National Audit Office

Investing for development: the Department for International Development's oversight of CDC Group plc

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 18 Session 2008-2009 | 5 December 2008

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A report by the Comptroller and Auditor General

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2 December 2008

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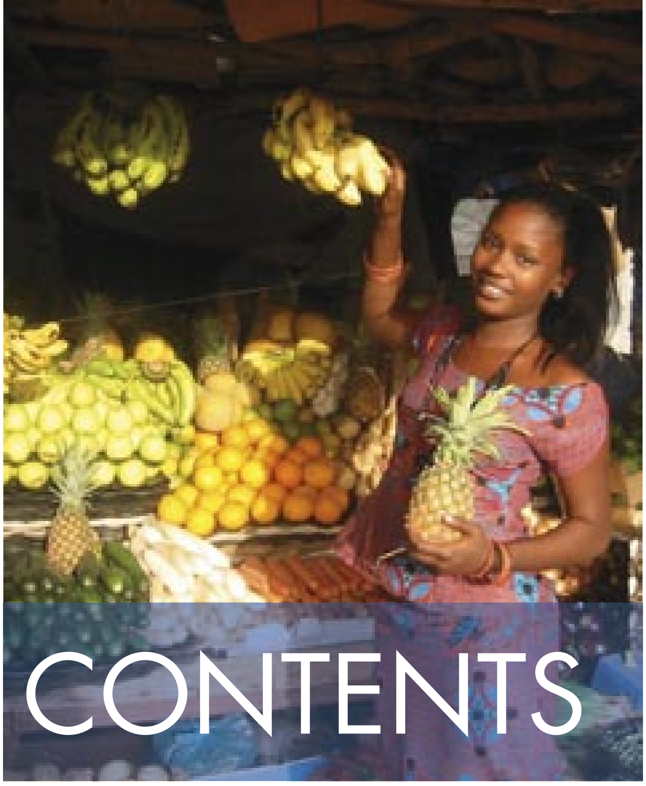

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Photographs courtesy of CDC Group plc

SUMMARY

1 CDC Group plc, formerly the 'Commonwealth Development Corporation', is a UK government-owned fund management business, with net assets of £2.7 billion, investing in private businesses in emerging markets, particularly Sub-Saharan Africa and South Asia. The Department for International Development (DFID) is its owner and sets the overall framework for CDC's investment policy, but does not interfere in individual investment decisions. DFID is advised by the Shareholder Executive **(Figure 1)**. In 2004, DFID agreed as CDC's principal objective:

> "To invest its capital so as to maximize the creation and long term growth of viable businesses in poorer developing countries through responsible investment and mobilizing private finance."

DFID expects that all of CDC's business should contribute to the Department's overarching goal of poverty reduction. CDC is a major element of DFID's support for the private sector in developing countries, aiming to help fill a shortage of finance for investment that is a major constraint to economic growth and sustainable poverty reduction.

2 CDC is one of a category of organisations known as Development Finance Institutions (DFIs), national or international public agencies investing in the private sectors of emerging economies. Amongst DFIs, CDC has pioneered investment through private sector investment funds, rather than by investing in businesses directly itself. Since a major reorganisation in 2004 it has specialised in equity investment, as opposed to loan

finance or technical support which are major elements of most other DFIs' business. An important rationale for the restructuring was to attract more private equity investors to emerging markets by demonstrating that commercially attractive returns could be made. The CDC that emerged had only limited previous experience of investing through intermediary investment managers, but is now a recognised leader in this area. DFID has, since late 2006, been taking stock of CDC's track record and the scope to increase further its contribution to UK objectives for poverty reduction in its next business plan.

3 The National Audit Office does not have statutory rights of audit access to CDC Group plc, which does not receive public funding and is not defined by the Cabinet Office or the Office for National Statistics as a public body. CDC and Fund Managers voluntarily cooperated with our study, however, to provide insights into their business. Our examination (detailed in Appendix 1), focused on DFID's role as shareholder since 2004; whether it has set an appropriate framework of policies, objectives and incentives, how CDC has performed against those objectives, and how effectively DFID, supported by the Shareholder Executive, has monitored CDC to secure an appropriate contribution to economic development and poverty reduction.

Financial performance

4 CDC has been self-financing before and since reorganisation, having received no Government funding since 1995. It has achieved exceptionally good financial performance against the forecasts agreed with DFID in its Business Plan for the period 2004-2007. It met or substantially exceeded expectations, generating impressive growth in its total assets from £1.1 billion in 2004 to £2.7 billion by the first half of 2008. The annual rate of growth in its assets has averaged 24 per cent compared to a cost of capital threshold of five per cent set by the Treasury in 2004. This over-performance reflects in part strong market upturns amongst emerging economies in this period, but CDC's investment performance also exceeded relevant market indices.

5 Investment success on this scale has also brought challenges. Sales from the portfolio have consistently generated cash in excess of the extent to which CDC and Fund Managers could reinvest responsibly and in accordance with DFID objectives. By mid-2008, CDC had £1.4 billion deposited in cash with the UK Debt Management Office, more than its £1.2 billion invested in businesses overseas. CDC point to the need to finance a £1.7 billion pipeline of future investments, equivalent to 121 per cent of cash held, to most of which it is legally committed. Between 2004 and 2006, however,

1 Key organisations referred to in this report

Department for International Development

Responsible for the UK's international aid programme, with the ultimate objective of poverty reduction. 100 per cent owner of CDC Group plc, but has not made financial contributions into CDC since 1995.

CDC Group plc

Formerly the Commonwealth Development Corporation, the UK's institution for investing in the private sector in developing countries. Since 2004, and uniquely amongst development finance institutions, CDC invests almost entirely through professional private equity Fund Managers. So its investment portfolio is a "fund of funds" and it employs its own fund management professionals to pick the best funds to invest in. At some 40 staff it is a much smaller organisation than it was prior to 2004.

Private equity fund managers

Private entities which purchase shares or make other investments in private companies, on behalf of investors. They select the individual businesses into which CDC and other investors' money is invested, monitor the investments and typically after 5–10 years sell the investment and return the proceeds including any profits to CDC and other investors.

Actis

CDC's largest Fund Manager, making investments in private companies in developing countries. Actis was created out of CDC in 2004, with DFID holding 40 per cent of the shares and Actis management the rest.

Aureos

Like Actis, Aureos was spun out from CDC but is a smaller Fund Manager specialising in investing in small and medium enterprises. It is a joint venture between CDC, Norway's and Holland's investment funds for developing countries and Aureos' management.

Shareholder Executive

A UK government body which helps Departments to be effective shareholders of government owned businesses. In relation to CDC, the Shareholder Executive has an advisory role, providing advice to DFID Ministers and officials on shareholder issues including business objectives, governance, strategy, performance monitoring, board appointments and remuneration.

Source: National Audit Office

CDC consistently overestimated the rate at which Actis would convert pipelines of proposed deals into actual investments. DFID has not set any policies on the use of cash. Though CDC as an organisation can make better returns on investments than on cash holdings, individual staff are rewarded for the performance level of the investments they oversee, and not according to the amount of resources which are invested. DFID and CDC are looking to see how incentives for judicious investment of available resources can be strengthened.

6 The Department saw the potential for trail-blazing investment by CDC to have a wider catalytic effect by demonstrating to other investors that good returns can be made in emerging economies. Since 2004 Actis and Aureos have raised some £1.5 billion from other investors in the funds in which CDC invests, exceeding DFID's target. However, the extent to which joint investment in these funds in particular, and foreign investment in poor countries in general, is attributable to CDC's participation is difficult to measure. The full effects of the current global economic volatility on CDC's financial performance and on the availability of equity finance in developing countries are as yet unclear. But an emerging market index used for comparison by CDC fell by over 60 percent in the 10 months to November 2008.

Focusing on poor countries

7 The absence of direct DFID involvement in CDC's investment decisions is a deliberate feature of the Department's oversight of CDC, and important to demonstrate CDC's commercial discipline, free of political interference, to other investors. Instead, CDC's Investment Policy is the principal instrument through which DFID ensures that the Company invests so as to grow viable businesses in poor countries, and in support of Government objectives for poverty reduction. Targets requiring CDC to invest at least 70 per cent in low and lower-middle income countries, and at least 50 per cent in Sub-Saharan Africa and South Asia have been exceeded, and CDC's portfolio is significantly more focused on the poorest countries than those of other DFIs. The new Investment Policy for 2009-2013, announced in November 2008, sets higher targets for investment through new funds in poor countries.

8 The most significant shift in the allocation of CDC's portfolio has been increased investment in four countries, India, Nigeria, China and South Africa, which now comprise 64 per cent of the portfolio. These countries are very different in their investment challenges and also contain many of the world's poorest people. From 2004 to 2008 China and Nigeria, however, have also had high inward investment from other sources. Other investors might have provided the necessary investment and development without CDC involvement. There is as yet no systematic evidence on the extent to which CDC investment adds to overall investment in poor countries. Assessing this aspect of performance presents technical challenges which all Development Finance Institutions face.

9 Since 2004, 15 per cent of new CDC investments have accepted higher risks and lower profitability than in the rest of its portfolio, in return for longer term market building benefits. This type of investment tends to appeal to Development Finance Institutions of other countries rather than to commercial private equity investors. CDC's existing business model, based on investment through profit-seeking fund managers, is well-suited to identifying and delivering fully commercial investment. While it can also support market development, with a narrower base of potential investors and available funds, it is not clear that using an investment fund approach in such areas is necessarily best. Moreover, CDC does not externally report to DFID its performance under different streams of its business, making appraisal of its performance more difficult.

The impact of investment on development and poverty

10 Profitable investments are likely to support economic growth, and through growth to affect sustainable poverty reduction. CDC's business principles have been designed to ensure that good financial returns contribute to development without adverse consequences: for example through CDC's principle that investee businesses should promote the protection of the environment. CDC's business principles for ethical investment are broadly consistent with those of other Development Finance Institutions and were recently updated to reflect international best practice. Reporting to DFID by CDC, and to CDC by Fund Managers, on compliance has been highly selective, saying nothing about levels of compliance or trends. Although some Fund Managers provide more comprehensive reporting, most reports lack a clear evidence base or independent verification. In October 2008, CDC instituted enhanced arrangements for monitoring business principles, which provide for deeper CDC scrutiny of high risk investments. The arrangements do not however provide aggregated, validated information on the extent of adherence to those principles across the portfolio.

11 Gaining a worthwhile assessment of the impact of investment on economic development and poverty reduction is inherently difficult, and the effort in collecting information needs to be proportionate to its value in decision-making. In the case of CDC the difficulty is compounded by the added challenge of working through over 60 fund managers. No standard group of simple indicators will fully represent all the development effects of a diverse range of investments. CDC's guidance to staff is to evaluate funds in depth after five and ten years, in addition to producing summary statements on development effects within semi-annual monitoring reports. CDC originally expected to have evaluated 22 of its funds by now but revised its evaluation programme after the first four had been completed. These had revealed consistent lessons relating to the quality of due diligence for investments made before 2004 under the old CDC's arrangements. The evaluations lacked depth, however, beyond financial and governance issues, offering little insight into the effects of constituent investments. CDC is continuing its evaluation programme by focusing on funds in which it had invested from 2004.

Governance of CDC

12 CDC's internal arrangements for governance are well designed and consistent with good practice against generally accepted corporate governance standards. Financial reporting has improved in line with private sector best practice. But arrangements for DFID oversight have not been as strong. Several factors have contributed.

- DFID's 1.5 person team overseeing CDC has been small in comparison to teams overseeing other government owned businesses, even with support from the Shareholder Executive and periodic input from advisers. Capacity has been particularly stretched as the Department identified and progressed changes in CDC's Investment Policy and governance since late 2006, and less than that required for shareholder oversight and direction given the risk and complexity inherent in a £2.7 billion investment business.
- CDC's 2004 Business Plan has acted as a medium term corporate plan. But it is not clear which of the financial projections it contains are forecasts intended primarily for internal use and revision by CDC Board and management, and which are targets designed to apply unchanged for the full period, and under which CDC should be accountable to DFID.
- Since 2004 DFID's approach has been to hold CDC to account through its Board rather than try to influence management directly. But DFID contact with its two appointed non-executives has been intermittent and unclear in its expectations of their role in holding CDC to account. From early 2007 DFID and the Board differed over where and how CDC should operate in the future. This issue has been resolved with the announcement of the new Investment Policy.
- DFID and CDC agreed a remuneration framework designed to incentivise good performance, especially good financial returns. CDC significantly outperformed the investment returns expected in 2004, which underpinned higher than expected pay. CDC's Board, however, following advice from its remuneration committee composed of non-executive Board members, remunerated the Chief Executive and other senior executives at levels well above thresholds set in 2004 as requiring consultation. Contributory factors included ambiguity as to how the thresholds would be applied in practice, and CDC Board's use of higher external pay comparators than had been stipulated in the framework, without informing the Department. Remuneration remained below median pay levels in the private equity fund of funds sector which CDC, and now DFID, consider to be the appropriate benchmark.
- In March 2008 CDC and DFID started a process to put in place new arrangements to improve assurance to DFID that remuneration levels are robustly scrutinised and comply with the framework DFID has set. DFID told us that they are taking these arrangements forward as part of a new overall agreement on remuneration.

Value for money conclusion

13 DFID's Investment Policy for CDC has focussed its investment portfolio on poor countries to a greater extent than other investors, and CDC invests more than 70 per cent of its portfolio in them, compared with 7 per cent of foreign investment overall. Its portfolio has nevertheless grown strongly, outperforming global emerging markets since 2004. By achieving this strong performance with a portfolio weighted towards poor countries, CDC will have made a credible contribution to economic development in those countries while also encouraging other foreign investors to engage with them. In these respects, and in securing a good return on the public funds invested, CDC will have achieved good value for money.

14 Economic growth is a precondition for pulling and keeping people out of poverty. But the direct effect of specific investments on poverty reduction for poor people is harder to demonstrate. CDC has invested in a wide range of businesses and has mainly concentrated on larger, established, enterprises in sectors such as power generation, retail banking and agribusiness with some exposure to small and medium size enterprises. Research evidence suggests that investment in such enterprises can be an effective way of providing, directly or indirectly, economic benefits for the poor. The extent to which it does so for the type of investments in CDC's portfolio is an issue on which further evidence is needed and DFID and CDC are working to improve the evaluation of such impact.

Recommendations

15 To build on success to date, DFID needs to sharpen the specification of its objectives for CDC, and improve its monitoring of performance to strengthen its management of the risks inherent in its shareholding. In November 2008 DFID announced a revised Investment Policy, and that CDC had updated its Business Principles. Our recommendations below (and in detail in Appendix 2) identify areas where DFID can further improve value for money while avoiding interference with the day-to-day management of the business

- **i** **CDC invests in a range of different funds and most of its portfolio has been chosen to achieve returns which would attract more commercial investors to developing countries. For 15 per cent of its portfolio, however, CDC has accepted higher risks and lower returns, aiming for longer term market building and high development benefits.** DFID should ask CDC to report separately on streams of business which follow different approaches to development objectives, and will have different financial and developmental returns.

- **ii** **The financial threshold annual return of five per cent set for CDC is of limited use as a basis for CDC investment planning or as a basis for DFID assessment of the company's performance. Emerging market indices in the period 2004-2007 increased annually by around thirty per cent, but have fallen by around 60 per cent in 2008.** DFID should set financial expectations for CDC by reference to regional market indices which better match CDC's business, or parts of that business.

- **iii** **Since 2004 CDC's cash balances have consistently increased relative to its equity investments, and now exceed the value of investments.** DFID and CDC should agree a policy governing CDC's ability to re-invest proceeds from disinvestment, which should reflect DFID's appetite for investment risk. They should also agree a protocol for assessing the amount of cash that it is prudent for CDC to hold, taking account of its future commitments and its authorised capacity to borrow. The protocol should require consultation with DFID over the use of any excess cash.

- **iv** **CDC's investments have been more heavily targeted, compared to other Development Finance Institutions, on countries with lowest GDP per head, and the new Investment Policy strengthens this targeting for investment in new funds.** DFID needs evidence on how far CDC's investments add to total private investment in poor countries, and fill a gap to which other investors have not yet responded. DFID should seek information on the range of other investor interest in the funds to which CDC subscribes, and on the financing options available to investee companies.

- **v** **CDC has established relevant Business Principles for ethical investment, but neither CDC nor DFID can assess the extent of compliance. DFID has asked CDC to obtain external validation only of its internal processes for implementing and monitoring the Business Principles.** DFID should also require CDC to provide validated, summarised information on the extent of actual adherence to business principles across its portfolio.

- **vi** **To date CDC has produced evaluations of the development and poverty impacts of just four of the funds it invests in.** DFID and CDC need sufficient information on impact to inform strategic decisions on where and how CDC should invest, and on what scale relative to other aid for developing the private sector.

- **vii** **The Business Plan set for CDC to apply from 2004 to 2008 did not make a clear distinction between forecasts and targets.** The next Plan should distinguish key targets from internal forecasts. It should be more specific as to which targets are subject to annual revision, and which are fixed for the full period.

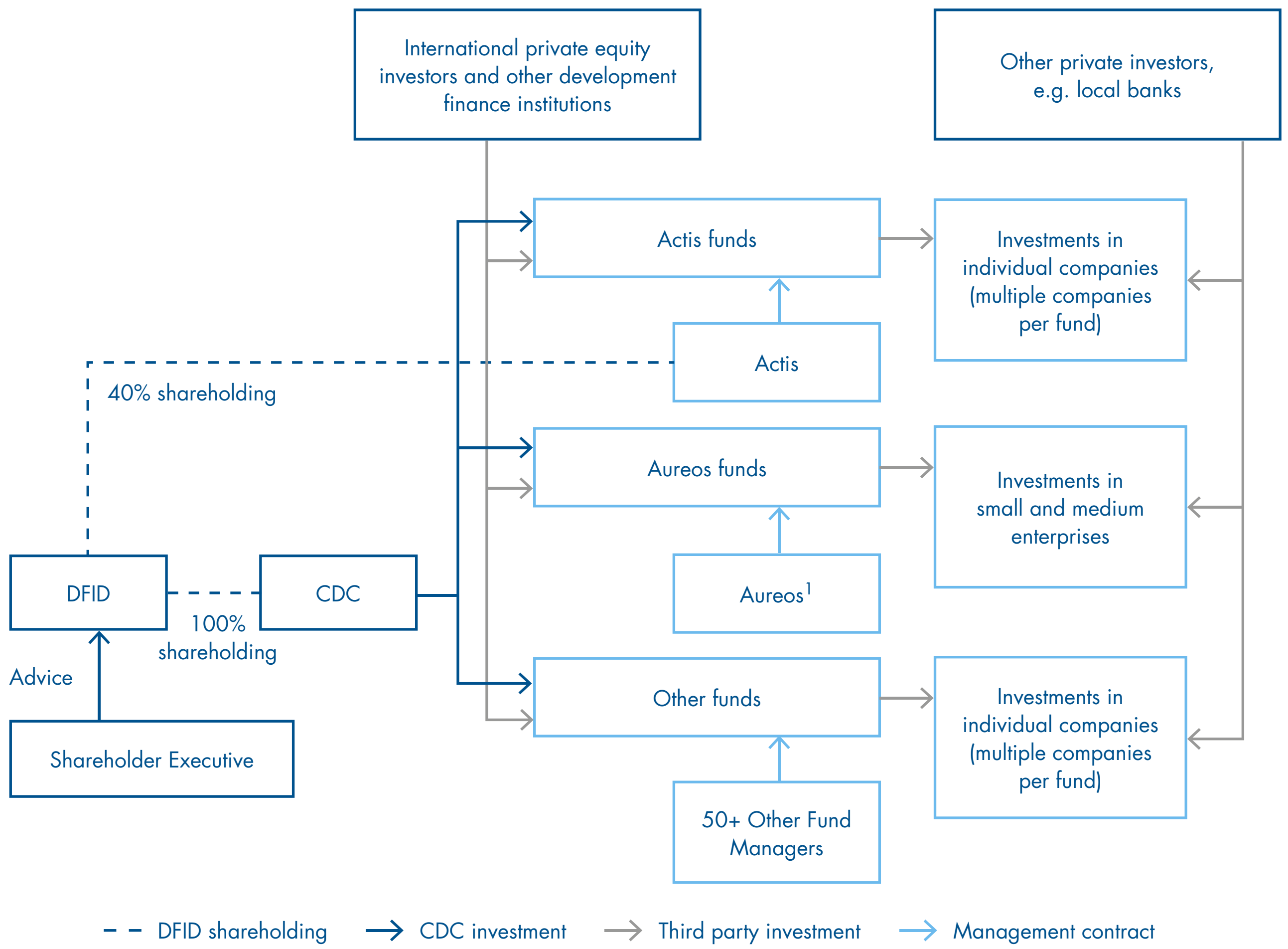
- **viii** **DFID has created a good governance model for CDC, although there have been concerns over the way it has worked in practice. DFID has recognised the need to clarify the duties of the CDC Chairman and the Board to itself as shareholder and strengthen its lines of communication with the Board.** The new arrangements will need to provide a framework within which CDC can be held accountable for the quality of its stewardship of Government funds, and for its performance. DFID should agree with CDC the information it needs to receive to support its analysis of CDC's medium term plans and prospects.

- **ix** **There have been lapses in oversight and governance of Executive Remuneration since 2004, with significant departures from the agreed framework, which also contained ambiguities.** In March 2008 CDC and DFID agreed that there would be revised governance arrangements, designed to improve oversight of CDC remuneration. They are now working on a revised remuneration framework. DFID and the Shareholder Executive need to ensure that the framework provides clarity over the evidence CDC must assemble to determine remuneration, and the range of factors it must consider.

Introduction

1.1 CDC became a plc in 1999, with a view to introducing private capital to the business, though since then it has remained wholly owned by DFID. In 2004, CDC stopped making direct investments, and the direct investment management part of its business was separated as Actis, with 60 per cent of the shares held privately. Since 2004 CDC has made all its investments through private equity Fund Managers, which buy shares in private companies (not normally listed in stock exchanges) on its behalf and for other investors **(Figure 2)**. More information on CDC's structure and rationale can be found in Appendix 3.

2 DFID's investments through CDC



Source: National Audit Office with CDC

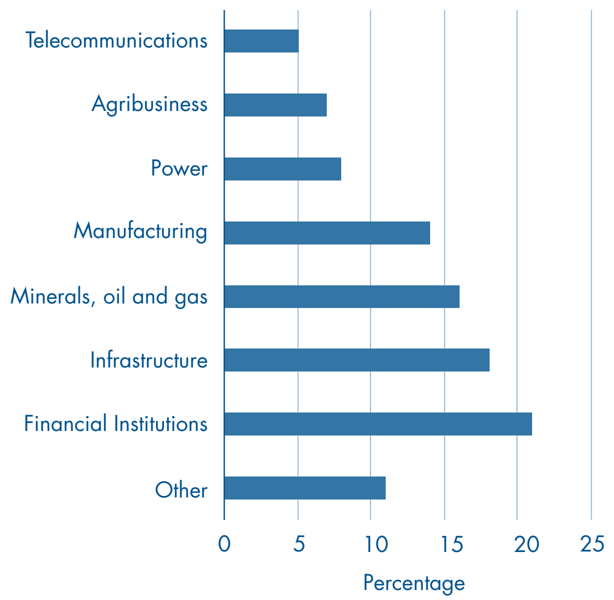
NOTE

1 Aureos is a joint venture between CDC, the Norwegian and Dutch Development Finance Institutions and Aureos' management.

1.2 CDC invests in over 120 funds, and through these has stakes in around 600 businesses. These funds specialise in particular regions or sectors such as energy or small enterprises. CDC's underlying investments are diversified across sectors, with financial institutions, infrastructure and minerals, oil and gas companies making up over half of the total portfolio **(Figure 3)**. The size of individual CDC underlying investments in businesses varies according to sector, with larger investments in financial institutions and power sector companies. There is a heavy and increasing geographical focus on Africa, with total share of CDC investment value increasing from one-third in 2003 to six-tenths in 2007. Statistics from CDC, based on latest estimates from Fund Managers, indicate that the 600 firms in which CDC and others are invested employ some one million people directly and pay an estimated £250 million in taxes to governments each year.

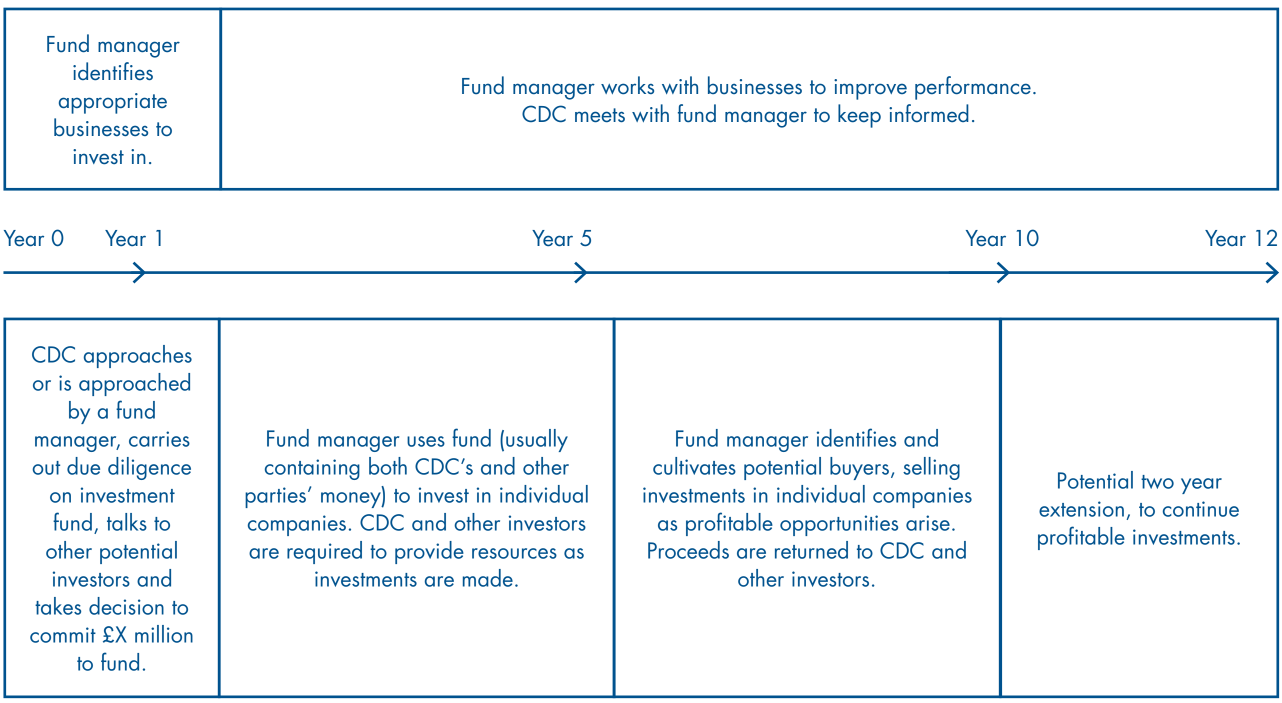
1.3 Since 2004, CDC has been sole investor in 18 funds, and has jointly invested with other private investors and Development Finance Institutions (DFIs) in another 102 funds, its share ranging from one per cent to over 90 per cent. Each fund invests in individual companies, in exceptional circumstances as few as one, or as many as thirty. Funds typically invest in companies over a five year period and disinvest over the following five years – so it takes some 10 years for CDC to secure the final return on its investments **(Figure 4)**. The timing of investment and dis-investment is an important factor in maximising rates of return. Active representation on company Boards is another.

3 CDC's investments by sector



Source: CDC annual report 2007

4 The typical life cycle for CDC's investments



Source: National Audit Office

1.4 Very high returns can be made in private equity investment through identifying businesses with unrealised potential for growth or greater efficiency and productivity, and transforming their financial performance, often from a low base. But equity investment is risky, and working in countries without well-developed capital markets can increase the risks. CDC investments can help boost economic growth in developing countries, particularly where investment opportunities exist but capital is difficult to raise. Through impacts such as employment, taxes paid and improved health and safety practices, businesses in the developing world can also make a valuable direct contribution to poverty reduction and social development.

1.5 The nature of the businesses CDC supports, through Fund Managers, varies widely. Examples include:

- CDC's largest underlying investment is in Diamond Bank in Nigeria – a stake worth £88 million. The Bank was set up in 1991, and CDC took a stake through a fund managed by Actis in 2004. With 120 branches, over 2,000 staff and a five per cent share of the Nigerian market, Diamond Bank provides both retail and corporate banking throughout Nigeria, including lending to small enterprises and providing mortgages.
- Elsewhere in Nigeria, CDC investment through an Actis fund led to a new management team being brought in to Mouka Limited. Mouka is now the largest foam producer in West Africa, providing direct employment to more than 400 employees.
- In Kenya CDC invests in a fund which aims to finance medium sized businesses which typically find it difficult to access commercial finance to support their growth potential (see Figure 21, Appendix 3). One of these businesses is a steel plant on the outskirts of Nairobi which directly employs 700 people. It operates mainly by recycling scrap metal.
- In China, CDC's investment in De Quing Yuan Poultry, managed by Capital Today, has helped to improve the firm's processing plants and quality control technology.
- CDC was the first institutional investor in Celtel, the largest African mobile operator outside South Africa, contributing to a 9.3 per cent stake. CDC supported Celtel to win licence bids and expand its business. In 2005, CDC's interest in Celtel was sold by Actis to a Kuwaiti telecommunications company as part of a US$3.4 billion deal, resulting in CDC receiving a cash return on their investment of more than 500 per cent over seven years. This was one of CDC's most successful investments ever.

PART TWO

CDC's financial performance

2.1 This section considers CDC's performance against financial forecasts agreed with DFID in the 2004 Business Plan. In almost all respects, CDC has met or substantially exceeded expectations, achieving particularly impressive financial returns. But with higher than expected profitability and realisations, CDC's cash balances have risen rapidly, and the challenge of finding enough opportunities for prompt and responsible reinvestment through Fund Managers has intensified the issue.

CDC's financial returns and operating costs

2.2 CDC's total assets grew from £1.1 billion in 2004 to £2.7 billion in the first half of 2008. The annual rate of return on all assets substantially exceeded the minimum five per cent required by the Treasury in 2004 (**Figure 5**, top row) and showed an improvement on profitability before 2004. Returns on CDC's investment portfolio, (Figure 5 middle row), are higher still because the return on total assets is depressed by the lower rates of interest earned on CDC's cash. An emerging markets index used as a benchmark by CDC indicates that growth in emerging markets since 2003 has buoyed CDC's performance, and some countries where CDC is strongly invested, such as Nigeria, have produced similarly high returns for other investors. Overall, however, CDC has increasingly outperformed the market index.

2.3 The five per cent rate of return threshold set in 2004 was based on UK government's cost of capital and so appears conservative in the context of the business's performance. But at that time emerging markets had been much less buoyant, a major restructuring from the old CDC had just taken place and CDC's new private equity business model had no track record of success. Against this background, Government intended the financial threshold to be financially stretching whilst also allowing CDC to pursue pioneering development opportunities that might offer more modest financial returns. Because the threshold is fixed, it does not reflect changing market conditions.

5 CDC's annual financial performance 2002-2007

	2002 %	2003 %	2004 %	2005 %	2006 %	2007 %
Overall business performance						
Increase in value of all assets (cash and investments)	0.4	4	19	35	23	33
Investment portfolio performance						
Return on investment portfolio (excludes uninvested cash)	13	20	22	42	43	57
Emerging market benchmark index[1]	–8	51	22	30	29	37

Source: CDC staff and CDC Annual Reports 2004-2007

NOTE

1 The benchmark used is the emerging market index of MSCI (Morgan Stanley Capital International). Though not a direct comparator to CDC's portfolio, it appears to be the best single benchmark available (paragraph 2.4).

2.4 Comparison of CDC's financial performance with investment markets is complicated by the lack of market indices corresponding to where and how CDC invests. The market index used by CDC is one of the better matches, although overall, CDC invests in less developed markets.[1] A useful refinement would be to examine CDC's performance by region against regional indices, to attempt a closer geographical comparison. Alternative indices show similar overall emerging market performance but with stronger growth in parts of Africa in recent years, including countries where CDC is heavily concentrated.[2] A further complication is the long time lag between making and realising an equity investment. Some 82 per cent of the profits realized by CDC since 2004 relate to investments made before CDC was restructured as a fund of funds that year. Given the typical life cycle of funds (Figure 4), it will not be until 2015 that most investments made from 2004 to date will have been realised.

2.5 Comparisons with other Development Finance Institutions are difficult because of differences in their mandates and types of investment (Appendix 4). The closest like-for-like comparisons are with the International Finance Corporation's listed equity arm and Norway's Norfund. Like CDC, IFC has staff incentives linked to financial performance, but fewer restrictions on where it should target investments. IFC informed us that returns on its listed equity investments were confidential, but that these had been lower than CDC's returns in 2006 and higher in 2004, 2005 and 2007. In contrast, Norfund reports lower returns, is much smaller (see Figure 27) and has no staff incentives linked to financial performance. It also invests more extensively than does CDC in small and medium sized enterprises, which have traditionally offered lower financial returns, but with potential for high development benefits.

2.6 DFID and the Shareholder Executive review quarterly CDC operating efficiency against expectations set out in the 2004 Business Plan, which envisaged operating costs for CDC itself of approximately £5 million per year (at that time equivalent to half of one percent of CDC's assets). As expected, CDC's internal costs declined substantially between 2004 and 2005, when the direct investment business was transferred to Actis. In 2006 and 2007, they rose as CDC brought in additional staff to manage the larger investment portfolio and placed investments through many more Fund Managers. However, the full economic costs of DFID's new investment model for CDC also includes fees paid and profits accruing to Fund Managers. CDC is not required to report these costs, making it difficult for DFID to assess the overall efficiency of the new investment model. **Figure 6** shows fairly stable direct management costs and fees expressed as a proportion of CDC's investments. Overall costs, taking into account profits shared with Fund Managers, have risen as a proportion of investment value.

6 The full costs of CDC's investment model

	2002	2003	2004	2005	2006	2007
CDC's own operating costs (£m)	39.3	33.3	16.0[1]	4.9	6.7	8.3
Fund management fees (£m)	N/A	N/A	14.6	25.5	26.2	34.1
CDC investment value (£m)	820.0	888.6	937.4	937.8	1,125.3	1,184.2
Costs and fees as a share of CDC's investments (%)	**4.8**	**3.7**	**3.3**	**3.2**	**2.9**	**3.6**
Share of profits taken by Fund Managers as 'carry' (£m)[2]	N/A	N/A	0.0	9.1	23.2	24.9
Costs, fees and profit sharing as a share of CDC's investments (%)	**4.8**	**3.7**	**3.6**	**4.0**	**5.5**	**5.5**

Source: CDC

NOTES

1 CDC's operating costs included full investment management costs until mid-2004, when Actis was created.

2 Carry is the share of profits which accrues to Fund Managers and is a pre-agreed percentage of all profits above a fixed threshold. Total profits taken by Fund Managers in 2005-2007 equated to nine per cent of the total profits realised over the period.

1 The Morgan Stanley Capital International Emerging Markets Index used by CDC over-represents the richest 30 per cent of countries where CDC invests, particularly Latin America, and under-represents key parts of CDC's portfolio such as Sub-Saharan Africa.

2 Standard & Poor's Emerging Africa indices show annual growth since 2005 averaging around 50 per cent in Nigeria, where CDC has increasingly invested.

Mobilising third party capital

2.7 A major objective of the 2004 reorganisation was to enable CDC to mobilise third party investment into its priority countries, especially private sector investment. For CDC, this translated into a target for the amount of third party investments alongside its own investments in Actis and Aureos funds. The target incorporated both private sector investment and that from other DFIs. From 2005, CDC exceeded this target significantly **(Figure 7)**, with the private sector contributing around 60 per cent of the co-investment. But mobilisation is a much wider concept than is measured by joint investment, and important aspects that are not currently evaluated or targeted include:

- The extent to which CDC acts as an "anchor" or lead investor in establishing funds, and was decisive in attracting third party investments to the fund.
- The extent to which CDC supports investments which would not otherwise happen.
- Wider demonstration effects where CDC investment has promoted private equity investment elsewhere in poor countries.

These aspects are difficult to measure through regularly collected business metrics but could be estimated through periodic evaluation studies.

2.8 The high levels of joint investment achieved mean that Actis and Aureos are now less reliant on CDC funding.[3] This is an important success, because it indicates that investment through Fund Managers should be sustainable. Under the restructuring of 2004, CDC was tied to investing 95 per cent of its resources through Actis. But proceeds exceeded those forecast and CDC took the opportunity to expand the scale of planned diversification to other Fund Managers interested in investing in poor countries, thus supporting broader capital market development. By June 2008, CDC had placed one third of its investments outside Actis and Aureos, and now it works with over 60 fund managers. These include over 25 newly established fund managers specialising in low income countries, where CDC's support in early stages can help develop the track record needed to attract private capital.

CDC's rising cash balances

2.9 Publicly owned businesses are required by the Treasury to avoid keeping excessive amounts of cash on their balance sheets.[4] Similarly in the private sector well-run commercial businesses, incentivised to maximise the return on their resources, will seek to minimise the proportion of their assets that they keep as cash deposits – taking account of future commitments and likely cash flow. Under its Investment Policy set by DFID, CDC is not restricted as to the portion of its assets which may be retained in cash or other short term financial instruments where as long as the directors of the Company consider cash retention to be in the best interests of the Company and its shareholders, or consistent with the Company's mission statement, and they expect such investments to be of a temporary nature. CDC's projections indicate that high cash balances will last for several years even if cash is drawn down for investment as quickly as currently forecast.

7 CDC's targets to mobilise third party investment

Third party investments in Actis and Aureos funds	2004 $m	2005 $m	2006 $m	2007 $m	2008[1] $m	Total 2004-08 $m
2004 Business Plan target projection	**350**	**93**	**110**	**400**	**No data[2]**	**953**
Actual	**100**	**490**	**255**	**653**	**1,096**	**2,594**
Of which Actis	61	453	137	526	1,094	2,271
Of which Aureos	39	37	118	127	2	323

Source: CDC 2004 Business Plan, CDC Annual Reports, CDC quarterly report to DFID, 2nd quarter, 2008

NOTES

1 Figures are for first half of 2008 only.

2 No target set for 2008.

3 Third party investment accounted for 39 per cent of Actis funds since 2004 and 61 per cent of new Aureos funds (Source: CDC 2nd quarter report, 2008).
4 CDC Business Plan 2004.

2.10 As early as August 2002 merchant bankers advised DFID that CDC could have sufficient resources both to fund future commitments and build up substantial cash. Since 2004 CDC has accumulated much higher amounts of cash through profitable disposals than was envisaged in the 2004 Business Plan. Though new investments exceeded the levels originally planned in 2004 they did not achieve revised annual projections **(Figure 8)**. By the end of 2007, CDC's cash deposits exceeded its investment in equity funds, though the level of deposits reflected in significant measure the disposal in June and November 2007 of the £620 million stake in the Globeleq power business, with a realised gain of £281 million.

2.11 Over this period CDC's cash flow forecasts to DFID did not include range estimates to show the implications of higher than expected disposals or slower than expected new investment. CDC's quarterly reports to DFID stated the total cash committed to new funds, though not the expected timescale over which this cash would be drawn down into actual investments. By mid-2008, CDC's pipeline of investments comprised £1.5 billion of legal commitments and £0.2 billion of obligations approved for investment by its Board and which will become legally binding later in 2008. After CDC commits to a fund it can typically take up to five or six years for the Fund Managers to draw down the cash to fund actual investments.

2.12 DFID internally discussed the possibility of extracting value from CDC in 2005 and 2007 and informally with Treasury in 2007. Resources released from CDC through a dividend or other instrument would go to the Government's Consolidated Fund rather than automatically add to the Department's resources. The Government would decide on the application of those resources according to its priorities.

2.13 CDC staff's financial incentives are derived from the performance and location of actual investments, not from minimising cash balances. DFID's preference is not to press CDC to invest faster than it can readily identify appropriate investments to make, as poor investments risk deterring other investors from poor countries and can be damaging to social and economic development. This is a reasonable principle, but requires DFID to clarify its tolerance of risk and the rate of return that it requires from CDC's portfolio, against the desirability of using uninvested cash for other purposes.

8 CDC's rising cash balances

		2004	2005	2006	2007
Cash held at year end (£m)	Forecast in 2004	152	79	79	81
	Updated[1]	285	461	543	852
	Actual	317	677	771	1,405[2]
Cash held, as a proportion of investments (%)	Forecast in 2004	16	8	7	7
	Updated[1]	30	49	48	72
	Actual	34	72	69	119
New investments (£m)	Forecast in 2004	202	222	211	221
	Updated[1]	236	271	455	460
	Actual	200	156	257	412

Source: 2004 Business Plan, National Audit Office analysis of CDC Quarterly and Annual Reports 2004-2007

NOTES

1 The updated forecasts were those reported to DFID in CDC's third quarterly business report in 2004, first quarterly report in 2005 and fourth quarterly reports in 2005 and 2006 for the subsequent years.

2 CDC's second quarterly report of 2008 reported that £1,374m of cash was held at June 2008.

Investment Policy Targets

3.1 DFID set CDC's Investment Policy, designed to ensure investments flow to poor countries. CDC has outperformed the Investment Policy targets. But patterns of global investment have changed since the Policy was drawn up, and affects the degree to which compliance with the Policy delivers the pattern of investment that matches DFID's aims.

Importance of the Investment Policy

3.2 The Investment Policy is the principal instrument through which DFID ensures that CDC invests so as to create and grow viable businesses in poor countries, and in support of the Department's overall objectives for poverty reduction. It comprises a set of targets on where CDC should invest, and a set of Business Principles about how it should invest. In 2004 DFID finalised with CDC the Investment Policy that would apply from 2004 to 2008, and required the Company to report quarterly and in its annual report, on its progress in meeting the Policy. Key features are summarised in **Figure 9**. CDC has discretion within the Policy to interpret whether each investment is in, and for the benefit of, poor countries.

Meeting CDC's targets for investment

3.3 Over the period 2004 to mid 2008 CDC exceeded the 70:30 target for investing in poor countries, and the 50:50 geographical target for new investments as set in its Investment Policy **(Figure 10)**. New investments in Sub-Saharan Africa and South Asia increased markedly. CDC's formal reporting has not covered compliance with the 10 per cent limit on indirect investments, although CDC told us only three companies fell into this category.

3.4 As a result of the current Investment Policy, and similarly expressed investment policies before its transformation in 2004, CDC's investment portfolio has been much more focused on poor countries than the investment portfolios of other Development Finance Institutions (DFIs), (Appendix 4, Figure 26). In addition, only seven per cent of total global foreign direct investment flows go to the countries where CDC is required to invest 70 per cent of its portfolio.

CDC's added value

3.5 All DFIs aim to support private sector businesses in markets which are under-supplied by other investors. CDC's strategy is different from that of many other DFIs in that it aims to concentrate on fully commercial investments. Whereas other DFIs may invest where the business environment is poor and it is difficult to make commercial returns, CDC specialises in identifying investments which are profitable but have been under-funded due to insufficient information on business opportunities and likely returns, or inaccurate perceptions of the degree of risk involved. By specialising, DFID aims for CDC to have a catalytic effect, demonstrating to private investors that good returns can be made in poor countries whilst observing responsible business standards.

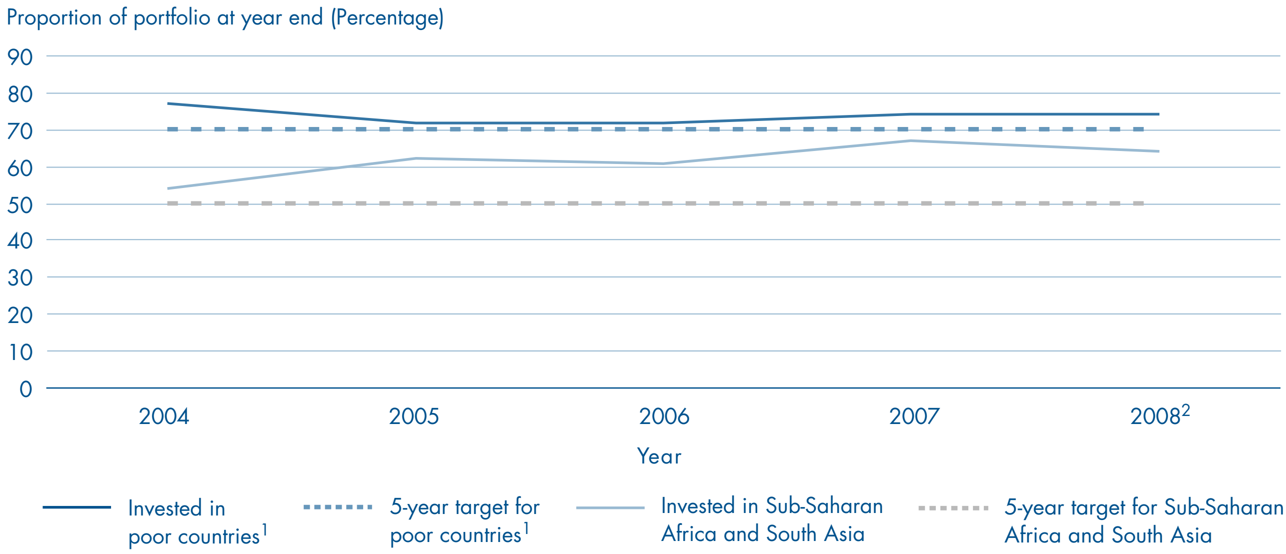
3.6 The 2004-08 Investment Policy provided a clear focus on poor countries, simplicity, and relative clarity as to the areas within which CDC are able to take business decisions, free from routine DFID intervention. The 70:30 target has led CDC to concentrate most investment in poor countries, where underinvestment is a general problem. The target does not, however, identify specific countries or markets where a shortage of commercial investment cannot readily be explained, and where demonstration effects might be greatest.

9 Key features of the Investment Policy targets for CDC Group plc, 2004-2008

Parameter	DFID's Rationale
The CDC Universe, (the 149 countries where CDC is permitted to invest), consists of those classified as low and middle income countries by the World Bank.	Businesses outside the CDC Universe should be able to find commercial financing. The aim is to focus on countries where business finance is lacking.
"70 per cent countries" At least 70 per cent of the capital invested by CDC will be deployed in investments which in the opinion of CDC are in and for the benefit of the poorer countries within the CDC Universe. These are countries with a per capita Gross National Income equal to or less than US$1,750 per annum. The Policy is deemed to have been met if complied with at the end of the five year period.	To focus CDC's new investment predominantly on poor countries, as opposed to middle income or "30 per cent" countries
"50 per cent countries" At least 50 per cent of the capital invested by CDC will be deployed in investments which in the opinion of CDC are in and for the benefit of countries of Sub-Saharan Africa and South Asia. The Policy is deemed to have been met if complied with at the end of the five year period.	To focus at least half of CDC's new investment in regions of particular strategic importance to DFID because of the prevalence of very poor countries in these regions.
Up to 10 per cent of capital invested may be made indirectly, in newly issued securities of businesses located principally outside the developing country, as long as this is for the immediate or prospective benefit of that country.	To allow CDC to invest in the poorer developing countries through companies whose domicile is outside these target countries.

Source: CDC Investment Policy, 2004

10 CDC's achievement of key Investment Policy targets



Source: CDC

NOTES

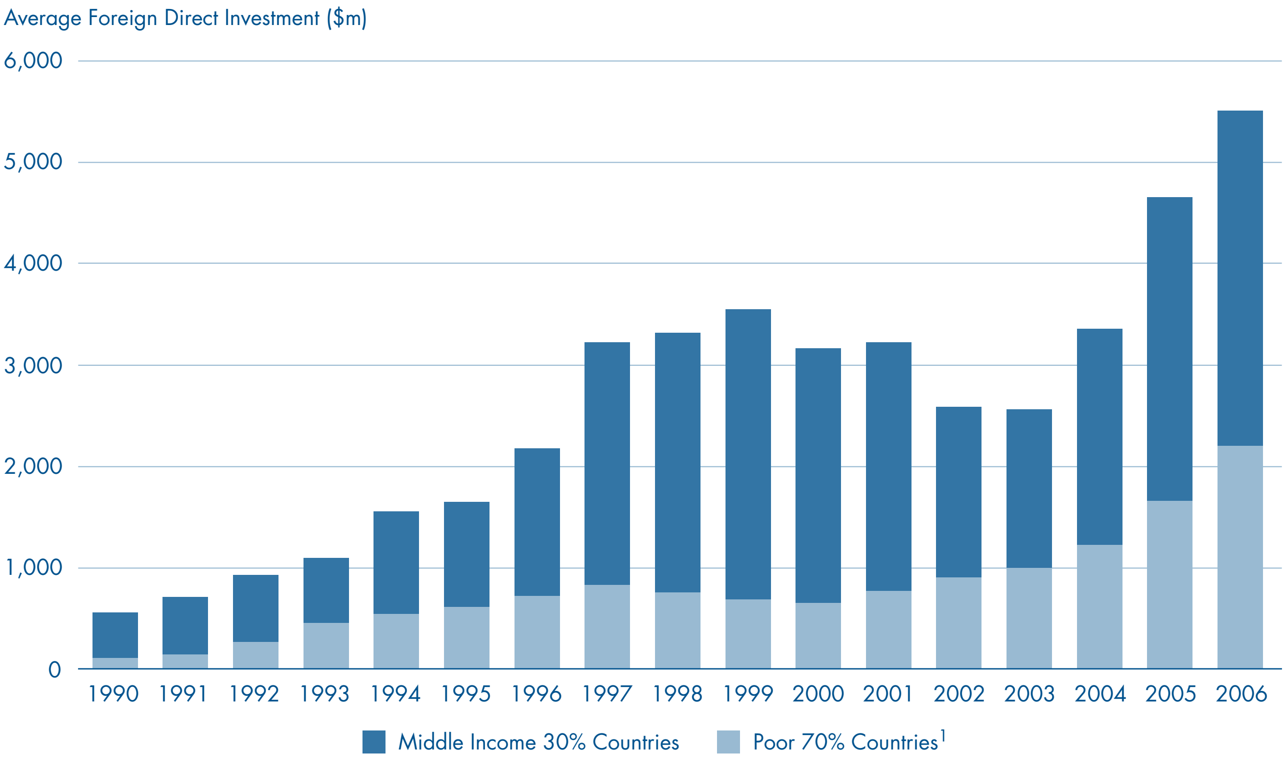
1 Defined as countries where, according to 2002 World Bank figures, Gross National Income (GNI) per head was less than US$1,750.

2 Figures are for first half of 2008 only.

3.7 The Policy was set at a time when foreign investment in poor countries had been falling back and was significantly lower than between 2003 and 2006 when there was a resurgence of growth in private sector capital flows to middle income and poor countries **(Figure 11)**. Increases and decreases in foreign investment affect the extent to which CDC investment is needed to combat any shortage of investment in emerging economies, or to leverage further investment. An UNCTAD report in September 2008 points to worsening prospects for investment in many emerging markets, particularly Sub-Saharan Africa, though India and China are likely to remain amongst the most preferred destinations.[5]

3.8 DFID permits CDC to invest in a universe of 149 low and middle income countries, of which it has invested in 77 since the start of 2004. It does not have any defined approach to analysing the pattern of CDC investment that results. That pattern will be affected by a variety of factors, including the size of country economies, the existence of suitable investment funds, the business environment and the existing degree of foreign investment. We explored CDC investment by reference to the last two factors. **Figure 12** shows that a quarter of CDC's investment is in countries with low foreign investment and relatively conducive to doing business, where successful investment might have the strongest demonstration effect. It includes countries with the highest ease of business but lowest foreign investment, where CDC undertakes no significant investment because the countries are small or not amongst the poorest and so are not the strongest candidates for substantial investment. In addition, CDC has deployed a further quarter in severely under-invested countries where the business climate is more difficult. Appendix 5 provides further detail on the specific countries covered by this analysis and on key changes in the deployment of CDC's portfolio since 2004.

11 Average levels of foreign direct investment in CDC's target poor ("70 per cent") and middle income ("30 per cent") countries



Source: National Audit Office analysis of World Bank data. Data are in current US dollars

NOTE

1 The "70 per cent Countries" represent average investment in countries where, according to 2002 World Bank figures, Gross National Income (GNI) per head was less than US$1,750. The "30 per cent Countries" represents average foreign direct investment per country above this limit but within the CDC Universe of poor and middle income countries.

5 United Nations Conference on Trade and Development, World Investment Prospects Survey, September 2008.

3.9 While complying with the Investment Policy, CDC has since 2004 significantly changed the deployment of the portfolio. A growing proportion, up from around one quarter to nearly two thirds, has been deployed in Nigeria, South Africa, India and China **(Figure 13 on page 20)**. Though not amongst the very poorest countries, these four countries together contain a majority of the world's poor. Most of this CDC portfolio growth came from new investments since 2004. This trend was particularly pronounced during 2007, when the proportion of CDC's investments in Nigeria and China more than doubled and increased by a half in India. Nigeria and China, though very different in their economic development, have attracted high foreign investment in this period relative to the wealth of their economies. These are large economies and important "gateways" to their respective African and Asian regions. The main countries that had declined as a percentage of the portfolio over 2003-2007 were Bangladesh, Pakistan and Sri Lanka (down from 15 per cent of the portfolio to two per cent), and several countries in the Americas (down from 17 per cent to four per cent). All these shifts are consistent with CDC's mission and Investment Policy. The recent shifts towards China and India were not discussed between DFID and CDC, although DFID is reducing its own aid in China.

Maximising the focus on the poorest countries

3.10 A key aspiration for DFID since late 2006 has been to develop a new Investment Policy for the post-2008 period that would steer CDC closer to, if not as far as, DFID's own 90 per cent focus of its resources on Low Income Countries. CDC has argued that an increasingly higher focus on poor countries might destroy value in CDC by delivering lower investment returns, resulting in less capital available for investment in later years, or financial losses that would harm CDC's reputation with partner investors. CDC believes that there is limited capacity in these countries to accept further equity investment.

12 Distribution of CDC's investment portfolio in countries where it is permitted to invest

A quarter of CDC's portfolio is in countries with low or very low foreign investment and where doing business is not at its hardest (dark blue cells). The percentages show the proportions of CDC investment in each category.[4]

Countries' success in attracting foreign direct investment[2]

Doing business ranking[1]	$$$ (Countries attracting highest investment)	$$ (Countries with high investment)	$ (Countries with low investment)	(Countries attracting lowest investment)
(Countries best to do business in) ✔✔✔	([3])	1%	18%	([3])
✔✔	([3])	28%	4%	3%
✔	([3])	13%	2%	23%
(Countries hardest to do business in) ✗	2%	([3])	([3])	3%

Source: National Audit Office analysis of CDC portfolio data and of World Bank published statistics

NOTES

1 The Rows are derived from the World Bank's "Ease of Doing Business" rankings which rank countries by their relative business-friendly governance and regulatory framework.

2 The Columns group the countries that CDC is permitted to invest in, into quartiles which express the amount of foreign direct investment into each country relative to its gross national income.

3 Denotes where CDC allocated less than one per cent of its investment resources. Figures do not add to 100 per cent.

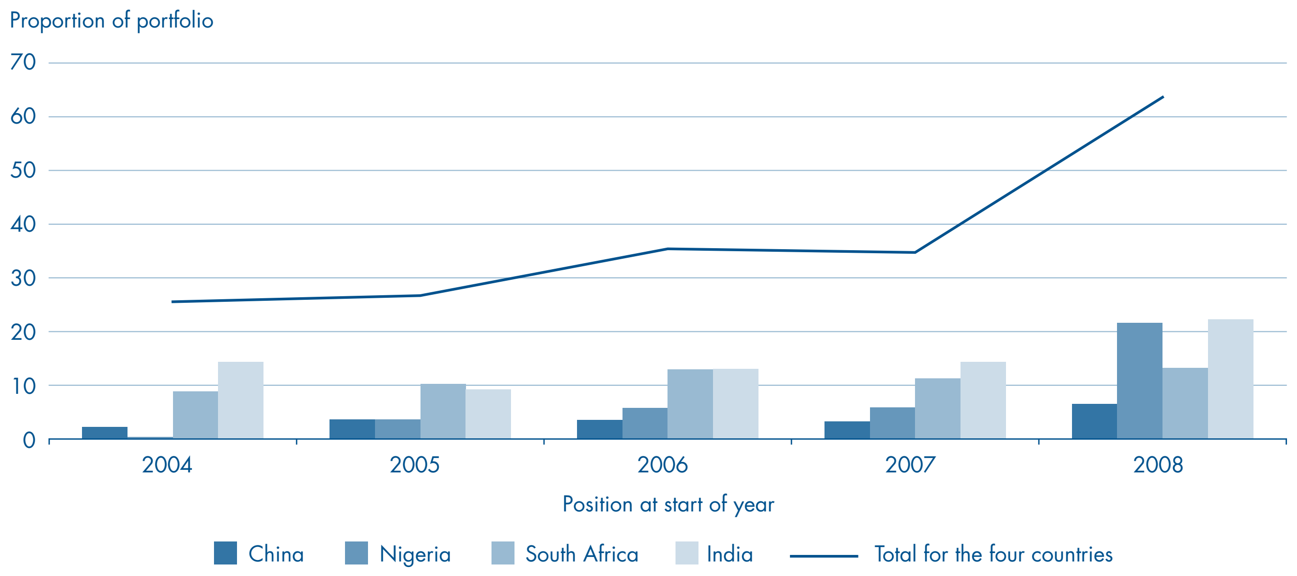
4 Percentages denote the allocation of CDC's portfolio at the end of 2007.

3.11 We found little quantified assessment of the effect on profitability of a more pro-poor investment policy in DFID's internal papers or in its documented exchanges with CDC, though the issue was frequently discussed. In practice there is little empirical research on equity returns which could help DFID and CDC in their decision-making. DFID had not applied approaches designed to deal with uncertainty, such as scenario analyses based on a range of expert assumptions. Discussions with Fund Managers indicate that high investment returns will be harder to find in the next five year period than it has been in the last. CDC's financial forecasts suggest that under the new investment policy from 2009-2013 there will be no material reduction of shareholder value, but rather continuing, albeit lower, long-term growth. The CDC Board's view is that risk will rise substantially, but also that the new policy addresses the need for more capital in low income countries where it is in short supply, particularly in the light of the recent "credit crunch".

3.12 DFID and CDC have also considered whether low income countries have the capacity to absorb substantial further private sector investment. CDC's own analyses estimated that annual demand for responsible private equity fund investment in low income countries would be only $600 million between 2009 and 2010, compared to the $1 billion of funds available if CDC were to match DFID's own threshold of 90 per cent invested in low income countries. But alternative indicators suggest that Sub-Saharan Africa is not near investment saturation. A World Bank study showed that enterprises complain more about lack of finance in Africa than in other regions, and are less likely to use external finance, factors which impede their growth.[6] CDC has emphasised to DFID other constraints, such as weak governance, legal and banking systems, political instability, and a shortage of qualified fund managers or other intermediaries in Sub-Saharan Africa, particularly outside South Africa and Nigeria. DFID's advice from a consultant in September 2008 concluded that CDC could do more to grow demand for private equity in low income countries, by developing more intermediaries and by actively supporting the development of potential investments.[7]

3.13 CDC invests in a similar proportion of available private equity funds in low income countries as it does in lower middle income countries **(Figure 14)**. When it finds the requisite quality in the poorest countries it tends to invest a greater share. The Investment Policy has deliberately restricted CDC's take-up of investments in upper middle income countries. The table indicates that CDC is, proportionately, a more significant player in funds focused on low rather than upper middle income countries.[8] DFID's new Investment Policy targets for CDC require it to focus substantially more on low income countries as defined by the World Bank, and in

13 Change in the deployment of CDC's portfolio



Source: National Audit Office analysis of CDC portfolio data

6 World Bank: Making Finance Work, November 2006.

7 DFID commissioned this short study in August 2008 from consultant Lisa Curtis to assess options for maximising development impacts and managing the financial and operational implications of the new Investment Policy targets developed for CDC.

8 In some markets there is a shortage of suitable fund managers and this can be an important constraint on CDC's operations.

Sub-Saharan Africa **(Figures 15 and 16 on page 22)**. The 2004-08 Investment Policy categorised poor countries as those with Gross National Income (GNI) per head less than US$1,750. The new Investment Policy revises this limit to US$905.

Implications of CDC's business model

3.14 CDC does not invest directly in businesses, but relies on Fund Managers to set up funds in suitable countries and sectors. Such Fund Managers must see prospects for a commercial return, often in areas where the rest of the private sector has been reluctant to commit, and where returns traditionally have been lower. For example investment in small and medium enterprises (SMEs) is one of the main finance gaps in Sub-Saharan Africa, a shortfall evident during our visit to Kenya. But the smaller deal size involved in this sector increases Fund Manager costs, relative to the value of an investment portfolio, and difficulties in selling these small investments can militate against equity finance. That has led some funds to increase deal size, moving out of small business finance. For example, Aureos, the main Fund Manager established through CDC to specialise in SMEs, has greatly increased its total investment in small and medium enterprises. It inherited in 2001 a £38 million legacy portfolio of 139 companies, with a book value of some £270,000 invested per company. At the end of 2007 it maintained total investments of over £120 million in 64 companies, an average investment per company of £1.9 million. Currently, investments in SME funds account for four per cent of the value of CDC's portfolio, although 40 per cent of underlying companies were valued at $25 million or less. CDC invests in microfinance businesses and SMEs through 37 specialist funds, 30 per cent of its funds by number.

3.15 CDC has also argued that moving away from its equity finance model, or moving still further into low income countries, might precipitate departures of CDC staff. CDC contends that without some exposure to more sophisticated markets it would be impossible to attract and retain a first rate team: staff need to maintain skills and contacts in mainstream equity finance; and deals in middle income countries can be of larger scale. The risk is hard to quantify. CDC has reported no undue difficulty in attracting or retaining professional staff since 2004. Some 17 of the 19-strong fund management team have been recruited from outside the organisation, and only one of the team has voluntarily left over this period, despite a period of uncertainty since late 2006 over the future Investment Policy. CDC has, however, told us of able staff in the market who have declined to join CDC at the salaries it can offer.

3.16 Since 2004, CDC has pursued certain investments with higher risks and lower expected profitability than in the rest of its portfolio, in return for longer-term market building benefits. This type of investment appeals to DFIs of other countries and sometimes to philanthropic investors rather than to traditional private sector investors. These investments represent some 15 per cent of CDC's new investment since 2004. CDC invests in this way where it considers there will be particular benefits for economic development. Examples of such investments include:

- several funds which support small banks and microfinance institutions, and which typically make small loans of several hundred dollars to small scale entrepreneurs in developing countries;

14 CDC's investment in known equity funds for emerging markets

	Number of countries in CDC universe 2006	Proportion of known funds that CDC invests in	CDC's average share in each fund %
Upper middle income countries	40	1 in 9	16
Low middle income countries	56	1 in 5	22
Low income countries	53	1 in 6	29

Source: CDC

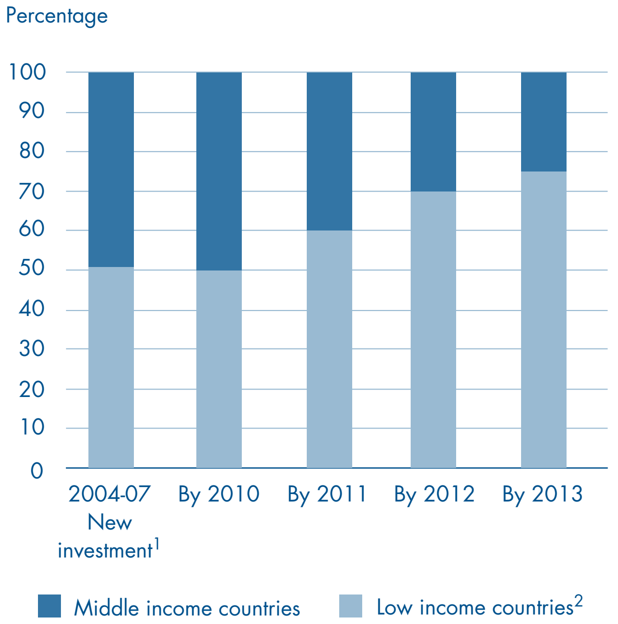
NOTE

For this analysis, countries were classified according to World Bank definitions of Gross National Income per head: with low income countries as up to $905, LMICS up to $3,595 and UMICS up to $11,115.

- investment in Grofin's (a private Fund Manager) East Africa fund which focuses on higher risk start-up and early-stage small businesses in the range of $50,000 to $1 million, so addressing the finance gap between microfinance and private equity; and
- supporting the development of new Fund Managers in Nigeria to benefit the development of that economy generally.

3.17 CDC's Investment Policy for 2004-2008 required investments that sought to offer a commercial rate of return compatible with the risk being undertaken. The Policy stated that the demonstration effect of these returns was key to mobilizing private finance. There are no criteria agreed with DFID by which CDC balances commercial and wider benefits, such as opening up and developing new markets for private equity investment.

15 Comparison of CDC's new investment distribution and the revised focus on low income countries



Source: National Audit Office analysis of CDC portfolio data

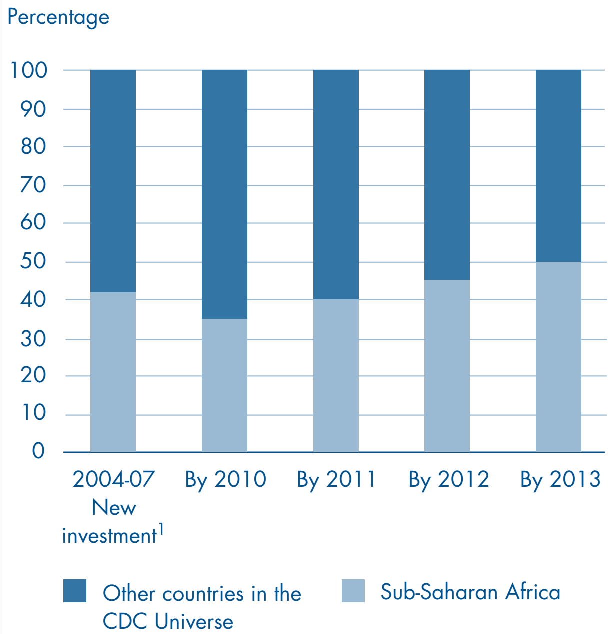
NOTES

1 This figure is for new investments made between 2004 and 2007. The proportion of CDC's total portfolio value invested in low income countries at the end of 2007 was 65 per cent.

2 Low income countries are categorised as those with a GNI per capita of US$905 or less. Middle income countries are categorised as those with a GNI per capita less than US$11,115, but more than US$905. Categorisations are made by the World Bank and are for 2006.

3.18 Fund managers we interviewed questioned the ability of a "fund of funds" business to secure the breadth of development benefits that DFID hopes CDC can deliver. They doubted whether higher risk and lower return investments were compatible with a commercial business model. Frontier funds tend to be smaller but are time-consuming for CDC and Fund Managers compared to more commercial funds because CDC's mentoring role to advise and nurture these funds is more onerous. DFID and CDC are considering how far some of these needs should be addressed through other instruments used to stimulate private sector investment in low income countries, but still through intermediaries rather than by direct investment by CDC. Recent consultant advice to DFID (paragraph 3.12), states that the fund of funds business model is suitable for pursuing different types of investment to meet the needs of both conventional commercial and many other stakeholders, if CDC can clearly communicate its strategy and objectives to diverse audiences.

16 Comparison of CDC's new investment distribution and the revised focus on Sub-Saharan Africa



Source: National Audit Office analysis of CDC portfolio data

NOTE

1 This figure is for new investments made between 2004 and 2007. The proportion of CDC's total portfolio value invested in Sub-Saharan Africa at the end of 2007 was 56 per cent.

PART FOUR

Tracking CDC's development results

4.1 DFID uses CDC's financial performance as its principal indicator of development impact. While a critical factor, it needs to be supplemented to assess fully CDC's contribution to poverty reduction. CDC sets ethical investment standards – its 'Business Principles' – and has recently updated these to reflect international best practice. During 2004-2008 there was no detailed or representative reporting to DFID on the extent of compliance with business principles, with partial reporting from Fund Managers to CDC, mostly for improvements to health and safety standards. CDC has begun to extend its information on development results beyond financial performance, but is constrained by its ability to obtain relevant data from more than 60 private sector fund managers.

Financial performance and development results

4.2 Profitable investments are likely to contribute to economic growth, and through growth to poverty reduction. Research shows that growth is an essential, although not always sufficient, precondition for poverty reduction.[9] It also suggests that strong growth depends in turn on high rates of investment. The particular effect of foreign direct investment (FDI) on growth is however difficult to disentangle from other factors such as the regulatory and legal systems or infrastructure development. Private foreign investment typically flows to markets where the other factors are already perceived to be favourable.[10] CDC's role is to test new opportunities and act as a catalyst for other investors. Strong CDC returns in countries initially lacking investment, which subsequently attract substantial private equity investment, would suggest such an effect. CDC's investments are rarely significant compared with total FDI in any country, however, making it impossible to attribute overall changes in macroeconomic growth to its own investments **(Figure 17)**.

4.3 There is no academic research examining DFIs' contributions to economic growth at country level. Their rationale is to provide and catalyse investment which promotes economic growth, which can in turn reduce poverty. Research on the development impact of individual investments by the International Finance Corporation showed that investee company profitability was closely associated with improvements in private sector development, such as new entrants in the market and changes in laws or regulations to improve the business environment.[11] However, the research also showed

17 Highest levels of CDC investment relative to total foreign direct investment stock, 2005

Top 7 countries	CDC investment as a share of total foreign direct investment %
Cuba	8.4
Burkina Faso	5.7
Solomon Islands	2.9
Kenya	2.5
Bangladesh	2.3
Mauritius	1.6
Mozambique	1.5

Source: National Audit Office analysis of CDC and UNCTAD data

9 For a short summary of the literature, see Overseas Development Institute, 2008, *Pro-poor growth and development*.
10 UNCTAD, 2006, *World Investment Report FDI from Developing and Transition Economies: Implications for Development*.
11 IFC, 2007, *Are Profits Made at the Expense of Development Impact?*

that profitability was not as strongly correlated with environmental and social performance or wider economic benefits. CDC has adopted business principles designed to ensure that its investments meet high ethical standards so that, in addition to their impact on poverty through economic growth, profitable investments contribute directly to poverty reduction and have no harmful side effects.

CDC's Business Principles

4.4 CDC's Business Principles reflect international best practice. They prohibit investments in arms and illegal drugs, and in companies where gambling, pornography and tobacco represent significant revenues. The principles include ethical standards for investments covering health and safety, environmental, business integrity and social issues. For example, they require investee companies to:

- provide safe and healthy working conditions for employees;
- pay at least local minimum wages;
- not employ children under 14;
- allow consultative work-place structures;
- properly record, report and review tax information;
- take account of the impact on the local community, ensuring potentially harmful effects are properly assessed, addressed and monitored.

A full list of the Principles is shown in Appendix 6.

4.5 Since CDC does not make direct investments, it relies on assurances from fund managers that companies in which they invest adhere to the Business Principles. It collaborated with a leading sustainable development charity, Forum for the Future, to produce in 2006 a toolkit to help fund managers integrate business principles into their investment decisions. CDC requires fund managers to inform it in writing of any event in a company they invest in which fails to comply with the Business Principles. In practice, DFID and CDC recognise that not all companies in the difficult markets in which CDC invests are likely to meet the business principles in full from the outset. Instead of applying them as a barrier to investing, CDC asks fund managers to ensure that companies have effective action plans in place to achieve the necessary improvements in reasonable time. The new Investment Code introduced in October 2008 updates and revises the Business Principles in light of the development of international best practice and CDC's lessons learned since 2004 (Figure 30, Appendix 6).

4.6 CDC commissions no independent verification or systematic monitoring of actual adherence to business principles, although CDC Executives and Board members maintain insights through reports from and dialogue with fund managers and periodic visits to companies. There are several instances where such visits identified further needs for improvements related to business principles and where CDC discussed how such issues should be addressed. On occasion, companies' adherence to certain business principles were audited by other bodies and CDC was a party to this information.

4.7 Other routes by which compliance with business principles may be raised include formal written notifications from fund managers to CDC of serious breaches of its Business Principles, ranging from fatalities or legal matters to conflicts of interest, of such magnitude that fund managers reported about them to CDC outside their regular quarterly and annual reporting practices. There have been nine such notifications since 2004, against a background of fund investments in over 600 companies. And over the same period DFID has received several allegations of breaches from third parties, usually non-government organisations. It considers each of these third party reports to have been unproven. DFID's normal approach has been to forward such enquiries to CDC for consideration and reply, copied to DFID. DFID has had no system for collating or analysing breaches notified to CDC or complaints.

4.8 Reporting to DFID and the public on compliance with business principles has been anecdotal. It mainly consists of examples of good practice in CDC's annual report (Appendix 6), but without systematic information on the extent of adherence or improvements across the portfolio, which DFID has not requested. The restructuring of CDC into an organisation which no longer makes direct investments has made the collection of compliance data a more extended and arduous process. CDC considers that it can positively influence a much larger number of businesses than before 2004, when CDC undertook direct investments. But as a consequence of working through intermediary Fund Managers, CDC now reports less information on compliance with business principles than it did prior to 2004, when it reported analyses of the quality of health and safety in investee companies and changes in the last year. CDC and DFID informed us of ongoing work to improve CDC's Business Principles including a requirement for independent audit of CDC's own processes (Appendix 6). In October 2008 CDC instituted enhanced arrangements for assessing compliance with business principles. Improvements include a requirement on fund managers to report immediately serious breaches or events, and a provision for on-site verification by CDC for high risk investments.

Tracking development outcomes

4.9 With over 70 per cent of CDC's portfolio invested in poor countries, where access to finance is limited, its strong financial performance can indicate an effective contribution towards economic development. Provided that sound ethical business principles are applied, the prime indicator of development impact can be financial performance, since good financial performance is associated with sustainable economic growth. The extent to which this translates to poverty reduction and social development is harder to demonstrate, particularly since these will be felt over the longer term. In 2004, DFID set out the need to agree an effective system for monitoring CDC's development impact, in addition to monitoring CDC's financial performance and compliance with the Investment Policy and Business Principles. DFID has to date lacked rigorous information on CDC's contribution to development and poverty reduction, beyond financial performance. It has drawn assurance mainly from CDC's annual report, which includes good practice case studies selected by CDC: three in 2007.

4.10 CDC established its own arrangements to evaluate development impact in June 2005. Although CDC staff write very short updates on development effects of each Fund every six months, CDC issued guidance to staff to carry out a comprehensive assessment of the development performance of Funds at five and ten year intervals, indicating that it expected to complete some 22 evaluations by the end of 2008. To date CDC has completed four evaluations. CDC revised the evaluation programme because these four had revealed consistent lessons, mainly covering the quality of due diligence for investments made before 2004 under the old CDC's arrangements. It is continuing its evaluation programme, by focussing on funds in which it had invested from 2004. DFID does not receive CDC's evaluations. Without better evidence, DFID is not well-equipped to consider the benefits of its investment in CDC, for example, in relation to other aid approaches or to understand the merits of different investments – such as those targeting market development.

4.11 CDC's monitoring framework uses four overarching development outcome criteria (with detailed explanations) against each of which it makes a subjective judgement. Financial performance accounts for just under half of the overall judgement on the fund's development impact. The criteria are:

- **business performance**, which rates the fund's financial performance relative to returns expected at the outset;
- **economic sustainability**, which assesses the profitability of underlying investments and levels of additional debt raised and may also consider other benefits, such as the provision of social services or training;
- **environmental and social effects**, rating the capability of the fund manager to assess environmental, social, health and safety risks accurately and noting good practice which goes beyond CDC's own standards; and
- **private sector development**, the extent to which CDC's investment supports the development of the private equity industry, local entrepreneurship and spreads the benefits of growth and private sector development throughout the economy.

4.12 CDC evaluates performance at fund level, rather than for individual companies, based on information supplied by the fund manager. Gathering information can be challenging for CDC, because not all fund managers are used to responding to such requests. The four evaluations completed by CDC to date are high level analyses, based on judgements by CDC investment managers using mainly financial and qualitative information. The evaluations contain detailed financial performance data, but lack summarised quantitative data on other development effects. One of the latest evaluations, however, offered a fuller narrative on private sector development and environmental, social, health and safety effects (Appendix 7).

4.13 DFID has not relied entirely on information from CDC's annual reports. Exceptionally, in 2007 it requested a full report on the development benefits of CDC's largest single investment, in Globeleq, a multinational company investing in power in emerging markets. CDC told us that they and the Fund Manager Actis jointly commissioned consultants, whose terms of reference were to "assess the achievements in human terms of CDC's investment in Globeleq" and how its sale would "fit into and strengthen CDC's overall development strategy". Actis approached Arthur D Little to carry out the review for CDC, and DFID received a draft in January 2008. A much shorter version of the report was published in July 2008, following close involvement by CDC and Actis. The review focused on evidence of Globeleq's benefits, rather than its net impact, so the evaluation did not represent a balanced view of Globeleq's development effectiveness.

4.14 CDC has less information on the non-financial aspects of the development effectiveness of its investments than do some other DFIs. CDC has not specified a set of development impact indicators, unlike the International Finance Corporation's listed equity arm, which also makes indirect investments through funds. CDC is now improving its monitoring in this area, having recruited a full time specialist in April 2008. From April 2008, CDC has started to monitor routinely several selective indicators of development performance, including employment and taxes.

4.15 Single indicators cannot adequately represent the development impact of a diverse range of investments, and over-concentration on a few indicators, such as jobs created, could lead to perverse behaviours. Collecting reliable information on development outcomes (beyond financial performance) and attributing it to CDC's investments would require investing in a broad range of data on many investments over a long period, and might not prove conclusive. But these new indicators will bring CDC's standard monitoring more into line with the indicators used by the International Finance Corporation's fund of funds business.

PART FIVE

CDC's governance

5.1 This section examines DFID's 'light touch' governance arrangements for CDC, the Company's accountability for results, DFID's ongoing oversight of the business, and the consequences of these arrangements. It also evaluates CDC's remuneration arrangements, which are important in shaping its staff incentives and securing value for money. In 2008, DFID – working with the Shareholder Executive and CDC – has made significant changes to the way governance and remuneration arrangements operate, and we report on the latest proposals.

DFID's approach to CDC's governance

5.2 DFID has a deliberate policy of avoiding direct involvement in CDC's business, stating in 2004 that "the Secretary of State intends to agree objectives and a clear remit with the CDC Board and then hold the Board responsible for the delivery of these, and to continue to leave the day-to-day management… to CDC". [12] This relationship reinforces the practice that individual investments are made on sound commercial grounds, and that civil servants lacking commercial expertise do not intervene in specialised investment decisions. By not being involved in day-to-day business, DFID can in principle better hold CDC accountable for results. Such a relationship requires DFID, as a public sector shareholder, to state the extent to which CDC is to be run as a commercial business, to set appropriate objectives and exercise effective oversight of CDC's performance.

5.3 DFID deploys limited staff to oversee CDC; some 1.5 full time staff at a full cost of about £120,000 per year.[13] This figure includes five per cent of the time of a Director General, and 20 per cent of the time of a head of department. DFID is also advised by the Shareholder Executive, which deploys 0.8 of a person to support oversight of the Government investment in CDC. Staffing has been less than that typically dedicated by government departments to oversight of other government owned businesses. These resources are stretched thinly across a wide range of routine, reactive and strategic activities including:

- quarterly monitoring of CDC's business, such as reviewing the results of investments, plans for new investments and cash flow;
- handling Ministerial, Parliamentary, public, and media contact and enquiries concerning CDC; and
- since late 2006, pursuing major strategic changes to CDC's business, chiefly the new Investment Policy, a new basis for executive remuneration, refreshing the composition of CDC's Board, and discussions over the ownership of CDC.

5.4 DFID sponsorship of CDC has evolved, particularly in considering the new Investment Policy, which has spurred much fresh analysis of CDC performance and prospects. There have, however, been occasions in the past when DFID did not pick up or respond quickly enough to some issues. Besides not reacting promptly to higher than expected levels of executive pay (paragraph 5.14):

- DFID were not initially aware of the extent to which CDC had already committed the proceeds from the £620 million sale of Globeleq in 2007 to specific follow-on investment, potentially limiting the extent to which the new Investment Policy could direct a change in the targeting of the portfolio.

12 Memorandum of Understanding between DFID and CDC, 2004.
13 DFID calculations.

- DFID has routinely reviewed CDC forecasts for total future investments, but there has been limited analysis of this pipeline of future investments, to inform consideration of issues such as the need for CDC to hold rising cash balances (Part 2), or the speed with which changes in the Investment Policy would lead to changes in overall investment patterns (Part 3).

In addition to receiving advice from the Shareholder Executive, DFID has had to learn from experience how to challenge on a well-informed and expert basis CDC estimates of the commercial implications of a greater pro-poor emphasis in the Investment Policy. In August 2008 it commissioned a consultant to help it evaluate these issues (paragraph 3.12).

5.5 DFID's specific targets for CDC have been limited to geographical targets for investments (Figure 9), joint investment (Paragraph 2.7) and financial performance. The requirement for at least a five per cent financial return (Paragraph 2.3) represents a threshold level of profitability, not a target, and is little use as a basis for interpreting financial performance. CDC's projections were set out in its 2004 business plan, which was used primarily as a five year Corporate Plan and did not clearly state which of the projections it contained were fixed targets for the five year period, or forecasts that needed to be revised annually. Businesses owned by the UK public sector typically have a medium term Corporate Plan setting the direction of the business over the coming three to five years, underpinned by an annual operating plan revised in the light of changing circumstances. CDC has provided DFID and the Shareholder Executive with its updated operating plans through its quarterly reports to the shareholder, though without explicit and approved revision of targets in the 2004 plan. CDC updated key business plan targets internally, although DFID did not see, or request sight of, these updates. In contrast, the International Finance Corporation, though admittedly a much larger organisation than CDC, has a corporate scorecard which sets clear targets for the next three years and which shareholders review and approve annually.

5.6 Aside from the absence of revised business plan targets, CDC's reporting on financial performance has been strong. Both DFID and the Shareholder Executive have worked with CDC to develop the format for quarterly reporting, which has improved since 2004 and provided updates against CDC's business plans. Appendix 8 shows that in some 80 per cent of areas, CDC's financial reporting is already in line with best practice in the private sector. It identifies specific areas for improvement, including the need to report on poorly performing investments. DFID's information on the full operating cost of the business model has also been incomplete, because CDC is not required to report in full on the extent of fees and profit sharing to all Fund Managers.

5.7 Whilst recognising the importance of financial performance to development results (paragraph 4.2), in 2004 DFID also recognised the need for CDC to report separately on other aspects of development results. DFID was not closely involved in CDC's efforts to track development impacts of CDC's investments beyond their financial performance: CDC took the lead in deciding what to monitor and report. CDC launched its method for evaluating development impact in June 2005, without consulting the Department as to the approach. DFID had required achievement of development results to be one factor in staff remuneration, but it was not until July 2006, two years after the restructuring, that CDC developed a framework to link staff rewards with an assessment of the development performance of funds. CDC did then consult, and DFID approved these proposals without comment, although these again included rewards for financial performance, which although important, was already strongly incentivised.

Corporate governance in CDC

5.8 The quality of CDC governance is an important source of assurance to DFID, as a shareholder. We found that CDC's governance model is consistent with good practice against generally accepted corporate governance standards.[14] Positive features include:

- a clear differentiation between the roles of Chairman and Chief Executive;
- a majority of non-executive Board members; and
- clear Board statements concerning the prospects for the business in its Annual Report and Accounts.

Although this model is good, there have been concerns over the way it has worked in practice.

14 Specifically, the Combined Code on Corporate Governance 2006, and OECD Principles and Guidelines 2004, 2005.

5.9 Until early 2007, DFID and CDC's Board had a positive relationship. Subsequently, during strategic discussions on CDC's future, DFID and the CDC Board took different positions over CDC's future investment policy, executive remuneration framework and the Company's responsibility for mobilising third party capital, although both parties had reached agreement on many important areas by October 2008. DFID's letter of appointment to CDC's Chairman in 2004, drawn up by DFID with support from the Shareholder Executive, was not as clear in emphasising his obligations and responsibilities to the shareholder as revised arrangements proposed by DFID with input from the Shareholder Executive in October 2008 and currently being finalised. The Shareholder Executive and CDC told us that DFID had engaged closely with the CDC Chair and Chief Executive, but not the two DFID-appointed non-executive directors, one of whom it had appointed in 1997. Service of over 10 years is not normally seen as conducive to maintaining the independence of non-executive directors from management. DFID and the Shareholder Executive recognised in 2007 that CDC's Board needed to be refreshed and were progressing this action at the time of our examination, beginning with the appointment of a Chair designate.

Remuneration

5.10 The right to be consulted on, or consent to, the remuneration policy for CDC's executive staff is an important part of the governance levers at DFID's disposal, and also affects CDC's value for money. Remuneration has the potential to align staff incentives with the objectives of the business as set by the shareholder. DFID set a remuneration framework for CDC in 2004, taking into account advice from the Shareholder Executive. Executive pay is determined by a Remuneration Committee comprising non-executive members of the CDC Board.

5.11 As a deliberate principle of the 2004 reorganisation, CDC planned to provide strong incentives for its staff, through both annual and longer term bonuses, to achieve high financial performance and other development impacts **(Figure 18 overleaf)**. In practice, however, monetary incentives for staff to pursue non-financial development objectives have been weaker than incentives for financial performance.

- In respect of Business Principles, an annual bonus is payable unless there has been a breach 'within CDC'. This includes CDC's obligation to sign fund managers up to comply with Business Principles. It does not cover actual levels of adherence across the relevant portfolio, for example by sampling adherence to health and safety or environmental regulations.
- CDC's contribution to mobilising third party capital, one of CDC's core objectives, is extremely difficult to measure. Assessment of this was underdeveloped in 2004 and remains so.
- CDC's Board first put in place a framework for calculating the development element of the long term bonus in mid-2006, two years after the bonus system was introduced. Until then the development component of executives' bonuses was scored through judgements made by the Board Remuneration Committee without objective criteria to guide them.
- In practice, just over ten per cent of the total long term bonus reflected assessment of non-financial development results, the balance being financial performance and incentives to improve the measurement of development effectiveness.

5.12 Consultants engaged by CDC in 2003 originally recommended that financial performance should represent 65 per cent of the long term bonus. DFID subsequently ruled that this was too high and set it at 40 per cent in 2004. However, DFID allowed CDC's Board the flexibility to adjust the weightings without reference to Government, against explicit advice from the Treasury to the contrary. DFID wished to set a flexible framework within which CDC should work so that Ministers would not need to be consulted on a regular basis. CDC applied a 55 per cent weighting from 2005, without reference to DFID. CDC told us this was because it considered that it had progressively less influence on the co-investment of third party capital and more on financial results.

18 CDC staff bonuses 2004-2008

Bonus type	Maximum annualised value[1]	Means of assessment	Content
Annual bonus	125 per cent of salary	discretionary judgement based on annual appraisal	■ Compliance with Investment Policy ■ CDC financial performance and 'reputation' ■ personal objectives[2] ■ breach of business principles within CDC
Long term bonus	200 per cent of salary (240 per cent for Chief Executive)	mechanical calculation	■ 55 per cent financial performance ■ 25 per cent joint investment/third party capital ■ 20 per cent development (but in practice, nearly half of this is financial performance and improving measurement)

Source: CDC and advice by Towers Perrin to CDC

NOTES

1 Values for 'on target' performance were set at half this level.

2 Various objectives, likely to include both financial targets, and new business deals.

5.13 In 2004 DFID deliberately designed a remuneration framework that allowed the CDC Board flexibility to set strong performance incentives for its staff. DFID sought to position CDC just above average pay in comparator organisations, so that "together with the attractions of working in CDC for the benefit of poor countries, this policy should enable CDC to recruit and retain high quality staff". DFID had recognised that higher than expected returns would lead to higher pay. But it also saw the need to indicate an upper pay threshold for 'exceptional performance'– an aspect reflected in principle in CDC's pay structure. DFID's 2004 framework provided estimated remuneration levels for 'on target' to 'exceptional' performance (including bonuses) for the Chief Executive and Senior Executives. These ranges were based on a comparison group which averaged remuneration packages in:

- staff in other Development Finance Institutions, where pay is lower;
- UK pension fund managers; and
- Managers of private equity fund of funds where pay is higher.

5.14 In setting CDC staff pay over successive years, CDC's Board were rewarding exceptional financial performance. The Board departed from the three-way comparison group stipulated by DFID, however, in focusing on what they considered the most relevant comparator – private equity fund managers. Taking these two factors together, the Board approved remuneration from 2005 onwards which exceeded the levels set in 2004 as requiring consultation with DFID.

5.15 CDC advised DFID in writing each year about its Remuneration Committee's proposals for the Chief Executive's total remuneration, but this document did not detail the basis for those proposals. The Chief Executive's proposed bonus for 2007 was reduced following discussion. DFID and CDC did not discuss levels of senior executive remuneration. CDC informed DFID that remuneration proposals complied with the 2004 Framework: CDC interpreted the Framework as having evolved under discussions each year; DFID believed CDC was confirming compliance with the three-way comparator group. The 2004 Framework did not require CDC's Board to report actual pay levels, and did not specify how the 2004 maximum estimated levels **(Figure 19)** should be updated over the next five years. The National Audit Office conclude that CDC should have sought formal approval to depart from the tripartite comparator group; while DFID should have drafted a more precise remuneration policy, and monitored its application more vigorously.

5.16 Throughout its decisions on remuneration DFID has, with support from the Shareholder Executive, sought expert independent advice. Although remuneration has been higher than originally expected, it has remained below median pay levels in the private equity fund of funds sector. Reflecting advice from the Hay Group in 2008, DFID and the Shareholder Executive now agree with CDC Board that private equity fund of funds is a better comparator group than the three-way blend. DFID intend a competitive and results-driven remuneration framework to be an important signal to potential co-investors that CDC is run to achieve excellent financial results. DFID and the CDC Board are now finalising a revised remuneration package, based on distributing a share of CDC's profits between its staff. The future scheme provides a more even balance between commercial returns and incentives to deliver development results and to invest responsibly in more difficult regions. There are a number of important design considerations relevant to good value for money:

- Taking into account that since 2004, the position of CDC's remuneration relative to the market has been sufficient to ensure the retention of a highly successful investment team.
- The timing of the change in the remuneration scheme coincides with a significant fall in the value of emerging market investments – care is needed to ensure an appropriate baseline for measuring future financial performance.
- The need to rigorously test the remuneration framework by simulating its payouts under different scenarios, including 2004-2008 performance. This should help ensure that CDC's staff are fully incentivised to perform against all areas of the business which matter to DFID.

In March 2008, CDC and DFID started a process to improve the future governance of remuneration by revising the terms of reference of the CDC Board Remuneration Committee and agreeing a clear annual process for CDC to follow in setting pay and in reporting outcomes and compliance with the framework to DFID. These elements will be incorporated in the 2009-13 remuneration framework.

19 CDC remuneration exceeded DFID's threshold for consulting DFID

	Upper threshold to consult DFID (2004)[1] £	Private equity benchmark (2004) £	Actual total remuneration[2] 2004 £	2005 £	2006 £	2007 £
Chief Executive	466,000	400,000 to 620,000	383,000	705,000	861,000	970,000
Senior Executives[3]	205,000	175,000 to 264,000	130,000	316,000	380,000	435,000

Source: CDC Annual Reports, DFID Remuneration Framework 2004, CDC notes on remuneration

NOTES

1 Thresholds were calculated at 15 per cent above DFID's estimated remuneration ranges set in 2004.

2 Amounts are rounded to nearest £1,000.

3 These figures do not represent any particular individual, but are an average of portfolio directors remuneration. In late 2007, at DFID's request, CDC reported on senior executive pay for 2006. Previously, CDC had shared information on all staff remuneration for 2004, but in other years, information was neither requested by DFID nor reported by CDC.

APPENDIX ONE

Study methodology

Review of all documentation held by DFID

We reviewed DFID's records relating to CDC since mid-2003, comprising over 500 documents, covering:

- monitoring information requested and collected by DFID;
- DFID's communications with CDC and the Shareholder Executive;
- information provided by CDC to DFID on its development impact methodology, Business Principles, remuneration framework, and investment portfolio;
- policy and strategy documents, including internal notes and submissions to Ministers, to understand the rationale and mechanics of the different governance levers DFID used to direct CDC as well as DFID's.

Using this information, our analyses included:

- collection and assessment of performance information provided by CDC to DFID;
- assessment of the evolution of CDC's reporting to DFID, through quarterly and annual reports;
- a mapping of the targets and governance levers which DFID has available and uses to provide strategic direction to CDC;
- ongoing consideration of DFID's and CDC's proposals to update various parts of the current arrangements, against weaknesses identified.

Our analyses focused on the extent of DFID's oversight over CDC and the information available to DFID for taking decisions. In particular it considered DFID's knowledge and consideration of:

- the rationale for restructuring CDC in 2004;
- the financial results to date of CDC's investments;
- information on the developmental results of CDC's investments;
- the evolving relationship between DFID and the CDC Board;
- CDC's Investment Policy, development impact evaluation, Business Principles and remuneration framework.

Benchmarking against other Development Finance Institutions

We benchmarked CDC against other Development Finance Institutions, chosen to reflect a range of financial instruments, regional spreads, ownership structures and include both national and multinational institutions. We collected information through a survey (eight responses received out of 10 issued) and publicly available sources. We collected information on their:

- ownership, governance structure, objectives and investment approach;
- staff remuneration;
- investment targets and concentration in low income countries;
- procedures for monitoring development impact and business principles;
- financial performance.

Our benchmarking review established:

- the different institutional context and objectives for CDC compared with other organisations;
- CDC's approach to investing compared to other organisations;
- CDC's financial performance and focus on particular geographies and poor countries compared with other organisations;
- CDC's approach to measuring development impact compared with other organisations.

We also reviewed two reports comparing Development Finance Institutions:

- *comparative analysis of European Development Finance Institution members*, 2007;
- review of *Development Effectiveness Measuring and Reporting in IFC and its Comparator Organisations*, Anders Grettve 2007.

Interviews

We carried out 20 detailed semi-structured interviews with individuals from key organisations between February and July 2008. DFID also responded to a structured questionnaire on its oversight of CDC.

DFID staff directly responsible for CDC and financial sector specialists.

Shareholder Executive staff directly responsible for CDC.

CDC Board and Management.

Actis (CDC's largest Fund Manager).

Aureos (Fund Manager specialising in small and medium sized enterprises).

HM Treasury.

Overseas Development Institute (a leading UK-based development think tank active in evaluation of Development Finance Institutions).

Forum for the Future (a leading UK-based sustainable development charity, which helped CDC develop its toolkit on environmental and social governance).

Policy Practice (a development consultancy which provided advice to CDC and DFID on reorienting CDC's portfolio towards poorer countries).

Key areas of our enquiry included:

DFID

- DFID's oversight of CDC, rationale for the structure and use of governance arrangements, and views on CDC's performance.

Shareholder Executive

- governance arrangements for CDC and the relationship with CDC's Board.

CDC

- CDC's relationship with DFID;
- rationale for CDC and how CDC's investments relate to development results;
- work in progress on development impact measurement.

Actis and Aureos

- their role and interests as CDC's Fund Managers;
- procedures to monitor development impact and Business Principles.

HM Treasury

- their role in setting targets and the accounting regime for CDC.

Overseas Development Institute

- how CDC compares to other Development Finance Institutions.

Forum for the Future

- views on CDC's Business Principles.

Policy Practice

- views on CDC's development focus.

Consultation with non-governmental organisations

In April 2008, we invited contributions from interested UK-based non-governmental organisations, coordinated via the UK Aid Network. We received one written submission (Christian Aid) and also held a meeting at our offices (Christian Aid, Save the Children UK, UK Aid Network) to discuss their views on CDC and DFID's oversight of CDC.

The consultation established:

- their views on CDC's investment structure and how this relates to development impact;
- the extent of information available in the public domain on CDC.

Consultancy review

Between March and June 2008, we engaged KPMG to evaluate:

- CDC's financial reporting compared with best practice in the private sector.
- CDC's cash management compared with best practice in the private sector.
- trends in CDC's investment portolio, CDC's portfolio management and reporting.
- CDC's compliance with best practice on corporate governance.
- CDC's remuneration framework compared with the private sector and Development Finance Institutions.

KPMG were selected in competitive tender through the NAO's Strategic Partners framework. An internal NAO team reviewed the work in detail to provide quality control.

Key findings included:

- CDC is broadly in line with best practice in the private sector in financial reporting and corporate governance standards, although there are specific weaknesses which need addressing.
- CDC is constrained in cash management by HM Government restrictions.
- comparable pay levels in the private sector and Development Finance Institutions.

Field visit to Nairobi, Kenya

In May 2008, we briefly visited Kenya for direct experience of the work that CDC and its fund managers undertake there.

- we observed a fund review meeting, where CDC and other investors met with a fund manager to review progress in individual investments;
- we interviewed three fund managers, covering the areas where they invest, trade-offs between securing development results and commercial returns, relationship with CDC;
- we interviewed donors operating in Kenya, including DFID (which does not get involved at an operational level in CDC's investments), World Bank, several European donors, and donor-funded private sector support services to assess the key constraints to private sector development in Kenya and the East Africa region;
- we visited an investee company, where we toured an industrial plant and met with the director to hear his views on the business and the difference that CDC and other investors had made.

The visit informed our understanding of:

- CDC's complete investment cycle from inception to investment to disinvestment;
- the operating environment for CDC's investments;
- constraints on private sector development, including access to finance;
- due diligence processes used by CDC and fund managers;
- trade-offs faced by CDC, its fund managers and investee companies.

Quantitative analysis

We analysed various performance data on CDC's investments available in the public domain, and provided by DFID and CDC.

- We reviewed data on CDC's portfolio of investments to calculate trends in country and sector exposure, share in low income countries and average investment values.
- We reviewed CDC's financial performance to calculate trends in key performance indicators, including growth in net assets, profitability, overheads and growth of cash balances compared with forecasts.

The data we received was based on hundreds of individual investments and it was not possible to confirm its accuracy against the original sources. However the various different sources we reviewed all corroborated each other, suggesting the data was reliable. Further assurance is provided through the independent audit of CDC's annual report and accounts by Ernst & Young LLP.

The analysis established:

- CDC's financial performance since 2004;
- changes in CDC's share of investments in low-income countries, by region and by sector since 2004.

Expert review

We consulted relevant experts during our scoping of this study and later to review our emerging findings and draft report. Two experts were internal to the NAO, providing specialist experience in private finance initiatives and private sector fund management. We also met with an external expert on Development Finance Institutions.

This confirmed that:

- our emerging findings covered key areas and were balanced and fair;
- our study took account of external evidence and analyses on CDC and other Development Finance Institutions.

APPENDIX TWO

Detailed Recommendations

Recommendations	Outcomes
i **CDC invests in a range of different funds and most of its portfolio has been chosen to achieve returns which would attract more commercial investors to developing countries. For 15 per cent of its portfolio, however, CDC has accepted higher risks and lower returns, aiming for longer term market building and high development benefits.** DFID should ask CDC to report separately on streams of business which follow different approaches to development objectives, and will have different financial and developmental returns.	
DFID should:	
■ Clarify the extent to which CDC should invest in market building funds with lower initial expected rates of return. This should provide CDC with a clear strategic direction on the scale of such activity, and expectations around short and long term benefits, including financial returns, third party capital mobilised and other specific development benefits.	Clearer shareholder awareness of the extent and risk of market developing investments. Reduced risk that CDC's demonstrator effect might be blurred by market development investment on an increased scale.
■ Ensure that financial reporting separates different types of investment business; and that where specific development benefits are part of the justification for the investment, they are fully monitored and reported.	
ii **The financial threshold annual return of five per cent set for CDC is of limited use as a basis for CDC investment planning or as a basis for DFID assessment of the company's performance. Emerging market indices in the period 2004-2007 have shown returns around thirty per cent, but have fallen by around 60 per cent in 2008.** DFID should set financial expectations for CDC by reference to regional market indices which better match CDC's business, or parts of that business.	
■ Provide annual targets for CDC's financial performance, including a clear rate of return target defined relative to emerging market performance on a regional basis.	A more relevant and market-sensitive basis to assess performance.
■ Require that CDC reports its financial performance disaggregated by region, size and risk profile of investee companies.	Improved shareholder ability to question whether financial performance is optimal, and commensurate with risk.

iii Since 2004 CDC's cash balances have consistently increased relative to its equity investments, and now exceed the value of investments. DFID and CDC should agree a policy governing CDC's ability to re-invest proceeds from disinvestment, which should reflect DFID's appetite for investment risk. They should also agree a protocol for assessing the amount of cash that it is prudent for CDC to hold, taking account of its future commitments and its authorised capacity to borrow. The protocol should require consultation with DFID over the use of any excess cash.

DFID should:

- Agree with CDC a definition of "Required Cash", defined as a proportion of CDC's legal commitments, which fall due within X months. The proportion should reflect CDC's historical rate of converting proposed investments at this stage of maturity into actual investments. It should also take into account the need to preserve CDC's viability as a profitable company.
- Clarify with HM Treasury what share of any surplus funds extracted from CDC could be spent through other development programmes or instruments, subject to identifying the comparative advantage of these.
- Extract funds in excess of "Required Cash" to reduce CDC's cash balances.
- Authorise a CDC borrowing facility sufficiently flexible to meet the risk of unexpected cash shortfalls, [and allow CDC to manage its own "required cash" balances to maximise interest].
- Review and revise these parameters annually in the light of CDC's record in consuming its "required cash", [and taking into account the extent to which it has earned interest on "Required Cash" above the level it would have earned at the Debt Management Office].
- Consider its own need to retain external specialist cash management advice on a periodic basis.

Better value for money by reducing the opportunity costs of excessive cash balances and financial savings in cash management.

iv CDC's investments have been more heavily targeted, compared to other Development Finance Institutions, on countries with lowest GDP per head, and the new Investment Policy strengthens this targeting for investment in new funds. DFID needs evidence on how far CDC's investments add to total private investment in poor countries, and fill a gap to which other investors have not yet responded. DFID should seek information on the range of other investor interest in the funds to which CDC subscribes, and on the financing options available to investee companies.

Evidence as to the additionality of CDC's investments will be complex to gather compared to existing measures, such as those on the extent of joint investment.

- Work with CDC to develop better understanding of market failures where private sector equity investors have under invested, and build this into the framework for targeting CDC's investments. This should include examining whether there are particular shortfalls in finance in certain regions or sectors.
- Commission research based on representative sample of post-2004 equity funds, of the extent to which CDC's participation had been essential to enabling co-investment by other investors.
- Commission research to assess the extent to which Development Finance Institutions are successful in attracting additional private finance, using both macroeconomic data and perceptions of private financiers.
- Use this information to set by 2010 a broader measure of CDC's ability to draw in extra third party investment than the current joint-investment target.

Improved understanding of CDC's contribution to development, and priorities for CDC's resources.

Clarity as to where CDC avoids "crowding out" other investors. Improved information to shape and refine successive investment policies, and to highlight areas where alternative approaches to private equity may be preferable.

v **CDC has established relevant Business Principles for ethical investment, but neither CDC nor DFID can assess the extent of compliance. DFID has asked CDC to obtain external validation only of its internal processes for implementing and monitoring the business principles.** DFID should also require CDC to provide validated, summarised information on the extent of actual adherence to business principles across its portfolio.

Although CDC receives information from fund managers on adherence to business principles it does not have systems in place to adequately assess the accuracy, independence or comprehensiveness of the information provided to them. These will take time to develop. In the short term, DFID should require CDC to:

- Maintain a record of fund managers' assessments of compliance with business principles, action plans to improve business principles, and reports against action plans.
- Assess and report to DFID on the quality of, and progress against, action plans, scoring against appropriate criteria.
- Collate all discovered breaches of Business Principles and provide periodic summary reports to DFID on overall trends and corrective actions.

In the medium term, DFID should require CDC to:

- Develop a balanced system for objective assessment of compliance with business principles, which makes it possible to track changes over time.
- Ensure that the new system is at least comparable in its coverage to the International Finance Corporation's private equity fund of funds and best practice in the private sector.
- Complement self-assessment by fund managers with more systematic independent verification. DFID needs to understand that the basis on which CDC selects funds and investee companies for verification, taking into account risk and materiality.

To provide more substantive assurance, to DFID, NGOs and others, that CDC's strong financial results have not been at the expense of business principles.

Improved scope to identify whether CDC investment leads to higher standards in investee companies, and to help identify the types of investments that pose greatest risk and opportunities.

Performance on Business Principles is measured, reported and incentivised.

DFID is better able to track the extent to which investment is leading to improvement in standards, and whether CDC is taking appropriate action to enhance this.

Increased confidence that Business Principles information is valid.

Better understanding and management of reputational and development impact risk in making investments.

vi **To date CDC has produced evaluations of the development and poverty impacts of just four of the funds it invests in**. DFID and CDC need sufficient information on impact to inform strategic decisions on where and how CDC should invest, and on what scale relative to other aid for developing the private sector.

DFID should:

- Ensure that CDC has put in place a basic data set of information on development impact which it communicates to fund managers.
- Consider a wider data set for investments where a lower financial return is envisaged in return for stronger market development.
- Ensure that CDC's evaluations of development impact provide representative coverage of its portfolio, so that all funds committed to before 2008 receive an evaluation by 2013.
- Receive CDC's summary of fund evaluations, use this to inform its strategic decisions on CDC's Investment Policy, and to inform its own programmes to support the development of private sectors in emerging economies.

Clarity amongst all participants as to what data is required.

Greater ability to inform trade-offs between financial return and development priorities.

Enhanced DFID ability to decide whether the value of its investment in CDC exceeds its opportunity cost.

vii **The Business Plan set for CDC to apply from 2004 to 2008 did not make a clear distinction between forecasts and targets.** The next Plan should distinguish key targets from internal forecasts. It should be more specific as to which targets are subject to annual revision, and which are fixed for the full period.

As soon as DFID finalises recent strategic changes, such as the new investment policy, it should work with CDC to:

- Agree with CDC a Business Plan for the period 2009-2013 which clearly identifies those formal targets to be used by DFID for assessing CDC's performance. The Plan should also clearly specify which parameters are to be revised annually, as opposed to those which are to apply for the plan period, and those which require DFID consultation or consent before amendment.
- Confirm and formalise CDC's reporting obligations to DFID, including specification of the information that CDC should update and provide annually.

More clarity on CDC's objectives.

Improved accountability for results.

To support these and other changes, and reinforce CDC's accountability, DFID should:

- Strengthen its staff and consultancy resources for oversight and review of CDC, sufficient to carry out its own detailed analyses of CDC performance and of future strategic options.

viii **DFID has created a good governance model for CDC, although there have been concerns over the way it has worked in practice. DFID has recognised the need to clarify the duties of the CDC Chairman and the Board to itself as shareholder and strengthen its lines of communication with the Board.** The new arrangements will need to provide a framework within which CDC can be held accountable for the quality of its stewardship of Government funds, and for its performance. DFID should agree with CDC the information it needs to receive to support its analysis of CDC's medium term plans and prospects.

DFID and the Shareholder Executive should use the opportunity to refresh the Board to:

- Clarify the strategic objectives for CDC through renewed letters of appointment to Board members and use this as a basis for frequent discussions with the directly appointed non-executives and Chair and to review the performance of Board members.
- Formalise the division of responsibilities between CDC's Board and management.
- Confirm expectations on the rotation of Board members and the timetable for future Board refreshes.
- Agree a timetable with the Board for key pieces of analysis needed in the medium term to support CDC's strategic development.
- Make publicly available the terms of reference for Board committees.

Clearer chain of accountability to DFID as shareholder.

DFID better able to rely on the CDC Board for independent oversight and advice.

CDC Board better informed of DFID's wishes as the owner of the business.

ix **There have been lapses in oversight and governance of Executive Remuneration since 2004, with significant departures from the agreed framework, which also contained ambiguities**. In March 2008 CDC and DFID agreed that there would be revised governance arrangements, designed to improve oversight of CDC remuneration. They are now working on a revised remuneration framework. DFID and the Shareholder Executive need to ensure that the framework provides clarity over the evidence CDC must assemble to determine remuneration, and the range of factors it must consider.

DFID and the Shareholder Executive should: ■ Re-establish clear 'on-target' and 'maximum' remuneration levels, for the Chief Executive and senior executives, and appropriate penalties for lower performance. ■ Require the CDC Board to define (in advance) what these targets mean in relation to CDC's performance against annual targets in the Business Plan. ■ Set pay at levels which reflect that CDC's need to attract staff from a commercial market, while giving full weight to CDC's status as a fund of funds, which does not compete for its funds, offers high job satisfaction, and its success since 2004 in recruiting and retaining talented staff. ■ Cross-check for compliance with agreed remuneration frameworks through examination of CDC's audited annual report and accounts, quarterly and other reports.	Better value for money. Staff rewards better linked to overall performance of the business.

APPENDIX THREE

The context in which CDC operates

Background

CDC is a UK government-owned fund, with net assets of £2.7 billion, investing in private companies in emerging markets, with particular emphasis on Sub-Saharan Africa and South Asia. Its mission is to "*generate wealth, broadly shared, in emerging markets, particularly in poorer countries, by providing capital for investment in sustainable and responsibly managed private businesses*".[15] CDC reinvests all net proceeds in its business, and has been self-financing since 1995.

DFID is the 100 per cent shareholder. With support from the Shareholder Executive[16], the Department sets the overall framework and objectives within which CDC operates, and monitors progress against objectives, but does not interfere in individual investment decisions. DFID's aim is that CDC will, by demonstrating that it is commercially viable to invest in companies in poor countries, attract private capital to areas where this is scarce and so support poverty-reducing private sector development.

CDC's predecessor was established in 1999 as a public limited company, with a brief to achieve higher financial returns demanded by private markets. Its portfolio included a large element of loan finance which was considered unlikely to achieve these higher financial hurdles. Much of the management team also changed, as part of a programme to equip the organisation to specialise in private equity investment. It also moved away from sectors such as agribusiness not expected to meet required financial returns.

The rationale for CDC

CDC is one of several means by which DFID supports private sector development, as a route to poverty reduction. DFID also supports private sector development through multilateral organisations such as the World Bank, as well as through bilateral assistance projects in developing countries, for example to strengthen regulation or to develop microfinance institutions. DFID uses CDC to address a shortage of investment finance in developing countries. It considers that this shortage is an important constraint to private sector development[17], economic growth and poverty reduction.

CDC is inherently different from DFID's other assistance to developing countries, because it aims to invest in similar ways to private financiers – to demonstrate to them that commercially attractive returns are possible through socially responsible investments in the poorest countries. CDC's mission is not to subsidise private enterprises, but to go where other investors irrationally perceive risks to be too high or returns too low, in order to demonstrate where profitable opportunities exist. The Department's objective for restructuring CDC was to achieve "a step change in CDC's economic impact and catalytic role". CDC's resources are less than one per cent of international private equity to developing countries[18], so for CDC to have a bigger impact, it would have to influence the behaviour of commercial investors. So CDC aims to invest through private equity Fund Managers as are available to commercial investors, so that others may follow.

15 CDC Annual Report 2007.
16 The Shareholder Executive is a Government agency set up in 2003 to improve the Government's performance as a shareholder in publicly owned businesses. Its role in relation to CDC is advisory.
17 Finance for All?, 2007, International Finance Corporation, shows that access to finance is a major constraint for small firms.
18 Based on Net private equity flows to developing countries in each year 2004-2007; source Global Development Finance, 2007.

CDC's investment structure since 2004

DFID completed this restructuring of CDC in 2004, and as a result, CDC no longer invests in companies directly, but instead uses intermediary 'fund managers', largely in the private sector, to invest on its behalf, selecting those funds which most closely meet its objectives. The restructuring resulted in the separation and part privatisation of the investment arm of CDC's business, now called Actis, an independent manager of private equity funds.[19] The restructuring committed CDC to investing the majority of its funds through Actis until the end of 2008, but CDC's new role as a 'fund of funds' means it also invests through some 50 other Fund Managers. DFID retains 40 per cent of the shares in Actis, but its management own the remainder, and Actis is run as a commercial operation. As a result, DFID pursues its policy objectives through its oversight of CDC, rather than Actis. Annual management fees to Fund Mangers are typically around one to two per cent of investment. The fund managers also receive a proportion of profits, typically 20 per cent, once an agreed threshold is achieved, though, where it is a dominant investor, CDC seeks to agree a sub market rate of 10 per cent. This is standard market practice for private equity funds and is intended to incentivise fund managers to make high financial returns.

CDC invests through some 60 Fund Managers, and these investments are spread across large and small companies in various sectors, including financial institutions (21 per cent), infrastructure (18 per cent) and agribusiness (7 per cent), and in various regions, including Africa and South Asia **(Figure 20)**. **Figures 21 opposite and 22 overleaf** give more details on CDC investments.

20 Changes in the distribution of CDC's portfolio (percentage by region)

	2003	2004	2005	2006	2007
Africa	34	39	45	49	60
Asia	41	37	34	30	35
Of which South Asia	*30*	*25*	*27*	*23*	*24*
Americas	22	19	18	20	5
Global/other	3	5	4	1	0

Source: National Audit Office analysis of CDC portfolio data

NOTE

2005 figures do not sum to 100 because of rounding.

21 CDC investments in Kenya

We visited Nairobi, Kenya, to understand how CDC makes its investments, meeting with CDC staff who were visiting, as well as staff from fund managers Actis and Aureos, private sector representatives and international donors working on private sector development.

Average annual income in Kenya is low at $680 per person, and foreign direct investment is only around six per cent of gross national product, compared with an average of over 20 per cent in all the countries where CDC is permitted to invest. Donors and private sector representatives told us that although a shortage of capital was a key constraint to growth, there were many other difficulties for private companies to overcome, including the quality of infrastructure, bureaucratic regulations, corrupt practices and also political instability over the recent elections. These factors all contributed to investors' perceptions of the difficulty of doing business. While large businesses tended to be able to access commercial finance and donors provided several sources of microfinance, in Kenya, it was informal sector businesses – with growth potential – which particularly lacked finance.

We visited one company, a steel plant on the outskirts of Nairobi in which CDC holds a seven per cent stake. It employs around 700 workers and recycles scrap metal collected across Kenya. This was one of several medium sized businesses in a fund managed by Aureos, and had attracted investment from other Development Finance Institutions. Other investments included companies involved in pharmaceuticals, banking, retail and ecotourism. We saw CDC's staff participate in a half-yearly meeting, where they and other investors questioned fund managers on the performance of the different businesses, received updated financial projections and a summary of progress against environmental, health, safety and other standards – a particular area of concern for CDC in the steel plant. CDC also worked with Aureos to collect information to support a more detailed mid-term evaluation of the development results of these investments.

We also met other Fund Managers, including Actis, which has a regional office in Nairobi and investment funds focusing on larger investments, including a fund specialising in agricultural businesses. A much smaller Fund Manager, Grofin, specialised in support to small enterprises requiring up to $1 million in finance, many of which do not have sufficient collateral to be eligible for loans from banks. Grofin also provides business support services, alongside financial support, to help the businesses grow and develop.

Source: National Audit Office visit to Nairobi, March 2008

19 The 1999 Commonwealth Development Corporation Act had previously transformed CDC into a publicly limited company, paving the way for the introduction of private capital through a public private partnership.

22 CDC Top 10 Underlying Investments at end 2007

	Investment	Description	Sector	Fund	Country
1	Diamond Bank	Diamond Bank delivers full banking services from a network of 120 branches throughout Nigeria and Benin, with a strong focus on the SME and corporate sectors. It employs more than 2,000 staff. In June 2007 the bank received an investment of US$134m from CDC, representing the largest single private equity investment ever made in Nigeria and CDC's largest underlying investment by value. Diamond Bank is the ninth largest bank in Nigeria with a 5 per cent market share.	Financial services	Actis Africa 2/ CIFA/ Co-Investment	Nigeria
2	Infrastructure Development Finance Co.	IDF is the largest infrastructure finance company in India, providing funding for infrastructure projects in sectors such as telecoms, IT, power, transport and urban infrastructure. The Group also provides advisory services to the Indian Government and corporate clients.	Infrastructure	Actis Assets 1	India
3	Platmin Ltd	Platmin's four key projects are located on the Bushveld Complex of South Africa, a geological structure that is estimated to contain approximately 90 per cent of the world's Platinum Group Metal (PGM) resources as well as some 80 per cent of its chrome.	Minerals, Oil & Gas	Actis Africa 1	South Africa
4	Songas	Songas provides energy to the Tanzanian national grid and industrial users in Dar es Salaam. The project includes a gas processing facility, a 225 km sub-sea and onshore gas pipeline, and the Ubungo power station, which supplies 20 per cent of Tanzania's electricity needs.	Power	Actis Infrastructure Fund	Tanzania
5	UAC of Nigeria	A public company in Nigeria, focusing on food and food services.	Consumer	Actis Africa 2 / CIFA	Nigeria
6	DFCU Limited	DFCU was founded in 1964 by CDC and the Ugandan Government. It is a commercial bank operating in the leasing, housing, finance and term lending segments.	Financial services	Actis Africa 1	Uganda
7	Mozal SARL	500,000 tpa aluminium smelter in Maputo Mozambique.	Minerals, Oil & Gas	Actis Assets 1	Mozambique
8	Moga Holdings Ltd	The leading mobile operator in Algeria with over 6 million subscribers.	Telecoms	Actis Africa 1	Algeria
9	Alexander Forbes	Alexander Forbes (AF) is a diversified financial services company that operates as an intermediary in the investment and insurance industries. AF is represented in 30 countries, with the majority of its operations in South Africa.	Financial services	Actis Africa 2/ CIFA/AAEF/ Ethos	South Africa
10	Continental Reinsurance	Continental Reinsurance Plc began operations in 1987 and is one of the largest players in the Nigerian reinsurance industry. The company offers many classes of Treaty and Facultative insurance, including Life, Fire, Engineering, Bond, General Accident, Marine, Motor and Liability.	Financial services	EMP Africa II/ Co-Investment/ Central Africa Growth SICAR	Nigeria

Source: CDC

At the time of the restructuring DFID and CDC agreed a Business Plan for the five years 2004 to 2008, and an Investment Policy designed to target CDC's investments towards the poorest countries over this period. Towards the end of this period and in parallel with our examination, DFID, CDC and the Shareholder Executive have been reviewing many of these arrangements, as well as associated matters such as the composition of CDC's Board and policies for executive remuneration.

Other Development Finance Institutions

Other countries also have Development Finance Institutions (DFIs), an imprecise term used to describe public institutions which provide financial and sometimes other assistance for private sector enterprises within developing and reforming economies. Unlike CDC, not all of these institutions have poverty reduction as their overarching aim. A half of European DFIs require investments to be tied to national interests, particularly trade.[20] Since 1997, CDC has specialised in providing private equity finance, and is unusual in making indirect investments through Fund Managers. Other institutions often provide loans, may provide cheap finance, additional advice or capacity building (forms of subsidies) and generally make direct investments, rather than through intermediaries. As a result of such differences, direct performance comparisons between CDC and other organisations can have limited utility.

CDC is now the second largest DFI, after the International Finance Corporation, part of the World Bank Group. **Figure 23** shows the relative size and geographical focus of different DFIs. Relative to other DFIs, CDC invests heavily in Africa and Asia.

23 Size and geographical focus of different Development Finance Institutions

	International Finance Corporation (World Bank)	CDC (UK)	DEG (Germany)	FMO (Holland)	All 11 other European institutions
Assets in £ million at end 2007	13,159	2,687	2,643	2,511	3,159 (average assets £287m)
Percentage invested by region					
Africa[1]	12	60	14	28	23
Asia	24	35	29	23	20
Americas	25	5	15	21	12
Central & Eastern Europe	15	0	24	18	19
Middle East / Mediterranean	11	0	8	3	9
Other	13	0	10	7	17
Total	100	100	100	100	100

Source: EDFI, and CDC annual report 2007

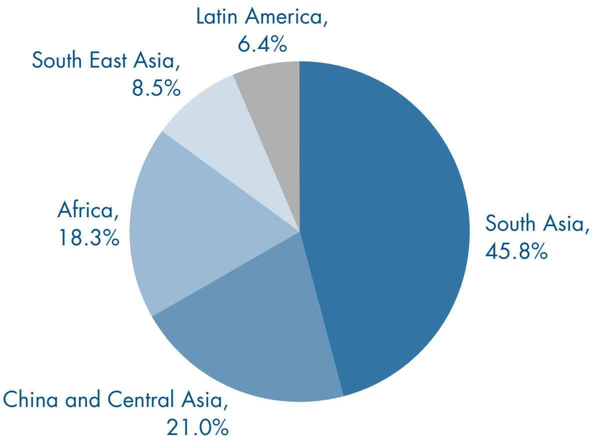
NOTE

1 Includes Africa, Caribbean and Pacific, apart from figures for CDC, which are just Africa.

20 Comparative analysis of members, European Development Finance Institutions, 2007.

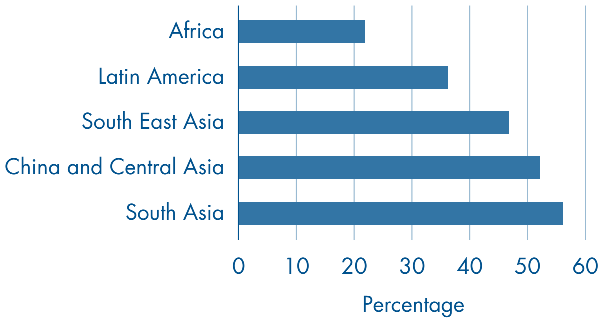
Figures 24 and 25 show that levels of joint investment vary significantly by region.

24 Third party funds jointly invested alongside CDC in new Actis and Aureos funds, by region, as a proportion of total mobilised



Source: National Audit Office analysis of CDC quarterly report to DFID, 2nd quarter, 2008

25 Third party funds jointly invested alongside CDC in new Actis and Aureos funds as a proportion of the total in each region



Source: National Audit Office analysis of CDC quarterly report to DFID, 2nd quarter, 2008

APPENDIX FOUR

Financial performance of Development Finance Institutions

Where information was publicly available, or we received survey responses from Development Finance Institutions (DFIs), we were able to compare profitability of different organisations. This comparison uses return on shareholder equity, as the most comparable statistic. As a result, figures reported for CDC differ from its growth in assets shown in Part 2.

It is extremely difficult to make meaningful comparisons on the profitability of different DFIs because of the differences in their mandates, investment tools, geographic focus and other factors. From the perspective of return on shareholder funds, **Figure 26** below shows that CDC was more profitable than all other DFIs with available data, except for in 2006, where one, the European Bank for Reconstruction and Development, was slightly more profitable.

26 Return on shareholder equity, by Development Finance Institution

Development Finance Institution	Return on shareholder equity (%)[1]			
	2004	2005	2006	2007
CDC (UK)	14	25	18	25
International Finance Corporation (World Bank), complete investment portfolio	13	21	12	18
Proparco (France)	[2]	10	9	16
European Bank for Reconstruction and Development	6	15	20	14
FMO (Holland)	7	11	15	10
DEG (Germany)	[2]	1	11	10
Norfund (Norway)	0	3	1	5
Swedefund (Sweden)	14	7	9	2

Source: National Audit Office calculations based on Annual Reports of Development Finance Institutions

NOTES

1 Return on shareholder equity is profit before tax, divided by shareholder equity at year end.

2 Data not available.

27 CDC's portfolio compared to other Development Finance Institutions

Development Finance Institution	Country	Investment portfolios as at end 2007 Mn Euros [1,3]	Share invested in poor countries (%) [4]
CDC	UK	3,789	66
DEG [2]	*Germany*	3,582	27
FMO	Netherlands	3,403	30
PROPARCO [2]	*France*	1,132	41
AWS [2]	*Austria*	498	5
IFU	Denmark	492	23
NORFUND	Norway	480	39
SIMEST	Italy	479	6
COFIDES	Spain	373	1
FINNFUND	Finland	240	7
SIFEM	Switzerland	222	37
SWEDFUND	Sweden	222	30
BIO	Belgium	126	51
SBI/BMI	Belgium	22	17
IFC	Multilateral	17,360	22

Source: European Development Finance Institutions

NOTES

1 Data includes both equity capital and loan investments.

2 DFI's without a substantial proportion of portfolio invested through equities (more than one third), are italicised.

3 IFC's portfolio is stated in euros using spot exchange rates prevailing at 31/12/2007.

4 Poor countries are defined as (1) Least Developed Countries (2) Other Low Income Countries as per definitions adopted by the OECD.

APPENDIX FIVE

CDC's role in addressing market failure

CDC's current Investment Policy focuses on poor countries, but does not explicitly address CDC's role in correcting market failure. Market failure can be measured in various ways. But if it is relatively 'easy' to do business in a particular country and it is still performing poorly in terms of attracting equity investment, this indicates a market failure which CDC and other Development Finance Institutions could consider addressing.

From 2003 to 2005 total Foreign Direct Investment (FDI) in emerging markets increased by 70 per cent. In this context CDC's role as a pioneer investor in some low and medium income countries inevitably became less distinctive than had originally been envisaged.

To better identify where pioneering investment would be most effective it is possible to construct models of relative market failure between countries. We have analysed the countries in which CDC is permitted to invest, for their relative level of market failure based on:

- World Bank Doing Business rankings from 2006 and 2007 (indicating the comparative ease of doing business), and
- World Bank statistics for Foreign Direct Investment (FDI) and Gross National Income (GNI) from 2002 to 2005, (indicating their relative success in attracting FDI weighted to the size of the economy).

We placed countries within this grid.

The next stage was to map onto this grid the allocation of CDC's investment portfolio.

Figure 28 overleaf shows that CDC's investment value held in poor FDI performing difficult markets has increased between 2004 and 2007. However, under the current Investment Policy the proportion of CDC's portfolio held in market failures has decreased (also shown in **Figure 29 on page 49**). Under the intermediated model it is important for DFID to set out an Investment Policy that focuses on these particular markets; this model is one way to do this.

28 The changing deployment of CDC's investment portfolio, 2004-07

CDC's portfolio is focused mainly on countries with low or very low foreign investment and where governance and regulation is relatively conducive to doing business.[1] The percentages show the proportions of CDC investment in each category.[2]

	Countries' success in attracting foreign direct investment, relative to gross national income			
Ease of doing business[4]	**1st quartile (Highest investment)**	**2nd quartile (High investment)**	**3rd quartile (Low investment)**	**4th quartile (Lowest investment)**
1st quartile (best to do business)	[3]	**2004[2]** **2007 1.0%** Botswana Mexico Thailand	**2004 22.5%** Pakistan Peru South Africa **2007 18.1%** El Salvador Malaysia South Africa	[3] [5]
2nd quartile	[3]	**2004 10.0%** China Dominican Republic Nigeria **2007 28.4%** China Colombia Nigeria	**2004 7.5%** Papua New Guinea Sri Lanka Tunisia **2007 3.6%** Ghana Sri Lanka Tunisia	**2004 15.3%** Bangladesh Kenya Solomon Islands **2007 2.5%**
3rd quartile	[3]	**2004 13.9%** Bolivia Mozambique Tanzania **2007 13.2%** Mozambique Tanzania Uganda	**2004 5.4%** Brazil Egypt Russia **2007 2.2%** Brazil Egypt Russia	**2004 15.3%** Guatemala India Indonesia **2007 23.3%** Guatemala India Indonesia
4th quartile (hardest to do business)	**2004[3]** **2007 1.6%** D.R. Congo Mauritania Sudan	[3]	[3]	**2004 1.8%** Burkina Faso Senegal Zimbabwe **2007 2.5%** Burkina Faso Rwanda Senegal

Source: National Audit Office analysis of CDC portfolio data and of World Bank published statistics

NOTES

1 Countries listed are those with the largest CDC investment up to a maximum number of three per quadrant for that year. Some quadrants have up to 12 CDC universe countries in them, though the average number is 10.

2 Percentages denote the allocation of CDC's portfolio at the end of 2004 and 2007.

3 Denotes where CDC allocated less than one per cent of its investment resources.

4 Derived from the World Bank's "Ease of Doing Business" rankings which rank countries by their relative business-friendly governance and regulatory framework.

5 This Top-Right cell, with highest ease of business, but lowest foreign investment, includes countries which though within CDC's permitted investment universe, are not strong candidates for pro-poor investment. It is understandable that CDC does not invest substantially here.

29 Change in distribution of CDC Portfolio between 2004 and 2007

	FDI performance			
Doing business ranking	1st quartile (high FDI relative to GNI)	2nd quartile	3rd quartile	4th quartile (low FDI relative to GNI)
1st quartile (best)	1	1	–4.4%	1
2nd quartile	1	+18.4%	–3.9%	–12.8%
3rd quartile	1	1	–3.2%	+8.0%
4th quartile (worst)	+1.6%	1	1	1

Source: National Audit Office analysis of CDC portfolio data and of World Bank and UNCTAD published statistics

NOTE

1 Less than +/–1% change in the distributed proportion of CDC portfolio.

We also did further analyses through a weighted distribution of relative CDC investment by the 'size of economies', and also by 'wealth of economies'. For the size of economies each quartile was given a combined percentage calculated by subtracting the share of GNI between 2002 and 2006 for each country within the CDC Universe from the proportion of its CDC investment value between 2004 and 2007. This gives a further perspective on where CDC's investment value is most focussed in relation to market failures.

Our analysis showed that CDC investment value held within market failures is fairly high when considering the size of those economies. DFID also intended CDC to invest as a pioneer in difficult markets and the results of the analysis demonstrate that this objective has been partly fulfilled through investment in countries such as Tanzania and Mozambique, which are receiving relatively high levels of FDI and do not have as amenable an investment climate. CDC has invested in these countries heavily in comparison to the size of their economies for over a decade and, since 2004, they have attracted increasing amounts of FDI from other sources.

However, to take into account that some economies such as Nigeria and China, are so large that CDC appears underinvested in these, we did further analysis by subtracting each countries' proportion of GNI per head of population in the CDC Universe between 2002 and 2006 from their proportion of total CDC investment value between 2004 and 2007. This provided a weighted distribution by wealth of economies.

Again CDC's investment value generally followed that which DFID intended with a relatively high proportion of investment value held in market failures. From this analysis, however, South Africa, India, Nigeria and China showed a relatively high level of CDC investment value commensurate with the relative wealth of these countries.

APPENDIX SIX

CDC's Business Principles

CDC's Business Principles are a set of ethical standards which CDC requires all underlying companies to meet. The principles include investment exemptions or prohibitions on arms, illegal drugs, gambling and tobacco, as well as expected standards in business integrity, social, environmental and health and safety issues. The Company requires its fund managers to enter into a 'side letter agreement' by which each fund manager commits to a best practice investment policy similar in form and substance to CDC's. This is supported by the following undertaking by the investee companies:

Best Practice Investment Undertaking

CDC will require its fund managers to procure that each potential investee company represents and covenants that the business of the company will be undertaken in a manner that:

1 provides safe and healthy working conditions for its employees and contractors;

2 encourages the efficient use of natural resources and promotes the protection of the environment;

3 treats all employees fairly in terms of recruitment, progression, remuneration and conditions of work, irrespective of gender, race, colour, language, disability, political opinion, age, religion or national/social origin;

4 allows consultative work-place structures and associations which provides employees with an opportunity to present their views to the management;

5 takes account of the impact of its operations on the local community and seeks to ensure that potentially harmful occupational health and safety, environmental and social effects are properly assessed, addressed and monitored;

6 upholds high standards of business integrity and honesty, and operates in accordance with local laws and international good practice (including those intended to fight extortion, bribery and financial crime);

7 promotes the use of quantified targets for Occupational Health and Safety, Environment and Social Issues and continuous improvement in relation to the same;

8 operates in accordance with local regulations or the appropriate World Bank/International Finance Corporation guidelines whichever is more stringent;

9 adopts the following minimum employment standards in accordance with internationally accepted good practice:

- not to employ forced labour of any kind;
- not to employ children under 14;
- to provide wages which meet or exceed industry or legal national minima and are sufficient to meet basic needs;

10 properly records, reports and reviews financial and tax information relating to the business of the company;

11 ensures that no payment of value is made or received (in the form of compensation, gift, contribution or otherwise) in the course of business in order improperly to induce preferential treatment for the fund manager and its affiliates; and

12 reviews this Policy periodically to ensure its ongoing suitability and effectiveness.

For investments including industrial operations:

CDC will require its fund managers to procure that each potential investee company represents and covenants that the business of the company will be undertaken in a manner that:

- Complies with local regulations on occupational health and safety as an absolute minimum. Where there is no local legal framework regarding occupational health and safety the investee company will take account of the recommendations of the following two World Bank documents as amended or supplemented from time to time:
- Occupational Health and Safety Guidelines for specific industries (issued September 1988);
- Health and Safety Guidelines – General (issued September 1995).

For investments including remote operations:

CDC will require its fund managers to procure that each potential investee company represents and covenants that the business of the company will be undertaken in a manner that:

- ensures that employees have access to the basic services of water, health care and education wherever possible and, where no other facilities are available, adequate housing. Provision may be by local or regional government or by the private sector.

Source: CDC

CDC's public reporting on adherence to this set of Business Principles is contained in its annual report. The 2007 Annual Review report on Business Principles consisted of the following three examples:

- Expansion at Zambian egg producer Golden Lay Ltd, an Aureos investment, has led to a 30 per cent increase in jobs. A waste management strategy is being developed and world-class bio-security measures to counter the threat from avian flu are being introduced. The company plays an active role in its community, with programmes to address problems in housing, water and sanitation, education and health;
- Actis's investment in Cavally, a rubber plantation in the underdeveloped western region of Côte d'Ivoire, demonstrates the viability of responsible investment in a politically unstable environment. Conservation of wetlands was undertaken to limit the environmental impact of the plantation's development and as part of its local social responsibility activities, Cavally has invested heavily in improving housing for its workforce, building over 500 new homes. The company built a hospital for the plantation, operates HIV/AIDS awareness programmes and has implemented initiatives in education; and
- V-Link is a 1,000-strong taxi company in Mumbai and the company has undertaken an extensive programme of driver health and safety awareness, management training and environmental improvement to the fleet. A community outreach programme has also been launched to support the educational needs of drivers' families.

30 CDC's improvements on Business Principles as set out in the new Investment Code

Improvements in the scope of the principles, include:

- All references to outdated international best practice standards have been updated.
- The exclusion list has been updated to investments prohibited in all illegal products and activities under local or national laws or regulations, as well as certain products or activities banned by global conventions and agreements.
- An objective to support the reduction of greenhouse gas emissions which contribute to climate change.

Planned improvements in compliance, include:

- A requirement for fund managers to consider CDC's Investment Code in all investment and disinvestment activities.

Planned improvements in reporting

- A requirement for fund managers to monitor, record and inform CDC about incidents involving portfolio companies that result in loss of life, material effect on the environment, or breach of law, and any corrective actions.

Source: CDC

APPENDIX SEVEN

CDC's development impact reporting

CDC's evaluations completed so far have included three at the 'end-of-life' fund stage, and one on an ongoing fund. Each evaluation is divided into 3 parts;

1 Introduction – A brief description of the fund's investments, CDC's objectives and rationale for involvement, and background on the private equity climate in the region and sector.

2 Performance Rating – The rating is a synthesis of the impact of the fund on the development of its host country based on an assessment of performance against the six parameters set out below, supplemented by the final assessment (vii):

- **i Business Performance** – The performance of each fund against the original target Internal Rate of Return
- **ii Economic Sustainability** – Rates the profitability of the funds' companies and allocation and provision of finance to the fund's companies through profits and additional debt raised. A small number of other indicators may be included.
- **iii Environmental and Social Effects** – Rates the impact of companies on the environmental, social, health and safety conditions. Information for this assessment typically comes from reporting on adherence to CDC's Business Principles.
- **iv Private Sector Development** – Rates the growth of viable financial institutions and capital market development as a result of the fund's operations.
- **v Investment Outcome** – A rating based on the financial returns of the fund. Unlike Business Performance, the Investment Outcome is a measure of a return relative to an absolute scale (composed of the universe of emerging market funds).
- **vi CDC Effectiveness** – This assesses whether CDC's role in the fund was additional or catalytic in bringing in other investors.
- **vii Impact of Investment Environment** – An assessment of the contribution made by the fund to the wider investment environment. No standard rating is given against this category.

3 Lessons – Lessons learned from the fund which can be applied to future operations.

Our review found a disparity in the quality of the four evaluations completed to date. For instance, the first evaluation in November 2006 contained no standardised overall assessment of the different areas reviewed. The remaining three evaluations were completed in December 2007, one of which has strong lesson learning assessments, but did not include an overall assessment of CDC effectiveness due to the lack of supporting evidence **(Figure 31)**. This evaluation was carried out by a CDC portfolio manager, supported by a development evaluation consultant. Below is the text from the explanation of each rating section of this evaluation. Commercially sensitive passages have been removed and references to specific companies and the fund anonymised.

31 An example of a recent CDC development evaluation report of a fund specialising in SME investment in two countries

Overall Development Rating: Satisfactory

Business Performance: Satisfactory

The business performance at investee level is rated satisfactory overall: five successful investments represent 85 per cent of the invested amounts. All these cases that range from tourist hotels, textiles to telecoms have had continuous good performance. The three other investments were in generally smaller start-up businesses in the tourism, leisure and IT sectors, all of which failed.

Economic Sustainability: Satisfactory

In measuring the economic sustainability of the fund, account has been taken of the financial returns, the various fund contributions and generally absent significant market distortions or subsidies in the selected businesses.

Five investments show positive returns in companies with sustainable profitable business. They operate in internationally competitive markets. One fast-expanding hotel group was helped to become a leader in Country A, and another family-run smaller hotel group to more modest profitable expansion. The one telecoms investment brought the highest individual Internal Rate of Return.

One significant strategic and operational fund contribution was to a denim-based textile firm. The fund's finance and advice helped this company adapt to rapidly changing global markets. A smaller IT investment that failed proved too early a launch for business information exchange on the yet immature Country A market. Advanced bowling alleys and leisure centres did also not meet sufficient local demand. This venture also lacked sector insight. Sponsor weaknesses were fatal in the third failed investment. The owner/managers lacked business insight and could not make use of any offered business and financial advice from the fund.

Environmental Effects: Satisfactory

Incomplete files from the appraisal and early monitoring stages make an assessment difficult. The one case with evident financier influence was an aborted new hotel investment. The project complied in full with local environmental standards, but not with those of co-investing IFIs. The following abandonment of this particular project by the sponsors became coincidental; the fund had approved the investment. However, one IFI subsequently performed an environmental review of all its investments in Country A. The highlighted risk of coral reef damage from the hotel project and the wider reputation risk persuaded the sponsor group to abstain from implementing the project. One of the major textile investments had the required ISO classification as exporters to the US before the fund invested, the beach hotel investments complied with local standards, and the telecoms investments had minor environmental risk. Based on the above indications, a satisfactory environmental effects rating appears to be justified.

Private Sector Development: Satisfactory

Investee level:

The fund was intended to provide capital and actively help add value to sustainable businesses, apart from various positive demonstration. Five of the eight investments became sustainable and made good use of the fund investments.

The fund, however, seems to have brought significant strategic or operational influence mainly in two cases: one is the aforementioned expanding textiles firm that started off on a modest scale, and the second is the more modest expansion of a family-owned three-star hotel. The other cases had sponsors and management capabilities that made the potential contributions quite marginal for a small fund such as this. This includes the further expansion of a leading local hotel group in Country A and another project sponsored by the leading local sugar and plantation groups. The latter project pioneered small scale power generation to the national grid based on local agricultural by-products and coal, essentially using the sponsors´ existing managerial and technical capabilities. The mobile telephone investment was indirect and very small relative to the project, which already had a leading global telecoms group as a strategic investor.

The three failed projects proved to have significant weaknesses in the market and sponsor due diligence resulting in limited scope for active intervention, even if the fund had possessed sector insight.

Wider sector and economy level:

Increased competition and demonstration of strategic or operational business reform followed three of the investments. These include the two most successful hotel and textile operations, and the aforementioned power project. The fund had one positive and one negative demonstration case relating to environmental and corporate governance standards: the first was coincidental upon a separate environmental review by a co-investing IFI but resulted in a highly visible demonstration of the risks to coral reefs with new hotels. The second case was more negative and occurred when one of the fund sponsors and co-owners of the management company sold its parallel stake in an investee company without honouring tag-along rights of the other partners.

A major assessed private sector development contribution was institutional. It lay in introducing the private equity concept to Country A and Country B. The pioneering launch of a small fund in the mid 1990s involved clear risks in terms of continuity and diseconomies of scale. Both risks were reduced with the subsequent launch of a second fund under the same manager. The limited size of the fund and resulting constraints on manager capabilities did not, however, enable this fund to show a strong record in appraisals or trouble shooting in SME investments. Still, several investment managers gained good experience. Most were subsequently engaged in local private equity activities, such as the second fund, a fund sponsored by a local bank, in the CDC network, or in IFIs with private equity activity.

It is too early to say if a private equity industry will take root in the limited markets of these two countries, and CDC has backed regional funds of late. The fund contributed by demonstrating to some key local financial institutions and parts of the business community how private equity can work. This element and the general record of the fund justify a satisfactory private sector development rating.

31 An example of a recent CDC development evaluation report of a fund specialising in SME investment in two countries *continued*

Investment Outcome: Partly Unsatisfactory

The modest 8.31per cent gross and 2.23 per cent net IRR to investors in US dollar terms was less than the fund's stated return objectives.

CDC Effectiveness: No Opinion Possible

This desk evaluation could not assess CDC effectiveness, as it proved difficult to trace the key appraisal and monitoring documents. An early Fund Manager development assessment before the fund had made any exits saw it as positive that the fund was fully invested in a short time and had continued active monitoring.

CDC was active in various process and conflict resolution as the fund approached the end of its life and in the solution of various manager and staff remuneration issues. The CDC Board nominee contributed to divestment of the telecoms investment in various ways.

Impact of Investment Environment

The project documents suggest that the sponsors aimed at influencing favourable regulatory and tax reform to facilitate private equity fund operations in Country A, and the Government had undertaken to provide a small concessional loan to help the start-up process. This desk review found no indication in the later monitoring reports as to the extent the expected reforms or the loan materialised. The fund structuring appears, however, to have safeguarded that the investors did not suffer from double-taxation on their distributions.

Source: CDC

APPENDIX EIGHT

CDC's financial reporting

Based on an assessment completed for us by consultants KPMG, we have sought to identify areas where CDC's financial reporting is in line with best practice in the private sector and where it could be improved. **Figure 32** summarises CDC's reporting against the main areas expected of the private sector. In around 80 per cent of areas, CDC is broadly in line with or better than the private sector investors on which KPMG had information, but should make specific improvements, notably:

- providing cash forecast containing different scenarios;
- updating its formula for reporting portfolio return;
- reporting on poor performing investments; and
- reporting in detail on a more representative sample of underlying investee companies, than the present top 10 companies provide.

32 CDC's financial reporting compared to private sector standards

Area	Does CDC report?	Number of private sector companies reporting (out of 10)	Particular observations
Overall financial performance			
Total return/net profit	Yes	10/10	A key indicator for CDC, with analysis supplied to DFID in quarterly reporting. However there is no explanation of the calculation.
Portfolio rate of return	Yes	6/10	CDC also reports rate of return on a fund by fund level. CDC does not publish the formula, but may be overstating performance moderately in certain years – by around 4% in 2006, but not in other years. This is because CDC appears to express portfolio growth as a percentage of portfolio size at the start of the year, rather than average portfolio size across the whole year. This overstates performance if CDC's portfolio expands rapidly during the year, as happened in 2006, where the reported return would differ by around 4 per cent. In other years, however, the effect is minimal. CDC considers that its calculation is standard practice in the private equity industry.
Portfolio multiple of cost	Yes	9/10	Only covered in quarterly reporting to DFID, not in annual report

32 CDC's financial reporting compared to private sector standards *continued*

Area	Does CDC report?	Number of private sector companies reporting (out of 10)	Particular observations
Overall financial performance *continued*			
New commitments	Yes	10/10	A key indicator, split by region and fund managers in CDC's quarterly reporting
Portfolio value	Yes	10/10	Again, split by region. However currency effects are not usually explained.
Performance against benchmark	Yes	2/10	CDC uses the MSCI emerging markets index as a benchmark – this provides a simple, relatively easily understood comparison of performance, but is not an accurate reflection of where CDC's portfolio is actually invested.
Cash flows	Partial	10/10	CDC provides a summary of cash flow as a key indicator in its annual report and provides forecasts to DFID in quarterly reporting. However, no variance analysis is provided, showing likely cash flow under different scenarios.
Performance against budget	Partial	1/10 (4/10 report this for underlying portfolio companies)	CDC provides DFID with summary financial statements alongside budgeted figures, although there is no key line analysis against the budget.
KPI summary	Yes	10/10	Covered in quarterly investment reporting
Industry/Market review	Yes	4/10	Covered in quarterly investment reporting
Profit and loss summary	Yes	3/10	Covered in quarterly investment reporting
Breakdown of management fees/ carry detail	No	5/10	No detailed information provided to DFID. Legal restrictions affect reporting of this information.
Reporting on individual investments			
Portfolio companies reported on	Partial	10/10	CDC only reports in detail on its top 10 investments, which may not always provide a balanced picture of the portfolio. The information that it reports on these is in line with best practice in eight out of nine areas.
Value creation analysis	Yes	3/10	CDC's quarterly report provides more detail on the value created in investments than is normal in private sector reporting.
Commentary on key investments	Partial	10/10	CDC's commentary is limited to Actis and Aureos investments
Commentary on failed investments	No	10/10	CDC provides no commentary on failed investments or under performing funds

Source: KPMG consultancy for National Audit Office, 2008

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