

IFC: Commercial Discipline for Development Impact

How “success” differs between public and private sector institutions, why beating market-based benchmarks is tougher than meeting objectives, and why IFC prefers measuring itself against a high hurdle.

Public sector institutions typically measure themselves against the achievement of objectives and whether a project's benefits exceed its costs. They typically report success rates of 75% or even higher. For over 80% of IFC's projects the financial and economic benefits exceeded the costs, but that benchmark is not “good enough” for a private sector institution. For private investors, the appropriate benchmark is whether a company outperforms the competition and market-based benchmarks – and almost by definition only roughly 50% of companies (or even less) can beat the market. This commercial discipline ensures that only the most efficient companies, that return more to their shareholders than their competitors, enjoy continued access to financing, can grow and are sustainable in the long run.

IFC's results also show that for the projects and companies it finances financial performance is very closely linked with other aspects of development results. The better the financial performance, the better the environmental, social and economic performance, and the stronger its broader impacts on private sectors development tend to be. This may not be true for all private sector companies, but at least it's true for IFC-financed operations: Since IFC screens for factors that could negatively affect stakeholders other than the financiers – for example in the form of negative externalities – financial performance has consistently been the lowest-rated among the four development results indicators, with just under 50% of projects exceeding the weighted average cost of capital benchmark, estimated at about 10% in real terms (or about 12% in nominal terms). Again, this compares to over 80% of projects for which the financial returns are positive.

To be financially successful, companies have to offer better quality goods to consumers at lower prices than competitors – that's the key to their success. Such companies try to grow, attracting workers by paying them well and training them so they can become more productive. They contribute to higher government revenues through taxes. Growing businesses require more goods and services from other companies, thus spurring further private business creation and employment through suppliers. With low profitability it's hard to make similar contributions, and even the long-term survival of companies will be threatened – and with it any lasting positive impact on the community where it operates.

Success rates also depend on the level of risk – the higher the risk, the lower the success rate, and financiers of a company are the last to benefit. Even among financiers, risks are unevenly distributed. For example, lenders face lower risks than equity investors, and not surprisingly IFC's own “success rate” for loans is about two to three times as high as that for equity investments: Historically, only about 50% of IFC's equity investments had positive returns, and 25% had real returns exceeding 10%. Nevertheless, on a portfolio basis equity investments have been more profitable for IFC than loans, since a small number of very successful projects more than compensated for the poorer performers. This pattern is very typical for equity investors: Successful private equity funds typically have a 10%-20% “success rate”, but these “winners” more than compensate for the “losers”.

Investor Returns

Investors get paid last. IFC puts high priority on commercial discipline in private sector investment considerations because of the strong, positive relationship between financial returns and development impact. Investors first have to put up their capital, build a plant, produce a product or service that consumers want to buy, pay their employees, suppliers and the government (in the form of taxes). If (and only if) they successfully complete all these steps – and do so better than their competition – can they earn a decent return on their investment. Not surprisingly, financial performance was consistently the lowest ranked indicator of development results among

IFC projects, with substantially higher success rates for economic, environmental, social and performance. In part this is due to the fact that IFC screens its projects so that they meet IFC's environmental and social standards and require that they avoid or mitigate negative externalities. We also require that our projects do not depend on subsidies or distortions, which may impose costs on governments or consumers. As a result, benefits to society tend to exceed benefits to financiers in IFC projects.

Financial performance was high for 40-60 % of IFC's projects – in line with market benchmarks. The financial rate of return is the best indicator of financial

performance for project finance and the standard used by IFC. About half of IFC projects produce returns higher than their weighted average cost of capital, estimated at about 12% in nominal terms (about 10% excluding inflation). This is probably “about right”: In a competitive market, you would expect about half (and perhaps slightly fewer) companies outperform the average. If financial success rates were much higher, that might be an indication that IFC was not taking sufficient risks and potentially forego attractive investments and associated developmental potential. If IFC were to use a lower benchmark, for example whether benefits outweigh the costs, the success rate would be over 80%. But such returns are not sufficient to attract private investors, who IFC needs as partners for its investments.

Success rates vary with project risk and investment instrument, and even well-performing private equity funds tend to have only 10%-20% “winners”. Not surprisingly, success rates differ by project risk. Our analysis shows that success rates are higher for expansions than for greenfield projects, and higher for repeat investments than first-time investments with a new client. Does that mean that IFC should only do expansion projects with existing clients? Of course not – but IFC, like any other institution financing private sector companies, needs to balance risks and rewards. Similarly, lenders take less risk than equity investors and IFC’s loans tend to be “successful” 2-3 times as often as its equity investments (25%-30%). Nevertheless, IFC’s equity investments have historically made a much stronger contribution to IFC’s profitability than its loans, since small numbers of big “winners” more than compensated for below-average and poor performance. This pattern is very typical for private equity funds, where a successful fund typically relies on 10%-20% of highly successful investments.

The Challenge of Comparing IFC Results

Even benchmarking financial performance and performance between private sector oriented institutions is difficult. IFC can benchmark – within limits – its financial performance against market benchmarks, such as the Emerging Markets Database Index. These comparisons have to be treated with caution. For example for the index all companies have to be listed on a stock exchange, but IFC’s clients are often not. With these caveats, typically IFC’s results are in line with or slightly better than the index.

For development results, no similar universally accepted measures exist. Whereas for the evaluation of private sector operations good practice standards that have been agreed between multilateral development banks exist, application of these standards differs so vastly among institutions (in 2005, the last assessment showed that application of the standards among institutions differed between 8% and IFC’s 92%) that comparison becomes impossible. Differing mandates and existing practices make different institutions hesitant to accept clear standards and benchmarks, even such basic ones as a financial rate of return.

Comparisons with institutions supporting the public sector is even more difficult. Private sector oriented institutions and typically benchmark themselves against “the market”, or in other words the competition. Almost by definition, this leads to “success rates” of about 50%, since only about half the companies can perform better than average.

Institutions supporting the public sector typically lack similar private sector based benchmarks and competition. Results are thus typically based on effectiveness – whether objectives are achieved, and efficiency – whether benefits outweigh costs. Given the lack of competition, it is difficult to construct “benchmarks” similar to those faced by private sector companies. Not surprisingly, success rates measured by these standards tend to be much higher and cluster around 75%-80% (see for example the 2006 Common Performance Assessment or COMPAS for Multilateral Development Banks).

By way of comparison, take bakers in a non-market economy. They could set a benchmark on number of loaves produced with some minimum quality standards, and most would likely achieve that objective. In a market environment, bakers benchmark performance on profitability and compete for customers who pay for bread seeking the best combination of quality and price. The best bakers would outperform their competition and grow, but only about half or less would earn market returns and some would go out of business.

Similarly, the market benchmarks IFC uses result in lower success rates than for other development institutions that lack a similar market-based test, or that use lower benchmarks.