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.