

# CHALLENGE FUNDS IN FRAGILE STATES

EXPERIENCE FROM THE AFGHANISTAN BUSINESS INNOVATION FUND



# Summary

The Afghanistan Business Innovation Fund (ABIF), managed by Landell Mills Ltd with funding from the UK Department for International Development (DFID) and the Australian Department of Foreign Affairs and Trade (DFAT) was a pilot project focused on incentivising investment in private sector-driven solutions to market constraints that impact Afghanistan's poor.

In this learning brief we highlight a number of insights from ABIF's experience. Many are applicable to any type of challenge fund, whether in a fragile or non-fragile state, but provide particular insight to Afghanistan, where ABIF was implemented as a pilot project from 2011 to 2015.

## Grantee selection process

- Marketing the fund – working through local chambers of commerce (or similar types of representative business organisations) helped to target populations of interested applicants and provided marketing value for money by leveraging existing representative organisation networks and resources. ABIF worked with the Afghan Chamber of Commerce and Industry (ACCI) at the marketing/fund promotion stage.
- Clearly reiterating eligibility and selection criteria at the initial application stage (for example, through regional workshops) increased the number of eligible concept notes, leading to higher proportions of fundable investment proposals.
- Providing application templates (downloadable from the project website) for the submission of concept notes and business plans ensured efficiency and consistency throughout the review process. However, this resulted in some applicants focusing more on saying the right things than providing a critically analysed, commercial business strategy. Leaving the applicants to come up with their own business plan model may force them to be more realistic and accurate with how they present their investment concept and the expected development impact that would result. Future programming could take this into consideration, depending on the size of the internal review team and resources (time and money) allocated to review of proposals.
- The capacity of firms in Afghanistan, and likely other fragile states, to develop commercially viable business plans was limited. Rather than provide support directly through our internal staff, ABIF subsidised applicants' costs to work with local business development service (BDS) providers. This resulted in higher quality business plans and simultaneously strengthened the BDS market, an indirect benefit following the M4P approach. However, since the project subsidised this support – and because many Afghan firms had no prior experience managing consultants – BDS firms sometimes viewed ABIF as the “real” client and tailored business plans for the ABIF fund management team, rather than for the applicants themselves.

Prior vetting of BDS firms beforehand minimised this issue, and a BDS workshop emphasised the importance of working closely with the applicant.

- Challenge fund programmes generally employ a cost-share mechanism to ensure adequate grantee ownership of the project; most commonly, they use matching grants or a pre-set cost-share percentage. However, these do not offer any objective system to ensure that too much public money isn't unnecessarily put forward to incentivise implementation of the investment. ABIF used a **risk determined approach to calculate grant awards**. Instead of setting an arbitrary fixed or target grant contribution and regarding any amount lower than this benchmark as a good result, ABIF looked at the risks and returns of individual investments to identify the investment decision's tipping point at which a grant would make an investment happen. The process depended on an initial assessment of investment risk in Afghanistan; then, through financial modelling of the investment costs and returns, ABIF determined the grant values necessary to provide effective incentives by offsetting enough risk to make the investment viable.

Given the lack of data on investment risk in Afghanistan, also common in other fragile states, ABIF undertook an investor survey to determine the cost of capital (estimated to be 25% in Afghanistan), to compliment the secondary data available. In all cases, applicants prepared robust business plans and related financial models to demonstrate that their business models were commercially sound. The defining step in the ABIF approach was that the same financial model was also used to calculate the forecasted internal rate of return (IRR)<sup>1</sup> which was compared to the investors' target returns; the decision tipping point at which the investment was justified. Put simply, the difference between the forecast and the target returns determined the amount of grant that was required to incentivise the investment. While marginally requiring more time than a traditional approach, the benefits of this approach were as follows:

- It justified not only the principle of public sector grants to private sector



Habibullah Haseeb Group

enterprises, but also the amount of grant that was awarded.

- It brought the discipline of private sector investment decision making to the allocation of public funds, improving the quality and reducing the implementation risk of the investment project.
- It transformed grants from a competing to a complementary source of finance, avoiding displacement of commercial finance providers. In many cases, the provision of the ABIF grant helped grantees obtain commercial or external financing, which may have proved difficult otherwise. In several specific cases, the grant helped leverage the use of commercial finance.
- It reduced the amount of public grant used to incentivise each investment project, allowed for a larger portfolio of investments and reduced project failure risk, thereby protecting future development impact. The grant amount provided by ABIF equalled 28% of the total estimated investment budget<sup>2</sup> (and 33% when compared to actual).
- It boosted development returns by allowing more projects to be funded, increasing the value for money delivered by the project.
- While adding to fund management costs, **in-depth reviews by technical, environmental and gender experts** gave credence to the validity of investment concepts and provided detailed critical feedback to ABIF and the applicants. These combined with **in-depth due diligence reviews and selection process**, ultimately resulted in a higher proportion of successful business models, thus improving value for money in the long-term. As well as sector-specific international experts, ABIF learned that local technical experts should be used to provide more in-depth feedback on the prices of local products or services or provide up-to-date conditions in various sectors. This can provide stronger points of reference when reviewing the financial models presented as part of the applicants' final business plans.
- Equally important is that due diligence set the stage for expectations in grantees' minds. If due diligence turns out to be merely a box-checking exercise, it will cause further challenges down the road and can cause grantees to question the seriousness of the project. However, if effectively done, it can be a powerful example for how the project intends to operate, and can establish professional boundaries from the very beginning that carry on throughout the life of the project. Establishing these boundaries

and then consistently applying them fairly across the board was a significant key to ABIF's success and our grantees' respect of the project itself.

- **Transparency in the selection process** reduces complaints received by non-successful applicants. As well as using set selection criteria to determine eligible applicants, ABIF assigned each final eligible applicant an "expected development outcome." All ABIF staff members then reviewed each grade assigned so that one member of the ABIF management team couldn't push his/her project for final approval without a very rational, logical foundation that was agreed by all other team members. Another more external transparent action occurred at the very end of the grant award process. Grant ranges that would ensure that each project could reach the target IRR in order to be sufficiently profitable were provided to each applicant. We then requested that they submit sealed 'bids' of the final grant sum required to successfully conduct the project. These bids were below or within the range given to them to reach the expected IRR. Then, in a public meeting with all final applicants, ABIF opened each of the bids, and combined them with the expected development outcome scores that ABIF had previously assigned. We had a ceiling limit of grant budget available, and grantees could see the cut-off point in the excel template. This process impressed all the applicants (even the unsuccessful ones) and we received no complaints about the transparent process of ranking and allocating funding for each project.
- **Use of an investment panel.** Many challenge funds use external investment panels to make the final decision on funding. The major lesson from ABIF's use of an Investment Panel was the need for the responsibilities of an IP to be made clear from the outset. If the fund manager is tasked with undertaking the due diligence and selection of grantees, then the IP's role should be only to ensure that the process, as outlined in a fund manual, has been followed correctly. The IP could also take the role of ombudsman in case applicants or grantees object to the fund's processes. This is particularly pertinent when DFID is moving to output-based payments for fund managers, which would be hard to reconcile if the fund manager cannot make the decision on which applicants should receive funding.

## Implementation of business models

- Linking grant payments to customised **lump-sum milestone schedules (payment-by-results)**<sup>3</sup>, based on data submitted from grantees' final business plans and financial models, incentivised them to provide better estimates for their projects' impact, rather than overstating and risking missing out on payment due to under performance. A stringent approach was maintained for achievement of milestones. Each milestone schedule included investment-related milestones, milestones related to implementation of key aspects of the business model and also milestones tied to achievement of targeted development impact. Linking a high proportion of the milestones to development impact provided an incentive for the business to remain focused on target beneficiary benefits. In hindsight, ABIF should have created a milestone related to development and successful maintenance of key administrative and financial management systems to make verification of milestones easier. Most SMEs in Afghanistan do not keep strong financial data, so especially early on, this was a challenge. Despite this shortcoming, the payment-by-results methodology was incredibly effective in ensuring value for money, grantee motivation and provided a substantial amount of leverage for ABIF over the course of implementation of the project.
- **An adaptive management style** is required (by the fund manager and donor) to change milestone dates and targets, particularly in a fragile state such as Afghanistan where security and politics may cause external pressures on investors' ability to implement according to envisaged timelines.
- In fragile states such as Afghanistan, it is difficult to work in certain areas due to **security** constraints. Working through private sector actors can help overcome these challenges. It is also important to protect information about the association of grantees with donors, limit visibility during site visits and be careful about publishing information that could compromise the businesses. From an internal ethics standpoint – which was also tied to security – at least two ABIF staff were sent on each site visit when verifying milestones. This reduced the likelihood of businesses trying to approach our staff with offers of corruption, which is prevalent in Afghanistan.
- The business case assumed a **£1:£2 leverage ratio** between grant funds and private investor funds. Strictly on a cash for cash basis, the ABIF leverage ratio

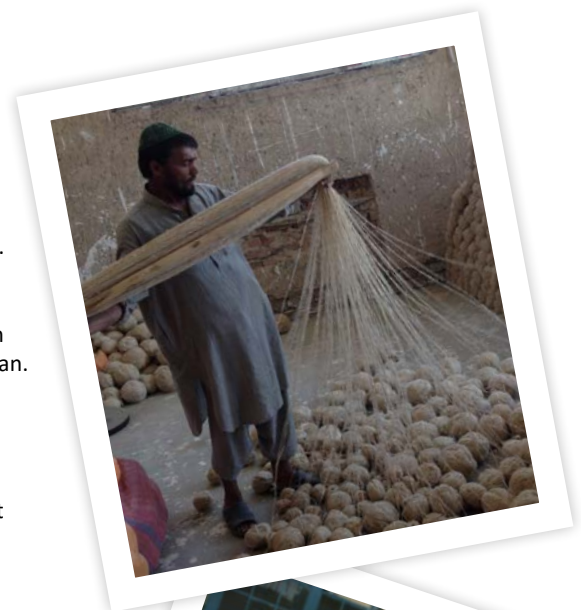


was £1:£2.2, which slightly exceeded expectations set forth in the business case. If analysed on a grant to total private investment basis (investor cash and assets), the leverage rate increased to £1:£3. Assets contributed by businesses were pre-owned assets that were put into productive use as part of the ABIF investment project. Due to the lack of information related to implementation of challenge funds in fragile states, in particular on details as to how investment costs have been calculated, it is impossible to compare ABIF's leverage rates with those of other challenge funds on a like-for-like basis. However, leverage rates are very comparable with challenge funds implemented in other, non-conflict-affected developing economies. One would assume that leverage rates for funds in conflict-affected states would be lower, providing further credence to the value for money provided by the risk-adjusted grant award system that ABIF employed. It is recommended that DFID standardise how leverage ratios are calculated, if like-for-like comparison between challenge funds are to be carried out.

- In many cases the true cash leverage from each grantee was not fully captured. It was a continual struggle throughout the project to convince grantees to submit comprehensive data about their investments and businesses. Businesses often wish to keep such information confidential. Note should be made of this in the information which is requested as part of grantees' reporting, and which should be a prerequisite for the release of funds.
- In some cases, grantees overestimated the amount of capital necessary to undertake and successfully complete their investment. Differences will always be present to some extent – especially in conflict zones when accurate planning is difficult – and future projects are recommended to do as much financial analysis as possible to ensure that plans are as closely aligned to reality.
- **M&E vs M&V.** Similar to other M4P projects, working through private sector businesses made evaluation particularly challenging because ABIF was never designed to work directly with its intended beneficiary populations. This led a substantial portion of ABIF's results measurement activities to focus on monitoring and verification (M&V) as opposed to monitoring and evaluation (M&E) of the project's impact. However, grantees were not used to keeping detailed business data about costs, sales, etc., so we provided basic templates for them. In hindsight, we

should have developed systems to enable the fund management team to spend more time with grantees analysing their business data, with an emphasis on how it could effectively be used for strong business operations in the future.

- If **third-party monitors** are used on similar projects, they should be introduced from the very beginning to have time to develop strong relationships with grantees for whatever verification activities are deemed necessary. On ABIF this was not the case and grantees were extremely hesitant to pass on data to the monitor for confidentiality reasons. This was even harder once grantees had received their full milestone payments as they had no incentive to share information and ABIF no longer had leverage. In fragile environments, lack of trust should not be underestimated by donors or project implementers, even to the detriment of "pure" M&E or M&V methodologies.
- **Post-grant support (PGS)**, on a cost-sharing basis using BDS providers, for activities such as market research, creation of marketing products, and financial and business management training, is an effective means of ensuring the sustainability of business models and scale-up, and deepening the likely development impact on beneficiaries. Through PGS support, ABIF leveraged an additional \$200,000 of private finance. Almost half of ABIF's grantees took advantage of this opportunity, despite having to contribute to the cost, which indicates demand for BDS in Afghanistan. Negotiations with BDS providers were done by the grantees to ensure prices were not inflated, with ABIF providing approval and oversight. Payment was done on a milestone basis. In the most successful cases, grantees continued to work with the same BDS providers even after ABIF's funding had ceased.



Sahib Zaman Carpet Company

# Introduction

This learning brief has been developed to illuminate lessons that could be drawn out from the Afghanistan Business Innovation Fund (ABIF), particularly concerning what is needed to make a M4P-focused challenge fund successful in a fragile state that exhibits underdeveloped markets.

The brief looks at the ABIF design, the process of its implementation and its final results. In a context of declining international attention and donor assistance to Afghanistan, the private sector will most certainly need to play a much larger role in driving the country's economic future. Looking back will help DFID and DFAT, ABIF's donors, consider next steps to encourage inclusive private sector growth in Afghanistan.

The original business case is a natural beginning point because it outlines the original thinking with regard to project design as well as intended/expected results. Later, this brief will address ABIF's actual impact against original expectations, highlighting several key points of particular interest and document several key lessons learned.

# ABIF business case context



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In an environment of substantial, but heavily donor driven, economic growth since 2001, ABIF was viewed as a pilot project that could incentivise Afghan business investment outside sectors that had primarily grown through donor aid such as construction, transportation, storage, manufacturing and government services – and had subsequently benefitted relatively small numbers of Afghans, driving substantial income inequality. Given this context, the business case noted “an urgent need to provide inclusive economic growth in order to increase the incomes of the poor.”<sup>14</sup>

At the time ABIF was being planned, DFID was supporting a number of other economic growth projects designed to address women’s income generation (for example, Zardozi), business regulatory issues (Harakat) and an underdeveloped local business development services sector (through support of IFC’s Business Edge training programme). ABIF was designed to be complementary to these efforts and was expected to focus on supporting inclusive business models that would result in benefits to poor Afghans in danger of becoming impoverished should they face unexpected economic shocks.

ABIF was envisioned as a pilot project because DFID was not sure exactly what the private sector response would be regarding investment in pro-poor business models. A pilot would allow DFID the flexibility, with minimal commitment, to draw down ABIF’s activities or scale them up, depending on the interest displayed by private sector actors and initial success of the project, and then use lessons learned to formulate further private sector programming.

## *Expectations and criteria for success*

The business case included a number of key assumptions surrounding the logic for ABIF and its potential impact that defined DFID’s expectations for success. First, it assumed unrealised productivity and income gains throughout Afghanistan’s economy that could be improved “from innovation aimed at improving market access, increasing skills and knowledge, and introducing new technology.”<sup>15</sup> Further, “ABIF will support private sector led investment in innovation as a route to accelerated and inclusive growth. ABIF will challenge the market to come up with innovative ideas that benefit the poor.”<sup>16</sup> This concept guided ABIF’s pursuit to incentivise investment in innovative business models and/or technology that was not widely available or used in Afghanistan.

Next, it was proposed that a challenge fund mechanism would be employed. A pioneer in the use of challenge funds, DFID is comfortable with the model and hoped that each £1 of grant money would leverage £2 of private sector investment.

Finally, the business case envisioned that ABIF would engage with approximately 20 medium-to-large businesses that would have the capacity to implement innovative investment projects at a scale that would reach large numbers of beneficiaries. The business case emphasised that “the wider impact of increased income and new or more secure income opportunities for 200,000 will be the true measure of the project’s success.”<sup>17</sup>

The ability for ABIF to achieve positive impact for this large number of beneficiaries was closely associated with “careful selection of sectors in which the poor are concentrated as producers, workers or consumers.”<sup>18</sup> The business case correctly recognised that ABIF would have limited interaction with direct

“ ABIF was expected to focus on supporting inclusive business models that would result in benefits to poor Afghans in danger of becoming impoverished should they face unexpected economic shocks. ”

beneficiaries under this model and that long-term impact of commercial projects could be realised “only when these ventures are fully operational” and often “several years after the investment has been made.”<sup>19</sup> Tracking ABIF’s impact was recommended to be carried out during and after ABIF’s period of implementation. In early 2016 DFID conducted a post-project process evaluation to extract as many lessons about ABIF’s implementation as possible (results of this were not available at the time of writing).

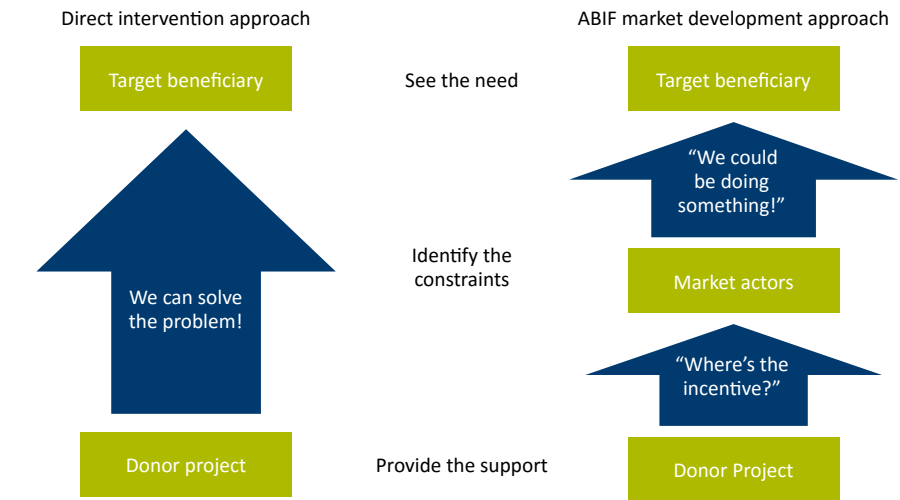
# ABIF design

Briefly outlined below are several overarching concepts that emerged to ultimately become ABIF's design.

## Privatising development impact

While it was always imagined that ABIF would operate within a challenge fund mechanism, the particulars of how the fund would function were only broadly defined in the business case. With an eye toward sustainability and the likelihood for large-scale impact, ABIF took an approach that fundamentally incentivised delivery of market development impact by private sector actors. Applying the underlying logic that the private sector is generally more efficient and sustainable – particularly in an environment lacking strong government infrastructure – ABIF saw working with the private sector as the most logical path to ensure long-term impact. As much as was possible, ABIF integrated commercial and development-related objectives into how the fund functioned. This is shown in the graphic opposite vis-à-vis other approaches in which donor projects implement their own interventions.

In order to understand how this functioned in practice, it is important to consider the roles and tasks of the involved actors. The roles of the project and the private sector partner were not so much to be giver and receiver of development support, as to be co-sponsors of a commercially viable project that would deliver targeted development impact. From the project's point of view, donor funds were being accumulated by mobilising private sector resources to achieve development objectives. The entrepreneurs' view was that he/she could increase investment resources by attracting donor funds as additional investment capital. Even if motivated by different but complimentary objectives, the partners worked together to bring sustainable change through their respective investments.



Market development (M4P) approach focusing on incentivising market actor solutions rather than intervening directly

## M4P approach

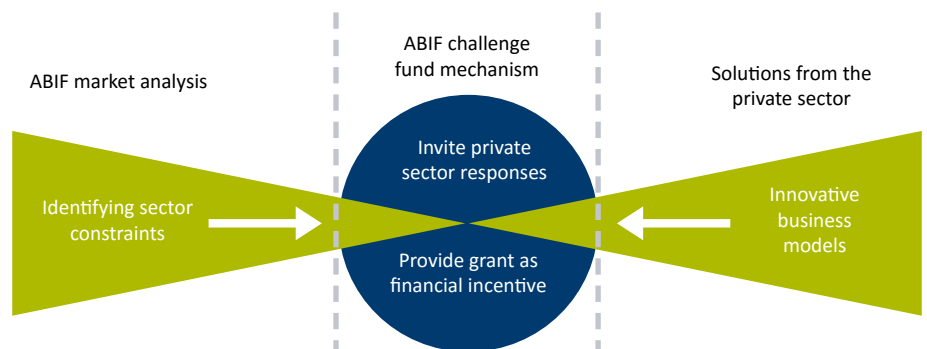
As an entity primarily interested in inclusive development impact, ABIF applied a strategy that incorporated principles of the market systems development approach, also known as Making Markets Work for the Poor (M4P), into its design.

One of the key principles of the M4P approach is that development projects should achieve their objectives by facilitating market change in co-operation with permanent market players rather than implementing change through direct interventions. This fits nicely with ABIF's goal of privatising development impact through its entrepreneur partners. Rather than intervening directly, and risk sustainability of long-term project impact, ABIF's design was to identify sector constraints and then incentivise permanent market actors to create solutions to those constraints in a commercially sustainable way. This model is shown graphically here.

Practically, ABIF incorporated this principle by inviting established private sector actors to conceptualise, develop and implement their own innovative investment projects. ABIF supported the best ideas with grant incentives to enable the concepts to come to fruition, thereby delivering the development impact desired by ABIF. More specific detail of this process is outlined later.

Working with existing and established market players increased the likelihood for the investment projects to achieve sustainability, and more importantly, to scale, which is another important consideration of the M4P framework. ABIF required that each investment proposal received from applicants include a basic scale-up strategy, which ABIF reviewed as part of its process.

Each proposal needed to exhibit a reasonable route to scale, which essentially indicated how the business could create linkages with a large number of target beneficiaries.



Facilitating market change in co-operation with permanent market players





Yasming Mining Limited

Then, ABIF reviewed the proposals' scale agents; those individuals motivated to grow the business to achieve scale and ensure strong, sustainable connections between the business and target beneficiaries. Finally, ABIF looked at the scale players; individuals in the market that would likely witness the investment's success and employ similar modalities into their own business model, or replicate the investment to the point where markets would shift in ways that further benefitted the poor who were engaged in them.

These concepts – and the language used to describe them – have been further developed and refined since implementation under ABIF<sup>10</sup>, but the general concepts were used in ABIF's analysis of each business plan it received.

Each ABIF investment project was considered to be somewhat of a pilot, but it was expected that each would enter initial stages of the scaling up zone within the project lifetime, assuming successful initial implementation. ABIF correctly envisioned that most crowding in effects would most likely occur after ABIF's interaction with the business had ended. As such, we conducted basic analysis on the likelihood of crowding in, but the bulk of our energy was expended ensuring that the original investment could be successfully completed, which would spur scaling up and crowding in later.

### Using grants as incentives

ABIF wanted investors to invest now, not in the future, and to invest in productive assets, rather than in alternatives that would have no positive impact on the poor. But when does a grant incentive become a subsidy? One of the main criticisms of public sector grants to private sector actors is that even allowing for a competitive challenge fund process means a grant can operate

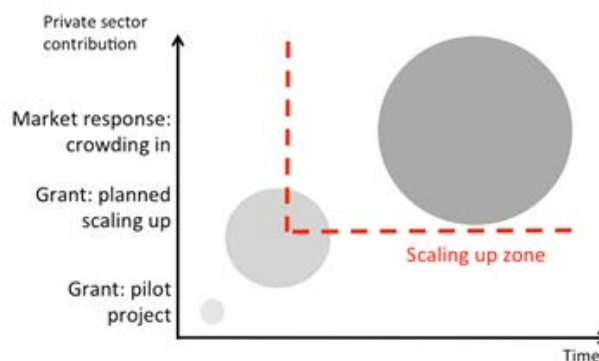
as a subsidy favouring one company over another, wasting public funds, distorting fragile markets and reducing competitive forces. Of course, nobody wants to see such unintended consequences. On the other hand, few dispute that grants are powerful incentives to encourage a recipient to behave in a certain way. If the financial incentive is big enough, grants can be used to induce grantees to follow a desired course of action. For example, they can cause one of the following:

- Accelerate investment
- Change allocation of limited capital
- Change investment location

The value for money emphasis in the business case was an opportunity for ABIF itself to be innovative in how it calculated and awarded its grants and justified provision of grant monies to private sector actors. This led ABIF to develop an alternative, unique challenge fund methodology.



Sahib Zaman Carpet Company



The process of achieving scale

# Challenge Fund methodology



Samsor Ban

DFID suppliers commonly use challenge funds especially when looking to engage with private sector actors. However, in keeping with the value for money and innovation values expressed in the business case, ABIF wanted to take both of these concepts to new heights. Challenge fund programmes generally employ a cost-share mechanism to ensure adequate grantee ownership of the project; most commonly, they use matching grants or a pre-set cost-share percentage. However, these do not offer any objective system to ensure that too much public money isn't unnecessarily put forward to incentivise implementation of the investment.

The dilemma facing ABIF then became how to capture the power of grant incentives to direct its grantees' investments toward market development impact without falling into the subsidy trap. Understanding the interplay of investment risk and future returns was the key to determine the incentive/subsidy threshold. A grant functions as an incentive when the amount is sufficient to offset the additional risk of investing in Afghanistan, but if the grant more than offsets that additional risk, public money is used unnecessarily, reducing value for money.

An approach that both maximised grant allocation efficiency and maintained transparency during the award process was a major step forward for ABIF. The risk-compensating grant approach developed by ABIF is designed to achieve both these objectives.

ABIF's starting point was different than the matching grant approach. Instead of setting an arbitrary fixed or target grant contribution and regarding any amount lower than this benchmark as a good result, ABIF looked at the risks and returns of individual investments to identify the investment decision tipping point at which a grant would make an investment happen.

The process depended on an initial assessment of investment risk in Afghanistan by undertaking a cost of capital/investor survey. Then, through financial modelling of the investment costs and returns, ABIF determined the grant values necessary to provide effective incentives by offsetting enough of the risk to make the investment viable.

This approach did require marginally more work than others as an estimate of country risk was an essential component of the model. However, once the cost of capital was known, there was no additional due diligence effort required than would be the case with matching grants. In all cases, applicants prepared robust business plans and related financial models to demonstrate that their business model was commercially sound. The defining step in the ABIF approach was that the same financial model was also used to calculate the forecasted internal rate of return (IRR)<sup>11</sup> which we then compared to the investors' target returns, the decision tipping point at which the investment is justified. Put simply, the difference between the forecast and the target returns determined the amount of grant that was required to incentivise the investment.

## *Benefits of the risk determined approach to donor and grantee*

1. It justifies not only the principle of public sector grants to private sector enterprises, but also the amount of grant that is awarded.
2. It brings the discipline of private sector investment decision making to the allocation of public funds, improving the quality and reducing the implementation risk of the investment project.
3. It turns grants from a competing to a complementary source of finance, avoiding displacement of commercial finance providers.
4. It reduces the amount of public grant used to incentivise each investment project, allowing for a wider portfolio and reducing the vulnerability of developmental results to individual investment project failure risk.
5. It boosts development returns by allowing more projects to be funded, increasing the value for money delivered by the project.

## The risk compensating grant approach in practice

ABIF considered three key variables when determining the amount of grant to award to its successful applicants. Each of these are explained below.

### Weighted average cost of capital (WACC)

The determinants of the WACC for ABIF applicants were equity (primarily retained earnings), debt and grant. The grant part of the combination was the simplest to deal with as the cost of capital was zero.

The cost of equity on the other hand, was more difficult to determine in the absence of capital markets. To arrive at a reasonable estimate, ABIF used a combination of published country risk assessments<sup>12</sup> (CRA) and its own research findings.

Multi-national enterprises have struggled with CRA for decades. One typical study concluded that CRA is complex, and involves multiple factors which are often subjective<sup>13</sup>. For Afghanistan, the analysis was even more complicated by the lack of reliable data that would usually inform a CRA.

The unsurprising general conclusion of such commercial CRAs is that Afghanistan was/is a high risk investment location. To arrive at a more specific estimate of how to price this risk, the ABIF design phase included a review of the most recent World Bank/DFID Investment Climate Assessment<sup>14</sup>, which provided valuable data. ABIF also commissioned an investor survey to understand what returns companies require from their investments in Afghanistan.

There were limitations to the ABIF study. For example, it was only possible to survey individuals who had actually made investments, as people who had decided against investing were unreachable. But the survey did show consistency among responses and correlation with commercially available CRAs. The eventual conclusion was that investors typically price equity at approximately 25%. This value was used as a proxy for the cost of equity capital in Afghanistan.

The cost of commercial debt was easier to determine than the cost of equity, but not as simple as originally assumed. Trying to determine the cost of bank borrowing was complicated by the lack of publicly available comparable borrowing costs. However, the investor survey showed that commercial debt is such a small element of investment finance (around 1%) that its impact on the WACC was negligible. Family debt (a popular source of finance in Afghanistan) in effect worked as equity, so this was given the same cost as the investor's equity. Combining these factors, ABIF used 25% as the cost of non-grant investment capital, and discounted future net revenues at this rate.

### The underlying principles

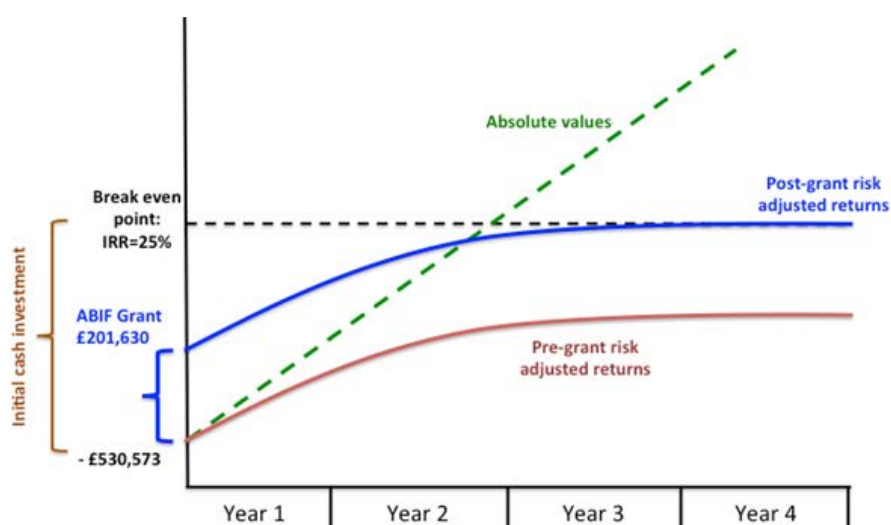
The tipping point in an investment decision is when the expected rate of return is greater than the cost of the capital invested to generate the return.

There are normally two sources of finance for an investment; equity (the investor's own money) and debt (money borrowed from others).

The cost of capital is largely driven by the finance provider's sense of risk. The higher the risk, the higher the cost will be.

It comes as no surprise that the cost of capital in Afghanistan is very high. So projects generating returns that make them viable investment opportunities in other countries are not justified in Afghanistan. They simply cannot generate the returns required by the finance provider. In a nutshell, this is why there is so little investment in the country.

But ABIF offers an additional source of finance at zero cost. So when this grant is mixed with expensive equity or debt, the average cost of capital is reduced. The risk determined approach allows ABIF to identify the right mix of grant, equity and debt to make a project viable.



How the ABIF investment “lifts” the risk adjusted cash flows into positive territory by reducing the initial negative cash flows borne by one of the ABIF grantees

## The investment project budget

ABIF made two sequential distinctions when looking at the investment project budget of proposed projects:

- First between investments financed by cash and others that have no incremental cashflow; and
- Then cash-financed investments were sub-divided between risk and non-risk investments.

The first distinction was made because the financial model used to calculate the grant was a cashflow model, so contributed assets were excluded. For some companies, there were no contributed assets, but frequently projects involved bringing pre-owned land, buildings or machinery into productive use.

The second distinction recognised that some investments were essentially non-risk because they could be readily liquidated at minimal cost to the grantee in the event of project failure. Although included in the cashflow model, these non-risk investments were also deducted from the total investment project budget when setting the grant ceiling.

These adjustments limited the value of any grant, regardless of the cashflow associated with the purchase of assets. The grant ceiling prevented ABIF from providing a grant that was somehow covering the costs of past investment or of investments that could readily be sold (possibly even at a profit).

## Operating financial forecasts

As a part of the business planning process, ABIF required that applicants prepare a four-year operating financial forecast. The forecast was finalised in discussion with the applicant and reviewed by ABIF and an external sector expert to ensure that it was reasonable and consistent with the narrative business plan.

The absolute values of cumulative investing and net operating cashflows (from the financial model) were discounted at a compound annual rate of 25% to arrive at the pre-grant, risk-adjusted values, which invariably showed a negative net present value for the project. ABIF then worked through the financial model to derive a milestone-linked grant disbursement schedule. The amount and the timing of grant disbursements was incorporated into the financial model so that the post-grant, risk-adjusted values reached a tipping point where the net present value was zero, and the post-grant IRR was 25%. This is when the project became a viable investment in Afghanistan's context.

## Sector selection

Finally, once ABIF had a general framework for project implementation, we identified sectors where relevant investments were possible and where they would likely have benefits on the largest number of people possible. Criteria from the business case helped ABIF define sectors that were ultimately chosen. Sectors needed to:

- Display a concentration of poor people,
- Display potential for successful introduction of innovative business models and/or new technology,
- Show likelihood for long-term growth, and
- Be generally aligned with government priorities, to ensure we would not face unnecessary regulatory hurdles.

Additionally, ABIF needed to be confident that it could solicit enough quality investment proposals to achieve the project's goals. After careful analysis of a number of potential sectors, ABIF looked at some of the main market constraints that were causing uneven growth in those sectors, a key aspect of the M4P approach. It was not enough to choose good sectors, because the long-term goal of changing the way markets function to provide stronger opportunities for economic growth was the intended goal of ABIF. So, after this deeper analysis, ABIF settled on the following sectors because they offered good opportunities for the private sector to successfully innovate with pro-poor investments: healthcare services, agriculture/horticulture, livestock, carpets, furniture production/carpentry and mining services.

“The amount and the timing of grant disbursements was incorporated into the financial model so that the post-grant, risk-adjusted values reached a tipping point where the net present value was zero, and the post-grant IRR was 25%. This is when the project became a viable investment in Afghanistan's context.”



# Grantee selection process

The actual award process used a time-tested methodology common to challenge funds. Further details are available in the ABIF Manual. The 'challenge'<sup>15</sup> was advertised. Interested applicants then underwent a lengthy process including submission of investment concepts leading to full business plans, due diligence reviews, workshops and face-to-face interviews. At each stage of the process, fewer applicants were selected for the next stage so at the end, ABIF was confident that it had gathered the strongest portfolio of potential investment projects as possible. Application phases and relevant activities are shown here.

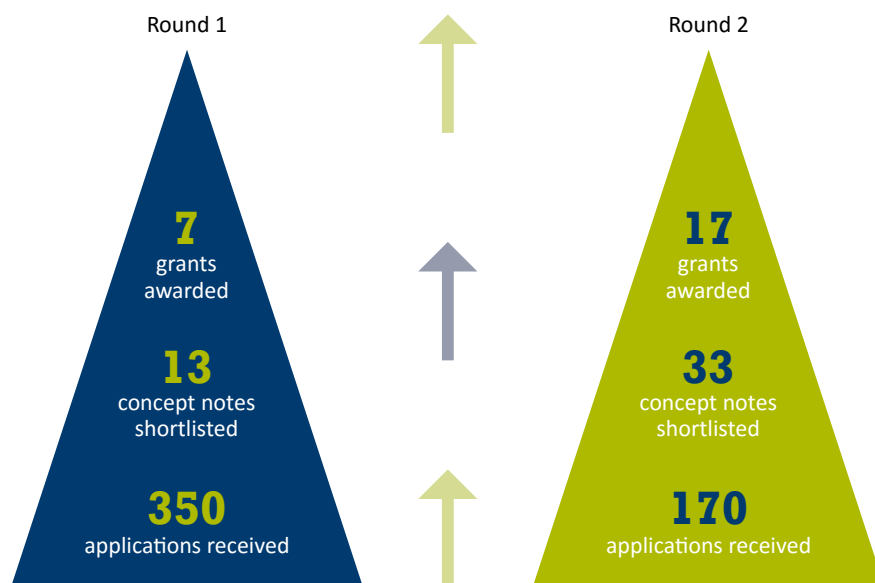
**Phase 1:** Marketing – Concept Note submission – Initial Eligibility and Concept Review – Shortlist – Investment Panel (IP) Confirmation of Shortlist – Invitation to shortlist to submit Business Plans.

**Phase 2:** Engage and Vet Local BDS firms – Workshop/Matchmaking for Applicants and BDS firms – Draft Business Plan Submission with BDS firm support – Technical, Environment and Gender Review – Feedback provided to Applicants.

**Phase 3:** Final Business Plan Submission – Technical, Environmental and Gender Review – ABIF Internal Review of Expected Development Impact and Financial Model – Acceptable Grant Ranges provided to Applicants – Final Bid Competition and Project Ranking – Due Diligence Conducted – Final List Recommended to IP and DFID – Grantee Interviews – Final Project Approvals – Development of Final Milestone Schedules – Implementation Begins.

Between two challenge rounds, ABIF received over 500 investment concept notes. In the first round, many of the initial concepts were automatically ineligible as they were submitted by non-private sector entities such as NGOs.

We quickly realised the importance of clearly reiterating ABIF, its goals and its eligibility criteria to potential applicants during our marketing efforts. With this improved communication, the percentage of eligible concept notes substantially rose during the second solicitation round, which made the



Challenge Competition Round 1 and 2

process far more efficient and led to a higher number of fundable investment proposals.

## Marketing

ABIF's partnerships were critical to its success. The most important partnerships at the beginning of the project were related to its marketing efforts. ABIF signed Memoranda of Understanding (MOUs) with ACCI and AISA, organisations that provided invaluable support to ABIF's ability to reach the most credible private sector applicants in Afghanistan. The organisations graciously supported our efforts to conduct a marketing "road show" of ABIF funding opportunities as well, and assisted in organising meetings across Afghanistan where ABIF solicited concept notes from potential applicants. ABIF held its applicants' workshop, as well as its bidding ceremony, at the ACCI office in Kabul. These locations were neutral spaces where Afghan businessmen felt comfortable being seen and where discussion of business matters was an everyday occurrence.

## Submission and review of concept notes and business plans

Aside from our internal in-depth reviews, ABIF used a pool of technical, environmental and gender experts to give credence to the validity of investment concepts and provide detailed critical feedback to ABIF and the

applicants. Many of the experts were familiar with Afghanistan, but in hindsight, ABIF recognised that it may have been helpful to also have several local technical experts on call who could provide more in-depth feedback on the prices of local products or services or correct conditions in various sectors. While not a major issue, it could have provided the ABIF team with stronger points of reference when they reviewed the financial models presented as part of the applicants' final business plans.

ABIF found it valuable to provide templates for submission of concept notes and business plans to ensure efficiency in the process and to maintain consistency throughout the review process. However, we found that this process had drawbacks as well because it provided grantees with a bit of insight into specifically what ABIF was looking for in the business plan. During our review of the business plans, it was clear that some applicants were focused more on saying the right things than providing a critically analysed, commercial business strategy. While the review process was certainly enhanced by having standardised templates, leaving the applicants to come up with their own business plan model may have forced them to be more realistic and accurate with how they presented their investment concept and the expected development impact that would result. Future programming could take this into

consideration depending on the size of their internal review team and resources (time and money) allocated to review of proposals.

ABIF did not expect shortlisted applicants to have the capacity to prepare a complete grant application without external support, which turned out to be a correct assumption. As such – and to also support some of the key players of an M4P economic framework – ABIF provided technical assistance to support preparation of a business plan.

This assistance was in the form of:

- Advice on the application process and evaluation criteria by the fund management team
- High level advice on sector specific, environmental and social issues and opportunities from the members of the expert pool
- Individualised consultancy from approved consultants (on a cost sharing basis between the applicant and ABIF, further explained later in the brief).

The applicants were expected to first submit a draft business plan, which was reviewed by the expert pool. When assessing technical feasibility and commercial viability, the experts evaluated the nature and degree of innovation involved in the investment project and the experience of comparable products or services in other markets. Furthermore they examined to which extent the investment project would address an identified priority constraint in the target market.

Technical aspects of the project were reviewed such as the manufacturing/service delivery process and product or service design. Commercial aspects of the project played a role and its competitiveness, target markets, projected sales volumes as well as the availability and adequacy of distribution channels were examined.

The strategic review of the already transmitted business plan covered the potential development outcome of the investment project, the level of grant support that was proposed for the investment project and the basic arrangements for project monitoring and evaluation.

As part of the business planning process, ABIF required all shortlisted applicants to prepare a four-year operating financial model. The model was reviewed to ensure that the companies' financial forecast was consistent with the narrative business plan. The financial model delivered the basis to project expected returns and the cost of capital in order to arrive at a grant offer appropriate for the business idea.

The exact level of grant support was

calculated using the risk-determined grants methodology explained above. It considered a rate of 25% for the cost of capital in Afghanistan and looked at the expected returns on investment during the next four years.

Admittedly, ABIFs methodology – in terms of how it awarded grants in an Afghan context – was somewhat complex from a financial perspective, and it required a significant amount of work and input from applicants. The effort to bring private fund management-style investment analysis into a grant-giving project demanded more than many grantees initially imagined.

Many private sector growth grant projects incorporate some type of business planning/ budgeting element into their application process, but to our knowledge, none in Afghanistan have been quite like ABIF. For most grantees, the requirement to come up with a fully-fledged business plan and financial model was a major challenge. We anticipated this and countered their lack of experience by using the local BDS sector. After developing a list of BDS providers, which ABIF personally vetted, we offered shortlisted applicants the opportunity to hire an approved BDS consultancy at a 50% cost-shared rate.

This process did not come without challenges. While many applicants recognised the importance of working with BDS consultants to develop a strong business plan, most had little-to-no prior experience working with them. Additionally, some applicants expressed concern about sharing details of their ideas with BDS consultants for fear that they would not be kept confidential<sup>16</sup>. In both of these cases, ABIF saw that BDS consultants sometimes took charge of development of the business plan, which made complete ownership of the plan difficult for the applicants. Sometimes, specific detail in the business plan was vague or embellished by the BDS consultant when they could not elicit specific information from applicants who were worried about confidentiality.

Additionally, in recent years, growth in the BDS sector in Afghanistan has largely been driven by donors. This led many consultants to be familiar with business planning, but the quality of their services varied widely as growth in this sector has not been driven by organic market demand (this was the purpose of ABIF having vetted the firms). At the end of the day, some consultants saw ABIF as the “real” client because we were subsidising the costs for the applicants and held final approval of payment; this led them to tailor the business plans for us, rather than for the applicants themselves. Prior vetting of the BDS firms beforehand minimised these situations, and a workshop

that we held with BDS providers also instilled in them the importance of working closely with the applicant, but indeed, ABIF did face some challenges in this regard. However, at the end of the day, the involvement of BDS consultants was critical to ensure that quality business plans and financial models were presented in a way that could be efficiently reviewed by ABIF and that ABIF received enough strong business plans to make it a truly competitive process.



Top: Arya Mellat Corrugated Box Production Company  
Bottom: Herat Ice Cream

## Final selection

Once ABIF had built this framework, we developed criteria for reviewing and grading business plans according to:

- Credibility of the investor
- Necessary corporate resources to implement and run the business successfully
- Commercial viability and technical feasibility of the investment itself
- Reasonable budget and financial forecasts, including a significant investment contribution from the entrepreneur
- A substantive positive impact on alleviating market systems constraints in a focus sector

A transparent and comprehensive process was extremely important for ABIF to achieve at this stage of the process. Credibility in Afghanistan depends greatly on the perception of fair and transparent processes, so ABIF did all it could to ensure applicants felt confident with the process.



Herati Cashmere and Skins

One of the most important ways that ABIF ensured transparency was how it used the criteria above to assign each final application with a numeric grade, which it termed an “expected development outcome.” The process to arrive at this score was quite detailed in which the fund management team analysed the potential number of beneficiaries resulting from each investment, the value of the benefits they would receive, and the capacity and sector reach of the proposed investor, which provided an indication of the management “risk” of each investor.

All ABIF staff members reviewed final applications and discussed (and in some cases, argued) for each grade assigned. In this way, internally, we ensured that one member of the ABIF management team couldn’t push his project for final approval without a very rational, logical foundation that was agreed by all other team members. The graphic below provides an example of how each final application was assigned expected development outcome (EDO) scores.

Contact	Beneficiary Groups		Potential #	Potential Value	PDO	Applicant Capacity	Market Reach	Management Risk	EDO	Total EDO
Sahib Zaman Carpet Co.	Primary	Cotton/Wool Farmers (Producers)	10,000	Significant	2	Very Significant	Significant	0.66	1.32	2.32
	Secondary	Wool Spinners and Carpet Weavers (Workers)	1,000	Significant	1		Very Significant	1	1	
Samimi Furniture Co.	Primary	Carpenters (Workers)	1,000	Very Significant	2	Very Significant	Very Significant	1	2	2
	Secondary									
Asia Pharma	Primary	Medical Cotton Users (Consumers)	100,000	Marginal	2	Very Significant	Very Significant	1	2	3.32
	Secondary	Cotton Farmers (Producers)	10,000	Significant	2		Significant	0.66	1.32	
Salamat Institute	Primary	Patients (Consumers)	100,000	Significant	3	Significant	Significant	0.5	1.5	1.5
	Secondary									
Nawshakh Health Clinic	Primary	“Insurance” Patients (Consumers)	1,000	Very Significant	2	Significant	Very Significant	0.66	1.32	2.64
	Secondary	Walk-in Patients (Consumers)	10,000	Significant	2		Very Significant	0.66	1.32	
Mili Medical Services	Primary	Histopathology Patients (Consumers)	10,000	Very Significant	3	Significant	Significant	0.5	1.5	3
	Secondary	Hospital Patients (Consumers)	100,000	Significant	3		Significant	0.5	1.5	
Afghan Rice Processing Mill	Primary	Paddy Farmers (Producers)	10,000	Significant	2	Very Significant	Very Significant	1	2	3.32
	Secondary	Rice Consumers (Consumers)	100,000	Marginal	2		Significant	0.66	1.32	
Arya Melat Corrugated Boxes	Primary	Farmers using cartons (Producers)	10,000	Significant	2	Significant	Significant	0.5	1	2
	Secondary	Waste Collectors & Farmers (Workers)	1,000	Very Significant	2		Significant	0.5	1	
Azimyan Food Products	Primary	Corn Farmers (Producers)	10,000	Significant	2	Significant	Very Significant	0.66	1.32	1.82
	Secondary	Poultry/Cattle Farmers (Producers)	1,000	Significant	1		Significant	0.5	0.5	

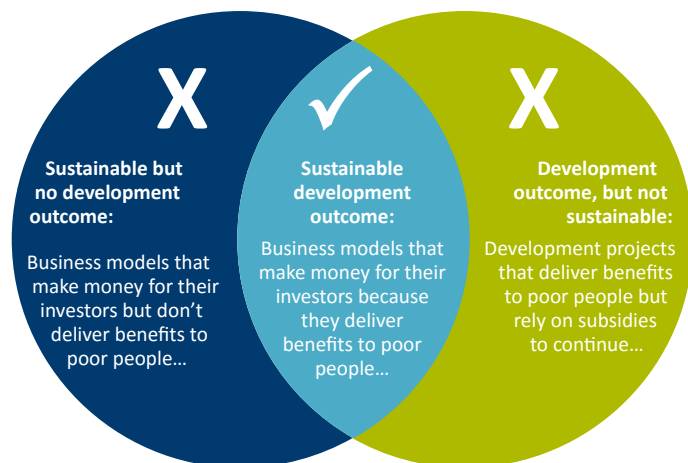
Potential Development Outcomes (PDOs) and Expected Development Outcomes (EDOs) for a sample of Round 2 grant applications

Another more external transparent action occurred at the very end of the grant award process. After all projects had undergone multiple reviews during which ABIF became confident about commercial sustainability and likelihood of substantive development impact, and after we had identified grant ranges for each proposed project that would ensure that each could reach the target IRR to be sufficiently profitable – and therefore – likely to be implemented, we introduced one final hurdle for the applicants.

After providing the acceptable grant ranges to applicants, we requested that they submit sealed ‘bids’ of the final amount that it would take for them to successfully conduct the project. These bids were below or within the range given to them to reach the expected IRR.

Then, in a public meeting with all final applicants, ABIF opened each of the bids, and combined them with the scores that ABIF had assigned previously. We developed an automated excel template that would rank each project against the others on a value for money basis as the final bids were entered into the sheet. All final applicants, and ABIF themselves, watched the template on an overhead projector as we entered each final bid into the template. Once all had been entered, the final applicants could see with their own eyes how competitive their project had been vis-à-vis the others, and if they were going to be put forward to DFID for funding. We had a ceiling limit of grant budget available, and grantees could see the cut-off point in the excel template. This process impressed all the applicants (even the unsuccessful ones) and we received no complaints about the transparent process of ranking and allocating funding for each project. The final ranking from the second round of grants is seen below.

Once all projects had been successful in this final competitive aspect of the process, only a few more steps remained.



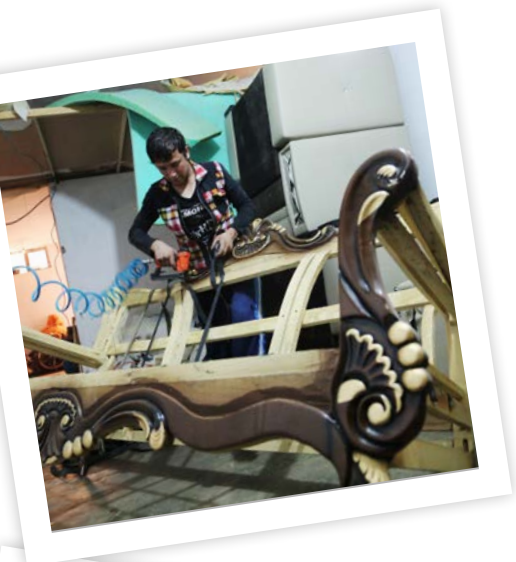
Logic of business models supported by ABIF

Applicant	Total EDO	Final Grant Request	VfM	Rank
Mili Medical Services	3	£39,780	13,260	1
Nawshakh Health Clinic	2.64	£73,785	27,949	2
Afghan Business Capacity Dev.	1.98	£71,514	36,118	3
Mohebi Building Materials	2	£76,704	38,352	4
Yasmin Mining Ltd.	3	£152,000	50,667	5
Afghan Rice Processing Mill	3.32	£199,908	60,213	6
Salamant Institute	1.5	£93,314	62,209	7
Arya Melat Corrugated Boxes	2	£130,576	65,288	8
Asia Pharma	3.32	£257,329	77,509	9
Afghan Marble Industry Assoc.	2	£159,328	79,664	10
Samsor Ban	2	£163,596	81,798	11
Samimi Furniture Co.	2	£169,863	84,932	12
Sahrai Brothers	1.32	£117,430	88,962	13
Ehsan Osman Trading Center Ltd	2	£182,382	91,191	14
Saamsmelt Consulting Services	2	£195,151	97,579	15
Sahib Zaman Carpet Co.	2.32	£256,493	110,557	16
Herat Ice Cream Ltd.	2	£251,627	125,814	17
<b>Funding Ceiling Limit</b>				
Azimyan Food Products	1.82	£233,446	128,267	18
Naveed Musarat	1.82	£249,843	137,276	19
Khukli Kunar Furniture Factory	1.98	£331,611	167,480	20
Wadan Hewad Ltd.	1.32	£232,411	176,069	21
Noor Agriculture Seeds Company	2.48	£437,225	176,300	22

Final ranking from the second round of grants



“ The process impressed all the applicants (even the unsuccessful ones) and we received no complaints about the transparent process of ranking and allocating funding for each project. ”



Samimi Furniture Company

## Due diligence

This due diligence process, while lengthy, played an enormous role in being able to choose the right partners which was essential to the project’s success in a) implementing commercially sustainable, pro-poor investments and b) successfully cooperating with ABIF.

In an environment like Afghanistan with weak infrastructure and little regulatory and/or legal enforcement, it was paramount that ABIF design its due diligence activities in a way that provided confidence in the legitimacy of its potential grantees while not being unrealistic in its expectations. We focused on due diligence that satisfied ABIF, DFID and DFAT’s requirements without being unrealistic or overly time-consuming. We did not want to incentivise grantees to present themselves as stronger candidates than they were in reality, but it was equally important that we received necessary information to provide confidence to move forward with their applications. ABIF struck this delicate balance quite well and was able to maintain it throughout the course of project implementation.

However, the due diligence process took substantially longer than initially expected, and was somewhat unfamiliar and intrusive for grantees. We requested items such as government-issued business licenses, business financial information, business references and current contracts. At this stage, ABIF had not developed significant trust with the applicants – who at that stage were not guaranteed grant funding – and it was very unnatural for them to freely part with private commercial information, so this partially explains why it took quite a long time for the grantees to gather and submit the information, and for ABIF to be able to satisfactorily verify it.

Equally important is that due diligence can set the stage for expectations in grantees’ minds. If due diligence turns out to be merely a box-checking exercise, it will cause further challenges down the road and can cause grantees to question the seriousness of the project. However, if effectively done, it can be a powerful example for how the project intends to operate, and can establish professional boundaries from the very beginning that carry through over the life of the project. Establishing these boundaries and then consistently applying them fairly across the board was a significant key to ABIF’s success and our grantees’ respect of the project itself. If we were to implement ABIF again, we would place even more emphasis on due diligence and build more time into the process to ensure that due diligence activities could be effectively undertaken.

## Final approval process - governance

ABIF had several layers of governance, but the most pertinent was an independent Investment Panel (IP), which consisted of several individuals familiar with Afghanistan’s economy and business environment. They were primarily tasked with oversight of ABIF’s processes and procedures and, as mentioned, participating in a final approval process by confirming which projects ABIF would ultimately recommend to DFID for funding. This occurred after the IP interviewed applicants in a type of “Dragon’s Den” or “Shark Tank” setting. This was a valuable step, as it forced applicants to display substantial ownership and detailed knowledge about their planned investments, and it even helped to weed out one business who could not articulate his business model well enough in person for ABIF to feel comfortable taking it forward to DFID for final grant approval.

The major lesson from ABIF’s use of an Investment Panel was that there is a need for the responsibilities of an IP to be made clear. If the fund manager is tasked with undertaking the due diligence and selection of grantees (and in many cases paid according to the success of this process and eventual fund impact and outcomes) then the IP’s role should be limited to ensure that the process, as outlined in a fund manual, has been followed. The IP could also take the role of ombudsman in case applicants or grantees want to complain about the fund process or to provide general advice as to reputation of applicants in various sectors.

The due diligence and selection process takes many weeks with often significant resources, so it would be unwise to entrust the final decision on the award of grants to an IP which only has a matter of days to review proposals and may or may not be familiar with specific sectors. It is assumed that the fund management is made up of experienced professionals with sufficient knowledge of the sector and country, so it is difficult to envisage how an investment panel could be better placed to override the fund manager’s selections.

While this was not the case in ABIF, the lack of clear roles and responsibilities between the fund management and IP did cause tensions, and one could see how this could potentially result in problems of ownership and accountability on other challenge funds. This is particularly pertinent when DFID is moving to output-based payments for fund managers which would be hard to reconcile if the fund manager cannot make the decision on which applicants should receive funding.

# Implementation of business models



786 Pharmacies

By all accounts, ABIF has been successful, especially considering its nature as a pilot project. The innovative and detailed design of the grant award mechanism made applicants work hard for grants. It ultimately incentivised Afghan (and several international) investors in working with pro-poor business models by successfully leveraging substantial sums of private capital for investment.

ABIF's portfolio of grantee businesses impacted a significant number of poor Afghans (more than 280,000) and these benefits will be sustainable for the foreseeable future and are likely to increase. Of particular interest, several of ABIF's most successful projects have wide geographical representation from which they source raw materials. This is important because of the fact that it is often difficult for donor projects to successfully operate in rural areas from a security standpoint. However, by focusing on working through private sector actors, ABIF showed that it is possible.

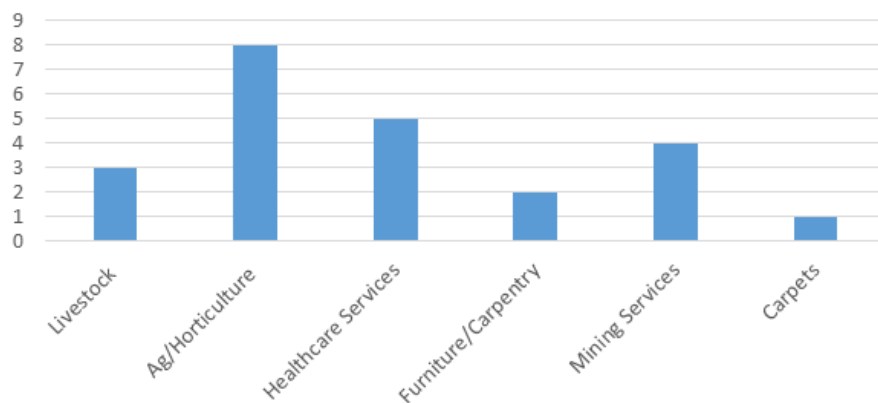
## Breakdown of sector awards

ABIF awarded a total of twenty-three grants. The highest number of ABIF projects were in the horticulture and livestock sectors, which is not surprising given the structure of the Afghan economy. Other sectors – particularly healthcare services – indicated major opportunity for impact and demand for additional investment in new technology and business models.

After award, two grants were eventually cancelled for non-performance. These grants were not able to gain much traction for a variety of reasons, and ABIF's design allowed it to employ a "fail fast, fail cheap" cancellation policy.

Also, from the beginning, both ABIF and DFID realised that the mining services sector was a somewhat riskier selection than other sectors. It certainly met key criteria for sector selection in that there is significant potential for growth and

also a high proportion of poor Afghans as workers, but the risk lay in the timing rather than the sector itself. For several years, the sector has been on the verge of a period of significant growth, and a strong mining sector requires a strong mining services sector. Our grantees in the sector were all able to implement their investment projects in terms of investing in machinery/infrastructure to kick-start their services. However, sector growth has been hampered by declining political stability and insecurity, which led to less demand for their mining services than initially hoped for. Several of these projects were thus unable to fulfil the conditions for achievement of all their milestones. ABIF began in a period of relative calm and stability in Afghanistan, but the economic, political and security challenges that occurred in the immediate post-Karzai period did little to incentivise growth in the mining sector, which had a negative knock-on effect on ABIF's grantees in the mining services portfolio.



Number of ABIF Grantees/Sector



## Project output/outcome data

The business case estimated that ABIF would work with approximately twenty businesses, would improve market access, increase skills/knowledge and incentivise introduction of new technologies that would impact some 200,000 beneficiaries while promoting inclusive growth. Additionally, the project assumed a 1:2 leverage rate of ABIF grant to private sector investment in cash-for-cash terms.

Actual ABIF outcome data, displayed here, indicates that ABIF exceeded expectations on every front despite challenges faced due to underperformance in the mining services sector.

The sectors with the highest numbers of beneficiaries were the agriculture/horticulture, livestock and healthcare services projects. This is unsurprising given Afghanistan's current economic structure and the importance of healthcare services in the country. Proportionally, the majority of ABIF's beneficiaries fell into the producer and consumer categories with fewer in the worker category, but considering the type of investments made, this was to be expected.

ABIF went to great lengths to only count direct beneficiaries of its projects via business data collected by its grantees. As is typical in countries with social structures heavily organised around the extended family, the significance of benefit felt by indirect beneficiaries is reasonably assumed to be very high, indicating a far wider impact than indicated by the reported data. Hopefully DFID will be able to develop a broader picture of ABIF's impact during its post-ABIF evaluation work.

Azimian Food Products

Round 1 & Round 2	Outcome 1.1		Output 1.1	Output 1.2	Output 1.3	Output 1.4		Output 2.1		Output 2.2
	# workers/ jobs	# customers and/ or producers	Sales of Consumer Goods	Sales of Invest- ment Goods	Purchase of Input Goods	Training	Extension Services	Eligible Invest- ment	Ineligible Investment	Contributed Assets
Phase 1 (From project inception through Q4 2013)	280	29,358	\$894,462	\$139,788	\$5,127,008	884	70	\$4,641,876	\$270,108	\$1,256,560
Phase 2 (Q1 2014)	128	23,079	\$795,191	\$232,822	\$299,574	493	-	\$2,961,950	\$347,816	\$2,210,600
Phase 3 (Q2 2014)	40	27,500	\$1,837,969	\$233,133	\$953,242	635	286	\$1,203,553	\$38,163	\$-
Phase 4 (Q3 2014)	34	31,167	\$1,276,633	\$103,239	\$1,679,323	479	822	\$580,278	\$2,230	\$-
Phase 5 (Q4 2014)	32	31,206	\$1,350,546	\$175,167	\$2,527,519	1,031	-	\$504,731	\$890	\$-
Phase 6 (Q1 2015)	20	33,863	\$1,799,829	\$394,415	\$915,334	505	-	\$522,771	\$750	\$-
Phase 7 (Q2 2015)	13	37,376	\$1,323,833	\$194,613	\$731,895	683	-	\$516,967	\$400	\$-
Phase 8 (Q3 2015)	12	37,512	\$1,604,528	\$338,080	\$1,249,013	392	-	\$406,994	\$380	\$-
Phase 9 (Q4 2015)	69	28,835	\$652,336	\$691,143	\$1,820,633	594	-	\$234,492	\$250	\$830,000
Quarters Accumulative Total	628	279,896	\$11,535,327	\$2,502,400	\$15,303,541	5,696	1,178	\$11,573,612	\$660,987	\$4,297,160
Outcome & Output Total	280,524		\$11,535,327	\$2,502,400	\$15,303,541	6,874		\$12,234,599		\$4,297,160

Round 1 and round 2 cumulative figures



## Mobilisation of private capital and value for money

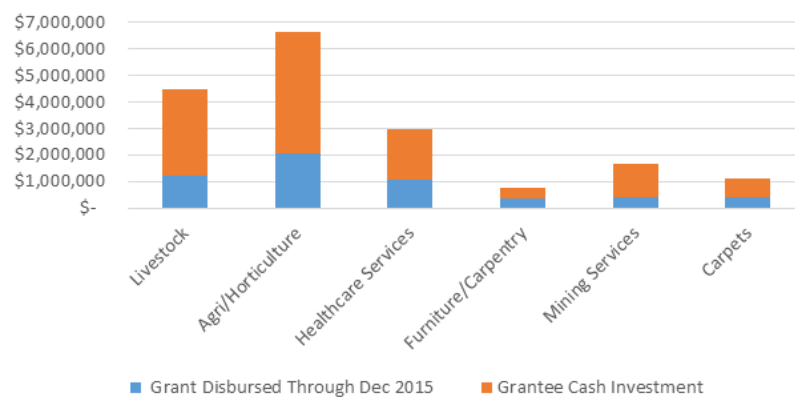
There are several ways to look at how much public grants leverage or mobilise private investment capital. In ABIF’s case, we reviewed grantee contributions to their investment projects in terms of cash and assets that were put into productive use. However, our grant calculations were predicated only on grantee investments that held some measure of risk for the business. Investments in non-risky assets did not factor into the grant award calculations so they did not distort the risk-mitigating design of the grant award process.

The business case assumed a £1:£2 leverage ratio between grant funds and private investor funds, which was nothing more than an informed estimate because of the experimental nature of implementation of a challenge fund within an active conflict zone. Though it varies, challenge funds in other areas of the developing world generally achieve a higher proportion of private capital leverage – somewhere in the £1:£2.5 to £1:£3 range, though sometimes this includes pre-owned asset contributions as well, so it is difficult to compare on a like-for-like basis.

Strictly on a cash for cash basis, the chart opposite shows the ABIF grant in relation to the grantee investment. If analysed on a portfolio-wide basis, the leverage ratio is £1:£2.2, which slightly exceeded expectations set forth in the business case. If analysed on a grant to total private investment basis (eligible and ineligible investment and contributed assets), the leverage rate increases to £1:£3.28.

Due to the lack of information related to the implementation of challenge funds in fragile states, in particular regarding details about how investment costs have been calculated, it is impossible to compare ABIF’s leverage rates with those of other challenge funds on a like-for-like basis. However, leverage rates are very comparable with challenge funds implemented in other, non-conflict-affected developing economies. One would assume that leverage rates for funds in conflict-affected states would be lower, providing further credence to the value for money provided by the risk-adjusted grant award system that ABIF employed.

“ Due to the lack of information related to the implementation of challenge funds in fragile states, in particular regarding details about how investment costs have been calculated, it is impossible to compare ABIF’s leverage rates with those of other challenge funds on a like-for-like basis. ”



ABIF grant to private cash investment by sector

On a cash for cash+assets basis, the chart below shows the ABIF grant in relation to what the grantee put forward. Assets contributed by businesses were pre-owned assets that were put into productive use as part of the ABIF investment project. Some projects had substantial pre-owned assets while other projects had none; it largely depended on the nature of the investment.

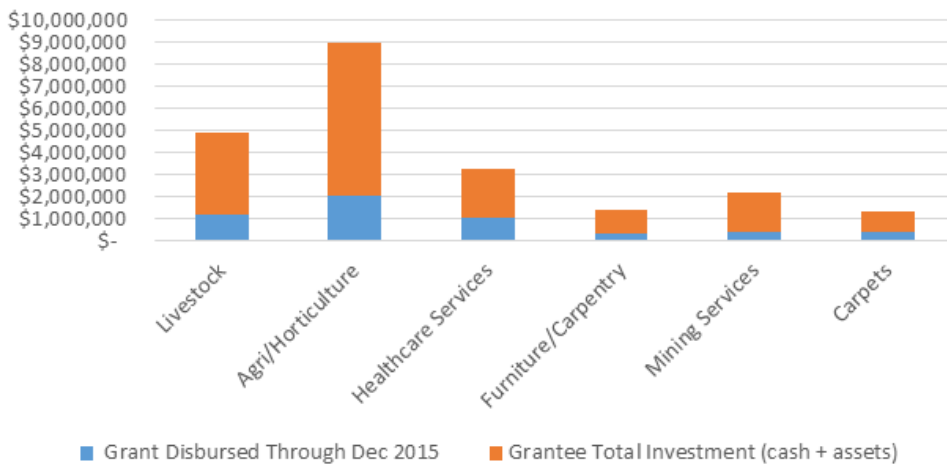
On a project-by-project basis, some grants leveraged smaller amounts of private capital than others while others mobilised considerably more than expected. Reasons for this varied. In some cases, grantees overestimated the amount of capital necessary to undertake and successfully complete their investment. Others ended up expanding far more than originally anticipated as they began to scale their project.

One lesson that can be drawn from this is the difference between business planning and real-life implementation. Differences will always be present to some extent – especially in conflict zones when accurate planning is difficult – and future projects are recommended to do as much financial analysis as possible to ensure that plans are as closely aligned to reality. ABIF did the best we could on this front with the resources that we had. The end result exceeded expectations, but with more information on sector behaviour and better up-front information from the applicants, the results could have even improved.

An additional note is in order. It is very likely that ABIF, in many cases, did not fully capture the true cash leverage from each of its grantees. It was a continual struggle throughout the project to convince grantees to submit comprehensive data about their investments and businesses. ABIF perhaps held unrealistic expectations from businesses who had long been successful by keeping information confidential, so we expended substantial effort building trust with them, which helped increase the flow of information, but we are certain that none of the businesses were fully transparent on this front at all times.



Yasming Mining Limited



ABIF grant to total private investment by sector



786 Pharmacies

### **Milestone schedules/flexibility**

One of the most effective aspects of ABIF was the way we structured and paid out grants to businesses. ABIF was very strategic about minimising the risk of grantee non-performance to preserve as much value for money and negotiation leverage as possible while still incentivising grantees to deliver on investment promises in a timely manner. The way we approached this was through development of customised milestone schedules that were based on data submitted from grantees' final business plans and financial models.

Due to the challenge fund nature of ABIF, grantees were somewhat incentivised to overestimate the likely impact of their investments in order to be more competitive for grant funding. During business plan development, ABIF and external evaluators pushed back on grantees when we believed their estimated impact was overestimated. Unfortunately, in some cases, we had little market data upon which to base our assessments, which inevitably led some grantees to indicate a higher than realistic expected impact. However, by developing milestones based on data that they originally supplied, ABIF helped to set expectations in the grantees' minds for the success they would need to bring out from their investments in order to receive milestone payments. Milestone payments tied to grantees' own projections incentivised them to provide better estimates for their projects' impact.

Some of our grantees had previously worked with donors and were familiar with grants programmes. However, the majority were not familiar with a pay-by-results methodology, especially when it required delving into the inner workings on their businesses. From the beginning, ABIF took a very stringent approach with grantees on achievement of their milestones. Many were initially surprised when we indicated that "close enough" was not adequate for milestone achievement. Early on, this showed grantees that we were serious about providing value to our client and ensuring that grantees delivered on their promises of both investment and impact. When discussing this with grantees, we took a very transactional approach, explaining that ABIF was essentially purchasing development impact from them. It was an explanation that worked well because, as businesses themselves, they could not imagine giving customers products or services without payment.

Many of the milestone targets were initially very high. Over the course of implementation, if it became clear that targets were unattainable, ABIF would discuss revised targets with DFID, but we worked hard to maintain targets that incentivised continual

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achievement and substantial impact. By allowing ABIF the flexibility to manage milestones with such scrutiny, our donors helped us extract as much value as possible from the grants (in terms of development impact of the investments). Substantial credit should go to DFID for allowing this adaptive management style to function so effectively.

Each milestone schedule included investment-related milestones, milestones related to implementation of key aspects of the business model and also milestones tied to achievement of the targeted development impact. In hindsight, ABIF should have created a milestone related to development and successful maintenance of key administrative and financial management systems. For verification of all milestones, ABIF required a substantial amount of financial data that was then verified using multiple methodologies. However, most SMEs in Afghanistan do not keep strong financial data so this was a challenge, particularly in the early stages. ABIF could have incentivised grantees to keep stronger records if we had tied a milestone payment to development and implementation of strong administrative systems, which would have also made our job of milestone verification easier over the course of implementation and provided a stronger basis of data that the businesses could use for future decision making. Similar future programmes would do well to consider this when developing similar pay-by-results milestone frameworks. Despite this shortcoming, a payment-by-results methodology was incredibly effective in ensuring value for money, grantee motivation and provided a substantial amount of leverage for ABIF over the course of the implementation of the project.

## Monitoring and evaluation (M&E) vs monitoring and verification (M&V)

As a project designed to incentivise private sector investment, ABIF's main points of contact throughout implementation were the businesses that were awarded grants. However, to ABIF, they were only a sustainable avenue to reach the project's intended target beneficiaries, the poor-but-economically-engaged Afghans in our target sectors. This made evaluation particularly challenging because ABIF was never designed to work directly with its intended beneficiary populations. We were always at least one step removed from them, which made it difficult to collect significant data about them other than occasional qualitative data for short case studies that was facilitated by the grantees themselves. This led to a substantial portion of ABIF's measurement activities to focus on monitoring and verification (M&V) as opposed to monitoring and evaluation (M&E) of the project's impact.

ABIF's milestone verification processes were helpful in incorporating regular, real-time feedback about business performance throughout the project. Verification of milestones depended on data provided by grantees, which was then verified and validated by ABIF, so we set into place reporting mechanisms for grantees to regularly report data back to us. We went to great lengths to ensure that the data we required our grantees to collect and report on was business-related that would be helpful to them anyway, if analysed and used properly. The type of data we tracked included sales, raw material purchases, number of customers and the like. This system helped keep grantees' reporting burden to a minimum, but ABIF still faced significant challenges as most grantees initially saw little value in keeping comprehensive, organised business data. The Africa Enterprise Challenge Fund, perhaps that best-known challenge fund supported by DFID reported the following:

*For our local grantees, capacity to implement has not been necessarily linked to formality in terms of corporate governance and financial management. Many of our partners are good at operating in a challenging environment, but not so concerned with, for example, keeping officially audited accounts. These businesses have been working opportunistically in a volatile, unregulated market with limited exposure to, or need for, formal business accounting, financial forecasting or long-term planning<sup>17</sup>.*

This description could be applied to most ABIF grantees as well. Grantees were not used to keeping detailed business



Arya Mellat Corrugated Box Production Company

data about costs, sales, etc., so we provided basic templates that grantees completed and submitted to ABIF at the end of each month. ABIF then reviewed and analysed the data and filed it for our records and tracking purposes.

Upon reflection, one unfortunate shortcoming of ABIF was that we were not able to effectively engage with most grantees on why this type of data was helpful and how strong analysis of said data could be valuable for their own operations and business decisions. Lack of strong business administration is certainly a widespread phenomenon in many developing countries, and Afghanistan is no different. It was apparent throughout ABIF that most grantees were not interested in substantial analysis of their own business data. Different business cultures hold different values, but if we were to implement ABIF again, we would develop systems to spend more time with grantees analysing their business data, with an emphasis on how it could effectively be used for strong business operations.

### Third-party M&V

Third-party monitoring and verification activities were helpful for ABIF, but posed many challenges for the monitor. Logistically, it was very difficult for them to engage with ABIF grantees who were concerned about their commercial and physical security and not at all used to providing confidential business information to strangers, even when introduced by ABIF. Additionally, the M&V was more concerned with verification of the data submitted by ABIF to DFID, and less about the impact on target beneficiaries; to some extent, this simply repeated work that ABIF had already done. Of course, this could be valuable for donors to get an idea of the validity of programme data reported to them, but it was extremely challenging for third-party monitors to work with grantees without a long track record of built-up trust between them.

A better model would have been the introduction of a third-party monitor from the very beginning of the project who had time to develop strong relationships with grantees for whatever verification activities were deemed necessary by the donors. In the end, it was necessary for ABIF to act as a middleman for both the grantees and the third-party monitor. We brokered sharing of the necessary information required by the monitor, which reduced some of the methodological independence of the monitor, but was far more efficient than when the third-party monitor approached grantees directly.

In many cases, the monitor would ultimately inform ABIF that the grantee did not have adequate information and/or documentation necessary to verify their activities, but in reality, it was a matter of the grantee not sharing the information with the monitor for confidentiality reasons. Additionally, convincing grantees to share information with monitors once they had received all their milestone payments was even more challenging. Grantees had no incentives to share information, and ABIF had no leverage with them. In conflict environments, lack of trust should not be underestimated by donors or project implementers, even to the detriment of "pure" M&E or M&V methodologies.





## Post-grant support

Post-grant support (PGS) was a key avenue for ABIF to add value to and increase the impact of the investments made by grantees. After most investments were well underway, ABIF provided grantees with the opportunity to conduct additional activities that would benefit their investment, solidify their impacts or otherwise add value to their business operations. These activities were focused on deepening the likely development impact on beneficiaries and improving business operations and likelihood of sustainability.

PGS activities were conducted on a cost-share basis with the grantee and heavily managed and monitored by the ABIF management team. In conjunction with grantees, packages of activities were chosen including market research and strategy development, creation of marketing products, financial and business management training, streamlining of company administrative systems, development of customised enterprise resource planning software products and technical assistance for installation, operation, maintenance and repair of factory machinery. Ten grantees chose to take advantage of this opportunity, and ABIF funds leveraged an additional \$200,000 in private funds to implement the packages of activities.

Once again, ABIF and grantees worked with a number of local BDS providers and also several international technicians for specialised TA. With ABIF's heavy involvement, and with crucial buy-in from the grantees themselves, implementation of PGS activities brought a significant amount of additional value to the investments. Many of the grantees' technical staff received training on how to fully operate, maintain and repair specialised machinery. Administrative staff were trained in better data management and analysis. Accounting staff were trained on how to get a stronger handle on a business's costs and profits. Companies have new software resources to plan procurement of raw materials, track their usage and waste, manage various business departments and improve record retention. All of these activities make the likelihood of further development impact through successful business operations even stronger in the future, and for some grantees, provided the opportunity for them to substantially increase the professionalism of how they work. Some of these efforts will also make grantees more credit-worthy should they apply for commercial financing for future investments.

ABIF found ways to creatively control PGS costs while still maintaining significant oversight. We knew that when donors are

involved in procurement of BDS services, price quotes often significantly increase. So, in some cases, we provided behind-the-scenes support, but left negotiation and contracting up to the grantees themselves. Clearly, since they paid for a percentage of the overall costs, they were incentivised to negotiate hard with service providers. ABIF still conducted a significant amount of due diligence on potential BDS providers, and in some instances, rejected providers that grantees chose because we did not believe they could provide high-quality training/service.

In other cases, we helped the grantees prepare contracts and handle payments to service providers. In order to receive ABIF's cost share, we had to provide approval of quality delivery of the activity, which provided ABIF with significant leverage and oversight. This flexible approach worked very well, ensured significant value for money and also allowed ABIF to have enough behind-the-scenes control to provide substantial quality assurance of all activities developed. The cost-share mechanism also allowed ABIF enough leverage to negotiate with businesses on exactly what type of support would best benefit their business operations.

Generally, the use of BDS providers for PGS activities worked better than it did during the business planning phase. For one, ABIF was better prepared for how to manage the process, and our heavy involvement (which was not possible during the application stage to avoid accusations of favouritism) meant that we had more control over the relationship with the BDS provider. In some instances, we were also able to better direct their activities than the grantee themselves because we held ultimate payment authority.

In the most successful cases, grantees continued to work with the same BDS providers even after ABIF's funding had ceased. For example, in January 2016, Herat Ice Cream hired Edgescope, the local BDS firm that ABIF contracted, on an 8-month contract to implement the sales/marketing strategy they developed under the PGS. This is a significant achievement; essentially, HIC is outsourcing operations in their Kabul market to Edgescope for an entire sales year. No donor funds were involved in this contract.

## Security

Clearly, security in Afghanistan is of immense importance. ABIF's ability to operate effectively in an insecure environment was a significant reason for the project's success. We were fortunate to be able to physically visit our grantees on many occasions, which provided all stakeholders with a level of confidence about the businesses' activities and ability to operate in challenging conditions. We

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quickly learned the importance of being able to meet businesses on their terms, and these meetings helped us value what our grantees valued when it came to security. We took care to protect information about their associations with donors, we limited our visibility during site visits and we were careful about publishing information that could compromise the businesses.

From an internal ethics standpoint – which was also tied to security – we sent at least two ABIF staff on each site visit when verifying milestones. This reduced the likelihood of businesses trying to approach our staff with offers of corruption, which is prevalent in Afghanistan. On a number of occasions, grantees complimented ABIF on this approach because it ensured integrity in our systems, which made them more comfortable at the end of the day.

# Conclusion



In summary, this learning brief has provided a helpful summary of DFID's business case intentions and how they matched with ABIF's ultimate implementation. Considering its pilot nature and untested methodology in a challenging environment with a small budget, ABIF has certainly been successful. The design enabled ABIF, for the most part, to engage with the right partners who have provided significant benefits to well over 280,000 target beneficiaries. It also enabled ABIF to be efficient in reaching this many people with valuable products and services, importantly showing that value for money can be achieved even in conflict-affected environments. The risk-adjusted grant mechanism and pay-by-results milestones worked very effectively and provided the ABIF management team with substantial leverage as well as helping to extract significant value-for-money from our grantees.

Of course, ABIF faced a number of challenges and there were instances where our planning and design could have resulted in more value and better impacts, but overall, we were able to create strong incentives for grantees and kept very high standards of project implementation to provide value to the businesses and deliver value to our clients. A key driver of any M4P programme is the ability to identify and absorb key lessons into programme management along the way. DFID and DFAT allowed us significant flexibility, which was enormously helpful in incorporating lessons along the way to improve our implementation.

Hindsight is extremely valuable. We have noted several instances throughout this brief about changes we would bring in should a project like ABIF be implemented again. Based on the successful performance of our grantee portfolio, we would not hesitate to demand even more of our grantees, demand higher standards of business operation and data collection and analysis, and delve even deeper into the businesses to inject more private-sector style analysis to their businesses. Through this, we would expect our pool of the right partners, likely, to shrink, but we would be able to work on deeper and wider bases to create stronger investments that would have even more impact on ABIF's target beneficiary populations in the future.

# Endnotes

- 1 IRR is used in corporate finance to measure the profitability of investments based on the risk adjusted value of future cashflows.
- 2 \$6,445,000 was committed by ABIF against planned investments of \$23,324,158. Actual grant disbursement at project end was \$5,514,306 against actual investments of \$16,536,259.
- 3 Rather than payments based on receipts (input-based)
- 4 ABIF Business Case, pg. 1
- 5 ABIF Business Case, pg. 1
- 6 ABIF Business Case, pg. 1
- 7 ABIF Business Case, pg. 8
- 8 ABIF Business Case, pg. 4
- 9 ABIF Business Case, pg. 8
- 10 See <http://beamexchange.org/en/community/blogs/blog-entry/2015/10/8/jamesblewett/> for more detail on these considerations.
- 11 IRR is used in corporate finance to measure the profitability of investments based on the risk adjusted value of future cashflows.
- 12 For example see: <http://www.euromoneycountryrisk.com/>
- 13 Country Risk and Foreign Direct Investment, Duncan H Meldrum
- 14 Available from: <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/>
- 15 Examples of challenge themes included lack of market access for agri/livestock producers, lack of consumer access to quality medicines and lack of farmer access to knowledge about agro inputs.
- 16 Anecdotes like this are highly reflective of SMEs' concern for commercial privacy.
- 17 Risky Business: Promoting Private Sector Development in Post-Conflict States, Lessons from the Africa Enterprise Challenge Fund, Impact Paper 12: August 2013.



