BACK TO A RISKIER FUTURE?
A brave new investment world for IFIs
The world of international development financing is changing. As IFIs move away from familiar markets, they are experiencing increasing levels of risk and are having to adapt accordingly.

The world of global development financing is evolving, as International Financial Institutions (IFIs) move away from well-worn paths in familiar markets. And this geographical shift is changing investment risk, as some of the biggest names invest in increasingly volatile territories. To some extent, this is a return to more pioneering days, such as those experienced after the collapse of the Soviet Union.

To understand how IFI activity is shifting, AlixPartners has analysed where and how three major IFIs – the International Finance Corporation (IFC) of the World Bank Group, the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) – are investing, and how this might affect the nature and level of risks they face. The answers provide a compelling picture of how IFIs are deploying their capital, and the changing nature of the challenges they now face.

Our analysis illustrates that while investment in Eastern Europe is falling, as well as in Russia and Turkey, the Middle East and Asia are becoming increasingly popular investment regions, despite the increased levels of risk these investments may face.

AN EVOLVING INVESTMENT LANDSCAPE

Since 2010, the total level of development financing has fallen by more than $13 billion, reflecting the changing activity of these institutions, who over the past eight years have halved their investment in Eastern Europe. Additional support established following the global financial crisis has also been wound down, dramatically reshaping IFI activity.

Alongside a reduction of activity in their historically ‘core’ investment jurisdictions, market conditions have made it difficult for European IFIs to reallocate available capital to new investments. Particularly for the relatively risk-averse EIB, the ultra-low interest rate environment – where investors have generally been forced to seek higher returns in riskier assets – has seen its total level of investments fall.

This fall in the total amount of development finance has been offset by the evolving nature of IFI activity and a move into a wider geographical area. As well as expanding to a more diverse set of countries, IFIs are looking to the future and increasing their investment focus on fostering broader goals, beyond economic growth, including tackling the global climate emergency and improving gender equality.

WHAT DOES THIS MEAN FOR IFIs?

Expanding investment horizons into new territories comes with associated increased risk.

In order to assess how the trends we have identified might impact investments made by IFIs, we have cross-referenced our data trends with two internationally renowned global indices, both important indicators of risk:

1. The World Bank’s Ease of Doing Business Index (EoDBI), which assesses the regulatory and legal environment for businesses in a country.
2. Transparency International’s Corruption Perceptions Index (CPI), which assesses the perceived level of corruption in a country.

Both indices rank countries based on a number of indicators, with 1 being best in class (i.e. least corrupt/easiest to do business’).

Investing in a lower-ranked jurisdiction in the EoDBI will mean that there is a greater risk of facing business challenges, such as poor investor protection, issues with contract enforceability and complex regulation, such as tax and business permits.

A lower CPI ranking means that an investment faces a greater risk of having to navigate corrupt officials in order to, for example, retain access to a certain market or business input (e.g. energy), or of the higher costs of doing business associated with dealing with corrupt market participants.

There has been a clear shift over the last eight years, with IFIs investing in more challenging jurisdictions. Both in aggregate, and individually, each IFI is seeing a material deterioration in the average risk ranking for their investments. Based on our analysis, IFIs are now investing, on average, more than 10 countries lower in the risk rankings (so higher risk), when measured on a weighted average basis.

On balance, this can be seen as a positive development, as IFIs are going back to focusing on countries with higher risk, and greater development requirements, helping to fulfil their institutional mandates.

1. Transparency International scores countries out of 100, with 100 being no corruption. However, they also rank countries based on this score, with 1 being the least corrupt country.
Republic and Hungary have experienced steady economic growth in recent years, with the IMF predicting a similar pattern for GDP increases in coming years (source: IMF, 2019). The greater challenges — politically and economically — now lie further afield.

This evolution has been further strengthened by the expanding scope of economic development targeted by IFIs to make a meaningful impact in areas such as tackling the global climate emergency and gender equality.

WHERE IS FINANCE FLOWING?

Excluding Russia and Turkey, which have both been impacted by their own geopolitical challenges, Asia and the Middle East have seen dramatic growth in the volume of development funding received from IFIs.

Total investment in the Middle East increased by 86% comparing 2010-2014 to 2015-2018, with Egypt, Lebanon and Jordan seeing significant increases. Across this period, investment in Asia increased by 25%, predominantly in China and India, but also in Central and Southern Asian countries such as Uzbekistan and Bangladesh. Perhaps surprisingly, Africa has experienced a decrease in overall investment, although the EBRD has already announced it is looking to expand its activities into sub-Saharan Africa in 2020, subject to shareholders’ approval.

THE CHANGING WORLD OF DEVELOPMENT FINANCE

The key driver in the total fall in IFI investments in the last eight years has been the sharp decline in investment in Eastern Europe, down 31% — more than $7.5 billion per year — between 2015 and 2018, compared to the period 2010-2014.

Years of investment to boost growth in Eastern European countries has been wound down as IFIs have met their objectives. Countries such as Poland, Croatia, Czech

<table>
<thead>
<tr>
<th>Ease of Doing Business Index</th>
<th>Weighted average rank</th>
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<tr>
<td>2010 to 2014</td>
<td>45.9</td>
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<tr>
<td>2015 to 2018</td>
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<tr>
<th>Corruptions Perception Index</th>
<th>Weighted average rank</th>
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<tr>
<td>2010 to 2014</td>
<td>67.0</td>
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<td>2015 to 2018</td>
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Note: figures exclude Russia

IFI INVESTMENT TRENDS 2010-2018

RUSSIA
Russia went from third largest recipient in 2010 ($3.5bn) to zero between 2015-2018

TURKEY
Investment in Turkey decreased from $5.5bn in 2015 to $1.7bn in 2018

EASTERN EUROPE
31% decrease in investment in Eastern Europe

MIDDLE EAST
86% increase in investment in the Middle East (excl Turkey)

ASIA
25% increase in investment in Asia
INFRASTRUCTURE A KEY FOCUS

The development financing approach of IFIs continues to focus on sectors that have the potential to drive forward economic growth.

Of the investments made in 2018, two-thirds were directed to financial services, and transport/infrastructure. These two combined sectors help leverage and maximise the impact of IFIs on the ground.

Infrastructure remains a key investment focus for IFIs as a way to make economies more attractive and competitive, with the EIB in particular traditionally an infrastructure-focussed institution.

For all three IFIs, investments in infrastructure and transport projects are now taking them into potentially uncharted territories. Madagascar, Uzbekistan, Kosovo and Cameroon all received significant infrastructure investment from 2015-2018, having received no investment in the previous four years.

GEOPOLITICAL SHIFTS

Alongside the fall in Eastern European development finance and the move into a wider range of countries, there have been major developments in countries that had historically been major recipients of IFI support.

Increased geopolitical conflict has led to a sharp reduction in support for Russia, particularly following the annexation of Crimea in 2014, and a move away from allocating funding to Turkey – a major recipient of IFI funding, given its pivotal position between Europe, the Middle East and Asia.

Having received investment totalling $3.5 billion in 2010, no IFIs invested in Russia between 2015-18, following the implementation of economic sanctions by Western governments.

Political developments in Turkey in the last three to four years – and consequent tensions with Western governments – appear to have led to a fall of 69% in investment since 2015. The negative impact of investment restrictions in Russia and Turkey would have been even starker in relation to the overall picture of IFI funding, if the three IFIs had not shifted strategies to increase investment further afield.

IFI INFRASTRUCTURE INVESTMENT 2010-2014 VS. 2015-2018

1. Based on investments exceeding an average of $100m for 2015-2018
Infrastructure investments come with unique challenges, including interaction with and reliance on government, potential for governance/corruption issues and the risk of cost overruns impacting profitability. Such projects benefit from close management and hands-on experience, which IFIs bring to investments as experienced international partners.

**THE IMPORTANCE OF FINANCIAL SECTOR INVESTMENT**

Additionally, in order to enable local financial sectors to lend or invest, and to use banks as a tool to effect behaviour change, it follows that financial services will remain the biggest recipient of IFI funding. While investment in local financial sectors remains a central tenet of IFI policy, financial sector investments by EIB and EBRD have declined by 20% over the period reviewed (in line with the overall decline in the amount of funding invested by these institutions). However, this has been offset by significant increases in financial sector investment by the IFC.

For the IFC, there has been a material increase in financial services investment in Central and South American countries, the Middle East, East Asia and Pacific countries. The biggest increase (2,600%) is in Argentina where the change in political leadership in 2015 appears to have prompted a revival in support from international institutions.

Investment in financial institutions in emerging markets means greater exposure to regions that are more prone to financial crisis, and the potential for governance/corruption issues. Such investments have the potential to increase the developmental impact of the IFIs, but the increased investment risk profile needs to be appropriately managed.

**IFC financial services investments increased by 42% from $3.7bn in 2010 to $5.2bn in 2018**

*The IFC has increased its financial services investments, particularly in South America, South Asia and the Middle East.*
MOVING TOWARDS A GREENER FUTURE

Reflecting IFIs’ objective to foster greener economic growth, our analysis identifies that investments in natural resources and energy have fallen dramatically from levels seen in 2010. Between 2010 and 2014 an average of $6.4 billion a year was directed to this sector. By 2018, the level of investment has fallen by nearly a third to $4.3 billion.

This move away from natural resource finance has coincided with financial investments that have included the establishment of financing methods for green technology and energy solutions, with infrastructure and transport investments often focused on sustainable initiatives.

The focus on environmental sustainability whether through direct stakes in developing energy solutions or enabling green investment in a new market, is instrumental in directing economic activity towards addressing the global climate emergency. As we have seen, IFIs are now more active in regions where the effects of the global climate emergency are already being acutely felt. There is also increased exposure to areas of Asia where the acceleration of economic development has often come at the cost of very significant environmental damage.

WHAT NEXT FOR IFIs?

For the world’s major IFIs, the trends we have identified, such as a changing geographical reach and an increasing green focus, look set to continue into the future. To invest successfully and support development, IFIs need to continue to increase their investments in geographical areas with greater levels of risk. This will require careful management in order to address the challenges of the local markets. It is also likely to result in an increase in the number of investments that eventually become distressed.

This evolution means that while there is a greater opportunity to positively impact local economies and the lives of people in some of the most challenged developing jurisdictions, IFIs will need to adapt their approach to adjust to the new investment risks they face. IFIs will need to partner with the right people, both in-country and internationally, to help them adjust to operating across a more diverse investment profile.

The changing geopolitical landscape that has shaped IFI activity in recent years in Eastern Europe, Russia and Turkey is expected to continue to be an important factor in future trends, as is the need to face the challenge of a rising China, as its influence on the world economy continues to grow, particularly in Africa and Asia.
The expansion of the ambitious Chinese Belt and Road Initiative will likely see the IFIs come into competition with China more frequently, as both look to increase their developmental impact in Asia.

IFIs will continue to play an essential role in fostering global co-operation to combat the global climate emergency and support those countries already suffering from the impact of changing weather patterns. The multilateral nature of IFIs puts them in a uniquely pivotal position to support the fight against the global climate emergency, as well as promoting gender equality and other developmental goals, and this growing focus is key for future investment.

In order to be successful, IFIs will need to be proactive in assessing and addressing the increased challenges around doing business and combatting corruption in the jurisdictions in which they invest.

In the long run, an increased IFI presence should reduce risk for all investors in these markets by improving practices and developing a more business/investor-friendly environment. This in turn should hopefully lead to a virtuous cycle of increasing levels of investment, and therefore development, improving the lives of the people that need it the most.

HOW ALIXPARTNERS CAN HELP

We have extensive experience in emerging markets, helping stakeholders navigate complex environments and governance challenges...when it really matters.

To find out more about our work, please visit alixpartners.com/clientstories

SOURCES

All investment data from AlixPartners analysis unless separately referenced.

EIB activity report 2018

IMF World Economic Outlook database:

EBRD activity report 2018

IFC Annual Report 2018
https://www.ifc.org/wps/wcm/connect/CORP_EXT_Content/IFC_External_Corporate_Site/Annual+Report

World Bank Ease Of Doing Business Index
https://www.worldbank.org

Transparency International Corruption Perceptions Index
https://www.transparency.org/research/cpi/overview

METHODOLOGY

To inform our conclusions, AlixPartners collated the investment data of the IFC, EIB and EBRD since 2010, excluding funding to Western European countries to avoid skewing the data. We then cross-referenced with the World Bank’s EoDBI and Transparency International’s CPI, excluding Russia. Given the dramatic decline in Russian investments, and their unique risk profile, the trend analysis was considered more insightful excluding these investments.

Back to a riskier future?
ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation. These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it’s not what we do that makes a difference, it’s how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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