Why the private sector matters for development effectiveness

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The development paradigm has shifted towards private investment and during the last decade, the private sector has been widely recognized as a key partner in development. Expectations are such that the private sector has become central to development strategies, thus contributing to broader economic development. Increasingly, development partners, including the African Development Bank, are working directly with the private sector in developing countries to deliver programmes to fight poverty in the continent.

The private sector as a development actor

In recent years, African economies have shown steady growth and improvements in political stability, governance, and the pursuit of sounder economic policies. These positive developments notwithstanding, Africa must confer a more dynamic role to the private sector and to the promotion of both foreign and domestic investments. This is important as the private sector is now widely recognized as one of the main drivers of economic growth and employment creation – key dimensions of the international community's work to promote sustainable development and poverty reduction. Donors have increased their engagement with the private sector community in areas such as enterprise development, aid for trade, financial sector and investment climate reform to catalyze contributions to development objectives. However, more needs to be done to draw lessons from past development experience in the private sector.

As a key development actor, the private sector may be

(i) a direct recipient of aid for investments and activities such as subsidies and loans to SMEs;

(ii) a contractor in implementing aid projects such as in project financing;

(iii) a provider of aid-equivalent development resources in areas such as enterprise development, aid for trade, financial sector policy and investment climate reform; or

(iv) a partner as in public-private partnerships to combine the strengths of different stakeholders.

It is thus critical for the private sector to prove its relevance as a key player in the development community.

In recognition of the crucial role that the private sector plays in development dynamics, the African Development Bank (AfDB) formulated its first comprehensive strategy for private sector development in 2004. The strategy highlighted the importance of adopting a Bank-wide approach to private sector development and has served as the primary road map for Bank interventions in the private sector over the past few years. As a result of this strategy, there was a sevenfold increase in the Bank's non-sovereign lending operations from 2004 to 2007 and a much stronger emphasis on development impact as the business driver. The Bank, like other IFIs, counts on the private sector as a key partner to leverage funding to meet the continent's development needs, such as infrastructure investments (sums that are estimated in the trillions), provide better services in a cost-effective manner through public-private partnerships, and be an engine of growth through job creation.

> **"We recognize the central role of the private sector in advancing innovation, creating wealth, income and jobs, mobilizing domestic resources and in turn contributing to poverty reduction"**
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> Busan Partnership for Effective Development Cooperation

Evaluating support to private sector development helps us understand the role of the private sector in the development arena. It also sheds some light on what works and what does not work, ensures accountability and promotes learning on the use of both public and private resources. These evaluations can also help private sector entities demonstrate their contributions and impact on development. However, there are specific challenges as private and public sectors rely on different drivers. Issues such as profitability, investment outcomes, additionality, benefits for the host economy, job creation must be addressed by the evaluations.

Evaluating support to private sector

The MDBs Evaluation Cooperation Group (ECG), through the Good Practice Standards (GPS), has developed a systematic approach for evaluating private sector operations with a clear objective of promoting rigor and objectivity in evaluations. The GPS were originally formulated in response to a call for harmonization of evaluation methodologies by the Development Committee Task Force in 1996. In 2001, the ECG issued the first edition of the GPS, followed by second, third and fourth editions in 2003, 2006 and 2011, respectively. Each subsequent edition was informed by the findings and recommendations of a benchmarking exercise, which assessed members' practices against the GPS. Since then, and with the growing portfolio of private sector operations in the Bank as well as in its partner institutions, most ECG members have partly or fully mainstreamed the private sector GPS in their evaluation framework and progress has been made to provide evidence on the impact of these operations.

Evaluating private sector operations or programmes promotes a better understanding of the potential contribution of private sector interventions to development. Sharing evaluation findings raises awareness about private sector potential among development agencies. In practice, it is worth noting that all IFIs are still grappling with private sector evaluation, especially with respect to harmonizing results indicators and the ex-ante approach. With its ADOA framework, the AfDB is a pioneer among peer institutions in ex-ante evaluation of private sector operations. The framework provides an estimate for development outcomes and additionality that private sector projects are expected to achieve. Launched in 2008, ADOA addresses two issues pertaining to the private sector:

- First, what do development finance institutions (DFIs) bring to private sector financing that commercial lenders cannot or do not bring?
- Second, what are the expected development outcomes?

The recent revision of the framework – in 2015 – has refined the methodology by addressing operating realities. This ex-ante tool has proven useful in facilitating the monitoring and evaluation of the Bank's private sector operations, with indicators aligned with the Bank's long term strategic priorities. ADOA has also sought to ensure alignment with many results measurement initiatives both within the Bank and in sister institutions. A recent working group on the harmonization of the indicators was launched by IFIs to further improve the methods and the indicators used to assess private sector interventions. Further work and discussions are needed on methods and standards related to evaluation of private sector support. Clearly there is no silver bullet in terms of methodology, but enhanced collaboration is needed for the learning process already underway. The AfDB's Independent Development Evaluation (IDEV) Department has produced a number of private sector evaluation reports[5]. Through these efforts to improve accountability and learning in the private sector area, IDEV endeavors to contribute to the dialogue on the real impact of the private sector on the ground.

[5] Independent Evaluation of Non-Sovereign Operations, 2006–2011 | Independent Evaluation of Bank Group Equity Investments | Evaluation of Bank Assistance to Small and Medium Enterprises (2006–2013)

There is a common understanding about specific drivers to look for in assessing private sector interventions. It is clear that all MDBs want to know the effect of their investments and how the private sector impacts the development agenda. However, IFIs still differ on the approach and on how to calculate the metrics.

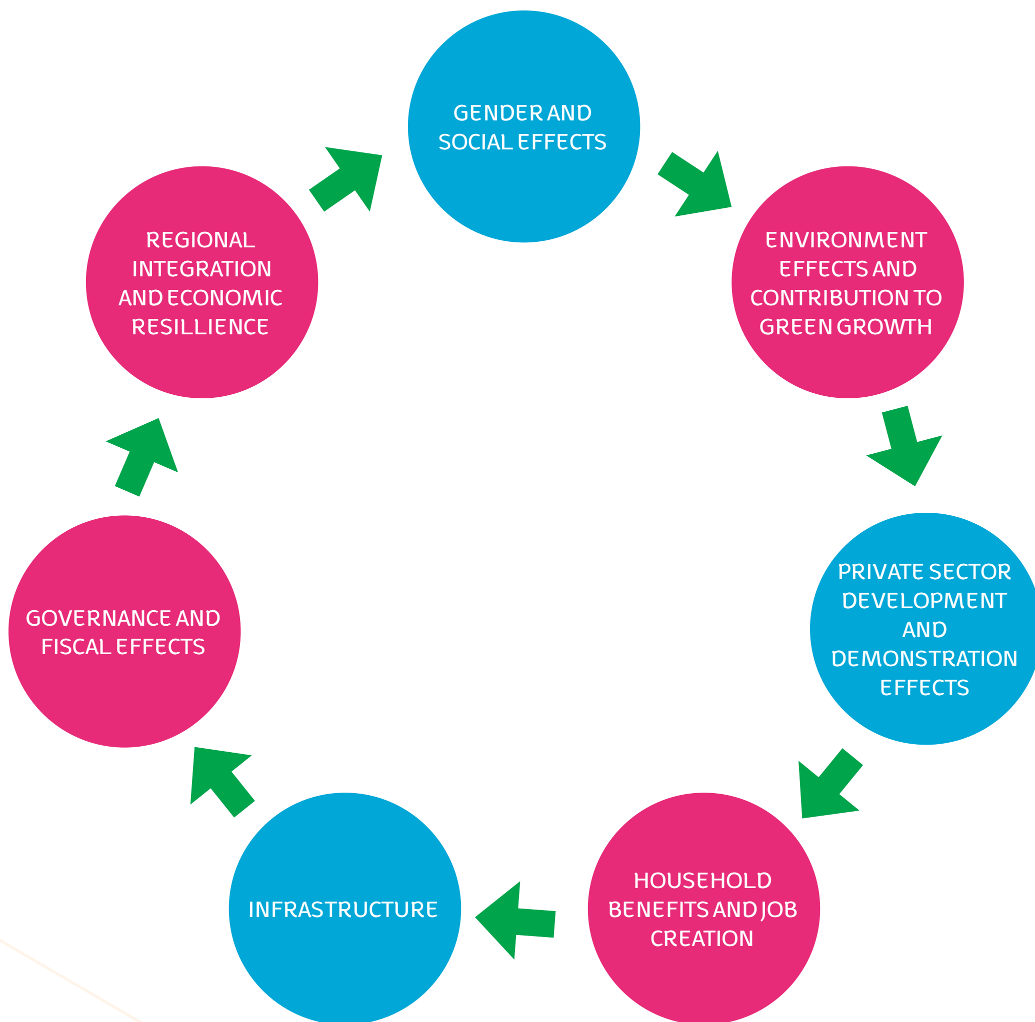
What to look for in private sector results / outcomes

Additionality: What does the Bank, along with other participating DFIs, bring to private sector projects that commercial investors cannot? Did the Bank demonstrate additionality in its intended interventions? Since private sector IFIs are operating in an open market for credit and investment, all IFIs are concerned with additionality as they do not want to crowd out financing from the market. Financial additionality, for example, measures the value – added of the Bank beyond what purely market sources would provide. It measures the extent to which the Bank provides financial support that is not otherwise available from commercial sources, catalyzing funding from other providers; or reducing perceived risks to investment in the company or sector. It mostly addresses the additionality brought by DFI financing by reducing commercial operators' exposure to credit, liquidity, or market risk, in ways that cannot be achieved using private sources and commercial players alone. Financial additionality depends on the overall reduction in commercial risk relative to the counterfactual scenario of no DFI participation.

Financial additionality is associated with key drivers such as long-term financing, improved currency matching or capital mobilization, including lead arranger role in syndications and catalytic effect. However, questions still remain on the methodology for assessing additionality, calling for further development of approaches. Non-financial additionality in mitigating other risks (for example, political risk), providing industry or technical expertise, or helping the client establish higher standards of governance, transparency or environmental and social sustainability, is also a relevant criteria. Holding IFIs to account for their additionality has been a driving force behind the adoption of their strategies and their increasing focus on low-income and high-risk countries over the past decade.

Catalytic role: crowding in other sources of financing is also a form of additionality. It is important to analyze how other investors are attracted to the project – sometimes other financiers or investors only participate in the PSO because of the comfort provided by the Bank's presence. So the question "Was the Bank able to attract other partners in its interventions" is very relevant. DFIs can mobilize resources by playing an active role in the fundraising process or providing a positive signal to private investors. In practice, this can be done by initiating contacts with potential investors such as pension funds, or assisting commercial investors in the due diligence process. Leveraging brings different parties together for the same investment. How will we assess who leveraged whom, who led the initiative, and who made it happen? And does that matter, or shall we focus on each party's contribution and how effectively it played its role?

Impact: The Bank finances the private sector as a means of achieving its



objective of broadening the economic development of its regional member states. It is therefore an imperative to assess the outcomes (intended and unintended) that the projects produced. For all DFIs, it is important to highlight the contribution of the private sector in a series of development outcomes that are predefined in accordance with their respective strategic priorities. For example, to corroborate the belief that the private sector is an engine of growth through job creation, the latter is an indicator to measure when assessing PSOs. Depending on the complexity and type of project (infrastructure), both direct and indirect job creation should be assessed, but this is still difficult to measure with objective standards. For the Bank, ADOA has defined seven categories of outcomes that match long term strategic priorities (see below graph).

Business Success and Profitability: The first indicator measures the fulfillment of the project financial objectives while the second assesses whether or not the Bank preserves its financial integrity. Private enterprises typically measure their performance in terms of growth in market share and revenues, earnings or profitability, firm productivity, financial

viability, and competitive position. Project business success measures and compares the project's actual and projected financial impact on the project's financiers (lenders and equity investors) over the economic life of the project, the project's contribution to other business goals articulated at appraisal and the project company's prospects for sustainable growth. The assessment can be done on a "with versus without" project basis, or on a "before versus after" project basis. The principal indicator for business success is the financial rate of return (FRR) based on real, after tax cash flows for project loans or the return on invested capital (ROIC) in the case of corporate investments.

For the Bank to continue to be sustainable, the investments it makes, whether in the form of loans or equity have to be profitable. It is clear that private sector operations require that the Bank operates on a commercial basis in its investment operations. This means taking the same commercial and business risks as other lenders and investors, and requiring investment returns that are commensurate with these risks. The evaluation framework therefore measures these investment returns, their adequacy in light of the risks, and their contribution to institutional profitability. Metrics of market share, profitability, and capital growth are straightforward in signaling who is successful and who is not. However, metrics are not always consistent and shared among IFIs to ensure similar yardsticks and foster learning from one to another.

Most IFIs still face some challenges in monitoring and evaluating private sector operations and in reporting development outcomes. For example, some attempts have been made to capture indirect effects using various methods in specific

sectors such as infrastructure, but a more rigorous methodology is called for. Many challenges still lie ahead despite the initiative to launch a working group on harmonizing indicators.

Challenges and way forward in evaluating private sector operations

The standards recognize the specificity of private sector evaluation, such as the competitive environment in which the private sector operates or the importance of the financial sustainability of projects, but some challenges remain. These include the need for more evidence to show the effects of private sector operations on the ground; for example, there is a need to come up with best practices and solutions on how to measure demonstration effects; catalytic effects, competition and linkages, how to better deal with attribution issues and beneficiaries' targeting, including SME definition and measurement. Indeed, there is a relatively weak evidence base in areas such as development outcomes and effects on end-beneficiaries arising from SME financing and PPPs. There are also ongoing discussions on how to better frame, provide guidelines and document both financial and non-financial additionality. Several IFIs are going through restructuring and change practices that may affect the implementation of the harmonized indicators. There is no silver bullet in terms of methodology. While others are already implementing the harmonized indicators list, some are looking forward to refining the definitions of some of the indicators (for example, taxes). Data quality and continuity are challenges facing IFIs and it is envisioned to go beyond project monitoring to impact evaluation.

Next steps:

- Set tracking systems to collect, monitor and evaluate development outcomes. DFIs can leverage their involvement in a project by requiring sponsors to commit to development targets. The Bank has succeeded, through its many years of experience, in getting a number of sponsors to agree to implement a development outcome tracking system. In spite of this progress, the Bank continues to challenge itself to improve its reporting mechanism.
- Increase evidence and impact by focusing on results: refine the indicators and their definition. For example, a common approach is needed to measure the social, environmental and financial impacts of projects. A project's development outcome rating is based principally on observed results on the ground, judged against market-based and company-specific benchmarks that test a project's commercial viability, economic and E&S sustainability, and demonstration effect. While the achievement of project objectives is considered, it is not the only criteria because delivery of the planned project infrastructure or services (at the point of completion) is no guarantee of the project's long-term viability or sustainability.
- Develop a 5th edition of the GPS. The ECG should do this, taking into account recent developments in each institution and in the evaluation field. For example, more instruments, such as trade finance or guarantees, are being introduced, but it is still unclear how and which metrics will be used to evaluate them in the future.
- Develop partnerships: Identifying next steps for increased collaboration with the private sector and the different stakeholders is necessary to improve measurement on development returns and its weight in the trade-offs between financial returns and risks; such measurements can then also be used as incentives for implementers.

The Bank continues to be an active member of a DFI-wide working group seeking to advance the estimation, collection and reporting of development outcome indicators, including those measuring inclusive growth. A list of harmonized indicators has been established and should guide the monitoring and reporting of all IFIs involved. In addition, two work streams are being pursued within this working Group: One on conversion methodologies to define a methodology to capture indirect development effects. The second on how to better conceptualize inclusive growth, green growth and impact investing and how to measure these effects. The implementation of the harmonized indicators will simplify project benchmarking and facilitate the sharing of best practices and lessons learned among IFIs.

- Draw on many years of experience to generate lessons to inform the role of the private sector in development and improve dissemination strategies. To foster learning, it is imperative to ponder the following questions: How can one project learn from the other inside the Bank and how can one IFI learn from the other? What do past experiences or recent evaluations tell us about financing private sector operations? It is important to always discuss

lessons from recent evaluations and evaluation approaches for support to private sector development programs, especially in the areas of private-public partnerships and support to small and medium enterprises where the challenges are many.

Private sector development initiatives are an essential part of efforts to achieve global development goals and commitments. Measuring, monitoring and evaluating PSOs help assess the effectiveness of the investments and improves future operations. It also helps to report on the Bank's performance in ways that reinforce public trust. Evaluation is mostly designed to meet reporting and accountability purposes to add value to the business; it is essential for the decision making process. However, the discussions on approaches and methodology are ongoing given the many challenges associated with private sector financing by multilateral development banks (MDBs). In fact, all development partners, including the private sector will have to rethink the metrics by which they judge success and failure of their investments and the impact on the development agenda. The evaluation community should urgently start paying attention to the growing use of private sector interventions to promote development and organize itself to play a strong role in the development of standardized tools to assess their results. In the meantime, the Bank with other IFIs will continue to contribute to this dialogue through the IFIs working group and other research and discussion forums.

Author's Profile

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Before joining the Bank, Hadizatou worked in Washington D.C. in both public and private sectors, at AIG and in international NGOs such as PSI, EGPAF and AED, working on USAID development projects around the world as a Financial Analyst and Senior Program Manager, respectively.

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