



USAID INVEST BLENDED FINANCE STARTER KIT:

**10 QUESTIONS ABOUT MOBILIZING PRIVATE
CAPITAL FOR BETTER DEVELOPMENT RESULTS**

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BLENDING FINANCE STARTER KIT: 10 QUESTIONS ABOUT MOBILIZING PRIVATE CAPITAL FOR BETTER DEVELOPMENT RESULTS

I. WHAT IS BLENDED FINANCE?

Blended finance is the strategic use of development funds, such as those from government aid and philanthropic sources, to mobilize private capital for social and environment results, such as improving infrastructure, education, agriculture, healthcare, and more. Blended finance strategies are designed to encourage members of the private sector, such as companies and investors, to invest in activities and projects that can achieve both financial returns and positive social and environmental outcomes.

2. HOW CAN BLENDED FINANCE ENCOURAGE INVESTMENT INTO DEVELOPING COUNTRIES?

Investors constantly weigh the potential return of an investment—the money it makes over time—against its risk—the possibility of the investment incurring a financial loss instead of a return.

Blended finance enhances an investment's potential return or mitigates its risk factors, making it more attractive to investors.¹ In other words, blended finance interventions improve the investment's risk-adjusted return. Risk-adjusted returns influence an investor's decision to invest in an activity, fund, company, etc. If two investment opportunities have the same anticipated return over the same duration of time, the one that has the lower risk will have the better risk-adjusted return, making it the more likely choice for investment.²

All investments incur some level of risk; however, investments in developing countries and frontier markets often present risks, such as macroeconomic, political, regulatory, currency, and information asymmetries, that are volatile and more difficult to mitigate than those in developed markets. While developing countries often have attractive investment features that developed economies lack, such as high yields, fast-growing economies, and uncorrelated markets, if the risk-adjusted returns aren't as attractive as the investment options in other markets, commercial investors won't engage in these opportunities.³

Through blended finance interventions, international development agencies can use their financial resources and development expertise to drive commercial investment into markets, sectors, projects, or companies that the private sector would not otherwise consider. Blended finance aims to make development spending more catalytic, meaning that for every public or philanthropic dollar spent on a development project, additional dollars in private capital are mobilized to invest alongside it, ultimately increasing social and environmental impact.

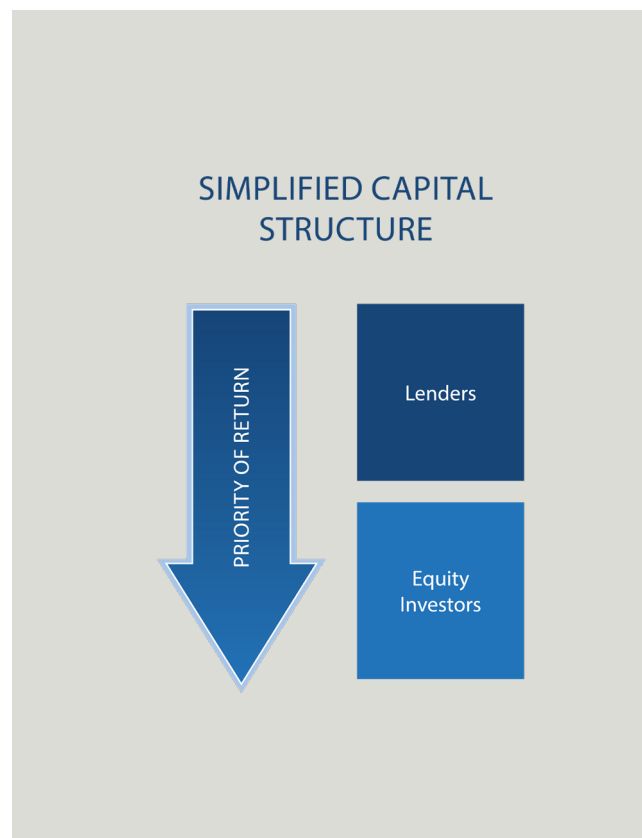
3. HOW DOES BLENDED FINANCE WORK?

In blended finance transactions, development agencies alongside other public or philanthropic actors use special strategies to improve the risk-adjusted return profile of a deal, thereby making it more appealing to investors. Blended finance transactions are often complex, yet development agencies often rely on a few fundamental interventions to support such transactions.

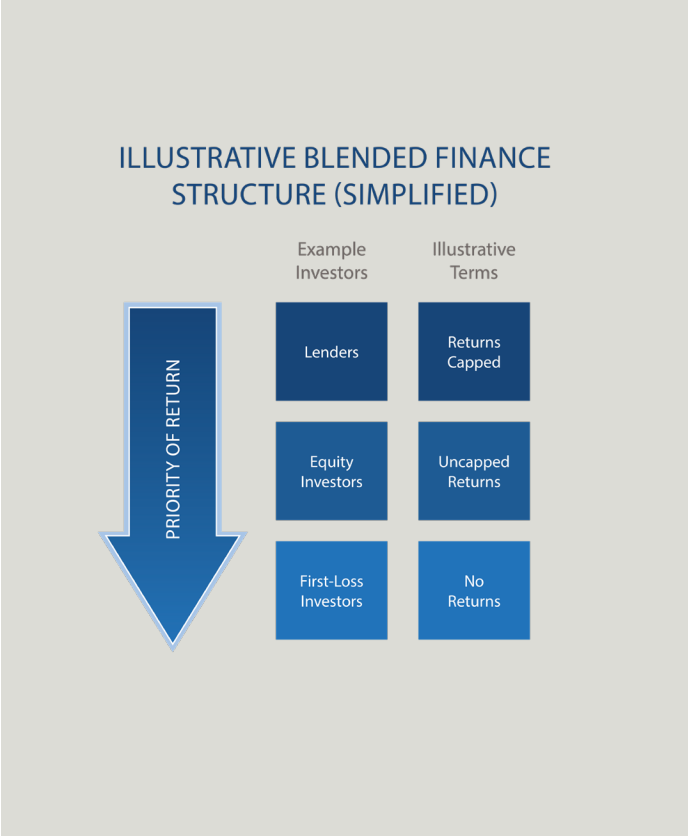
One intervention involves participating in the structuring of a deal. Structuring is the combining of different types of capital, risk mitigation, and incentives to attract investors and appropriately fund an investment. Capital structure in blended finance refers to the specific combination of debt, equity, or grant capital used to finance an investment.⁴

Debt and equity are the two main ways to raise money for an investment.⁵ By taking on debt, the borrower owes another party money, pays interest to borrow that money, and has a defined repayment schedule. By taking on equity investments, the investee is allowing an outside party to take partial ownership of the company. Lenders who issue debt are paid back before equity investors gain profits, so lenders take on less risk than equity investors. For this reason, equity investors expect a higher rate of return and more control over the investment. However, unlike debt, equity investments do not have to be paid back, which can be helpful if a firm encounters a period of declining earnings.⁶

Capital structure also includes the priority of investors and lenders in terms of absorbing losses and earning a return. For instance, although lenders receive payment before equity investors, even within the group of lenders, certain creditors will be paid back before others. Having the right percentage of each type of capital in the structure is vital to the success of a deal; repayments need to match to the investment's projected cash flow, and the cost of obtaining the funding needs to be less than the investment's overall profits.⁷



International development agencies can attract private investors to participate in a deal by injecting catalytic (aka concessional) capital into its structure. Concessional capital is a type of financing that has more favorable terms than those set by the market. For example, it may have low or no interest, grace periods for repayment, or long payback timelines.⁸ Development agencies can provide catalytic capital in the form of grant-like capital, for which there is no expected payback. By contributing a new layer of capital into the structure, development agencies can absorb lower returns or the first financial losses, thereby protecting the returns of private sector partners if the investment does not turn out as forecasted.⁹ Ultimately, the presence of catalytic capital helps de-risk investments and creates the appropriate risk/returns ratio required to crowd in private sector investors.



Blended finance interventions do not always require international development agencies to participate in the structuring of a deal. Instead, development agencies can use their resources to improve an investment’s risk-adjusted returns via other approaches, including the financing of technical assistance such as transaction advisory services and sidecar facilities. The lack of transaction advisors in emerging markets often creates barriers that prevent private capital from entering these markets. By covering the fees of transaction advisors, development agencies can incentivize investors to work on deals in emerging markets that they would otherwise avoid because these markets to be riskier and less profitable than developed markets. A technical assistance sidecar is a facility through which fund managers can provide portfolio companies with business advisory services, thereby decreasing the risk associated with investing in these companies.

Other blended finance approaches that development agencies use include:

- providing a guarantee to lenders in the case of losses,
- purchasing insurance against certain risks, or
- assisting in the development of a project so that its fruition appeals to private sector actors and simultaneously has social and environmental benefits.¹⁰

DEPLOYING BLENDED FINANCE TO ACHIEVE COMMERCIALLY ACCEPTABLE RISK-RETURN PROFILE

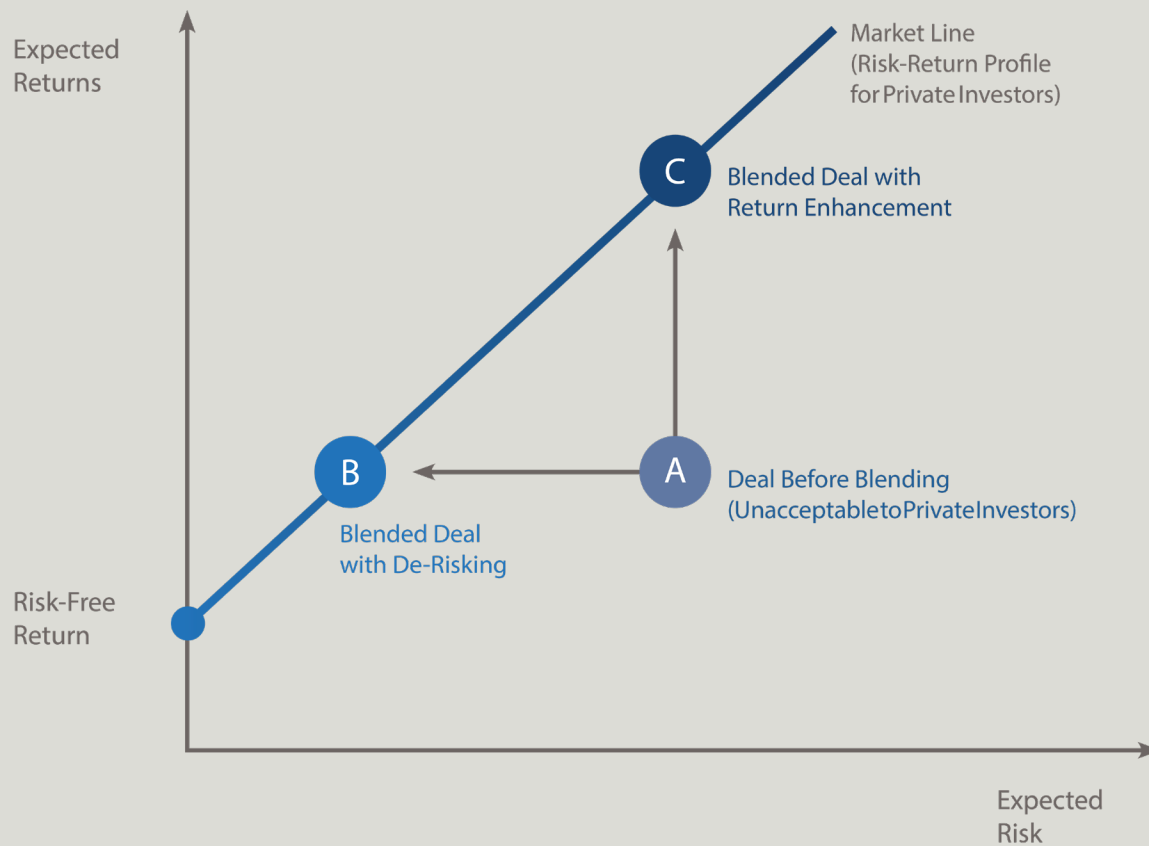


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4. WHO ARE THE KEY PLAYERS IN BLENDED FINANCE TRANSACTIONS?

Structuring blended finance transactions successfully may require the participation of many parties, including but not limited to interational development agencies and philanthropic organizations, private investors, development finance institutions (DFIs), multilateral development banks (MDBs), and intermediaries.

- **INTERNATIONAL DEVELOPMENT AGENCIES** are funded by governments. They support the economic, environmental, social, and political development of developing countries. In blended finance transactions, depending on the development agencies’ structure and authorities, they can provide catalytical capital, guarantees, and technical assistance—all of which helps crowd in private investors. They also bring valuable development expertise, knowledge of local context, and in-country networks. However, because international development agencies have traditionally deployed funding through grants, they generally lack the investment expertise necessary to structure financial transactions.¹¹ Examples of international development agencies include the United States Agency for International Development, the Danish International Development Agency, and European Commission’s Directorate-General for International Cooperation and Development.
- **PHILANTHROPIC ORGANIZATIONS** are nonprofit, nongovernmental organizations that use donations and income to fund and provide social services. Some philanthropic organizations, such as the Bill and Melinda Gates Foundation, the Shell Foundation, and the Rockefeller Foundation, use blended finance strategies in their programming.

- **PRIVATE INVESTORS** have significant pools of capital under their management. These investors include institutional investors, family offices, and high net worth network individuals. Institutional investors are organizations that make large investments on behalf of their members or clients. Each of the six segments of institutional investors—insurance companies, sovereign wealth funds, commercial banks, investment banks, private equity firms, and asset/wealth managers—has different mandates, constraints, and risk-adjusted return preferences that affect their ability and desire to partake in blended finance transactions.¹²
- **MDBs** are international financial institutions set up by two or more countries to provide financial assistance, traditionally in the form of loans and grants to other governments, to increase economic and social progress in developing countries. Examples of MDBs include the World Bank, the Interamerican Development Bank, and the Asian Development Bank.
- **DFIs** are usually majority-owned by one or multiple national governments. They support private sector growth in developing countries by providing capital for activities that would not be able to secure funding from commercial lenders. Examples of DFIs include the U.S. International Development Finance Corporation, the UK's CDC Group, Investment Fund for Developing Countries (IFU), European Investment Bank (EIB), and the German Investment Corporation (KfW DEG).

MDBs and DFIs have significant investment expertise and wide networks across developing countries. DFIs and the private sector arm of MDBs have development mandates, yet they lend exclusively to the private sector. As such, they sit at the intersection of concessional/catalytic and commercially-oriented capital, making them well-qualified to structure deals that achieve both financial returns and development results. Given this expertise, they often act as the intermediary in blended finance transactions.¹³

- **INTERMEDIARIES** facilitate transactions between those in need of capital (e.g., projects, funds, and companies) and those with capital (e.g., investors and lenders) for the benefit of both parties. There are two types of intermediaries: financial intermediaries and advisor intermediaries (transaction advisors).¹⁴

FINANCIAL INTERMEDIARIES are institutions or vehicles used to channel capital between a lender/investor and a borrower/investee. They include commercial banks, investment banks, private-equity funds, venture capital funds, microfinance institutions, insurance companies, and others.¹⁵

ADVISOR INTERMEDIARIES OR TRANSACTION ADVISORS help reduce transaction costs and information barriers via a network of in-house and external specialists.¹⁶ They bridge the gap between investor and investee, helping to structure and close deals between them. Their services include preparing financial, marketing, and legal documents, conducting due diligence, and more.

In blended finance transactions, transaction advisors often act as the “blenders of capital,”¹⁷ so they need to be able to work with a deal’s many different actors to accommodate their individual needs. They must structure investments that combine varying risk-return profiles while using methods that are replicable and scalable.

In private sector transactions, transaction advisors are compensated after the closure of a deal, at which time they receive a percentage of its value (the deal size) as payment. However, the increased risks and smaller deal sizes of developing markets deter transaction advisors who are compensated only by these means. In a blended finance transaction, development agencies can use their resources to cover all or part of the transaction advisory costs via a payment scheme that combines both a base and performance fee.

5. WHY ARE INTERNATIONAL DEVELOPMENT AGENCIES PURSUING BLENDED FINANCE STRATEGIES?

International development agencies like the United States Agency for International Development (USAID) aim to reduce poverty and inequity while improving health, education, and employment worldwide, without damaging the environment. Because they draw in private capital, blended finance tools ultimately allow international development-focused organizations to make progress towards their objectives, far beyond what they could achieve with their own limited budgets.

Engaging the private sector and deepening local financial markets are also integral aspects of helping developing nations progress on their Journey to Self-Reliance, defined as a country's capacity to plan, finance, and implement solutions to their development challenges. USAID recently reoriented its policy framework around assisting partner nations on this journey. In other words, it aims to use foreign assistance funding to help developing nations see their development solutions through effectively. By ensuring that these solutions are implemented inclusively and with accountability, USAID's work is playing an important role in closing the global development gap, thereby working towards a time where foreign aid is no longer necessary.

At the moment, however, the global development gap is still vast, estimated at trillions per year.¹⁸ Development agencies and philanthropic organizations do not have the resources to fill this funding gap on their own. After all, official development assistance from government aid worldwide is only about \$150 billion a year.¹⁹ Closing this gap thus requires mobilizing the world's largest financing pools: private capital.

Unfortunately, many developing countries have unattractive investment climates that negatively affect the appetite of banks, institutions, and individuals to lend to and invest in businesses and projects operating in their jurisdiction. Numerous barriers prevent capital flows into these markets, including:

- weak liquidity,
- high market volatility,
- exchange rate fluctuations,
- small size of individual investment opportunities, and
- potential investors' lack of familiarity.²⁰

Good blended finance transactions not only mitigate investment risks and align private capital with immediate development needs, but they also have a positive long-term impact on local financial ecosystems—an important stepping stone on a country's path to self-reliance. Blended finance projects are projected to generate revenue and/or to appreciate in value, enabling them to be sold to repay the investment. As a result of this pathway to commercial viability, development agency support is anticipated for a finite period of time, making blended finance investments more sustainable than those activities funded solely by public or philanthropic resources.

6. HOW DOES BLENDED FINANCE DIFFER FROM OTHER SUSTAINABLE INVESTING TRENDS?

Blended finance can be understood within the broader landscape of sustainable investing and benefit from its momentum. Sustainable investing began with negative screenings in which investors avoid investments that conflict with their values and worldview, e.g. avoiding investments in alcohol, tobacco, or firearms. The trend then progressed to environmental, social, and governance (ESG) integration in which investors consider the sustainability and ethical impact of an opportunity as part of its investment assessment. A third trend, impact investing, in which investors actively look for investment opportunities that create measurable positive social or environmental impact alongside financial returns, has grown rapidly in the last decade.

Blended finance is a structuring approach designed to allow different types of capital, whether impact-oriented or commercial, to invest alongside each other while achieving their own objectives.²¹ Government and philanthropic organizations can reach their social and environmental objectives, and private sector investors can make the financial returns they require. Although impact investors often participate in blended finance transactions, the structure makes it possible for investors to partake in a deal without having the intention of creating positive social or environmental results with their investments.²² The focus on achieving market-rate returns means that investors with fiduciary responsibilities—such as those managing pension funds or insurance companies—can consider participating in these transactions.²³ By making investment opportunities in emerging and frontier markets accessible and appealing, blended finance has the potential to attract private capital at the scale needed to solve the world’s development challenges.

BLENDED FINANCE COMPARED TO OTHER FORMS OF FUNDING

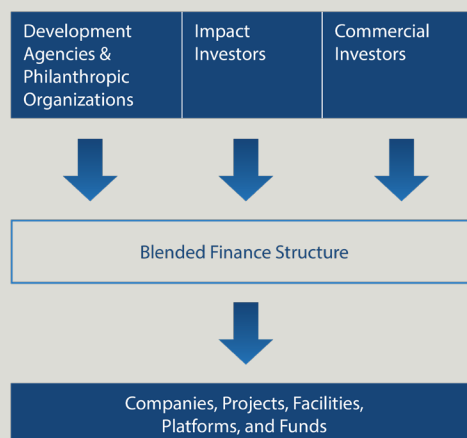
TYPICAL FORMS OF FUNDING

	Development Agencies & Philanthropic Organizations	Impact Investors	Commercial Investors
Returns	Prioritize social and environmental returns above financial returns and recouping capital	Prioritize a combination of social/ environmental results and financial returns. The trade-off between these results and returns depends on the individual investor.	Prioritize returns at or above market rate
Impact Targets	Intentional	Intentional	Unintentional
Investment Risk Appetite	Risk-tolerant to neutral	Neutral to risk-averse	Risk-averse
Key Actors	Development agencies, donors, NGOs, individuals	Impact investment firms	Banks, institutional investors



Companies, Projects, Facilities, Platforms, and Funds

BLENDED FINANCE



Blended finance approaches allow different types of investors—aid/philanthropic, impact-oriented, and commercial—to invest alongside each other while still achieving their individual objectives.

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7. WHEN SHOULD ORGANIZATIONS USE BLENDED FINANCE?

Blended finance can be used to address development challenges for which financing is a constraint and for investable activities that will produce enough cash flow over time to provide an investor with acceptable returns.²⁴ As such, it cannot be used to address all world’s development challenges. Nonetheless, approximately half of the funding needed to close the global development gap could come from private investment.²⁵

Blended finance can be deployed across the lifecycle of a project, from its preparation stages to ensuring its long-term commercial viability. The blended finance approach, such as the amount of catalytic capital or technical assistance provided, can be tailored for each stage.²⁶ For instance, in early stages, the financing might mostly come from donor-provided catalytic capital, and the technical assistance might revolve around foundational groundwork, such as conducting feasibility studies. However, by later stages, the financing might be comprised largely of commercial investment, with international development agencies providing a concessional guarantee.

EXAMPLE OF BLENDED FINANCE DEPLOYMENT OVER A PROJECT’S LIFECYCLE

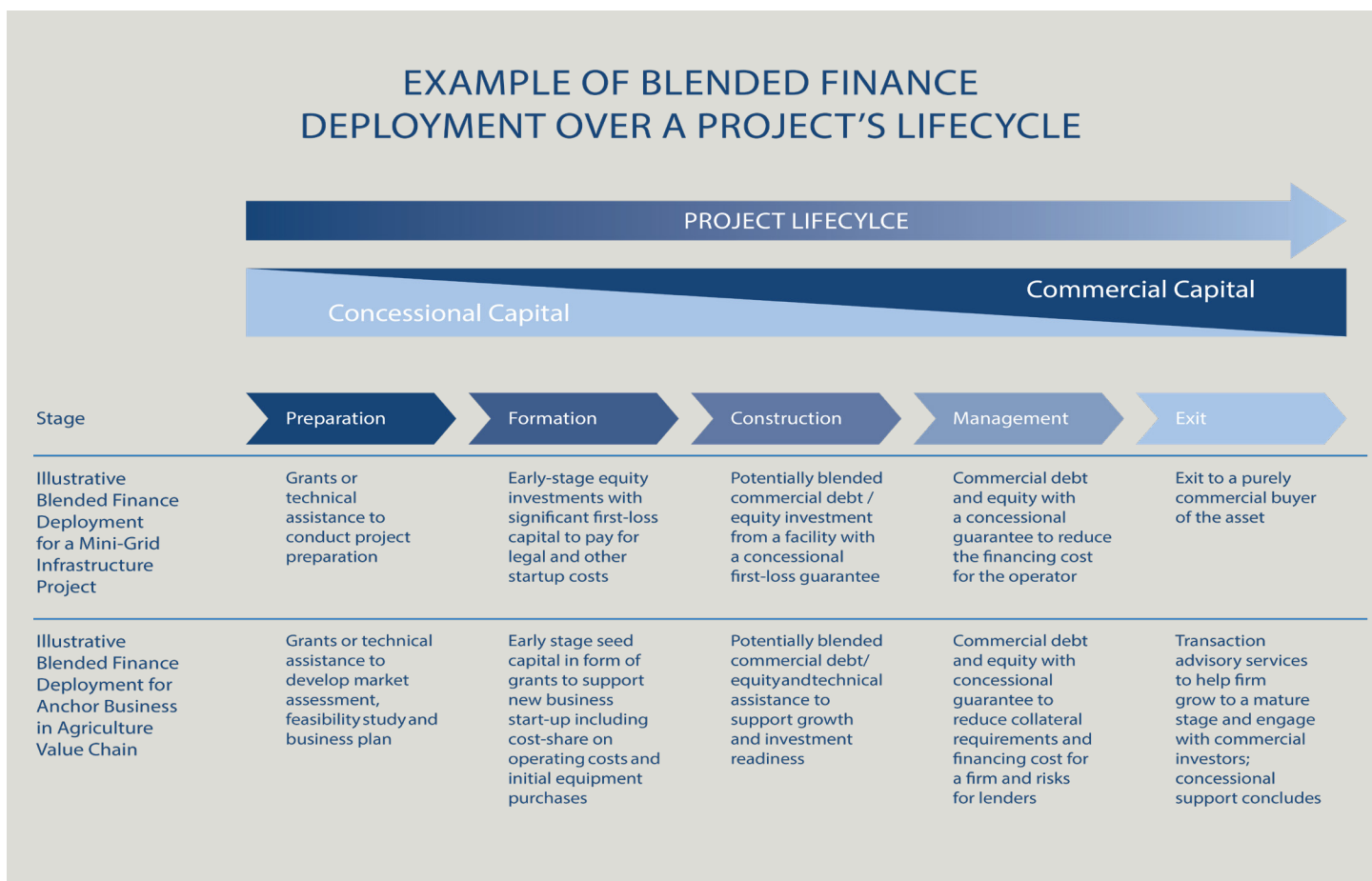


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8. WHAT CONDITIONS MAKE FOR SUCCESSFUL BLENDED FINANCE TRANSACTIONS?

All blended finance transactions should have three signature markings that demonstrate the alignment of private and development interests: additionality, impact, and returns.²⁷ *Additionality* offers proof that the blended finance intervention (catalytic capital, insurance, technical assistance, etc.) generated meaningful private sector participation that wouldn't have happened otherwise. *Impact* illustrates the ways in which the investee or investable project contributes to sustainable development in a developing country. Lastly, *returns* demonstrate that the transaction is expected to generate a profit, the size of which varies depending on the private sector investors involved and whether they are primarily seeking profits or impact.

Blended finance is best suited to situations where an investment clearly has a projected social or environmental impact as well as projected financial returns on investment, or to situations where it can address market failures, affordability constraints, or information deficiencies that have hindered private sector development. In such situations, risk mitigation measures, such as a development agency taking the first losses to protect private sector partners, can motivate commercial investors to come to the table.

While blended finance is designed to overcome market challenges, it cannot compensate entirely for the failures of a poor enabling environment. Projects in these environments may require long-term subsidies or major political changes to be successful. For example, if a country suffers from extreme corruption, political instability, weak legal systems, and unpredictable government decision-making processes, then private capital will not flow into the market at scale. Governments must address these issues, but blended finance projects can play a supporting role. While no amount of blended finance interventions can fully compensate for a weak enabling environment, blended finance projects can have demonstration effects that lead to policy changes, and they can strengthen local intermediaries, helping capital markets to function better. Blended finance approaches can therefore reinforce efforts to improve enabling environments, making such efforts more effective.

9. WHAT IS ADDITIONALITY?

Simply put, additionality refers to the evidence that an international development agency's intervention generated meaningful private sector participation that wouldn't have happened otherwise. International development agencies participate in blended finance deals to bring private capital into a transaction. Catalytic capital, guarantees, and technical assistance often result in the closing of a deal. If private capital would have entered the deal (at the same value and with the same conditions or time frame) without the development agency's involvement, then there is little to no additionality.

Additionality provides the rationale for pursuing blended finance strategies. Without proof that blended finance helps secure additional financing or improves a project's development results, international development agencies run the risk of wasting resources on transactions and projects that would have been equally successful without their involvement.²⁸ The worst-case scenario is that their resources "crowd out" private capital that would have come naturally into the transaction had the development agency not stepped in to fill an assumed void.

10. WHAT ARE THE CHALLENGES OF EVALUATING ADDITIONALITY?

Unfortunately, additionality is difficult to prove because blended finance transactions do not function like science experiments that carefully compare an intervention against a control group. No alternative transaction exists to quantify the amount of money that would have been raised without the intervention. Likewise, a project can't quantify how successful or unsuccessful it would have been had additional private capital not been mobilized.²⁹

Often international development agencies report leverage ratios—the amount of commercial financing mobilized by development capital—for blended finance transactions.³⁰ However, the blended finance ecosystem lacks a universal methodology for calculating leverage ratios, which makes comparing ratios from multiple sources difficult.³¹ The risk profiles of blended finance transactions differ depending on the particularities of the individual transaction. The sectors and markets in which specific transactions occur influence the relationship between development funding spent and private capital mobilized. Likewise, leverage ratios also change depending on the type of blended finance intervention used; for instance, the leverage ratios of a guarantee or technical assistance may be very different than those of a catalytic capital investment, even if used in the same sector or market. All these factors make comparing leverage ratios across different blended finance transactions challenging.³²

The relationship between leverage ratios and additionality is also a complicated one. At face-value, high leverage ratios seem positive because they show a significant amount of private capital spent per donor dollar. However, high leverage ratios can underscore that the blended finance intervention was not truly needed.³³ For instance, if a deal attracts a significant number of high-value, private sector investments, then it's possible that it would have attracted commercial investments without development agency participation. Blended finance transactions with lower mobilization can be shown to have high additionality because they reveal that a development agency influenced commercial investment in an area with significant risks but high social or environmental returns (e.g., investing in conflict-affected areas or least developed countries).³⁴ Thus, high leverage ratios may actually be at odds with additionality, signifying an unnecessary blended finance intervention rather than a successful one.

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