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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Department for International Development

Department for International Development: investing through CDC

Report by the Comptroller and Auditor General

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Comptroller and Auditor General
National Audit Office

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This report focuses on the value for money of the Department for International Development's investment in CDC Group plc (the UK's development finance institution).

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Contents

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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.

Part One

The Department's strategy for and oversight of CDC

1.1 This part of the report covers:

- CDC Group plc's (CDC) role in delivering one of the Department for International Development (the Department)'s key priorities;[3]
- the Department's role as a shareholder;
- the Department's oversight of CDC;
- the Department's business case for recapitalisation; and
- the Department's and CDC's response to previous Parliamentary concerns.

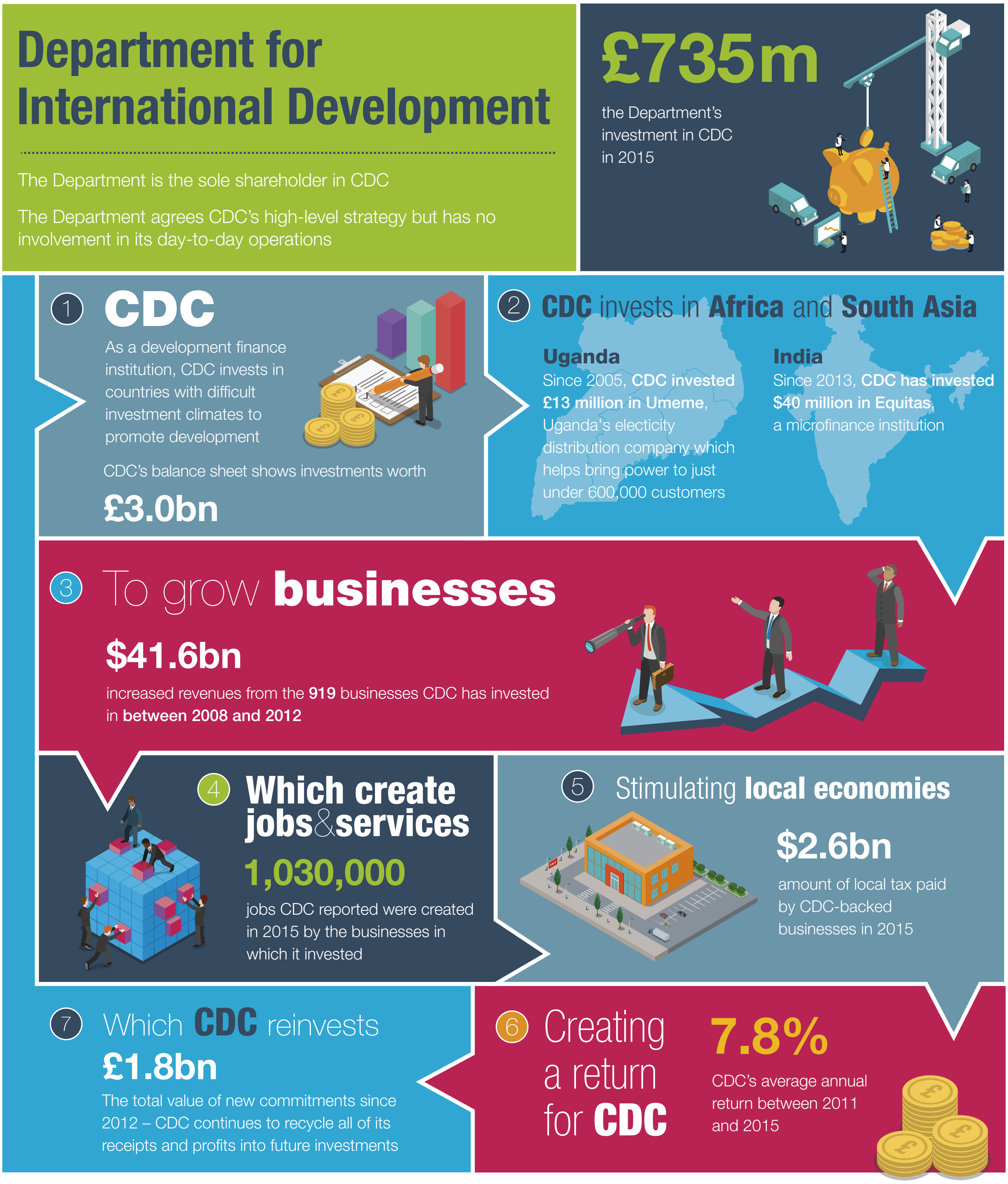
CDC's role and approach

1.2 CDC is a private company wholly owned by the Secretary of State for International Development.[4] It is one of a category of organisations known as development finance institutions – national or international public agencies investing in the private sectors of developing countries. 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 looks to achieve this aim by providing both long-term investment and practical expertise, helping businesses build their teams, and achieving good environmental, social and business integrity standards (**Figure 1**).

1.3 One of the Department's key priorities is encouraging economic development in developing countries. In 2015-16, the Department spent £2.2 billion, 22% of its budget for that year, on economic development. While the Department supports private sector development through multilateral organisations such as the World Bank, and through bilateral assistance projects in developing countries, CDC is the Department's principal mechanism for encouraging private sector investment in developing countries. As a long-term investor and lender, CDC provides support to businesses to help them to grow over the long-term and enhance their environmental, social and governance performance. **Figure 2** on page 12 outlines CDC's investment process.

3 CDC was formerly known as the Commonwealth Development Corporation.
4 The Secretary of State owns all shares in CDC bar one, which is owned by the Treasury Solicitor's Department (now Government Legal Department).

Figure 1
How CDC works in practice



Source: National Audit Office

Figure 2
How CDC makes its investments

Elapsed time

0 to 2 years

Sourcing

Either

CDC approaches a fund manager or business it would like to invest in which it has identified through: research and market intelligence; relationships across markets; and/or market- and sector-mapping.

Or

CDC is approached by a fund manager or a business who has heard about CDC's reputation as a provider of patient capital[1] and would like CDC to invest in them.

0.5 to 1 year

Screening and completion of investments

Potential investments selected by the investment team are reviewed by a Screening Committee of the Investment Committee.

Potential investments which meet initial screening then undergo due diligence (including anti-money laundering and 'know your client' checks), technical preparation and negotiation, and then return to the Investment Committee for an interim review and decision to proceed or not.

After this, the investment team undertakes final due diligence, usually involving third-party consultants' reports, and the investment is taken to a final Investment Committee. If approved, prior to completion, legal negotiations and formal documentation are completed.

CDC's ESG[2], development impact, BI[3] and legal teams are involved throughout working closely with the respective investment teams.

5 to 10 years

Life of the indirect investment (funds)

Fund manager uses fund to invest in individual businesses. CDC and other investors are required to provide resources as investments are made.

The fund manager works with businesses to improve performance.

CDC meets and keeps in touch with the fund manager to monitor progress of fund and to provide strategic support (by, for example, sitting on the advisory committee).

Life of the direct investment (equity, debt)

The CDC investment team which selected and made the investment carries out ongoing monitoring, including: portfolio reviews of performance, operations and strategy; annual valuations; and ESG and BI visits.

In some investments, the CDC investment team or selected external experts sit on the board of the business supporting decision-making and strategy creation.

1 to 2 years

Exit

Fund manager identifies potential buyers, selling investments in individual companies as profitable opportunities arise. Proceeds are returned to CDC and other investors.

CDC can choose to extend a fund for two years either to continue profitable investments or to avoid selling in poor market conditions.

Exit

CDC plans for success by assisting the business in becoming sustainable over the longer term.

When CDC has achieved this, it identifies potential buyers, selling investments in individual companies as profitable opportunities when the business and market conditions are right.

Notes

1 Patient capital has long time horizons, often 10 years or more, and is key for building infrastructure and early stage business; reduces disruption for businesses that re-financing causes; and minimises cyclical investing.

2 ESG refers to environmental, social and governance. CDC sets requirements to businesses in this area and provides active support as they begin to implement and adopt more sustainable business practices.

3 BI refers to business integrity. CDC sets requirements to businesses in this area to ensure CDC's investments are not subject to corrupt practices and helps businesses develop its business integrity standards.

Source: National Audit Office report 2008; Department for International Development's business case for recapitalisation; and interview evidence

1.4 In July 2015, the Department agreed to invest £735 million in CDC, the first government funding of CDC since 1995 (CDC was self-financing for that period – it invested its profits in further investments). In 2015-16, it invested the first of two tranches – £450 million in the form of a promissory note which CDC will draw down when needed. The Department will invest the balance – £285 million – in 2016-17.

1.5 CDC also manages the two funds which together form the Department's Impact Programme. Under this programme the Department funds investments which look likely to have a large development impact but to produce a very low financial return:

- the DFID Impact Fund – set up with £75 million of funding in 2013-14; and
- the DFID Impact Acceleration Facility – set up with £40 million in 2015.

1.6 The Department is considering increasing its financial support to each fund by several hundred million pounds.

The Department as shareholder

1.7 The Department has established a three-tiered corporate governance framework in order to fulfil its duties as CDC's shareholder (see paragraph 1.2). As **Figure 3** overleaf shows, this framework is thorough and comprises a wide range of arrangements. But as we set out below, there are some reasons why the Department should consider updating these arrangements.

1.8 The Department's shareholding allows it to appoint its own board member. It chooses not to do so as it considers that direct departmental representation on the Board would blur the lines of accountability for investment decisions taken and might undermine CDC's commercial reputation. The Department considers it does not have officials with the depth of commercial investment experience brought by others to the Board. The Secretary of State's shareholding gives her the power to appoint the chair to the board and two non-executive directors on the Board, and the Department is involved with the appointment of all non-executive directors.[5] The Department considers that this power, together with its role in agreeing the Investment Policy with CDC, gives it sufficient influence over CDC.

1.9 The Department leaves the day-to-day management of CDC to CDC's board and its management team. In circumstances of consistent or extreme underperformance against the targets CDC has agreed with the Department, the Secretary of State has the power to make appropriate changes to CDC's structure and management and to review its Board's composition.

5 The powers of the special shareholder are set out in the Articles of Association of CDC Group plc.

Figure 3

The Department – CDC Corporate Governance Framework

Tier 1: Constitutional and legal frameworks

- This tier is the constitutional architecture comprising legal documents that create the binding arrangements for all of CDC's activities.
- It includes CDC's Articles of Association, the CDC-DFID Memorandum of Understanding and UK and international legislation such as the CDC Act, the Companies Act and the Corporate Governance Code.

Tier 2: Shareholder documents and governance arrangements

- This tier comprises a range of accountability arrangements which sets expectations for how the CDC Board and management should operate.
- It includes an overarching Chairman's letter and specific arrangements to codify remuneration activity, the Investment Policy, development impact work and responsible investing.

Tier 3: CDC-prepared documents and internal controls

- This tier sets out CDC's internal governance arrangements to ensure effective delivery against standard operating policies and procedures.
- It includes the five-year strategy and business plan, terms of reference for the Investment Committee, a business integrity policy and other codes and registers.

Source: National Audit Office

1.10 The Department's position is that it does not get involved in, among other things, investment decisions – for example, in which companies should the CDC invest and from which investments it should exit.[6] Nor does it, as a general rule therefore, receive information from CDC in advance of CDC making an investment decision. Because the Department sometimes receives information about potential investments, there may be confusion about its involvement in investment decisions.

1.11 A recent example of this was in September 2015, when CDC partnered with Norfund – the Norwegian development finance institution – in an agreement valued at more than $700 million, to take direct ownership of Globaleq, the largest independent power producer in Africa. This investment was (and remains) CDC's single largest investment. CDC consulted the Department about the investment before proceeding. However, the Chair of CDC made clear that this was for information only, and that the decision to invest, and accountability for that decision, rested with CDC and the CDC Board.

1.12 CDC is looking to develop its in-country presence (paragraph 3.4), which presents new opportunities for CDC and the Department to work together. For example, where the Department has a country office, it might share with CDC local and sector knowledge and support it in discussions with host governments and stakeholders. The business case for recapitalisation referred to several examples where such collaboration takes place.

6 Exiting means that CDC will sell its interest in an investment.

1.13 The Department recognises that there may be a tension between its current position as shareholder and its potential role as a partner. It has issued guidance to its country offices on the respective roles of the Department and CDC. But it has not been distributed to other government departments which may be involved. The Department said it would consider in due course whether a more strategic and targeted approach to collaboration was merited.

The Department's oversight of CDC

1.14 In our previous report on the Department's oversight of CDC, we expressed concern that the small size of the team overseeing CDC had contributed to weaknesses in oversight.[7] The Department now has a team of six staff dedicated to the oversight of CDC (compared with 1.5 full-time equivalents when we last reported) and draws on others' expertise where necessary – for example, the team draw on the Department's legal experts for advice on changing the Commonwealth Development Corporation Act 1999. These resources cover a wide range of routine, reactive and strategic activities. Given the Department's plans for investing more heavily in CDC in future years, it will be important to ensure that the level of resources available for oversight is appropriate for the Department's investments through CDC.

1.15 The Department and CDC share information in three ways.

- **Through formal meetings**

  For example, the Department's team responsible for the oversight of CDC's performance meets with CDC's Chair, Chief Executive Officer, Chief Operating Officer, and CDC's management teams. The Chief Executive Officer meets with the Department's Permanent Secretary annually.

- **Through informal meetings**

  Formal meetings are supplemented by informal meetings at all levels.

- **Through reporting**

  CDC provides, for each Quarterly Shareholder Meeting, an information pack for the Department with data on, for example, the performance of investments and their progress on environmental and social issues as well as the performance of CDC.

7 See footnote 6.

1.16 The Quarterly Shareholders' Pack has evolved over the three years since it was introduced in response to suggestions from the Department, Internal Audit and the National Audit Office. For example:

- in June 2015, the Department requested investment impairments to be included as a standard agenda item at the Quarterly Shareholder Meetings to satisfy National Audit Office requirements;
- CDC added a risk report in April 2016 to improve the Department's assurance on CDC's management of risk (a weakness identified by the Department's internal audit function); and
- CDC revised its environmental and social reporting to include a more comprehensive rating system in response to the Department's request.

1.17 The Department does not, however, receive information on all business integrity issues that CDC encounters in its investments – and has asked CDC to consider reporting on this.

1.18 The business case for the recapitalisation of CDC included up to £5 million for monitoring and evaluation over 15 years by an independent monitoring company, to assess the development impact of CDC's investments. The Department's delivery plan for CDC's capital increase included an action to recruit a senior evaluation specialist (by July 2016) to lead the design and procurement process for the longitudinal impact study. As at November 2016, this appointment was outstanding. The Department told us it recognised that this work was overdue and needed to be advanced.

Supporting CDC's recapitalisation

1.19 In 2015, the Department agreed to recapitalise CDC by £735 million. In line with its usual practice, the Department produced a detailed business case to support its decision. In summary, the business case recommended the additional capital for CDC to allow it to expand the breadth and depth of its business in Africa and South Asia, where it judged demand for capital to exceed supply.

1.20 Overall we found that the business case made a convincing argument for the need for the additional capital. For example, it made a case for the potential for additional investment in Africa and South Asia and for the macro-economic impact of increased investment. It was quality assured internally and the team responsible responded positively to the feedback from this process.

1.21 We identified some areas for the Department to consider from this process as it develops its new strategy for CDC and considers any future investments through CDC.

- **Whether adherence to the current investment strategy acts as a constraining factor on CDC's development.**

  The business case states that CDC's financial projections on the use of the new capital are based upon its current Investment Policy and operating model; and that if these change, CDC may no longer be able to (i) make the investments contemplated by the projections and/or (ii) deliver the development impact related to such additional investments. We are concerned that this may constrain the Department's ability to revise the Investment Policy post-2016.

- **Whether the Department's targets for CDC's performance are appropriate.**

  The Department set the current financial performance target of 3.5% in the 2012 Investment Policy in line with the Government cost of borrowing when the target was agreed. However, portfolio modelling conducted for the 2015 business case suggested that a wider range of potential performance was achievable that is, rates of return could vary between 3% and 6%. Aggregated performance across the three strategies (equity, debt and funds) has consistently exceeded the 3.5% portfolio target. The Department did not want to change the target with only one year remaining under the current Investment Policy. The forthcoming Investment Policy represents an opportunity to better match the target with likely performance and projected investment conditions.

  The business case gives a detailed explanation of how the Development Impact Grid was designed and what it measures. It does not explain how the target of 2.4 out of a maximum of 4 was agreed with CDC. Only one of the 17 types of investment in which CDC is involved scored an average development impact score below 2.4 in its May 2014 proposal for £1 billion of additional capital. When reviewing the target for development impact as part of the new Investment Policy, the Department should consider what impact a higher or lower target would have on the number and type of investments CDC would make.

Responding to previous Parliamentary concerns

1.22 We last reported on the Department's oversight of CDC in December 2008.[8] In April 2009, the Committee of Public Accounts published its report on the same subject.[9] Both we and the Committee raised concerns about the adequacy of the Department's oversight of CDC, which had resulted in excessive remuneration of CDC employees, and in CDC's focus on financial returns from investments rather than on development impact. We also identified weaknesses in CDC's operations, such as rising administration costs, very high cash balances and a failure to measure the impact of its investments.

8 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.

9 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.

1.23 Overall, the Department and CDC responded positively to the recommendations in both reports. The Committee of Public Accounts' recommendations and the Department's response are summarised in Appendix Three. The main changes are set out below.

- A new strategy and investment policy for 2012–2016 with greater focus on the poorest countries, in South Asia and Africa.
- The introduction of a method – known as the Development Impact Grid – to help focus investment decisions on job creation.
- A new remuneration framework, which benchmarks CDC staff pay against comparable development finance institutions, replacing the previous practice of benchmarking against commercial private equity firms.
- Changes to the membership of the CDC Board and a new senior executive team.

1.24 We identified two areas where the Department and CDC need to make more progress. The Department needs to advance plans for evaluation studies beyond those already undertaken (paragraph 1.18), such as the 2015 independent Josh Lerner evaluation of the impact of CDC's funder of fund investments between 2004 and 2012. It also needs more progress in isolating CDC's effects on poverty reduction (paragraphs 2.21 to 2.24).

Part Two

CDC's performance

2.1 In this part of the report we look at CDC Group plc (CDC)'s

- progress in implementing its new strategy;
- financial performance;
- development impact;
- reporting on job creation; and
- approach to reporting its development impact.

Implementing the new strategy

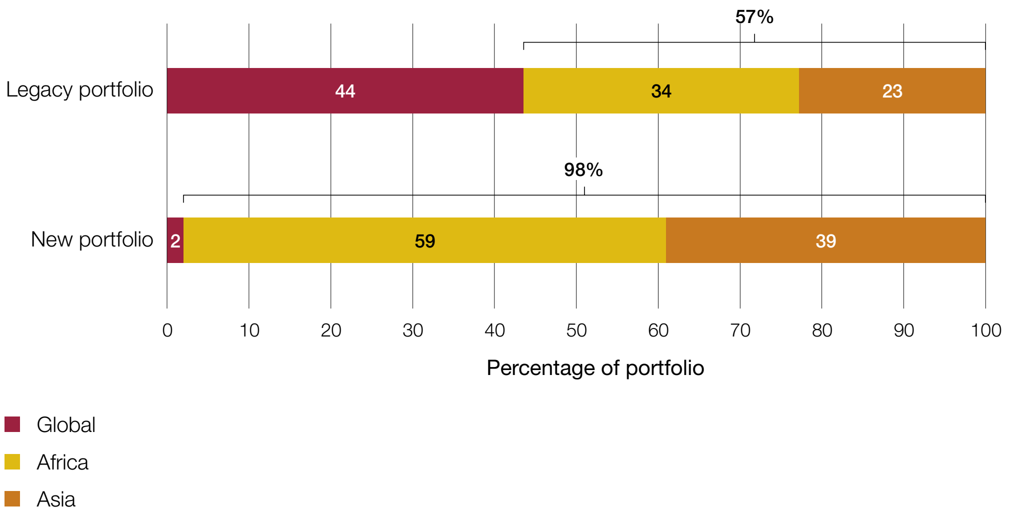
2.2 In 2012, the Department for International Development (the Department) and CDC agreed a new investment strategy and policy for the five years from 2012 to 2016. The new strategy was a significant departure from the previous strategy – it changed the focus of the geographical regions and sectors in which CDC would invest and the financial instruments it would use.

2.3 In our examination of CDC's progress against these three elements we found that, on:

- geography: CDC has shifted its total portfolio significantly towards Africa and South Asia, as it has not made any investments outside these areas since 2012 (paragraph 2.4);
- instruments: CDC is using a wider range of financial instruments than before 2012, shifting its portfolio away from a funder of funds model (paragraph 2.5); and
- sectors: CDC has made fewer investments in sectors outside of its priority sectors since 2012 (paragraph 2.6 and 2.7).

2.4 Before 2012, the Department invested in a wide range of developing countries, including China and Brazil. The Department and CDC's new Investment Policy narrowed new investment commitments to Africa and South Asia.[10] While CDC has investments in countries not covered by the new Investment Policy, these pre-date the current strategy (known as its legacy portfolio). CDC expects that, by the end of 2019, it would have exited the majority of its investments which make up its legacy portfolio. In **Figure 4** we show that CDC has complied with the new Investment Policy, investing 98% of its new portfolio in Africa and South Asia, compared with 57% of its legacy portfolio. Of the development finance institutions we consulted CDC is the most focused in Africa and South Asia.

Figure 4
Geographical distribution of CDC's investment portfolio



Notes

1 The global segment of the new portfolio represents a single investment. This investment was originally in a company in India. That company has subsequently merged with similar companies from other countries, some of which fall outside of Africa and South Asia, thereby changing the classification to global

2 Figures may not sum due to rounding.

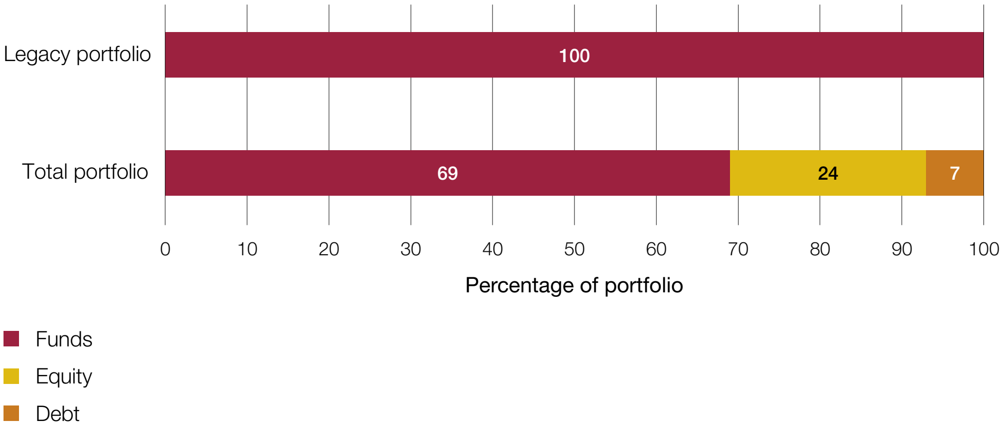
Source: National Audit Office presentation of CDC Group plc's data

10 Where over 80% of the world's poor live as set out in the Eligible Countries list in its 2012 Investment Policy. A number of countries in these regions remain ineligible for investment except in exceptional circumstances, which are set out in the 2012 Investment Policy – for example, Mauritius, Botswana and South Africa.

2.5 Between 2004 and 2012, CDC only made indirect investments – investing through funds, which would in turn invest through either debt or equity in businesses on behalf of CDC and the fund's other partners. Of the seven development finance institutions we contacted, one had adopted an investment model which used only one instrument. Since 2012, CDC also invests directly, mainly by investing equity in, or providing debt to, businesses. Throughout 2013, it also expanded its use of trade finance as an investment instrument (see Appendix Four). CDC's plan is that by 2021 the composition of its portfolio will be as follows: 54% equity; 24% debt; and 22% funds. CDC has in place strategies for each of its investment instruments setting out how it will achieve this. **Figure 5** shows that CDC has made good progress against this plan with the funds business falling from 100% to 69% of its total portfolio, and direct equity rising from 0% to 24%. Debt is lagging behind at 7% of the total portfolio and the expansion of this business line, including the trade finance strand, is an immediate priority for CDC.

Figure 5

Instrument distribution of CDC's investment portfolio – 2015 (by value)



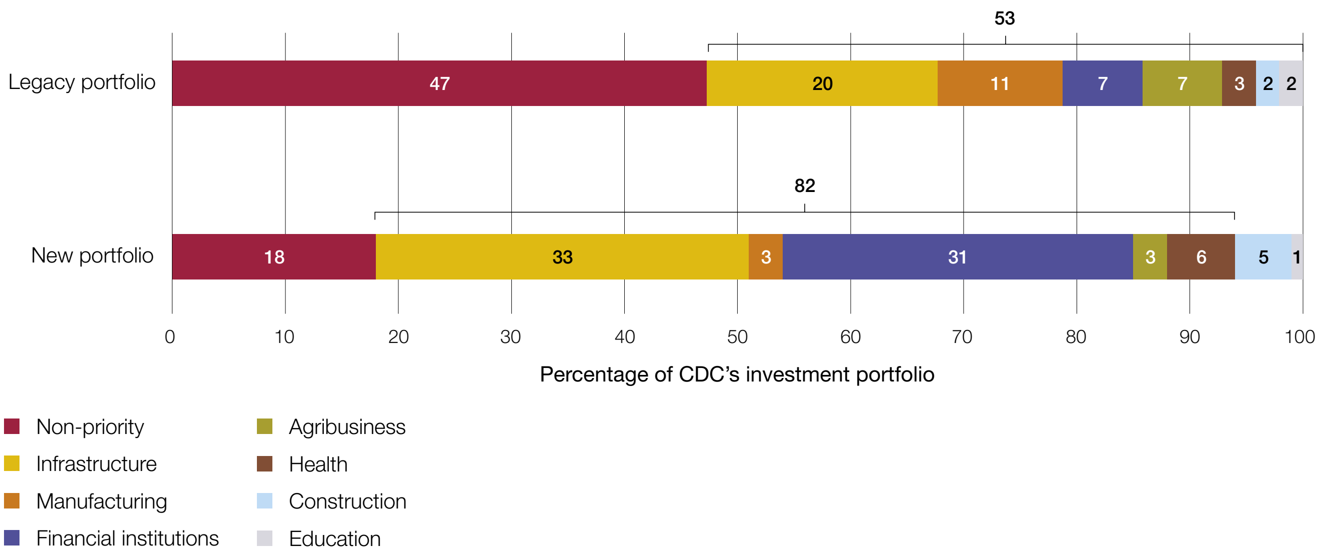
Source: National Audit Office presentation of CDC Group plc's data

2.6 In 2012, CDC decided to target its investments at the seven sectors which CDC considered had the best potential to create jobs. Described as priority sectors by CDC, they are: agribusiness; construction; financial institutions; infrastructure; manufacturing; health; and education. CDC is not limited to investing in these sectors, however.

2.7 **Figure 6** shows that CDC has made good progress focusing on its priority sectors. 82% of investments in the new portfolio are in the seven priority sectors, compared with 53% of its legacy portfolio.

Figure 6

Sector distribution of CDC's investment portfolio



Note

1 Non-priority sectors: trade, business services, communications, mineral extraction and real estate.

2 Figures may not sum due to rounding.

Source: National Audit Office presentation of CDC Group plc's data

Meeting targets for financial performance

2.8 With regard to financial performance, CDC is required to achieve an average portfolio return of 3.5% annually for the period since 1 January 2012.[11] The Department and CDC's rationale for achieving a positive financial return are as follows:

- A financial return, secured from investing in businesses which grow, is closely correlated with development impact through the creation of jobs.
- CDC aims to 'crowd in' other finance into its investments to help show other investors (for example, in the private sector) that investing in difficult markets is financially viable – sometimes described as the demonstration effect – therefore, returns must be positive.
- CDC can, as it has done in the past, reinvest financial returns in other investments, potentially increasing its impact.

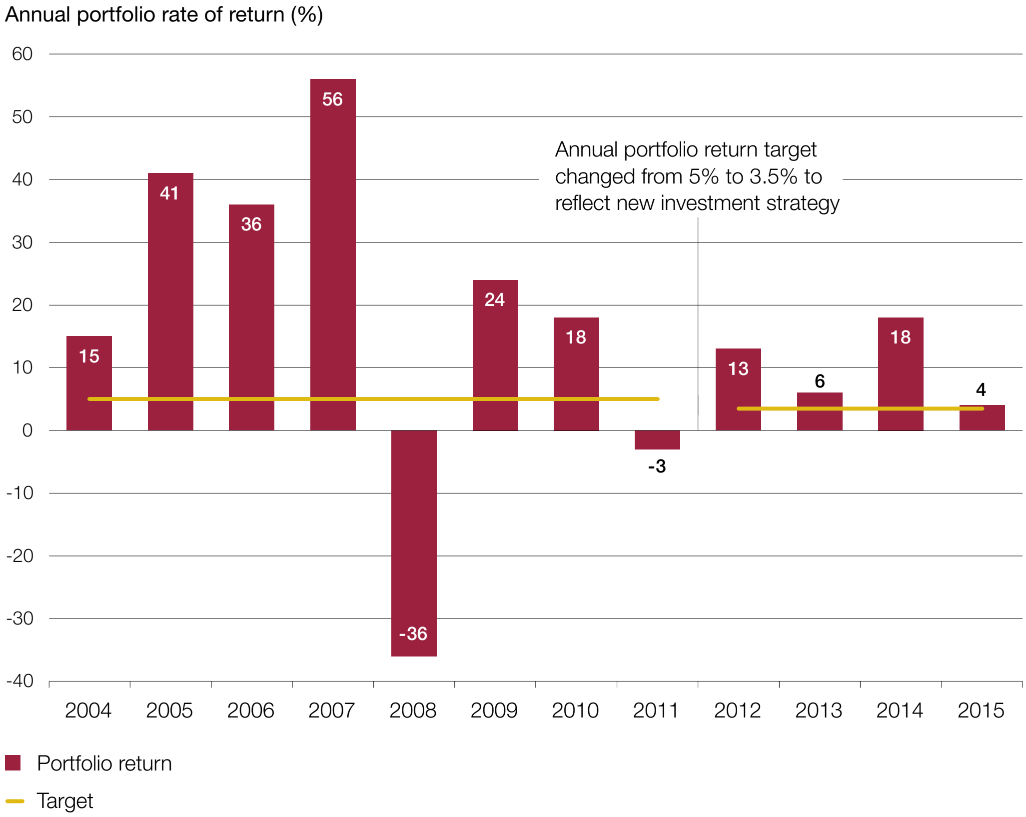
2.9 CDC reports annually on its portfolio return. When we last reported on CDC, we said it had achieved an exceptionally good financial performance for the period 2004–2007. The average annual rate of return for this period was 37% compared with a cost of capital threshold of 5% set by HM Treasury in 2004 (**Figure 7** overleaf). Performance took a downturn in 2008 as a result of the global financial crisis and CDC experienced variable performance alongside the rest of the market in the following years. Since 1 January 2012, when the financial target for the portfolio return was set at 3.5%, CDC has exceeded it each individual year since then, averaging 10.3%.

2.10 The lower returns since 2012 are consistent with the Department's and CDC's expectation that its new portfolio, focused on harder markets, will deliver a lower level of return. **Figure 8** on page 25 shows that CDC's legacy investments, which were more focused on mature emerging markets such as Latin America, continue to make up a significant proportion of returns (between 30% and 95%). In 2014, the returns from the legacy portfolio were particularly high at £422 million because of several large sales and large currency translation gains. CDC expects its legacy investments will be a significant feature of their returns until it exits from them, which it expects to do by the end of 2019.

11 The average portfolio return is calculated by dividing total realised and unrealised profits by the opening value of the portfolio.

Figure 7

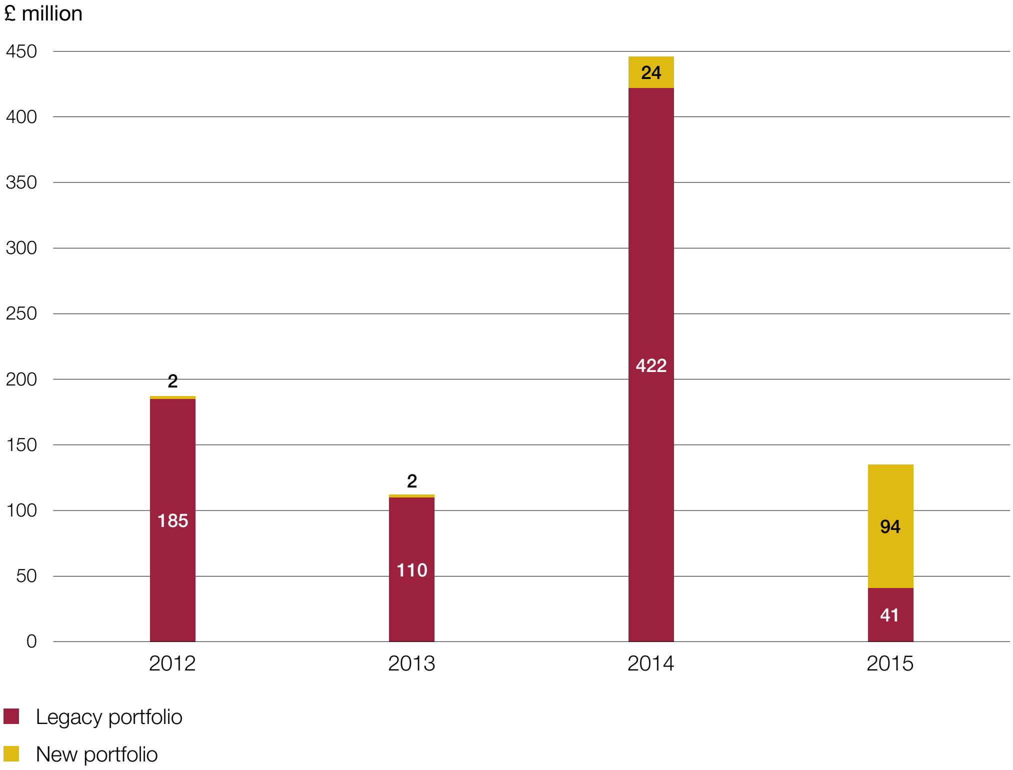
CDC's average portfolio return from 2004 to 2015



Source: National Audit Office presentation of CDC Group plc data

2.11 Because many of the post-2012 investments are in the early stages of their investment cycle, where large returns are not expected, it is too early to assess the performance of the new portfolio independently. In recent years, there have been some promising signs that CDC will be able to meet its target based on the new portfolio. CDC has received positive returns from the portfolio in each of the years from 2012 to 2015, which has grown year-on-year (Figure 8). In 2015, CDC received its highest return from the new portfolio yet as it was boosted by strongly performing equity investments in financial institutions.

Figure 8
The composition of CDC's annual portfolio return 2012–2015[1]



Note

1 Excludes hedging gains and losses.

Source: National Audit Office presentation of CDC Group plc data

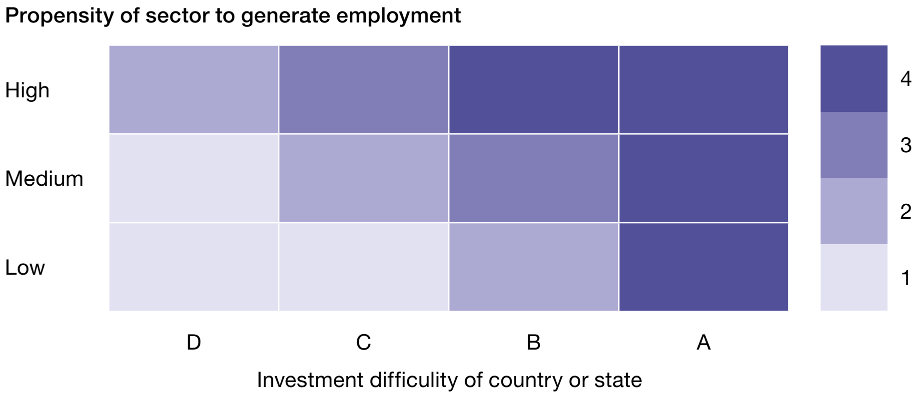
2.12 As well as the annual portfolio return, CDC's positive financial performance is demonstrated by its total portfolio value, which has grown from £2.2 billion in 2012 to £3.0 billion in 2015. This is a result of net new investments and valuation gains driven by the growth of underlying investee businesses.

Meeting a target for development impact

2.13 CDC is required to achieve a minimum aggregate development score of 2.4 out of 4 across all investments made in the preceding three years, weighted by the size of investment. The development score is CDC's definition and measurement of potential ('ex ante') development impact, rather than actual development impact. It is based on a framework called the Development Impact Grid (**Figure 9**). CDC developed the grid with external consultants and academics and then agreed it with the Department.

2.14 CDC has achieved above the 2.4 target as measured on the Development Impact Grid in each of the years since its inception. In the three years 2014 to 2016, it has achieved an average of 3.05 across its portfolio weighted by the size of its investments and has therefore met its target for development impact (**Figure 10**).[12]

Figure 9
CDC's development impact potential grid



Notes

1 Development impact potential of a potential investment will be assessed on the basis of the following criteria:

- **Investment difficulty of country or state** – assessed with regard to: (i) market size; (ii) income level; (iii) ability to access finance; and (iv) the ease of doing business.
- **Propensity of sector to generate employment** – the propensity of each business sector to generate employment was assessed with regard to: (i) the potential to create employment directly; (ii) the potential to create employment through backward linkages in the supply chain; and (iii) the potential for investment into essential infrastructure to remove business constraints and build an environment for jobs.

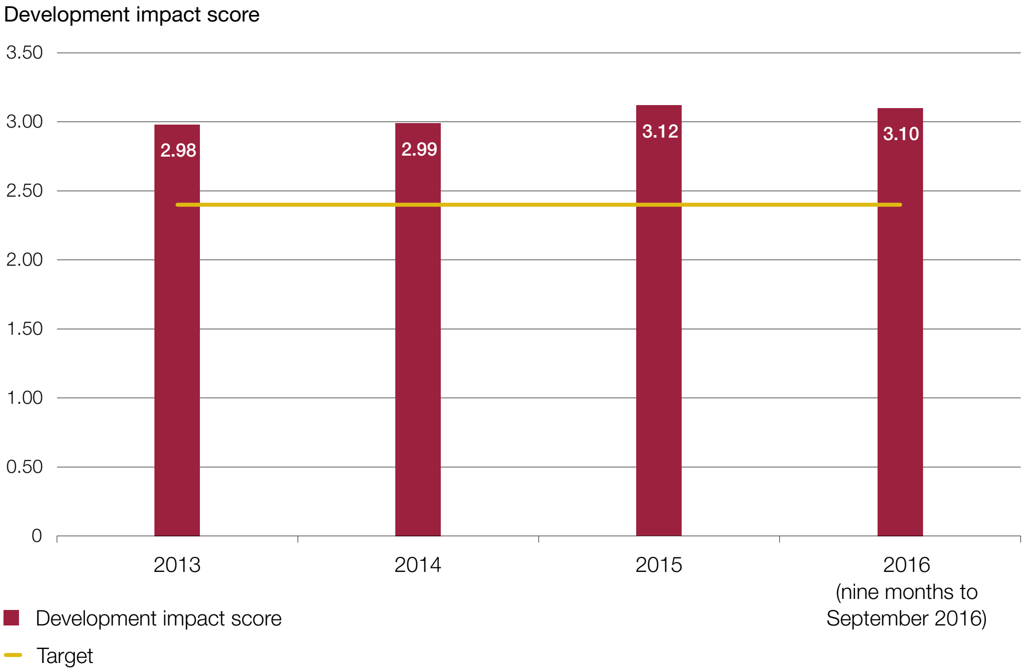
2 Development impact scores range from 1 to 4, where 4 is the score for the highest development potential.

Source: CDC Group plc Investment Policy 2012–2016

12 Based on data for the nine-month period to September 2016.

Figure 10

CDC's development impact score – 2013 to 2016 (nine months to September 2016)



Note

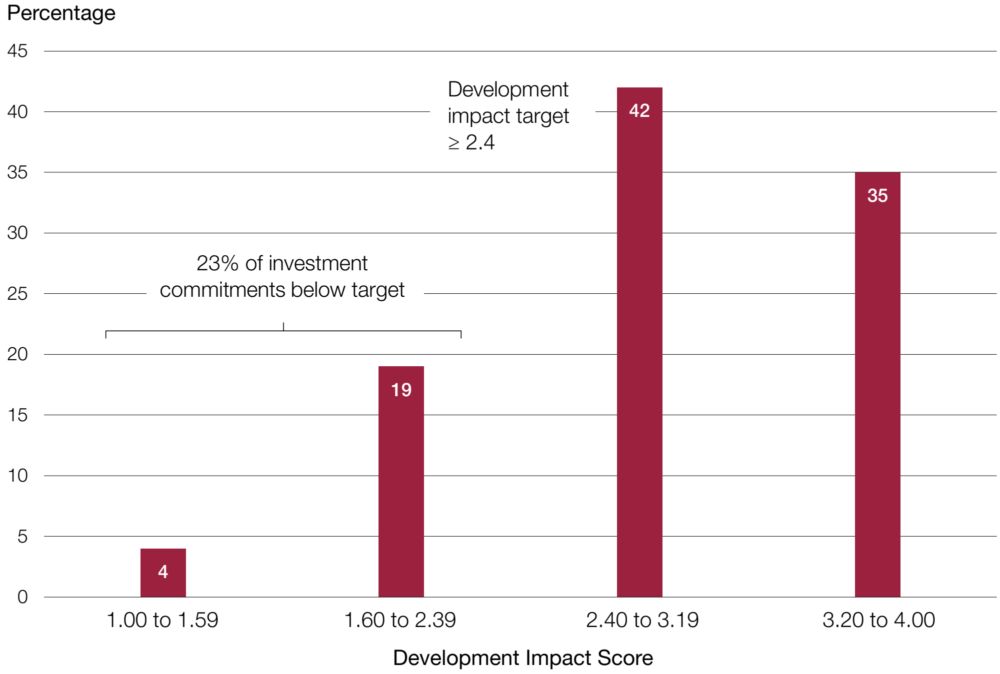
1 CDC is required to achieve a minimum aggregate development score of 2.4 out of 4 across all investments made in the preceding three years, weighted by the size of investment.

Source: National Audit Office analysis of CDC Group plc's data

2.15 The majority of CDC's investments made since the introduction of the grid have scored above the target, 23% have scored below 2.4 (an investment can still proceed in this situation as the target relates to a weighted average across CDC's portfolio). **Figure 11** overleaf shows the range of these development impact scores. CDC and the Department also monitor the variation of development impact score at the instrument and team level to make sure the grid is being applied consistently across its business and over time.

Figure 11

Distribution of development impact scores since 2013



Note

1 An individual investment can still proceed if it scores less than 2.4, as the target relates to a weighted average across CDC's portfolio.

Source: National Audit Office analysis of CDC Group plc's data

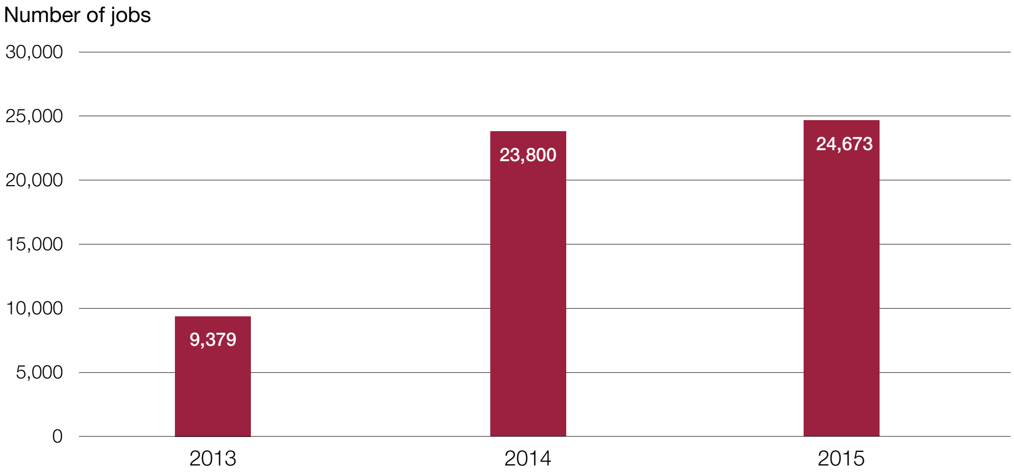
Reporting on job creation

2.16 CDC does not have a target for actual development impact but does attempt to measure it. Although CDC believes its work has broader benefits, it focuses on the number of jobs created by its investee businesses in Africa and South Asia. It has measured direct jobs created since 2013 by collecting employment data from its portfolio companies. In 2015, 484 businesses reported, representing 77% of the total African and South Asian portfolio. Of these, 46% reported job creation, 28% reported no change and 25% reported a reduction in jobs.[13] Overall, a net 24,673 direct jobs were created in 2015, compared with 9,379 in 2013 (**Figure 12**).

13 Businesses in Ghana and Zimbabwe reported reductions in the number of jobs. CDC concluded that the likely reason for the reduction was the economic difficulties both countries were facing in 2015.

Figure 12

Direct jobs CDC investee businesses in Africa and South Asia helped to create – 2013 to 2015



Source: CDC's annual reports 2013, 2014 and 2015 (and underlying CDC data for 2015), and CDC commissioned Development Impact Evaluation

2.17 Since 2014, CDC has estimated the number of indirect jobs the investee businesses have created by using a methodology developed specifically for CDC by experts. It covers jobs that are created in supply chains; through local wages; and through better access to energy and finance. In 2015, CDC's investee businesses created just over one million indirect jobs, making up 97.6% of total jobs created by CDC investee businesses (**Figure 13** overleaf).

2.18 CDC does not seek to attribute the jobs created by its investee businesses to its investment for a number of reasons:

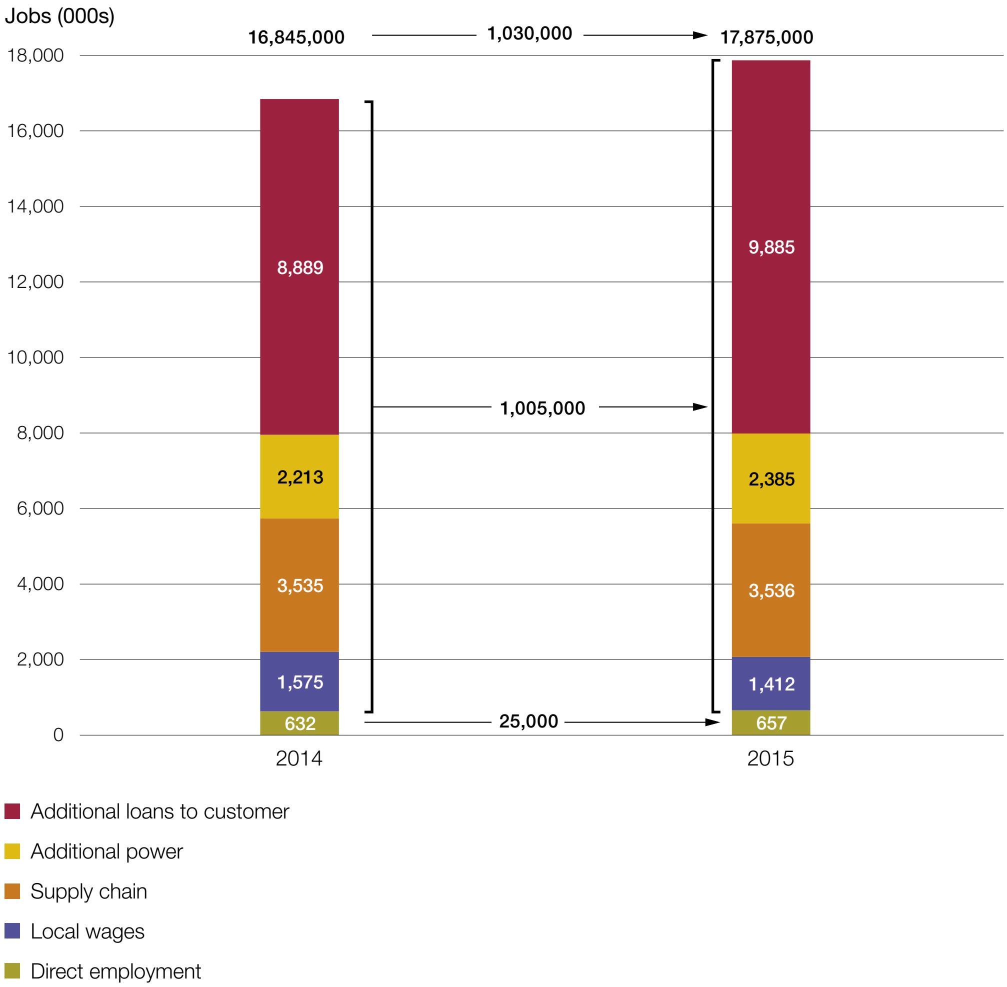
- The capital CDC invests is only one of several contributory factors to job creation such as good management, a supportive business environment, and political stability.

- CDC often invests alongside others and in different roles, sometimes having only a small stake in the business.

- It may also, with an equity investment, be an active or passive investor (in the former case taking a position on the board and therefore exerting more influence). This makes it difficult to determine how much credit can be claimed by CDC.

Figure 13

Direct and indirect jobs created by businesses supported by CDC – 2015



Note

1 Figures may not sum due to rounding

Source: National Audit Office analysis of CDC Group plc's data

2.19 Whether and how to solve the issue of attribution is shared by other development finance institutions and the wider development community. In 2013, CDC joined the Let's Work global partnership which looks to generate common methodologies around job creation and attribution. CDC is hopeful that new methodologies being piloted under the Let's Work partnership will assist it to refine its approach to job measurement.

2.20 In its 2012 annual review CDC announced its intention to explore the quality of the jobs created by investee businesses. Quality of employment includes considerations such as fair wages and safety in the workplace, as well as maximising the productivity and efficiency of businesses. CDC has, since 2015, supplemented the data it collects on accidents with data on time lost due to injury. It has also recently commissioned advice on how to measure job quality and has visited five businesses to study this issue. It has, however, not yet established an overall methodology or approach to measuring quality against which to track performance.

Reporting impact information

2.21 As part of the Investment Policy agreed in 2012, CDC and the Department introduced a new performance framework to track the shift CDC was making away from its old funder of funds model. In addition to the two key performance targets described in paragraphs 2.8 and 2.13, the framework sets targets and indicators – each linked to an objective – for a broad range of CDC's activities. Specifically, the framework includes two targets – for financial performance and development impact and six indicators such as investment success in target geographies and spread of investments across instrument types (**Figure 14** overleaf).

2.22 We have identified a number of ways the framework could be improved:

- The Department monitors CDC's progress against the targets and indicators at the Quarterly Shareholders' Meetings. The Department and CDC told us that if an indicator is not met, it is discussed at the Quarterly Shareholder Meeting but these discussions are not always formally minuted.
- The framework does not include indicators for actual development impact achieved. CDC's job creation measure effectively fulfils this purpose but CDC is not formally required under the Investment Policy to report on this measure by the Department.
- Investment teams are required to justify the additionality as part of the process of deciding whether to make an investment.[14] However, the Department does not require CDC to report on the value additionality of investments made. Given that additionality is a core principle of CDC's investment strategy, we consider it a flaw that it is not covered in the framework.

14 As a public sector development finance institution investing in the private sector, CDC needs to ensure it supplements and mobilises private sector funding rather than displacing it. Additionality, in financial terms, captures the concept of providing capital where it is not offered at all, in sufficient quantities, or on reasonable terms. Additionality, in value terms, recognises that CDC provides more than money, for example, knowledge and advice, which can also be additional to what the private sector is offering businesses.

Figure 14
CDC 2012 Performance Framework

	Objective	Measured by
Targets		
Target 1	New investments have targeted the geographies and sectors with the greatest potential development impact	Aggregate development score for all investments made in the preceding three years, weighted by size of investment – 2.4.
Target 2	Portfolio makes a minimum annual return	The average portfolio return (aggregate realised and unrealised profits from the investment portfolio divided by the beginning value of the portfolio) for the last 10 years (or, if shorter, since 2012) – 3.5%,
Indicators		
Indicator 1	Demonstrates investment success in its target geographies	Number of second time funds where CDC backed the first-time fund/team. Number of second-time funds where CDC backed the first time fund/team with an increased percentage if non-development finance institution capital. Number of third time funds where CDC backed the first time fund/team. Number of third time funds where CDC backed the first time fund/team with increased percentage non-development finance institution capital. Percentage of direct equity investments exited with a positive internal rate of return (by number). Number of un-exited direct equity investments who raised further capital from non-development finance institution at a higher per-share valuation. Percentage of debt investment not impaired (by value).
Indicator 2	Mobilisation of additional funding	Mobilisation Indicator[1]
Indicator 3	Portfolio remains appropriately diversified against risk	Largest fund manager (excluding Actis) as a percentage of total portfolio value <10%. Percentage of total portfolio value invested in a single Eligible Country (excluding India) <20%. Percentage of total portfolio value invested in India <30%. Percentage of total portfolio value invested in a single non-Eligible Country <10%. Largest investment into an investee company (looking through any investment holding company) as a percentage of total portfolio value <5%.

Figure 14 *continued*
CDC 2012 Performance Framework

	Objective	Measured by
Indicators *continued*		
Indicator 4	Investments across the range of investment instruments	Debt and structured finance as a percentage of total new investments over the investment period, by end 2016 – 20%. Equity investments as a percentage of total new investments over the investment period, by end 2016 – 20%.
Indicator 5	Continues to drive environmental, social and governance standards in its investments	Percentage of evaluations rated satisfactory and above >70%.
Indicator 6	Provide a range of forecasts of annual Official Development Assistance and monitor and communicate actual Official Development Assistance against these forecasts	The Department satisfied with schedule of ODA forecasts (yes/no).

Note

1 Mobilisation: In making fund investments, CDC aims to mobilise third party capital investment into Africa and South Asia. As part of the 2012 Investment Policy, one of the indicators agreed was a three-year rolling mobilisation indicator. It is a fraction, expressed as a percentage, the numerator of which is the amount of investments in funds by others subsequent to a legal commitment by CDC plus all capital committed at subsequent closings of the fund, subject to a tapering factor and the denominator of which is the sum of CDC's investments in funds. The tapering factor depends on whether it is a first, second or subsequent fund.

Source: CDC's Group Plc Investment Policy 2012–2016

2.23 In 2015, the Department decided to recapitalise CDC as described in paragraph 1.19. As part of the business case it developed a log frame which set out the expected outcomes from its investment in CDC and identified additional areas of development impact for which the Department wanted to monitor CDC's performance:

- total jobs supported by CDC investee businesses;
- tax contributions by CDC investee businesses;
- change in revenue for CDC investee businesses; and
- private finance directly mobilised by CDC.

2.24 In 2015, the Department chose not to update the Investment Policy to include these new indicators and therefore has not required CDC to report on them. Nevertheless, CDC has reported on three out of four of the indicators in each financial year between 2012 and 2014, and all four in 2015 (**Figure 15** overleaf). The Department and CDC are looking to refine the indicators on jobs supported and mobilisation of capital.

Figure 15

CDC's reported development impact 2012–2015

	2012	2013	2014	2015
Jobs[1]	Supported: 1,109,000	Supported: 1,100,000	Created: 1,277,000	Created: 1,030,000
Taxes paid by investee businesses in Africa and South Asia	$2.19 billion	$2.11 billion	$2.34 billion	$2.60 billion
Percentage increase in revenue of investee businesses in Africa and South Asia	–	–	–	3.4%
Mobilisation: directly mobilised private finance	$252 million	50%	65%	$832 million
Mobilisation: three year rolling mobilisation[2]	385%	265%	Not reported	Not reported – awaiting a definition for a new measure
Additionality: commitments at first close of funds[3]	76%	70%	Discontinued as an indicator	
Additionality: first-time fund managers[3]	33%	30%	Discontinued as an indicator	

Notes

1 Prior to 2014, CDC reported on jobs supported by its investee businesses, for example, direct jobs employed in all its investee businesses. Since 2014 it has reported on jobs both direct and indirect created by its investee businesses, for example, the net jobs created by its investee businesses both directly and indirectly.

2 See note 1 in Figure 14.

3 Additionality: CDC aims to develop capital markets and grow investment capacity in poor countries. To achieve this, CDC will frequently help a new fund get started by advising the fund team and then endorsing them to the market. CDC can demonstrate confidence in a fund and its team by committing capital at the fund's first close, a move that can encourage others to invest. These indicators were discontinued in 2014 as they were becoming less relevant as CDC moved away from an exclusive funder of funds approach.

Source: National Audit Office summary of CDC Group plc's data

Part Three

CDC's approach to its business

3.1 In this part of the report we look at:

- how CDC Group plc (CDC) is organised to support its current strategy;
- how its operating costs have changed over time;
- how salaries and staff numbers have changed over time;
- its approach to liquidity; and
- its approach to reporting fraud and corruption.

Changes to the organisational structure

3.2 In Part One of this report we explained that the Department for International Development (the Department) and CDC introduced a new strategy in response to recommendations we and the Committee of Public Accounts had made in 2008 and 2009. In Part Two we set out the performance measures introduced to support the new strategy.

3.3 We looked to see whether CDC had changed its internal organisation to focus on implementation of the new strategy:

- **Figure 16** overleaf shows how CDC is organised. We have highlighted in yellow those departments and teams which CDC introduced to support the 2012 strategy. Those departments outlined in red existed prior to 2012 but remain relevant to CDC's business.
- **Figure 17** on page 37 shows how each aspect of its current approach is reflected in its current organisational structure. For example, CDC now looks for development impact from its investments, reflected in the recruitment of a specialist team in this area.

Figure 16
CDC's organisational structure

Note

1 Teams and divisions highlighted in yellow were introduced following the introduction of the 2012 strategy agreed between the Department for International Development and CDC. Those departments highlighted in red existed prior to 2012 but remain relevant to CDC's business.

Source: National Audit Office

Figure 17

The alignment of CDC's strategy with its organisational structure

Focus of the strategy	How CDC implements the strategy
Direct equity and debt investments	CDC established new deal divisions for each type of investment – equity, debt, and intermediated equity (funds).
Development impact	CDC has a team, separate from its deal teams, to advise on and develop its approach to development impact. It also has separate teams to manage the department. CDC has separate teams which manage the Department's Impact Funds (see paragraph 1.5).
Environmental and social (E&S), and business integrity (BI) issues	CDC enlarged its separate E&S team which has grown from four to 11 staff in the past three years. It established a separate BI team in 2013, which has grown from one staff member to eight staff.
Countries	CDC has created two regional teams which focus on Africa and on South Asia, which provide specialised support on regional issues to other teams across all instruments.
Sectors	CDC has created deal teams within its direct equity division that focus on the four largest priority sectors.

Source: National Audit Office summary of documents from the Department for International Development and CDC Group plc

3.4 Having made these organisational changes, CDC had a two-phase approach to the growth of its overseas presence.

- In phase one, between 2012 and 2016, it concentrated on implementing its new strategy by developing its London office. This phase saw the expansion of teams responsible for different types of investment.
- In phase two, from 2016, CDC aims to expand its physical presence in Africa and South Asia. Six out of the seven development finance institutions we consulted also have staff based overseas to support their businesses. CDC has appointed locally-based staff in four countries, including regional directors in Africa and in India, and wants to expand these teams. CDC told us that a country presence may be particularly helpful in supporting investments in category A countries and states (see Figure 9 – the most difficult, in CDC's assessment, for successful investments). The Department is supportive of CDC's plans.

Operating costs

3.5 Since 2012, when CDC introduced its new strategy, its total operating costs have increased from £14.8 million a year to £33.5 million in 2015, an increase of 126%. Almost half of the increase was in the first year, and year-on-year increases have declined in both absolute and relative terms. Staff costs accounted for 70% of the increase in operating costs between 2012 and 2015. Other significant cost increases include:

- deal costs: not known in 2012 to £2 million in 2015;[15]
- facilities: doubled from £1.9 million to £3.8 million; and
- travel: increased from £1 million to £2.5 million.

3.6 **Figure 18** shows CDC's operating costs in the context of the value of its portfolio, a measure intended to assess changes against an expansion or contraction in CDC's business. CDC's operating costs have increased at a faster rate (126%) than the value of its portfolio (34%). As a result, operating costs as a percentage of the value of the portfolio has almost doubled from 0.66% in 2012 to 1.12% in 2015. CDC has calculated this will increase further from 1.12% to 1.6% in 2017 followed by a fall to around 1.18% by 2020.

3.7 Given the focus of CDC's 2012 strategy (paragraph 1.21) – on direct investments and development impact – the increase in this ratio is to be expected. For example, CDC needs to develop new skills to reflect the change in focus; and there may be a time lag between identifying and then making new investments. Neither the Department nor CDC, at the time the new strategy was developed and introduced in 2012, assessed what impact the change of focus might have on operating costs. Subsequently, CDC has completed two benchmarking exercises which look at, for example, its operating costs in the context of its business model.[16]

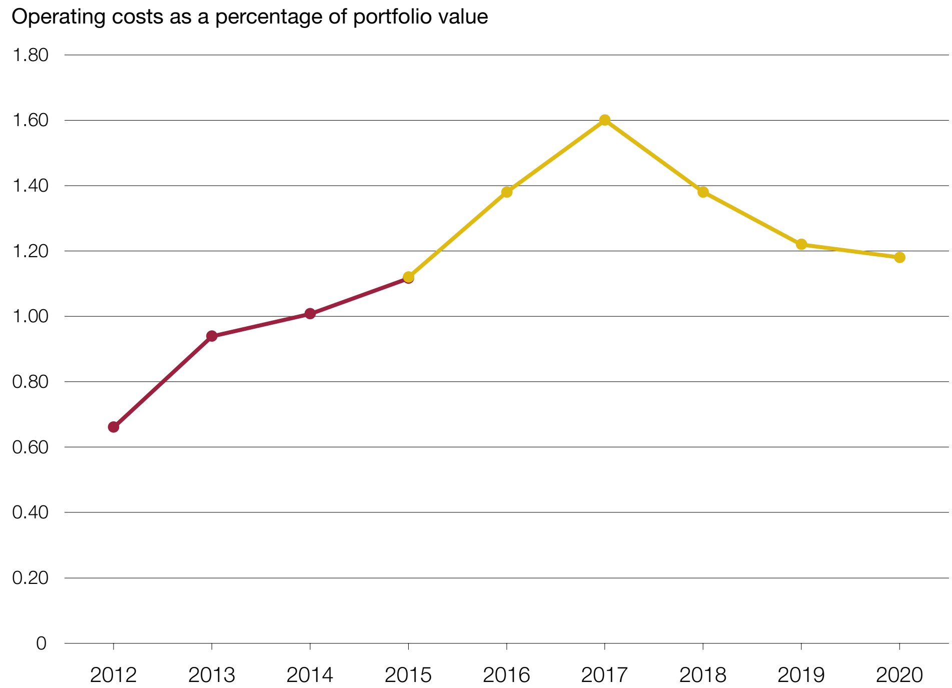
3.8 CDC's performance compares favourably with development finance institutions overseas. CDC analysed similar information available from six development finance institutions to compare its performance for each year between 2012 and 2016. This analysis shows that CDC's operating costs as a percentage of portfolio value has generally been lower than, or at the lower end of, the other organisations. When compared to six development finance institutions, CDC had the:

- lowest percentage in 2012 and 2015;
- second lowest percentage in 2013; and
- third lowest percentage in 2014.

15 Prior to the introduction of the new Investment Policy, CDC only invested in funds. Under this model, deal costs were less significant and were combined with other legal costs. They are not therefore separately identifiable. With the move towards direct investments, deal costs became more significant. CDC then reported them separately.

16 In 2014 and 2016.

Figure 18
CDC's operating costs as a percentage of the value of its portfolio – 2012 to 2020



	2012	2013	2014	2015	2016	2017	2018	2019	2020
Operating costs as a percentage of portfolio value	0.66	0.94	1.01	1.12					
Forecast operating costs as a percentage of portfolio value					1.38	1.60	1.38	1.22	1.18

Source: National Audit Office analysis of CDC Group plc's financial information

3.9 CDC noted that benchmarking exercises such as this need to recognise the differences between organisations when interpreting the results. For example:

- different organisations may account for costs and value assets in different ways (CDC has used each development finance institution's publicly available financial statements);
- different financial instruments require different resource commitments (funds require less resource than direct investments); and
- not all organisations have received a cash injection.

Remuneration

3.10 In our 2008 report on the Department's oversight of CDC we concluded that CDC's spending on pay had been higher than expected for a number of reasons. For example, CDC's board had recommended remuneration packages at levels well above thresholds set out in the remuneration framework agreed between the Department and CDC. CDC's board had also used higher external comparators of pay than set out in the framework.

3.11 In 2012, the Department and CDC agreed a new remuneration framework to support its new investment strategy while keeping control of pay.

- The framework recognised the need to focus attention on recruiting people who wanted to focus on achieving a development impact as well as having investment skills.
- It broke the link, through benchmarking, to the remuneration of those working in private equity and for commercial banks.
- It introduced a long-term incentive element to its pay to encourage retention.

3.12 The remuneration framework has had the desired effect on control of salaries. CDC's average pay has decreased over the same period that its headcount has increased. Between 2011 and 2015, its average annual salary has reduced by 27% from £123,000 to £90,000 (**Figure 19**).[17]

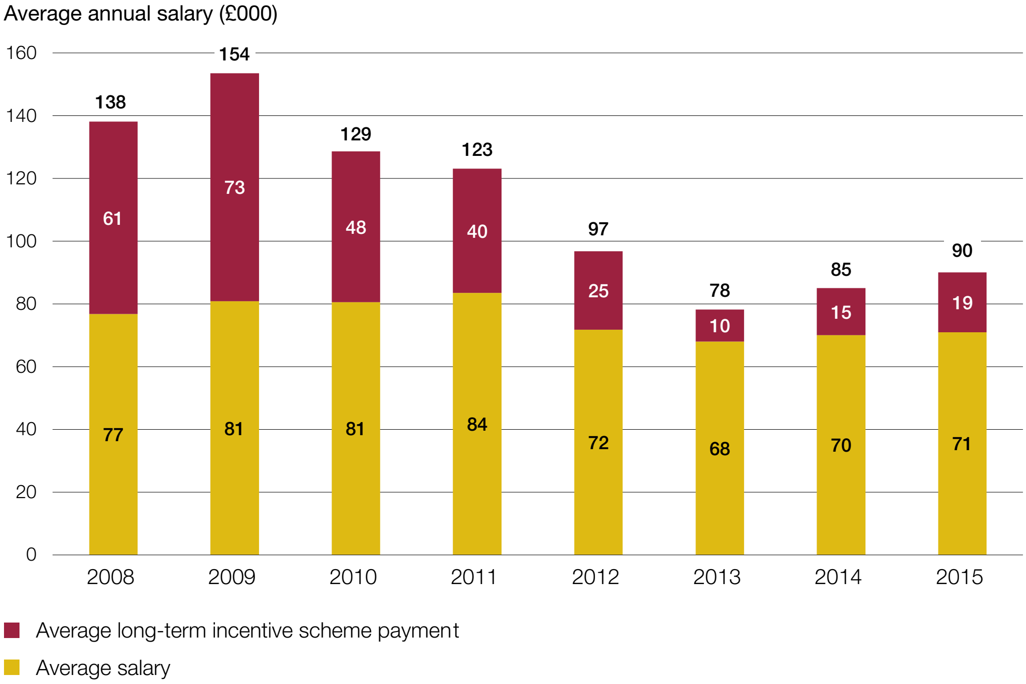
3.13 Total pay, however, has increased as CDC has expanded its business and employed more staff (**Figure 20** on page 42). In September 2016, CDC employed 212 people, an increase of 332% compared with 2011 (when CDC employed 49). Over the same period the number of new investment commitments made has increased by 116% (from 12 to 26). The different rates of growth could be explained by the change in CDC's strategy. For example, direct investments are resource intensive, and CDC now employs a team to consider development impact as well as business integrity.

3.14 In 2014, CDC carried out a benchmarking exercise that compared its team compositions to deal flow, portfolio size and organisational structures of other development finance institutions and investment institutions. It used this exercise to check its organisational model and determine future resource requirements as it continues to expand. The Department and CDC monitor progress with recruitment and expansion of teams at Quarterly Shareholder Meetings.

17 These figures are adjusted for inflation and reflect 2015 prices.

Figure 19

CDC employees' average annual salary – 2008 to 2015



Notes

1 These figures have been adjusted to reflect 2015 prices.

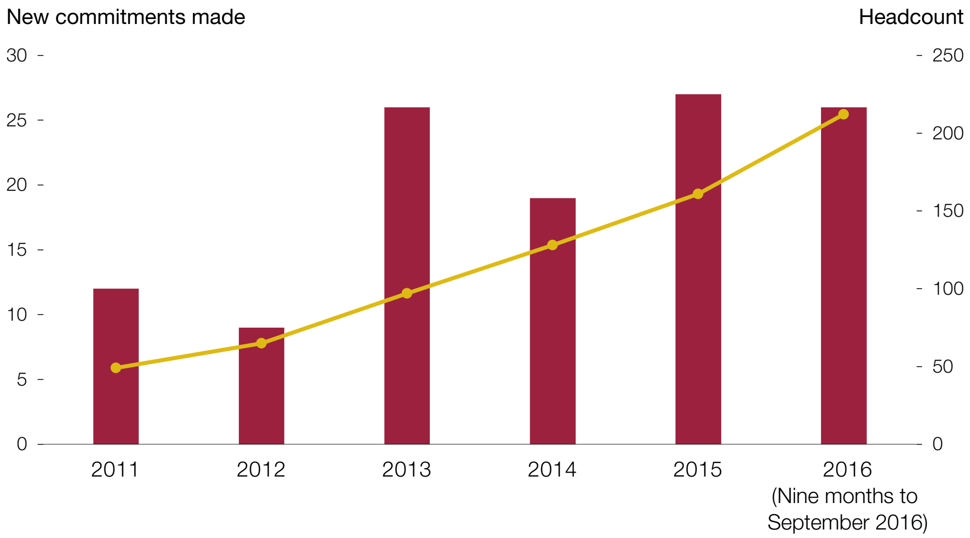
2 Figures may not sum due to rounding.

Source: National Audit Office analysis of CDC Group plc's financial information

3.15 Recruitment and retention, however, remains a key risk for CDC's operation. They are classified a high or severe risk in both CDC's and the Department's risk registers. CDC has struggled to attract and recruit staff with the appropriate skills into mid-level management and senior positions in particular. As an example, it took over a year to recruit both the Chief Financial Officer and the Director for Business Integrity. At the same time, CDC and the Department consider attrition rates of existing staff to be fairly high (**Figure 21** on page 43). Of the five bilateral development finance institutions we consulted, three told us they did not have problems attracting and retaining staff. The other two, however, recognised a similar challenge and highlighted government pay restriction as a barrier.

Figure 20

CDC's headcount – 2011 to 2016 (nine months to September 2016)



	2011	2012	2013	2014	2015	2016 (Nine months to September 2016)
New investment commitments	12	9	26	19	27	26
Headcount	49	65	97	128	161	212

Source: National Audit Office analysis of CDC Group plc's data

3.16 CDC and the Department monitor staffing levels and their impact on the business closely at Quarterly Shareholder Meetings and CDC's Remuneration Committee. CDC is currently undertaking a review of the remuneration framework, including analysis of the root causes of high attrition levels at middle and senior levels and a salary benchmarking exercise. By January 2017, CDC and the Department expect to have agreed on the key challenges identified in the review and principles for resolving them. By March 2017, they expect to have drafted a revised remuneration framework and submitted it to ministers for approval.

Liquidity

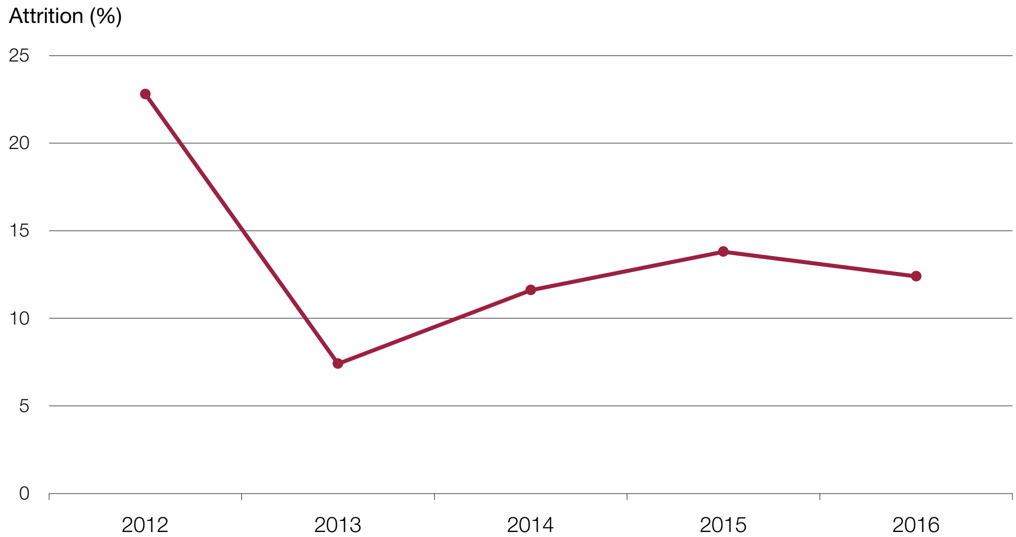
3.17 In our 2008 report on the Department's oversight of CDC, we concluded that it has consistently overestimated the rate at which Actis would convert proposed deals into actual investments.[18] We also noted that the Department had not set CDC any polices on how it might use its cash.

3.18 CDC has to manage two key risks with respect to its cash holdings.

- It does not have sufficient cash available to fulfil its commitments to companies in which it has decided to invest.
- It holds too much cash, which might otherwise be better invested.

18 Actis is CDC's largest fund manager, making investments in private companies in developing countries. Actis was created out of CDC in 2004, with the Department holding 40% of the shares and Actis management the rest.

Figure 21
CDC's annual staff attrition rate, 2012 to 2016



	2012	2013	2014	2015	2016
Attrition rate (%)	22.8	7.4	11.6	13.8	12.4

Note

1 CDC has estimated attrition for 2016, taking into account figures for the period January to September 2016.

Source: National Audit Office analysis of CDC's Group plc's data

3.19 In September 2014, six years after we raised concerns, CDC introduced a liquidity policy to help it manage these two risks. It stated that CDC should:

- expect to hold cash in an amount equal to between 0% and 10% of its net asset value; and
- target having cash availability in excess of 80% of CDC's aggregate outstanding contractual commitments (including investment commitments).

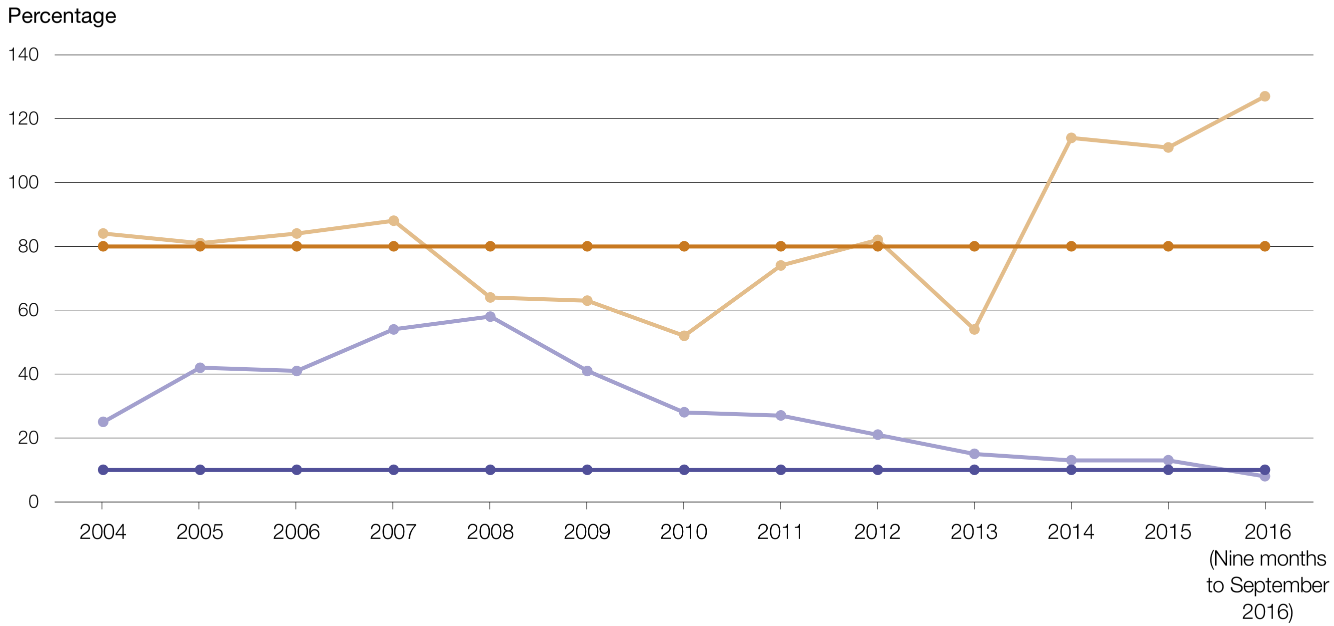
3.20 Figure 22 overleaf shows CDC has achieved these targets.

- It has reduced the amount of cash that it holds as a percentage of net asset value from a peak of 58% in 2008 to 8% at the end of September 2016. Over that period CDC's cash balance reduced by 70%; at the same time the value of its portfolio grew by 233%.
- In 2015 and 2016 (nine months to September 2016), CDC's cash availability as a percentage of its total undrawn commitments was 111% and 127% respectively.

Figure 22
Changes in CDC's cash position – 2004 to 2016 (nine months to September 2016)

CDC's liquidity policy states that it should

- expect to hold cash in an amount equal to between 0% and 10% of its net asset value; and
- target having cash availability in excess of 80% of it's aggregate outstanding contractual commitments (including investment commitments).



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016 (Nine months to September 2016)
Available finance as a percentage of undrawn commitments	84	81	84	88	64	63	52	74	82	54	114	111	127
Target – finance as a percentage of undrawn commitments	80	80	80	80	80	80	80	80	80	80	80	80	80
Cash as a percentage of the portfolio's net asset value	25	42	41	54	58	41	28	27	21	15	13	13	8
Target – cash as a percentage of the portfolio's net asset value	10	10	10	10	10	10	10	10	10	10	10	10	10

Source: National Audit Office analysis of CDC Group plc's financial information

Fraud and corruption

3.21 As a provider of capital to businesses in some of the world's most challenging investment environments, corruption and other business integrity risks are inherent in CDC's mission. CDC's policy is to take a 'zero tolerance' approach to all forms of corruption and it is committed to preventing bribery in all its investments. To minimise the risk of investing in potentially corrupt businesses, it has established due diligence procedures to support its investment decision process. For example, CDC carries out background checks on the senior management team of funds or businesses, and spends time with them to understand their motivations and values. Between 2012 and 2015, CDC rejected 19% of possible investments because of business integrity and environmental or social concerns.

3.22 We asked CDC for details of the allegations of fraud and corruption it had received concerning existing investments. CDC advised us that it dealt with such allegations in two principal ways. Firstly, it monitors risks and issues arising from investments through its regular portfolio management processes. Secondly, it has in place a mechanism through which whistleblowers can raise allegations of fraud and corruption.

3.23 However, until recently CDC did not keep a consolidated record of all the allegations it receives. This made it harder for it to provide comprehensive reporting to the Department. For example, during the period 2009 to 2016, both CDC and the Department received four allegations of fraud and corruption covering the same cases. The Department's internal audit function concluded that the figure of four cases was surprisingly low.

3.24 In addition, CDC received a further three allegations, which it raised informally with the Department, and a further one which it did not because it judged that the issue had been investigated and dealt with. Not having a consolidated picture of these cases makes it harder for CDC to feed the insights arising from them back into future investment decisions. As a result of our inquiries, CDC has now established a register that brings together its records of fraud and corruption allegations, together with the actions it has taken in response.

Appendix One

Our audit approach

1 This study focuses on the value for money of the Department for International Development (the Department)'s investment in CDC Group plc (CDC), the UK's development finance institution. It examines:

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

2 We applied an analytical framework with evaluative criteria to determine whether the Department has secured value for money from its investment in CDC. This included examining whether the Department has shaped and maintained effective stewardship of CDC's operation and performance; whether CDC is achieving the performance targets and impacts it agreed with the Department; and whether CDC is maintaining effective control of the Department's investment.

3 Our audit approach is summarised in **Figure 23**. Our evidence base is described in Appendix Two.

Figure 23
Our audit approach

The objective of government

CDC is the Department for International Development (the Department)'s main vehicle for delivering one of its key priorities – economic development in developing countries.

How this will be achieved

The Department is the sole shareholder in CDC, which invests in businesses throughout Africa and South Asia to encourage growth of the private sector. The Department agrees CDC's high-level strategy but has no involvement in its day-to-day operations and investment decisions. It last agreed a new strategy in 2012, which increased CDC's focus on development impact. In 2015, the Department decided to recapitalise CDC with £735 million – the first cash injection since 1999 – to expand the scale of its operations.

Our study

The study examines whether the Department's investment in CDC is securing value for money.

Our evaluative criteria

- Whether the Department is maintaining effective stewardship of CDC's performance and operations.
- Whether CDC is achieving the objectives and targets it has agreed with the Department.
- Whether CDC is maintaining effective control over the Department's investment.

Our evidence

(see Appendix Two for details)

We analysed CDC's data on its investment spending and performance, its operations (such as costs and staff numbers), and its development impact.

We conducted semi-structured interviews with Departmental officials, CDC employees, representatives from UK Government Investments (formerly the Shareholder Executive) and stakeholders.

We reviewed the Department's and CDC's key documents.

We conducted a benchmarking exercise with seven other bilateral and multilateral development finance institutions.

We undertook two case study visits of how CDC has invested its funds in developing countries.

Our conclusions

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.

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.

Appendix Two

Our evidence base

1 We reached our independent conclusions on the Department for International Development (the Department)'s investment in CDC Group plc (CDC) following our analysis of evidence between April and September 2016.

2 Our audit approach is outlined in Appendix One. Our main evidence sources were:

- **Quantitative analysis** of key data supplied by CDC, including analysis of:
  - CDC's current investments – for instance, their value; geographical and sectoral distribution; and their development impact scores;
  - CDC's operations – for instance, staff numbers and attrition rates; operational costs; and cash and liquidity balances; and
  - CDC's performance – for instance, jobs created by investee businesses; mobilisation of additional capital; and revenue and tax raised by investee businesses.
- **Semi-structured interviews** with the Department, including:
  - the team that oversees CDC;
  - the internal audit function; and
  - the Anti-Corruption and Counter Fraud Unit.
- **Semi-structured interviews** with CDC's staff, including:
  - two board members, including the Chair;
  - senior management, including the Chief Executive Officer, Chief Financial Officer, the Chief Operating Officer; and the Chief Investment Officer;
  - investment professionals, such as the managing directors of the equity, debt, and funds teams; and
  - operational teams, such as those with responsibility for development impact, social and environmental considerations, legal matters and finance.

- **A review of the Department's and CDC's key documents**, including:
  - public information, such as CDC's Investment Policy, the Department's business case for recapitalisation, and CDC's annual reports; and
  - internal papers, such as CDC's policies, CDC's investment papers, and CDC's performance monitoring packs.
- **Consultation with bilateral and multilateral development finance institutions** – Proparco (France), FMO (the Netherlands), OPIC (the United States of America), SIFEM (Switzerland), Norfund (Norway), the International Finance Corporation (a global multilateral development finance institution), and the European Bank for Reconstruction & Development (a European multilateral development finance institution). We sent the consultation questionnaire to one additional institution which chose not to respond.

  The consultation was carrried out between 25 July and 12 August 2016, although we accepted some later responses. We requested information regarding the institutions' objectives and strategy, relationship with its shareholder, approach to investing, targets set for its investment portfolio, performance of its investment portfolio, monitoring and evaluation, staffing, environmental and social considerations, and fraud and corruption.

3 We completed two case study visits to examine CDC's investments on the ground in both the geographies covered by its current stategy:

- South Asia – **India**, where we visited seven businesses across three regions – for example, hospitals, microfinance banks, and an agricultural fund.
- Africa – **Uganda and Kenya**, where we visited five businesses in each, for example, solar product companies, a hydroelectric power plant, an internet retailer, a cement producer, a microfinance bank and an energy distribution company.

4 We selected these countries to make sure we covered a range of different types of CDC's investments, in terms of both instruments used and businesses invested in. For each case study visit, we reviewed relevant investment information; interviewed investee businesses; collected performance information; interviewed the Department's country office; and interviewed CDC's in-country staff.

Appendix Three

The Department's response to previous Committee of Public Accounts recommendations

Committee of Public Accounts recommendation	Department's response (see source)	Current status	Progress rating
The Department should set medium-term financial targets for CDC to relevant market indices.	The Department will ensure that CDC's new five-year Business Plan (2009–2013) includes clear medium-term financial targets, including a financial rate of return by reference to regional market indices.	Under the 2012 Investment Policy, the Department has set CDC a target of a minimum financial rate of return of 3.5% on CDC's total portfolio.	
The Department should routinely be consulted on the nature and scale of major CDC commitments and on their effect on cash balances.	The Department agrees it should be consulted by CDC in advance on any major strategic options not covered in CDC's Business Plan. The Department will continue to monitor the levels of cash held by CDC to ensure that they are not excessive and will discuss corrective action with CDC if needed.	At the Quarterly Shareholders' Meeting, CDC reports on actual and projected investments, operating expenses and liquidity. CDC models its short-term and long-term cash flow requirements to manage its liquidity position.	
The Department and CDC must recognise that high levels of pay, however merited, must be subject to effective oversight.	The Department has put in place a strengthened remuneration framework for CDC.	Since the Treasury Minute response, the remuneration framework has been revised again. The current framework was introduced in 2012, but is under review as CDC considers it is having a negative impact on recruitment and retention.	
Part of that pay … reflects a dubious comparison with private sector 'funds of funds' businesses … And the pay arrangements place too much emphasis on financial performance and too little on poverty reduction.	The Department disagrees that the comparison with private sector funder of funds is dubious. In November 2008, the Department agreed a revised Remuneration Framework for CDC. This sets pay levels which reflect CDC's recruitment and retention needs and links CDC executive remuneration more tightly to the delivery of the Department's objectives.	In the 2012 remuneration framework, pay is no longer benchmarked to commercial private equity and international commercial banking industries. Pay awards are now linked to development impact as well as financial performance, and reward longer tenure.	

Committee of Public Accounts recommendation	Department's response (see source)	Current status	Progress rating
Compliance by businesses and fund managers with CDC's ethical business principles is not independently verified. The Department should ensure that assurance and assessment are independent of CDC and fund managers, and that the assessments cover the whole portfolio.	The Department agrees with the Committee conclusion that independent verification of compliance is desirable … In 2009 CDC will commission an independent audit of compliance of a representative sample of CDC's overall portfolio of investments. In addition, from 2009 CDC will provide the Department annually with an independent audit of its implementation processes in relation to its Investment Code (business principles).	The Investment Policy requires CDC to maintain a certain level of positive external evaluations. It met this test through 2014 but has now changed its approach from evaluating individual investments to thematic evaluations, plus quarterly assessment and reporting of environment, social and governance performance across the pipeline and investment portfolio.	
The Department should ensure that CDC concentrates its resources in deprived areas and markets.	From January 2009, the new investment policy will focus CDC investment operations even more tightly on the poorer countries of sub-Saharan Africa and South Asia.	Under the 2012 Investment Policy, CDC only invests in Africa and South Asia. The Development Impact Grid incentivises teams to invest in those countries with the most difficult investment climates.	
And it needs to improve the way that CDC measures and reports its effectiveness in mobilising additional investment.	The Department and CDC will work together to develop improved methods of measuring and reporting on CDC's effectiveness in mobilising additional investments.	The recapitalisation business case included £5 million for the Department to assess the development impact of CDC's investments, including how successfully they stimulate subsequent private investment. They have yet to let a contract for this work.	
The Department needs to make sure that CDC's financial targets, business model and incentives do not impede the adoption of financial instruments other than equity. CDC's reporting should clearly distinguish results achieved from different types of business.	The Department agrees with the Committee's conclusion. CDC's plans for introducing new financing instruments will be elaborated in the five-year Business Plan. Going forward, CDC reporting, including its new annual development impact report, will distinguish where feasible between the results achieved from different types of business.	CDC reports on development impact performance by financial instrument in the pack for the Quarterly Shareholders' Meeting.	

Committee of Public Accounts recommendation	Department's response (see source)	Current status	Progress rating
There is limited evidence of CDC's effects on poverty reduction. CDC is working to collect improved information on the developmental effects of its investments, and the Department should require CDC to report the results systematically and in a way which fairly represents the portfolio.	The Department and CDC acknowledge that they need to do more to demonstrate the human development impact of CDC's investments, directly and indirectly. CDC has recently undertaken a major project to review and update its development impact policies, procedures and methodology. CDC has strengthened its development impact recording methodology.	CDC has developed a methodology for measuring the jobs impact of investments, which is published on its website. CDC reports on job creation in its investee companies in its annual report but does not seek to attribute jobs to CDC's investment per se. The Department is working with CDC and with other development finance institutions to refine approaches to impact measurement in this area.	
The Department should commission an independent evaluation of CDC's impact, timed to inform the next five-yearly business review.	The Department agrees.	In 2015 the Department and CDC jointly commissioned a Harvard University-led evaluation into the impact of CDC's funds. In 2016 the Department commissioned a review of CDC's strategy to assess whether CDC had achieved its objectives as set out in the Investment Policy and 2012–2016 strategy and which areas of CDC's work may need to be changed, and why, to better align them with the Department's goal of poverty reduction in the poorest countries.	
CDC has found it challenging to collect and report non-financial information such as its contribution to reducing poverty.	The Department agrees. However, unless private investors believe that CDC will respect commercial confidentiality, they will not invest alongside CDC and CDC will fail to deliver its objective of mobilising private investment.	In its 2015 Annual Review, CDC reported on job creation based on data collected from 484 businesses (up from 388 businesses in 2014). This represents 77% of businesses it invests in across Africa and South Asia.	
As one of the few entities with money to invest in the downturn, CDC should use that influence to promote greater transparency and openness.	The Department will continue to work with CDC to influence fund managers, through which CDC places its capital, to provide further information on plans and performance.		

Source: Recommendations and Departmental Response taken from Treasury Minute on the Eighteenth Report from the Committee of Public Accounts 2008-09: Department for International Development: Investing for development: Department for International Development oversight of CDC Group plc, Cm 7636

Appendix Four

CDC Investment Glossary

Explanation and description of key CDC investment instruments

Key term	Definition	Example
Equity investment	In an equity investment, CDC invests from its own balance sheet directly in a business. It can take an equity stake of any size between 1% and 100%. Equity has an uncertain return and is high risk because investors are paid last both in terms of financial returns and in the event of insolvency. By taking a stake in businesses, in addition to providing the capital, CDC is able to bring in expertise to improve governance, management and technical capacity, which is often lacking in developing countries.	In August 2013, CDC made its first direct equity investment in India since the launch of its new strategy. It invested US $17.3 million in Rainbow Hospitals, a 400-bed paediatric and maternity healthcare business based in the southern Indian state of Andhra Pradesh. After the investment, Rainbow went on to build four modern hospitals in Andhra Pradesh and Bangalore, taking the bed count up to more than 700 as of today. The new hospitals will provide new direct jobs (doctors and nurses for example), which are up from 1,028 in 2013 to 1,989 in 2016, and indirect jobs (for example, construction suppliers). In 2016, CDC invested US $15 million more to help expand to other areas of India.
Debt investment	A debt investment covers loans and debt financing such as long-term loans to companies and financial institutions, bonds and debentures, and guarantees. Debt is less risky than equity because it generally has a fixed repayment time horizon and has pre-agreed returns. Debt enables the business to undertake activities that have a good expectation of success earlier than the business would otherwise have been be able to do so if the business had used existing revenue and cash balances. CDC includes certain requirements in its debt agreements with businesses, such as compliance with CDC's environmental, social and governance standards.	In February 2014, CDC invested €40 million to Bharti Artel Africa as part of a debt facility agreed by a consortium of development finance institutions. Bharti is one of the largest mobile phone operators in Africa, and pursues a high-volume, low-price business model which benefits low-income consumers, who are the most price sensitive. The facility aims to help Bharti expand its telecommunications provision across its 17 operating countries in Africa, including some of the least developed states. Since CDC's investment, Bharti has already created more than 450 jobs in Africa. The investment in infrastructure and technology will also result in the creation of many more indirect jobs in supplier companies.
Trade finance	Trade finance is a sub-type of debt and a form of guarantee that has a short tenure. It is required by businesses to help them close a trade cycle funding gap, principally acting to mitigate payment risk between cross-border buyers and sellers of goods and services. It allows firms to use goods as collateral, rather than capital, which can instead be used to fund development.	In 2013-14, CDC signed a US $150 million risk participation arrangement with Standard Chartered Bank to help increase the availability of trade finance illiquid developing country markets. The majority of businesses which received trade finance under the agreement are in Bangladesh, where the economy heavily depends on trade. One transaction supported by CDC trade finance provides for a manufacturing business to import milled wheat, which is used in the production process of a wide variety of breads.

Explanation and description of key CDC investment instruments

Key term	Definition	Example
Funder of funds	As a funder of funds, CDC selects and funds intermediate private equity fund managers. These fund managers select the individual companies into which CDC and other investors' money is invested. Fund managers then monitor and sell the investments and return the proceeds, including any profit to CDC and other investors. Fund managers then receive an annual management fee and a proportion of the profits, usually 10%–20%, when investments are sold (typically after five to 10 years).	In 2011, CDC invested US10m in the Progression Eastern African Microfinance Equity Fund (PEAMAF) owned by Progression Capital Africa Ltd (PCAL). PCAL is a first-time fund manager and CDC committed to invest in its fund at first close where few financial institutions are willing to take the first-time partner risk. PEAMAF focuses on investing in financial inclusion institutions and enabling financial technology sectors such as mobile money companies across East and Southern Africa. It was started because of the huge financial inclusion gap in the target region, where a significant proportion of the population in each country still do not have a formal bank account. In 2009, CDC invested US $10 million in the India Agribusiness Fund owned by Rabo Equity Advisors, a first-time fund manager. In 2014, it set up India Agri Business Fund II where CDC made another commitment of US $30 million as an anchor investor. These funds invest in growing businesses across India's agribusiness industry, such as agricultural input, food processing, and warehousing and distribution companies. The first fund made investments in 10 companies which directly employ almost 5,000 people. For one family-owned company, Prabhat Dairy, the investment allowed them to expand capacities and diversify their product from only milk collection to cheese and yoghurt production.

Note

1 Of the examples described, the National Audit Office visited Rainbow, Progression Capital Africa Ltd and Rabo Equity Advisors.

Source: National Audit Office summary of CDC material

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