Enterprise Challenge Funds

Funding instrument that distributes grants (or concessional finance) to profit-seeking projects on a competitive basis. A challenge fund subsidizes private investment in developing countries where there is an expectation of commercial viability accompanied by measurable social and/or environmental outcomes. Challenge funds can mitigate market risks, while spurring innovation to fight poverty and environmental degradation.

Key Words: inclusive businesses; impact investment; ODA; agriculture; trade; energy; tourism

How does it work?

Enterprise challenge funds (challenge funds) are established by a public entity, foundation or development partner to provide financial contributions in the smallest possible effective amount to socially or environmentally worthwhile projects that are delivered by the private sector. The fund is a versatile instrument—a distinctive smart subsidy–that reduces the risks and costs of private investment while “challenging” the private sector to innovate for the public good. The grants (or concessional finance) are risk-sharing subsidies since the private firm co-invests its own resources. Challenge funds can thus leverage public financing and ODA to achieve better developmental outcomes, while influencing market behaviours through demonstration and imitation effects. The latter is linked to the promotion of sustainable and inclusive business by influencing the private sector to adopt business models that respond to the needs of the poor or of the planet. Three elements characterize challenge funds: 1. the private sector drives the solution’s design, co-financing and implementation; 2. subsidies are awarded through a competitive process; and 3. a broad development and commercial focus—the “challenge” (versus a prescribed approach)—that prizes innovation. Challenge funds can also be used to disburse grants to non-profit institutions, but this aspect is not covered here.

Once capitalized, challenge funds operate through calls for proposals, which are assessed competitively and according to established criteria. Performance-based grants or concessional financing is offered to the best proposals, which are submitted by the private sector. The selection process is open to for-profit firms. The funds do not usually provide a grant to cover the costs of project preparation. The call for proposals defines templates, eligibility criteria and the selection process. While the fund might focus on a very specific sub-sector or theme, submitted projects need to demonstrate they can deliver measurable social and/or environmental outcomes while maintaining commercial viability.

Four signposts describe their functioning: 1. description of the fund’s focus and scope; 2. determination of the responsibilities of the trust fund manager; 3. determination of the fund's capitalization and distribution modality (in most cases grants); and 4. design of the selection and monitoring processes.

Focus and scope. Challenge funds have demonstrated their versatility in practice, having supported a diverse range of projects in a wide variety of sectors. Examples include: extending financial services to the poor or marginalized groups; solving health problems; and introducing socially and environmentally sustainable practices in agriculture. There is a trade-off between narrowing the fund’s focus to a specific sector or country (deeper contextualization) and the potential for innovation (achieved through maintaining a spectrum of options and wide of participation). In any circumstance, the description of the challenge will not itself prescribe a single, predetermined solution.

Fund manager’s responsibilities. Donors' or investors’ primary responsibility is the identification of a capable fund manager, usually to be found among private sector consultancies and international organizations. The manager’s responsibilities vary, ranging from financial management and administration to mentoring, provision of technical assistance, research and advocacy for systemic reforms. Challenge funds can also be embedded in traditional private sector development programmes that promote wider reform packages.

Capitalization, leverage and financial products. There is no pre-determined or appropriate scale for a fund’s capitalization or thresholds for issuing grants. The economy of scale argument applies insofar as larger capitalization and average grants lower management costs. Therefore the minimum size for projects—usually between US$100,000 and US$250,000—is defined, sometimes with the identification of different sized windows for larger projects. Challenge funds offer matching grants to for-profit firms, but concessional finance, equity participation and guarantees can also be provided either as stand-alone financing or as part of a larger package of services. The combination of different financial products can help companies that have been awarded challenge funds to grow and graduate to commercial finance. For example, the Africa Enterprise Challenge Fund (AECF) offers grants, loans and guarantees. However, the experience of

Summary

Our Perspectives

What role for the private sector in financing the new sustainable development agenda?

Malawi Innovation Challenge Fund

Related Results

Generate Revenue

Deliver Better

Related Instruments

Grant

Equity and Debt

Related Sources

challenge funds with concessional or commercial finance is limited. Moreover, the benefit of using challenge funds to deliver commercial finance is unclear: the simultaneous provision of grants and commercial products has historically contributed to generating negative incentives (for repayment) and market failures. The offering of mentorships instead, to assist with accessing commercial funding from a third party, is less risky (e.g. Connect's programme with AECF). Co-financing is one of the selection (and/or eligibility) criteria and an effective instrument for sharing risks. The challenge fund usually requires the applicant to cover at least 50 per cent of project costs. The leverage ratio of challenge funds can range from 1:1 to 1:4.

Selection and monitoring process. The design and management of the call for proposals and the selection process is the key success factor, as it will determine the number and quality of applications. The core elements of the process include outreach and marketing, management of early contacts with applicants and the establishment of a transparent selection mechanism. Challenge funds utilize multiple communications channels that can encompass television, radio and the Internet, workshops and events and professional networks. The process is structured in different stages: 1. Application, 2 Selection, 3. Award, and 4. Monitoring and Assessment.

After a call for proposals (or financing windows) is opened, for-profit enterprises submit a (project) concept note, which is reviewed by the trust fund manager to check against the eligibility criteria (e.g. time in existence, legal records, solvency, audits, Corporate Social Responsibility (CSR) policy). Shortlisted concept notes are then transferred to an independent investment panel composed of high calibre professionals from the business and banking sectors. The panel decides the number of proposals that will graduate to the second phase, which is the submission of a detailed business plan. The fund manager undertakes due diligence (e.g. site visits) for the investment panel that will later sit to select the best plans based on a set of criteria (e.g. commercial viability, potential for replication, benefits for the poor, management of environmental impacts, financial leverage, degree of innovation, etc.). Induction workshops can be organized to facilitate the submission process and clarify selection criteria and templates. Successful firms will later enter a contractual agreement with the fund that details responsibilities and performance indicators. The disbursement of funds depends on the achievement of agreed milestones and is described in the contract. The duration of a challenge fund is usually limited and determined by the number of calls on it that were planned and the duration of the projects financed.

Two funds exemplify the process—the regional (Africa) fund, AECF, which awards for-profit companies up to US$1.5 million in grants and interest free loans through eight thematic and country funding windows and the Malawi Innovation Challenge Fund (MICF) that disburses grants up to US$750,000 to enterprises in the agriculture and manufacturing (non-traditional) export sectors. In its first round, which lasted approximately six months, the MICF awarded grants to 22 companies after consideration of 202 concept notes and 29 fully-fledged business plans. AECF's agribusiness financing window (1st round) attracted 718 applications (concept notes) that turned into 35 business plans and 22 projects funded. The average award ratio is of the order of one or two for 50 applications in the first stage (i.e. submission and consideration of concept notes) but over 50 per cent in the second stage (i.e. submission and consideration of business plans).

Stakeholders

- **Funder(s)/donors:** the Government, development partners or philanthropic foundations capitalize the challenge fund. The funder(s) usually chairs the fund's board and presides over the selection of the fund manager.
- **Fund manager:** the entity responsible for the management of the fund, including administration, financial management, disbursement of funds, management of the selection process, monitoring of the grant/investment portfolio, and marketing and communication.
- **Review/investment panel:** independent panel composed of high calibre professionals from the business and banking sectors that is mandated to select the project proposals submitted to the fund.
- **Applicant/awarded company**: for-profit enterprise (or consortia) that responds to the fund's call. If its project proposal is accepted, the company will be invited to sign an agreement with the fund. The agreement includes the extension of a grant and/or concessional finance to the company.

Potential in monetary terms (revenues, realignment, savings, cost-savings)

The amount invested in challenge funds worldwide is estimated at over US$1 billion, with a leverage ratio in the range of 1 to 4. Challenge funds that have selected multinational companies have a higher leverage ratio than those focusing on SMEs. DFID has spearheaded the development of challenge funds and remains their largest sponsor in development cooperation. The Nordic countries, Australia, Canada, the USA, multilateral development banks and the UN system are all currently funding enterprise challenge funds across the globe.

The capitalization of challenge funds can range from just over US$1 million to more than US$100 million in the case of regional and global facilities. The suggested capitalization of a country-focused challenge fund or window is in the range of US$10-25 million, depending on its scope and objectives. Economies of scale usually start with budgets over US$10 million, with more substantial cost reductions after US$25 million. The value of the average grant transaction varies, but is mostly within the range of US$100,000-1.5 million. The average grant amount awarded by MICF in its first round was about US$400,000.

When is it feasible?

NATIONAL

INTERNATIONAL

Related SDG

8 DECENT WORK AND ECONOMIC GROWTH

9 INDUSTRY, INNOVATION AND INFRASTRUCTURE

17 PARTNERSHIPS FOR THE GOALS

Related Sectors

AGRICULTURE

ENERGY

FORESTRY

FISHERY

WATER

TOURISM

FINANCE

MINING

TRANSPORT

There is no specific legal requirement for the establishment of a challenge and innovation fund. A sufficient amount of capitalization, which will determine the most suitable type of legal entity, is the main requirement. The feasibility study should identify the best governance and disbursement mechanisms and conduct a market review to identify the presence of sufficient prospective applicants to justify establishing a fund.

Minimum investment and running costs

The fund capitalization is spent on two items, the awarding of grants or other types of concessional finance, and management costs. Management costs vary from 15 per cent to over 30 per cent of the fund's value, depending on the functions and responsibilities of the fund manager. The management costs of the largest fund in operation are approximately 20 per cent of its value. The value of the manager's contract for a US$10 million fund can be estimated at between

US$500,000 and US$800,000 annually over three years. The outsourcing of additional functions (e.g. the provision of or the selection of providers of technical assistance) can increase the costs by up to about 30 per cent (e.g. ECF) or more. Monitoring and evaluation costs are set at about 5 per cent. Economies of scale can reduce management costs, both in terms of the fund's capitalization and of the average size of the financing offered by the fund.

The companies that apply to the fund bear the sunk costs of the drafting of the concept note and of the business plan, including carrying out feasibility studies and market research. Normally, the challenge fund does not reimburse those costs to the company, even if it is awarded a grant.

Use in appropriate time and context

Enterprise challenge funds are more appropriate:

- when the solution to a development challenge can be better addressed by the private sector;
- there is market failure in the financial sector with respect to servicing the operations of inclusive businesses and/or innovative enterprises;
- when commercially viable solutions are not readily available, and/or businesses are reluctant to undertake them. Challenge funds are not appropriate—by definition—to fund initiatives that are not commercially viable;
- when a sufficient number of businesses are interested in the challenge–a narrow focus combined with few prospective applications can lead to failure.

What are the main risks and challenges?

Pros

- Challenge funds offer an effective means to engage the private sector in development, with minimal market distortions; challenge funds can influence the behaviour of the private sector through systemic innovations and imitation/demonstration effects (e.g. M-PESA).
- The funds' focus on a competitive and open selection process can offer greater assurance of performance and the identification of cost-effective solutions.
- Innovation is increasingly seen as a way to solve today's world challenges; challenge funds broaden the usual menu of options available to address development problems.
- Challenge funds can leverage public resources with private financing.
- The latest generation of challenge funds applies rigorous and more stringent evaluation criteria than traditional private sector development projects.

Cons

- It might generate expectations from the private sector about public support.
- Innovative projects might be chosen over less ground-breaking projects with greater potential impact.

Risks

- Political interference can influence the selection of projects and the overall results. It might also increase exposure to corruption risks.
- Limited participation or interest from the private sector. Narrow targeting, both geographical and thematic, can reduce the number of potential bidders. Investment in outreach and marketing is therefore required.
- Poor quality of proposals.
- Legal risks related to contractual non-compliance by awarded companies, and any type of fraud.
- Currency exchange risk, if the grants are in a currency different from the one used by the companies receiving them.
- Adverse selection: the fund may attract applicants which are unable to secure funding from elsewhere due to the financial unsustainability of the project proposed.
- Altering competition: the fund should ensure that funded projects do not compromise the competitive neutrality

of other businesses, or displace commercial finance providers.
- The challenge fund's portfolio is influenced by the business risks commonly encountered by the projects it has funded, including exogenous risk factors, such as changes in the regulatory environment, or endogenous factors, such as e.g. marketing or product failures.
- Challenge funds that offer both grants and commercial finance are likely to face higher risks of defaults, judging from the experience of public lenders and microfinance offering a similar mix.
- Failure to deliver developmental impacts or innovative approaches can turn the fund into a subsidy scheme that benefits only a few enterprises and damages the reputation of the sponsor organizations.

How can the design be ameliorated to improve the impact?

Despite the significant funding provided and the number of facilities in operation, there is insufficient evidence to demonstrate whether enterprise challenge funds have achieved the hoped-for development impacts. The focus of evaluations has often been often limited to measuring the efficiency of operations— management costs, leverage ratio, etc.—rather than their development impacts. Analysis of the most recent generation of funds and the establishment of internationally recognized standards for them would yield a more accurate understanding of impacts and thus generate lessons learned. As challenge funds involve investing scarce public resources in support of profit-seeking ventures, they require all the counterfactuals to be carefully screened.

The success and social/environmental impact of a challenge fund depends on: 1. additionality (i.e. serving companies that could not access commercial finance); 2. positive externalities (i.e. the selection of projects with the highest development benefit); and 3. systemic impact (i.e. driven by demonstration/imitation effects and the creation of new markets, these can be summarized as "crowding in"/copying successful practice, changes in the business and regulatory environment and changes in factor markets). Trade-offs among these three results of challenge funds need to be balanced and require careful consideration in the fund's objectives and design. For example, an overemphasis on financial and commercial viability and/or co-financing in the selection criteria can allow projects to qualify that could be funded via traditional channels, but it can also increase the fund's leverage ratio and its systemic impact.

The fund's monitoring and evaluation framework is critical to enhancing the social/environmental impact, and it should be fully integrated into the selection criteria. The DCED Standard provides a framework for the development of a results measurement system, while the IRIS catalogue provides template indicators to measure the social, environmental and financial performance of projects. It is important to highlight the role of social/environmental indicators in measuring impact. For example, the leverage ratio is commonly considered an indicator of success for challenge funds, but it is not a good proxy for assessing social and environmental impacts. The fund should also comply with international social and environmental safeguards (e.g. equator principles). Despite a lack of data, early evaluations of challenge funds suggest the achievement of development impacts. Impact indicators primarily encompass the increased income of households reached by projects and the number of jobs created.

The AECF aims to generate pro-poor systemic change in agricultural and financial markets, creating jobs, enhancing livelihoods and improving access for the poor as consumers. Examples from the AECF and its predecessors provide evidence of results: the grant provided to Unilever for a smallholders' pilot scheme to introduce Allanblackia nuts, a low cost source of vegetable fat for export, has benefited 4,000 smallholders in Tanzania; the grant awarded to Vodafone and Safaricom to develop the mobile platform, M-PESA, has contributed to transforming the retail finance market in Kenya by substantially expanding access opportunities for low income individuals. More recently the AECF supported M-KOPA, which combines mobile and solar technology. The system can be purchased with a deposit of US$35, followed by daily mobile payments of 43 US cents. The company reached over 300,000 customers in three years, selling 500 new systems each day in Kenya, Uganda and Tanzania. In 2015 AECF released its first consolidated impact report (one of the first of its kind), which notes that its projects have reached a total of 1.39 million households. Each household was estimated to benefit on average by US$84 (additional household income is the main impact indicator); and over 5,100 jobs have been created since 2008 (with a cumulative wage bill of US$60 million). Moreover, about one third of the projects have reported at least one systemic impact. The AECF has also piloted a rough measure of impact—the Development Rate of Return—to estimate the return on the funds invested by donors. The smaller Australian Enterprise Challenge Fund has awarded A$11 million in grants to 21 projects that are estimated to have increased the income of 78,154 people in three years. Evidence based target setting can point to expected future impacts: a MICF financed project aims to double the income of 3,100 smallholders and create 100 new jobs by investing in meat processing for locally produced high quality beef in a region that had none.

While the provision of technical assistance from the fund in the preparation of the project documents produces additional costs and a possible bias in the selection, it can also improve the quality of the proposals, particularly with the identification and measurement of social/environmental impacts and in helping funded companies to graduate into commercial financial products.

Guidelines and Case Studies

Detailed guidance

Measuring Results in Challenge Funds: Practical Guidelines for Implementing the DCED Standard

Understanding Challenge Funds (ODI)

Guidelines: Challenge Funds (SIDA)

Meeting the challenges: How can enterprise challenge funds be made to work better?

Case studies

Africa Enterprise Challenge Fund

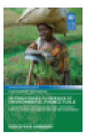
Malawi Innovation Challenge Fund

Enterprise Challenge Fund for the Pacific and South-East Asia

Compete Caribbean

Our work

International Guidebook of Environmental Finance Tools null



Sustainable Development Goals

Environmental finance

Our Perspective

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We should reach a consensus on the fact that macroeconomic policies in low-income economies need to also jettison the conventional wisdom of undue restrictiveness.