National Audit Office

Report
by the Comptroller
and Auditor General

Department for International Development

Department for International Development: investing through CDC

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Key facts

£735m
amount invested in CDC Group plc by the Department for International Development in 2015

3.05
weighted average development impact score for 2014-16 against target of 2.4 (maximum score 4)

10.3%
average rate of return since 2012 against the target of 3.5%

81	number of new investments made since 2012 committing a value of £1.8 billion
216%	growth in number of staff in CDC Group plc since the introduction of a new investment strategy in 2012
24,673	number of direct jobs created in Africa and South Asia by CDC Group plc's investee businesses in 2015
1,005,000	number of indirect jobs in Africa and South Asia supported by CDC Group plc's investee businesses in 2015
4	number of alleged fraud cases in CDC Group plc's 1,293 investee businesses formally reported to the Department for International Development since 2012

Summary

1 The Department for International Development (the Department) leads the UK's work to end extreme poverty. It aims to reduce poverty in part by promoting economic development and global prosperity in the developing world. In 2015-16, the Department spent £2.2 billion, one-fifth of its budget, on economic development in developing countries. The Department's principal mechanism for encouraging private sector investment in developing countries is CDC Group plc (CDC), a private company wholly owned by the Secretary of State for International Development.

2 CDC's mission is to "support the building of businesses throughout Africa and South Asia, to create jobs and make a lasting difference to people's lives in some of the world's poorest places". It invests in businesses either directly (by investing equity or providing debt) or indirectly (by investing through investment funds). Between 1995 and 2015, CDC self-financed its business by reinvesting returns from its portfolio into new investments. In 2015-16, the Secretary of State for International Development approved a £735 million recapitalisation of CDC, to enable it to expand the breadth and depth of its business.

3 We last reported on CDC in 2008.[1] The report was positive about CDC's performance in securing a good return on public funds, but raised concerns about excessive remuneration packages and the Department's ability to demonstrate how CDC investments contributed to poverty reduction. Since then, CDC has made a number of changes to its operations and governance.

4 In 2012, the Department and CDC agreed a new Investment Strategy which narrowed the geographical footprint for CDC's investments, focused CDC on seven sectors deemed to have the greatest potential for job creation, and expanded the range of financial instruments it uses.

Scope of this report

5 In this report we have assessed the value for money of the Department's investment in CDC by examining:

- the Department's strategy for and oversight of CDC;
- CDC's performance; and
- CDC's approach to managing its business.

1 Comptroller and Auditor General, *Investing for Development: The Department for International Development's oversight of CDC Group plc*, Session 2008-09, HC 18, National Audit Office, December 2008.

6 Full details of our audit approach and evidence base are set out in Appendix One and Appendix Two. Appendix Three summarises the recommendations made in the Committee of Public Accounts' 2009 report on the Department's oversight of CDC and the Department's response.[2] Appendix Four describes the different types of investments made by CDC.

Key findings

On the Department's strategy for and oversight of CDC

7 The Department's governance arrangements of CDC are thorough but should make explicit the Department's role in investment decisions. The Department's formal positon is not to involve itself in CDC's investment decisions and we found no evidence that it did so. It does not therefore as a general rule receive information in advance of CDC's decision to invest. The Department's governance arrangements do, however, encourage CDC to share information in certain circumstances. Our concern is that, without an explicit statement of such a policy, there may be confusion about the involvement of the Department and other branches of government in investment decisions (paragraphs 1.7 to 1.13).

8 The Department can learn lessons for future investment from its 2015 business case for the recapitalisation of CDC. The business case recommended a capital injection of £735 million to CDC. In doing so it rightly considered, for example, CDC's track record of successful investments, its closeness of fit with the Department's geographical and sector priorities for economic development, and CDC's capacity to invest. The business case used the financial and development impact performance targets from the 2012 Investment Policy, although modelling conducted for the business case suggested that a wider range of potential performance was achievable (paragraphs 1.19 to 1.21).

9 Our previous scrutiny of the Department's oversight of CDC led to important, positive changes. In response to concerns that CDC was investing in markets which already attracted foreign investors, the Department and CDC agreed a new strategy and investment policy for 2012–2016 with greater focus on the poorest countries. They revised the remuneration framework to curb excessive pay and to strengthen the Department's oversight in this area. They also introduced an approach to support the selection of investments on the basis of their potential development impact as well as predicted financial return (paragraphs 1.22 to 1.24, and Appendix Three).

2 HC Committee of Public Accounts, *Investing for Development: the Department for International Development's oversight of CDC Group plc*, Eighteenth Report of 2008-09, HC 94, April 2009.

On CDC's performance

10 **CDC's current portfolio of investments reflects the strategy it agreed with the Department in 2012.** Since 2012, CDC has been making more use of direct investments focused on the countries and sectors it agreed with the Department. For example, 98% of CDC's new portfolio of investments are now in Africa and South Asia, and 82% are in one of its seven priority sectors, compared with 53% of its investments made before 2012. This shift reflects deliberate management action to align CDC's investment portfolio with the Department's priorities (paragraphs 2.2 to 2.7).

11 **CDC has met the target for financial performance it agreed with the Department.** In each of the four years since the start of the new strategy, CDC has exceeded its target for the financial return from its investments. Performance has ranged from an annual return on its portfolio from 4% to 18%, compared with a target of 3.5%. CDC's legacy investments still make significant contributions to its financial returns. For example, these investments accounted for 95% in 2014 and 30% of the performance achieved in 2015 (paragraphs 2.8 to 2.12).

12 **Since 2012, CDC has exceeded the target for prospective development impact it agreed with the Department.** The target score – a proxy measure that considers the likelihood that an investment will generate employment alongside an assessment of the difficulty of investing – was 2.4 out of a maximum of 4. CDC averaged 3.05 (paragraphs 2.13 and 2.14).

13 **CDC uses job creation by investee businesses as a measure of actual development impact.** CDC reports the number of additional jobs that the companies in which it invests report they have created in a given year. For example, in 2015 it reported that more than one million direct and indirect jobs had been created by these businesses. CDC does not attribute these jobs directly to the investment it makes in the company. Since 2012 it has been considering how to measure job quality but has not yet established an overall methodology to do so. While we recognise CDC's ambitions in this area and the methodological difficulties in achieving this aim, its progress has been slow (paragraphs 2.16 to 2.20).

14 **Changes in reporting development impact over the last four years have made it difficult for CDC and the Department to set out a consistent picture of what has been achieved.** In addition to the financial and development targets set in the Investment Policy, the Department's business case for recapitalisation included a commitment to monitor a number of other indicators and measures of CDC's impact. Although some performance indicators have remained consistent, the basis for others has changed and CDC reported on one indicator for the first time in 2015. Furthermore, despite securing £5 million of funding in 2015 for impact assessments and a longitudinal study to assess the economic impact of CDC's investments, including how successfully they stimulate subsequent private investment, the Department has yet to award any contracts (paragraphs 2.21 to 2.24).

On CDC's approach to its business

15 **CDC has taken positive steps to change the way it is organised, reflecting the change of focus of its approach.** In particular, CDC has established specific teams to focus on its new types of investments. It has a separate team to consider the development impact from each investment. It is in the early stages of expanding its presence overseas, although it does not yet have a fully developed plan for this expansion (paragraphs 3.3 and 3.4).

16 **CDC's operating costs are increasing as a result of the change and expansion in its business.** In 2012 CDC did not have a baseline against which to track operating costs relative to the growth in its business. CDC has subsequently completed two benchmarking exercises in 2014 and 2016. In 2012, its operating costs were 0.66% of its portfolio's net asset value. In 2015, they were 1.12%. The increase is explained by the change of focus in CDC's business towards direct investments (which are more resource intensive than funds) and the assessment of development impacts. Its costs relative to the size of its business are low compared with the costs of other development finance institutions (paragraphs 3.5 to 3.9).

17 **CDC has addressed Parliament's previous concerns about pay. However, recruitment and retention challenges remain a significant risk to CDC's operations.** CDC has reduced average pay from £123,000 to £90,000 by severing the link with commercial sector salaries. However, both the Department and CDC classify recruitment and retention as a high or severe risk. In response to these challenges, the Department and CDC will shortly be negotiating a new remuneration framework (paragraphs 3.10 to 3.16).

18 **CDC's management of cash balances has improved.** In 2014, six years after we raised concerns, CDC introduced a liquidity policy that set out two liquidity targets. CDC is currently meeting both of its targets (one just recently). CDC's cash balance has decreased by almost 70% since 2008; at the same time the value of its portfolio has more than trebled (paragraphs 3.17 to 3.20).

19 **As a result of our inquiries CDC has recently improved its procedures for recording allegations of fraud and corruption.** The nature of CDC's business and the countries in which it invests – together with the intricacy of the supply chain – can increase the risk of fraud and corruption. CDC's due diligence approach is designed to avoid investing in potentially corrupt sectors and businesses. However, while it has whistleblowing arrangements, it has only recently established systems to consolidate records of all the allegations it receives. As CDC continues to grow, this should help it to track risks across the portfolio over time (paragraphs 3.21 to 3.24).

Conclusion on value for money

20 The Department has improved its oversight of CDC and has directed it to address many of the weaknesses in its operations previously identified by Parliament. Through tighter cost control, strengthened corporate governance and closer alignment with the Department's objectives, CDC now has an efficient and economic operating model.

21 CDC measures its effectiveness through financial return and development impact targets, which it has met. However, the development impact target measures prospective rather than actual impact. It remains a significant challenge for CDC to demonstrate its ultimate objective of creating jobs and making a lasting difference to people's lives in some of the world's poorest places. Given the Department's plans to invest further in CDC, a clearer picture of actual development impact would help to demonstrate the value for money of the Department's investment.

Recommendations

22 The Department and CDC should:

a **Do more to capture CDC's development impact.** For example, helping CDC to build a measure of attribution will not only help CDC to make investment decisions but will also help to improve accountability for its performance.

b **Embed the recently introduced practices to better capture and record allegations of fraud and corruption.** Having a full record of allegations of fraud and corruption received will help CDC to track risks across the portfolio over time.

The Department should further:

c **Review the performance targets set for CDC for the financial return and development impact it secures from its portfolio of investments when agreeing the new investment policy.** The review should take into account the new five-year strategy objectives and the characteristics of the markets in which CDC invests, in order to better match its targets for CDC with CDC's actual and projected performance.

d **Use, as a matter of urgency, the approved budget to place the planned evaluation contract that was part of the business case for the recapitalisation of CDC.** Alongside existing evaluation, performance and management information it currently collects, a detailed longitudinal evaluation of CDC's impact will provide the Department with intelligence that can be used when making future investments in CDC.

e **Clarify the policy that the Department and other branches of government do not involve themselves in CDC's investment decision-making.** This is necessary to address the current ambiguity in this area.