Submission to the International Development Select Committee

About Us

Gryphon Holdings Plc is a merchant banking firm, regulated in the UK by FCA, with a focus since 1991 on private sector investing in the main emerging markets of Central & Eastern Europe, Middle East and North Africa ("**CEEMENA**"). This is one of the four emerging markets regions (the others being sub—Saharan Africa, Latin America and South-East Asia). We operate in 10 CEEMENA markets and work with entrepreneurs and businesses seeking investment from western sources. We are therefore typically on the side of the end-users who are looking for investment from the DFIs and the funds which they support.

Although BII has a principal focus on Africa and Asia, there are commonalities among all emerging markets and, due to our long history working in these territories, we are qualified to speak to the experience of users of DFI financing and how DFIs operate in low- and middle-income countries.

Background to DFI Financing

When the Berlin Wall fell in 1989, the post-Communist world in the east and non-aligned states in Africa and the Middle East (that previously had access to Soviet money) had a single financial choice - the monopoly supplier of capital was the west. The conduits for this capital flow have been the World Bank, the IMF and the development finance institutions ("**DFI**s") (including supranational banks like the EBRD, the IFC and the African Development Bank - also referred to as "multilateral development banks" - and national development finance institutions like BII and Proparco in France).

The market offering to emerging economies was:

1. Westernise your economy – create a rule of law and contract-based system – privatise your State businesses and free up your markets to outside investment and competition.
2. We will help you achieve that through knowledge transfer, cheap financing and institution building (like creating a stock exchange and supporting the commercial banking system).
3. You will then have created an attractive destination for investment.
4. Our seed financing and support will stimulate many western businesses to come to your country and catalyse a vast pool of inward western finance, creating jobs and raising living standards.

The two successful US-led precedents on which the DFI system is based were the Marshall Plan in Europe and the reconstruction of post-war Japan. However, the critical problem for all DFIs (including BII) is that in the majority of developing countries, western private sector capital hasn't been particularly stimulated to fund development, leaving the DFIs as the sole or major source of long-term finance, especially in smaller countries or sectors.

Indicators of low private sector financial involvement in emerging markets include:

1. Using capital market measures (e.g. number of mergers and acquisition deals, financial assets under management, etc.), the quantum of financial activity in CEEMENA is equivalent to one tenth of the equivalent activity in the west relative to GDP. In Africa it is lower.

2. Public markets are on a different scale to western equivalents. As a benchmark, the entire Egyptian stockmarket capitalisation is currently €32bn, the same as one UK business, Vodafone plc and the entire Turkish stockmarket is the same size as Coca-Cola Inc.
3. Emerging corporate bond markets are almost non-existent.
4. In private markets, according to the Emerging Markets Private Equity Association ("**EMPEA**"), in the last pre-COVID year, $200bn of private equity was deployed in western Europe vs $7bn across the 40 countries of CEEMENA. Africa attracted $3.5bn. (See Annexe for the complete dataset.)

Key exceptions to these trends have been the major Asian markets (China, India) with large populations and large technology sectors, which have attracted major western private sector financial engagement. The conclusion in general from this data, however, is that while western financial markets (and especially private equity) have metastasized over the last decade, a minimal proportion of that capital has been stimulated by the DFIs to flow into low- and middle-income countries as an alternative to investing in the global west. And without the ability to stimulate private capital, the DFIs are too small alone to transform poorer economies.

An example is the EBRD, a development bank in which the UK Government has an 8.5% stake and which was set up to fund the reconstruction of eastern Europe.

1. The EBRD footprint across CEEMENA covers around 40 countries with an aggregate population of 750 million from Morocco in the west through to Mongolia in the east.
2. For project financing or low-cost capital of some sort, in some of those countries, the EBRD is the only (western) choice and is the western reference institution.
3. However, the EBRD has a balance sheet of only €76bn, which makes it the same size as the 38th largest bank in the USA.
4. Therefore, the principal conduit for western financing into 40 politically important economies is the same size as a regional lender in Memphis, TN. (The IFC, which has a global emerging markets mandate, has similar metrics.)

Private Markets

Private markets are defined as investments into the shares or debt of companies that are not listed on a stockmarket. This segment represents most of BII's (and similar DFIs') investing programmes – either direct investments and loans into projects or via investment in funds (referenced in Committee evidence as "intermediaries" and "intermediated investments").

In the latter category, these funds are typically managed by financial professionals who earn a fee and a share of the upside for selecting investments and managing them on behalf of the end investors (in this case BII and other DFIs). In the west, private equity funds like this would typically acquire a stake in a company and hold that investment for 4-7 years, with the aim of selling it at a profit and distributing the upside (minus the management bonus) to the investors. The same basic model has been applied to emerging markets since the 1990s.

For BII, a key rationale for investing through funds is that it avoids having to put its own team on the ground (at substantial cost) to locate and execute each investment. It delegates the responsibility to the fund manager and effectively shares the cost of the fund management team with all the other investors in the fund. There is also a knowledge transfer benefit – in principle, each fund team looks

at a lot of businesses and this accumulated understanding of the country and its business sectors flows upwards to BII, increasing its intelligence as an investor.

However, BII's capital is thinly spread. According to the BII Annual Report 2021 (p11), BII is a £7.7bn investor, of which two-thirds is in 242 funds managed by 146 different fund managers and in 164 direct investments. This is an enormous number of separate commitments by private sector standards (although not unusual by DFI standards) and each individual commitment is therefore small. By contrast, KKR (a marquee US private equity fund management group) manages a £400bn portfolio divided among just 123 direct investments. (It is likely that a proportion of BII's direct investments are in companies that are also owned collectively through a fund: for instance, a fund may have 10 investments but BII has also chosen one project in particular to add additional capital.)

The evolution of DFI-backed private equity funds has been as follows:

1. Through the 1990s, privately managed funds were created to invest in private businesses and infrastructure, as a logical component of a developed market economy.
2. These funds were seeded by the DFIs who acted as cornerstone investors (in other words, the investors that commit first to a fund to get it started and see if the fund management team can perform).
3. In the 2000s, some funds had generated a sufficiently attractive track record of financial returns to raise new, larger funds and raise more capital, targeting mainstream financial investors.
4. At this point, around 2004, institutional (non-DFI) money (eg major US pension funds) started to make meaningful commitments to the better emerging markets funds alongside the DFIs. A few emerging markets funds – notably in Turkey – broke through the $1bn size barrier.
5. However, in the 2010s (a period when western private equity was metastasizing), the financial performance of funds deteriorated and CEEMENA funds actually contracted, with the number of fund managers shrinking from a peak of about 130 to around 40 today.

Western private sector institutional money (that would have massively scaled the emerging markets private equity industry and seemed for a brief moment to be on its way) dwindled and the surviving private equity fund managers in 2023 (apart from Asia with a focus on technology) are back where they started in the 1990s, almost totally reliant for new money from the DFIs like BII. The DFI seed capital was supposed to be boosted many times by the participation of western investors at scale (creating a transformational impact on emerging economies) but this multiplier effect only sporadically materialised.

In the last 5 years, according to an oral submission to the committee on 7th March by the Impact Investing Institute, BII has stimulated £2.5bn of private sector investment alongside its £7bn balance sheet over the last 5 years. This low ratio is not exceptional. We estimate that DFIs now represent at least 70% of all new money into private equity funds operating in emerging and frontier markets with less than 30% coming from private sector investors, as opposed to the originally desired outcome where private sector investors would have committed many multiples of the DFI contribution.

Why private sector investment has not mobilised

The principal reason why global financial investors have only marginally responded to the impact investing opportunity is that financial returns on emerging markets private equity funds have been

weak. According to the EMPEA, the $ returns on private equity in sub-Saharan Africa or CEEMENA have been the lowest of any major financial asset class over the last 3, 5 and 10 years (see Annexed dataset). Therefore, there is no financial track record of consistent success to attract third party capital. This weak financial performance has five main causes:

1. **Debt**. According to two surveys of European private equity deals published in 2009, the contribution of debt (or "**leverage**") was calculated as between 23% and 36% of the accomplished returns to western private equity fund investors. In other words, in the west, up to one third of returns in western private equity and infrastructure funds is generated from simply borrowing part of the money for a project or business at low interest rates (in the same way that you might buy a house with a mortgage). However, most emerging markets have high local interest rates and debt - which enhances returns in the above manner - is either expensive or simply unavailable. This means any investor comparing a western fund to an emerging markets fund needs to believe that the emerging markets fund can not only perform better but can do so with a major in-built disadvantage, which is not an attractive bet.
2. **Currency**. Emerging economies have volatile currencies prone to devaluation. No investment manager, however competent, can avoid taking losses in £ if the local currency halves in value, a not uncommon occurrence. The devaluation typically harms the operations of the underlying business and damages investor confidence in general, as well as the book loss on the investment.
3. **Exits**. Emerging markets (especially smaller countries) are of less interest to multinational corporates or stockmarket investors who might buy the business in which you have invested after a few years (thus generating a return for the fund). While private equity-owned businesses in western economies are bought and sold all the time, finding buyers for emerging markets businesses is usually a long and laborious process, which reduces returns. (There are examples of emerging markets funds that cannot sell their investments at any price and the term "patient capital" is sometimes a euphemism for simply holding unsaleable investments.)
4. **DFI constraints**. DFIs require their fund managers to select investments that can meet their development criteria (e.g. ESG compliance, diversity, impact and similar). In the universe of potential opportunities in any given emerging market, only a small fraction of businesses can meet the compliance criteria that DFIs require. The sheer volume of auditing and compliance required by DFIs takes time, is expensive and means that most potential projects won't be eligible for investment, however financially attractive.
5. **Diversification**. Most emerging markets private equity funds are relatively small and, in line with best practice, are required to diversify their portfolios. For example, a €200mn fund will normally invest in, say, 10 different businesses, which means €20mn per investment. That means investing in small enterprises. That's fine if the small business has the potential to become a big business but small businesses that stay small tend to be more risky investments and less saleable.

These drawbacks to the western private equity model as transferred into emerging markets mean that mobilising mainstream financial capital to "crowd into" DFI-backed private equity funds has not occurred in the last three decades, despite the best efforts of the DFI-backed fund managers (who have been clearly motivated to promote their funds to bigger and more flexible investors than DFIs and scale up). There is no evidence that this will change and, simply put, the big money isn't interested without the prospect of high returns. Technology investing in Asia, for example, mobilised serious western private sector capital because firms in that sector in India or China were demonstrably making a lot of money and rewarding investors accordingly.

There has been some discussion among DFIs that hybrid financing (i.e. making investments as debt but with a share of the profits of the business does well) can be an alternative approach but there is limited evidence that this structure mobilises private sector financial capital either. In CEEMENA, funds (like Syntaxis in Central Europe) and banks (like BNP in Poland) that have attempted this "mezzanine finance" model have remained small scale – as a concept, it should work but it hasn't. There is simply no substitute for exciting, high return potential in mobilising private sector financial investors and that has not been achieved by regional private equity funds to date.

Conclusions

It is probably impossible for BII (or indeed any other DFI) to fulfil all the FCDO's objectives, which fall into two broad areas and are partially or wholly mutually exclusive.

1. If the principal objective is to stimulate large flows of private capital into emerging economies and support the development of a western rules-based market system, history suggests this won't be accomplished using the private equity-type investment approaches of the last three decades. This is either a capitalist project aimed primarily at stimulating private sector involvement in poorer countries at scale or it isn't. If it is, then the approaches used to date will need to be revised or abandoned in favour of other strategies to attract capital into emerging markets.
2. If, on the other hand, the principal objective is to provide capital from the UK taxpayer directly to address poverty and supplement the aid budget (on a small scale, creating fishermen rather than providing the fish, to repeat an analogy used in oral evidence), then the FCDO cannot expect BII to fulfil the first objective because the financial returns on those projects will be too low. In most projects and funds, BII would continue to participate in a club with other DFIs with similar investment criteria and minimal third-party western private sector investment will be stimulated.

BII certainly can play a critical role in stimulating private sector capital flows into emerging economies. No other DFIs have been particularly effective in this area and BII sits in the middle of Europe's main financial centre, so BII is well placed **if** it can show the City an attractive product. Its many current fund and direct investments will have created a unique body of institutional knowledge about countries and marketplaces and the prize in foreign policy terms is significant: any DFI that is, in fact, capable of stimulating serious private sector investment and capital flows into emerging economies will find itself in an influential position, both in the investee countries and among the DFI peer group. And a failure in this mission by western DFIs in general will leave the emerging markets playing field open to the west's rivals, who have far fewer qualms about investing in an exploitative manner.

However, the private equity fund and direct investment approaches that BII and all other DFIs deploy have been proven to be unattractive to the wider capital markets. If mobilising private sector financial capital is the mission, BII probably needs to abandon DFI private equity investing orthodoxy and develop some new ideas. Financial innovation is a key UK strength and this product development work (on what kind of financial approach can actually gain support in the City and meet the needs of the target countries) should be the foundation for the next evolution of BII.

Annexe:

EMPEA Data – last pre-COVID year

Comparative End-to-End USD Returns by Region (as of 30 June 2020)

Index (% annual change in value)	1-Year	3-Year	5-Year	10-Year
US PE & VC	9.73	14.84	12.32	15.49
Europe Developed PE & VC	5.37	13.14	14.40	13.91
S&P 500	7.51	10.73	10.73	13.99
Africa PE & VC	**-4.87**	**2.09**	**1.00**	**4.07**
Europe Emerging PE & VC	**-2.30**	**1.85**	**5.36**	**6.18**
Middle East Emerging PE & VC	**2.43**	**2.70**	**1.83**	**8.45**

Source: Cambridge Associates LLC. Pooled horizon internal rate of return (IRR) calculations are net of fees, expenses, and carried interest. Data as of 30 June 2020. The Emerging Markets Index is a horizon calculation based on data compiled from 708 EM private equity & venture capital funds, including fully liquidated partnerships, formed between 1986 and 2019. The Asia/Pacific Emerging Index includes 462 Asia/Pacific emerging private equity & venture capital funds formed over the same time period. Public equity returns included for reference only.

Global Fundraising & Investment

Note: Includes private equity, venture capital, private credit, infrastructure, and natural resources.

Fundraising by Region, 2006-1H 2020 (USDm)

Region	2013	2014	2015	2016	2017	2018	2019	1H 2020
United States	248,176.8	322,292.1	288,798.7	342,757.7	406,764.9	399,746.5	485,581.7	189,077.8
Western Europe	106,734.0	79,629.4	91,550.5	112,739.8	149,365.1	117,326.5	167,583.7	46,872.9
Other Developed Markets*	20,220.5	28,322.2	24,941.9	33,035.6	31,819.9	126,926.1	20,329.4	35,403.2
Africa	1,893.1	3,655.5	4,502.5	2,641.6	2,268.0	3,146.4	3,278.5	876.1
Emerging Asia	31,329.2	36,064.9	40,186.7	50,456.1	56,906.1	80,854.8	71,879.5	30,546.5
CEE & CIS	1,702.4	2,049.2	932.8	1,677.0	1,246.6	1,692.6	1,472.2	1,030.4
Latin America	6,016.3	11,502.0	9,244.6	4,633.7	4,876.3	9,240.9	3,745.7	1,723.8
Middle East	892.4	956.0	257.1	158.0	215.3	91.4	465.0	-
Multi-Region	5,213.2	1,643.3	2,539.1	3,669.2	4,204.4	766.4	5,083.2	512.2
Emerging Markets	**47,046.6**	**55,870.9**	**57,662.8**	**63,235.7**	**69,716.7**	**95,792.4**	**85,924.1**	**34,689.0**
Global**	422,177.9	486,114.6	462,954.0	551,768.7	657,666.7	739,791.5	759,418.9	306,042.9
EM as % of Global	**11.1%**	**11.5%**	**12.5%**	**11.5%**	**10.6%**	**12.9%**	**11.3%**	**11.3%**

Investment by Region, 2015-2019 (USDm)

Region	2015	2016	2017	2018	2019	1H 2020
United States	296,368	320,793	346,165	401,944	463,628	178,104
Western Europe	173,419	130,040	172,372	174,804	197,799	76,150
Other Developed Markets*	44,009	47,087	50,606	45,036	79,417	22,767
Africa	5,220	4,801	3,174	4,149	3,585	1,264
Emerging Asia	69,613	75,065	105,260	139,702	87,746	41,383
CEE & CIS	**2,944**	**1,617**	**7,090**	**3,408**	**2,442**	**755**
Latin America	5,432	9,332	7,519	10,717	14,800	3,573
Middle East	**577**	**771**	**434**	**886**	**4,409**	**541**
Pan-EM	24	1,266	407	237	252	50
CEE/CIS/MidEast as % of Total	**0.6%**	**0.4%**	**1.1%**	**0.5%**	**0.8%**	**0.4%**

* Includes Australia, Canada, Israel, Japan, and New Zealand. ** Global fundraising and investments are the sum of the regions listed above.
Sources: Emerging Markets – EMPEA : Developed Markets – PitchBook