

MINISTRY OF FOREIGN AFFAIRS OF DENMARK

DANIDA | INTERNATIONAL
DEVELOPMENT COOPERATION



Strategy document

The Ministry of Foreign Affairs' Strategy
for
The Investment Fund for Developing Countries (IFU)
2017-2021

Date: 14 March 2017

1. Introduction

This document presents the Ministry of Foreign Affairs (MFA's) strategy for the Danish Investment Fund for Developing Countries (IFU). The strategy is aligned with Denmark's strategy for development policy and humanitarian action ("The World 2030"). Based on the strategy, it is recommended that the 2017 Finance Act allocation of DKK 200 million for general equity contribution to IFU be approved by the minister for development cooperation.

It has due to the existing monitoring structure for IFU been decided to waive a formal appraisal of the strategy. However, a "Peer Group" with relevant staff from various offices in MFA has contributed to the formulation of the final strategy document.

2. Context of IFU

2.1. Background

Private investments and expanding public-private cooperation in the form of blended finance are two of the most important ways the international community can support developing countries as they seek to generate the very large amount of domestic and foreign investment required to meet the SDGs by 2030. Trillions of dollars in public and private funds are to be directed towards the SDGs, creating huge opportunities for investors and companies.

Official development assistance (ODA) is crucial, especially in the poorest and most fragile countries. However, this is by far not enough to achieve the SDGs. There is a need to leverage ODA to bring in private investment and help countries mobilize domestic resources and attract private investments. Development finance institutions (DFIs) like IFU have a key role in the process.

DFIs that engage on commercial terms through investments can make a significant difference when it comes to mobilizing capital from the private sector. The DFIs provide "additionality" and they are "catalytic". They are additional in the sense that they invest in regions, sectors or segments that would not otherwise have had access to the required financial resources, technology and know-how – and DFIs bring sustainability and responsibility into the mindset of the private sector. This is their focus, their comparative advantage. They are catalytic by partnering with co-investors and enabling other private investors to follow in new areas that have proven to offer sustainable investment opportunities.

DFIs can also play a key role in addressing the market failure of lack of bankable projects in developing countries. There is capital available for investments in the developing countries, including from institutional investors. However, a sufficient pipeline of bankable projects is needed or the DFIs will lose the opportunity to bring in sufficient private sector capital from international and domestic sources. DFIs' can help improve the quality of projects through participatory processes with partners that de-risk projects and mature them to become bankable.

2.2. IFU's mandate and key experience

In 1967, the Danish government established IFU as a state-owned DFI with the purpose of promoting industrial development in developing countries by facilitating investments in these countries in cooperation with Danish companies and investors. The mandate and the scope for IFU's investments have been significantly broadened over the years, from a strictly tied fund in 1967 to an untied fund from 1 January 2017. See annex 1 for a description of IFU's activities.

IFU has over the years been an important executor of the private sector component in Denmark's strategy for development cooperation with demonstrated positive development impact and results for almost 50 years. Investments with IFU and IFU-managed funds have created an estimated 560,000 direct and indirect jobs, provided significant technology transfer, embedded leading sustainability practices and generated sizeable tax revenue locally. Furthermore, IFU and IFU-managed funds had at end of 2015:

- made over 1,200 investments with 800 Danish companies in more than 100 developing countries.
- invested close to DKK 18 billion in equity capital and loans, which in turn has generated investment projects totaling DKK 170 billion, corresponding to a leverage factor of 8-9.

IFU's historical strong ties to the Danish business community enable IFU to catalyse investments to developing countries in particular from Danish enterprises and institutional investors. The Danish business community, on the other hand, benefits from partnerships with IFU and other development finance institutions by becoming more international and able to operate in emerging markets.

See Annex 6 for Highlights. IFU was evaluated by the MFA in 2004. In 2006, Rigsrevisionen (The Office of the Auditor General) carried out a review of IFU. The climate fund (DCIF) was reviewed by MFA in 2015. It is planned to perform an evaluation of IFU in 2018.

3. Presentation of MFA's strategy for IFU

3.1. Objective and targets

The overall objective of MFA's strategy is that IFU shall promote investments that support sustainable development in developing countries and contribute to the realisation of the Sustainable Development Goals (SDGs). This objective supports Denmark's strategy for development policy and humanitarian action ("The World 2016"), which underline that IFU and its managed investment funds shall mobilize large-scale private funding, including from pension funds, foundations and businesses, with a view to investing in sustainable growth, decent employment and technology transfer, for addressing e.g. the climate and environmental problems in difficult markets in the developing countries.

The investment projects of IFU are assessed and monitored in terms of both financial return and expected development outcomes, and the expected development outcomes is a key guiding principle for IFU's investment activities. IFU will contribute to the achievement of several of the SDGs through the implementation of substantial investments that would otherwise not take place or only at a much smaller scale and pace. The indicated outcomes of IFU, which are estimated on the basis of historic IFU records from a large number of investments, include: Total commitment of DKK 3 billion in private capital to the planned SDG Fund (see section 3.5), mobilization of private capital in portfolio investments by a factor 7 and the annual creation of about 16,000 direct jobs and an additional 16,000-32,000 indirect jobs.¹ Please refer to annex 2. IFU – Result framework. Furthermore, IFU's investments will contribute to reduction of greenhouse gas emission from sustainable energy investments, a considerable

¹ According to UN research, every direct job creates 1-2 additional jobs in for example local supply chains or service companies.

annual tax revenue (in 2015 companies in which IFU invested paid DKK 372 million in tax to the related tax authorities), transfer of modern technology and knowhow and compliance with international standards for responsible business conduct.

Responsible business conduct is an integrated condition of IFU's investments. IFU's contribution to sustainable development is carefully assessed, monitored and reported. IFU has adopted or is working to adopt a number of sustainability policies, procedures and standards including the UN Global Compact, the UN guiding principles for business and human rights (UNGP), and other relevant international standards for investments and business activities in developing countries. IFU reports work on sustainability as part of the financial annual report. IFU has a sustainability advisory board composed of external stakeholders within environment, human rights, development and company policies. IFU's focus on sustainability in investments covers all investments, both IFU Classic and through IFU managed investment funds.

Further details on the results framework, indicators, sustainability approach and IFU's Development Impact Model are provided in section 3.5 and in annex 2.

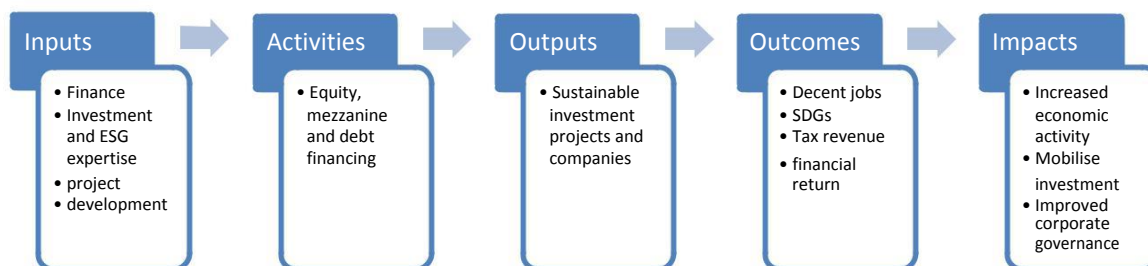
3.2 Theory of Change

IFU invests both directly and indirectly into companies in developing countries. When these investments are commercially and financially successful, this can:

- ensure the viability and the growth of companies, subsequently leading to direct creation of decent jobs, technology transfer and sustainable growth
- increase taxes paid by the companies (improving governments' ability to finance public services)
- lead to sector specific outcomes (for example increased production of renewable energy or other goods underprovided by the market)
- have demonstration effects which lead to an increase in private investments in certain sectors
- lead to indirect outcomes, including the creation of indirect jobs in the supply chains of the project companies

IFU's main impact on the SDGs, including poverty reduction, will occur when recurrent capital investments are made in the developing countries and sustained at a high, long-term level. IFU's development impact comes from financially successful investments that grow sustainable companies, create decent employment, crowd in private investors and demonstrate to the market that investments in these countries and sectors can be commercially and financially viable. Therefore, IFU's financial return is an important feature in its investments.

Diagram of Theory of Change



3.3 Justification

Relevance: A massive increase in sustainable private sector investments is needed for developing countries to achieve the SDGs. DFIs can play a critical and bigger role in mobilisation of private capital, technology and knowhow for sustainable investments in SDG relevant sectors in developing countries. Therefore, IFU has a key role in promoting private sector led sustainable development in Denmark's new strategy "The World 2030" particularly with regards to the promotion of inclusive and sustainable growth (SDG 8).

IFU's activities are also in line with the development policies, needs and priorities of those countries that IFU is investing in, as most developing countries today have development of the private sector as a key agenda item.

Efficiency: The productivity of IFU's organisation (administration at head office, regional offices and operational investment teams) compares well with other DFIs. A restructuring of the organisation in 2015 has significantly enhanced IFU's efficiency and strategic focus. The increased size of IFU's activities, including fund management, has created organisational synergy and contributed to reduced transaction costs and thereby higher efficiency.

Effectiveness: The effectiveness of the IFU's investment activities is considered to be high as investments will mobilise considerable additional capital to the developing countries. Further the effectiveness is high in terms of achieving development impacts and financial returns.

Impact: IFU's investments will significantly contribute to the achievement of several of the SDGs. The most significant impacts are envisaged to include decent job creation, access to affordable and clean energy, reduction of greenhouse gas emission, food production, local tax contribution and promotion of responsible business conduct.

Sustainability: IFU has a strong focus on the sustainability of its investments. The application of sustainability standards, including UN Guiding Principles on Business and Human Rights (UNGPR), as well as a number of other international sustainability standards during screening, design, implementation and management of investment projects is envisaged to ensure high social, environmental and financial sustainability.

3.4 Strategic considerations

Rationale for selecting IFU as strategic partner: In IFU, the MFA owns a DFI, which play a key role in the implementation of the "World 2030" strategy. IFU has a long and solid track record for investments in developing countries and is at the forefront of the international sustainability agenda. A capital increase of DKK 200 million will enable IFU to scale up its impact through mobilization of private sector finance and knowledge from Denmark and abroad invested in commercially viable SDG investments. IFU is thus MFA's principal mechanism for leveraging private sector capital for commercially sustainable investment projects in developing countries and emerging markets.

Funding requirements: It is estimated that the funding of IFU's sustained growth to 2021 will require around DKK 1,000 million in additional capital (incl. the payment from IFU to the Danish State of an annual dividend of DKK 50 million) The financing could be funded by a combination of capital contribution from MFA and/or debt financing based on state guarantees.

Capital contribution of the Danish state: The capital invested by the Danish state should be considered as development capital assets that are envisaged to generate a return. IFU has been

a profitable business for the Danish state: The state's aggregate capital infusion of DKK 3,607 million to IFU and IFU-managed funds have by the end of 2015 more than doubled in value to around DKK 8,358 million in the forms of accumulated dividends to the state of DKK 4,884 million and the remaining value of IFU's equity of DKK 3,474 million.

Financial products, including a Development Bank-model: The majority of IFU's capital is expected to be used for equity investments. Equity capital is strongly needed in most investment projects, and equity capital is fundamental for the mobilisation of additional capital, including loan capital, from other sources. However, there is also an increasing need for loans to finance infrastructure projects in developing countries. The Lake Turkana Wind-project in Kenya is one important example. It should therefore be considered to develop a Development Bank – model, which can strengthen IFU's role within development financing. The recent decision in principle to transfer the operative part of the Danida Business Finance (DBF) to IFU will be an important element in these considerations. IFU has decided to prioritize this area and will within the coming months establish a Vice President function for financial investments in the organisation, which should focus on developing a Development Bank model with focus on infrastructure loans.

Project pipeline: Access to a strong pipeline of bankable projects is fundamental for the success of the IFU. There is a general shortage of bankable investments in developing countries, and these challenges need to be addressed. IFU has generally been successful in maintaining a solid pipeline, but to accompany growth in investments, efforts will be made to strengthen internal project development capacity, strengthen cooperation with international and local project developers, and sharing lessons learned with other DFIs etc. The initial experience with the commercially based project development instrument, launched in the middle of 2016, is positive.

Eligible investments: IFU's mandate has become untied with effect from 1st January 2017. It is envisaged that also Danish investors and companies in general would benefit from the untied IFU mandate as it will open up for new international cooperation and investment opportunities. However, it is important that the untying of IFU is managed in a consequent manner and that potential risks relating to untying, e.g. in relation to social safeguards, are addressed. IFU will need to secure that its foreign partners have the same focus on sustainability issues as traditional Danish companies

Eligible countries: IFU can invest in countries that are registered on the OECD/DAC list of ODA recipients. However, at least 50% of IFU's investments must be made in countries with a GNI per capita below 80% of the upper limit of Lower Middle Income Countries (LMIC)² measured at a 3 year moving average. This means that 50% of the investments must be made in LMICs and the Least Developed Countries (LDCs).

Leverage: A key role for IFU is to mobilise private capital, technologies and knowhow. There is no clear defined target for the leverage factor which depends on the type of investments, country risks, commercial risk issues etc. However, the leverage factor will be measured, and it is expected to be around 7 based on IFU's historic observations.

Additionality: Additionality will be assessed in qualitative terms in order to ensure that the IFU generates SDG related investments and outcomes that would otherwise not have been achieved or achieved in a much less ambitious way, ref. section 3.5 and annex 2. The additionality

² Countries with a GNI per capita of less than USD 3,300 (80% of the upper limit of LMIC

assessments will focus on: a) financial additionality ensuring that public sector participation only is taking place when a market failure exists or an investment is too risky to obtain full financing from commercial investors; and b) value additionality which refers to the unique role of public sector stakeholders in e.g. improving the development impact of an investment by influencing the design, improving management performance through board participation, and/or through the incorporation of standards for responsible business conduct, environmental, social and governance sustainability etc.

Investments with high impact: To achieve greater development impact, IFU will after establishment of the SDG fund still invest in investments that are less suitable for public-private partnerships. This includes investments in frontier markets contributing to sustainable growth, promote stability and prevent irregular migration. However, it should be recognized that the risks are higher in frontier markets, including unstable governments and policies, security risks etc..

Strategic cooperation: The potential for cooperation between IFU and MFA's departments for development and trade (i.e. Danida and Trade Council) at the head office-level and at the Danish Embassies – is not fully exploited. The cooperation will be strengthened with IFU employees at country level placed at Danish diplomatic missions. Furthermore, there will be increased focus on creating synergy between IFU's investment activity and MFA's development and export promotion activities.

Organisational development: It is required that all IFU's investments are based on a thorough due diligence-process, which also includes a comprehensive assessment of sustainability risks, environmental, social and governance risks, development impacts and risk mitigation measures related to the specific project. This requires that IFU has the right organisation in place in terms of capacity and competencies. It is important that IFU in line with its growth strategy make the necessary investment in institutional development and human resource development.

Communication and results: Several stakeholders have emphasized the need for IFU to strengthen its sustainability work, including the implementation of the UNGP in IFU's daily investment operations. Furthermore, there is call and request from stakeholders that IFU's openness and communication about projects (preparation, due diligence, development impact etc.) is enhanced. This disclosure must, however, respect the need not compromise the required confidentiality on commercial issues to IFU's investment partners.

3.5 MFA's strategy for IFU

Based on the above strategic considerations, MFA's strategy for IFU 2017-2021 consists of the following instruments:

- **SDG Investment Fund:**
 - MFA and IFU will develop a new SDG Investment Fund with significant contributions from institutional investors (DKK 2.5-3 billion)
- **IFU Classic:**
 - Going forward, IFU Classic investments shall focus on projects with high development impact, project development, SME investments, high risk projects and frontier markets.
- **Development Bank**

³ OECD/DAC: Peer learning: Lessons from DAC members of effectively engaging the private sector in development cooperation. October 2016.

- Develop a model for “Development Bank” lending – in particular larger scale infrastructure projects
- **Strategic Partnerships**
 - Build strategic partnerships with public and private partners, e.g. IFC
- **IFU’s contribution to sustainable growth**
 - IFU’s annual investment volume should almost double from approximately 1.1 billion to DKK 2 billion over the next five years, thereby supporting the SDGs and the development cooperation strategy
- **Framework agreement between MFA and IFU, covering:**
 - Specific goals for IFU’s contribution to development impact as reflected in the current agreements on the IFU managed MFA facilities.
 - Strengthen cooperation and synergy between IFU, Trade Council and Danida
 - Establish a fact track procedure for IFU’s co-location on relevant Danish Embassies
- **Openness and communication of development results**
 - IFU shall continue to seek to enhance its communication policy directed towards key stakeholders
- **Possible access of IFU to EU’s blending facilities etc.**
 - The untying of IFU makes it now possible for the fund to be accredited to international financial institutions, which can provide financing and investment opportunities for IFU. This includes among others access to and participation in various facilities of the EIB
- **Executing agency for Danish strategic private sector initiatives (i.e. Ukraine)**
 - IFU is in a position to implement government initiatives within specific regions or sectors.

3.5 Results framework

In an effort to capture development effects of its investments better and improve its ability to report on the new SDGs, IFU has upgraded its monitoring framework and operates now a comprehensive Development Impact Model (DIM).

This new system for monitoring of development impact consists of a total number of 38 indicators, which are measured across the investment portfolio. The indicators are categorised into **general development indicators** and three types of more **strategic indicators**. Some of the development indicators are general such as direct employees and tax contribution and some of them are sector specific related to climate change mitigation, renewable energy, agri-business and micro-finance. The indicator definitions used by the DIM are in general mainly standard indicator definitions used among the group of European Development Finance Institutions (EDFI).

The strategic indicators are divided into three groups related to additionality, catalytic effect and project sustainability. Additionality includes elements like training provided, technology transfer, board membership etc. Indicators for catalytic effect are related to leverage and 3rd party investors. Finally project sustainability is measured on environmental, social and governance scores as well as risk ratings and IRR. The Results Framework for the SDG fund and a complete overview of the DIM indicators are presented in annex 2.

A rating methodology will be applied in the DIM with three basic outcomes: **Exceed, Meet and Below**. The rating will be assigned according to predefined units and thresholds according

to IFU's expectations. Each indicator group will also be assigned a group rating Exceed, Meet and Below and finally the project will be assigned an overall project headline rating going from **critical** over **poor, fair** and **good** to **excellent**. The database will enable compilation of project specific reports as well as data extraction across projects on specified indicators.

Expected results of a particular investment are used for the decision making in IFU's board. The ex-post results will be recorded in connection with the Final Evaluation Report (FER) to be filed at the end of the investment project. The Final Evaluation Report will make comparisons and analyse differences between the ex-ante and ex-post values.

The annual monitoring will capture selected actual numbers for a given year. As IFU gains more experience with its new Development Impact Model it will be possible to benchmark the individual investments against others and to gain specific sector knowledge about effectiveness and efficiency of each investment type in terms of development outcomes and impacts.

3.6 Risk assessment

Investments in developing countries are generally associated with a relatively high perceived and real risk, not least for medium- and long-term investments which constitute the majority of the portfolio under IFU. A risk management matrix is presented in Annex 3. The matrix presents the main contextual, programmatic and institutional risks in relation to IFU.

IFU has a set of well-developed risk policies and guidelines to minimise the overall risks in its project portfolio. These policies include guidelines for appraisal of commercial risk, for project, partner and country risk exposure, guidelines for managing direct financial risks and guidelines for sustainability risks.

4. Management set-up and MFA's monitoring of IFU

MFA is the parent ministry/"owner" of IFU. The Minister for Development Cooperation approves IFU's statutes ("rules and guidelines for running the business of IFU"). Furthermore, the Minister appoints the Board, including the chairman and deputy-chairman, the observer from MFA and the chief executive officer of IFU. Finally, the Minister has approved a dividend policy for IFU. IFU is considered to be a state-owned company, and MFA's monitoring is based on "Statens Ejerskabspolitik (April 2015)"/"Ownership Policy". This implies the following monitoring structure:

- "Annual General Assembly"-meeting between the Minister, IFU's chairman and CEO. The agenda focuses on the annual report of IFU and MFA's strategy for IFU.
- MFA's observer to the Board, who has access to all board documents, reports to the Minister concerning relevant issues.
- MFA-IFU High Level Coordination-meetings are held minimum 2 times a year. The agenda focuses on strategy, results, development impact, cooperation between IFU-MFA etc.
- On-going meetings between employees from MFA and IFU.
- Rigsrevisionen supervises IFU's activities. IFU's accounts are audited by a state authorized public accountant through an agreement between Rigsrevisor (the Auditor General) and the Minister.

5. Budget

The funding of IFU's sustained growth to 2021 is estimated to require around DKK 1,000 million in additional capital (incl. an annual dividend of DKK 50 million). The financing gap could be funded by a combination of capital contribution (equity) and debt financing based on state guarantees. The 2017 Finance Act allocates DKK 200 million for general equity contribution to IFU. These allocations are envisaged to be complemented with additional appropriations in 2018-2021.