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Conference Paper

Building thriving companies in low-income economies

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The Global Economy

Building Thriving Companies in Low-Income Economies

The Challenges

Post-conflict economies and many low-income countries such as Bangladesh, Rwanda or Haiti offer prospects for high returns. The African continent illustrates this well: untapped economic potential abounds. New research shows that attractive profits are made across the continent (e.g., Collier & Warnholz, Harvard Business Review, 2009).

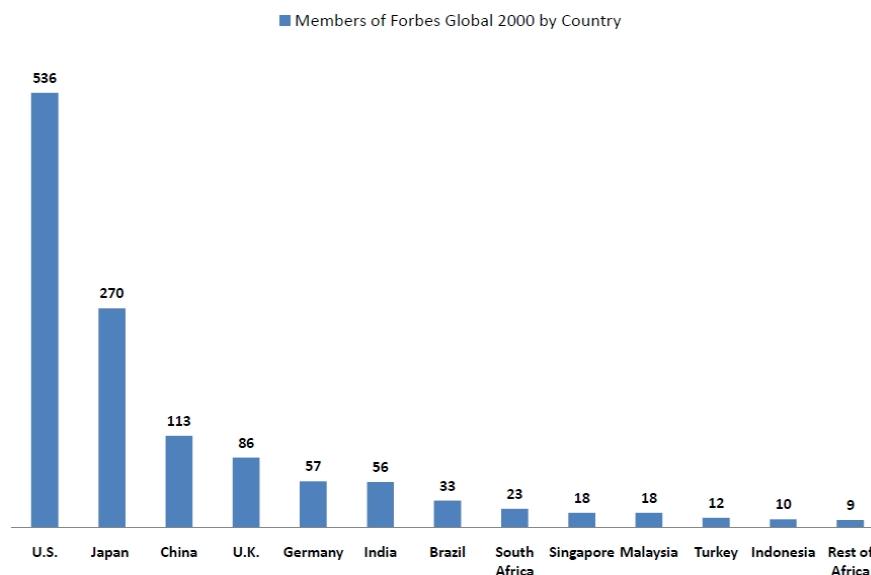


However, investment flows outside of oil and mining have remained scarce and have taken a direct hit during the financial crisis. This group of economies is locked in a pervasive disequilibrium sustained by low expectations, a dismal reputation, high entry barriers and poor information. The creation of steady employment in formal enterprises is central to economic development and stability.

The few successful companies in these markets merit attention. Factors that depress investment today may unravel as credible evidence of profitability shifts collective expectations. To fully exploit these potentially benign dynamics, a number of questions have to be addressed:

Why have some companies succeeded where others have failed? Can a number of success stories change the economic landscape and inject new dynamism? Can recent promotion efforts (e.g., Blair in Sierra Leone and Clinton in Haiti) pump-prime investment from ground zero? What does this imply for economic policy and international assistance? Are development banks too conservative to be relevant in risky fragile economies? How can low-income countries credibly signal attractive business opportunities? Will greater access to market information change entrenched negative perceptions of investors? How can competitive special economic zones develop in fragile states? Is there scope to reverse the marginalization of the poorest countries in the global economy?

Snapshot Distribution of the World's 2,000 Largest Companies





Proposed Solutions

Jean-Louis Warnholz

Co-Founder and Director, Bottom Billion Ltd.

Highlight nascent economic opportunities

Work on low-income countries has largely been donor-driven and focused on the social sectors, governance, and a range of macroeconomic issues. The private sector has received limited attention by donors and researchers. Developing the private sector and creating employment in formal enterprises play a vital part in building a modern economy and working towards social and political stability. Post-conflict economies and many low-income countries are locked in a pervasive disequilibrium sustained by a dismal reputation, low expectations, high entry barriers and a complete lack of trusted market information. Over the past years, there have been a number of high-level promotion efforts that lured investors into fragile states (e.g., Bill Clinton for Haiti, Tony Blair for Sierra Leone and Rwanda) and hitherto untapped economic opportunities in low-income markets have received greater prominence. A few private equity funds provide capital, networks and expertise to catalytic projects in low-income countries. These funds often act as a first-mover and as such might play a pivotal role in unlocking opportunity for growth and signaling an economy's nascent potential to other investors. Encouraging this spotlight on a set of untapped economic opportunities and potential islands of excellence could be transformational and break with the prevailing focus on the many unmet needs and challenges of this group of countries.

Capturing the middle ground between grant funding and risk-adjusted market rates of return

The Acumen Fund, the Soros Economic Development Fund and the Omidyar Network, among others, use market forces to fight poverty. These funds are run like businesses with clear performance indicators and a premium on sustainable solutions. They provide seed capital, loans and equity and would accept financial returns below the market rate in exchange for tangible social outcomes (e.g., new jobs created, farmers' revenues improved, patients treated). The need to generate a financial return and demonstrate impact injects greater scrutiny into the vetting process of proposals. Soros, Acumen and Omidyar tend to have a higher risk tolerance than other funds—because they can accept lower average returns, allowing them to invest in smaller and innovative ventures in challenging business environments. However, they are limited in their scalability (i.e., number of projects they can invest in). This has a number of reasons. First and foremost, costs for due diligence are very high. Good ideas are plentiful, but well structured business plans, let alone audited financial statements and clean property titles that would make vetting easier, are largely absent. While opportunities abound, good, bankable projects do not readily exist. This is why several African venture funds will not even consider projects below thresholds of \$15m. One way around this is to invest in informal credit ratings that lower search, due diligence and other transaction costs. In a more developed financial market, financial institutions can accept a greater number of projects with the successful ventures cross-subsidizing the many businesses that inevitably go bankrupt. In most low-income economies that's not the case. Multilateral and bilateral donors could play a pivotal role in two important ways: First, they could make available a funding line (i.e., fund of funds) that includes some technical assistance to allow these funds to search for attractive opportunities and undertake the ancillary support functions that any venture requires (e.g., developing and testing a business plan, running informal audits etc.). Second, these funding lines could operate on 80% cost recovery, providing a cushion that enables these providers to accept greater risks and a greater number of initiatives. In a high



risk environment like Haiti or Tanzania, many ventures will fail, but a select few might spearhead the recovery and grow into successful businesses. Currently, what's on offer is plenty of grant money, but only very limited risk capital.

Bring new relevance to international financial institutions

The portfolios of the large sources of risk capital such as the World Bank's International Finance Corporation, the IDB's International Investment Corporation, US OPIC, the UK's Commonwealth Development Corporation are concentrated heavily in emerging markets, where they are among a large group of funds and corporations pumping money into these growing economies. IFC, for example, requires risk adjusted market rates of return. For example in Haiti, a country without a sovereign credit rating and high political and exchange rate risk, risk premia are prohibitive and only a few projects satisfy their criteria. These public sources of risk capital could be mandated to hold a more significant portion of their portfolios in low income markets, even if this implies tolerating financial returns below market in favor of spearheading investments in more challenging climates.