the "other side" in setting strategy. | ✓ Strengthen ecosystem mapping.  
• Support coordination at country level.  
✓ Pilot cross-organizational secondments.  
✓ Implement training (e.g., mini-CFA). | ✓ DFIs proactively support first-time local fund managers and experiment with new fund model, with PSD program potentially reducing transaction costs and risk. |
| PSD program only | ✓ Increase use of smart investment indicators in PSD results frameworks.  
• Strengthen handover and exit strategies to maintain momentum. | ✓ Utilize specialist investment advisory and facilitation expertise. | ✓ Build commercial relevance of PSD offers.  
• Re-align systems change terminology.  
• Experiment with results-based/pay-for-performance financing. |
| DFI only | ✓ Increase emphasis on market shaping as part of investment screening. | Pool DFI TA around joined-up initiatives. | |

✓ = represents quick wins

CFA = chartered financial analyst, DFIs = development finance institutions, PSD = private sector development, TA = technical assistance.

Gatsby Africa is inviting donors, implementers, and DFIs who are interested in discussing the topic or exploring opportunities to collaborate to reach out to us.

Resources


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Arjun Bhoopal is Head of Partnerships at Gatsby Africa, a private foundation supporting sector transformation in East Africa. He works with like-minded donors and funders who wish to share learning and combine resources to create even greater impact across the development sector. Prior to joining Gatsby Africa, Arjun worked in sustainability and private sector development at PwC, Save the Children and UNICEF, focusing on ways in which business can make a positive impact.