



Australian Government

Department of Foreign Affairs and Trade

Investment for Development

Challenge Funds to Overcome Barriers to Private Sector Growth

This document explains

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What is a challenge fund?

- A challenge fund provides cash incentives for individuals or groups to meet a need that is not being met by institutions or markets alone – in short, it rewards people who respond to a specific challenge.
- Many challenge funds are ‘push’ mechanisms – grants awarded under competitive tender to pursue desirable initiatives. Challenge funds could also be ‘pull’ mechanisms – rewarding proven achievements that meet program objectives. The overall objective is to encourage people to pursue desirable initiatives that have high costs or other risks that discourage people taking the first steps.
- This guidance note focuses on enterprise challenge funds – funds that invest in business opportunities that will overcome barriers to future business growth – but challenge funds may take various forms:
 - The Child Education Challenge Fund by the Mohammed bin Rashid Al Maktoum Foundation invested in business proposals to improve education outcomes (better education is the challenge).
 - The UK Government’s University Challenge Funds invested in proposals that would turn university research discoveries into commercial products (commercial application is the challenge).

The Enterprise Challenge Fund for the Pacific and South East Asia

- From 2007 to 2013, AusAID ran a pilot program called the Enterprise Challenge Fund for the Pacific and South East Asia (ECF pilot). Public sector funds in this program were provided solely by Australia, in contrast to the multi-donor Africa Enterprise Challenge Fund that Australia participates in.
- Under the ECF pilot program, Australia provided up to 50% of the investment capital required to expand or start-up promising business opportunities, to leverage ‘pro-poor’ private sector investment that would not otherwise occur (a ‘push’ mechanism model).
- The objective of the ECF pilot was to encourage businesses to pursue pro-poor business development opportunities that would *catalyse market improvements and future business growth*.
- This is an important distinction – an enterprise challenge fund (ECF) is not intended to simply expand business opportunities that have some form of pro-poor benefit. An ECF should drive strategic investment that will generate more business growth in the future (see Box 2 for detail).

Why have a challenge fund with the private sector?

- Growth in private sector business and trade can be an effective method of reducing poverty but growth can be impeded by weaknesses in the business enabling environment.
 - For example, in places where investment capacity or business confidence is low, or barriers to market entry are costly to overcome, even profitable opportunities that would improve the business environment and drive future business growth may fail to attract investment capital.
- Improving the underlying structural barriers to business growth (e.g. regulation and infrastructure) is the ideal way to drive sustainable economic development but it is a longer-term task. An ECF can provide more immediate enterprise development or can influence existing companies to enhance their poverty impact (Davies and Elgar 2014) while broader reforms are pursued.
- As an innovative mechanism with proven records of driving pro-poor business growth, ECFs are a potentially useful tool for DFAT teams to achieve their strategic objectives. However, ECFs are not suitable for all countries and all economic environments, and a successful program requires substantial planning, design and monitoring.

Critique of challenge funds with the private sector

- While challenge funds are a potentially useful tool for driving pro-poor business growth, they are not universally supported. Arguments against investment challenge funds include:
 - It is not the role of Government to provide free money to business, investment should be sourced from the private sector. In short, Government should leave the business of business to business.
 - 'Subsidising' one business at the expense of others distorts the market.
 - Some number of funded projects will not prove commercially sustainable – 'wasting' public funds.
 - An ECF could fund business activities that would have been pursued anyway – therefore failing at the core objective of leveraging pro-poor investment that would not otherwise occur.
- Arguments against investment challenge funds should be taken into account when considering the appropriateness and design of challenge funds, and also for managing perceptions and expectations.

Box 2 - Strategic Investment vs Investment Subsidy

- An ECF seeks to drive business opportunities that will overcome *barriers to future business growth*. The barriers might be lack of infrastructure, information, or to access finance – and the challenge fund has a role where the market fails to overcome barriers alone.
- An ECF should therefore select projects that are likely to overcome these barriers – not simply fund projects to employ an additional dozen people, raise one business's income in the local area, or provide a public good (e.g. increased sanitation) *.
- An example of a good enterprise challenge fund project is WING mobile payment facility in Cambodia. With ECF funding, WING expanded its operations and provided training and financial literacy education to potential customers in rural Cambodia.
- The business now reaches all Cambodian provinces and, in 2013 alone, 6% of adult Cambodians sent approximately USD1.5 billion (10% Cambodian GDP) through this service. The WING services reduce the cost of remittances, open microfinance access, raise incomes for merchants that supply WING customers or act as rural cashpoints, and improve payroll options for local businesses – all of which will help to drive future income and business growth.

*Note: Business growth facilities and challenge funds to provide public goods like health or education are valid program choices but are distinct from enterprise challenge funds considered by this paper.

Key lessons from the ECF pilot

- The 2009 and 2011 independent reviews of the ECF pilot program identified a range of lessons about what makes an ECF effective. At the broad level, these lessons include:
 1. An effective ECF requires a high level of *selectivity*: an ECF is not appropriate in all countries, all economic environments, or for all industry sectors.
 2. An effective ECF requires a great deal of *preliminary work*: well before grants are considered the program should have clearly identified goals and priorities, and a detailed strategy for identifying target industry sectors, selecting individual proposals, managing risks, and conducting independent monitoring.
 3. An effective ECF should fund those proposals that will be *sustainable* but would not otherwise be funded by the private sector (they are *additional*). Additionality is a core requirement of an ECF.
 4. An ECF is a *portfolio investment* requiring some tolerance of risk and failure. The best selectivity and preliminary work cannot guarantee success for all private-sector business opportunities and an appropriately structured program, with correct frameworks and tolerance of risk, will achieve high successes, some average performers, and some failures.
- Failure to act on these lessons will reduce the effectiveness of the ECF and increase the risk of financial waste and critical reviews.

Selectivity of Location

- Several factors determine whether an ECF will be effective for your target area:
 - i) An ECF is appropriate for lower-income countries, where increased employment and incomes will deliver comparatively higher benefits. Richer countries are likely to have better financial markets and higher market competition, reducing the applicability of an ECF and the ability to deliver results with this mechanism.
 - ii) An ECF requires a population high enough to provide a critical mass of high-quality business opportunities. The smaller the population, the fewer high-quality opportunities will exist to justify the costs of an ECF.
 - iii) An ECF is appropriate where the financial market and private-sector investment capacity is lacking. The stronger the finance market, the less likely ECF projects will be additional.
- These factors should be weighed against each other to determine whether a challenge fund is an appropriate business development mechanism. For example:
 - i) An ECF may be a suitable development option in a country that has a stronger financial market than other countries if the population size and its finance needs greatly outstrip the available investment capacity.
 - ii) Low investment capacity increases the applicability of an ECF – but if investment capacity is so low that it is difficult for businesses to invest at least \$250,000, an ECF becomes a more costly business-development option (see cost and risk tolerance for further information).
- At some point, selectivity will rule out an enterprise challenge fund. For example, some Pacific island nations are unlikely to have the business population size to justify a challenge fund approach, so regional approaches or different business development mechanisms may be more appropriate (e.g. a risk-sharing facility for banks, to encourage credit for business proposals that drive pro-poor development).

Issues for Program Design

- One of the most important lessons of the ECF pilot is the degree of *preliminary work* necessary to ensure an effective challenge fund. Before tendering for a fund manager you should clearly identify:
 - i) The *objectives* of the program, ranked by priority. Objectives should be clearly focussed and drawn from existing DFAT and country strategic documents, and the issues below.
 - ii) *Market barriers* impeding pro-poor business growth in the target region. Without a clear understanding of what barriers exist and how they might be overcome, the challenge fund is unlikely to effectively target the correct industry sectors or select the right projects.
 - iii) *Target industry sectors* where projects are likely to overcome barriers to future growth. The ECF pilot found that agriculture, aquaculture, tourism, and financial services are likely to offer the greatest potential for future business growth. Other research identifies agricultural investment as leading to the greatest pro-poor income growth (Kleaver 2012). Identifying which sectors or industries employ majority women or men is also very important to women's empowerment.
 - iv) A *staged approach* to help to react to lessons as they emerge. This could involve approving projects in annual tranches, or approving staged funding. For example, the [USAID Development Innovation Ventures program](#) grants up to \$100,000 funding to prove feasible concepts. Only the best projects qualify for later funding to test at scale (up to \$1 million) or implement at scale (up to \$15 million).
 - v) *Results measurement* standards. Results measurement is crucially important to identify whether you have achieved your *objectives*. The [DCED Standard for Results Measurement](#) provides guidance for effective results measurement and DFAT staff should understand how to critique results reports, for example, to identify whether results are *additional*. The fund manager should be responsible monitoring and evaluation but participating businesses can provide vital data.
 - vi) Some *partnerships and links* with supporting services for businesses. For example, build support for the program in the local Chamber of Commerce and business advisory services so they can help mentor participating businesses. Programs should consider partnering with commercial finance instead of excluding projects that can obtain some degree of commercial funding.
 - vii) *Clear roles* for selection panels, managing contractors and independent review teams.

Cost and Risk Tolerance

- Reviews of the ECF recommend management fees of approximately 20 per cent of total expenditure as an acceptable benchmark (e.g. grants of \$10 million could see management costs of \$2.5 million).
- Many costs will be fixed so the smaller the grant size, the higher the management fee to grant ratio (often used as a measure of administrative efficiency). The lessons of the ECF pilot recommend a minimum grant size of \$250,000. However, in a 50 per cent matching grant program, this limits an ECF to locations where businesses can obtain at least \$250,000 of finance (unfeasible for some countries).
- Some projects *will* fail to meet objectives or fail as a business. Estimates of small businesses failure range from 60 to 90 per cent within five years, and expectations should be managed so that a program can be viewed as a success despite some project failures. A realistic expectation may be 30 per cent meeting/exceeding objectives (high quality performance), 40 per cent meeting most objectives (adequate performance), and 30 per cent meeting few objectives (poorer performance).
- Prioritising *selectivity, expansion, and replication* is likely to improve ECF project performance above 'natural' business failure rates but an ECF remains a business development mechanism – it is only appropriate for those areas that can accept a certain level of management cost and project failure.

Box 3 - Lessons in brief: the Challenge Fund checklist

Does your target area have:

- Sufficient population base to generate proposals that catalyse future growth?
- Market barriers that prevent investment in projects with flow-on effects?
- A constrained investment capacity?

Can you accept:

- Up to 20% management costs?
- A degree of planned project failure in a successful program?

Does your design document clearly identify:

- Program objectives?
- The market barriers?
- Target industry sectors and which industries employ women/men?
- Types of eligible projects?
- Ways to identify business links and partnerships?
- Clear roles for contracted service providers?
- Results measurement standards?

Management and Measurement

- The ECF pilot recommends contracting fund management to an existing challenge fund manager or small-medium enterprise equity fund manager with local knowledge and a track record of success.
- The *fund manager* should be active and not simply a 'light touch' observer of business performance and program funds. This role does not extend to interfering with the recipient business but should, for example, extend to identifying *partnerships* with successful businesses that could have a vested interest in the recipient's success (e.g. a tourism company that would sell tours to a recipient's factory, or another factory that will purchase product that is excess to the recipient's needs).
- The fund manager should also conduct due diligence to review the viability of eligible projects, and the likelihood of meeting the objectives and criteria of the ECF. This will include site visits to the final eligible projects and actively culling projects of lower suitability, before selection is finalised.
- The final selection of projects should be made independently of the fund manager, by an *independent selection panel*. An active fund manager should reduce the field of applications to suitable and comprehensive candidates, leaving the independent selection panel to adjudicate between the proposals most likely to achieve the best results according to program objectives.
- To ensure applicants deliver high quality applications and the selection panel can identify which proposals will achieve program objectives, project selection criteria should clearly explain:
 - i) The concepts of *market barriers* and *market failure*
 - ii) The specific market barriers or market failures identified in a target region, and
 - iii) The objective of strategic investment (*catalysing future growth*) to overcome the failures/ barriers.
- Measuring the effects of the ECF requires an understanding of:
 - i) The *business impact* – the direct impact on the business
 - ii) The *development impact* – the result as measured by development indicators (e.g. increased income, increased employment, or cost savings), and
 - iii) The *systemic impact* – the changes to the market or business enabling environment that will catalyse future business and development impacts.
- Measuring and attributing these effects accurately will require quantitative baseline and comparison figures, supported by qualitative analysis and case studies. Systemic impact in particular is difficult to measure with quantitative data alone. The Donor Committee for Enterprise Development (DCED) results measurement standard is an excellent guide to structuring results measurement.

Resources and Further Reading

ECF for South East Asia and the Pacific resources:

- ECF Homepage – <http://www.enterprisechallengefund.org/>
- 2011 Independent Review of the ECF for South East Asia and the Pacific – <http://www.usaid.gov/countries/pacific/fiji/Documents/enterprise-challenge-independent-progress.pdf>
- 2009 Midterm Review of the ECF for South East Asia and the Pacific http://www.usaid.gov/Publications/Pages/2179_5123_9221_7348_509.aspx
- Measuring Results in Challenge Funds – Practical Guidelines for Implementing the DCED Standard <http://www.google.com.au/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=2&ved=0CDMQFjAB&url=http%3A%2F%2Fwww.enterprise-development.org%2Fdownload.ashx%3Fid%3D2272&ei=zEKNUui3MYXqiAeL9YDoCg&usg=AFQjCNHxCUBMevCuFKm5oluWEj5vaomXtw&bvm=bv.56643336,d.aGc>

African Enterprise Challenge Fund (AECF) resources:

- AECF Homepage – <http://www.aecfafrica.org/>

Other Resources

- Davies and Elgar 2014, *Enterprise development or business impact? On the purpose and design of enterprise challenge funds for development*. Development Policy Centre, ANU (publication pending, available on request to the ANU Development Policy Centre).
- Kleaver C, 22 June 2012. *Investing in agriculture to reduce poverty and hunger*, International Food Policy Research Institute, <http://www.ifpri.org/publication/investing-agriculture-reduce-poverty-and-hunger>.
- Pompa C, July 2013. *Understanding challenge funds*, Overseas Development Institute, London, United Kingdom.