FMO
Entrepreneurial
Development
Bank

Dalberg

Review of Development Contributions for Market Creation

NOVEMBER 2023

FINAL REPORT (SUMMARY)

Executive summary

FMO Context

FMO has set an ambitious goal of raising its impact with its 2030 strategy, where Market Creation (funding non-revolvable projects with an expectation of future investment pipeline) plays a prominent role. FMO recognises that Development Contributions (i.e., grants) will need to play a strong role in this ambition.

Study Description

This strategic study aims to help FMO improve its DC product for market creation (MC). It examines all 176 DCs in MASSIF, MFF, and BP from 2018-2022 and deep dives on a shortlist. The analysis is supplemented with secondary research, a survey of grantees, and interviews with other DFIs, grantees, and FMO.

Conclusions and Recommendations

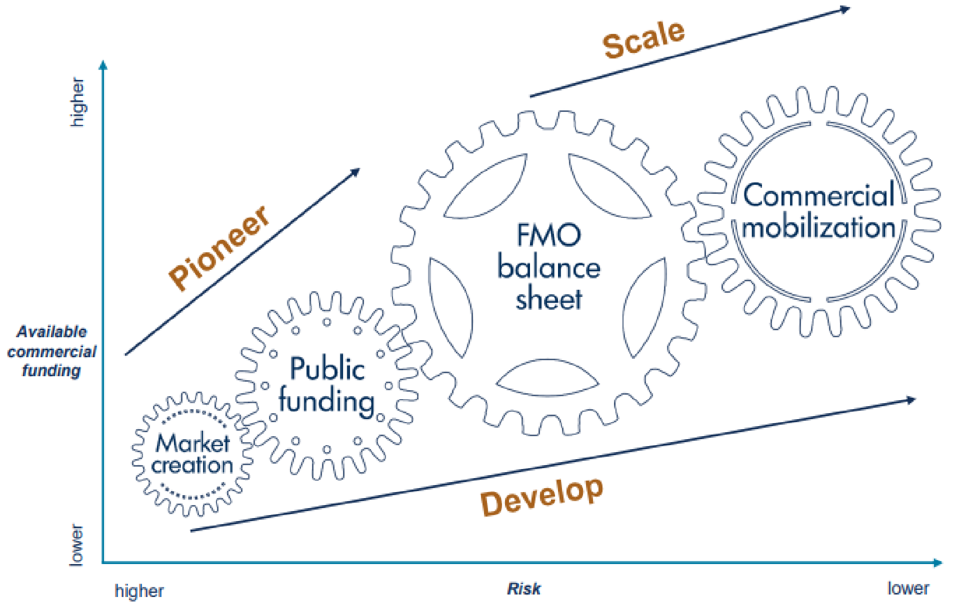
1. ***Use a strategy and market barrier-first approach:*** *The current approach to designing Development Contributions (DCs) is usually ad-hoc and reactive to new opportunities as they arise, using FMO and Fund strategies as a filter to assess projects. A more impactful approach would be to proactively — with IO involvement — choose markets to develop, identify the right barriers, and then design projects that can address those barriers to investability.*
2. ***Use DCs as a leading instrument:*** *FMO, especially MASSIF, underspends in areas such as gender and climate because DCs currently reflect where existing investment allocations lie. Instead, FMO and particularly MASSIF could use DCs in areas where it wants the investment portfolio to grow in the future.*
3. ***Continue what has been working well:*** *FMO has rich experience with many types of DC projects. Recently, more projects are relevant for (MC). Setting standards for ESG has emerged as a particular strength for FMO, which it could continue going forward.*
4. ***Increase seed financing:*** *Seed financing instruments, such as repayable grants, have shown success in FMO's and other DFI's portfolios for developing investment pipeline. FMO has struggled to use them because of internal constraints. MASSIF has especially struggled despite targets for their use.*
5. ***Take a balanced portfolio approach to DCs:*** *FMO has seen success with projects in categories such as venture acceleration and ESG standards setting, often because they had close collaboration with investment officers. Pipeline was generated with high frequency and in a short time span. Future MC pools (i.e., funding pools devoted specifically for market creation) could increase the impact of DCs for Market Creation by building on FMO's existing strengths and raising ambitions. It could do so by making space for newer types of projects like influencing policy and value chain coordination.*
6. ***Fill implementation gaps in three critical areas:*** *To make the changes listed above, FMO would need to improve gaps in strategy, MEL, internal processes, and a lack of capability/knowledge of local market barriers. Figuring out how to resolve issues with IO involvement and creating a learning agenda for testing solutions will be especially important. A key risk to manage will be misalignment between MC, fund, and FMO strategies.*

Context: FMO considers *Market Creation* key to its 2030 strategy, with Development Contributions (DC) playing a central role

Market Creation (MC) is the first step to raising impact through FMO's "Pioneer, Develop, and Scale" Strategy

Definition: *Market Creation is a way of funding or financing activities undertaken by market participants, including FMO, its partners, and its clients, and is part of the FMO progression model. According to this model, Market Creation activities are not expected to be fully revolving. Public funds are typically revolving net of costs/fees, and FMO balance sheet funded propositions are expected to earn a return on equity, and commercially catalysed investments are expected to earn a risk/return acceptable to the market.*

FMO's progression model



Development Contributions (DCs) are FMO's grant instrument that are not assumed to generate a return

DC Typology

While some types of DCs like Repayables and Convertibles could give FMO returns, such returns are NOT assumed ex-ante

1. DC grant – traditional grant
2. Repayable DC – grant that is returnable after milestones
3. Convertible DC – grant that converts to equity or debt
4. Partnership DC – pass through grant to other funder
5. Technical Assistance – in-kind procurement of third-party services

"We will need to raise additional funding for Market Creation in grants and instruments like repayable grants."
- FMO Staff

Source: Updated Strategy Towards 2030: Pioneer - Develop - Scale

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Approach: This study analysed the experience of FMO and other DFIs with DCs to help inform FMO's Market Creation efforts

This study had five key questions

1. What has FMO done so far?
2. How effective has it been? Why?
3. What have other DFIs done?
4. What should FMO's product strategy and market positioning be?
5. How should FMO change its implementation approach towards its renewed goals?

The study looked at all 176 DC projects in MASSIF, MFF, and BP before analysing a subset in greater detail

MASSIF	140 DC interventions	2018
BP	35 DC interventions	
MFF	1 DC intervention	2022

- Long list of 176 DC projects across MASSIF, Building Prospects (BP), and MFF during 2018-2022
- 82 projects after removing projects with no/limited market creation potential[a] (including post-investment TA projects, to the extent identifiable[b])
- Short list of 18 high relevance projects based on market creation potential[c] and diversity of characteristics
- 4 case studies for deep dives

The study used a variety of sources, internal and external to FMO, to triangulate findings

1

FMO Reports

2

FMO Entrepreneurial Development Bank

FMO staff interviews

3

TREEVIVE M-KOPA THE MELOY FUND Finance for Jobs Consulting Services

Grantees' interviews and online survey

4

DFC KFW DEG British International Investment

DFIs' interviews and document review

Notes: (a) Based on a rapid assessment of the 176 DC projects; mostly classified as non-MC when the work was limited to enhancing the social impact of a company/ a few companies. (b) Elimination of post-investment TA projects was done based on an assessment of project descriptions. (c) Non-agribusiness or non-forestry projects within the BP Fund were also removed as they were out of scope. (d) Identified by how strongly and clearly the project description articulated objectives related to business or ecosystem development.

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Recommendations: The study helped develop six key directions across three categories — Project Selection, Project Type, and Implementation

		Recommendation	Description
Project Selection	1	Use a strategy and market barrier-first approach	FMO could take an approach that: (1) starts with the strategy, (2) identifies the market it wants to develop, (3) discovers barriers with IO support, and (4) develops a set of complementary DC projects that address those barriers.
Project Selection	2	Use DCs as a *leading instrument*	DCs could lead where FMO wants to invest in the future. FMO, especially MASSIF, could use DCs more heavily in themes such as gender, climate, and low-income countries where it currently struggles to find investments.
Project Type	3	Continue what has been working well (e.g. ESG)	Given FMO's accomplishments to date, it could continue to expand work in standards-setting, especially in sector initiatives for ESG standards, and play a stronger thought leadership role in this area among other DFIs.
Project Type	4	Increase use of *seed financing*	FMO should increase *seed financing*. In the short run, FMO could bypass internal bottlenecks by partnering with others to expand *seed financing*. In the longer run, it might find new models to resolve these internal bottlenecks.
Project Type	5	Take a balanced portfolio approach to DCs	New Market Creation (MC) funding could consider balancing: (1) more projects in categories with a track record of success (e.g., venture acceleration and setting ESG standards) with (2) testing new categories that could enhance success (e.g., value chain coordination and government policy).
Implement.	6	Fill implementation gaps in three critical areas	FMO could create a cross-team, agile working group to: (1) iterate strategy and invest in new MEL capabilities targeted for MC, (2) set up and use a learning agenda to test solutions to internal bottlenecks like IO involvement, and (3) strengthen FMO's abilities to reveal local market barriers.

Project Selection

1

Rec 1: With MC as a strategic focus, FMO should move from an ad-hoc to a more strategic approach towards DC origination (1/2)

FMO's current approach to DC Projects

Usual approach to DCs uses the strategy or fund themes as a criteria for assessing projects

Sourcing: Project idea comes from TA officer, IO, existing investee, or from partner organisation

Initial development: Project is developed further with additional details, in collaboration with project partners

Strategy: Project is assessed and revised based on strategy or fund themes

Implementation: FMO and partners co-design and implement projects

Example:

M-KOPA asked to design project after FMO investment → *M-KOPA proposes e-mobility project and presents to FMO* → *FMO teams assess project against fund themes and strategy, and help M-KOPA revise design before giving go-ahead* → *FMO and M-KOPA work together on design, hiring consultant, and M-KOPA carries out implementation*

M-KOPA

A revised approach could be more deliberate about identifying and addressing specific market barriers (2/2)

Proposed shift in approach across FMO's full Market Creation portfolio

For the MC team, the alternative approach would not just identify themes, but also the relevant markets and the barriers before design and implementation

Strategy: Thematic or SDG focus determined by strategy

Market: Within these focus areas, FMO identifies which markets to develop or create

Barriers: Within selected market, FMO uses knowledge of IOs, other teams and conducts studies and consultations to find the key barriers

Initial development & Sourcing: Based on identified barrier, FMO ideates category and approach through co-creation with project partners

Implementation: FMO completes project design and starts implementation[a]

Example: FMO has successfully taken such an approach with its sector initiatives especially in Nepal

MASSIF strategy identified focus on financial inclusion in fragile countries/LDCs → *FMO determines it wants to develop market for MFIs/FIs in Nepal with DFI investment* → *FMO determines barrier of nascent market not having ESG standards is key* → *FMO creates partnerships and programmes to help FIs adopt ESG standards* → *FMO finds the right DFIs, consultants, other orgs to design and implement*

Invest for Impact Nepal

Rec 2: FMO's approach to DCs could be more intentional by considering future investment areas

Lagging

DCs reflect the current investment portfolio which has also struggled to source projects in some areas

Gender

FMO[a] and MASSIF spending on Gender is low :

- EUR ~3M out of EUR 27M total across three funds
- ~9% of MASSIF DC value in 2022

Green/Climate

FMO[a] and MASSIF spending on Green Opportunities/ Climate is low:

- EUR 4.5M on SDG 13 (climate) vs EUR ~6.5M on SDG 10 (inequality) vs EUR 10M on SDG 8 (inclusive growth)
- ~10% of MASSIF DC value in 2022

Low-Income Countries

Share of spending in LICs has decreased in recent years

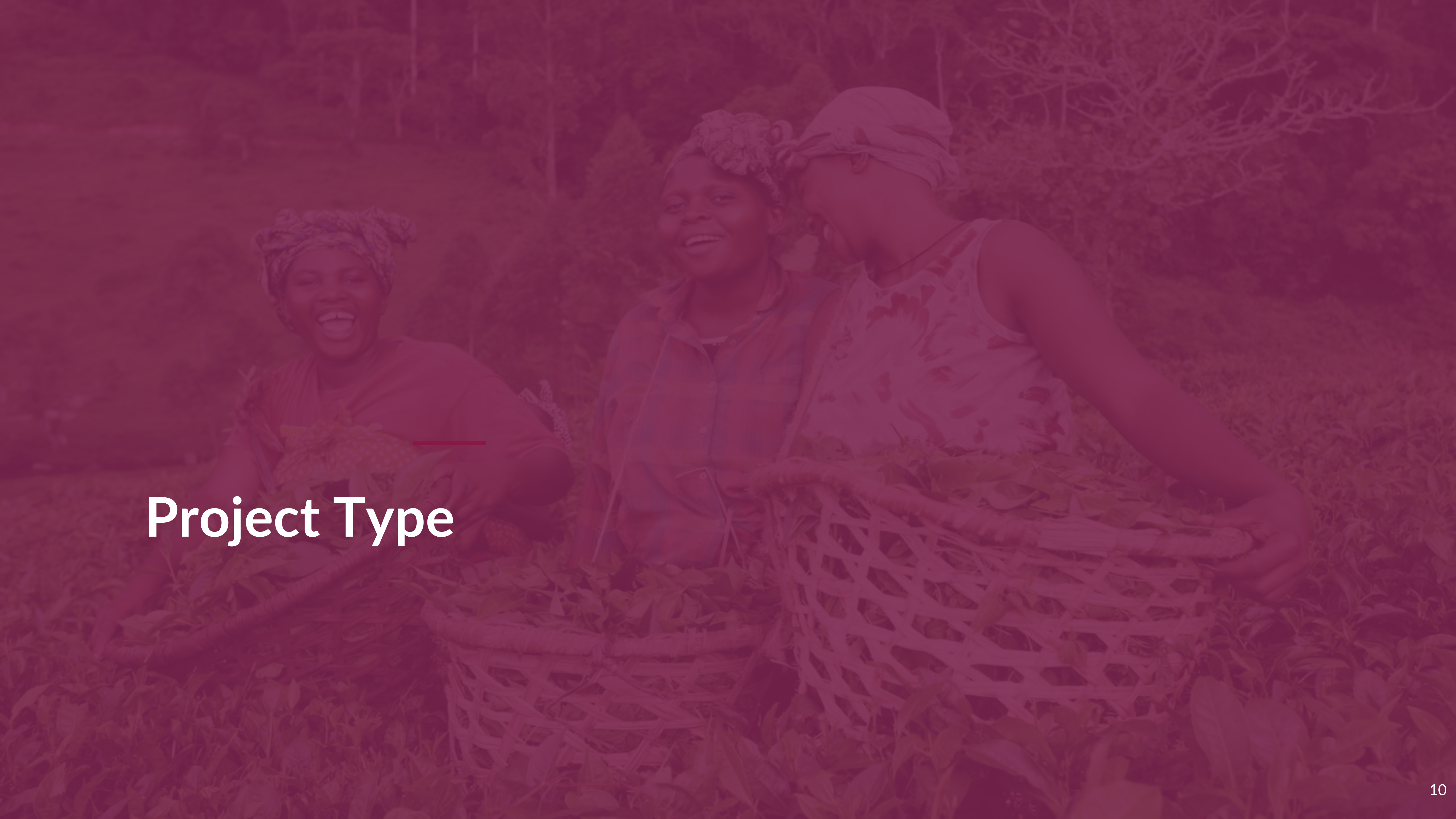
- Fall from high of 84% in 2020 to 33% in 2022 across three funds
- Fall from high of 83% in 2020 to 56% in 2022 for MASSIF

Leading

DCs show the way for the future investment portfolio, leading spending in key focus areas

1. Increase project volume by identifying key markets in each of these strategic focus areas that MASSIF wants to develop
2. Work with intermediaries that can help source impactful projects
3. Ensure that increasing number of projects, especially in gender and climate, do not involve making trade-offs with other impactful projects. Over time, the gender and climate lens should be embedded across most, if not all, projects

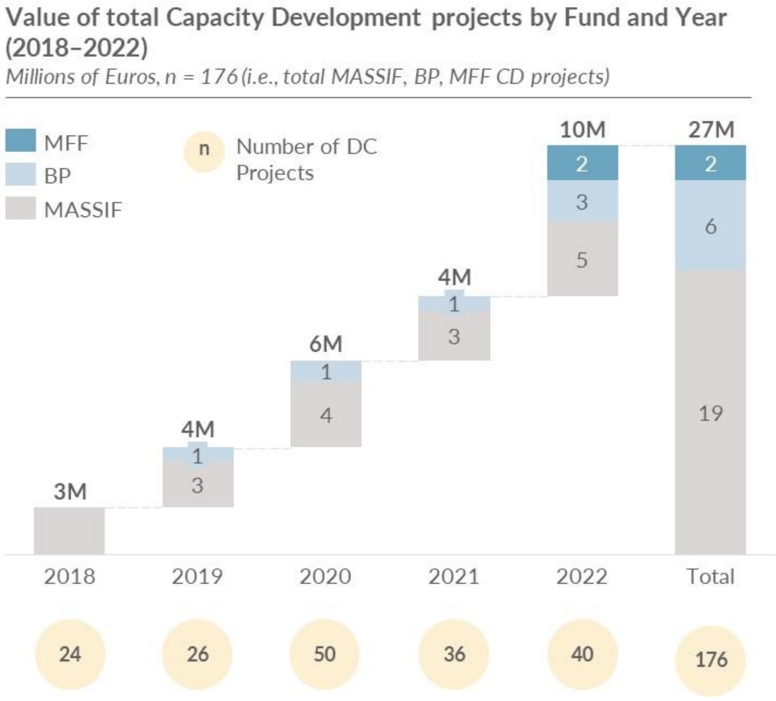
Source: Dalberg analysis; Dalberg interviews
Note: (a) FMO spend here only encompasses DC projects across MASSIF, BP, MFF during 2018–2022.



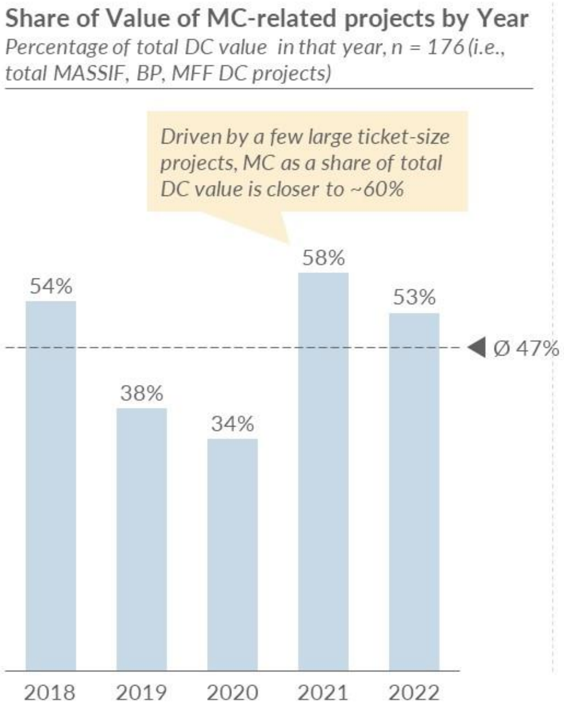
Project Type

Between 2018-22, ~50% of DCs had a plausible connection to Market Creation; among a shortlist of these, ~50% led to (potential) pipeline

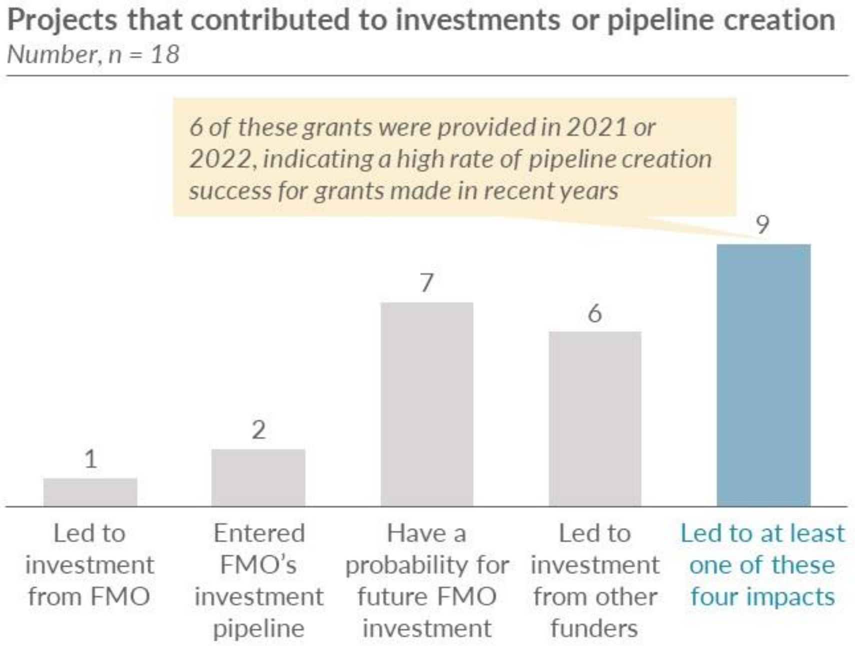
MASSIF, MFF, and BP had EUR ~27M in DC value across 176 projects in 2018-2022…



….on average ~50% of this value was to projects that might be MC



Among a shortlist of 18 of these MC-related projects, 9 had at least high pipeline potential



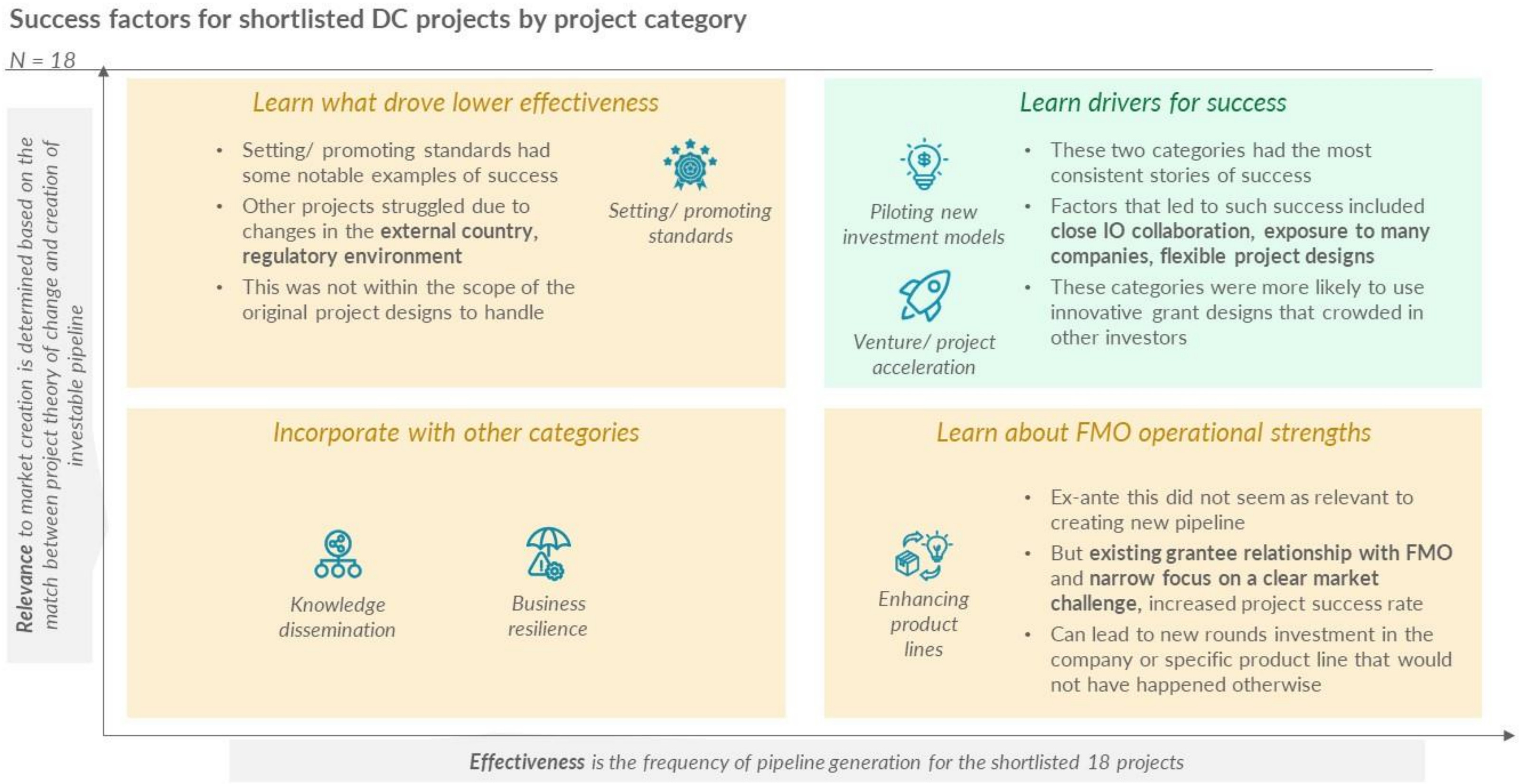
Source: Dalberg analysis; Dalberg interviews

Broadly, spending took place across eight categories, with varying levels of relevance and effectiveness towards Market Creation

Project categories

- Market Research
- Enhancing Product Lines
- Business Resilience
- Training and Capability Upgrade
- Venture and Project Acceleration
- Setting / promoting standards
- Piloting new investment models
- Knowledge Dissemination

Review of relevance and effectiveness for market creation by category



Source: Dalberg analysis; Dalberg interviews

Rec 3: While setting standards had some challenges, multiple pieces of evidence point towards it being a key strength of FMO

Multiple sources pointed to FMO's strength in this category

Increasing spend and examples of impact:

- Category had medium volume of pipeline amongst shortlisted projects (2/3 had high potential for pipeline)
- There were a total of 14 Standard Setting projects across the three funds from 2018 to 2022. Most (11) of them were in 2021 and 2022
- E&S made up 36% of MASSIF's DC total value in 2022

Interviews:

"Sector initiatives have been an effective area of expertise for FMO, where it has utilised its DFI role and E&S expertise to raise standards and generate pipeline while advancing SDGs."

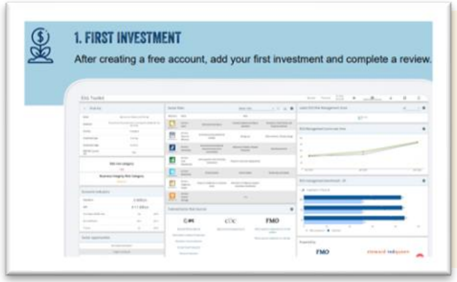
- FMO staff

Evaluations:

"FMO retains the largest E&S department of the comparable DFIs and is widely seen as a leading DFI on these issues."

- ITAD Evaluation of FMO, 2020

FMO is known externally for its tools in ESG standards



- FMO's **web-based Environmental & Social Management System (ESMS) tool** is aimed at enabling banks and FIs to manage ESG risks at transaction and portfolio levels

"FMO has developed toolkits that can be easily downloaded on their website and used by any company or individual."

- Centre for Strategic International Studies (2020)


FMO
Manual for the CG Toolkit for banks, NBFIs and MFIs
MANUAL for the Corporate Governance Toolkit for banks, NBFIs and MFIs
1. Introduction
What is Corporate Governance?
Why Corporate Governance Matters for our Investee Companies

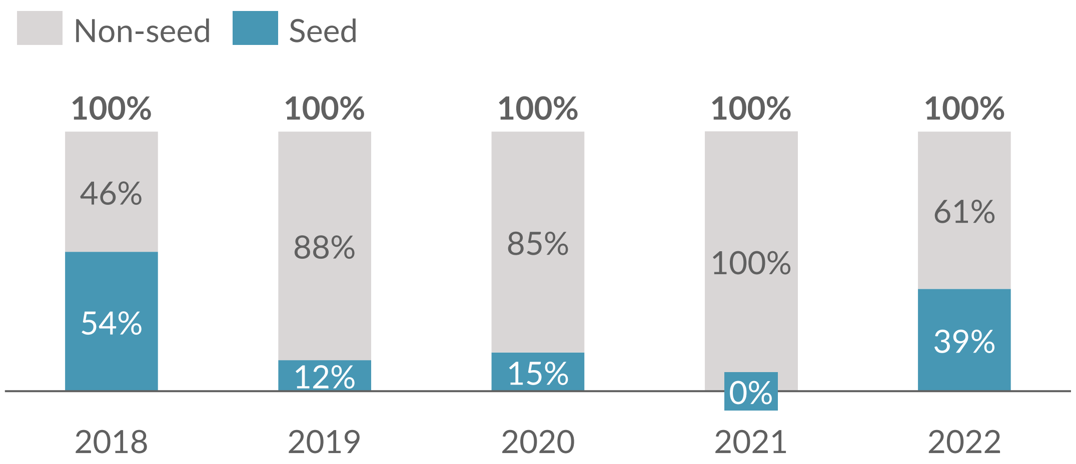
- FMO's **Corporate Governance Toolkit for Banks, NBFIs and MFIs** offers assessment instruments to institutions across various developmental stages and regulatory environments during the investment phase

Source: Dalberg analysis; Dalberg interviews

Rec 4: Despite targets, FMO, and MASSIF especially, have struggled to use *seed financing* instruments such as repayable grants (1/3)

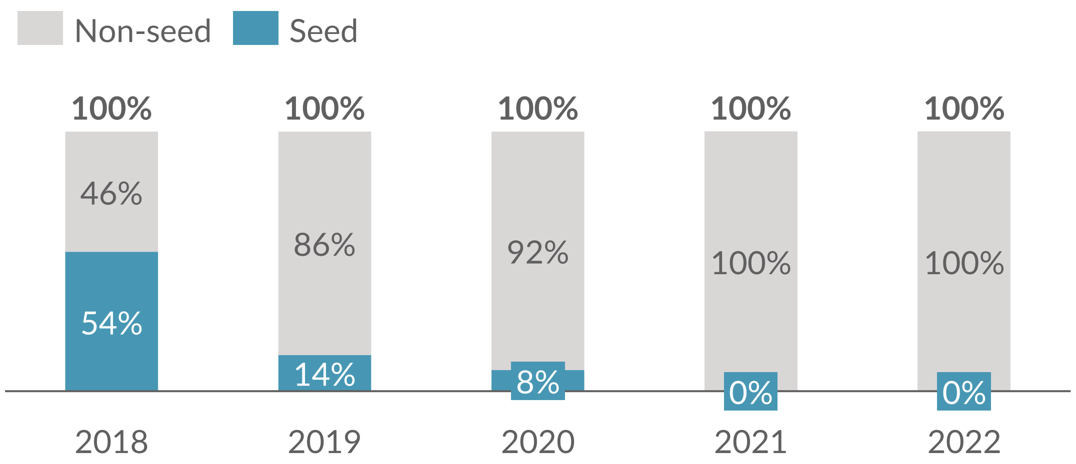
Proportion of Value of Total DC projects (MASSIF, BP, MFF) by Seed or Non-seed Type and Year

Percentage of total DC value in that year, n = 176



Percent of Value of MASSIF DC projects value by Seed or Non-seed Type and Year

Percentage of total DC value in that year, n = 140



- MASSIF Next Frontier Strategy | The MASSIF strategy for Capacity Development suggests **adding *seed financing* or early-stage technical assistance** through ‘deeply’ subordinated debt or redeemable equity, for innovative projects with a limited track record; **products such as conditional grants, first loss funds or convertible grants** could be used

- An **increase in the recent KYC requirements** for seed instruments resulted in insufficient resources/capacity to do KYC for DCs. Moreover, typically, seed financing requires new client on-boarding, which is a **high level of effort**
- As a result, **MASSIF took steps to achieve the same aim of providing financing to early-stage, innovative projects through different means** (such as acceleration programmes, innovative grants through partners, support via parties which were already KYC'ed)
- Other Funds' seed financing increased in 2022 as KYC capacity was available to them through the KYC Corporates team

Source: Dalberg Analysis; Fund Annual Reports 2018-22; Note: we count any DC project with a non-vanilla grant (i.e., repayable grant, convertible, first loss, etc.) as seed financing

4

There are operational bottlenecks involved in doing more such projects within FMO (2/3)

Common across all types of MC projects

Know Your Customer (KYC)

In 2019, there was a corporate decision to not do convertible grants and to make KYC for repayables stricter

"…corporate decision made KYC stricter for repayables…"
- TA Officer

FMO guidance

FMO's guidance was especially against the use of convertible grants as they were too complicated and involved multiple teams

"Recent steers have been to not use convertibles as it's too complex…at the point of conversion, the equity team could say they don't want it."
- TA Officer

Investment knowledge of TA teams

TA teams lack adequate expertise or capacity for structuring and designing alternative instruments

"We need dedicated people in investment teams who are familiar with the grant process to work in conjunction with TA officers."
- TA officer

Involvement of IOs

IOs have their own volume targets and therefore, limited capacity to engage on smaller deal sizes

"…no incentives for IOs to bring projects to the TA team. IOs are steered on strong production targets, which are short-term, compared to MC which can take several years."
- FMO Staff

Source: TA officer and FMO staff interviews

4

MASSIF could increase seed financing through partnerships in the short run and institute robust internal processes in the long run (3/3)

Short-term solutions

- ✓ Partnerships with other DFIs, funds, platforms, accelerators, and other intermediaries to implement seed financing rather than internalising within FMO

Example

Triple Jump

FMO's Market Creation team does this by partnering with Triple Jump, which manages a seed capital facility

Long-term solutions to explore

- ✓ Dedicated KYC staff capacity for MC/TA
- ✓ Separate KYC/Due Diligence process for MC/TA
- ✓ Separate sub-organisation with own processes and IOs, like DEG's Up-Scaling programme

FMO should explore the cost efficiency, feasibility, and strategic alignment of these options

"Our Up-Scaling programme that provides repayable grants to early-stage companies has its own processes for deals with a much leaner and faster KYC for deal sourcing…we ***do not follow the standard DEG process which is quite rigorous****…we source DEG IOs who are not tied to Up-Scaling as well as external consultants for risk assessment."*

- DEG Up-Scaling

Source: Dalberg analysis; Dalberg interviews.

Rec 5: For the MC pool[a], FMO could take a portfolio approach, balancing High-Yield, Transformative, and Test Bed projects (1/2)

Type 1

High-Yield (Continue): High potential MC, which FMO is already doing well

- Venture and Project Acceleration
- New Investment Models

Type 2

Transformative (Improve): Industry or sector building initiatives, which FMO does well but has room for strengthening **- >** ***Improve***

- Product Line Enhancement (in new markets)
- Standard Setting and Promotion[b]

Type 3

Innovation Test Bed (Make Space): Experimental Pilots where FMO has potential for MC but less experience

- Value Chain Coordination
- Government Policy Work
- Marginal Investment

Some initial things to try

Note: (a) Refers to funding pools specifically dedicated for market creation (b) Depending on the market or sector conditions these activities could be Type 1

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5

The MC team could experiment with new categories, products, or ways of working to enhance impact (2/2)

Type 3

New categories, products and ways of working		Implications/recommendations for MC strategy
Value Chain Coordination	• Constraints in the value chain are a risk to success for one-off projects • Other DFIs have seen some success in co-ordination across multiple constraints	• The MC team could design projects where this might be catalytic • If the MC team chooses not to do these activities directly, it could explore partnering with others to de-risk its projects
Government Policy Work	• Challenging country context can threaten the success of even promising projects (as seen in the MEDA and CMA grants) • Influencing government work is identified as key to removing barriers	• While FMO cannot deploy funding to governments directly, it could inform government policies by funding research of think tanks, advocacy and dialogue conducted by industry association • It could partner with other DFIs with strong capabilities in this space (e.g. the World Bank) and create linkages between FMO's projects and their work
Marginal Investment	• Working with potential investees that were rejected or just passed over for investment • Identifying the key barriers/needs for getting them over the "finish line" • Discovering any other barriers and types of projects that FMO does not have experience with	• The MC team could dedicate funds or a separate programme to work with impactful "almost-clients" and opportunities • This would require new processes, such as coordination between IO and MC teams, to determine what type of pre-investment TA is needed • FMO could conduct studies to document these rejected opportunities, to learn more about what barriers it should be addressing and to identify potential areas of improvement in its own investment/ TA/ MC approach

Source: Dalberg analysis; Dalberg interviews

Implementation

6

Rec 6: FMO would need to fill key gaps to implement these recommendations (1/2)

	Seven areas of change	Main goal	First step of implementation
Strategy and MEL	Strategy	A working group constituting members from various teams to fill gaps in the MC strategy and support the MC team's decision-making	Organise a workshop to gauge the group's top interests in terms of their priority markets and the barriers they are keen on addressing
Strategy and MEL	Monitoring & Evaluation (M&E)	Improved data/tracking systems to track spending and M&E frameworks, KPIs, etc. to measure impact	In the initial meeting between the MC and M&E teams, commit to two process-related questions and create a plan for exploring those
Strategy and MEL	Learning and Knowledge Management (KM)	Alongside the KM team, execute a learning agenda to deepen the understanding of MC	Identify 3-4 main questions to guide the overall MC learning agenda
Existing Internal Processes and Capabilities	Know Your Customer (KYC) processes	Explore possible short- and long-term solutions to overcome operational bottlenecks in doing more seed financing	*See 'investment capability for seed funding'*
Existing Internal Processes and Capabilities	Collaboration with IOs	Pilot collaborative approaches to better integrate TA and investment teams	Identify 1-2 Fund Managers & 3-4 IOs to be 'champions' of TA/MC, and establish regular touchpoints with them
Existing Internal Processes and Capabilities	Investment capability for seed funding	Transfer investment expertise to MC and TA teams, with relatively lesser experience in structuring seed instruments	Pilot a few workshops/ trainings for the MC and TA teams to learn from IOs, with a key topic area being KYC processes
New Capabilities	Local barrier/ market knowledge	Build expertise and knowledge within the MC team to identify market barriers	Choose one market of interest, and initiate a brief internal study to map the challenges/ constraints in that market

Source: Dalberg Analysis

It would also need to institute measures to mitigate potential risks associated with coordinating between teams (2/2)

Risk	Potential Mitigation	Impact	Likelihood
Resistance from teams to the new approach	Facilitate a more gradual transition. For example, gradually increase the responsibilities and time commitment of champions from the investment team, and introduce other internal incentives (e.g. internal innovation awards) to incentivise IOs to get involved in MC	●	●
Lack of ownership of the MC strategy across the rest of FMO	Ramp up communications efforts (especially of early wins) to highlight the benefits of MC to IOs and other teams, especially the potential of grant-supported companies and markets leading to viable investment opportunities in the long-term, even if they are not immediately lucrative	●	●
IOs missing volume targets due to involvement in MC projects	Adjust the IOs' volume targets and timelines to appropriately reflect the time commitment required to facilitate their involvement in MC strategy and projects	●	?
Disconnect between FMO-level directives and the MC team's strategic choices	Widely disseminate the MC strategy, outlining the team's vision and key objectives. Additionally, create channels for two-way communication to pre-empt any risks to the MC strategy arising from FMO-level decisions, and to discuss potential solutions	●	●

● Low ● Medium ● High