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Risky Business: Promoting Private Sector Development in Post-Conflict States[1]

Lessons from the Africa Enterprise Challenge Fund

Abstract

As donors move toward more constructive engagement in post-conflict states, a growing body of research has recognized the importance of the private sector. Businesses can create jobs for frustrated citizens, bridge social divides and contribute to the economic growth necessary to support lasting peace. However, private sector-led development is a relatively new concept in the aid world, and even less tested in fragile environments. What methods work best? How can donors ensure that their programmes are effective while balancing heightened risks, limited local capacity and higher costs of engagement? In this paper, we discuss insights to these questions, drawing on our experience implementing the post-conflict windows of the African Enterprise Challenge Fund (www.aecfafrica.org)

[1] This is one of a series of short pieces from KPMG IDAS Advisors designed to show forward thinking based on our extensive experience, that covers general development topics, fragile states, private sector development, governance, assessment and organisational development, renewable energy and adaptation to climate change. The series is edited by Julio Garrido-Mirapeix, Head, and Abijah Kanene, Manager – Market Intelligence Learning and Knowledge, IDAS Africa. This paper was written by Rachel Keeler, Manager, Impact and Innovation, IDAS Africa and Jenny Lofbom, Window Manager, South Sudan Window and Post Conflict Window, AECF.

Limited evidence exists to demonstrate what kind of aid works best in post-conflict states. We know that traditional methods such as budget support do not work well, because central institutions are weak, corrupt or non-existent. But we also know that the risks of doing nothing are fast outpacing the risks of engagement.[2] The chance of a country relapsing into war within five to 10 years of negotiating a peace agreement is estimated at around 40-45%.[3] Destroyed infrastructure, unemployment, social fissures, poor public services, physical insecurity, uncertainty over property rights, corruption and crime all come together in these fragile environments to create a vicious cycle of instability. If nothing is done to break this cycle, perpetual conflict can threaten regional and even global stability by creating refugees, spreading disease, facilitating trafficking of drugs, people and arms, and breeding terrorism.

A growing body of research recognizes the importance of the private sector ing addressing the unique challenges posed by fragile states. Growing businesses can create jobs, bridge social divides, lobby for better economic policies and, in doing so, facilitate economic growth and lasting peace. Data has shown that a 10% economic growth rate can reduce a country's chance of relapsing into war to 27% (Collier, Hoeffler and Söderbom, 2006:10). Conflict is more often fueled by lack of economic opportunity than political grievances, and thus job creation is one key to stabilization (Ibid; World Bank 2013; Dudwick et al 2013).

PSD interventions in post-conflict states have thus far focused largely on infrastructure projects (which also create jobs), skills training, and other enabling environment reforms. But some practitioners argue that more direct engagement with business is needed to kick-start growth and generate sustainable employment (Dudwick et al 2013). Short-term jobs created by public works projects may actually deprive local businesses of labor resources (World Bank 2013; DCED 2010). Conversely, operating environment reforms are necessary for sustainable development, but take a long time to set in. In the meantime, it is crucial to provide unemployed citizens with opportunities in the first years after a conflict ends to prevent a relapse into war (DCED 2008; World Bank 2013).

In this paper, we discuss challenge funds (CF) as one good option for channeling donor funds into direct support for the private sector in post-conflict states. KPMG IDAS Africa (www.kpmg.com/das) has worked for many years in several post-conflict states in a variety of roles. Here we focus on insight from our role as the fund manager for the Africa Enterprise Challenge Fund. Within its continental portfolio, the AECF has run dedicated competitions in post-conflict environments for South Sudan (SSW), and DRC, Liberia, Sierra Leone and Somalia/Somaliland (PCW)[4]:

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[2] Randel et al (2004) found that in the past, many donors thought that costly engagement with fragile states did more harm than good. However, in the last 10 years, almost all major international donors have released policy statements highlighting the need for further engagement (AfDB 2008, DFID 2005, ERD 2009, IMF 2008, World Bank 2008, USAID 2005).

[3] Collier, Hoeffler and Söderbom (2006: 10) find that "The risk during the first four years is 23%, and during the remaining six years it is 17%, conditional upon the first four years having been peaceful... If the economy remains stagnant through the decade the decade-risk is 42.1%. If, instead, it grows at 10% per year, which is fast but not without precedent, the decade-risk falls to 26.9%". World Bank (2007) estimates a 44% risk of relapse within the first five years.

[4] The AECF is a multi-donor funded, special partnership initiative of the Alliance for a Green Revolution in Africa (AGRA). The post-conflict window is funded by the Swedish International Development Cooperation Agency (Sida). The South Sudan window is funded by the UK's Department for International Development (DFID).

- The South Sudan Window (SSW) will provide USD 4.4 million to six companies over three years as grants and repayable grants. These grantees work in agribusinesses including maize production and milling, seed multiplication and honey production and processing, as well as microfinance.
- The Post Conflict Window (PCW) will provide USD 12.5 million over the coming three years through grants to 20 businesses. The PCW focuses on agribusiness and financial services, with projects including fruit juice processing, palm oil production, cassava processing, fish canning, input supply projects such as animal health projects, microfinance and information support services.

The first section of the paper reviews the CF mechanism as a tool for PSD in post-conflict states. The next sections look in detail at how we have addressed several common challenges faced by CFs operating in fragile environments: informal private sector with capacity constraints; binding constraints to business growth; few alternative sources of financing, if any; and understanding the political, economic and social forces that determine a CF's contribution to peace building. We conclude with thoughts about how to effectively manage risk and evaluate impact in post-conflict PSD programmes.

Challenge Funds as Useful PSD Tools in Post-Conflict States

A challenge fund is an especially useful tool in countries where investment may have been discouraged by conflict (DCED 2010). In these environments, grant funding is a better financing tool than debt, due to the lack of institutions to facilitate debt collection and judicial systems. Grant funders can also take on more risk and go where commercial equity investors may fear to tread. Furthermore, because CFs work directly with the private sector, they are not dependent on having functioning national institutions in place. CFs can instead work in tandem with institutional strengthening and policy reform programmes.

The potential impact of a challenge fund in post-conflict states is quite high. But the work also presents serious risks and limitations. Potential partner companies will on average be less formal, less capable, and engaged in short-term opportunistic activities. Until enabling environment reforms set in, business growth will be constrained by poor infrastructure, volatile economic shifts, unpredictable regulation, lack of property rights, and corruption. The cost of engagement will be much higher than in other states. Grant-making procedures will need to be flexible enough to accommodate business constraints, yet adept enough to navigate the high-risk environment. To promote peace and avoid unintentional harm, implementers must also understand the complex political, economic and social forces around them.

This is all easier said than done. We still grapple with many unanswered questions, but our experience at AECF thus far offers some valuable insight to how to implement grants in post-conflict states. We work with large grants and relatively capable grantees, and only in the agribusiness sector, which in some ways limits the extent of our understanding. However, we think the following observations offer important lessons about how to manage some common challenges:

Informal private sector with capacity constraints

The Challenge: Many local businesses in post-conflict states are limited in size, scope, skills and capacity. This in turn limits the pool of potential partners for challenge funds, which are designed to fund businesses able to implement with minimal support. Although our choice of high-quality partners has been limited, we have been able to find a mix of promising, capable, local companies and international firms with whom to work. Even so, both types of grantees present their own challenges. 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. Accredited auditing services may not even be available. In Somaliland, audited accounts are not a legal requirement, regardless of business size. Multi-nationals are often better at formal functions and are important partners because they have more resources to invest in scaling up and job creation, and can transfer foreign expertise and technology to the local market. However, local partners are often better at local execution, and contribute more to widespread and sustainable economic growth.

Diverse Conflicts and Markets

There is a strong historical and cultural effect on business types and economic structures in post-conflict markets. Unlike in many other African countries, Somalia's economy is not built on a colonial past. Business is therefore dominated by the local culture of trading. In the DRC and Sierra Leone, where colonialism was strong before conflict broke out, business has followed that history through investment in manufacturing, production and cash crops, while relying on the rehabilitation of former colonial infrastructure to support the economy.

In Somalia, the economy is buttressed by the country's widely successful and entrepreneurial Diaspora. We have seen this reflected in the diversity and sophistication of our Somaliland portfolio. In South Sudan, there is far less support of this kind. The lack of first British colonial and then Sudanese investment in education in South Sudan has also left the local population far behind in terms of basic skills.

FM response: Working with these companies presents grey areas for any fund manager. On the one hand, the grant fund can and should play an important role in "formalizing the formal sector" by requiring that grantees bring their corporate governance and financial management standards up to par. On the other hand, some costly formalities may offer little value for a business trying to compete in a difficult market. Asking a business owner to map out a five-year financial forecast in a country like South Sudan, which was not even a country until two years ago, can easily become a box-ticking exercise. The owner can concoct figures for an excel spreadsheet, but those numbers might not be a practical management tool in a very unpredictable environment.

Navigating these challenges requires a grants management team with the skills and flexibility to make appropriate judgement calls. At AECF, we often link formal requirements to a second rather than first disbursement, to give a post-conflict grantee time and resources to improve their practices. Where legal processes are slow or service providers are unavailable, grantees may require even more time. At times, requirements are scrapped altogether – no business in South Sudan, for example, can produce the standard three years of audited accounts. Instead, we ask for management accounts and auditing going forward. More flexibility is often required at the start of the grant, growing more stringent over time. It is most important during the early grant period for the fund manager to understand the situation through close communication with the grantee. Donors must in turn be prepared to offer the space and resources necessary for active fund management. Making an informed, subjective decision requires more time and staff training than it does to simply tick a box. While the standard question may be, "does this grantee have a best practice procurement policy in place?", the more appropriate question in a post-conflict state may be, "who is even willing to sell to this grantee, and what can we do about that?"

Technical Assistance

Challenge funds are not traditionally set up to offer capacity building, which limits their ability to work with low-capacity grantees and can constrain donors that seek to work with marginalised groups, such as women-owned businesses or SMEs.

A study on donor-backed finance for SMEs in post-war Liberia found that without capacity building support, 38% of businesses failed within one year and the rest struggled to service their loans (Gorlorwulu 2011). In such cases, TA is clearly necessary. But the use of TA should be selective and well targeted, and a good corporate governance structure must be in place to make sure that TA is not used unnecessarily or excessively. Donors must also be very careful with providing TA during the pre-grant application process, as this can create an unlevel playing field and skew funding decisions in unproductive ways.

The AECF model relies on indirect capacity building, where, for example, an established agribusiness may use grant funds to work with less capable smallholder farmers as outgrowers, providing skills training in the process.

Binding Constraints to Business Growth

The Challenge: Grant finance may be futile if business growth is thwarted by other factors such as physical insecurity, poor infrastructure, corruption or lack of property rights. Insecurity and something that could be called "flee risk" has traditionally prevented businesses in fragile states from investing in long-term production. "You can run with your cows, but not with your crops," so the local wisdom goes. Weak support institutions, unpredictable regulation and economic volatility can also make it quite difficult for businesses to operate. Oil volatility in South Sudan, for example, affects forex restrictions that can make or break a business earning revenue in South Sudanese pounds and purchasing inputs abroad in dollars.

FM response: The role of the fund manager is therefore to differentiate between the plausible and implausible when assessing business plans. We have found entrepreneurs in post-conflict states who do want to move away from trading. For these businesses, a grant fund plays an essential role in taking on some of the risk of investing in long-term productive assets in an insecure environment. However, the FM needs to think through the reality of the security situation and its specific effects on a grantee's business.

Too much insecurity, for example, may make it impossible for outgrowers to operate where a production facility, on the other hand, might be alright. Perceived insecurity may also be different from real insecurity, and real insecurity may have a different effect on different kinds of people and businesses. In some fragile states, for example, truckers report that it is more secure to drive goods through areas not controlled by the Government because "rebels" can guarantee protection from raiders and hijackers for a price, while the government cannot.

The Cost of Insecurity

Insecurity has serious implications for a fund manager's ability to carry out standard due diligence and grant management. It may be too dangerous for management staff to visit the sites of the businesses they fund. Assessments and later site visits are often contracted out and donors must therefore accept a greater level of uncertainty in their risk management. At AECF, one of our grantees operates a promising tuna factory in Somalia. We are keen to visit, except that the facility is located in what has been described by locals as a "pirate's den". Recognizing the potential benefits of the project, we chose to take the added uncertainty of contracting out site visits while keeping our staff safe. Extra management costs are incurred as well, and often donors have not thought through the extent of this expense. Does the fund manager have resources for security details when in country? Is ransom insurance necessary? What about trauma counselling in the event of an attack? These are all difficult but important considerations for anyone planning to work in a post-conflict environment. There is also a level of uncertainty in being able to plan for these expenses: security situations can arise and change rapidly, requiring constant reassessment throughout the life of a programme.

AECF tries to mitigate other potentially binding constraints by supporting businesses that have already found ways to operate successfully in the local market. Many of our grantees have sourced their own solutions to infrastructure problems by producing power locally, sinking boreholes for water supply or locating projects near rivers. A grant fund can also strengthen businesses and encourage them to build up private sector institutions to address the sources of volatility shocks – to act as a check on government and to advise policymakers on regulations that will facilitate business growth. Challenge funds can also work in tandem with a policy or infrastructure fund to tackle specific hurdles faced by grantees.

Fewer alternative sources of financing, if any

The Challenge: In a post-conflict environment, donor grants may be the only source of financing available for private companies. Formal financial systems might not even exist. Loans are often based on constant cash flow, supporting short-term trading but not long-term projects. Judicial systems and ownership titles are usually weak. Businesses cannot borrow against collateral such as land or buildings because no one can be sure that they actually

Goldtree (SL) Ltd, Sierra Leone

Size of grant: USD 450,000
Total benefit to farmers over 6 years: USD 540,000

The company has put up a new palm oil mill on a site where a mill destroyed by the war once stood. The company has taken on the challenge of sourcing oil palm fruit bunches from local smallholder farmers. The bunches are abundantly available, but hard to source in an area where feeder roads are more or less non-existent. Goldtree has come up with an innovative solution: providing 'walking tractors' to farmers on a leasing model that can be used to transport fruit bunches down foot paths. The tractors act somewhat like motorised wheel barrows – a significant improvement over the current transport method of carrying bushels on farmers' heads.

own those assets; and even if they did, there is no legal forum through which to extract money from the assets to service non-performing loans.

FM Response: This all means that more grant money may need to be disbursed up front, e.g. to cover capital expenditures that might normally be financed through a bank loan. Matching funds will be harder for businesses to obtain. At AECF, we have widened the definition of what constitutes matching funds to accommodate more existing assets rather than fresh investment. But that means that grant funds will need to cover a larger portion of the new project costs. This all increases the donor's share of the risk, even as his ability to manage it lessens. Large up-front disbursements are less tied to progress reports over time, reducing recourse if things don't go as planned. The good news is that because financing of any kind is so hard to come by in post-conflict states, most grantees have a greater appreciation for donor funding and are easier to work with.

Fund managers will also need to think carefully about the lack of available follow-on funding. Challenge funds work to demonstrate the viability of an idea in the market to the point that it can attract commercial investment. In post-conflict countries, it might be a decade or more before other funding becomes available. For the AECF post-conflict windows, we have therefore focused largely on projects carried out by established businesses that can continue to operate following the end of grant support.

PSD and Peace: Understanding the Political, Economic and Social Forces around You

The Challenge: Research shows that job creation can contribute to peace by offering opportunities to disenfranchised youth. Value chain development can also bring divided communities back together and entrench stability, as has been seen with coffee in Rwanda and cotton in northern Uganda (Dudwick et al 2013). Agribusiness projects that create outgrower jobs offer good opportunities for internally displaced people and refugees to return home to work in their rural communities. DCED (2010: 58) further finds: "Evidence from a number of countries shows that where the private sector has a competitive advantage and an active interest in a stable operating environment, it has taken steps proactively to address conflict causes and legacies through core business operations, social investment and policy dialogue initiatives."

However, the connection between PSD and peace is not automatic. Certain kinds of economic activity can fuel conflict by instigating unrest over land rights or division of wealth. Researchers caution practitioners to ensure that the benefits of their programs are spread across communities and ethnicities to avoid exacerbating social fissures. This requires a keen understanding of the divisions that originally caused conflict and the political, economic and social forces still at work in the country. Donors must also beware

Neo Trading Company, Somaliland

Size of grant: USD 300,000
Jobs to be created over 6 years: 240
Total benefits to gum collectors: USD 750,000

The company is currently involved in exporting high quality grades of raw olibanum gums and resins, extracted by smallholder farmers from trees in remote areas of Somaliland. This aromatic resin, also called frankincense, is distilled abroad and used as the base scent for many perfumes, cosmetics and shampoos around the world. With AECF support, Neo Trading will invest in a factory to facilitate local distillation of the low quality portion of the raw resin, thereby increasing the product's profit margin by 50 times.

This project is exciting because it will develop a more profitable value chain for a traditional market that has employed remote communities of farmers for generations. Certain areas of Somaliland, Puntland and Oman are the only places in the world where this kind of tree that produces high oil content olibanum can grow. The trees cannot be farmed on a plantation, therefore encouraging traders to work with a variety of clans from different regions across Somaliland to collect the resin. This model is interesting because it brings broad-based economic opportunities to multiple marginalised communities.

of working with so-called "conflict entrepreneurs" – businessmen operating successfully in the market thanks to exploitative or illicit connections.

FM response: In practice, none of this is quite so straight forward. Challenge funds in particular function as somewhat blunt instruments. It is impossible to know exactly what the response will be from the private sector, and with a limited pool to pick from, the focus is usually on finding capable grantees rather than those from a specified community. Rural projects will necessarily employ people from the local community who will usually be all from the same ethnic background. Even so, at AECF this has been less of a problem because we work with large grants and well-established companies – potential to cause conflict over distribution is much less than when giving out small grants to large numbers of people.

Regarding conflict entrepreneurs: It is possible to avoid working with people flagged on official sanction lists. But these are far from exhaustive. Connections in conflicted environments are always murky, and donors are usually reticent to pay for expensive due diligence investigations. Commercial equity investors working in African agribusiness tell us that they spend tens of thousands of dollars, sometimes in to the hundreds of thousands, on a single due diligence, even for small investments of US$1-2m. Their investigations take weeks or months. Compare that to the usual grant fund due diligence, which spends a fraction of the funds and is carried out usually over just a few days. Due diligence requirements can be lessened by working with large reputable companies. But the trend is toward more involvement with smaller local companies, which bring the benefit of a larger portfolio, better local knowledge and sustainable change. Risk exposure for grants funds in post-conflict states is thus almost always higher than the amount of risk management donors are willing to fund in response.

Gaining an in-depth knowledge of the country context is generally costly and time consuming. But this knowledge is especially important because every conflict and state functions very differently. We have found, for example, that land rights are more of a problem in Zimbabwe than other conflicted states. Social divisions in South Sudan are less of a problem than in other fragile states because South Sudan's conflict was with the North. One might think that fostering business connections between North and South Sudan could contribute to peace, and indeed at AECF we had applications from northern businesses hoping to move into the south. We were unable to fund these projects, however, because the government subsequently closed the border and cancelled all flights from Khartoum to Juba.The complexity of these considerations may offer an argument for longer-term, larger programmes like the AECF, which foster institutional knowledge built from experience.

Conclusion: Risk and Reward

Many of the considerations above relate to the need for flexible risk management and the patience to pursue delayed benefits in post-conflict states. Aid logic in conflict affected states is often counter-intuitive: imposing tight reporting requirements or inflexible financial controls in a fragile environment can actually increase programmatic risk and decrease the chances of success (OECD 2012-13). And even where flexible management is achieved, the chance of short-term failure will necessarily be higher than in other states. This all goes against the normal way of doing business in development, which is traditionally risk averse and focused on demonstrating short-term impact to justify expense.

Literature on working in fragile states has recognized the need for more innovative risk management (Ibid.; OECD 2011; Leader and Colenso 2005; Otker-Robe 2013; World Bank 2012), but suggestions often take the form of risk sharing or risk shifting mechanisms such as multi-donor trust funds or implementation through agents (Bhargava 2011; OECD 2011). These methods are helpful, but equally if not more important is the discussion about how to take the right risks and manage them effectively, in line with commensurate reward. Much time, effort, funding, and risk to personal safety are involved in these engagements; it is important for everyone to know that the outcomes are worth it.

We think the balance is about right at AECF. Thanks to extra support from us and having begun from a lower base, our post-conflict grantees tend to make significant progress, resulting in greater impact from funds invested and more opportunities to learn from grantee growth and challenges. Working in clusters also gives us the chance to have a greater effect on a relatively small national market. We see potential for challenges to become opportunities: e.g. because regulations and policies are in such a state of flux, they may be easier for our grantees to influence toward more positive outcomes.

Habo Fish and Tuna Canning Factory, Puntland

Size of grant: USD 1,000,000
Jobs to be created over 6 years: 272
Total benefits to fishermen: USD 2.8 million

By adding a canning line for small pelagic fish to the current canning line for tuna, the company hopes to extend Puntland's commercial fishing season from the current four to five months of the year to about nine months. The project will provide additional income opportunities in an area where opportunities are few and competition from illicit activity is high. Because of the strong potential for local benefits, AECF has taken the risk of funding this project, even though security considerations (arising from local pirate activities) prevent the team from conducting site visits.

Still, judging the risk-reward balance is not easy, and will likely require a different way of thinking about reward. In PSD, a business may fail commercially, but can offer valuable lessons for other businesses, may have built up the capacity of its staff, may have enfranchised former combatants, lobbied for better regulations, or helped build up needed institutions such as business associations. Viable businesses may still fail to create a large number of jobs, or to offer huge income benefits to small farmers, but they can offer value in demonstration of new ideas and techniques. What kind of indicators can capture these benefits? These are all important considerations for monitoring and evaluation methods in post-conflict programmes.

Furthermore, when assessing the performance of programmes in post-conflict states, it is essential that donors pair all of the above considerations with a fair amount of patience. It may simply take longer for projects to work through the many barriers they face. Recent experience has shown that donors are willing to experiment with more flexible implementation systems to address these challenges. But they have yet to follow with equally flexible systems for judging performance. This is especially important where funding decisions are linked to performance reviews. If the assessment metric does not match the context, donors may risk cutting off funding prematurely for a potentially successful programme.

It is too early to tell exactly what the results will be for the AECF post-conflict portfolio, but we expect there to be a significant impact. We hope that our work will continue to facilitate more innovative ways of thinking about how best to achieve and measure impact in post-conflict states.

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