MINISTRY OF FOREIGN AFFAIRS
Danida

Evaluation

The Industrialization Fund for Developing Countries

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NCG

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This report was prepared by independent consultants with no previous involvement in the activities mentioned. Responsibility for the content and presentation of findings and recommendations rests with the evaluation team.

The views and opinions expressed in the report do not necessarily correspond to the views of the Danish Ministry of Foreign Affairs, the recipient governments, or the implementing organisations.

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Preface

This report presents the findings of the evaluation of the Industrialization Fund for Developing Countries (IFU), which was established by the Danish Government in 1967.

The Evaluation was commissioned by Danida with the consent of IFU's Board and carried out by Nordic Consulting Group A/S during the year 2003. The fieldwork was carried out in the period March-April 2003, and the main analysis period carried on until December 2003.

The Evaluation consists of a main report and 12 annexes. While the main report brings together the principal findings, it cannot adequately reflect all the details and contextual nuances of the individual studies. The interested reader is therefore referred to the 11 annexes that are included on the CD-ROM attached to the main report.

The information received by the Evaluation team from IFU, Danish partners or project companies in connection with the Evaluation have been treated as strictly confidential and the Evaluation does not refer to any specific companies. This has led to an unavoidable loss of detail in presentation of evidence. Detailed analyses have been conducted for about 25% of all approved IFU projects. The scope and the outcome of the analyses have been shared with the Evaluation Department and IFU throughout the analysis period. The Evaluation Department, is therefore satisfied that the Evaluation has covered its Terms of Reference, and that sufficient information to back the analyses has been available to the team.

Various drafts of the report have been discussed with Danida and IFU, however, the views and opinions presented in the report are those of the authors and do not necessarily correspond to the views of Danida or IFU.

IFU disagrees with the Evaluation's interpretation and assessment of fulfilment of IFU, and the assessment of additionality. In order to reflect the views of IFU, an appendix containing these points of disagreement has been included immediately after the main text.

Copenhagen, June 2004
Danida's Evaluation Department

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List of Abbreviations

BC	Binding Commitment
BSPS	Business Sector Programme Support (Danida)
BtB	Business to Business Programme in South Africa (Danida)
CAD	Corporate Administration Department (IFU)
CDC	Commonwealth Development Corporation (United Kingdom)
CIP	Clearance in Principle
CoC	Code of Conduct
DAC	Development Assistance Committee (OECD)
Danida	Danish International Development Assistance
DFI	Development Finance Institution
DIPO	The Danish Import Promotion Office
DKK	Danish Kroner
DP	Danish Partner
ECA	Export Credit Agency
ECIP	European Community Investment Partners
EDFI	European Development Finance Institutions
ETF	Environment and Training Fund (Danida)
EU	European Union
FDI	Foreign Direct Investment
FIN	Finance Department (IFU)
Finnfund	Finnish Fund for Industrial Development Co-operation
FMO	Financiering Mataatchappij voor Ontwikkelingslanden (the Netherlands)
FMS	Fund Manager System
GDP	Gross Domestic Product
GNI	Gross National Income
GNP	Gross National Product
HRD	Human Resource Development
IC	Investment Committee
IFC	International Finance Corporation
IFI	International Finance Institution
IFU	The Industrialization Fund for Developing Countries (Industrialiseringsfonden for Udviklingslandene)
IFV	The Investment Fund for Emerging Markets (Investeringsfonden for Vækstmarkeder)
IGF	Investment Guarantee Fund (Investeringsgarantifonden)
ILO	International Labour Organization
IMD	Investment Management Department (IFU)
IMF	International Monetary Fund
IØ	The Investment Fund for Central and Eastern Europe (Investeringsfonden for Østlandene)
IPM	IFU's Procedures Manual
IRR	Internal Rate of Return
ISO	International Standardisation Organisation
JV	Joint Venture
LDC	Least Developed Countries
LIC	Low Income Countries
LMIC	Lower Middle Income Countries

LP	Local Partner
MBA	Master of Business Administration
MCP	Mixed Credit Programme (Danida)
MD	Managing Director
MoFA	Ministry of Foreign Affairs, Denmark
Norfund	Norwegian Risk Capital Fund for Developing Countries
ODA	Overseas Development Assistance
ODIN	IFU's Database
OECD	Organisation for Economic Co-operation and Development
OHS	Occupational Health and Safety
OPIC	Overseas Private Investment Corporation (US)
PAIR	Project Appraisal and Improvement Report
PC	Project Company
PDD	Project Development Department (IFU)
PID	Project Identification
PIM	Pre Investment Meeting
PSD	Private Sector Development
PSDP	Danida's Private Sector Development Programme
R&D	Research and Development
ROA	Return on Assets
ROE	Return on Equity
ROI	Return on Investments
SIMI	Scandinavian International Management Institute
SME	Small and Medium-Sized Enterprises
SOD	Special Operations Department (IFU)
Swedfund	Swedish Fund for Industrial Co-operation with Developing Countries
TNC	Trans-National Corporation
ToR	Terms of Reference
UK	United Kingdom
UMIC	Upper Middle Income Countries
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
USA	United States of America
USD	United States Dollar
WB	World Bank

Exchange Rate: USD 1.00 = DKK 6.43 (May 2003 average):

Executive Summary

Background

The Danish Government established the Industrialization Fund for Developing Countries (IFU) in 1967 with the purpose of promoting industrial development in developing countries by facilitating investments in these countries in collaboration with the Danish industry. The scope for IFU's investments was broadened in 1971 to include the service and agro-processing sectors. Private sector and business sector development have over the years attained a more prominent position in donors' development assistance, as the sectors' importance for broad-based development is increasingly recognised. Danida has from the mid 1990s developed its business sector instruments in accordance with this wider perception of the sectors. IFU's legal mandate and objective could accordingly be interpreted in this perspective. However, while several discussions have taken place on IFU's mandate and objective, a reinterpretation or modification has not materialised. During the first years of IFU's existence, its operations were mainly financed by taxes from coffee and coffee products amounting to DKK 300 million. IFU was self-sustained from 1979-1996. In 1996, the Danish Government agreed to provide a capital injection in the amount of DKK 750 million over a five-year period.

In late 2002, Danida decided to undertake an evaluation of IFU with the consent of IFU's Board. The Evaluation was conducted from January to October 2003. Its main objective is *"to assess to which extent IFU's investments have promoted economic activity in developing countries in accordance with §9 of the Act on International Development Co-operation in 1976 and the Appropriation from June 1996"*. It was conducted simultaneously with a study assessing the capital basis required for maintaining IFU's current level of investments and establishing criteria that could be used in withdrawing part of IFU's equity capital.

IFU can – according to its statutes – support Danish investments in developing countries by: financing of feasibility studies, buying shares, provision of loans, provision of guarantees and securities, and other interventions which would enhance IFU's objective. The most common mode for IFU's engagement today is with investment and advisory services in project companies involving Danish companies and, most commonly, local partners. IFU provides risk-willing capital to projects in countries where this cannot be obtained by the project companies on a commercial basis or on reasonable terms and conditions.

The total number of IFU projects that have reached the agreement stage was 449 by the end of 2001. Of these, 101 projects have for various reasons not had any disbursement. The number of ongoing projects by the end of 2001 was 211 with a total investment of DKK 1,839 million and reservations for future losses amounting to DKK 904 million. 26 of these projects have not had any disbursement. IFU's equity capital was DKK 1,872 million at the end of year 2001. The equity was constituted of the net current value of the project portfolio valued by IFU at DKK 898 million (incl. DKK 42 million relating to interest receivables related to projects), cash and bonds amounting to DKK 967 million (of which DKK 539 million were committed to new projects and DKK 139 million were for projects that were cleared in principle), and accumulated assets and liabilities amounting to DKK 8 million.

Findings

Relevance
Denmark's bilateral development assistance concentrates on low-income countries, as most 'Danish programme countries' belong to the group of least developed countries (LDCs). IFU operates basically in the same category of countries, but it has a higher concentration on lower middle-income countries (LMICs) and upper middle-income countries (UMICs) and, therefore, poverty reduction is not as pronounced from a global perspective as for the Danish bilateral assistance. Irrespective of the choice of host country and location, most IFU investment projects are generally relevant and they do stimulate the economy in terms of employment, technology innovations, and management practices. IFU's individual investment projects are, generally, in line with the host countries' development policies and priorities.

The distribution of IFU projects by region has changed over time with Latin America dominating up to the mid 1970s, and Africa dominating from the mid 1970s to the mid 1980s. From the mid 1980s, the picture changed, with Asia taking over as the dominant region. When looking at the geographical concentration of IFU's projects, it is clear that investments are high in a few countries (LMICs and UMICs) where investment conditions are better than in LDCs and other low-income countries (LICs). The relative share of IFU's investments in LDCs has fallen after 1996; and the Africa portfolio has become less focussed on the poorer countries.

IFU's investment projects have promoted economic activities in developing countries. A broader interpretation of IFU's objective of supporting business sector development would imply complementary interventions – in the form of soft instruments – to those of generating economic activity. However, the general position of IFU's owner and Board has been that IFU should concentrate on the investment modality. Accordingly, IFU's investment strategies are mainly directed by Danish partners' investment needs more than by the global need for development finance institutions' (DFIs) interventions.

Impact
Most IFU projects are found to have positive development effects. Many of the Danish partners, with whom IFU engage are capable of producing impressive development impacts, independent of IFU[1]. In all regions, the investment projects have resulted in some degree of direct employment creation, the securing or conservation of jobs, and indirect job creation through sub-contractor jobs. For all regions, human capital investments through training and involvement of local staff and changed management regimes have been key features of the Danish enterprises' activities. The Danida Environment and Training Fund (ETF) has contributed well to human resources development.

Environmental and working environment impacts have, generally, been the result of applying Danish norms and Danish corporate policy of the involved enterprises. The net contribution of IFU's Code of Conduct (CoC) has not been easy to verify, as the CoC is today mostly at a par with especially the large Danish partners' in-house code. A repeated finding is that the different development indicators appear to be mutually reinforcing and that the learning experience for the local partners and for competing enter-

1) *This statement is based on the Evaluation's interviews with IFU's project partners in Denmark and the host countries.*

prises watching the Danish establishments, has been that well trained and treated local staff provide the basis for profitable and competitive enterprises.

IFU's investment projects have, to a large extent, generated positive effects for the Danish companies, and have promoted their internationalisation. The smaller Danish companies have generally benefited relatively more from the cooperation with IFU, as they possess the required expertise for international operations to a lesser extent than the larger companies. Most Danish companies strive to improve their long-term competitive edge in terms of market penetration through productivity enhancement measures, technology innovations, and improved product quality – whereas some seek short-term gains through major equipment supplies and use the joint venture arrangement as a means to secure the deal.

Sustainability
IFU is, as a fund, highly sustainable. Over the 1968-2001 period, IFU has, overall, managed the investment portfolio in a way that it has returned the Fund a total income on project activities of DKK 1.2 billion. In addition, the total financial income over the same period has been DKK 1.9 billion. Besides this, IFU has received a paid in capital from Government of DKK 1.05 billion. The realised losses on share capital and loan principals on all concluded projects have been DKK 591 million, and project and operating expenses have totalled DKK 0.8 billion. Despite the fact that IFU has registered a net profit, it has not presented an operating profit from its investment activities during the past three years. This is mainly due to the very high provisions for expected losses on its investments, which are, though, approved by the auditor and the Board. Rather, it appears that its profit has been derived from the income on its high level of cash and bonds. The policies related to the provision for losses and the availability of liquid capital have been very cautious with a view to having a financially robust and trustworthy institution. Less cautious liquidity policies would have had the potential to increase the project portfolio, provided the demand for investment existed. The demand for investments during the 1996-2000 period did not evolve fully as anticipated, as the number of projects declined and the average investment size doubled at the end of the five-year period for both new and existing projects. Hereby the total planned investment amount was attained.

The financial quality of the portfolio and the performance of the invested projects show a varying but slightly increasing trend over the last years, suggesting that the performance of the portfolio is improving. This could indicate that the general project performance is better, but since there has been a shift from equity capital towards loans especially since 1996, it could also indicate that IFU is now less exposed to equity return variations.

In Asia, three-fourths of all projects assessed by the Evaluation have a probability of sustainability – although some projects never materialised, because IFU and the Danish partners, before disbursements took place, reassessed the projects and concluded that they would most probably be unsustainable. Half of all projects in Latin America have economic difficulties threatening sustainability; however, IFU has demonstrated exceptional ingenuity in resolving threatening conditions, and most projects continued on a better platform after IFU interventions. In Africa, more than half of the projects assessed are financially non-sustainable – some of the causes being poor project preparation and partner assessment, over-reliance on other Danish business sector instruments, insufficient monitoring and absence of hands-on IFU board participation in project companies. Furthermore, IFU's project portfolio in Africa has been affected by considerable

political and economic turbulence, which has contributed to the portfolio being thinly dispersed across the continent. The many political conflicts across the African continent, which change once relatively well functioning countries into volatile places, generate poor enabling environments for invested capital and make it difficult to attract new foreign investments.

Efficiency
The productivity of IFU's administration can been assessed by the number of new projects per year and the annual investment volume per staff member. The number of ongoing projects per staff was 1.5 per year during the 1970-90 period, after which there was a marked increase to 4.5 in the late 1990s. The number of new projects follows the same trend. Measured in this way, IFU performs very well compared to other DFIs. Measured as administrative costs per project, IFU also performs well. However, a number of projects, for which agreements were made, never reached the disbursement stage – resulting in lower administrative efficiency.

The productivity of IFU's administration increases with fewer but larger projects. Disbursements for the five biggest projects have all been above DKK 70 million, and they have in total received 10% of all IFU disbursements. The concentration of projects on specific Danish partners is quite high, with one Danish concern accounting for 13% of the total agreed IFU investments. The top ten Danish partners in terms of number of projects have 28% of all projects, and the top ten in terms of total IFU investment got 47% of all IFU funds. IFU has not utilised investments in intermediaries as a way of increasing efficiency in the handling of small projects with small local partners, as the tying to Danish partners has restricted this approach.

IFU's Africa promotion policy after 1996 aimed at increasing the number of new projects per year in Africa from five to 15, and the yearly invested amount from DKK 10 million to DKK 40 million. The number of projects fell short of expectations, but the investments exceeded the targets, mainly due to large interventions in cement and container business – much of it assisted by the Danida contribution. The required annual level of disbursements from the Danida contribution was thus partly met by investments in a few, large projects.

IFU's implementation procedures have become more efficient. IFU has undergone significant organisational changes since its creation in 1967 and a major restructuring of the organisation was embarked on from January 2002 that significantly enhanced IFU's efficiency. The regional and adviser offices, with competent officers and the network of advisers, play an important role in ensuring local know-how and consistency of IFU operations. Particularly since the late 1990s, IFU's participation in project companies' boards with locally appointed board members has been positive. IFU has in recent years strengthened its pre-investment and exit procedures based on lessons learned. Danish and local partners, and authorities in the host countries generally perceive IFU as a competent and well-esteemed institution.

IFU's efficiency in utilisation of the financial resources is low. IFU's gain on project investments is temporarily invested in bonds – however, almost half of the Fund's total net assets are placed in cash and bonds. This indicates a high level of liquid assets available for investment in projects relative to the actual annual investments in projects. Further, IFU has only to a very limited extent borrowed (as this was generally not accepted) or syndicated capital, using its equity as a guarantee for expansion of the capi-

tal base for more and larger investments. These factors may indicate that IFU has had some difficulties in developing and growing a profitable and sustainable portfolio relative to its institutional capacity. The volume of investments compared to the resources at IFU's disposal indicates that the capital utilisation is sub-optimal, or the present market for IFU financing is too limited – and/or the number of bankable projects within its mandate area represents a considerable limiting factor.

Effectiveness
IFU's objective has been fulfilled to some extent. The potential has not been fully exploited, due to the concentration on countries with enabling environments more or less in place and on Danish partners that have adequate financial resources and profound international experience. Furthermore, the high level of funds maintained in treasury bonds, together with the low level of leverage, have also contributed to the objective not being met to its full potential.

Globally, foreign direct investments are concentrated on a few countries that tend to be some of the more wealthy developing countries (LMICs and UMICs) where the framework conditions are better than in LDCs and other LICs. The share of IFU investments in LDCs declined from 17% before 1996 to 12% after 1996, indicating that IFU has not been effective in improving the poverty orientation of the project portfolio. IFU's investments are concentrated in the industrial production sector with only marginal investments in the financial sector. Some of the dominating sectors, e.g. cement and chemical production, are very capital intensive, attracting a disproportional large share of the investments. The cement sector is, e.g. by far the largest sector in Africa with 28% of the regions planned investments after 1996, and it is also significant in Asia and Latin America (12-13%). Relying on the demand from a limited number of Danish actors in specific sectors may not be optimal for IFU in the fulfilment of its objective.

The objective of the 1996 appropriation has also only to a certain extent been met by the additional financing to poor countries, especially in Africa, after 1996. When looking at IFU investments in all poor countries (LDCs and other LICs) there was no remarkable impact of the Danida contribution. The main results of the contribution were that about half of the projects were new, as many new projects were started in Asia as in Africa, and 14% of the funds were used for debt relief. Danida reacted on IFU's use of the contribution when discovering that a disproportionate share was used for debt relief. No funds went to debt relief in 1999 and 2000.

Conclusions

IFU has over the years of its existence developed a unique expertise. The need for DFIs has not diminished over the years. The Evaluation thus sees the need for IFU's continued existence as an autonomous institution in the years ahead, but the operational modality may need to be modified to comply with external requirements and with the varying conditions in IFU's three major regions.

IFU is operating within its mandate. However, the mandate can be interpreted in several ways, ranging from optimising the returns by investing in the more wealthy developing countries to optimising development impacts by directing the investments to the poorer countries where, from a global perspective, they are more needed. The Evaluation concludes that IFU could direct a larger share of its investments to the poorer countries,

and could explore instruments, jointly with other DFIs, to improve the investment environment in these countries. Although attempts have been made over time to reinterpret IFU's mandate, no contemporary interpretation has materialised, which could otherwise have enabled IFU to incorporate relevant elements of the evolving private and business sector development concepts.

The 1996-2000 Danida contribution was intended to change the project portfolio profile by focusing on low-income countries – particularly those in Africa. The project portfolio profile did change in favour of more IFU investments in Africa in the period. The contribution did, however, not prevent the share of projects in LDCs to be almost halved after 1996 compared to the situation before 1996. The IFU investment projects are largely demand-driven by the Danish partners, but the 1996-2000 efforts demonstrate that pro-active, policy-driven interventions by IFU have the prospects of changing the project portfolio profile in a desired direction.

The Government's capital withdrawal to the amount of DKK 750 million, which is anticipated to be undertaken in early 2004, will give rise to considerable reconsideration as regards IFU's 2003-07 strategy and its operational modality.

The five-year strategies could be an effective planning and monitoring instrument for IFU's operations by incorporating qualitative and quantitative target and associated success criteria. The notion of 'business sector development' will open for further opportunities to improve the enabling environment in those countries where there is a critical mass of project companies. The establishment of a regional or adviser office will, in itself, be a means of attracting new investments and improving the enabling environment in targeted regions.

Most European Development Finance Institutions (EDFIs) have untied their operations to national companies, but they have still retained the national client base. Because IFU is tied to Danish companies it is constrained in its cooperation with other EDFIs and financial intermediaries in the host countries in relation to addressing national or local development needs. It is not anticipated that an untying to Danish companies will change the cooperation pattern with the Danish business sector dramatically, but it will provide IFU with additional means for policy driven interventions.

IFU's Board works elaborately with approval of projects. Project approval seems to consume most of the Board's time, providing limited time for strategic considerations. Interpretation of IFU's objective in relation to the rapidly changing social and economic environment caused by globalisation requires substantive strategic considerations.

IFU has succeeded in restructuring its organisation so that it responds more effectively to the diversified tasks of managing the project portfolio in many countries. The regional offices, the adviser network, and the growing involvement of local professionals improve IFU's effectiveness and efficiency. It is anticipated that IFU's operations will continue to be human resource intensive. Since IFU's investment level and workload are unlikely to decrease, there is no immediate need, from a productivity point of view, for reducing the number of staff.

The majority of project companies are well operated and generate positive local impacts in the host countries, whether they are low- or middle-income countries. Danida's ETF has on many occasions resulted in environmental management being more comprehen-

sively addressed than would otherwise be the case. IFU has successfully developed the project mode for large and small project companies. However, IFU appears to be less well equipped to deal with small Danish partners and SMEs. Cooperation with well-performing financial intermediaries, in countries where IFU is well engaged, could under this circumstance be a more effective means of supporting SME development.

IFU's project facilitation additionality during project planning, implementation and operation phases is generally high irrespective of the countries' enabling environment and partners' resourcefulness. IFU's economic additionality is low when cooperating with well-established, internationally experienced and larger Danish companies in countries with good enabling environments. The security of these investments is relatively high. The economic additionality is comparatively higher when this category of Danish partners operates in countries with a poor enabling environment. In contrast, IFU's additionality is high when operating with less experienced and smaller Danish companies in countries with a poor enabling environment having relatively low investment security.

IFU's procedures have, generally, undergone substantial improvements during the last few years. However, procedures for losses, committed and non-committed capital appear to be overly conservative. The share of loans, as generally defined, of the total investment has increased over time. This practice limits IFU's additionality in several ways. IFU's performance monitoring does not adequately capture IFU's corporate performance in relation to development strategies and success criteria.

The Annual Reports do not provide precise information on realised losses and status of actual projects. IFU's public information strategy is not to any large extent directed towards potential new partners and provides the public with limited access to information.

Recommendations

The recommendations are directed to the owner, IFU's Board, management and administration. Based on the Evaluation's observations and conclusions it is recommended that:

Institutional framework: IFU continues as an independent and self-governing, state-owned institution with Board, management and administration and the roles of these parties, as well as that of the owner, are clearly defined.

Strategy: The current practice of preparing strategies with a regional focus should be maintained. Increased attention should be given to the poorer countries (LDCs and LICs). The engagement limits for countries, partners, projects and sectors should be reviewed. IFU should jointly with other DFIs contribute to improving the enabling environment for business sector development. The regional offices should be provided with the mandate to outline policy directions for further consideration by IFU's management and Board. The cooperation linkages between IFU and Danida's business sector instruments should be further developed. IFU should also explore new avenues for cooperating with other DFIs.

Objectives: IFU's objective should be modified so that the tying to Danish partner com-

panies is abolished. The objective should maintain the developmental role of IFU consistent with the Danish development cooperation policy. The 1976 objective should be reinterpreted or modified to be coherent with Danida's "Programme of action for Denmark's support of business development in the developing countries, September 2001".

Board composition: The composition of the Board should ensure that the corporate competence is available in order to match IFU's objective and operations. The role of Ministry of Foreign Affairs' Board members of representing the Government should be clarified. Strategic consideration and discussions should play a more significant role during Board meetings.

Human resources: The staff level should in the short-term remain largely as it is today, as the annual investment level is likely to be stable over the years ahead. The comprehensive approach to human resources development – including regional offices – should be maintained.

Operational modality: The primary mode of operation should remain as participation in project companies with foreign and local partners, as relevant for the project company. However, IFU should pursue some involvement in the financial sector, including local venture capital funds. IFU's company level instruments should be utilised to their full potential and be expanded with soft instruments that, in general, contribute to improving the investment climate. Increased attention should be given to small and medium-sized companies.

Procedures: IFU procedures should be updated on a continuing basis to reflect strategies and priorities. Procedures for more appropriately sized provision against losses and committed and non-committed liquid capital should be elaborated. Considerations should be given to merging the capital assets of IFU and the Investment Fund for Central and Eastern Europe (IØ) with due attention to the funds' respective objectives. Since the Investment Fund for Emerging Markets (IFV) activities will be terminated, a further consideration could be to transfer ongoing projects to IFU until their time of exit. Performance monitoring procedures should be further developed to provide information on IFU's corporate performance in relation to investment strategies, development strategies and success criteria.

Public information: The Annual Reports could benefit from a clearer presentation of the actual performance of the investment portfolio.

1 Introduction

1.1 Background

The Danish Government established the Industrialization Fund for Developing Countries (IFU) in 1967 with the purpose of promoting industrial development in developing countries by facilitating investments in these countries in collaboration with the Danish industry. During the first years of IFU's existence, its operations were mainly financed by taxes from coffee and coffee products amounting to DKK 300 million. IFU was selfsustained from 1979-1996. In 1996, the Danish Government agreed to provide a new capital injection of DKK 750 million over a five-year period.

During the initial years of IFU's existence, it was relatively unattractive for most Danish companies to invest outside the OECD countries. During those years, most of IFU's Danish partners were small companies or larger equipment suppliers. The main thrust was on local markets with the involvement of local partners. Following the end of the Cold War era in the late 1980s, the 'globalisation' gained a momentum that sparked a new wave of investments in most economic sectors. It became imperative for the larger Danish companies to embark on international marketing and production strategies in order to remain competitive. The services provided by IFU were increasingly in demand and the number of projects grew from 10-15 per year during the 1980s to 25-30 in the late 1990s. However, the investment climate changed dramatically over the years – so once stable countries deteriorated (i.a. Argentina, Columbia, Venezuela, the Philippines, Indonesia, Ivory Coast, Togo, Nigeria, Cameroon, Kenya, Tanzania and Zimbabwe) and new countries became attractive for investment (i.a. China, India, Vietnam, Brazil and South Africa).

In late 2002, Danida decided to undertake an evaluation of IFU with the consent of IFU's Board. The Terms of Reference (ToR) for the Evaluation are attached in Annex I. It was conducted from January to October 2003. It included visits to countries in Africa, Asia and Latin America. This is the first ever Evaluation of IFU, but IFU was subject to an assessment by Government in 1984[2].

The main objective of the Evaluation, as stated in the ToR, is to *"assess to which extent IFU's investments have promoted economic activity in developing countries in accordance with §9 of the Act on International Development Co-operation in 1971 and the Appropriation from June 1996. Furthermore, the evaluation shall assess to what extent the investment projects are in agreement with Danish development co-operation policy objectives in general. The evaluation shall identify strengths and weaknesses of the organisation, as well as potentials and opportunities and recommend measures for improvement if relevant".*

The Evaluation was conducted simultaneously with a study assessing IFU's required capital basis for maintaining IFU's current level of investments and establishing criteria that could be used in withdrawing part of IFU's equity capital. The study was commissioned by the Danish Ministry of Foreign Affairs (MoFA), the Ministry of Finance and the

2) *The Danish Government (1984) Report No. 1006, Government Programmes for Private Capital Transfers to Developing Countries, the Government Committee on private capital transfers to developing countries (also termed the Nyboe-Andersen Report), 1984. Chapter 4 elaborates in some detail on IFU's performance.*

Ministry of Economy and Business[3]. The Evaluation Team was informed about the study in the course of conducting the Evaluation. No coordination has taken place between the Evaluation and the study. The Evaluation Team has not been party to any of the conclusions of the study – and vice versa.

Danida has adopted the Organisation for Economic Co-operation and Development's (OECD) definition of evaluation, as developed by its Development Assistance Committee (DAC): *"An evaluation is an assessment, as systematic and objective as possible, of ongoing or completed aid activities, their design, implementation and results. The aim is to determine the relevance and fulfilment of objectives, developmental efficiency, effectiveness, impact and sustainability"*. Evaluations are intended to provide reliable information to political authorities, the general public and development agencies. The true value of the evaluation lies in using the conclusions and recommendations in improving the quality of development assistance.

The Evaluation Report has been divided into six chapters. The present chapter presents the framework and methodology for conducting the Evaluation. Chapter 2 outlines the rationale for Development Finance Institutions such as IFU. More details on these issues are presented in Annex II on the CD-ROM. Chapter 3 outlines IFU's regulatory and legal framework and organisation. More details on these issues are presented in Annex III on the CD-ROM. Chapter 4 provides an overall assessment of IFU's performance as a fund and of the projects. This is done in relation to Danida's five evaluation criteria. More details on the management of the project portfolio and fund assets are found in Annex IV on the CD-ROM, and details based on field and desk studies on each region are found in Annexes V, VI and VII on the CD-ROM. Chapter 5 presents the Evaluation synthesis and lessons learned. Finally, Chapter 6 presents conclusions and recommendations.

The Evaluation Team would like to express its thanks to all officials and individuals met for their support and for the information they made available during the country visits and in Denmark. This greatly facilitated the work of the Evaluation Team – not least the tireless efforts of IFU for providing all requested documentation and information.

The views presented in the Evaluation Report are those of the Evaluation Team, which are not necessarily shared by Danida and IFU.

1.2 Methodology

The objectives of the Evaluation are stated in the ToR, presented in Section 1.1. However, the purpose of IFU, as reflected in the ToR, follows a translation of the Act on International Development Co-operation from 1971 that is not entirely in accordance with the Danish wording in the Act[4], as it would be interpreted today[5]. A contemporary translation would most probably replace *"have promoted economic activity"* with "have promoted business sector development". This broader interpretation will not have any

3) *Two other investment funds, which are jointly administered with IFU, were also subject to the assessment; one being the Fund for Emerging Markets (IFV), for which the Ministry of Economy and Business is the parent ministry.*
4) *The Act was revised in 1976. The Evaluation uses the 1976 Act as a basis for the assessment of IFU.*
5) *IFU comment: IFU does not concur with this interpretation. IFU's opinion is explained in Appendix 1.*

implication for the Evaluation of the investment activities undertaken by IFU, but will rather point to complementary interventions that, in recent years, could have been included in IFU's operations in support of meeting the host countries' needs.

The Evaluation of IFU combines two types of evaluation[6]: i) evaluation of aid forms (IFU as a development financing institution (DFI)); and ii) evaluation of projects. The results of the project evaluations, together with an assessment of IFU as a fund manager, provide inputs to the overall evaluation of IFU's operations and organisation as a DFI. With 449 approved projects from 1968 to 2001, representing an agreed investment amount of DKK 4.7 billion in 71 countries, a current project portfolio of DKK 1.8 billion in 2001 and a cumulated financial income of DKK 1.9 billion, the Evaluation of IFU has involved studies of complex relationships and the application of a holistic approach. The list of IFU projects is presented in Annex VIII on the CD-ROM.

The ToR includes a paragraph on confidentiality related to all information received from IFU and project partners, as well as the requirement that no specific companies should be identifiable from the Evaluation Report. The Evaluation respects these conditions. The presentation of findings from the project analyses is consequently made as unspecific as possible, in order not to reveal confidential information.

Evaluation approach

The Evaluation has been carried out in three main phases: a desk study, a field study and a synthesis phase.

During the *desk study*, the Evaluation Team analysed documentation available in the Danida files and they were given access to an extract of IFU's database, ODIN. They conducted interviews with key persons in Danida and IFU. The Evaluation methodology was elaborated in detail, with an identification of the key issues to be studied, the criteria for selecting projects for the field and questionnaire studies, an elaboration of a Field Manual, including a field study work plan, and an Inception Report. Benchmarking of other European DFIs was initiated. A workshop was held in Copenhagen presenting the study methodology for Danida and IFU key persons. Prior to the fieldwork, the Evaluation Department and IFU gave their consent to the criteria for project selection, as well as to the final list of projects to be included in the study. Reference is made to the Methodology Annex IX on the CD-ROM for the "Interpretation of Key Issues", the "Criteria for Project Selection" and the "Project Company Questionnaire". The List of References is presented in Annex X on the CD-ROM.

The *field study* phase consisted of preparatory studies of country literature, research on project files in IFU's archives for those projects selected for field studies, interviews with the Danish partners (DPs) representing the field study projects, as well as with IFU staff responsible for countries visited. Difficulties in getting access to addresses of ongoing and completed projects delayed the fieldwork planning. The field studies were conducted in Africa, Asia and Latin America by three regional field study teams, each composed of two international consultants and local consultants as needed. In many interviews, a local IFU representative participated as a resource person, at the discretion of the Evaluation Team. Project companies (PCs) and other concerned stakeholders were interviewed, and the

6) *Danida (1999) Evaluation Guidelines, MoFA February 1999.*

responses from the structured interviews and the closed-end questionnaire survey were used in the qualitative analyses of projects and of country and regional portfolios. The questionnaire was thus used for guided interviews, asking supplementary and in-depth questions to those in the questionnaire. Where relevant, the Danish representations and other international and local financing institutions were visited and, where practical, a stakeholder workshop was conducted at the end of each country field visit. To validate findings from the investigation, the same questions have been addressed to the foreign and Danish partners and other concerned stakeholders. The Evaluation Teams' observations during field visits were compared with these responses in order to form the final analysis. Finally, country and regional reports were produced covering projects included in the field and questionnaire studies, as well as additional information from the ODIN database. The Evaluation Team's composition and the itinerary, as well as the timeframe for the Evaluation are attached in Annex XI and the List of Persons Met is in Annex XII on the CD-ROM.

In the *final synthesis* phase, the results from the field and questionnaire studies were analysed to find patterns of significant correlation. The fund manager and benchmarking analyses were completed, as were the general analyses of IFU's operations and organisation. Additional interviews were conducted with IFU's staff and Board, Danida, as well as with resource persons in Denmark. The inter-relationships between the different study topics were at the fore, requiring subsequent reviews of earlier analyses and also additional information gathering from IFU. As the extract from the ODIN database initially made available for the Evaluation did not contain all data needed to perform the analyses required for answering the ToR, subsequent requests have resulted in additional information being made available to the Evaluation Team. Since the information from the ODIN database was received at different stages of the Evaluation, and not always in a format allowing electronic data analyses (e.g. on all disbursements), the comprehensiveness, thoroughness and timeliness of data analyses have not been as initially foreseen. A Draft Final Report was produced for discussion with Danida and IFU at a meeting in Copenhagen and, subsequently, a Final Report was elaborated.

Analytical framework

The Evaluation approach is based on an analytical framework covering the five evaluation criteria – relevance, impact, sustainability, efficiency and effectiveness – at four levels – project, country, region and IFU's operations. This framework has been used for assessment of projects visited during the field studies and for those projects included in the questionnaire survey. For the assessment of the Fund as a DFI, the framework has been used at the country, regional and general IFU operational level. The framework covers the issues listed in the ToR under 'scope of work', 'policy', 'strategic and operational issues' and 'development effects'.

The fund analysis has been done through an assessment of the Danish development cooperation policy and strategies, literature studies on the role of joint ventures (JVs), foreign direct investments (FDIs) as well as DFIs in development, benchmarking with European sister funds, and an analysis of the fund's portfolio and asset management. Benchmarking has been done through an assessment of the annual reports of selected members of the Association of European Development Finance Institutions (EDFI), as well as by means of a questionnaire survey to five European DFIs.

The definitions of the five internationally recognised evaluation criteria, as given in

Danida's Evaluation Guidelines, are the basis for the Evaluation, although the criteria are presented in a slightly modified way under Scope of Work in the ToR:

- **Relevance** is an overall assessment of whether the IFU activities are in keeping with Danish international development co-operation and host country policies and strategies, with local needs and priorities, as well as with the needs of the Danish private sector. The perspective is that of the society.

- **Impact** is the positive and negative effects or consequences (development effects), expected or unforeseen, that the IFU projects have on society, locally or nationally. Often, it is only possible to measure impact a long time after a development activity has ended and it can be difficult to ascribe impacts to any particular activity. The projects are assessed on their economic, social, political, environmental, institutional, and technological effects and on their impact on local companies, and whether better market access has been made possible for Danish companies. The perspective is that of the society.

- **Sustainability** of project activities is an indication of whether the positive impacts are likely to continue after external assistance has come to an end. To what extent does the positive impact justify the investment? Are the involved parties willing and able to keep projects going and continue on their own? Firm answers to these questions can only be given many years after project completion and therefore assessments shortly after external assistance has ended will remain a qualified judgement. The perspective is that of the society.

- **Efficiency** is the degree to which the outputs achieved derive from an efficient use of financial, human and material resources and the degree to which the outputs have been produced within the set budget and timeframe. In other words, efficiency is a comparison between the outputs and the inputs. The perspective is that of the implementing companies for the project analysis and of the fund owner in the fund analysis.

- **Effectiveness** is the degree to which the formally agreed objectives of IFU (as laid out in the Act of 1976 and the Appropriation of 1996) and of the IFU projects have been achieved, or can be expected to be achieved. The perspective is the target group: beneficiaries or users.

Evaluation sample

Out of 449 approved IFU projects, 109 were selected for field studies, representing 25% of the portfolio, and 30% of IFU's total engagement value. The sample includes 35% of all projects receiving money under the Danida contribution, representing 52% of the value received under the contribution. 67 project companies representing 77 projects in five countries in Africa, three countries in Asia and seven countries in Latin America were eventually visited. An additional 28 projects were selected for questionnaire survey from the remaining project portfolio to complement the field study selection according to the selection criteria, and 22 projects were eventually included. The projects were selected out of a range of criteria including country Gross National Income (GNI) per capita; size of the IFU project portfolio in each country; size of projects; size of IFU share and loan capital contribution; exited/on-going projects; joint ventures and fully Danish-owned project companies; sector; Greenfield/Brownfield projects; etc. Each of

the criteria for selection of projects for the sample are representative of the total project portfolio, taken into consideration unavoidable deviations such as start year before 1980 excluded. For practical reasons, a certain amount of pragmatism was needed in the final project selection. Some projects exited by IFU years ago, and projects that appeared in the project list, but which had not materialised with IFU participation or not at all, could not be visited. A total of 282 persons were interviewed by the Evaluation Team and of these, 190 persons were related to the project companies, hereof 61 in Denmark and 129 in developing countries.

2 Rationale for Development Finance Institutions

2.1 Trends in Bilateral DFI Strategies

Most OECD DAC members have established some sort of Development Finance Institution for the purpose of stimulating capital and technology transfer to private sector development as an active instrument in development cooperation. Following the implementation of structural and sectoral reform programmes in most developing countries since the early 1980s, the role of the private sector as an engine of growth and poverty reduction has become much stronger among donor countries. Together with export credit agencies (ECAs), DFIs make up what is known as the International Finance Institutions (IFIs). The total IFI financing to the private sector in developing countries in 2000 was about USD 25 billion, which amounts to roughly half of global official development assistance flows. The bilateral DFIs supplied about USD 2.5 billion and the International Finance Corporation (IFC) USD 2.7 billion – out of these IFI flows. The top three bilateral DFIs in 2000 were OPIC (USA), CDC (UK) and FMO (the Netherlands). In addition, DFI financing/guarantees often lever other international and domestic finance.

The Nordic DFIs such as IFU (Denmark), Finnfund (Finland), Norfund (Norway) and Swedfund (Sweden) are all members of the Association of European Development Finance Institutions. EDFI comprises all the DFIs in the European Union (EU) countries plus Norway. IFU has been in operation for 35 years, Swedfund for 25 years, CDC of the UK for more than 50 years, whereas Norfund has only been in operation for five years.

The various DFIs have been given different mandates from their governments. Some focus only on developing countries, while others combine this with funds for other emerging markets, especially in Central and Eastern Europe. The funds are also from different sources; a few, such as FMO, have, besides public funds, substantial private shareholders, but the majority are dependent on public funds. For the DFIs dependent on public funds, new funds have been made available from time to time, but the international trend is for the EDFIs to prepare for being self-financed and for operating as revolving funds. As an example, CDC has experienced a change, having been notified that no new public funds can be expected. IFU has only received public funds, but IFU is experiencing that funds can also be withdrawn by the government and, thus, the equity capital can be reduced significantly.

The trend is for the EDFIs to promote the expansion of the business base in recipient countries and improve the competitiveness of the underlying economies in order to make fully commercial returns on their investments. The youngest of the EDFIs, Norfund, is also anticipating such an autonomous setting for their operations within the next few years. Another trend stems from the OECD pressure on untying of aid funds. This has also reached the EDFIs, among which untying, with regard to home country industry partners, is now taking place.

As can be seen from Table 2.1, the types of products offered are also different, and the various EDFIs have quite different product profiles. Providing equity for direct invest-

ments in project companies is the most common product. Some EDFIs also provide indirect share capital through intermediaries. Loans, and a combination of loans and equity, are also common – and the loans' share of FDI by EDFIs has been growing in recent years. Another trend has been for the EDFIs to invest in local small and medium sized enterprise (SME) funds and SME fund management companies possessing local expertise that are better placed to select and manage investment candidates.

Table 2.1 Types and product range of some Development Finance Institutions

Organisation	Investments 2000 in USD million	Targets for distribution on country categories/regions	Product focus	Tied/untied
CDC	400	50% to Africa and South Asia; 70% in LMIC and LIC	Equity and fund management	Untied
FMO	339		Equity, loans and guarantees	Untied
IFU	60	Up to World Bank loan threshold	Equity, loans and guarantees	Tied
Norfund	20	33% in LDC; Up to World Bank loan threshold	Equity, SME funds and fund management.	Untied
Swedfund	12	Up to LMIC	Equity and loans	LDC untied
EDFI total	(Approx.) 2,000	*	*	*
IFC	2,709	Global, including UMIC	Equity and loans	Untied
DFI total	10,418	*	*	*

Note: LDC: Least Developed Countries; LIC: other Low Income Countries; LMIC: Lower Middle Income Countries; UMIC: Upper Middle Income Countries, according to OECD DAC's List of Aid Recipients.

2.2 Comparative Assessment of DFIs

A financial comparison has been made and a questionnaire has been circulated to, and been answered by, IFU and five other EDFI members – CDC, Finnfund, FMO, Norfund and Swedfund – in order to provide a holistic assessment of their differences and similarities[7]. The results from the questionnaire survey highlight some substantial differences between the DFIs, and they indicate that the financial performance comparison has to be interpreted in a broader perspective, including aspects such as strategy, national interests, development objectives, etc.

7) *Details are presented in Annex II.*

The strategy of the DFIs

There are substantial differences in the DFIs' subjective assessment of a number of key strategic issues. These issues include: high return from investments, high level of equity investments, high level of share investment in the poorest countries, high level of loans, low provisions for losses, available cash, autonomy from national donor organisation, autonomy from other DFIs, high level of intermediaries, SME focus, sector/industry diversification of projects, geographic diversification of projects, environmental policy, and code of conduct. Actually, consensus is rare, except when it comes to issues such as available cash, environmental policy and code of conduct.

Differences in perceptions are assumed to shape strategy and ultimately the performance of the DFIs. In the following sections, some of the more notable divergences between the DFIs are presented.

Performance of different types of DFI projects

Geographical distribution
Comparing IFU and its peers, it is notable that there is a considerable difference when it comes to the geographical distribution of investments[8]. The most frequent reasons for a geographical diversification are the demands from companies, development concerns and the DFI's own strategy. With regard to the latter, FMO notes that it tries to focus on a limited number of countries in order to gain the necessary critical mass and acquire a more focused knowledge regarding the countries of operation. According to FMO, this focused strategy is likely to improve the performance of the overall project portfolio. Five out of six DFIs state that the geographical distribution of the investments affects the financial performance. According to the DFIs, the financial performance is low in Africa and high in Asia, Latin America and Central and Eastern Europe.

The size of the projects
Apparently, size does matter. If the bottom line alone was in focus, large projects should be preferred. Five out of six DFIs conclude that larger projects perform better than small projects. Thus, from a purely financial perspective, IFU and other DFIs should focus only on large projects. However, large companies engaged in large projects are often able to implement these projects without the participation of a DFI. Large companies tend to have sur-plus resources and more experience in international markets, which enable them to take larger internationalisation steps. In contrast, small companies lack the resources and the market knowledge necessary to carry out a joint venture in an optimal way. If large projects involving major companies are likely to be implemented even without the DFI funds, the relevance of the DFI's engagement is rather limited.

Sector distribution
Unlike all of its peers, IFU investments in the financial sector are negligible (less than 1%). The EDFI members' total portfolio is primarily invested in the financial sector, while the industrial/productive sector is important for many of the DFIs included in this comparison. According to most DFIs, the sectoral split is demand driven. However, some also consider the sectors of investments as a part of the DFI's strategy and/or link

8) *It should be noted that only IFU and CDC do not work in Central and Eastern Europe. IFU's sister fund, IØ, has this area within its mandate.*

it to development concerns. Few DFIs see the sectoral split as a reflection of national interests in the DFI's resident country.

The use of intermediaries
The use of intermediaries differs significantly between the DFIs. Intermediaries carry out more than 75% of Norfund's investments, whereas less than 10% of CDC's, FMO's and IFU's funds are invested through intermediaries. The reasons for using intermediaries are, according to the DFIs, often related to concerns about the size of the investments and the market conditions. Small projects in unfamiliar countries are better implemented using intermediaries. According to Finnfund, *"small projects in relatively unfamiliar countries are better taken care of through intermediaries"*. Moreover, FMO notes: *"FMO participates in equity funds where a local active partner is the fund manager or in, for instance, micro finance funds, which generally make investments that are too small for FMO to undertake from a cost point of view"*.

Some EDFIs have established special instruments for SMEs. For instance, Norfund and CDC Capital Partners run Aureos Capital, a fund management company, which targets SMEs in developing countries. Moreover, FMO supports especially local banks with (local currency) credit lines on-lend to SMEs, invests seed capital in these banks and invests directly or indirectly in micro finance institutions. However, such instruments must be balanced with existing efforts to support SMEs. IFU does not have any such SME instruments.

None of the six DFIs consider intermediaries as being of vital importance, and four out of six DFIs are of the opinion that the return from investments through intermediaries is lower than direct investments. Whether the low performance is caused by the nature of the investment type (intermediaries) or the nature of the investment (small projects) is unsaid.

Types of investments
The mix of investment instruments – equity capital, loans, subordinated loans, quasi loans and guarantees – differs significantly among the DFIs. However, for five out of six DFIs, equity investments constitute around or above 50% of all investments. Most DFIs perceive the mix of investments to be demand driven. A few also mention company strategy, reduction of risk exposure and development concerns. Five out of six DFIs consider the type of investment to affect the financial performance of the DFI. The different types of loans are generally considered as having a higher financial performance compared to equity capital and guarantees. According to FMO, they expected to get a high return from investments in equity capital. However, it is becoming increasingly clear that the risk profile of these investments is much higher than anticipated. FMO is now concentrating more on mezzanine finance (like e.g. subordinate loans), which has a more interesting return potential without the level of risk associated with equity.

Utilisation of financial resources and return on assets and equity
Comparing IFU's financial performance with similar EDFIs is complicated because the profiles of the different institutions vary, as described above; their objectives and operational priorities, as well as country-wise variations in accounting conventions, makes comparison of numbers difficult even for similar activities. The more general ratios of asset utilisation and profit margin are, however, calculated and compared for the six EDFIs, as are the key profitability indicators for financial intermediaries: the Return on Assets (ROA) and the Return on Equity (ROE).

The option of using its equity as a guarantee for (borrowing/syndicating) additional external capital resources – leverage – and expanding the capital base for more and larger investments has only to a marginal extent been utilised by IFU. IFU, as well as the other Nordic DFIs, have a low leverage, but IFU is along with the youngest DFI, Norfund, at the lowest level. The average leverage for DFIs compared is 1.52 and IFU's lower leverage (1.06) could indicate that the demand for resources for investments has not been a pressing issue for IFU.

Each of IFU's peers – with the exception of Norfund – showed deterioration in their financial performance in 2001. That year, four of the six peer institutions had a positive ROE. The ROE for IFU was, however, the fourth after three better DFIs, but ahead of CDC, which registered substantial losses, and Norfund with minor losses. On the other hand, IFU's ROA is on a par with Finnfund, but significantly lower than Swedfund's results. The difference between the ROA and ROE is the leverage. Thus, while Finnfund had an ROA comparable to that of IFU, its ROE is significantly higher due to the higher leverage.

Table 2.2 Comparative Return on Assets (ROA) and Equity (ROE), end 2001

ROA & ROE	CDC	Finnfund	FMO*	IFU	Norfund**	Swedfund
Total Assets, net	1,293,800	108,014	1,497,696	1,978,259	808,988	1,025,383
Equity	279,900	66,251	633,446	1,872,255	794,823	907,498
Net Income after Tax	(155,600)	615	4,259	11,513	(24,400)	37,129
ROA	(12.0%)	0.6%	0.3%	0.6%	(3.0%)	3.6%
ROE	(55.6%)	0.9%	0.7%	0.6%	(3.1%)	4.1%

Note: Figures are in currency reported. Whereas the figures are not comparable, the relative ratios, however, are relevant for analysis. * FMO had an extraordinary income of EURO 10 million in 2001.
** Including Norfund's management results of earlier NORAD loans, the result is 26,512 with ROA 3.2% and ROE 3.3%.

Besides low levels of leverage, IFU's Nordic peers – Finnfund, Swedfund and Norfund – have a high ratio of cash and bonds, thereby indicating similar policies. The more highly leveraged institutions, CDC and FMO, on the other hand, have a much lower level of cash and bonds. Given the cost of borrowed funds, it stands to reason that these institutions will not take on borrowed funds unless they have a viable portfolio of institutions/companies in which to invest. This indicates a more active use of the available resources for development purposes.

2.3 Rationale for Development Finance Institutions

The international cooperative framework

In 1992, the DAC issued the principles for effective aid based on the conviction that the vicious circle of underdevelopment that links high population growth, poverty, malnutrition, illiteracy and environmental degradation can be broken only through economic and developmental strategies and policies. The importance of good governance, including democratisation and respect for human rights as basic conditions, was reaffirmed for broad-based sustainable economic and social development. Furthermore, economic, financial, trade and structural adjustment policies by OECD countries, which aim at an improved world economic environment, were established as of critical importance for developing countries.

In recognition of the need further to promote the cooperation framework with developing countries, the OECD Secretariat in 1999 stated that three basic foundations for sustained high growth are: sound market-oriented economic policies; appropriate social policy frameworks, including strong investment in human capital and adequate social safety nets; and good governance. It also stated that trade, finance and investment, coupled with the new information and communication technologies, are the most powerful mechanisms for transfer of human and organisational capacities, which are the foundations of development progress. Since most of the world's stock of knowledge is in the developed countries, it is imperative that developing countries should be open to trade and investment if they are to capture and internalise this knowledge. This process could be greatly facilitated by the developed countries reducing the protective barriers that restrict imports from low and middle-income countries and remove developed countries' subsidies to the agricultural sector.

The "Trade and Development Report, UNCTAD 2002" demonstrates that trade without technological innovations, capacity development, and value added in the production processes has limited development effects. This underscores the need to maintain a high focus on technology innovations and capacity development, with a view to attaining appropriate levels of development impact. The need for capital injections in developing countries is also evident. At the end of 2001, the worldwide stock of cross-border bank loans and deposits was USD 9 trillion, of which only around USD 700 billion was attributable to developing-country borrowers[9]. The stock of global cross-border investment in securities was some USD 12 trillion, of which developing-country borrowers accounted for just USD 600 billion.

Private sector development as a development instrument

The rationale of DFIs must be seen in such a development context, where private sector development has become an increasingly important element of donor organisations' strategies. Already in 1967, in the preparatory work leading up to the approval of the bill establishing IFU, the minister responsible for development issues emphasised that utilising coffee tax funds for investments in developing countries through an investment fund *'is not put into action first and foremost to help the Danish business community; it is*

9) *The Economist, May 3rd-9th 2003: A survey of global finance.*
10) *Folketingstidende, 7.3 1967, spalte 2311, in Christian Kelm Hansen (2000) Fremad ABA, 2000.*

put into action first and foremost to help the industrialisation in developing countries, and this motive for assistance should not be effaced' [10]. Whereas most donors have poverty reduction as the overall objective, it is less clear how coherent the donors' private sector initiatives are within this overall objective. Often a theoretical short cut is made between, on the one hand, support to the private sector and the (supposed) resultant economic development and, on the other hand, reduction of poverty. Especially when such Private Sector Development (PSD) support is tied to the donor country's own private sector, questions can be raised about not only pursuance of the idea of a free market but also the effect on poverty reduction in the recipient country.

Private sector development is taking place at various levels: international (countries); macro (state); meso (branch) and micro (firm), and has various elements, as presented in Figure 2.1.

Figure 2.1 Levels and elements of private sector development

Level:	**International**	**Macro**	**Meso**	**Micro**
	Countries	**State**	**Branch**	**Company**
Elements:	• Free and rule-governed international trade • Access to international markets • Debt reduction • Donor policies and practices (including coordination)	**Macroeconomic policies** • Trade policy • Privatisation • Exchange rate, monetary, labour market and fiscal policy • Inflation reduction • Financial institutions (capital market) • Balance of payments regulation **Physical infrastructure and human capital** • Education and skill training • Health • Roads, railways, telecommunication, etc • Social security and pension schemes **Good governance** • Fight against corruption • Transparency • Legal system • Competition policy • Corporate governance	*Institutional infrastructure* • Chambers of commerce • Employers' organisations • Labour unions • Intermediary finance institutions • R&D institutions • Training institutions	• Access to technology, expertise and capital • Manpower • Management and entrepreneurship • Market access and information

Source: Gibbon and Schulpen, WIDER 2002

The Danish private sector and business sector development instruments

The Danish development assistance is concerned with the promotion of sustainable development through poverty-oriented economic growth. The development of a private sector is seen as a central element in achieving this goal. As noted in the Danish Development Policy[11]: *"Increased trade with the surrounding world is crucial to creating new economic growth which must also be sustainable. The Government will support the trade policy interests and capacity of the developing countries in order that the poorest countries also – not least in Africa – can be better and more quickly integrated into the global economy. Strengthening the private sector and the framework conditions for its activities is decisive for attracting the necessary investments to ensure sustainable economic growth."*

IFU is predominantly involved in firm level (micro) activities. A number of the private sector initiatives introduced by Danida since the early 1990s also operate at this level, among these the Mixed Credit Programme (MCP), the investment guarantee scheme, the Private Sector Development Programme, the Business-to-Business Programme (BtB) in South Africa, the TechChange programme linked to the PSD Programme, and DIPO[12]. All of these programmes, as well as IFU, are tied to the Danish private sector (the only exception being the untied window under the MCP).

The latest initiative in the Danida private sector programme portfolio, Danida's Business Sector Programme Support (BSPS) activities initiated in the late 1990s and now implemented in three programme countries[13], is operating at the macro and meso levels, i.e. the enabling environment: the economic, physical, legal, regulatory and institutional framework within which business operates. None of the Danida administered private sector programmes were in existence in 1967 when IFU was created. The invention of a private sector programme more directed at the enabling environment reflects the recent change in perception about which kinds of assistance brings about private sector development. It is increasingly the understanding that support to individual enterprises alone does not bring about a thriving private sector. The dilemma of whether an enabling environment should be in place before micro level interventions can be effective is bypassed by Denmark (and many other donors) by selecting richer developing countries for the PSD interventions (such as the MCP and IFU) than for bilateral aid in general.

The role of development finance institutions

DFIs such as IFU can best be compared with normal venture capital funds, which provide finance to businesses that have substantial economic potentials. Normally, the objective of venture capital funds is to achieve high returns based on the sale of equity stake rather than through dividend income. Venture capital is increasingly recognised as having a number of positive impacts on innovation, job creation, economic growth and industrial renewal[14]. The major difference between DFIs and other venture capital funds is probably that venture capital funds must justify their existence by referring to their rate of return, whereas DFIs must be evaluated on their ability to meet both social and

11) *Development Policy, MoFA Homepage, 2003.*
12) *The Danish Import Promotion Office for Products from Developing Countries promoting contact between exporters from developing countries and Danish importers.*
13) *See e.g. Evaluation of the Business Sector Support Programme, Tanzania, Danida, 2002.*
14) *Mason & Harrison, 1999.*

economic goals. In other words, the *raison d'être* of DFIs like IFU depends on their ability to be financially independent and generate the above-mentioned impacts on employment, innovation, etc. Moreover, the return from investments is not distributed between the owners but is placed in new investments or accumulated as reserves. The dilemma for DFIs regarding financial independence is formulated in an evaluation of Finnfund: *The financial sustainability of DFIs requires investments in relatively "safe" projects in "safe" countries, whereas on the other hand the objectives set for overall development assistance would direct investments to poorer countries with more risky business environment for such activities*[15].

DFIs can, however, also play an active role at the meso and macro levels, for instance by attaching importance to infrastructure projects, sector level training and education as well as to policy dialogue, e.g. on liberalisation of investment regimes. Many developing countries do not possess a well functioning financial sector, which could act as an engine for sustainable economic growth. The principal role of DFI's in this context is to fill gaps where there are capital market failures. DFIs can also act as catalysts to bring local and international players together to make capital available to the business community. Investments through intermediaries (such as local venture capital funds) and contributions to building effective co-operation with the local capital markets, rather than substituting them, are thus other forms of upstream impacts. So far, the use of intermediaries by IFU has been very limited compared to other DFIs. This is formally because of the tying to Danish enterprises.

The role of foreign direct investments

Foreign direct investments with participation of DFIs are expected to have a number of positive impacts on working conditions, environmental protection, technological transfer, competence building, and gender awareness. These additional effects can be seen as a reflection of the overall tendency among DFIs to adopt social and environmental issues. As Kragh et al.[16] note: *"More recently, emphasis has been on combining capital, training, environmental awareness and technical transfers, rather than on the isolated economic support for private investments"*.

FDIs to developing countries[17] have increased dramatically in the last decade. The concentration of FDIs on these countries is, however, extremely high with the top ten countries[18] attracting more than 80% of all FDIs to developing countries in year 2000. China alone was responsible for 17% (or 43% if Hong Kong is included) of FDIs to developing countries that year, while the LDCs on the other hand attracted only 1.6%, and Sub-Saharan Africa 2.4%. Since 1993, FDIs to developing countries have each year been higher than the total Overseas Development Assistance (ODA) flow to developing countries. However, for the LDCs ODA still remains of paramount importance, although

15) *Finnfund, 1992.*
16) *Kragh et al., 2000, p. 321.*
17) *UNCTAD's definition of developing countries differs from the World Bank/OECD definition by including countries and territories such as Hong Kong China; Singapore; Taiwan; Korea; Kuwait; Cyprus; Qatar; United Arab Emirates; as well as e.g. Bermuda and Cayman Islands.*
18) *Hong Kong, China, Brazil, Mexico, Argentina, Bermuda, Korea, Cayman Islands, Singapore and Taiwan. If the DAC list of Part I countries is used, the top ten countries in 2000 include China, Brazil, Mexico, Argentina, Malaysia, Venezuela, Chile, Thailand, Colombia and Vietnam. These ten countries attracted 70% of the FDIs to developing countries.*

almost being equalled by FDIs in year 2000. An important rationale for DFIs is, therefore, to direct investments to those countries that have difficulties in attracting FDIs on their own.

The size of partner enterprises and cooperation patterns
FDIs increasingly take place with the participation of trans-national corporations (TNCs) that, although still with a base in their home country, have organised their production on a global scale with the location of specific parts of the production process in those countries where this is most advantageous for the TNC. TNCs often have the possibility of arranging parts of the trade of goods and services needed for the initial investment and for the production in a particular country as internal trade in the TNC. The pricing of these goods and services may not necessarily adhere to market prices and determination of dividends, profits and losses, may be placed in that country where it is most profitable for the parent company. This may even be a tax haven. These features make it difficult for both the host country and for co-investors such as a DFI (IFU) to control and get a share in the profits, and many of the DFI-intended development effects are lost. An important role for DFIs such as IFU is to carefully prepare and monitor their partnerships with TNCs.

UNCTAD has noted: *For TNCs ….the issue is less whether to produce at home or abroad and more where to locate their production facilities (and other functions) for maximum efficiency…. Such firms increasingly regard the globe as a borderless whole, and make their location decisions mainly on economic and strategic grounds rather than nationality. Thus, from the supply side, the potential for FDI is limited only (or largely) by the potential for investment in general. It is up to the demand side to ensure that the conditions and policies investors need for efficient operation are in place*[19]. DFIs and other donor agencies have a crucial role to play in bringing about these conditions.

The forms of cooperation between companies can be mere trade arrangements or more or less binding agreements and strategic alliances as well as FDIs. The joint venture form ranks second highest and fully foreign owned acquisitions (or Greenfield establishments) highest amongst cooperation forms.

Historically, there has been a tendency to favour investment projects with local partnerships. Local involvement and ownership have been seen as crucial elements in knowledge transfer, diffusion of knowledge and technology, etc. A number of conditions might justify joint ventures as the preferable organisational form, e.g.:

- *Government restrictions*. Investment regulations in the development countries require a link to a local firm.
- *Cost and risk sharing*. Development countries are in general considered as being more risky than operations elsewhere in the world. Therefore, a local partner can reduce the risk of entering a new market.
- *Lack of country familiarity*. Industrial country companies may lack knowledge of local conditions. A local partner can reduce some of the uncertainty, which is associated with operating in a country that is unknown to the foreign investor.

19) *World Investment Report 2002, p. 14. UNCTAD.*

However, it is increasingly recognised that a local partner is not necessarily a precondition for generating positive development impact. Based on an analysis of 70 joint ventures between companies in industrialised countries and developing countries (Argentina, Brazil, India, Mexico, the Philippines and Turkey), IFC concluded that joint ventures in general are seen as the second best solution for both parties. If companies had all of the requisite ingredients for success in a particular undertaking, most managers would prefer a "go-it-alone" policy instead of entering a joint venture. The main reason for this attitude can be explained by the wish of enterprises to keep control of the activities. DFIs with local experience can assist their home country enterprises in such JVs or "go-it-alone" decisions and with such knowledge even help facilitate foreign investments and technology transfer, particularly with local SMEs[20].

SMEs have an important role to play in the development of the business sector in developing countries through job creation, innovation, and diffusion of technologies. DFIs, such as IFU, face a major challenge in engaging more actively in this important development area. According to the United Nations Industrial Development Organisation (UNIDO), SMEs make up over 90% of enterprises in the world and account for 50-60% of employment.

20) *The following definitions are used for size of enterprises: small: up to 100 employees; medium: 101-300 employees; large: more than 300 employees.*

3 IFU's Regulatory Framework and Organisation

3.1 The Legal and Regulatory Framework for IFU

Legal provisions

IFU is a self-governing institution founded pursuant to Section 10 of the International Development Co-operation Act No. 243 of June 1967 and replaced by Act No. 297 of June 1971. The 1971 Act is a framework act that has been subject to several amendments over the years through legal notices (1972, 1974, 1976, 1977, 1978, 1982, 1985, 1989, 1998 and 2002). IFU's legal status is that of an independent, self-governing legal entity which is limited in its liability to the extent of its net-worth only. The Ministry for Development Co-operation is the parent ministry for IFU. The Minister for Development Co-operation approved IFU's current *statutes* in February 1998. The Minister appoints the ten-member Board, including the chairman and deputy chairman, for a three-year period. The Board approves the *rules of procedures* and the *job description* for the managing director. The Minister appoints the managing director, who has executive powers similar to those of a managing director in a limited company. The Minister has no authority to interfere in the execution of the individual projects. However, the Minister may be held responsible if significant critical problems occur without the Minister intervening[21].

Objectives and Danida's business sector strategy

The International Development Co-operation Act's Section 1 states the overall objectives[22], which have remained unchanged since 1971. *"The objectives of Denmark's governmental assistance to developing countries shall be: to support, in collaboration with governments and authorities in these countries, their efforts to achieve economic growth in order to contribute towards ensuring their social progress and political independence in accordance with the United Nations Charter, purposes and fundamental principles, and also, through cultural collaboration, to promote mutual understanding and solidarity."* The Danish Government Committee[23] that in 1982 considered IFU's relation to the law recommended that IFU be administered in accordance with the overall objectives and principles of the law. IFU's objective has undergone a number of changes since its establishment in 1967 as follows:

21) *This statement relates to the Government Attorney's (Kammeradvokaten) assessment in 1996.*
22) *There is no official translation of the Act. The English version of the objectives is an unofficial translation from 1971 by the Ministry of Foreign Affairs.*
23) *The Danish Government (1982) Report No. 958, Principles for the Danish Assistance to Developing Countries, 1982.*

1967 Act 243, §10	*For the purpose of promoting industrial development in developing countries, a fund is created to promote investments in these countries in collaboration with Danish industry.*
1971 Act 297, §9	*For the purpose of promoting economic activity in developing countries, funds from the net revenues of the customs duty levied on green coffee, coffee substitute with a content of coffee, and extracts and essences of coffee, shall be transferred to a fund established to promote investments in these countries in collaboration with trades and industries* (see Footnote 22).
1976 Act 145, §9	*IFU has been created to promote investments in these countries in collaboration with Danish trade and industry (IFU's version).*

The change in the law text in 1971 as regards IFU's objective was prompted by the wish to expand the scope for investments to include the service and agro-processing sectors. The change in 1976 was concerned with replacement of the coffee revenue funding mechanism with contributions from the government budget. None of the legal notices after 1976 have had any implications for IFU. The legal notice of 10 July 1998 updates the full text of the International Development Co-operation Act. The Danish legal text from 1971[24] has, from the mid 1990s, assumed a wider meaning concurrently with the development of Danida's business sector instruments and the general wider perception of private sector and business sector development, as it has evolved over time. An up-to-date translation of IFU's objective would be: *For the purpose of promoting business sector development in developing countries, IFU has been created to promote investments in these countries in collaboration with the Danish business community*. Several discussions have taken place over the years on IFU's objective and mandate, but a reinterpretation or modification has not materialised.

IFU generally interprets its objective as promoting economic activity in developing countries, as stated in the 1971 Act, by means of meeting Danish companies' demand for foreign investments. IFU plays a promotional role in relation to the Danish companies in order to concretise these demands. It is assumed that meeting the demands of the DPs means that economic activities are generated in the host countries. IFU's interpretation implies that investments in the respective countries are mainly directed by the DPs' demand, as opposed to being directed by development priorities of the host countries. Not withstanding that the DPs' investment needs is a crucial point, a wider interpretation of 'business sector development' – as it has evolved over time – would provide a number of complementary opportunities, which to a higher degree could accommodate the host countries' development priorities. These complementary interventions would comprise soft instruments, e.g. advice to governments, business associations, etc. that generally enables the investment environment. However, the general position of IFU's owner and Board has been that IFU should concentrate on the investment modality.

IFU does indirectly, through its membership of the International Financial Institutions (IFIs), contribute to improving the enabling environment for investments through IFIs dialogue with governments and information sharing among the IFI members. IFI has organised a database around five impediment categories: 1) commitment and function-

24) "erhvervsmæssig udvikling" and "erhvervsliv"

ing of government; 2) commercial legislation and institutions; 3) openness and competitive nature of markets; 4) corporate governance; and 5) tax system. The focus of the database is on factors having a bearing on the ability of markets to function, covering institutional frameworks, commitment and administrative practices of the authorities. The database has been developed for a number of countries in Europe, Middle East, Asia, Latin America and Africa.

At the strategic level, Danida's "Programme of action for Denmark's support of business development in the developing countries, September 2001"[25] was elaborated to create some measure of coherence between the Danish business sector instruments. The focus of the Programme of Action is on the bilateral cooperation with Denmark's programme countries. The three main areas for the Programme of Action are: a) promotion of a favourable business climate; b) promotion of the business sector within the framework of sector programme support; and c) promotion of the business sector through specific market instruments. Specific market instruments refer to Danida's programmes (e.g. the PSD Programme, BtB Programme for South Africa, Mixed Credits, Guarantee Facilities, etc.) and IFU. The Action Plan states that cooperation with IFU will be intensified with a view to formulating investment strategies for some of the Danish programme countries, especially in Africa. There will be an increased focus on securing coordination of IFU activities with the PSD Programme and more effective use of the Environment and Training Fund (ETF) administered by IFU.

IFU's services and partners

According to the statutes, IFU can support Danish investments in the developing countries by: a) buying shares, b) financing of feasibility studies concerning the investment potentials and other launching activities, c) provision of loans, d) provision of guarantees and securities, and e) other interventions which – according to the Board's judgement – would enhance IFU's objective. The statutes states that IFU will – with due consideration to the developing countries' interests and specific conditions that prevail for investments in these countries – function according to *commercial principles and in close cooperation with the private business sector*. IFU's support will have a 'launching character', implying that the support ceases at a time when the companies receiving the support would normally have attained economic stability.

IFU participates with investment and advisory services in project companies involving Danish companies and, most commonly, local partners. IFU provides risk-willing capital to projects in countries where this cannot be obtained by the project companies on a commercial basis or on reasonable terms and conditions. IFU's investments are either in the form of shares or loans, or a combination of both. IFU participates most commonly as a partner in joint ventures and through board membership. In most cases, IFU participates in projects, which include both Danish and local partners, but Danish partners find it more efficient in some markets to establish project companies with IFU alone and without a local partner. The projects must be located in developing countries included in OECD's DAC list with a GNI per capita below USD 5,185 (2003), which is the World Bank's (WB) Group IV eligibility limit.

25) Danida (2001c). The Programme of Action is derived from "Partnership 2000", the strategy for Denmark's development cooperation, adopted by the Danish Parliament in October 2000.

The theme of cooperation with the Danish business sector has been subject to many considerations over the years. Most recently, the Government Attorney elaborated a Note dated 9 October 2001 on legal requirements for a Danish partner. Generally, a Danish partner is defined as an active Danish or foreign owned company located in Denmark; or a subsidiary outside Denmark, but owned and controlled by a company with domicile in Denmark. Some flexibility has been exercised over the years in interpreting 'cooperation with the Danish business community'. Noteworthy examples are the two venture capital funds (the Acacia Fund and the West Africa Growth Fund) that were established in cooperation with other DFIs. During the extraordinary Board meeting in November 1999, it was discussed whether, in relation to the EU, it would be possible in the longer term to maintain a requirement of a national investment partner. The majority of the European DFIs have untied their investments. Like IFU, Cofides and Simest still tie their investments to national partners. The tying is only related to the partner and not to procurement of equipment and services.

There is no legal requirement for involving local partners, except for the mentioning in IFU's statutes "in close cooperation with the private business sector". Originally, it was found most appropriate to involve local partners. In recent years there has been a tendency for IFU to advocate for not involving them, as there have been a number of discouraging cases. IFU's position is explicitly expressed in a Note on pros and cons of having local partners dated 11 October 2001: "*As an overall conclusion, one can see that there is – seen from both a business and development point of view – absolutely no need for bringing in local partners, more often it is even better to do projects without local partners*". Although there are several examples demonstrating that development effects can be attained without a local partner, the Evaluation considers that IFU's position in the Note appears to be too one-sided.

Funding of IFU's operations

During IFU's first ten years of existence, its operations were financed by government duties on coffee and coffee products totalling DKK 287 million[26]. In the period from 1976-79 IFU received a further contribution from the Danish government to the amount of DKK 13 million. From 1979 to 1996, IFU's investment level in project companies did not warrant further government contributions, and IFU was thus in principle self-sustaining, as the returns on bond holdings and revenues from project companies were adequate to finance IFU's activities.

In 1996, MoFA – based on IFU's demand forecasts and investment projections – initiated that a further capital injection was made to IFU. The background was that the number of new projects had increased from 10-15 per year in the early 1990s to 25-30 in the mid 1990s – and MoFA was interested in IFU keeping this level. The additional rationale for the capital injection was that the average investment per project company had increased from DKK 5 million to DKK 8 million and that the returns on bonds were likely to be reduced to half due to the fall of the international interest rate. MoFA wanted to give preference to the development of relevant investment activities in the poorer developing countries, not least the African countries, but which would still provide investment opportunities for Danish companies. MoFA introduced the GNI limit of

26) *The use of the coffee revenues for funding of IFU's operations came into being as the Danish government rejected reducing the level of the duties, but then in turn promised to use these for development assistance. The Danish Parliament thus considered the allocations to be part of the Danish development assistance.*

USD 2,316 for the DKK 750 million capital injection to ensure the focus on poorer countries. China was excluded from participation in this arrangement due to the government's decision in 1991 to stop bilateral assistance to China because of its human rights violations.

By Document No. 382 of 6 June 1996 MoFA pleaded for the DKK 750 million capital injection for the 1996-2000 period to the Appropriation Committee of Parliament, using the above arguments. It was approved on 26 June 1996. The capital injection was considered part of the Danish bilateral assistance. Conversion and debt relief – inclusive interests – were considered part of the net contribution for countries below the fixed GNI limit. Administrative costs that related to the capital injection's project portfolio would also be considered part of the net contribution. MoFA anticipated that there would be no further need for capital injection for a number of years after the five-year period.

The government is currently considering withdrawing DKK 750 million. There is no provision for this in the current statutes and thus the withdrawal is likely to require the approval by the Parliament. The withdrawal is included in the draft 2004 Finance Bill. The argument provided for the withdrawal is to adjust the equity capital and liquidity policy to modern business principles.

IFU's net disbursement in terms of equity and equity related capital is incorporated as part of Denmark's ODA in accordance with OECD's DAC rules. The argument is that IFU's funds derive from government sources and its activities are development oriented. Losses incurred are considered as a grant element in Danish bilateral assistance. In connection with the 1996-2000 capital injection, it was clarified that debt relief would be reported as ODA for those countries that were severely indebted according to "The World Bank Debt Tables". In recent years, there have been 'negative' ODA flows. It is currently being considered whether IFU's activities should continue to be recorded as ODA.

MoFA's Investment Guarantee Fund (IGF) was established in 1966 with the objective of limiting the risks for Danish companies' investments in developing countries and of increasing the inflow of capital. The guarantee only provides for losses caused by political developments and it is restricted to new investments. Coverage is provided for countries on DAC's list of developing countries having a GNI less than USD 3,000. The IGF has a commitment ceiling of DKK 2.5 billion. By mid-2003, the IGF covered 32 investment projects in 17 developing countries involving 22 companies. The total amount covered was about DKK 1.1 billion. It is mainly IFU's Danish partners that utilise the IGF, as 28 of the investment projects were with IFU partners.

3.2 Organisation and Capacity

The evolution of IFU's organisation

IFU has undergone significant organisational changes since its inception in 1967. A major restructuring of the organisation was embarked on from January 2002, following an intensive period of internal consultations and facilitation by a consulting firm. The organisation's geographical focus was replaced by one in which the structure follows the project development process. Expert teams are assigned to the projects – in contrast to the former situation where one investment officer in principle managed the project from conceptualisation to the exit.

The following departments were created as the result of the January 2002 restructuring, each of which is headed by a department director:

- Project Development Department (PDD): deals with promotion, identification, appraisals of, and negotiations in connection with, new projects, and it manages the approval and commitment process.
- Investment Management Department (IMD): manages IFU's involvement in the project companies, monitors their performance, and intervenes if critical situations occur. IMD maintains the relationship with regional and adviser offices and the adviser network.
- Special Operations Department (SOD): deals with the exit process as regards IFU's involvement in the project companies when this requires a certain measure of clarification. The exit process can vary from agreeing on the market value of IFU's shares to very complex and non-planned situations. SOD deals with projects in severe difficulties, which are taken over from IMD when deemed necessary.
- Corporate Administration Department (CAD): develops and maintains administrative, documentation and IT systems; provides e.g. legal and environmental professional support; and manages human resources development.
- Finance Department (FIN): manages project accounts, annual accounts and IFU's assets. FIN operates the Fund Manager System (FMS), which distributes revenues and expenditures and keeps track of the assets for the Danish International Investment Funds. FIN has, furthermore, the overall responsibility for personnel administration.

In 1993, it was decided that the three funds IFU, IØ (Central & Eastern Europe – established in 1989) and IFV[27] (emerging markets – established in 1996) should all share the same Board and administration, including personnel. The three Funds are by IFU collectively called the Danish International Investment Funds[28]. Accounts for the three funds are managed separately. The administrative costs of operating them are allocated pro-rata in accordance with a distribution key being set on an annual basis. The Danish International Investment Funds are members of EDFI. EDFI's objective is to enhance mutual cooperation between the 13 member agencies and to resolve common issues in relation to the European Commission and its institutions, including the European Investment Bank (EIB). The EDFIs jointly have 65 regional offices.

A number of internal functions have been set-up to enhance coordination across the departments and to improve the quality of IFU's operations. One of the most essential coordination mechanisms is the Investment Committee (IC). The IC comprises members from management and department directors (PDD, IMD and SOD) and sanctions all investment proposals based on the members' professional judgement before they are presented to the Board or the managing director for final approval according to the authorisation criteria.

In 1980, the first regional office was opened in Ecuador, but it was closed by 1981. It was not until 1986 that the concept of regional offices was effectively introduced with the purpose of making IFU's operations more efficient – by its staff being closer to and

27) *New IFV investments ceased by the end of 2003, but operations will continue, as all ongoing engagements will need to be terminated according to the agreements made.*

28) *Formally, the three funds do not have a common name, as MoFA maintains that the funds have different mandates, boards and accounts.*

more accessible to the project companies in those countries that had an adequate project volume. The second batch of regional offices was established from 1986 in Malaysia, Togo and Uruguay. Regional offices (termed either regional, liaison or representative offices dependent on the legal situation of the host country) have since been opened in Zimbabwe, Mexico, India and China, while some of the former ones have been closed down (Uruguay and Togo in 1994, Mexico in 2001 and Zimbabwe in 2002) – and this reflects a flexible adjustment to the volume of business. Today, IFU has regional offices in South Africa, China and India and adviser offices in Togo and Brazil.

The concept of adviser offices was introduced in 2002 to be applied in countries where: formerly there were regional offices but where IFU's investment level had declined; or in countries where the investment level would not justify a fully-fledged regional office but where a more permanent presence would still be warranted. In the former case, the staff of the regional office would be available to represent IFU on a consulting basis as per IFU's requests for services. The advisers running the adviser offices are allowed to undertake assignments for other clients.

In addition to regional offices, IFU has a corps of advisers that complements IFU's permanent staff. The IFU advisers are assigned on an ad-hoc basis when need arises in either the planning or operation phase. They are senior business people with substantial insight into the local business environment, i.e. investment, financing, accounting, taxation, legislation, etc. The first two advisers were assigned in 1989 (in USA and Malaysia). The number of IFU advisers has increased to 32 in 2003, including the two assigned to the adviser offices in Togo and Brazil. Five of the advisers are attached in Africa, nine in Latin America, eight in Asia, and the remaining nine in Europe and USA (of which six are in Denmark). Seven of the advisers also function as facilitators in conjunction with the establishment of joint ventures with a view to resolving potential conflicts of interests prior to the formal establishment.

Considerations on cooperation with Danish embassies, EU representations, and other DFIs have been made on a recurring basis with a view to optimising the resource inputs. Cooperation with the Danish embassies has been on a project-to-project basis, but overall at a moderate scale. In those cases where there has been a coordinator attached to the Danish embassies for management of the PSD Programme, cooperating relationships have been well established. IFU has on many occasions cooperated with other DFIs on investment projects having a Danish partner and has had framework agreements with the European Investment Bank. IFU has attempted to establish a broader strategic cooperation with other DFIs, but these attempts have often failed, basically because IFU, as one of the few DFIs, is obliged to deal with national investors.

One notable exception is the cooperation with the European Community Investment Partners (ECIP)[29] . ECIP provides funding to: 1) chambers of commerce, governments and public agencies to promote private sector development and joint ventures; and 2) European and local partners who form joint venture companies in selected developing countries in Asia, Latin America, the Mediterranean and South Africa. The cooperation between IFU and ECIP has, since the early 1990s, involved some 50 projects for which

29) The ECIP Facility was in 2003 replaced by the European Financing Partners Facility under the Cotonou Agreement.

ECIP has committed EUR 14 million. The obligation to include Danish investors prevents IFU from cooperating with local venture capital funds – with a few exceptions.

Board
Today, IFU's Board[30] comprises 10 members, including one chairman and one deputy chairman. The deputy chairman and two Board members are women. The entire Board was re-appointed in June 2003 for a new three-year term with effect from August 2003. Six members of the current Board are recruited from the business sector (of which one is a commercial banker), one from the Labour Movement, one from the Ministry of Economy and Business (as IFV is connected to this ministry), and two senior officials from MoFA. Two members have served three terms, two members two, and the remaining six members one term. Except for the senior official from MoFA's South Group, no members are recruited from the development field.

The Board deals with all three funds. It holds monthly meetings to discuss and approve project proposals. Extra-ordinary Board meetings are held when major issues require substantial discussion. A half-day session is conducted annually to discuss IFU's strategy development. Given the nature of IFU and the rapidly changing investment and development context, strategic considerations could possibly have a more pronounced role.

The *rules of procedures* for IFU's Board state that its members are appointed in a personal capacity. The owner, represented by MoFA, appoints the Board members, including the two senior civil servants from MoFA, with the purpose of enhancing coherence with the Danish development assistance policy. The two MoFA members may at times be placed in a double role – that of representing MoFA as civil servants and that related to their personal opinions.

Capacity
The number of full-time employees has been steadily increasing over the years but stabilised in the mid-1990s at around 75-80[31]. The average number of full-time employees (combined for IFU, IØ and IFV) has been stable during the last five years (78-81 staff members). A major part of the staff increase took place in the regional offices after 1986. In 1994, a temporary decline in regional staff occurred in connection with the shift of the Uruguay office to Mexico and the Togo office to Zimbabwe.

IFU has, with a view to strengthening the capacity in the regional offices, arranged that local staff were offered a two-year Master of Business Administration (MBA) at the Scandinavian International Management Institute (SIMI) in Denmark. While undertaking their studies, the SIMI students were given part-time assignments at IFU's headquarters and they thus attained practical experience about IFU and the Danish business sector. Danida has provided the funding for the MBA education. The local staff members return to the regional offices after the completion of their studies. Eight staff members have benefited from this arrangement (China two, India three, Vietnam one, and Zimbabwe two). This kind of training has greatly facilitated building of local capacity.

30) *IFU's 2002 Annual Report replaces the name 'Board of Directors' with 'Supervisory Board'. The rules of procedures for IFU's Board indicate that it has powers that exceed a supervisory function. Similarly, 'Board of Management' is replaced by 'Executive Board'.*
31) *The employees manage IFU, IØ and IFV. IØ constitutes about half the workload.*

In connection with the January 2002 restructuring of IFU, a Human Resources Development (HRD) unit was established (attached to CAD) in support of the restructuring process. The objective of the HRD interventions was to ensure that the appropriate level of competence was available at all levels, and for all functions in the organisation, corresponding to the expectations to the staff as elaborated in their individual job profiles. A new training approach was introduced that comprehensively addressed the identified training needs for staff and managers and utilised the internal expertise for training interventions. The new training approach was very positively received by trainers as well as trainees, and it contributed significantly to competence development and cross-organisational cooperation and communication. It is planned that training will also be extended to the regional offices' staff.

Corporate performance

The Report on IFU's Organisation, July 2001, revealed – based on staff interviews – that IFU's staff are highly committed to the organisation and the nature of its work, but also that the organisation is felt to be too bureaucratic, not delegating adequate responsibility to staff members, not having effective communication systems, too highly focused on new projects, etc. – all of which impact on the corporate performance and project quality. The staff turnover was relatively high. The restructuring process and training interventions have attempted to address these issues. IFU has evidently benefited from the restructuring in terms of increased staff satisfaction and improved organisational effectiveness. Combined with the recent restructuring, the arrangement with regional offices and an advisory network, as they have evolved over time, indicate that IFU can allocate its resources effectively and can compose qualifications that match the project companies' requirements. From interviews with Danish and local partners, most of whom have been involved with IFU long before the 2002 restructuring process, the general impression is that IFU is a competent organisation and its staff contributes well in all stage of planning and operating project companies.

A number of old projects have suffered from being inadequately prepared and having no clear exit arrangements. The management has placed increased attention on non-performing project companies and it strives hard, through SOD, to exit these companies, while at the same time improving preparation procedures drawing on good and bad experiences.

Correlating the number of new and ongoing projects per staff member can attain one measure of productivity. With some variation, the number of ongoing projects per staff was 1.5 per year during the 1970-90 period, after which there was a marked increase to 4.5 (IFU and IØ) in the late 1990s. Similarly, the number of new projects per year increased from 0.25 to 0.75 (IFU and IØ) in the same period. The increase in productivity has been attained through substantial investments in IT technology and through the more efficient mechanism of having the regional offices. Measured in this way, IFU[32] performs very well compared to other DFIs. Measured as administrative costs per project, IFU also performs well. This measure, however, does not reveal anything about project quality.

An in-house scoring system was introduced in 2001, related to project companies' per-

32) Not all of the approved projects are actually being launched, but they still appear in the statistics.

formance on: a) protection of the environment; b) occupational health and safety; and c) corporate governance with regard to major human rights resolutions and International Labour Organisation (ILO) core conventions. The in-house review in 2001 confirmed the result of an independent evaluation of project companies in India conducted in year 2000. The main purpose of the scoring system is to intervene in those cases where the project companies obtain a score that is critical or poor. Some 150 project companies were subjected to the performance assessment in 2002. As regards the external environment and Operational Health and Safety (OHS), all projects obtained a score between "fair" and "excellent". As regards corporate performance, one was classified as "critical" and two as "poor" – which prompted IFU to intervene.

3.3 Operational Procedures

IFU has developed various instruments that direct and guide its operations: a) the five-year strategy plan provides the overall direction and the framework for the annual business plan; b) the regulatory instruments provide eligibility criteria for IFU's engagements; and c) business procedures provide detailed guidance for the preparation and operation of project companies. In addition, Danida has made the Environment and Training Fund (ETF) available for IFU project companies, with some restrictions.

The rolling strategy plan

In October 1995, a comprehensive Strategy Plan was for the first time elaborated for all the Danish international investment funds for the 1996-2000 period. The Strategy Plan for IFU was based on the assumption that there would be a significant demand for investments during the plan period, but that its equity basis was inadequate to accommodate the increased level of investments. The forecast was 30 new projects per year with a total investment requirement of DKK 1.6 billion. IFU's estimate for additional equity capital was DKK 1.2 billion. MoFA was approached to consider the situation. This led to MoFA's capital injection of DKK 750 million to be disbursed during the plan period (ref. Section 3.1). The project portfolio did, for a number of reasons, not evolve quite as anticipated, e.g.: 13% fewer new projects were initiated compared to the Strategy Plan's target; the investment in new projects were only DKK 1.2 million; and the relative share of investments in LDCs declined during the plan period (see Section 4.5).

IFU's Board approved the current Five-Year Strategy for the 2003-07 period in October 2002. The strategy was transformed into a business plan for 2003, which contains the medium-term strategic perspective. The business plan elaborates on the investment climate and IFU's perceived interventions for Africa, Latin America and Asia. Despite the negative investment climate in Africa, IFU expects, judged from the project pipeline, that ten new projects would be generated in 2003 with an investment frame of DKK 100-120 million. In Asia the expectation for 2003 is 18-20 new projects with an investment frame of DKK 300-400 million.

During the five-year period, the annual investment level is expected to increase by 60%. This is a quite significant increase and it might have to be adjusted in the light of the Danish government's intended withdrawal of DKK 750 million that substantially reduces IFU's equity capital. Most of the expansion is foreseen to take place in Asia, where the annual investment level over the five-year period will increase by 102%. The corresponding figures for Africa and Latin America are 14% and 38% respectively.

Excluding the additional financing, which may occur in any of the regions, 15.7% of the investments will be made in Africa, 19.9% in Latin America and 63.8% in Asia.

The investment projections are driven by what is anticipated to be the Danish companies' motives. For all three major regions, there is a clear indication that IFU will coordinate and cooperate with the PSD programmes in Danida's programme countries. Danida is implementing the BSPSs in Ghana, Tanzania and Vietnam, all of which have substantial scope for further cooperation.

Regulatory instruments

In August 1982, the engagement limit for investments in countries and company groups was set at 15% of IFU's equity capital, and the risk limit thus changed with the growth or decline of the equity capital. The ceiling for an investment in a project company is 5% of the equity capital. In October 2001, IFU's administration recommended an increase of the engagement limit for China to 25%, but a compromise of 20% was reached. In connection with the Danish Government's intended capital withdrawal, IFU suggested in April 2003 that the engagement limit should be estimated based on IFU's and IØ's combined equity capital. Generally, there seems to be limited consistency as regards engagement limits among the DFIs.

IFU's investments are driven by the companies' demands – *'client-driven'* – and are thus naturally directed towards countries having economic growth and good enabling investment climates. In order to contribute to IFU's policy goals of investments in LDCs and LICs having constrained investment climates, IFU undertakes specially designed interventions to promote investments in these countries – *'policy-driven'*. The Africa strategy has demonstrated that IFU to some extent can influence investments positively in the poorer countries. This, however, requires comparatively more management and financial resources. In a note to the Board of October 2001[33], IFU argued that it is necessary to muster clients' confidence in IFU in client-driven countries in order to promote their interest in policy-driven countries and that it is necessary to apply incentives to direct a greater share of investments to policy-driven countries. IFU's administration recommended to the Board that a targeted promotion among Danish companies should be conducted to enhance their interest in poorer countries with a particular focus on Africa and Western China.

IFU considers that a number of sectors and groups of materials are sensitive because of ethical and environmental (external environment and OHS) concerns. These concerns have mainly been directed at the project companies, but they will in future also be extended to sub-suppliers. A list of sensitive sectors and materials was presented to the Board in October 2000 and it was reconfirmed in October 2002. The list is reviewed regularly, based on a scrutiny of the ongoing project portfolio and with regard to the general development related to ethical and environmental concerns.

IFU's business procedures

Subscription for shares versus granting of loans
It has been a recurrent theme for debate whether IFU's goal fulfilment and/or income optimisation are best achieved through a position as shareholder or lender in the project

33) The note combined observations and recommendations for IFU and IØ.

companies. In general, it has been assumed that subscription for shares is the first priority, whereas, in cases where this is not expedient, loan capital is acceptable. One underlying assumption has been that share capital is more development oriented than loans. It has, furthermore, been assumed that the return from share capital investments is higher (although slower to materialise and having higher risks) than loans. New financial instruments have been developed that combine features of share capital and loans in many different ways. Subordinated loans with normal repayment schedules are the most frequently used mezzanine instruments, while equity loans, where returns depend on the project company's profit, are not widely used.

Environmental policy
In May 1998, the Danish Investment Funds adopted an Environmental Policy. It is based on the indispensable requirement that all project companies must comply with environmental rules and regulations of the host country. IFU intends to prevent or minimise possible adverse environmental effects and to promote positive environmental impacts. The Danish partners and the management of the project companies have the responsibility for environmental impact assessments and environmental management. The Danish partner will provide a 'Best Judgement Declaration' to confirm the compliance with the Danish legislation regarding the external environment and the working environment.

In most cases, the impact assessment will be based on the Danish environmental rules and regulations. In cases of non-compliance with these, environmental impact assessments will be conducted in accordance with the World Bank Environmental Guidelines. The project companies will issue an annual environmental status report to their boards giving an account of the environmental management interventions and their effects.

Danida's Environment and Training Fund (ETF)
In 1993, Danida established a fund for training and educational activities for IFU projects. Following a review in 1998, the ETF received a further allocation of DKK 15 million that also included support to environmental improvements and technology adaptation. A second review was conducted in 2002 with a view to granting a further allocation of DKK 15 million. The review confirmed the appropriate use and effect of the ETF and recommended that the grant should be continued for a further two-year period and that environmental improvements should become a permanent feature, but that the technology adaptation should be abolished. It was further recommended that IFU should be given a clearer mandate in administering the ETF and that the ETF's Guidelines should be updated. Danida granted DKK 8 million for the 2003-04 period.

Code of Conduct (CoC)
In November 1999, the Danish Investment Funds adopted a Code of Conduct, which stipulates IFU's commitment in all its business operations to enhance awareness, heighten standards and work for continuous improvement related to business ethics, social responsibility, human rights, occupational health and safety, and the external environment. The project company partners sign on to the CoC with the financing agreements and IFU will, whenever relevant, promote and propagate the principles of the CoC in all of its preparatory and operational activities. IFU will, on an annual basis, take stock of the actual accomplishments and shortfalls in the active project companies.

Project processing
The procedures for project processing are accounted for in IFU's Procedure Manual (IPM). The IPM is an internal document, which has been developed to enhance: consistency of data collection and processing; communication between departments and overseas offices; and effective use of IFU's database ODIN. The IPM was first issued in October 1999, but it is constantly updated to accommodate adjustments in IFU's operational procedures. The IPM is, like IFU's organisation, structured in accordance with the project life cycle. The team members handling the projects will alternate according to the transfer arrangement from PDD, IMD and SOD. Transfer meetings between departments are conducted to ensure an effective hand-over. An account of the IPM's main features[34] is given below.

The *First Contact* (FC) is when the project or project concept is first presented to IFU. A FC Note is written containing information on the project concept, the Danish partner, the size of investment, mode of IFU's participation and other relevant information.

Clearance in Principle (CIP): After the receipt of the project proposal, an internal project appraisal meeting is called to decide on the further processing and to discuss apparent and potential problems. The project proposal is subsequently discussed in the Investment Committee, which can issue a CIP if the investment is below the certified level or send it to IFU's Board for approval. If the project proposal is rejected, the reasons for rejection are stated in the ODIN database. A CIP is valid for 12 months from the date of decision. CIPs for the same proposal are prepared for shares and loans respectively. When the CIP has been granted, or is about to be granted, a pre-investment meeting (PIM) is, in principle, conducted with the Danish and local partners to discuss important issues, potential risks, and potential conflicts of interest. However, often only one PIM takes place just before or after the BC is granted.

Binding Commitment (BC): The further steps to obtain the BC require a number of specifications, e.g. environmental class (according to WB's classification), best judgement declaration, expected exit strategy, project risk class for shares and loans, risk of loss on shares and loans, expected export from Denmark, planned number of employees, total investment in shares and loans, type of IFU finance and currency, and financial terms, etc. The approval and rejection procedures for a BC are similar to those of a CIP, including holding of a pre-investment meeting. Based on the feasibility study, the investment officer prepares a *Project Appraisal and Improvement Report* (PAIR). Cash-flow budget projections for IFU's expected disbursements and reimbursements are prepared. After approval by the IC or IFU's Board, a letter of commitment is issued to the applicants. The BC is valid for six months.

Agreement: The agreement is adapted to the host country's legislation as well as to well-founded and reasonable arguments proposed by the other partners. The agreements with Danish and local partners contain clauses concerning environment and code of conduct. Most loan agreements are based on Danish law and arbitration, whereas shareholder agreements are based on the host country's law and international arbitration. A *Deviation Note* is prepared to account for the changes made compared to the standard agreement. Legal opinion may be sought to ensure that the agreement and statutes are not contradictory and are in accordance with the host country's and with Danish laws, as relevant. The agreement is valid for one year and, if the share capital has not been

34) The IPM is relatively new and the comprehensive procedures may not be fully carried out.

fully or partially paid in by the Danish and local partners, IFU does not *disburse* its part and thus terminates the agreement. Similarly for a loan agreement, IFU's obligation to disburse any amount expires at the end of the draw down period. If the agreement is cancelled, a *Cancellation Report* is written. All projects that have reached the agreement stage, whether disbursements have taken place or not, are recorded in IFU's Annual Reports. Agreements with non-disbursement are recorded to indicate that IFU has made a legal commitment towards a partner. The 1995 Annual Report was the only one that indicated which projects were cancelled before becoming 'active'.

Monitoring: The shareholders and loan agreements specify the requirements for the project companies' reporting with a view to monitoring their corporate performance. The project company should submit monthly progress reports from the signing of the agreement to start of production. Quarterly reports should be submitted once production has started. Annual accounts and the budget for the next year should be submitted one month after the end of the financial year. Assessment of the environment and corporate governance should be submitted yearly. Minutes of board meetings and annual general meetings should be prepared shortly after the meetings have been held and submitted to IFU.

Exit: When IFU decides to exit from a project company, or IFU receives an offer to sell its shares, the handling of the project is transferred to SOD. Uncomplicated loan and shareholder agreements, however, stay in IMD throughout the exit. IFU generally wants to exit a project once it has reached a satisfactory consolidation. After the fifth year, if an exit arrangement has not been reached before then, the exit options are evaluated yearly. This procedure has been introduced to ensure that there are solid arguments in cases where IFU's engagements exceed the 'normal duration'. If an exit agreement has not been made, negotiations with potential buyers commence and the price of the shares is stipulated according to the market value, which, however, may prove difficult to determine. A note on the sales arrangements is submitted to the IC and IFU's Board for approval. A sales agreement is prepared, specifying the terms of IFU's withdrawal. If a project company encounters serious problems and is deemed by IFU to be in crisis, the project is also transferred to SOD. If the project company cannot be turned into a viable business and it is no longer in IFU's interest to keep the shares, the shares may be sold at a symbolic price. In such cases, IFU remains with the project company until all legal matters have been resolved. Similarly, if loans cannot be paid back, they may be remitted. A *Final Evaluation Report* is prepared providing an account of the project company's performance, IFU's returns and the associated Internal Rate of Return (IRR).

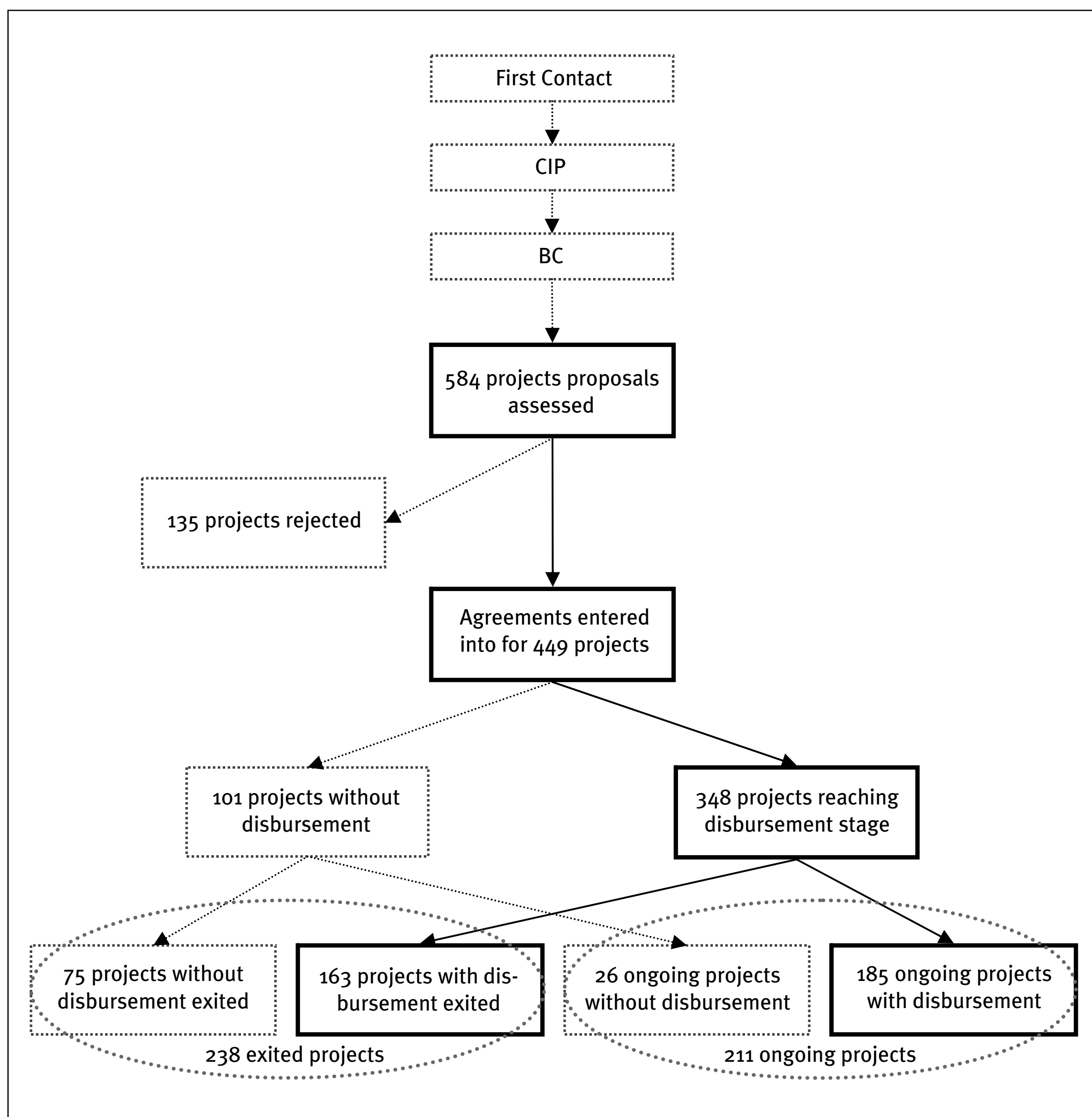
An overview of the project flow from proposal to the exit stage is provided in Figure 3.1 (the numbers include projects to the end of 2001). Out of the total number of proposed projects, 77% have resulted in agreements. Of these, 82% have had disbursement and of these, 42% have been exited.

IFU commissioned a review, "The Fund’s Project Evaluation and Criteria for Project Participation, October 2000" to consider a number of cases from IFU's project portfolio that had performed worse than anticipated at the appraisal stage, and where the causes could not be related to unforeseen events in the project environment. The projects were non-representative of the project portfolio, as they were selected among projects that evidently had had unfortunate courses of event – 21 projects constituting 3-4% of the total portfolio. The majority of the mistakes were related to the project analysis and decision-making and less to implementation. Surprisingly, considering IFU's substantial experi-

ence, the identified mistakes were rather commonplace. The project analyses had, in the majority of cases, had an inadequate focus on central operational and management aspects.

The IPM and the introduction of PIM have meant that many of the central questions related to the project concept and business opportunities are identified and clarified at an early stage in the project preparation process. The review pointed out that focusing on the project owner and the conditions for the project company's operational targets may lead to further improvements and that pre-investment meetings are essential in refining the project concepts. It was, furthermore, recommended that intensified project monitoring and management support – particularly related to the 'weaker' project owners – could further reduce the risk of mistakes.

Figure 3.1: IFU's Project flow



4 IFU's Performance

4.1 Relevance

The Danish international development cooperation policies and strategies, with their overall objective of poverty alleviation, do include the objective of business sector development in developing countries. However, the general Danish policy on business sector development is much focused on individual enterprises, tied to Danish firms, and it has only recently been amended with general enabling framework instruments. For the majority of the Danida cooperation countries, there is a need for support to the enabling framework as much as to individual enterprises. IFU's activities are concentrated neither in the Danida programme countries nor in other of the poorer developing countries, but in the more wealthy developing countries with well-developed enabling environments – or in the wealthier parts of the countries. IFU's country profile appears to be directed mainly by the Danish partners' investment strategies more than by the global needs of how a DFI composes its project portfolio and pro-actively attempts to attract investments in the poorer developing countries. Endeavouring to direct IFU investments to poorer countries, and poorer parts of the countries, would contribute to making IFU's activities more in keeping with the general Danish international development cooperation objectives.

The distribution of IFU projects by region has changed over time, with Latin America (and Europe) dominating up to the mid 1970s, and Africa dominating from the mid 1970s to the mid 1980s. From the mid 1980s, the picture changed, with Asia taking over as the dominant region to an extent where 45% of all realised projects from 1967 to 2001 have been in Asia. IFU investments going to Africa were record low in the first half of the 1990s with only 14% of all IFU investments. The concentration of IFU investments on individual countries has, moreover, been fairly high throughout the period. For each five-year period up to 1995, the top ten countries have attracted between 76-96% of all IFU funding for between 51-77% of the projects. After 1996, the concentration on countries has decreased, with the top ten countries attracting 57% of the funding and 42% of the projects. Over the entire period, India and China have by far been the dominating countries – India in terms of projects and China in terms of financial commitment.

Before 1996, there were almost the same number of IFU projects in LDCs and UMICs, and they received almost the same share of the IFU funds. There has, however, been a change since 1996, where the poorest developing countries are getting fewer, but relatively bigger projects, and where the UMICs are getting twice as many of all projects and twice as much of all planned investments as the LDCs. The LDCs' share of IFU investments thus fell from 17% before 1996 to 12% after 1996. Whereas the Danida contribution from 1996-2000 has been directed towards the poor countries in Africa, it has at the same time freed up IFU capital for investments in other countries, especially in Latin America, which have a GNI per capita above the limit established for the Danida contribution. 37% of the new projects initiated by IFU from 1996-2000 were wholly or partly funded by the Danida contribution, and 47% of the amount disbursed by IFU to projects started in this period came from the contribution. The increase in IFU projects in South Africa after 1995 has made the African portfolio in its totality less focused on the poorest countries.

IFU's objective is in line with the development policies, needs and priorities of those countries that IFU is investing in, as most developing countries today have development of the private sector on the agenda. Across the regions, the majority of the project companies that IFU has invested in are also assessed to be in line with the needs of the private sector in the host countries. Many projects are focused on the alleviation of bottlenecks for economic development in their countries and on the transfer of Danish technology, and business and management culture. A distinction must, however, be made between the project companies as such and what IFU is adding to these activities. The additionality of IFU is clearly least for those projects where the Danish investors would go ahead without IFU's participation. This is the case in half of all projects in Asia assessed by the Evaluation, three-fourths of the projects with large DPs and half of the projects with SME DPs in Africa, and two-thirds of the DPs in Latin America. For those projects where IFU advisers act as board members, the participation can have an impact on higher project quality. As regards awareness, attention to and monitoring of good corporate governance and transparency principles, active IFU participation appears to have contributed to clarity and facilitated more stringent approaches by the DPs for transfer to, and implementation of, the many projects.

The investment facilities that IFU offers, primarily risk capital and risk sharing, are needed in some developing countries more than in others. Countries that have developed enabling frameworks are able to attract foreign direct investments, also without the assistance of DFIs. This is evident in the more well off countries in Latin America and Asia, where the Danish partners would have invested also without IFU's assistance. In both Latin America and Asia, IFU has indirect projects without any capital involvement, indicating that it, for various reasons, is beneficial to both IFU and the Danish partner to channel funding through an existing mother company and not through the newly established subsidiary. In most African countries, on the other hand, poorly developed or un-conducive environments make it difficult to attract FDIs and this accentuates the need for IFU's risk sharing. Investment facilities other than those presently offered by IFU, i.e. assistance in the development of local capital markets through local investment funds, enhanced advisory facilities and upstream policy dialogue on the conditions for development of locally owned enterprises, etc. are needed for business sector development in countries without sufficient enabling environments.

Danish private sector enterprises that are interested in establishing companies in developing countries have different needs vis-à-vis IFU, depending on their previous experiences and the market they are investing in. It is primarily risk sharing, by having access to risk capital that is attractive to the enterprises investing in both mature and less mature markets. For less experienced firms, general facilitation of deal structuring and local financing drawing on the IFU advisers' local know-how and insight is attractive, whereas the 'blue stamping' of having an official Danish developing financing institution on board is useful to many firms regardless of their experience in the market.

4.2 Impact

IFU's overall objective, as interpreted by IFU, is to promote economic activity in developing countries. Promotion of economic activity will not necessarily in itself generate positive development effects and it is thus important to add a qualitative perspective. A contemporary interpretation of IFU's objective, 'promotion of business sector development', would have added a complementary dimension to promotion of economic activi-

ty. It should, though, be kept in mind that the impact from one IFU-supported enterprise on a whole economy, especially a large economy, is marginal. An impact analysis of development effects, therefore, is difficult. As IFU does not in a systematic manner keep contact with and monitor exited projects it is, further, difficult to assess long-term development impacts of IFU projects. The assessment from the Evaluation field studies is that most IFU projects are found to have positive development effects; however, these are not always attributable to IFU, but rather to the Danish partners. Most of the DPs IFU engages with are capable of producing rather impressive development impacts as a result of the particular investment projects. Only insofar as the investment would not have taken place without IFU can the development effects be said to be related to IFU's engagement.

In all regions, the investment projects have resulted in some degree of direct employment creation, the conservation of jobs, and indirect job creation through sub-contractor jobs. Job creation varies between projects and regions, with some performing above expectations, some below. There is, in general, a discrepancy between the appraisal figures listed by IFU in the annual reports and the actual jobs created and attributable to IFU. The reasons for lower-than-expected job creation are, for example, that planned labour intensive activities have been substituted with capital intensive or that there has been a discontinuation of the activities (Africa) or macro-economic instability (Latin America and Asia).

For business sector development, not only the size of the workforce but also the enhanced competencies of the workforce are of outmost importance – whether or not the employees remain with the same enterprise in the long run. For all regions, human capital investments through training and involvement of local staff and changed management regimes have been key features of the Danish enterprises' activities. Technology transfer, in terms of technical equipment and procedures, transparent and open management principles and corporate governance – by some described as a cultural change – as well as quality control and monitoring are mentioned as impacts of the Danish enterprises. Broad-based training locally and visits to Denmark have facilitated human resource development. In some particular industries, international certifications such as ISO (International Standardisation Organisation) and HACCP (Hazard Analysis Critical Control Point) have resulted from the Danish presence. However, these impacts are often reported to be irrespective of IFU's participation.

The ETF is, in general, praised for its contributions where it has been accessible; but since it can only be used in countries that are not Danida cooperation countries and that are below a GNI per capita of USD 2,500, it has not been widely accessible to the enterprises assessed by the Evaluation. In Africa, the impact from technology transfer and training is reported to have been modest, especially where the PSD/BtB money has benefited the Danish partner and not the JV or project company, thereby reducing business commitment of the enterprise management.

Environmental impacts have been the result of applying Danish norms and Danish corporate policy of the involved enterprises – often operating at the frontier with regard to environmental mitigation investments. Almost no projects report environmental problems presently. The improved external and internal environmental conditions in Latin America appear to be more due to the DP business culture than as a result of IFU's influence. Also in Asia, the Evaluation found that while IFU has assisted with environmental matters, they did not bring anything new in this field to the DPs. The environ-

ment policy is not on the agenda in African SMEs. A general remark is that IFU's environmental policy is not widely known to project companies, and the impact of IFU's environmental policy is thus not easy to verify, although scrutiny of all old projects and remedial work has taken place since 1998. The Danish enterprises have, in general, contributed with safe and healthy working conditions, ergonomic working positions, applied the right to organise, etc. but, again, it is difficult to establish IFU's net contribution in this aspect.

The net contribution of IFU's Code of Conduct has not been easy to verify. The company culture of most well-established Danish companies are in agreement with the CoC and, thus, it is not difficult for the Danish partners to agree with IFU on the necessity of applying the conditions for the project companies. In situations where local authorities or partners deviate or want to deviate from the stipulations made in the CoC, the agreement serve as a means of convincing all parties of the need to adhere to the CoC principles. Most large DPs have transparency, governance and staff incentives as part of their corporate policy. Many African project companies report that IFU's CoC is not widely known to especially the SME enterprises – or that these do not see a need for it. Large DPs have similar codes. For exporting companies in Asia, IFU's CoC is perceived to be more stringent and easier to monitor than those of the DPs and, therefore, easier to implement. IFU participation might also make it easier to convince local partners of the value of such CoC.

In Latin America and some Asian countries, many DPs have adopted the Danish approach to gender equality in the work place, and gender discrimination is not reported to be a problem. In Africa, there have been no perceived effects on gender equality in the investment projects.

A repeated finding is that the different development indicators appear to be mutually reinforcing and that the learning experience for the local partners, where these exist, and for competing enterprises watching the Danish establishments, has been that well trained and treated local staff provide the basis for profitable and competitive enterprises. The increased employee-incomes generated by the projects, the increasing demand for local services and inputs and also an increased economic use of the local resources, all stimulate economic activities in the countries invested in. This has the potential of providing an improved domestic revenue generation.

There have been almost no negative development effects, although some local companies may have lost some markets – and thereby employees – because of the entrance of the Danish enterprises. Environmental problems do occur in a few projects.

There are no clear trends regarding the performance of different types of IFU investment projects according to Greenfield/Brownfield project, size of the project and of the DP, or whether the DP would have invested without IFU. In some countries, the large DPs dominate, with a higher number of larger projects that are often clustered; the development impact is proportional to size. But IFU's additionality is less or even invisible in these projects. There is a clear indication that SMEs are more dependent on IFU than the large DPs.

In general, IFU's project participation has not had any measurable impacts on the DPs' activities in Denmark. In both Asia and Latin America, a few Danish TNC partners, the largest and most experienced in Danish industry, represent two-thirds of the total invest-

ment volume, where IFU has share participation. This is in capital-intensive industrial sectors. 45% of IFU investments in Latin America are with four internationally experienced DPs that do not need IFU's assistance in internationalisation. IFU has, though, followed these large DPs to new regions of the world after similar projects in other continents, and this has deepened the internationalisation of already international DPs. This significant degree of clustering around a couple of strong and internationally experienced DPs that do not need IFU's assistance makes IFU's additionality limited, compared to an important assistance to less experienced DPs. Most DPs have strengthened their competitiveness as a result of their foreign investments in Asia, and some establishments have resulted in significant exports from Denmark, especially to Sri Lanka and China. In Africa and Latin America, the initial equipment procurement by the project companies has generated exports from Denmark, but mainly in Latin America have continued exports been noted. Market access is the main reason for half of the DPs investing in Africa. Only a limited number of DPs have changed their organisation and employment in Denmark as a consequence of the investments in Asia.

4.3 Sustainability

IFU is, as a fund, highly sustainable. Over the 1968-2001 period[35], IFU has, overall, managed the investment portfolio in a way that it has returned the Fund a total income on project activities of DKK 1.2 billion. In addition, the total financial income over the same period has been DKK 1.9 billion. Besides this, IFU has received a paid in capital from Government of DKK 1.05 billion. The realised losses on share capital and loan principals on all concluded projects have been DKK 591 million, and project and operating expenses have totalled DKK 0.8 billion.

In 1986, IFU changed policy to include provisions for losses and not actual losses in the net result for the year. Provisions for losses by far represent the biggest expense line in the annual statement, thereby significantly influencing the Fund's net annual operating result. The change in 1986 has thus resulted in a cumulated net result over the entire period being DKK 860 million less. Despite the fact that IFU has registered a net profit, it has not presented a significant operating profit from its investment activities during the past three years, mainly due to overly high provision for expected losses on its investments. Rather, it appears that its profit has been derived from the income on its high level of cash and bonds.

The financial quality of the portfolio and the performance of the invested projects are expressed in the financial return on invested funds (ROI). The ROI shows a varying but slightly increasing trend over the last years, indicating that the performance of the portfolio is improving. This could indicate that the general project performance is better, but since there has been a shift from equity capital towards loans especially since 1996, it could also indicate that IFU is now less exposed to equity return variations.

The performance of share investments and loans can be assessed by calculating the Internal Rate of Return, or the average equivalent yield performed in 2001. The overall return, without provisions, is positive with 3.13%, which is in conformity with a net

35) *IFU has changed accounting principles several times since 1967. The changed principles are explained in annual reports, but the amounts being affected by this are not presented. The Evaluation has used the officially reported figures adjusted with internal figures provided by IFU. Annex IV presents the actual figures.*

gain on all IFU project activities. The IRR is, however, below the Board's set target of 4% to cover administrative costs and maintaining the real value of the Fund from being eroded by inflation. IFU is making specific reserves for losses for a project at the time when a loss can be anticipated and these anticipated losses are influencing the calculations of the IRR on the Fund's projects. Thus, when the associated reserves are included, the return becomes negative, and particularly negative for equity investments. As IFU has not experienced any net losses on projects – but on the contrary a net profit – there seems to be no reason to include specific reserves in the IRR calculations. Since profits are larger than losses, the specific reserves will in all likelihood not be needed.

Sustainability of the investment projects from the point of view of IFU is, however, calculated to be negative, with an IRR for the Fund of -0.33% for all exited projects (incl. interest losses on project loans). This does not necessarily say anything about sustainability seen from the point of view of the individual project, although some resemblance would be expected.

In Asia, three-fourths of all projects assessed by the Evaluation have a probability of sustainability, while half of all projects in Latin America have economic difficulties threatening sustainability. In Africa, more than half of the projects are financially non-sustainable. In Asia, many projects never materialised, due to joint assessments by IFU and the DP undertaken before disbursements took place that concluded that they would most probably be unsustainable. As these assessments came after the agreements were signed, the projects are listed in the annual reports as IFU projects. In Africa, on the contrary, poor project preparation and partner assessment – no PIM conducted – over-reliance on the PSD/BtB programmes, insufficient monitoring and absence of hands on IFU Board participation, have been identified as reasons for the failures of projects that had in the first instance received disbursements. In Latin America, IFU has demonstrated exceptional ingenuity in resolving threatening conditions, and most projects continued on a better platform after IFU interventions.

4.4 Efficiency

The *productivity of IFU's administration* can be assessed both on the number of new projects a year and on the annual investment volume. From 1967 to 2001, the IFU administration has, in total, assessed proposals describing 584 projects. 449 projects (77% of proposals) have resulted in agreements, while only 348 projects (78% of agreements) have actually received disbursements from IFU. Disbursements have been DKK 3.6 billion, or 75% of the agreement value. Of the 101 projects that had not received any funds from IFU at the end of 2001, 75 were exited and thus cancelled after agreements were signed. This high figure indicates that the efficiency of the Fund is sub-optimal, as preparatory work, for various reasons, has not been done in a way that allowed the projects to be implemented. However, in some cases reassessment and cancellation of projects after agreement, before disbursement, is better than starting implementation of projects that would have a high probability of failure. Out of the 101 projects, 27 indirect projects were from the start planned to have no capital contribution from IFU – the majority of these were with large DPs. Projects without IFU money do not incur any financial loss or gain for IFU, but do, of course, have an administrative cost for the Fund.

The duration of projects that receive disbursements is on average 7.6 years, with shortest lifetimes in Latin America (6.9 years) and longest in Africa (8.8 years). 185 of the 348

projects that actually got off the ground were still active at the end of 2001, while the other 163 had been exited. Although the Fund has been in existence for 35 years, it is thus about half of all its projects that have got off the ground that are still active. The efficiency of the administration should, however, also be judged on the basis of the numerous agreements assessed and signed for these projects; in addition to a total of 796 agreements signed for the 449 projects, more than 200 applications for new or additional financing of projects have been rejected by the Fund.

The productivity of IFU's administration increases with fewer but larger projects, but this does not necessarily imply a higher IFU additionality or development impacts. The average planned size of IFU investments has increased from DKK 9.2 million before 1996 to DKK 12.9 million after 1996. The projects are largest in Latin America and smallest in Africa. The average project sizes covers for the fact that the concentration on large projects is quite high, also when looking at projects that received money from the Danida contribution. Disbursements for the top five projects have all been above DKK 70 million, and they have in total received 10% of all IFU disbursements. The top 30 projects (7% of all) received more than DKK 30 million each, and have together received 41% of all IFU disbursements. Combined, the top 30 projects received almost DKK 450 million accounted for under the Danida contribution. Amongst the 93 projects receiving funds under the Danida contribution, 17 of these (18%) each received DKK 20 million or more from the Danida contribution, totalling 64% of the whole Danida contribution. IFU has not utilised investments in intermediaries (the financial sector) as a way of increasing efficiency in the handling of small projects with small local partners.

The sector distribution of *the Danida contribution* is dominated by cement, with 28% of the total contribution allocated to this sector. For those projects started after 1996, 41% of the Danida funds went to the cement sector. For IFU's administration, it is likely that this was an efficient way of reaching the required annual disbursement level. However, the additionality of IFU in projects with large, internationally experienced Danish TNCs with several projects already in the IFU portfolio is low. For projects started before 1996 receiving funds under the contribution, food & beverage (20%), primary production (18%) and textile production (18%) dominate. 60% of the projects exited by IFU during 1996-2000 that had received funds under the contribution were in the primary production and food & beverage sectors. For IFU's administration it is likely that it was efficient to use the Danida contribution to exit many of these projects that – for quite a few of them – had been troublesome for years[36].

IFU's *Africa promotion policy* after 1996 aimed at increasing the number of new projects per year in Africa from five to 15, and the invested amount from DKK 10 million to about DKK 40 million per year. The activity level increased, but the number of projects fell short of expectations. However, IFU's investments exceeded the targets, mainly due to large interventions in cement and container business – much of it assisted by the Danida contribution. The required annual level of disbursements from the Danida contribution was thus partly met by investments in a few, large projects. Most of the projects in African countries, where the PSD/BtB programmes were active, have been with these programmes. As, on an average, a PSD project is too small to be considered by

36) See Annex IV for further information.

IFU, enhanced collaboration with the PSD Programme still needs further formalising in order to focus on projects suitable for IFU participation. Activities in the 1996-2000 period confirm that IFU's additionality is marginal in larger projects and considerable or essential in many SMEs.

IFU has improved its *pre-investment support* quality with the introduction of PIM in 2000. Before the PIM was introduced, some project investments in India suffered from IFU eagerly pushing DPs to enter into joint ventures without proper preparatory investigations and with resulting costly lessons for the DPs and IFU. IFU has consistently put in additional funds, especially in Greenfield projects, but financial results are, in most cases, yet to be forthcoming. It is found that the ex-ante assumptions in many PAIRs are unrealistically optimistic and without scenario development, assessing combinations of critical factors that can negatively reinforce each other. In Sri Lanka, there has been no IFU involvement at all in the visited projects during start-up, and, as the DP/JV had IFC experience, IFU had nothing to add in these matters. In China, the professional guidance prior to and during start-up has been pro-active, cost-efficient and effective in half of the cases. This involvement can avoid pitfalls, delays and poor, costly partner and government relations. In Africa, there is a need for a more thorough assessment of resources and competencies of partners during PIM, prior to agreements. There has been effective professional guidance prior to, and during, start-up in four of five African project companies. The observation from Africa is that, if the PIM had been used before Binding Commitment, portfolio efficiency would have improved with less non-starters or projects experiencing problems. Poor planning can be blamed for chronic underfinancing of some Brazilian projects.

IFU's *implementation procedures* have become more efficient. Particularly since the late 1990s, IFU's board participation with locally appointed board members has been positive. In Africa, the majority of IFU board members are reported as playing an active role, but there is no indication that this has improved management; in the remainder of the project companies, IFU board members have been passive. In India, earlier failures are attributed to a mismatch of objectives, culture and business ethics of the partners. Generally in Asia, the efficiency of IFU's participation in operations is largely very positive. In Latin America, efficiency of IFU's exit receives little credit from DPs and PCs; a clear IFU exit strategy at the time of signing the agreement would reduce tensions, where financial interests (between IFU and/or the PC/DP) are conflicting. Although IFU found the end-result satisfactory, the Evaluation assesses that one early success in Mexico had as a result that insufficient critical assessments or scenarios of mutually reinforcing negative indicators were made for the succeeding projects with the same DP. The Evaluation finds that for some troublesome Ghanaian projects, the period of low financial performance was prolonged by IFU's decision to remain on board, instead of cutting its losses, dropping the project or pulling our at an earlier stage, thus reducing its exposure. IFU, however, continued to allocate both administrative and financial resources to the projects. A much earlier IFU exit would have sent a strong signal to the market about IFU's ability to take immediate and necessary actions to safeguard its capital. Please see Section 3.3, p.48, regarding IFU exit procedures[37].

37) IFU Comment: As a shareholder, IFU neither can nor should exit when problems arise. In such situations IFU endeavours to provide additionality by assisting in finding sustainable solutions and, if everything fails, a responsible termination of the project.

IFU's *administrative set-up* has also undergone changes, and especially the regional offices in China and India staffed with highly educated, local professionals are praised. This staffing has resulted in a careful search for quality and sustainable projects, which has replaced the volume focus of ten years ago that was driven from IFU Copenhagen. Also the local board members are praised for their innovative use of local knowledge and moderation of unduly optimistic market studies – or for facilitating additional financing. This is in contrast to earlier Indian cases that are referred to as rather passive – bordering on the counterproductive or damaging performance. Despite the regional office in India, Indian PIM meetings are, since 2000, conducted in Denmark because this has been the preference of the partners and there is no longer an IFU facilitator based in India. Sri Lanka is assessed to be well covered from the India regional office.

The high efficiency of IFU regional employees is praised, whereas headquarters staff is viewed as less efficient. The regional office in South Africa enhances efficiency by being present and able to provide local part-time advisers and facilitators with local knowledge and understanding. The absence of a regional office in East Africa limits the resources for proactively addressing the needs of SMEs during the start-up phase in the region. The organisational set-up in Africa is, in general, not geared for local SMEs. In Latin America, the finding is that there is also a clear correlation between a dynamic local IFU representative and the project companies' appreciation of the IFU support and guidance. Where there is no local IFU representative, the IFU support has not left lasting impressions. A general finding from Latin America is that large PCs find IFU more effective than small ones do.

In India, *project efficiency* has previously been low with 13 of 20 exited projects not getting started at all. In India, it is also not clear whether good money is thrown after bad in two out of six closed down projects assessed by the Evaluation, and financial success has not been experienced in projects exited by IFU. More than half of the projects in Africa are established within the set time frame and budget; however, the budgets could have reflected the market situation better if there had been more assistance from IFU. In Mexico and Brazil, half of the projects are on time and within budget. The number of projects in SOD was expected to be around 40-50 at any time, but there have consistently been almost 70 projects. This indicates that the quality of the earlier exit agreements on equity investments has been problematic, and this has generated doubt about sale prices and other issues related to IFU's exit.

About two-thirds of all projects are *joint ventures with a local partner*. Half of the projects in Asia assessed by the Evaluation are with a local partner. There are more and better JVs in China and Sri Lanka than in India. The efficiency of the JV establishments has been low to medium in India and Sri Lanka – and high in China. In Mexico and Brazil, large projects do not have local partners, whereas in the rest of the region, projects – and most of the smaller projects – appreciate having local partners on board. There seem to be no correlation between the size of the DP or size of the JV and degree of success. In Africa, almost all projects are with a local partner, but the development impact of those without such partners is higher – and it is higher for large DPs than for small ones.

The *concentration of projects on specific Danish partners* is quite high. The top ten Danish partners in terms of projects has 28.3% of all projects, and the top ten in terms of total IFU investment got 46.5% of all IFU funds. One Danish partner alone accounts for 13.4% of all agreed IFU investments. The concentration on large DPs that received

money from the Danida contribution is also high. DKK 595 million (62%) of the total Danida contribution and 45% of all projects were with 26 large DPs. A few cement projects have received almost one third of the Danida contribution, while 35% of the contribution has been scattered thinly on SMEs in mainly Africa. A significant clustering in Asia and Mexico on a couple of large, internationally experienced repeat DPs with a smaller than average IFU share of investments and where IFU's additionality is lower than for less experienced DPs, suggests that IFU's efficiency could be higher if resources had been used on other partners.

IFU's *efficiency in utilisation of the financial resources* is low. IFU's gain on project investments is temporarily invested in bonds. The Fund's relative level of cash and bonds as a percentage of total net assets is quite high (49%), indicating a high level of liquid assets available for investment in projects. Further, the option of using its equity as a guarantee for additional external capital resources – leverage – and expanding the capital base for more and larger investments has only to a marginal extent been utilised by IFU. IFU's equity thus represents 95% of its reported assets net of reserves for losses. The high level of liquid assets, together with a low level of leverage, may indicate that IFU has had some difficulties in developing and growing a profitable and sustainable portfolio relative to its institutional capacity (equity base). An assessment of the volume of IFU investments compared to the resources at the disposal of IFU indicates that the capital utilisation is sub-optimal, or the present market for IFU financing is too limited – and/or the number of bankable projects within its mandate area represents a considerable limiting factor.

4.5 Effectiveness

IFU's objective has, from a development point of view, not been fulfilled to the full potential due to the concentration on countries with enabling environments more or less in place – and on Danish partners that already have extensive international experience. A high concentration on certain sectors may be opposed to a broad-based business sector development.

Globally, foreign direct investments are concentrated on a few countries that tend to be some of the more wealthy developing countries (LMICs and UMICs) where the framework conditions are better than in LDCs and other LICs. Also the IFU investments are concentrated in a few of these countries. China, which has recently been reclassified from 'other LIC' to an LMIC country, figures as the top one country globally, as well as in the IFU portfolio. A number of the other countries at the top of the IFU portfolio do also, globally, attract investments to an extent where this is not only due to companies having their investments facilitated by DFIs. For instance, in Latin America there have been significantly less achievements in establishing enterprises that generate economic growth in the less developed rather than in the more developed countries. At the other end of the scale, LDCs globally only attract 1.6% of all investments to developing countries, whereas IFU's portfolio shows that a DFI is able to direct investments to countries without the framework conditions prevalent in the more wealthy countries. However, the decline in the share of IFU investments in LDCs from 17% before 1996 to 12% after 1996 indicates that there is still scope for improvement in the direction of the IFU project portfolio.

IFU's investments are concentrated in the industrial production sector, with only marginal investments in the financial sector (0.1%). A few sectors are very capital intensive

(as opposed to labour-intensive), attracting a disproportionally large share of the investments, for instance, cement and chemical production. There have been some significant changes after 1996 in the sector distribution of IFU's planned investments. Before 1996, food & beverage was the dominant sector both in terms of the number of projects (22%) and planned investment (29%), overall, as well as for each region and income group of countries. After 1996, this sector's importance declined sharply to 12% of the number of projects and 6% of the planned investments. Many projects in this sector were exited after years of troublesome operations. After 1996, the largest sector in terms of planned investment is cement (18%); however, the sector's significance varies between regions and across country income groups. The cement sector accounts for 45% of planned IFU investments in LDCs, 24% in other LICs, and 20% in LMICs. The cement sector is by far the largest sector in Africa with 28% of the regions planned investments, and it is also significant in Asia and Latin America (12-13%). Relying on the demand from a limited number of Danish actors in specific sectors may not be optimal for a DFI such as IFU in the fulfilment of its objective.

The objective of the 1996 appropriation has also only to a certain extent been met by the additional financing to poor countries, especially in Africa, after 1996. The declining trend of IFU projects and funds going to Africa was reversed. However, when looking at all poorer countries (LDCs and other LICs) there was no remarkable impact of the Danida contribution. Only 52% of all projects receiving money under the contribution were new IFU projects, and only 23% were new projects in Africa. By using as large a share of the contribution for debt relief as on new projects in Africa, the activities have only to some extent been within the scope of the objectives and the intentions of the 1996 appropriation. Danida reacted on IFU's use of the contribution when discovering that a disproportionate share was used for debt relief. No funds went to debt relief in 1999 and 2000. A change in focus of IFU's activities towards poorer countries, local enterprises and support for establishment of enabling environments where these do not exist, would make IFU more effective in meeting the stated objectives.

IFU's cooperation with Danida's business sector development instruments has primarily been with the PSD and BtB programmes. The interaction with Danida's PSD activities and Danish development assistance, in general, has been limited. In India, cooperation with the Danish embassy and Danida could be improved. The ETF has resulted in enhanced job opportunities for those involved in these activities. In Latin America, there has been limited interaction with Danida, due to the fact that Danida is only active in Bolivia and Nicaragua, which are the poorest countries in the region and of limited interest to the DPs. In Africa, the PSD Programme training grants did not have the anticipated impacts, as most grants in IFU supported projects benefited the DPs, disturbing sound business principles and commitment. There has been extensive cooperation with the BtB in South Africa for identification of IFU projects.

5 Evaluation Synthesis and Lessons Learned

5.1 Evaluation Synthesis

The synthesis of IFU's performance is related to the Evaluation's objectives as stated in the Terms of Reference and as interpreted by the Evaluation Team.

Have IFU's investment projects promoted economic activity in developing countries?

IFU's investment projects have promoted economic activities in developing countries. The objective has been fulfilled to some extent. The potential has not been fully exploited, due to the concentration on countries with enabling environments more or less in place and on Danish partners that have adequate financial resources and profound international experience. The focus on the project level may not be adequate to furthering development goals, as Danish partners have company specific priorities. The "client driven" approach may thus only partly contribute to the overall development goals in the host countries. Furthermore, the high level of funds maintained in treasury bonds, together with the low level of leverage, have also contributed to the objective not being met to its full potential. If IFU's mandate had been interpreted differently (ref. Section 3.1) allowing IFU to undertake complementary interventions i.a. to improve the enabling environment, more could have been achieved. Through IFU's membership of IFI, IFU has, indirectly, contributed to improving the enabling environment in those countries that IFI's database covers.

The key issue in relation to economic activities is the extent to which these are sustainable and thus generate long-term development effects in the developing countries. The degree of sustainability of the investment projects depends substantially on the enabling environment in the respective host countries, which varies from region to region and within the regions. Sustainability of IFU's investment projects in Asia and Latin America is relatively high, whereas sustainability in Africa is generally low. The low degree of sustainability in Africa can be attributed to poor enabling environments, inadequate preparation and appraisal of a number of investment projects, and small and less experienced Danish partners. IFU's project portfolio in Africa has been affected by considerable political and economic turbulence, which has contributed to the portfolio being thinly dispersed across the continent. The many political conflicts across the African continent, which change once relatively well functioning countries into volatile places, generate poor enabling environments for invested capital and make it difficult to attract new foreign investments.

The investment climate in the developing countries is subject to many internal and external social, economic and political factors that either result in an attractive investment environment or the opposite. Stable countries with good market potential and enabling environment attract substantial foreign direct investment. Unattractive countries may gradually change into attractive ones and remain so for a long period of time, while the opposite may also be the case – and at times very abruptly. Low-income countries may, after years of sustained economic growth, become middle-income countries. The investment opportunities thus change quite dynamically around the world. The main justification for DFIs is to direct their investments to developing countries where there is relatively limited foreign direct investment, but in which an enabling environ-

ment is evolving. It is in these countries that the facilities and services of IFU are most needed and where they, relatively, can contribute most to business sector development. Directing the capital to the countries in most need would, correspondingly, imply that DFIs should gradually decrease their investment activities in countries, which have a stable investment climate and substantial foreign direct investment.

Have IFU's investment projects generated effects for Danish companies?

IFU's investment projects have, to a large extent, generated positive effects for the Danish companies, and have promoted their internationalisation. The smaller Danish companies have generally benefited relatively more from the cooperation with IFU, as they possess the required expertise for international operations to a lesser extent than the large companies. The effects vary from short to long-term effects. Most Danish companies strive to improve their long-term competitive edge in terms of market penetration through productivity enhancement measures, technology innovations, and improved product quality – whereas some seek short-term gains through major equipment supplies and use the joint venture arrangement as a means to secure the deal. The scale of the effects is closely linked to the sustainability aspects, i.e. high sustainability implies substantial positive effects and vice versa. The investment projects have only in a few cases resulted in a reorganisation of the Danish companies and transfer of workplaces to the host country. In some cases, the Danish companies export semi-products and thus contribute to maintaining workplaces in Denmark. The closedown of project companies – whatever the reasons may be – has generally substantial negative effects on the Danish partner.

Are the IFU investment projects in agreement with Danish development cooperation policy in general?

IFU's investment projects are, generally, compatible with Danish development cooperation policy. Denmark's bilateral development assistance concentrates on low-income countries, as most "Danish programme countries" belong to the LDC group – Egypt[38] being the only exception. The Danish assistance under the Environment, Peace and Stability Facility (MIFRESTA) operates in low and middle-income countries. IFU operates basically in the same category of countries, but some upper middle-income countries are included as well. IFU's investment portfolio is concentrated in the more wealthy developing countries and, therefore, poverty reduction is not as pronounced from a global perspective as for the Danish bilateral assistance. In the countries in which IFU invests, there is a tendency that investments are placed in the more thriving parts of the countries. From a private sector and demand driven point of view, investments are likely to be made in locations where market opportunities and enabling frameworks are good, which frequently coincide with the more wealthy countries and regions in these countries. From a development perspective, the countries with poor enabling environments are the ones that most need the support from development finance institutions such as IFU.

Irrespective of what has been said above about choice of host country and location, most IFU investment projects are generally relevant and they do stimulate the economy in terms of employment, technology innovations, and management practices. The addi-

38) The Danish cooperation with Egypt will be phased out over a number of years.

tionality may, however, not be equal to the actual number of jobs and income created, since other investors could have undertaken a comparable investment, if it were attractive. Some investment projects – particularly those where the production is dependent on agricultural produces – target poverty reduction directly by securing employment for poor people. Most project companies cooperate with local sub-suppliers and service providers and have thus a wider effect. In terms of corporate governance, social security and rights, external environment and working environment, the standards are generally very high – being the result of sound corporate policies of many Danish partners and IFU's Code of Conduct. Gender equality is not a prominent feature in the design of the investment projects, but women generally enjoy the same rights as men in the project companies.

Strengths and weaknesses of IFU's organisation, as well as potentials and opportunities for improvement measures

Danish and local partners, and authorities in the host countries, generally perceive IFU as a competent and well-esteemed institution. IFU has, in recent years, strengthened its pre-investment and exit procedures based on lessons learned, which is likely to reduce the operational problems that have sometimes been encountered in the past. The recent reorganisation, combined with improved operational procedures and an emphasis on human resources development, has resulted in more efficient operations.

Regional and adviser offices, with competent officers and the network of advisers, play an important role in ensuring local know-how and consistency of IFU operations. The permanent presence help in addressing problems between board meetings in the project companies. Delegation of increased authority to the regional representations has the perspective of further enhancing IFU's corporate performance. Danish, as well as local partners, appreciate continuity with regard to IFU's representatives and working relationship. There have been some cases in the past where frequent shifts in IFU representatives tend to disrupt the working relationships. The shift in IFU's teams from preparation, operation and to exit – according to the new procedures – poses a particular challenge vis-à-vis IFU's partners.

Africa poses a particular challenge with its thinly dispersed investment projects, which require special attention to ensure continuity and consistency. Due to the rapidly changing and difficult investment conditions in Africa, IFU has frequently been compelled to change its investment focus to countries that occurred to be relatively stable. The 1996-2000 capital injection demonstrated that it is possible to influence the investment level in Africa – although the interventions could have been undertaken more effectively. Despite appropriate policy statements, IFU appears to be less well equipped to deal with the more difficult investments, e.g. small Danish partners and SMEs with local partners in countries with a poor enabling environment. A SME window in IFU could redress this situation.

IFU's mode of operation – based on specific projects – is work intensive in contrast to what it would be if working through intermediaries. The project approach provides a good opportunity for drawing on IFU's expertise and promoting corporate governance. However, direct support to local venture capital funds may overcome some of IFU's operational constraints in dealing with the more difficult markets and SMEs. The working relationship between IFU's Board and administration is effective as regards project approvals. However, a large part of the time at Board sessions is spent

on discussing project specific issues, which leaves less time for addressing the overall strategic issues.

The policies related to the provision for losses and the availability of liquid capital have been very cautious with a view to having a financially robust and trustworthy institution. They have been maintained out of a concern for IFU's survival. On average, the actual accumulated losses have been half of the provisions made. Less cautious policies would have had the potential to increase the project portfolio, provided the demand for investment existed. The demand for investments during the 1996-2000 period did not evolve fully as anticipated, as the number of projects declined and the average investment size doubled at the end of the five-year period for both new and existing projects. The attainment of the planned investment level during the 1996-2000 strategy period was based on IFU's estimated need for a capital injection in the amount of DKK 1.2 billion. Danida's capital injection in the amount of DKK 750 million proved to be adequate to reach the planned investment level at DKK 1.6 billion for new and existing projects.

5.2 Lessons Learned

The main lessons learned are:

- Policy driven instruments can influence the composition of the project portfolio;
- Good corporate governance has considerable impact on social and environmental aspects and it enhances competitiveness;
- Human resources development in project companies contributes to enhanced corporate performance;
- Proper preparation and appraisals have a definite impact on the quality of project companies' operations;
- Pre-investment meetings are effective mechanism for resolving potential conflicts between foreign and local partners, before agreements are signed;
- Active support to project companies during operations can effectively resolve problems that would otherwise grow unnecessarily big;
- Proper exit arrangements with project companies help in avoiding complicated negotiation at the withdrawal time;
- IFU's additionality is less with resourceful Danish partners and in countries with well functioning market mechanisms;
- IFU's additionality is high with less experienced Danish partners and in countries with imperfect market mechanisms.

The issue of additionality has many dimensions as it can be related to the global development situation, the host country's economy and business sector, local partners and Danish partners. The establishment of a viable and well-operating company would always have a certain degree of additionality irrespective of the country's income level. Potential types of positive development effects at the project company level, stemming from DFI investments, are indicated in the box below.

Potential types of development effects from DFI investments

The project should ideally:

- contribute to a useful production of goods and/or services;
- create profitable workplaces, which improve the social and economic conditions in the host country;
- be located in areas in need of increased economic activity;
- include training of the workforce;
- provide the basis for other economic activities;
- use and refine local raw materials;
- apply appropriate technology and contribute to development of the host country's technology level;
- contribute to improvement of external relations by creating import substitution or export promotion;
- *external environment;*
- *working environment;*
- *corporate management;*
- *human rights – code of conduct.*

Source: Norwegian Development Agency (NORAD). The types indicated in Italics have been added by the Evaluation.

IFU, generally, has project facilitation additionality during planning, implementation and operation phases in relation to most of its partners, irrespective of their experience and knowledge. IFU will thus, in this respect, generate additionality from its engagements – particularly so if IFU is represented on the project company's board. Facilitation additionality may be perceived differently by project partners over the time from entering into an agreement to the exit. Their perception is likely to be influenced by the project company's success and how the enabling environment evolves. In the late 1990s, IFU's efforts to promote environmental management and corporate governance were manifested by adopting its Environmental Policy (1998) and Code of Conduct (1999) and, thus, impress on its partners that these issues were absolutely essential. In countries where IFU has a substantial project portfolio, there is a certain amount of cross-fertilisation as the general experience gained by IFU can be shared with all its partners.

If the point of departure, however, is to channel investments to those countries that are in a dire need for attracting foreign investments and of improving the enabling framework, the degree of IFU's additionality will be relatively higher for the more needy countries than for the more wealthy countries. Correspondingly, the degree of additionality would be relatively higher for Danish partners, who would not establish a project company without IFU's involvement, compared to those who would go ahead anyway.

6 Conclusions and Recommendations

6.1 Conclusions

IFU has, as an institution, over its years of existence developed a unique expertise, the maintenance of which depends on a high degree of continuity, experienced professional investment and business staff, and supporting management systems. The need for DFIs has not diminished over the years. On the contrary, DFIs possess continued potential for attaining substantial development effects in developing countries through leveraging local and foreign investments. The Evaluation thus sees the need for IFU's continued existence as an autonomous institution in the years ahead, but the operational modality may need to be modified to comply with external requirements and with the varying conditions in IFU's three major regions.

IFU is operating within its mandate. However, the mandate can be interpreted in several ways, ranging from optimising the returns by investing in the more wealthy developing countries to optimising development impacts by directing the investments to the poorer countries where, from a global perspective, it is more needed. Most DFIs are confronted with this dilemma, but they balance their investments in order not to erode their capital by taking too high risks. Yet they pursue a fair distribution among the various income categories of developing countries. The Evaluation finds – from a global development perspective – that IFU could direct a larger share of its investments to the poorer countries, and could explore instruments, jointly with other DFIs, to improve the investment environment in these countries. The Africa and West China strategies are examples of such "*policy driven*" interventions, where IFU has succeeded in promoting viable project companies. The fact that IFU is a development finance institution provides a number of choices to be made – the outcome of which will remain within IFU's current mandate:

- level of investment risks,
- returns on the investments,
- complementarity with commercial investments,
- degree of additionality,
- degree of development effects,
- degree of poverty reduction.

These choices leave room for interpretation of IFU's mandate by its owner, Board and management. The answers may not lie in the individual investment project, but rather in the composition of the project portfolio, where these competing interests can be balanced. The focus on projects in policy execution may have major drawbacks for IFU's development impact. Although attempts have been made over time to re-interpret IFU's mandate, no contemporary interpretation has materialised, which could otherwise have enabled IFU to incorporate relevant elements of the evolving private and business sector development concepts.

The 1996-2000 Danida contribution was intended to change the project portfolio profile by focusing on low-income countries – particularly those in Africa. The project portfolio profile did change in favour of more IFU investments in Africa in the period, compared with the record low levels in the first half of the 1990s. Whereas the Danida con-

tribution has been directed to the poor countries in Africa, the upsurge in IFU projects in South Africa after 1995 has made the African portfolio in its totality less focused on the poorest countries. The contribution did not prevent the share of projects in LDCs to be almost halved after 1996 compared to the situation before 1996. The main results of the contribution are, in summary: half of the projects were new; as many new projects were started in Asia as in Africa; as many projects were at the point of being exited, as there were new projects in Africa; there was a concentration on large projects and on a few sectors; a fourth of all projects, receiving these funds, were exited by IFU during the period, and 14% of all funds was officially used for debt relief.

The IFU 2001 Annual Report declared that special efforts in Africa will be continued and an increased focus on Western China will be maintained; the first will especially contribute to a better poverty profile. This aim was reiterated in the IFU 2002 Annual Report (ref. "Foreign direct investments combat poverty", p. 32). The IFU investment projects are largely demand-driven by the Danish partners, but the 1996-2000 efforts demonstrate that pro-active, policy-driven interventions by IFU have the prospects of attaining the "warranted profile" of the project portfolio.

The Government's capital withdrawal to the amount of DKK 750 million, which is anticipated to be undertaken in early 2004, will give rise to considerable reconsideration as regards the 2003-07 strategy and the operational modality. The size of the capital withdrawal is based on the assumption that the annual investment level is DKK 450 million for the 2004-13 period. To mitigate the liquidity effect in part, the State will give a guarantee for a credit facility of DKK 300 million in a commercial bank. The capital withdrawal will reduce IFU's annual secondary revenues. The Government's decision to withdraw DKK 750 million would alone prompt IFU and its Board to revise its strategy and operational modality – including engagement limits. In the light of this, there is an urgent need to rethink IFU's operations.

The five-year strategies could be an effective planning and monitoring instrument for IFU's operations by incorporating qualitative and quantitative targets and associated success criteria. The notion of "business sector development" will open for further opportunities to improve the enabling environment in those countries where there is a critical mass of project companies – particularly so in those countries where IFU has regional and adviser offices. These opportunities will include dialogue with government agencies, business associations, and representatives from other DFIs. The establishment of a regional or adviser office will in itself be a means of attracting new investments and improving the enabling environment in targeted regions.

Most EDFIs have untied their operations to national companies, but they have still retained the national client base. Because IFU is tied to Danish companies, it is constrained in its cooperation with other EDFIs and financial intermediaries in the host countries in relation to addressing national or local development needs. It may be a question of time before EU regulations require IFU to untie, as has been the case with Denmark's bilateral assistance. It is not anticipated that an untying to Danish companies will change the co-operation pattern with the Danish business sector dramatically, but it will provide IFU with additional means for policy driven interventions. Moreover, the untying will not prevent the pursuance of greater coherence between the Danish business sector instruments.

IFU's Board works elaborately with approval of projects. Due to the fact that the three

investment funds are dealt with during Board session, there is a risk that the distinction between their respective objectives may be blurred. Project approval seems to consume most of the Board's time, providing limited time for strategic considerations. Interpretation of IFU's objective in relation to the rapidly changing social and economic environment caused by globalisation requires substantive strategic considerations and corresponding adjustments and use of IFU's instruments and cooperation patterns.

IFU has succeeded in restructuring its organisation so that it responds more effectively to the diversified tasks of managing the project portfolio in many countries. In connection with the recent restructuring, IFU has placed further emphasis on human resources development in headquarters and overseas offices. This contributes to added competence and motivation increasing the productivity. The regional offices, the adviser network, and the growing involvement of local professionals improve IFU's effectiveness and efficiency. Although the mode of IFU's operations may be somewhat modified to comply with new challenges, it is anticipated that operations will continue to be human resource intensive. Since IFU's investment level and workload are unlikely to decrease, there is, from a productivity point of view, no immediate need for reducing the number of staff.

IFU has successfully developed the project mode for large and small project companies. The majority of project companies are well operated and generate positive local impacts in the host countries, whether they are low or middle-income countries. Danida's ETF has on many occasions resulted in environmental management being more comprehensively addressed than would otherwise be the case. IFU has, in recent years, taken note of poorly performing projects and it has subsequently improved its preparation, appraisal and operational procedures. Well performing project companies, with the participation of internationally experienced Danish companies, add to IFU's reputation and esteem in host countries and in Denmark. This provides IFU with a greater leverage when assisting less experienced companies during preparation and operations.

Although IFU is engaged in a significant number of SMEs, it appears that IFU is relatively better equipped to deal with large DPs. The partnerships with SMEs require comparatively more resources and are thus, from an investment point of view, less attractive. However, SMEs play an important role in developing countries' business sector development and should, from this perspective, be promoted and their enabling environment improved. Cooperation with well-performing financial intermediaries, in countries where IFU is well engaged, could under this circumstance be a more effective means of supporting SME development.

IFU's economic additionality is low when cooperating with well-established, internationally experienced and larger Danish companies – many of whom would have made the investment without IFU's assistance – in countries with good enabling environments. The security of these investments is relatively high. The additionality is comparatively higher when this category of Danish partners operates in countries with a poor enabling environment. In contrast, IFU's additionality is high when operating with less experienced and smaller Danish companies in countries with a poor enabling environment having relatively low investment security. The low additionality is mainly due to IFU choosing resourceful and experienced Danish partners that pursue investments in countries with good enabling environments, and partly a result of how many others would have liked to take on that particular investment. This category of Danish partners has proven corporate policies and is capable of coping effectively with changing requirements. Thus, they are less dependent on IFU's know-how and capital. IFU's project

facilitation additionality during planning, implementation and operation phases is generally high irrespective of the countries' enabling environment and the partners' resourcefulness.

IFU's procedures have generally undergone substantial improvements during the last few years. However, procedures for losses, committed and non-committed capital appear to be overly conservative. The share of loans, as generally defined, of the total investment has increased over time, and a number of large loans have been given to projects with a limited number of large, repeat Danish partners. This practice limits IFU's additionality in several ways, e.g. IFU will not, through board participation, have the opportunity to provide its services, and the large companies are likely to have access to other funding sources, as they, in many cases, could undertake their investments without IFU fund contribution. IFU's performance monitoring does not adequately capture IFU's corporate performance in relation to its development strategies and success criteria.

The Annual Reports do not provide precise information on realised losses and status of actual projects. IFU's public information strategy is not to any large extent directed towards potential new partners and provides the public with limited access to information.

6.2 Recommendations

The below recommendations are interconnected. The substance of the individual recommendation may need to be adjusted depending on the degree to which the recommendations are accepted in their totality. The recommendations are directed to the owner, IFU's Board, management and administration. Based on the Evaluation's observations and conclusions it is recommended that:

a. *Institutional framework*
   IFU continues as an independent and self-governing, state-owned institution with Board, management and administration and the roles of these parties, as well as that of the owner, are clearly defined.

b. *Strategy*
   The current practice of preparing strategies with a regional focus should be maintained with due respect to the varying conditions and opportunities in the three main regions and their respective countries. Increased attention should be given to the poorer countries (LDCs and LICs) – the policy-driven approach – in terms of the number of projects and investment in these countries. Correspondingly, less attention should be given to the more wealthy countries (UMICs) that are able to attract FDI. The engagement limits for countries, partners, projects, as well as sectors, should be reviewed to better fulfil the Fund's objectives and the adopted strategy. The strategies should be operationalised, instruments and resources defined, verifiable and flexible targets set, and the strategy monitored. IFU's participation should be concentrated in countries where there is a potential for several investment projects in order to exploit synergy effects and to generate a critical mass of projects to enable that a broader development impact can be attained.

   In such countries, IFU should, jointly with other DFIs and other cooperation partners, contribute to improving the enabling environment for business sector development,

e.g. advice to the government on measures that would improve the business environment, support to business associations concerned with market and technology aspects, etc. The establishment of an adviser office should be considered for East Africa to stimulate IFU investments in a relatively stable part of Africa. Success criteria reflecting the strategy and its priorities should be reviewed. The regional offices should be provided with the mandate to outline policy directions for IFU's interventions.

The cooperation linkages with the PSD Programme (being the Danida business instrument that has the largest relevance for IFU) should be further developed and possibly institutionalised – not only to deal on a project-to-project basis, but also by developing a more comprehensive approach in Danida programme countries where IFU has strategic interests. This approach could be further enhanced through interface with the new BSPSs in Ghana, Tanzania and Vietnam. Other linkages to Danida's business sector instruments should be considered. IFU should also explore new avenues for cooperating with other EDFIs to optimise the 65 regional offices around the world, and between the EDFIs and their respective donor organisations, where there is scope for improvements, e.g. more use of coordinated missions.

c. *Objective*
IFU's objective should be modified so that the tying to Danish companies is abolished. This will facilitate cooperation with other DFIs, particularly the EDFIs and with venture capital funds in developing countries. The objective should maintain the developmental role of IFU consistent with the Danish development cooperation policy. This change may require amendment of the Development Co-operation Act. In any event, the 1976 objective should be reinterpreted or modified to be coherent with Danida's "Programme of action for Denmark's support of business development in the developing countries, September 2001".

d. *Board composition*
The composition of the Board should ensure that corporate competence and development insight are available to match IFU's objective and operations. The composition of IFU's Board should be amended to strengthen the development perspective and to meet the need for strategic considerations. Criteria for the Board's composition should be prepared. The composition could be as follows.

- 5 from the business community
- 1 from the labour movement
- 1 from the development field (e.g. development economist)
- 1 from the Ministry of Economy and Business
- 2 from MoFA (1 South and 1 North)

The Board should, ideally, include a banker and a venture capital expert from the business community. In the event of closing down IFV, the representation of the Ministry of Economy and Business may no longer be required. The role of MoFA's Board members of representing the Government should be clarified and elaborated in the rules of procedures. Strategic consideration and discussions should play a more significant role during Board meetings.

e. *Human resources*
As the annual investment level is likely to be stable over the years ahead, the staffing level should in the short-term remain largely as it is today. A further trans-

fer of functions to regional offices is likely to result in further gains in effectiveness at lower costs. The reduced financial income in consequence of the capital withdrawal may warrant staff reductions. However, as services of a high quality should remain a key feature, the staff level should only be reduced as productivity gains are attained.

The comprehensive approach to human resources development should be maintained on a continuing basis to ensure high levels of competence and dedication. HRD should involve both headquarters and regional staff. The process of developing local capacity in countries where IFU has a significant project portfolio, or wishes to have one, should be continued. The continuation of the "SIMI arrangement" should be explored – with or without Danida financing.

f. *Operational modality*
The primary mode of operation should remain as participation in project companies with foreign and local partners, as relevant for the project company. However, IFU should pursue greater involvement in the financial sector by involvement in intermediaries, especially in the event of untying to Danish companies. The balance between equity and loan support for projects should be reconsidered with a view to promoting equity investments and thus a greater involvement of IFU. The definition of a foreign partner will need to be elaborated, if the untying to Danish partners is abandoned, to ensure that the cooperation contributes to the development goals. The current instruments at the disposal of IFU are considered appropriate, but they should be utilised to their full potential and expanded with soft instruments such as advice to governments, business associations, etc. Increased attention should be given to small and medium-sized companies, in terms of the number of projects and invested capital, and less to the large, Danish repeat partners.

High-level professional assistance should continue to be provided for the project companies during planning and operation – particularly so for the less resourceful companies during the initial phase of operation, as many of the feasibility studies and appraisals tend to be over-ambitious. Project opportunities that address needed interventions may also be identified in the host countries by IFU and presented to potential foreign and local partners. Well-conceived and sound projects should be the point of departure, so that uncertainty and risks are solely related to external factors. Corporate governance in project companies should remain an essential feature. The Danida ETF should ideally be continued beyond the 2003-04 period. The newly introduced review of projects' exit options five years after they have been launched should be maintained to secure timely exit of projects and recycling of the capital for new investments.

g. *Procedures*
IFU procedures should be updated on a continuing basis to reflect strategies and priorities as they evolve. Procedures for more appropriately sized provision against losses, committed and non-committed liquid capital and leverage options should be elaborated to reflect investment priorities in relation to the current capital base, and thus also the capital withdrawal. This should include incentives to promote investments in the poorer developing countries.

In the wake of the capital withdrawal, considerations should be given to merging IFU and IØ capital assets with due attention to the funds' respective objectives.

Since IFV activities will be terminated, a further consideration could be to transfer ongoing projects to IFU until their time of exit.

Performance monitoring procedures should be further developed to provide information on IFU's corporate performance in relation to investment strategies, development strategies and success criteria. Project monitoring should also include exited projects to facilitate ad hoc reviews and evaluations in the future. Independent reviews should be conducted on an ad-hoc basis of ongoing and exited projects. Independent evaluations should be conducted every five years, or more frequently, to provide inputs to the strategic planning and to confirm coherence to objectives and strategic targets. The independent evaluations could be undertaken to coincide with IFU's five-year reports.

h. *Public information*
The Annual Reports could benefit from a clearer presentation of the actual performance of the investment portfolio, as regards realised losses and the list of projects with actual realised projects and investment amounts. Information material presenting IFU products and procedures, accessible on the homepage, would expand the marketing potential of IFU, as well as give the general public insight into its operations.

Appendix 1 IFU's comments to the Evaluation Report

Danida has with the consent of IFU's Board of Directors commissioned an independent evaluation of IFU's activities.

IFU can support most of the Evaluation's findings and recommendations many of which have already been acted upon and the rest of which will be further considered at IFU's forthcoming strategy meeting.

IFU, however, finds that the report in spite of a number of meetings between the evaluation team and IFU does not give a balanced presentation of the following two essential areas:

- IFU's legal mandate – too imprecise
- IFU's additionality to the projects – too simplified

IFU's point of view on these two points is therefore clarified below.

IFU's legal mandate

The report gives the impression that IFU's legal mandate as it exists could have been interpreted differently. This is not correct.

The legal mandate of IFU is defined in Article 9 in the Danish Act on International Development Cooperation ("Lov om internationalt udviklingssamarbejde") according to which IFU shall promote economic activity ("erhvervsmæssige udvikling") in developing countries *by promoting investments in these countries in collaboration with Danish trade and industry ("dansk erhvervsliv")*.

Since IFU's establishment in 1967, IFU's board and management have worked on the basis of the law text, and the interpretation and limitations of the said law text have over the years been supported by numerous statements from the Government's Attorney (Kammeradvokaten).

While the NCG evaluation acknowledges that IFU has operated fully within its legal mandate, the NCG Evaluation suggests that Danida has from the mid 1990s developed its business sector instruments in accordance with a wider perception of the business development concept, *and* that IFU's legal mandate and objective accordingly could have been interpreted in this perspective.

IFU does not agree to NCG's suggestion that a broader reinterpretation of IFU's legal mandate would have been possible in the context of the existing law. And in his newest statement of February 17, 2004, Kammeradvokaten has again confirmed and concluded that there is no basis for such broader interpretation. Furthermore, IFU's Board has at no point in time found it necessary to suggest or request a modification or change of the mandate.

IFU's additionality to the projects

The NCG report does not – in IFU's view – give adequate attention to the additionality dimensions of IFU's activities, which have many more aspects than those analysed.

Additionality is an important concept in relation to development projects but difficult to measure. According to the Terms of Reference for the evaluation, the evaluation of IFU's additionality to the projects should be based on "an assessment of whether the projects would have been implemented without IFU's financing and whether IFU's participation has resulted in higher project quality and/or shorter start-up period".

The simple fact that a large number of Danish companies of different types and sizes have chosen to implement their investment in cooperation with IFU is in itself a clear indication of IFU's additionality. IFU wants to draw the attention to the fact that previous surveys have given clear indications of a significant IFU additionality for projects with large and small partners alike. This is also reflected by the fact that IFU has been involved as co-investor with large and small partners alike in the majority of all relevant investment projects undertaken by Danish companies in the countries where IFU can operate.

A thorough analysis of IFU's additionality should have included an analysis of IFU's positive impact on such elements as:

a) Improvement of project business plan and feasibility studies;
b) Guidance on obtaining local approvals and
c) Enhancing project bankability and securing access to external financing

IFU finds that a more precise and detailed evaluation of these aspects would have improved the understanding of IFU's additionality. IFU finally believes that the report should have paid more attention to cross fertilisation of ideas and free flows of lessons-learned among small and large projects as continuously facilitated by IFU because these aspects are of significant importance in relation to the development of best practice of management, corporate governance, environmental procedures and financial discipline – all important aspects of IFU's additionality.

Appendix approved by IFU's
Board of Directors on 1st June 2004.

Annex I Terms of Reference

Copenhagen, 10 September 2002
Eval. j.nr. 104.O.14.Eval.

EVALUATION OF THE INDUSTRIALIZATION FUND FOR DEVELOPING COUNTRIES (IFU)

1. Background

IFU was founded by the Danish Government and included in the Act on International Development Co-operation in 1967. IFU was created "with the purpose of promoting economic activity in developing countries by promoting investments in these countries in collaboration with Danish trade and industry".

IFU is a self-governing fund with a board of directors appointed by the Minister for Development Co-operation. The Minister also appoints IFU's managing director.

During IFU's first 10 years the Fund was financed by duties on coffee and coffee product as part of Danish assistance to developing countries at a total of DKK 287 million. In the period 1976-79, IFU received additional contributions totalling DKK 13 million from the Danish government. Thereafter the Fund was self-financed until 1996.

In the five-year period, 1996-2000, IFU received a total of DKK 750 million, divided into five annual quotas only released if IFU's net disbursements exceeded DKK 150 million each year, from the development aid budget in order to promote the establishment of projects in countries with a GNP per capita of a maximum of USD 2,316 per annum (1996). The additional equity capital could not be used for projects in China.

On 31st December 2001 IFU's total assets amounted to DKK 2,882 million while reserves against losses were DKK 904 million. The portfolio of active projects was 212 of which 67 were in Africa, 107 in Asia, 34 in Latin America and four in Europe.

Except for the “Nyboe-Andersen” Review from 1984, IFU has not previously been evaluated but the completion of the Danish Government's capital injection presents an opportunity to carry out an evaluation with special emphasis on investments in the poorer developing countries (GNP below USD 2,396 per capita per annum in 2001) during the period 1996-2000.

2. Objectives

The main objective of the evaluation is to assess to which extent IFU's investments have promoted economic activity in developing countries in accordance with §9 of the Act on International Development Co-operation in 1971 and the Appropriation from June 1996.

Furthermore, the evaluation shall assess to what extent the investment projects are in agreement with Danish development co-operation policy objectives in general.

The evaluation shall identify strengths and weaknesses of the organisation, as well as potentials and opportunities and recommend measures for improvement if relevant.

3. Scope of Work

The evaluation shall provide a description of IFU looking at the rationale for its introduction and describing the changes over time as well as the current situation. The report should provide an overview of the investment projects co-financed by IFU and an assessment against the internationally recognised evaluation criteria (Ref. Evaluation Guidelines, Chapter 4):

- The relevance of IFU (Are the objectives still in keeping with Danish international development co-operation policies and strategies and national and local authorities' needs and priorities and with the needs of the Danish private sector).

- The effectiveness of IFU (To what extent have agreed objectives (as laid out in the Act of 1971 and the Appropriation of 1996 been reached?).

- The efficiency of the IFU's administration (Could it have been done better, more cheaply and more quickly?).

- The possible impact (development effects) of the projects implemented with IFU co-financing (What are the positive and negative effects and do the positive effects outweigh the negative effects?)

The evaluation report should state causes and explain reasons for successes or failures and contribute suggestions to making IFU's investments more relevant, effective, efficient and sustainable, as well as state lessons learned.

4. Issues

To support the above general assessments the evaluation must assess the following issues without necessarily being limited to those mentioned.

4.1 Policy and Strategic Issues

- An assessment of whether IFU's investment facilities are in line with the development policies and needs of the host countries.

- An assessment of whether IFU's investment projects are in line with the needs of the private sector in both Denmark and the host countries.

- An assessment of whether the projects would have been implemented without IFU financing and whether IFU's participation has resulted in higher project quality and/or a shorter start-up period. (Additionality).

- An assessment of the interaction between IFU's activities and Danida's programmes supporting private sector development as well as Denmark's development assistance in general.

- Assessment of the volume of IFU's investment operations and the relative importance of IFU's project investments and return on liquidity.

4.2 Operational Issues

- An assessment of the support given and the criteria applied to pre-investment activities.

- An assessment of IFU's promotion policy with special emphasis on the promotion campaign for investments in Africa.

- An assessment of the suitability of the implementation procedures(promotion and appraisal by PDD, project management by IMD and SOD) of IFU based i.a. on interviews with Danish and local partners, other Danish and local credit institutions, Confederation of Danish Industries and Danish companies who have not made use of IFU's facilities.

- An assessment of the suitability of IFU's administrative setup including regional offices and advisers with special emphasis of the monitoring activities carried out by IFU staff and advisors on the boards of the projects in which IFU is a shareholder.

- An assessment of the performance in relation to training, education and follow-up including the use of the Environment and Training Fund.

- An assessment of the internal and external effects of IFU's Code of Conduct from 1998.

- An assessment of IFU's handling of environmental and occupational health and safety problems.

- An analysis of the partners' size, ownership structure and contractual arrangements.

4.3 Effects

- Analyses of the performance of different types of IFU investment projects i.e. large/small projects, shareholder/loan provider (or both), Greenfield/non-greenfield, poor/very poor countries, with/without local partner, length of engagement, length of engagement after Danish partner's withdrawal, and industrial sector. All analyses should differentiate between regions, year of commitment as well as giving overall figures.

- An assessment of whether the IFU investments have facilitated the projects' and the Danish partners' access to local, national or international markets.
- An assessment of the likely planned and unplanned, positive and negative development effects of the investment projects in terms of employment creation or preserva-

tion in the short, medium or long terms; domestic revenue generation; enhanced competence (e.g. through use of advanced technology; influence on external and working environment; increased involvement of women and any other spin-off effects).

- An assessment of the effects in Denmark of the investment projects (competitiveness, internationalisation, employment, division of labour, export generation etc.).

5. Methodology

The assignment implies the study of complex relationships and requires the application of a contextual approach.

The evaluation shall be carried out in accordance with Danida's "Evaluation Guidelines" published in February 1999. In order to make the assessments listed above the evaluation shall focus on the investment projects which are sufficiently advanced to permit meaningful conclusive documentation of the processes and results. Benchmarking should be carried out by comparing IFU with similar international finance institutions such as FinnFund, Swedfund, as well as CDC, DEG, FMO and IFC.

In its initial phase the evaluation comprise a study of documentation and interviews in Danida followed by desk studies and interviews at IFU. A detailed inception report shall be presented after the end of the desk study phase detailing methodology, the consultants' understanding of the key issues and a draft plan for the field work specifying the additional documentation required, the meetings to be held and the proposed sample of activities/projects to be subject to detailed study during the field work. The inception report should include a description of the criteria used for the selection of the sample. The inception report should be discussed at a workshop in Copenhagen after which the final plan for the field work shall be worked out.

The information received by the evaluation team from IFU, Danish partners or project companies in connection with the evaluation shall be treated as strictly confidential and shall not be handed over to others. The evaluation report and possible other information provided to Danida shall not refer to any concrete companies, and it shall therefore not be possible to identify concrete companies from the information given in the report. All material received by the evaluation team in connection with the evaluation shall be returned to IFU after completion of the evaluation.

6. Composition of the Evaluation Team

The team shall be composed as follows:

- Team leader.
- Specialists (engineers/financial analysts/economists) covering the main industrial sectors and short-term specialists covering the remaining activities.

The team should comprise several Danish-speaking persons as substantial parts of the documentation is in Danish, and should include local consultants and interpreters in each of the countries selected for the field studies.

7. Timing and reporting

The evaluation is scheduled to take place from November 2002 to August 2003.

November 2002	Mobilisation
December 2002	Desk studies in Danida
January 2003	Desk studies in IFU
Mid-February 2003	Inception Report, selection of case studies
Mid-February - Primo March 2003	Interviews/questionnaire
March - April 2003	Field studies
28 May 2003	Draft Interim Report (to Evaluation Secretariat and IFU management)
19 June 2003	Interim Report (to IFU's Board)
July 2003	Draft Final Report (Comments from Danida and IFU)
August 2003	Final Report

8 Documents provided

The following Danida and IFU reports and publications provide background information:

- Evaluation Guidelines, Danida February 1999, Revised 2001. (Available on-line: http://www.um.dk/danida/evalueringsrapporter/eval-gui/index.asp).
- IFU's Annual Report 2001. (Available online: http://www.ifu.dk/ifu/ifu_default.htm)
- IFU's Code of Conduct. (Available on-line: http://www.ifu.dk/ifu/ifu_default.htm)
- Denmark's Development Policy, Strategy: Partnership 2000, October 2000. (Available on-line: http://www.um.dk/publikationer/fremmedsprog/English/policy-strategy/index.asp).
- Erhvervsudvikling – en fælles opgave. Handlingsplan for dansk støtte til erhvervsudvikling i udviklingslandene, September 2001.
- Nyboe-Andersen Review from 1984.
- Evaluation of the Private Sector Development Programme, 2001/1. Danida, October 2001.
(Available on-line: http://www.um.dk/danida/evalueringer/eval2001/2001-1/.) .

For the desk study appropriation documents, feasibility studies, appraisal reports, extracts from IFU's database ODIN, etc. will be made available for the Evaluation Team. Also available will be IFU's own assessment of the IFU vs. DanIFU.

Evaluation Secretariat, 10 September 2002

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