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ReDesigning Development Finance Initiative

Blended Finance in the Private Sector Context

An initiative of the World Economic Forum and the OECD with support from Monitor Deloitte

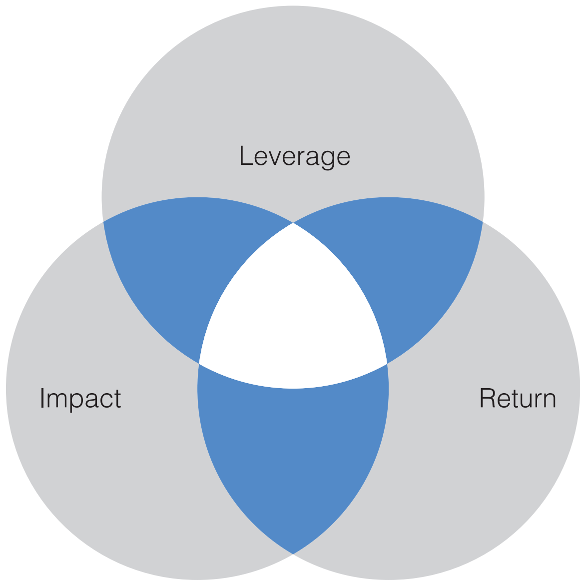
Overview

Investors and commercial institutions are increasingly attracted to emerging and frontier markets for their young populations, booming middle classes, high growth rates and strong return performances in over the last decade. This trend coincides with challenges faced by public and philanthropic institutions ("development funders") who are mandated to promote development in these markets, but face significant financial constraints and a lack of capacity or expertise in structuring transactions and sourcing deals. Consequently, there is political will for effective public-private collaboration, presenting a strong unique opportunity for investors and financiers to develop more effective strategies for managing their participation in emerging markets.

Blended Finance, the strategic use of development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets, helps to alleviate concerns faced by investors in these markets, mitigating risks and managing returns in line with similar investments in developed markets. For development funders, this provides access to new capital sources and expertise to deliver products, services and infrastructure that can contribute to development goals.

Blended Finance is built around three key pillars which align the interests of both private capital and development funders:

- **Leverage:** *use of development funder resources to attract private capital into transactions*
- **Impact:** *projects or transactions that provide social, environmental and economic benefit for their communities*
- **Returns:** *commercially attractive financial returns for some, if not all, contributors to the capital stack*



This paper builds on *Blended Finance Vol. 1: A Primer for Development Finance and Philanthropic Funders*, which lays out the opportunity for commercial investors and financiers in emerging and frontier markets, highlights the motivations and attributes that development funders can bring to a structured transaction, and maps out some of the structures and opportunities that can align incentives.

Through increased public-private cooperation in Blended Finance transactions, private investors and financiers can broaden their investable universe in emerging and frontier markets, using an effective approach to manage their capital exposure. As a result, increased use of Blended Finance approaches should increase funding for products, services, infrastructure and sources of capital in these markets, making significant contributions to development outcomes in these regions.

Market Opportunity

Emerging markets offer attractive fundamentals for investors. Increased wealth accumulation and young demographics are driving growth and creating new investment and commercial opportunities. The middle class in emerging markets is poised to expand up to 3 billion people by 2030[1] (an increase of over 40% from 2015) while emerging and developing countries are home to 90% of the global population under the age of 30.

Growth rates in these markets exceed those in developed markets. Emerging and frontier markets contribute to more than 39% of global GDP,[2] with projections of market growth of 4.0% in 2015 and 4.5% in 2016, compared to 2.0% and 2.2% for advanced economies over the same period.[3] Meanwhile, assets under management in emerging markets are expected to double to roughly $13 trillion by 2020.[4]

Returns in emerging markets have historically been strong. Emerging market private equity and equity markets have outperformed their developed market counterparts, with both listed and private equity having outperformed advanced economies for the past 10 years.[5]

Yet portfolios are underweight. Despite these trends, investment in emerging markets remains low with only 11% of private equity funds flowing to these markets in 2014.[6] A recent survey of fund managers found depressed sentiment towards emerging markets, with a record 34% of fund managers being underweight.[7] Meanwhile, 33% of limited partners (LPs) in a separate survey planned to increase private equity allocations to emerging markets through 2017, with 78% noting that returns in these markets exceeded or met their expectations.[8]

Perceived risks often do not reflect investment conditions. Perceived risks are often cited as a limiting factor, despite these being unfounded or overemphasized.[9] Concerns of a lack of quality investment opportunities in these markets are also inaccurate. For example, most corporate debt issuance for infrastructure outside of North America is investment grade (92% in Europe, Middle East and Africa (EMEA), 87% in the Asia-Pacific and 57% in Latin America and the Caribbean).[10]

The business and investment climate has improved. The rise of regional trade blocs, and legal, regulatory and governance reforms have improved investment regimes in a number of countries. Average time to start a business across developing countries has fallen 40% to 30 days since 2005, while developing regions such as Sub-Saharan Africa continue to reduce the complexity and cost of regulatory processes and to strengthen legal institutions. Growing regional integration, including the rise of regional trading blocs, has eased cross-national business and contributed to increased investor protection.

Funds and capital pools are successfully accessing the market. Private equity investment in emerging markets reached $57 billion in 2014, with increased interest from LPs resulting in fundraising totals far exceeding previous years.[11] A recent survey on Blended Finance funds and facilities found capital commitments of $14.9 billion across 61 funds.[12] Private actors noted "access to high-growth markets," "responding to client demand for responsible investment" and "financially attractive investments relative to other opportunities" as key drivers.

Blended Finance provides access to new business opportunities through the capital structure. Development funders can support investments that provide "additionality" (transformative social, environmental or economic impacts) through Blended Finance. Resources such as technical assistance, flexible financing and political support can mitigate risks and enhance returns. This allows investors to increase their investable universe by allocating risks and returns to those parties best suited to manage them.

Investors articulate a range of benefits that have resulted from partnering with development funders. Blended Finance allows development funders to support private capital in transactions by:

- **Participating in transactions that are deemed too risky or that offer marginal returns to some investors**
- **Assuming operational, regulatory and political risks**
- **Providing liquidity and exits for investors, particularly for institutional grade investments**
- **Hedging or guaranteeing prices and returns to reduce volatility and ensure commercial viability**
- **Reducing market entry and transaction costs**
- **Sharing local knowledge, access and reputation**
- **Engaging on regulatory and investment reform**

Benefits of Blended Finance extend beyond capital. While access to capital can be a motivation for investors, qualitative factors also make development funders an attractive partner in the capital structure, by providing:

- **Engagement at earlier stages of the investment life cycle, when the potential upside is greater**
- **Increased long-term sustainability of returns**
- **Reputation enhancement of the transactions for investors and other stakeholders**
- **Access to partners, technical skills and in-country training that enhances the viability of investments**

Characteristics of Development Funders

Development funders have access to deep financial and technical resources and unique capabilities. Capabilities ranging from guarantees to in-market assistance and networks are essential for helping private investors to overcome market challenges that prevent the scale-up of financing, from the selection of the right partners to facing risks specific to a particular sector, geography or stage of maturity - a critical element of a Blended Finance transaction.

Development funders are motivated by a range of non-financial and qualitative objectives. Mandated to enable social, environmental and economic development, even at the expense of financial returns, development funders tend to focus on the "development return to capital," a return that places a value on a range of non-financial and qualitative objectives:

- Achieving public policy goals
- Transfering knowledge and technology transfer
- Overcoming market failures
- Addressing pressing challenges
- Enabling new markets
- Providing greater access to affordable capital

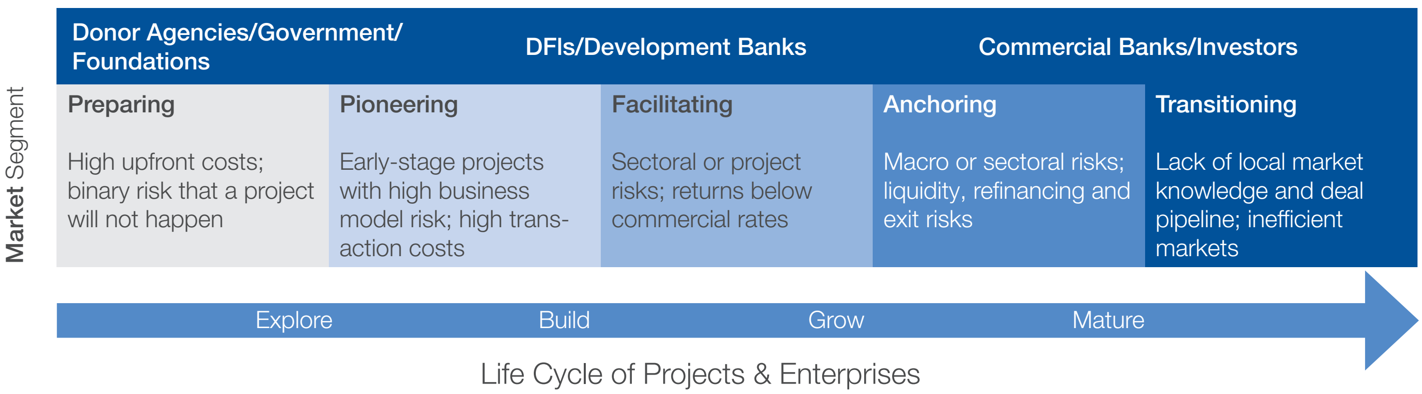
Consequently, development funders can engage in transactions that are not normally commercially viable to ensure outcomes can be realized. Many development funders, particularly those representing national interests, are also tasked with facilitating market entry for private actors. This can include:

However, development funders are not a homogenous group. Important distinctions between mandates and capabilities of development funders are necessary for private sector investors to find the right partners and effectively engage in Blended Finance. For example, while bilateral donors and foundations will typically defer returns and be willing to participate at earlier stages of the investment life cycle, development banks will typically expect competitive financial returns and participate at later stages.

Development funders are also cautious regarding partnership with commercially driven institutions. Concerns around the profit motives of private capital have limited engagement by development funders. Successful transactions have been realized by ensuring alignment of return objectives and the potential impact and benefits for all parties, as well as robust assessment criteria. Key sensitivities of development funders related to engaging in a commercial investment include:

- Participation of the development funder may be creating an artificially high return for a transaction that would be ordinarily be funded by private actors
- Public funding from the development funder may crowd out private capital
- Development funders may have limited influence and input on governance in the transaction
- Environmental, social and governance (ESG) performance of the transaction may create a reputational risk for the development funder
- Private actors may not see the intangible benefits of a development funder in their capital structure and are just looking to reduce transaction or origination costs

Although each institution is different and there are no clear distinctions between what activities different institutions can undertake, there are typically significant differences between the types of transaction and stage of development that donor institutions and development banks engage in, driven primarily by the risk tolerance of the institution.



Working with Development Funders

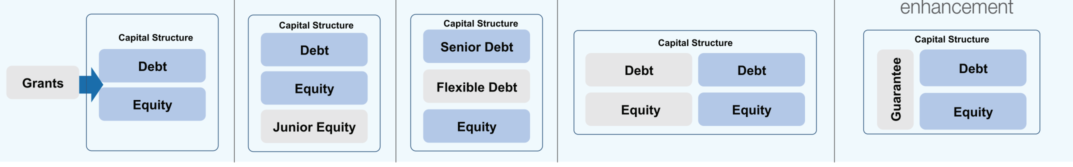
	Philanthropy	National/Regional			Multinational	
	Foundations	**Donor Agencies/ Governments**	**Development Finance Institutions**	**Development Banks (Emerging Markets)**	**Multilateral Development Banks/Financial Institutions (MDBs/MFIs)**	**World Bank Group**
Overview	Individuals and non-profit, non-public organizations that provide charitable funds to serve the public good	Government agencies providing financial aid and assistance from donor governments to low- and middle-income countries directly from one country to another (bilateral funding).	Financial institutions that act as a catalyst for private investment from developed countries by targeting growth and sustainable development in emerging and frontier markets	Finance institutions created by emerging market governments that provide financing for the purposes of economic development in the country	International financial institutions with governmental membership that carry out developmental activities	An international institution lending to its181 member countries, aiming to integrate developing and transition economies with the global economy, and reduce poverty through economic growth.
Motivation	Realize organizational mission that may include international development objectives	Leverage a limited supply of capital to drive more money to development	Invest/finance and deliver sustainable development impacts while remaining cost-neutral or generating positive returns	Attract and build local capacity to deliver on national development plans and improve economic conditions domestically	Engage private capital in supporting long-term sustainable infrastructure and economies in emerging markets, seeking to increase quality and quantity of capital in their regions of interest	Promote policy reforms and development projects, and offer policy advice, technical assistance and non-lending service with returns ranging from zero recovery to an annual target return
Examples	– Bill & Melinda Gates Foundation – The Rockefeller Foundation – Wellcome Trust	– DFAT (Department of Foreign Affairs and Trade, Australia) – GAC (Global Affairs Canada) – Sida (Swedish International Development and Cooperation Agency) – USAID (US Agency for International Development)	– CDC Group plc (UK) – FMO (Netherlands) – OPIC (Overseas Private Investment Corporation USA) – Proparco (France)	– DBSA (Development Bank of South Africa) – BNDES (Brazilian Development Bank) – Development Bank of Kazakhstan	– AfDB (African Development Bank) – ADB (Asian Development Bank) – EBRD (European Bank for Reconstruction and Development) – IDB (Inter-American Development Bank) – IsDB (Islamic Development Bank)	– IBRD (International Bank for Reconstruction and Development) – IDA (International Development Association) – IFC (International Finance Corporation) – MIGA (Multilateral Investment Guarantee Agency)

Philanthropic institutions, donor agencies and governments, in particular, play an important role in Blended Finance, given their tolerance for risk and lower return expectations relative to counterparts. These institutions deploy their capital using a range of securities and instruments, accounting for $135.2 billion in OECD Official Development Assistance in 2014.[14]

Blended Finance allows investors and lenders to reduce the uncertainty and costs related to risk-return expectations in an emerging market transaction by leveraging the financial instruments, reputational support, and local expertise that development funders can provide, narrowing the range of outcomes to allow for more opportunities to be viable.

Common financial instruments used by development funders

Grants	Junior Equity	Flexible Debt	Market Rate Debt or Equity	Guarantees
Funds costs and activities that lead to investment	Subordinate position absorbs highest risk	Favorable terms shift risk-return profile	Investment on same terms demonstrates viability and provides investor comfort	Risk reduction tools that protect investors against capital losses or provide credit enhancement



New initiatives, including those supported by mainstream financial institutions, will continue to underline the potential of Blended Finance as a core business and investment approach to emerging markets:

Sustainable Development Investment Partnership (SDIP)

A multistakeholder platform comprising approximately 20 public and private institutions seeking to mobilize $100 billion in emerging markets by 2020, with an infrastructure focus
http://www.sdiponline.org/

Convergence

A virtual marketplace and knowledge resource platform, which aims to aggregate and increase Blended Finance flows by facilitating transactions for private investors and development funders
http://www.convergence.finance/

Blended Finance Network

An exclusive online forum for practitioners to learn about Blended Finance and share best practices

https://toplink.weforum.org/project/blended-finance-network

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