



# **Mobilizing Private Finance for Development: A Comprehensive Introduction**

January 2019

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*"The biggest benefit of finance, in my view, is to provide opportunities to people, in the sense that in a world where there is no finance, the only way to start a company is to be born rich or to have saved for a long time. In a world where finance works well, the people with talent can start firms and reach their dreams without waiting to either have saved the money, or be lucky and receive it from their parents. Once you create this opportunity, you will have the most talented people take advantage of those opportunities, which favors growth, which favors a good allocation of resources and, ultimately, innovation."<sup>1</sup>*

Luigi Zingales  
Professor of Finance  
University of Chicago's Booth School of Business

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<sup>1</sup> <https://www.theatlantic.com/business/archive/2015/02/does-finance-benefit-society/385176/>

# Introduction

## The power of mobilizing private finance for development

When peace was reached in Colombia, there was an urgent need to provide financing for farmers and rural businesses to support economic recovery in former conflict areas.<sup>2</sup> However, Colombian banks had not been present in many of these areas for years and were doubtful that they could lend to this unfamiliar client base prudently and profitably. In response, USAID and the Colombian government launched the Rural Finance Initiative (RFI), which supported the banks in reaching out to these clients through a combination of technical assistance, partial guarantees and results-based incentive grants. In the space of two years, the RFI helped to transform the livelihoods of more than 146,000 people in former conflict areas – generating over \$150 million (MM) in financing through 49,000 loans which have helped to kick-start economic recovery.<sup>3</sup>

This and numerous other successes are testimony to USAID’s ability to mobilize private (non-public) financing to support development. This allowed USAID to leverage our limited development dollars with vastly more abundant private dollars to accomplish more. Research by Deloitte and others shows that across the world, private enterprise is finding more and more ways of profitably serving the poor<sup>4</sup>. Engaging the power of *private enterprise* in development – supporting responsible spending of [Agency](#) resources for sustainable outcomes – is becoming an essential capability for development agencies.

## Purpose of this guide

This Guide is intended to serve as an overview for development professionals at USAID and elsewhere who wish to learn more about how to mobilize private capital and engage with private enterprise to accomplish development objectives. It has been written to accompany the “Mobilizing Financing for Development” course offered by USAID’s Office of Private Capital and [Microenterprise](#) (PCM) and Deloitte<sup>5</sup>, but can equally serve as a stand-alone introduction to this timely topic.

The Guide is organized into four chapters:

- **Chapter One** addresses the questions: “what is finance?”, and “why does finance matter for development?.” It introduces financial sector actors and instruments, and how they relate to the different financing needs of households, businesses, and governments.
- **Chapter Two** explores the constraints that impede finance and hinder [investment](#) in developing countries. It outlines a range of interventions which development agencies can use to mitigate these constraints.
- **Chapter Three** suggests an approach to deciding which interventions to undertake, and how to incorporate them into programming. It advocates for the use of ‘pay-for-results’ in programming, as well as new approaches to engaging non-traditional partners.

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<sup>2</sup> [https://www.usaid.gov/sites/default/files/documents/1862/RFI\\_FactSheet\\_030717.pdf](https://www.usaid.gov/sites/default/files/documents/1862/RFI_FactSheet_030717.pdf)

<sup>3</sup> <https://www.usaid.gov/news-information/fact-sheets/red-rural-finance-initiative>

<sup>4</sup> Reaching deep in low-income markets - Enterprises achieving impact, sustainability, and scale at the base of the pyramid: <https://www2.deloitte.com/us/en/pages/operations/articles/economic-sustainability-low-income-markets.html>

<sup>5</sup> As used in this document, “Deloitte” means Deloitte Consulting LLP, a subsidiary of Deloitte LLP

- **Chapter Four** provides a deeper dive into the field of finance. It provides a guide to understanding the main financial accounting statements, and an overview of key finance concepts. A compendium of key finance terms is also provided in the appendix. If nothing else, after reading this chapter you will be able to impress your friends by talking about “*weighted average cost of capital*” and “*time value of money!*”

Upon completion, the reader should:

- Understand how development agencies are shifting their focus from acting as development funders toward becoming “investment catalysts”
- Have a basic understanding of what finance and **financial markets** are and how they work
- Understand why access to finance in developing countries such as USAID presence<sup>6</sup> countries is often a challenge, the constraints which impede financing, and different ways in which USAID and other development actors can mitigate or offset these constraints
- Have a basic understanding of how to determine which interventions are most appropriate, and have sufficient understanding of the financial context of economic development and the related finance concepts to be able to plan projects and engage with experts and stakeholders.

*Project vignette:* In Jordan, USAID found that promising small and medium enterprises (SMEs) were stymied – unable to get the financing they needed to continue their rapid growth. Thus, USAID’s Growth Readiness Program supported these enterprises with business planning and management coaching services, and facilitated visits with investors and financial institutions. The result was that six of the firms were able to raise a combined \$17.6MM in debt and equity financing to fund their growth. A similar USAID program with Open Capital Advisors in east Africa was able to leverage \$634,000 of USAID investment into \$3.75 MM of early stage investment in start-up businesses that would likely have been overlooked by traditional or foreign direct investments.<sup>6</sup>

This **Guide** and the **Mobilizing Finance for Development** course is intended to help development practitioners transition from the traditional model of *funding* development (through grants and contracts), to a new model of engaging with private enterprise and leveraging private capital to conquer development challenges.

The focus is on facilitating the *financing* needed for private enterprise-led development – from both a systemic perspective (easing access to finance broadly) and from a transactional perspective (catalyzing specific transactions). It is premised on the fact that the world today (including developing countries) is awash in capital looking for attractive investment – at levels which dwarf Official Development Assistance (ODA).<sup>8</sup> As such, development agencies should consider shifting their focus from being a funder to being a facilitator – helping to unlock market forces and to transform that abundant private capital into investments that can advance development.

The **Mobilizing Finance for Development** ethos suggests a different approach to leveraging private capital in three ways.

<sup>6</sup> See “Resources” appendix for internet address of current list of USAID presence countries

<sup>7</sup> USAID PCM project experience, published in USAID publication “Finance Vignette Handbook, A Financing Growth Training”

<sup>8</sup> <https://www.csis.org/analysis/rethinking-private-capital-development>

**First**, it engages with a new set of 'partners': commercial enterprises and finance providers such as banks and [investors](#) that place a high value on profit. This can be challenging for some development practitioners - the notion that businesses may profit from taxpayer-funded ODA resources can be disconcerting. However, there are ways to align interest by layering social and development outcomes alongside commercial (profit) objectives in a manner that could lower the cost of achieving those outcomes.

**Second**, it encourages the direct use of ODA funds to catalyze private capital for transactions important to our development objectives. Many development agencies have been hesitant to directly subsidize transactions. Indirect tools such as USAID's Global Development Alliances and Development Credit Authority have been highly effective in leveraging private sector funding. More direct and explicit approaches to catalyzing finance have shown success and may accomplish similar results at a lower cost.

**Third**, it promotes taking a comprehensive approach to mobilizing capital - addressing transactional challenges (*how to get the specific deal done*), and also systemic challenges (*how to make it easier for all other deals to get done*).

For development practitioners this may be an exciting, although daunting, new paradigm for development. It requires leaving our comfort zone, relying less on traditional implementing partners, and taking more calculated risks. It requires getting more comfortable with private enterprise, and developing new strategies for aligning commercial objectives with development objectives. Since it entails using development agencies' public funds to catalyze private funds, it imposes new challenges in project design and funding. Some examples include ensuring that development funding achieves additionality (i.e., supporting transactions which might otherwise not happen), that leverage is maximized (minimal ODA funds are used), and that markets are not distorted.

Daunting indeed...but what a mighty impact if we can get this new model right!

*Project vignette:* In Haiti, there is an urgent need for affordable housing. Developers have been reluctant to build low-cost housing units because very few Haitian households have sufficient savings to cover the purchase price. Additionally, Haitian banks and credit unions have been reluctant to provide housing loans to these households due to their lower income. USAID's Haiti HOME project is demonstrating that construction of affordable housing can be profitable and that lending to moderate income Haitian households can be both profitable and prudent. A key element in HOME is the use of incentive-based "blended capital" to leverage private capital through buying-down risk. In two years HOME has generated \$5.8 MM in private capital to support affordable housing, an eightfold multiple of USAID's incentive payments of \$694,000.<sup>9</sup>

<sup>9</sup> USAID PCM project experience and authors' experience

## Chapter One:

# What is 'finance' and why does it matter in development?

## Introduction

In this chapter we address the questions “what is finance?” and “why does finance matter for development?” We introduce the main categories of financial sector actors and instruments, and relate them to the different financing needs of households, businesses, and governments.

“Now, the third and final revolution I’d like to describe this morning is... the **burgeoning new relationship between private enterprise and the development community**. Leaders in both sectors are finally realizing, finally figuring out how to take advantage of the unique capabilities that each have and apply them to challenges that neither could fully take on alone - problems that once seemed insurmountable.

**It’s hard to overstate how big a shift this is for the development community**. For years, whether we realized it or not, USAID and others saw donors and governments as the most important, if not the only, drivers of progress in the developing world. Private enterprise was something to keep at a distance, or perhaps try to bend to our will. We welcomed donations from private enterprise, and we were even willing to contract with private business to obtain goods and services.

Today, all that’s changing. We’re trying to move beyond contracting and grant-making to collaborating, co-financing, co-designing programs, tools, initiatives. **Today, we’re recognizing that agencies like USAID don’t need to be the sole actors in the development space** when we can more effectively serve as catalytic actors in that space.”

**USAID Administrator Mark Green’s Remarks at U.S. Chamber of Commerce, November 14, 2017**

## Why mobilize private capital for development?<sup>10</sup>


It may be difficult to see how development objectives and the profit goals of private enterprise can align.

In his remarks to the Chamber of Commerce in November 2017<sup>11</sup>, USAID Administrator Green gave a clear but cogent answer: **because the world is changing**. Business leaders increasingly appreciate the value of development, and in turn development agencies such as USAID have come to understand the contributions which private enterprise brings to our development efforts.

<sup>10</sup>In this Guide, the term ‘private capital financing’ is used broadly to mean all non-public financing and includes both debt and equity.

<sup>11</sup> <https://www.usaid.gov/news-information/press-releases/nov-14-2017-usaid-administrator-mark-greens-remarks-us-chamber-commerce>


USAID and other ODA agencies should consider focusing on mobilizing private capital because:



**The global context is right:** The time is right for this shift. As Figure 1 shows, while Official Development Assistance (ODA) has been flat in recent decades<sup>12</sup>, foreign direct investment has continued to grow. But even more remarkable is the growth in local (domestic) capital within emerging market countries. Private capital is abundantly available and seeking investment in USAID presence countries and other developing economies. Thus, development agencies can play a critical role in facilitating that investment.




**Efficiency and better outcomes:** Perhaps among the best reasons to mobilize private capital is that it brings with it the private enterprises which own or manage that capital. Engaging private enterprise in investment decisions can lead to better and more sustainable investment outcomes in which development dollars can have higher long term impact.



**There is a need:** Engaging private capital is necessary to meet development objectives as ODA alone may not be sufficient.

- In Health, there is a need for investment in clinic, pharmacies, modern equipment and hospitals
- In Agriculture, farmers need investments in tractors, irrigation pipes and agricultural processors
- In Water, Sanitation, and Hygiene (WASH) there is a need for investment in last mile piping and water treatment plants.

Altogether, meeting the Sustainable Development Goals is estimated to cost \$4 trillion annually. Current ODA funding is only \$1.4 trillion annually, leaving a \$2.6 trillion gap that private capital can help to close<sup>13</sup>.



**This is an Agency priority:** Leadership of development agencies globally, including the USAID Administrator, have made a strong case for enterprise-led development, stating that the ultimate goal of development should be creating the conditions in which countries can stand on their own and meet their needs in health, education, etc. without reliance on foreign assistance. Engaging private sector capital, both international and domestic, can help advance countries on the path to self-reliance.

There is a clear correlation between the robustness of a country's financial system and its sustained economic growth<sup>14</sup>. This is because:

- Access to finance is critical to enterprise growth
- Financial markets perform the critical function of allocating funds for investment.

Simply put – economic growth results from productivity improvement, and productivity improvement requires investment in areas such as technology, equipment, and education. However, because the payoff from those investments is not immediate, they require financing in forms such as a business loan, borrowing from family and friends, or perhaps a [municipal bond](#).

In a perfect world, financing for such investment would be readily available on affordable terms and conditions. In developing countries, constraints in the financial sector can mean that this is often not the case. Consequently, investments that could have real benefits in areas such as agricultural productivity or improved health outcomes may not happen.

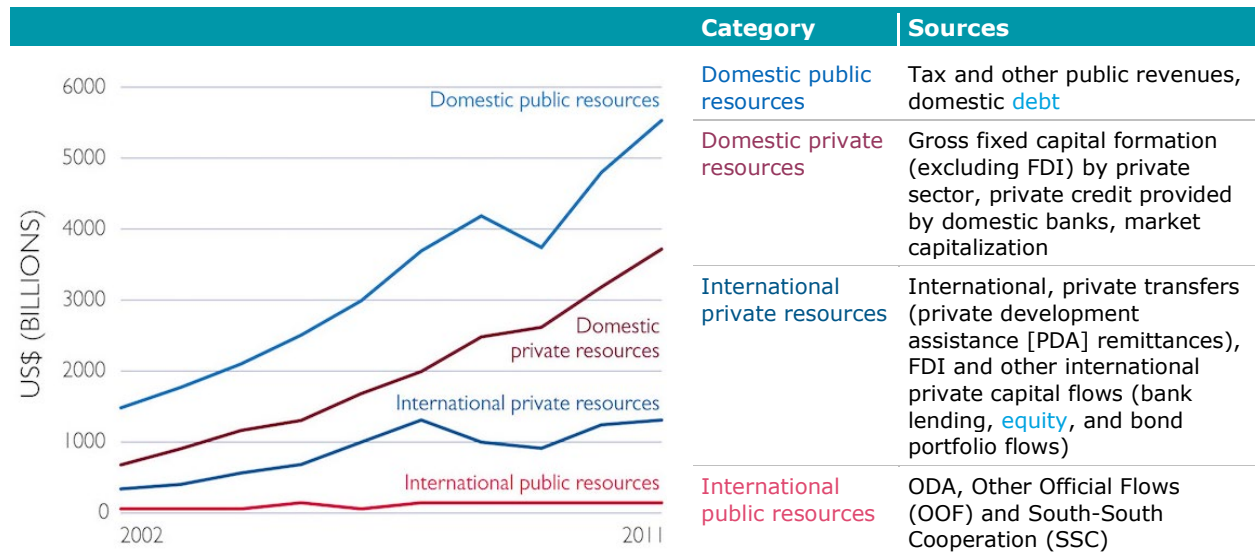
<sup>12</sup> Authors' observations, from project experience

<sup>13</sup> <https://www.greenbiz.com/article/why-mobilizing-private-capital-towards-sdgs-good-business>

<sup>14</sup> Finance, Financial Sector Policies, and Long-Run Growth, The World Bank, Policy Research Working Paper 4469, Asli Demircuc-Kunt, Ross Levine



**Figure 1: Trends in international and domestic development finance, developing countries, 2002 – 2011<sup>15</sup>**



### Teo’s Tractors – Meet Teo and Mary



Throughout this text, key principles will be illustrated by the story of Teo, a fictitious, illustrative entrepreneur in Ghana starting a tractor rental and servicing business. Teo’s start-up is similar to that of Mary, the founder of a tractor rental and servicing business in Illinois, USA. However, Teo faces challenges in securing financing requirements in his country that Mary does not face. This is a common issue in development, despite the important need Teo’s business would fulfill in his community.

Although Teo’s business is expected to produce strong operating income, he finds it difficult to get the financing needed to launch the business because interest rates are so high in Ghana. Thus, there are challenges in reaping the development benefits this tractor service would support both directly and indirectly.

#### The journey starts here!

This Guide will use the example of Teo and Mary’s fictional companies to: Illustrate finance concepts; Demonstrate the importance of catalyzing finance for development; and Consider how development agencies like USAID can facilitate financing for enterprises such as Teo’s Tractors.

You may find it useful to review the explanation of financial statements in Chapter 4 in parallel with each “visit” to Teo and Mary.

<sup>15</sup> <https://www.usaid.gov/sites/default/files/documents/1864/investing-for-impact-aug2017-508.pdf>

## What is “Finance?”

*There are many accepted definitions of “finance”; for the purpose of this Guide, the authors define finance as the remarkable process through which savings are bundled and allocated as capital for productive investment within the economy*

Finance is the process which gathers and pools unused or idle funds such as savings and retirement fund contributions, and then allocates those funds (the pooled funds within the financial system is often referred to as “capital”) to productive investment.

### Who Performs These Functions?

Financial intermediaries (e.g. banks, mutual funds) perform this function. They are in the business of assembling or tapping into pools of capital and of providing that capital to finance seekers as loans or equity investments.<sup>16</sup> They expect to make a profit from performing this role, and thus look to receive an income, known as a “return.”

### What is a Return?

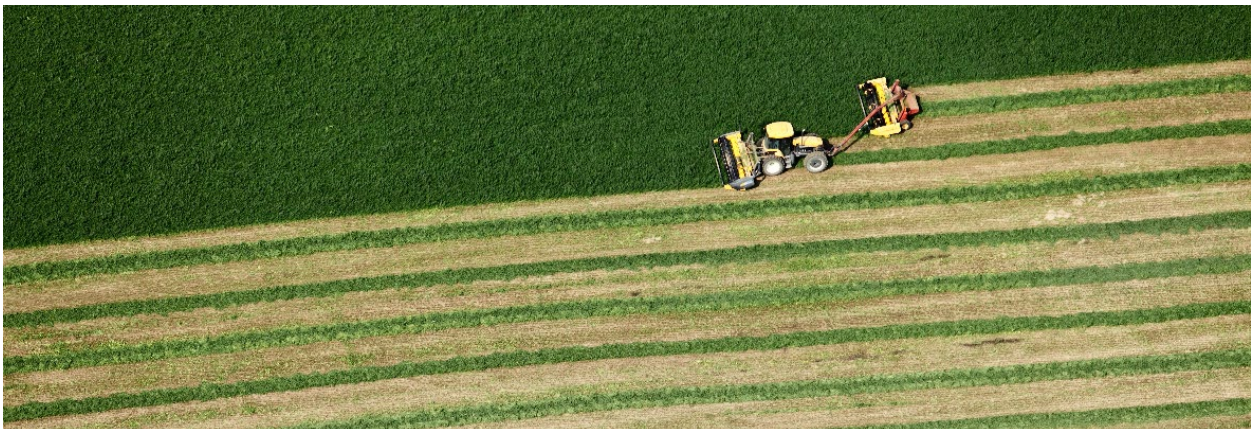
The income received by the finance provider needs to be higher than the cost incurred for the funds they provide, thus rewarding the service they provide with a profit or “return.”

For banks, that return comes from the loan “spread”, or the difference between the **cost of funds** and interest rate charged, as well as any fees charges. For equity investors such as mutual funds, the return comes in the form of dividends and an expected increase in the value of the investment.

Successful finance providers must be skilled at the art of assessing risk and the probability that the proposed loan or equity investment will succeed. In other words, that the loan will pay interest and repay debt, or the equity will produce a positive return.

### Why are Financial Intermediaries Important?

Financial Intermediaries play a vital gatekeeper role in the market economy - ensuring that capital is only channeled to transactions<sup>17</sup> which are likely to be successful.



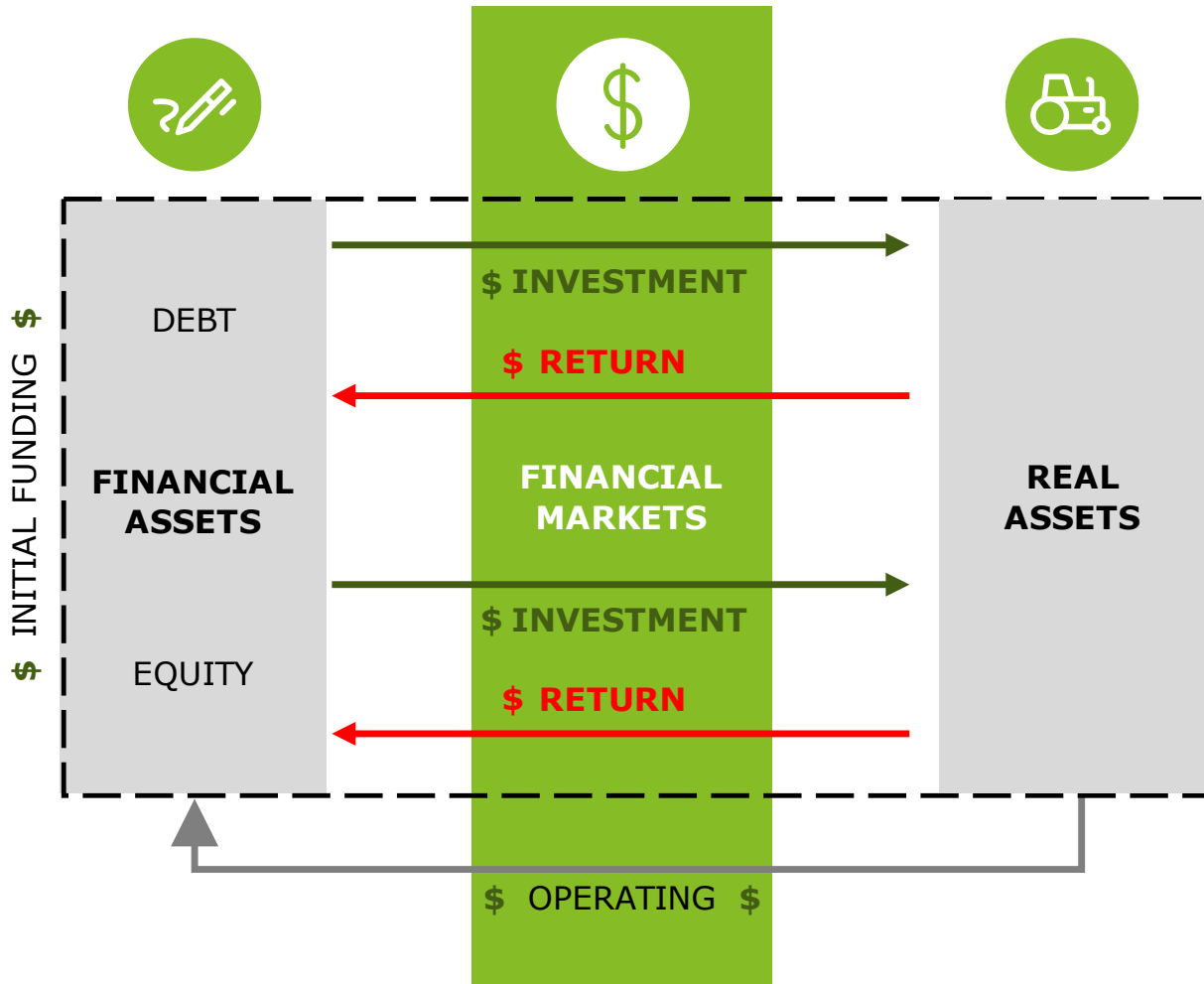
<sup>16</sup> For the purpose of this document, the authors define equity as a form of investment in which investors become partial owners of a business and therefore does not have repayment requirement in the way a loan does

<sup>17</sup> The term “transaction” is used herein as shorthand for proposed or actual provision of financing whether debt or equity

### Financial Assets and Real Assets

In **Figure 2**, we see the role of the financial markets in transforming financial assets into real assets. They do this through the processes described above - **Pooling** unused funds and allocating them to investments in real assets that are expected to offer a suitable return. This is further described in the Teo's Tractors box on the next page.

**Figure 2: Financial Assets and Real Assets<sup>18</sup>**



<sup>18</sup> Graphic developed and owned by USAID PCM

## Teo's Tractors – A Role in Transforming Financial Assets into Real Assets?



In the case of Teo, financial assets would be used to buy a tractor. Teo would seek funding to purchase the tractor - in this case, a loan through the financial capital markets.

Financial intermediaries assess the likelihood that the Teo's investment in the tractor will be successful (i.e., produce positive operating income sufficient to cover the debt costs, which is the interest costs on top of the debt repayment). If they believe it will, they may provide financing for that tractor, thereby converting a "financial asset" into a "real asset."

As Teo receives payments from his customers for the use of the tractor, income will be generated, which will be used to pay interest on the loan and pay off the debt, as well as potentially returning a profit to Teo.

These funds, once they are larger than the original cost of the tractor, will then "re-flow" to financial assets which can be "re-loaned" or reinvested in other real assets.

This virtuous circle creates capital and builds wealth through the accumulation of profits for Teo's and for the lender, which in turn can:

- Drive economic growth
- Create jobs
- Improve the lives of citizens.

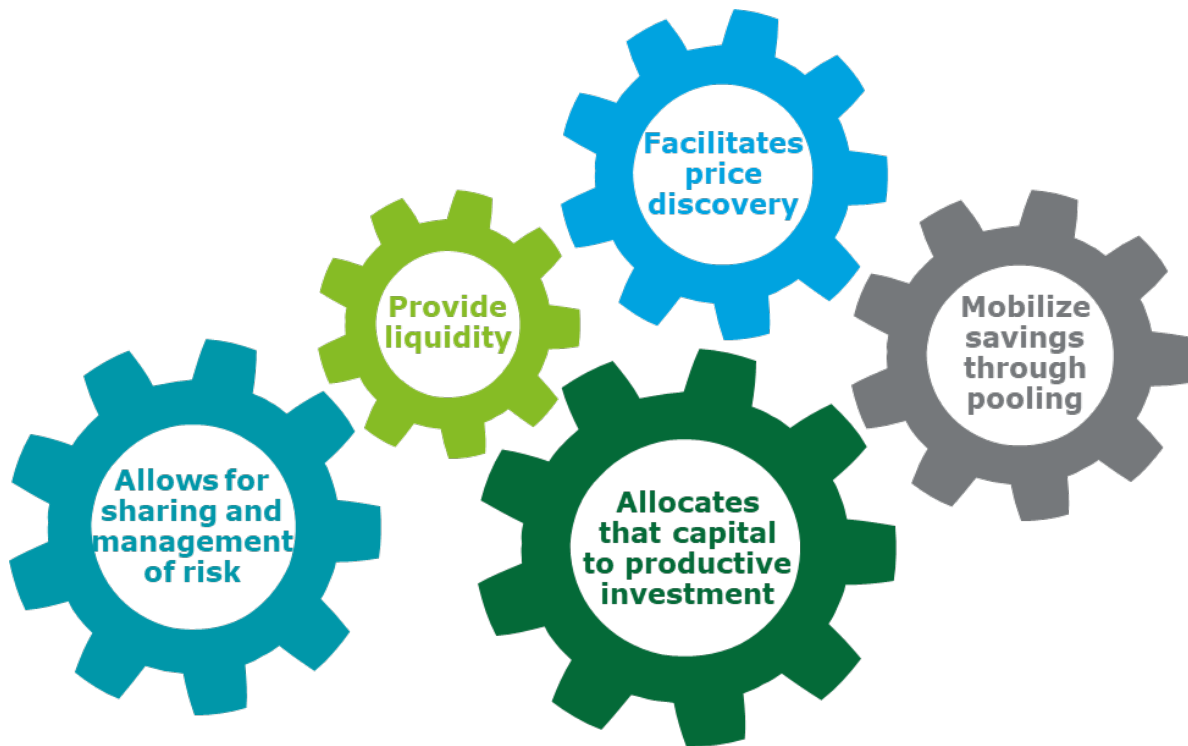
Teo should only purchase the tractor if he expects a positive financial return above and beyond the cost. A finance provider will only lend to Teo if they expect to gain a financial return on top of the initial capital.

As the cycle repeats, a financial asset is used to purchase another real asset, the real asset produces income, that income is used to repay the debt plus interest, thus converting it back to a financial asset and generating wealth and economic growth.

### What Other Benefits Does the Finance Sector Provide?

A well-functioning, sophisticated financial marketplace also provides a range of other benefits to the economy.

Figure 3: The Well-Functioning Financial Marketplace<sup>19</sup>



Beyond pooling savings into capital and allocating that as investment, it:

- **Provides liquidity** (the ability to rapidly access **cash**). Many businesses have seasonal changes in their cash needs. *For example, toy stores increase **inventory** ahead of Christmas. The ability to access financing when needed means that they can borrow the money they need for Christmas inventory rather than maintaining a high level of cash all year long.* Liquidity also provides investors confidence that they can sell their financial asset for cash if needed or desired.
- **Facilitates price discovery** (the act of determining the proper price of a security, commodity, or good or service through the competitive market forces of supply and demand). This allows prices to efficiently signal the most productive use of financial resources
- **Allows for the sharing and management of risk** via the diversification of investments and by matching the risk appetite of individual investors to the risk profile of different investments. In the Teo's example, finance providers diversify their risk by providing loans to other clients in addition to Teo.

Finance and the financial markets play a critical role in the market economy by allocating capital to productive investment, creating a virtuous circle of wealth which drives economic growth.

<sup>19</sup> Graphic developed by Deloitte for USAID PCM

## What are the key financial instruments?

When capital is deployed, it is done so through “financial instruments.” Financial instruments are monetary contracts between parties involved in a financial transaction. As financial markets have evolved, financial instruments have also evolved. Broadly speaking, they fall into two groups: **equity** and **debt**.

### Equity

The term ‘equity’ has several different meanings, and for purposes of this *Mobilizing Finance for Development* Guide, **equity means ownership of an entire or part of a business**. This can range from ownership of a stall in the market, to owning shares of stock in a company. When investors purchase equity, they pay funds to the previous business owners, who are thus able to invest those funds in real assets as described in “What is Finance?” above.

### What do businesses like about equity?<sup>20</sup>

**It is “Patient” Capital:** Unlike debt, which requires repayment on a periodic basis and usually is not granted for more than 2-3 years, equity is “patient capital.” It is there for the “long haul.”

A new business just starting up may take several years to become established and profitable. In this case, debt, with its shorter-term repayment requirement, may not work because cashflow may not be sufficient or stable enough to ensure the ability to repay. Debt providers (i.e., lenders) tend to require a proven track record from their borrowers.

**It is Friendly to Growth:** Even if they are profitable, rapidly growing enterprises may not produce enough profit (or more importantly, ‘cash flow’<sup>21</sup>) to finance all the capital expenditures (e.g., purchase of additional equipment such as manufacturing machinery) needed to grow.

Some of this growth investment may be funded with debt, but at some point, they could ‘max out’ on debt if cashflows are insufficient to adequately cover expected interest payments and/or the ratio of debt to equity becomes too high and the bank refuses to grant more credit.



<sup>20</sup> <https://www.investopedia.com/terms/e/equity.asp>

<sup>21</sup> See Chapter 4 for an explanation of profit and cash flow.

**It Gives Access to Expertise and Shared Interest:** With ownership comes an interest in ensuring that the business does as well as it can. Equity investors can often bring valuable expertise, networks, and partners to the businesses they invest in. This is especially true of early stage equity providers such as **venture capitalists** and **angel investors**<sup>22</sup> who often have direct experience launching a successful business.

### What don't business like about equity<sup>23</sup>?

**There is a Higher Expected Return:** Equity is much more expensive than debt due to the higher risk associated with equity. The risk to equity holders is higher because in the event of bankruptcy, they are the last to be repaid after all other creditors. An equity investor expects a significantly high rate of return, in the form of increased value of the firm's shares due to the firm's strong performance, or periodic dividend payments to equity holders.

**Businesses must give up ownership control:** An equity investor is a part owner and may want a large share of the enterprise in return for the investment. Business owners are often reluctant to give up part of business they have built and/or let others have a say in how they run it.

### What are the concerns of those providing equity – what do investors want?<sup>24</sup>

**Limited Liability:** An equity investor is betting on the success of an enterprise and typically wants the management of that enterprise to aggressively grow and pursue success. However, if the business fails, an equity investor does not want to be liable in any way. They want the ability to walk away from the venture with their losses limited to the amount of money they invested, and with no liability to meet other potential unpaid bills of the failed business.

**High Growth:** Equity holders are paid only after all other claims on the business, such as staff salaries, and debt are paid. Typically, equity investors are tolerant of risk and willing to 'reach for the stars' in hopes of the company they invest in becoming the "next big thing." Therefore, downside liability is limited to the amount of their investment, but their upside benefit is virtually unlimited.

**Ability to Exit:** Unlike debt, an enterprise is under no obligation to repay its shareholder for their equity investment. Therefore, shareholders want to be able to 'exit' an enterprise at some point, either by selling their shares back to the company or to another buyer.

## Debt

Debt is basically raising money through a loan<sup>25</sup>. Virtually every business has more debt than equity.<sup>26</sup>

### What do businesses like about debt?

**Debt is Cheaper:** First and foremost, debt is cheaper than equity. Debt holders are paid first and usually get collateral. They are at less risk than the equity holders, who only get their money back at some unspecified time if the firm is successful. Because risk to the lender is lower, the cost of debt financing is lower than the cost of equity.

**Debt does not Cede Ownership Control:** Unlike equity, debt holders do not own any part of the business and thus have little say in the operation (other than any specific commitments called **covenants**, which are agreed upon within the loan).

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<sup>22</sup> See appendix Glossary for definitions of venture capital and angel investing

<sup>23</sup> The two following sections are statements of experience/opinion by the authors

<sup>24</sup> <https://www.elon.edu/e/CmsFile/GetFile?FileID=952>

<sup>25</sup> See Chapter 4 for detailed explanation of debt

<sup>26</sup> <http://www.business-literacy.com/financial-concepts/debt-to-equity-ratio/>

**Debt is Tax Deductible:** Interest payments on Debt are typically tax deductible.<sup>27</sup> This can reduce the effective cost of debt to the borrower.

### What don't businesses like about debt?

**Collateral and Covenants:** Banks usually require collateral to secure their loans, and loan agreements generally provide restrictions (covenants) about what the business can and cannot do.

**It is Not "Patient" Capital:** Debt usually requires regular interest and principal repayments. The event of a **default** in those payments, regardless of the reason, may allow a bank to seize its collateral and essentially shut down the business.

### What are the concerns of those who provide debt – what do banks and other debt providers want?

**Low Risk:** Debt providers don't want defaults. They want predictable and regular payments, which means they don't like surprises. Accordingly, they prefer to lend to entities with established track records of strong operating performance and debt repayment.

They also want collateral as a secondary source of repayment. They tend to be less enthusiastic about lending to smaller, newer businesses, those unable to provide collateral, or those with less formal financial systems and records.

**Minimal Leverage:** The term 'leverage' is explained more fully in Chapter 4. In finance, the term refers to the ratio of debt to equity. Since debt is repaid before equity, a larger amount of equity in relation to debt (or the lower the debt-to-equity ratio) corresponds to a bigger "cushion" of resources in the firm to protect the lender if there is a problem.

**Relatively Short-Term Commitment:** Banks, credit unions, and some microfinance institutions (MFIs) raise much of their funds through deposits and short-term loans from other banks. Thus, they prefer to keep the loans they grant to borrowers shorter-term, so as not to create a mismatch by making longer term loans with shorter term funds.

Within these two broad categories of **Equity** and **Debt** financing, there is a wide landscape of financial instruments (as well as hybrids of both debt and equity.) Each specific type of debt or equity is designed to meet a variety of financing needs and intended to meet the differing objectives of finance providers (who as we will see later have different appetites for risk, duration/tenor, and transaction size). The topic of combining and blending different types of finance is called "**blended finance.**"



<sup>27</sup> <https://www.investopedia.com/terms/t/tax-deductible-interest.asp>



## What is the financial marketplace and who are the actors?

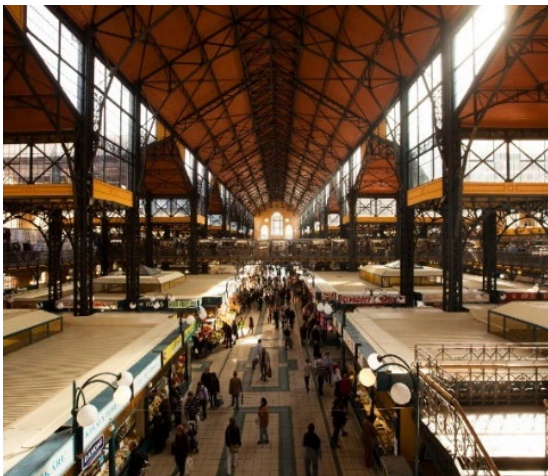
### The breadth of financial services:

We are all familiar with markets in which we buy and sell physical goods. The financial marketplace is much the same, except that instead of physical goods, it is a marketplace in which financial instruments such as stocks, bonds and loans are issued, sold and traded.

A financial asset is a non-physical asset whose value is derived from a contractual claim, such as bank deposits, loans, and stocks. A financial liability is a contractual agreement to deliver cash or financial assets to an entity at a future date.

The global financial marketplace is a vast interconnected web of financial institutions, markets and economic actors (both international and domestic) which facilitate the financial flows that drive economic growth and trade through essentially the same process described under “What is Finance?” above – only at a far greater scale. Total global financial assets were around \$300 trillion in 2015<sup>28</sup>.

**Figure 4: The markets for goods and those for financial services have many similarities**



Fundamentally, financial marketplaces enable a broad range of financial transactions including serving households, businesses, and governments.

- **Individual and household funding** needs may range from a \$200 loan to pay the electricity bill, to a \$20,000 student loan, to a \$300,000 30-year mortgage to buy a home.
- **Businesses** may use financing for short-term purposes to fund **working capital** and inventory, as well as for long-term purposes such as building new plants and procuring equipment.
- **Governments** may use financing to build roads and schools, often through issuing bonds in the financial marketplace.

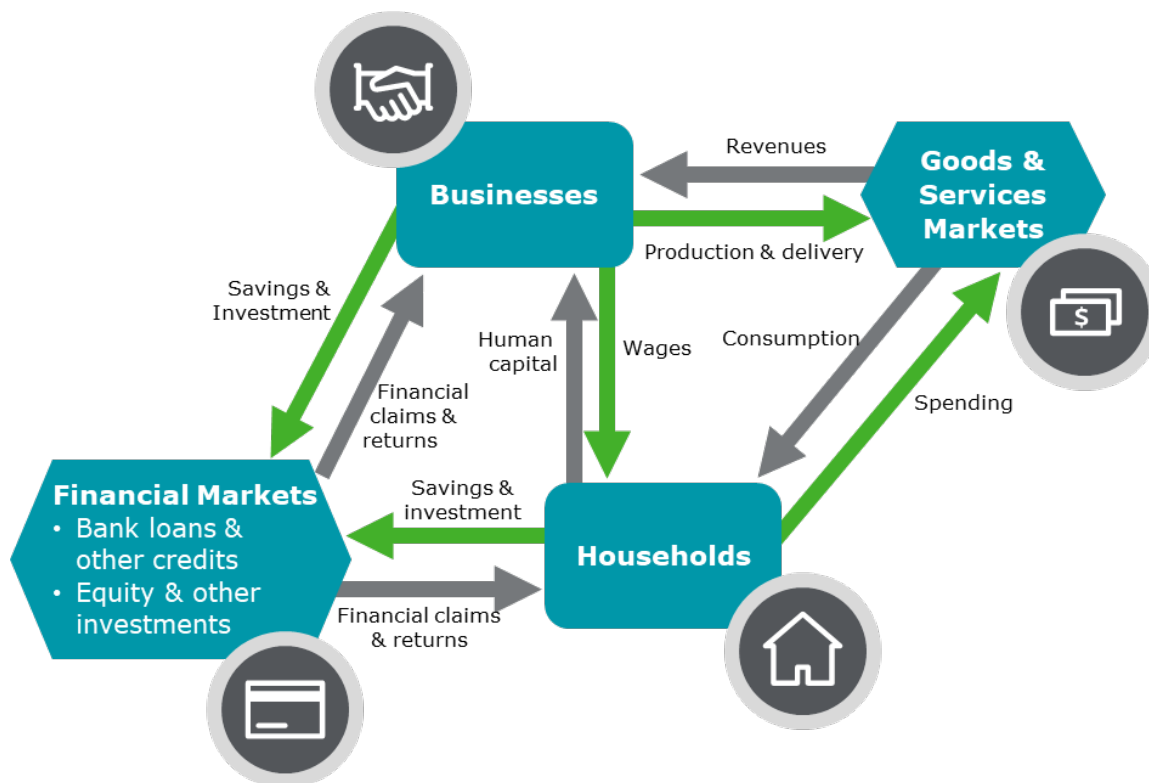
Furthermore, households, businesses and governments can all be simultaneous *finance users* (borrowers or investees) and *finance providers* (lenders or investors). A household can provide financing via its contributions to a retirement savings account while using financing when taking out a car loan.

<sup>28</sup> <https://medium.com/design-matters-4/the-worlds-money-in-numbers-d04e6f345a06>

The flow of finance is dynamic and continuous. We exchange our human capital and labor for financial capital (wages) and use those wages for consumption of goods and services produced by businesses, and for savings. Businesses use the revenues from household consumption for capital investment, to pay wages to employees, and to pay returns to finance providers on debt borrowed and equity investment. Finance providers then redeploy those funds as loans or equity investment.

Through this continuous flow of finance, wealth (i.e. economic development) is continually created. As funds are borrowed, invested, or spent, the expected benefit from the purchase or investment of funds will typically exceed the cost of those funds. Thus, a virtuous circle of value and wealth creation which supports economic development (see Figure 5).

**Figure 5: Virtuous Circle of Finance**<sup>29</sup>



## The origins of the financial sector

The origins of finance date back through the millennia, with pictographic tablets recording transactions dating back to 3000 BC.<sup>30</sup> Lending emerged at least 2,000 years ago, appearing in ancient Greece, China and India. Early banks and banking systems emerged in medieval and Renaissance Italy, with the oldest continually operating bank dating back to 1472.<sup>31</sup>

Over time, the finance sector has continued to formalize and evolve. Today, particularly in developed economies, there is a wide array of financing providers offering a diverse set of financial services and instruments.

<sup>29</sup> Graphic developed for and owned by USAID PCM

<sup>30</sup> <https://www.armstrongeconomics.com/research/a-brief-history-of-world-credit-interest-rates/3000-b-c-500-a-d-the-ancient-economy/>

<sup>31</sup> <http://www.oldest.org/structures/banks/>

## The lifecycle of a business’ financing needs

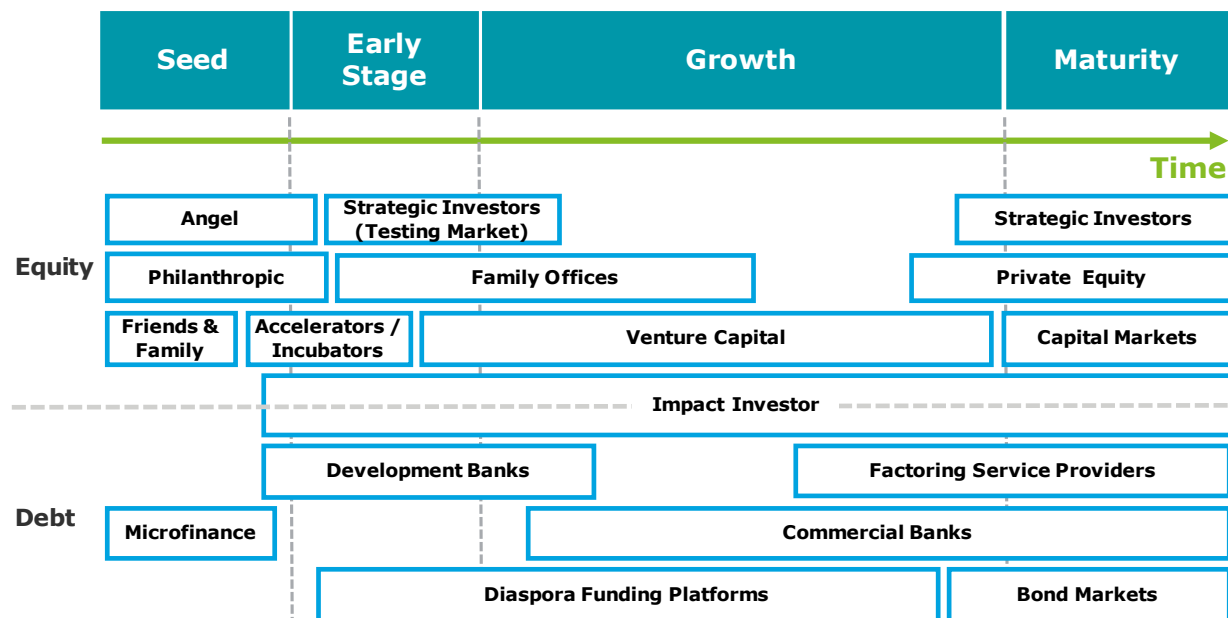
This evolution of the financial sector has led to increased specialization with different finance providers focusing on different financing needs through instruments such as:

- Loans
- Equity Investment
- Insurance
- Leasing

Different equity and debt needs can be viewed as corresponding to different points in the lifecycle of businesses (Figure 6).

New businesses are not likely to generate much, if any, operating income and therefore are less likely to meet the strict repayment requirements of a loan. For such firms, equity (“patient capital”) is likely more appropriate, whether it be from the entrepreneurs’ savings, family and friends, or from venture capitalists or “angel” investors. These are finance providers interested in investing in companies that are just getting started and are perceived as having a high potential for future success.

**Figure 6. Indicative Finance Needs at Each Stage of the Lifecycle of a Business**<sup>32</sup>



If new enterprises are successful and start to grow rapidly, they often need additional financing as expenses needed to support rapid growth can exceed income once the initial cash investments have been expended.

However, these companies are often not ready for “commercial” financing, such as a bank loan that needs to be paid back on a regular basis, because they may not have the steady positive cashflow or track record required by lenders. Thus, they may need additional rounds of venture capital.

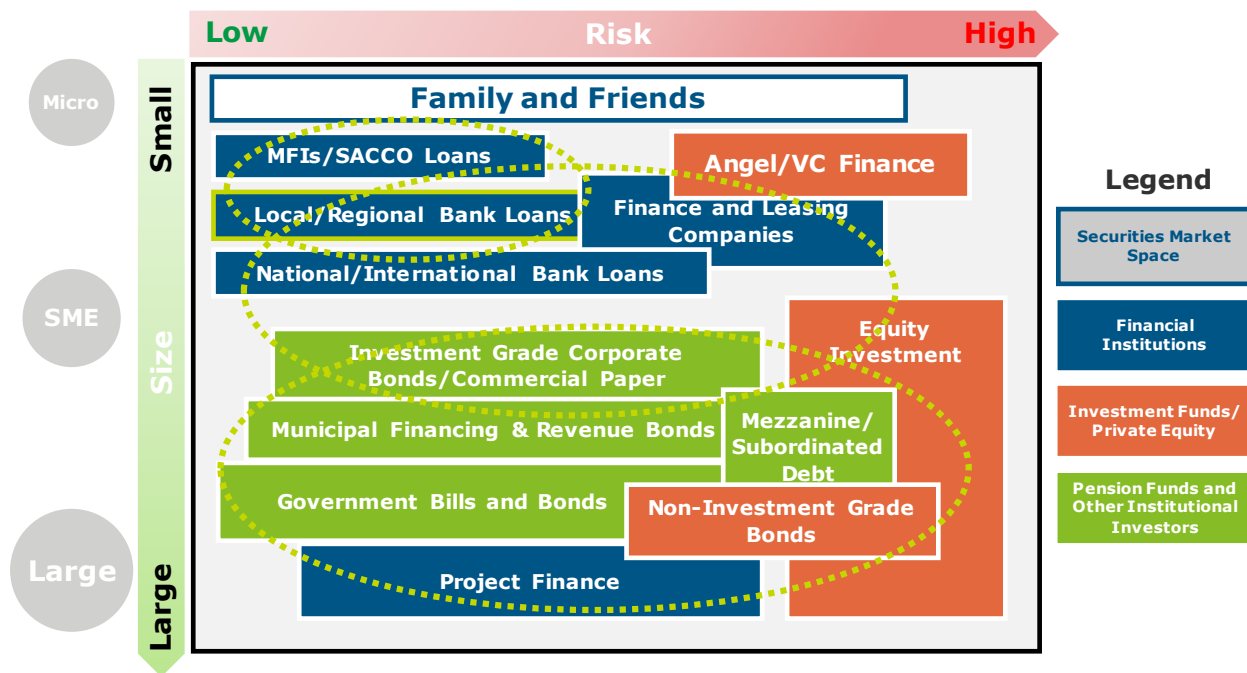
<sup>32</sup> Graphic: USAID Global Development Lab

As success is proven and companies continue to grow, they may be able to have greater access to commercial bank loans. Commercial banks require that a business maintain a base level of capital and are unwilling to lend if the ratio of capital to their loans is too low.

While growth may slow as firms become mature, cashflows and profits tend to become more predictable, at which point (in sophisticated financial markets typically), companies may be able to access debt through the capital markets in the form of a bond issue, often at lower costs and/or longer periods of time. Bonds typically are available to entities with strong track records and low risk, and are lower cost because they are 'liquid' (i.e., can be readily bought and sold). See Chapter 4 for an overview of risk as it relates to finance.

The range of finance providers within the financial market can also be grouped by type and appetite for transaction size and risk. (Note that these categories overlap and there are no fine lines.) The dotted ovals in Figure 7 approximate to the "seed"/"early stage", "growth" and "mature" phases in Figure 6.

**Figure 7: Spectrum of Financing Sources and Instruments by Transaction Size and Risk<sup>33</sup>**



<sup>33</sup> Graphic developed for and owned by USAID PCM

## Financing sources

**Family and Friends:** This source of financing is a popular primary source for many people and small businesses, especially in developing economies. The close familial/friendship relationships between lender and borrower tends to support a level of trust and risk tolerance that most start-ups are unable to secure from outside lenders. This financing is often 'informal' (i.e., without a formal contractual agreement) and the transaction sizes tend to be small. The terms and conditions tend to be flexible but relatively patient, reflecting the fact that this sort of financing usually supports start-up or rapidly growing businesses.

**Debt Providers:** These include commercial banks, microfinance institutions (MFIs), credit unions, and leasing companies which bundle short-term funds and then extend them as loans or leases. Financial transactions here tend to be larger (with the exception of MFIs), and low-to-medium risk. Debt is an essential financial instrument because of the lower cost relative to equity. It has greater flexibility and does not require the borrower to cede control.

**Equity Providers:** These include "public collective investment vehicles" such as mutual (stock) funds and exchange traded funds, and private funds such as private equity funds. Such funds tend to be primarily 'equity' focused (taking ownership in business rather than a lending to businesses).

Equity providers are often aligned with *investment banks*, which are primarily in the businesses of structuring and selling (often termed "placing") equity investments to investors and providing financing advisory services to businesses. As noted in Figure 7, investment funds are highly diversified and often segmented by appetite for risk and specific sectors. While investment funds are not prevalent in USAID presence and other developing countries, equity can benefit start-up and rapidly growing businesses by providing longer-term patient capital, and in some cases advisory services, while having a higher tolerance for risk.

**Institutional Investors:** These include pension funds and insurance companies with large amounts of cash inflows that typically need to be invested over the long-term. Institutional investors are important because of their size and huge appetite for debt and equity. While institutional capital in developing countries remains relatively small, it is growing rapidly and is generating interest as to how it can be unlocked to support development.



## A “perfect” world, or not quite?

In the previous section, we presented an idealized picture of a broad, diversified and sophisticated financial marketplace; a marketplace which is capable of seamlessly and efficiently meeting the highly varied financing needs of households, businesses and governments. This “perfect” (and fictional) marketplace operates within a conducive, enabling environment characterized by consistent, transparent laws and policies, overseen by effective regulators. This ideal financial system would have characteristics such as:

The **enabling conditions** are such that:

- Disputes can be quickly resolved
- Contracts are enforced
- Macroeconomic conditions are stable
- Fiscal policies are business-friendly
- There is effective regulation and oversight of the financial markets

The **financial sector infrastructure**, which underlies the financial marketplace is such that:

- Credit information is easily available
- Registering collateral is generally quick, transparent, and inexpensive
- There is a broad spectrum of sophisticated financing providers ready to meet financing needs.

In advanced economies such as the US and Europe, financial systems can have characteristics close to this ideal scenario. They enjoy a wide range of finance providers, competing against each other to provide financial services. As such, access to finance for most is not a key challenge.

In contrast, while tremendous advances have been made globally in the availability of finance over the past 15 years (domestic credit provided by the financial sector more than doubled from 74% of GDP to 152% from 2002 to 2017)<sup>34</sup>, access to finance remains constrained in the majority of developing and emerging economies, including USAID presence countries.

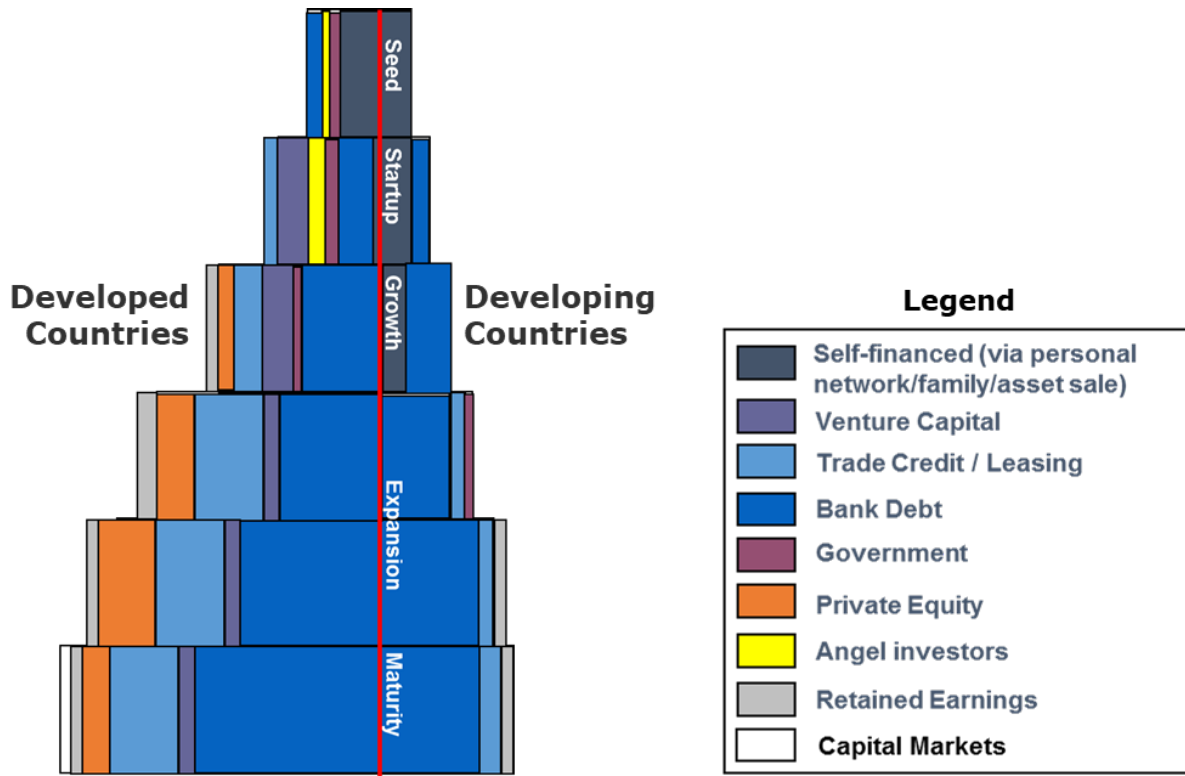
In these economies, financial markets are less “deep” and often less competitive. Financial market “depth” is a concept that captures a range of market characteristics, including size, trading volume and liquidity. A “deeper” market is generally more resilient and better able to serve an economy’s financing needs. Lack of depth combined with greater risk and higher **transaction costs**, this tends to limit the availability and affordability of financing.

**Figure 8** illustrates the relative “shallowness” of financial markets in developing economies as compared to developed economies, which have a more limited range of financial intermediaries throughout the lifecycle of finance. Given the centrality of finance to economic growth, this is a critical challenge for development.

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<sup>34</sup> <https://data.worldbank.org/indicator/FS.AST.PRVT.GD.ZS>

Figure 8: Depth of Financial Intermediaries Developing vs. Developed Countries<sup>35</sup>



## Chapter recap

In this chapter we addressed the questions: “what is finance?”, and “why does finance matter for development?”. We also introduced financial sector actors and instruments, and how they relate to the different financing needs of households, businesses, and governments. In the next chapter, we review some of the reasons for these challenges, and the consequences for economic development.

<sup>35</sup> Graphic developed by the Milken Institute, owned by USAID

## Chapter Two:

# What are the constraints to financing, and how can we overcome them?

## Introduction

In this chapter, we explore the constraints that tend to impede finance and hinder investment in developing countries. We introduce the Five Points Framework for assessing these constraints and outline a range of potential interventions that can mitigate them.

## The constraints to financing

Financial decisions are influenced by a number of factors and occur within a complex financial ecosystem. As noted earlier, not all financial ecosystems are equally developed. Often in developing economies, such as those in USAID presence countries<sup>36</sup>:

- There are fewer and less varied financial actors
- The enabling environment may be less conducive
- The financial sector infrastructure is less developed.

As a result, there can be more constraints to securing a loan or other investments than there are in the US and other OECD countries<sup>37</sup>. Consequently, there are higher hurdles that impair the ability of households, businesses and governments to secure the financing they need. In turn, this reduces both consumption and investment expenditure, impacting the rate of economic growth and development.

There are numerous factors which can make transactions harder to conduct and/or drive up the required return on those transactions. The Five-Point Framework can be used to group and to systematically understand these many constraints.

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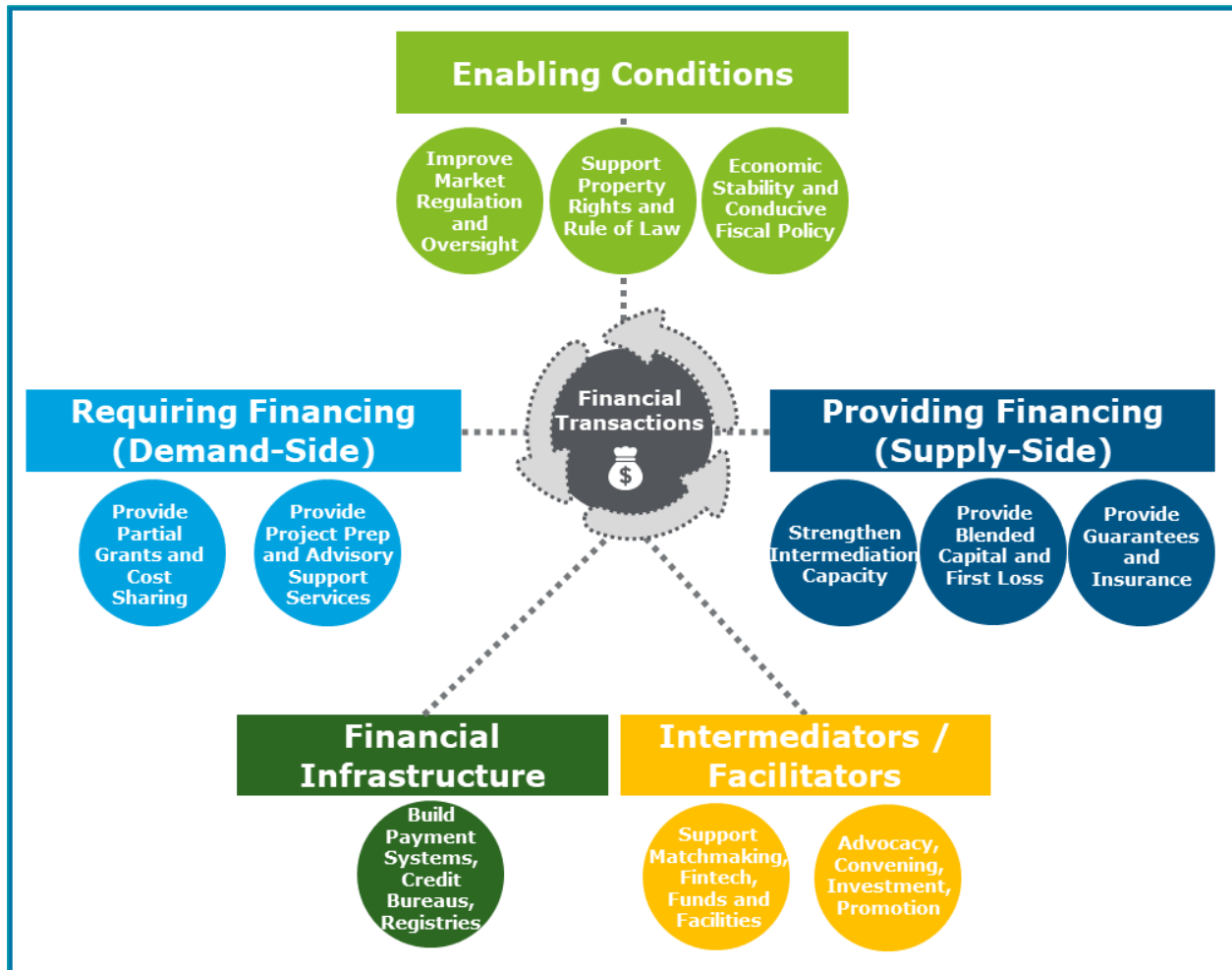
<sup>36</sup> The following bullets are statements of experience/opinion by the authors

<sup>37</sup> This is a statement of experience based on observation by the authors



## The Five-Point framework

Figure 9: The Five-Point Framework<sup>38</sup>



The vertical elements of the framework (**Enabling Conditions**, **Financial Infrastructure**, and **Intermediators/Facilitators**) represent the broad, systemic conditions in which the finance sector of an economy operates.

The horizontal elements of the framework (**Finance Seekers** and **Finance Providers**) represent the parties to any individual financial transaction.

All five elements work together to influence the nature of each and every financial transaction, as indicated at the center of the framework.

<sup>38</sup> Graphic developed by Deloitte and owned by USAID PCM

## Enabling Conditions

Figure 10: Enabling Conditions<sup>39</sup>



**Enabling Conditions** impact the financial market broadly and have a bearing on all financial transactions. Key elements to a conducive enabling environment include:

- **Market Regulation and Oversight:** The absence of strong and independent financial market regulation and financial market supervision can undermine confidence in the integrity and soundness of the financial marketplace, and tends to discourage competition in the marketplace.
- **Property Rights and the Rule of Law:** A necessary condition for an effective financial marketplace is rule of law, the assurance that property rights are secure and that contracts will be enforced. Uncertainty about the ability to rapidly enforce a financial contract in the event of a default increases the [risk premium](#) and thus the transaction costs.
- **Economic Stability and Conducive Fiscal Policy:** A sound and stable [macroeconomic environment](#) and the fiscal discipline that underpins it is an important driver of economic growth. For example, the potential for high inflation or currency devaluation is a strong deterrent to business investment. Poor or unstable fiscal policies discourage investment by increasing the risk of loss and making the potential for positive returns more uncertain.

No country enjoys a perfect enabling environment, but in less developed countries the challenges are often more pronounced, which can deter investment and drive up the costs and the risk premium for finance providers. For example, finance providers must consider the higher likelihood and higher costs associated with events of default and price in the risk of possible events such as a currency devaluation.

<sup>39</sup> Graphic developed by Deloitte and owned by USAID PCM

## Financial Sector Infrastructure

Figure 11: Financial Infrastructure<sup>40</sup>



The financial marketplace is supported by the **financial sector infrastructure**, which enables efficient payments and transactions. Key elements within the financial sector infrastructure include:

- **Payments systems** that can strengthen the financial sector by reducing the time, risk and cost of transferring funds. Modern systems can facilitate digital payments, including mobile money, which enable more people to pay bills and transfer money electronically.
- **Credit reporting bureaus and rating agencies** which efficiently provide objective information on the creditworthiness of bonds, stocks and borrowers (individuals or businesses), thereby reducing the time and cost associated with due diligence and determining whether to extend the financing.
- **Collateral registries** which provide a means for finance providers to record a security interest in collateral pledged by a borrower. A number of countries have recently implemented “movable property” registries which allow banks to take collateral other than land and buildings (immovable property), and thus opens up the range of borrowers able to provide security and thus access lending to include those who do not own land or buildings.

<sup>40</sup> Graphic developed by Deloitte and owned by USAID PCM

## Financial Sector Intermediation Systems

Figure 12: Financial Intermediators and Facilitators<sup>41</sup>



As discussed in Chapter One, the fundamental role of the financial sector is **financial intermediation**: the pooling of funds available to be invested (typically, savings from households and net positive cashflows from businesses) and the matching of them with organizations and institutions seeking funding (typically, businesses and households that can put the funds to productive use).

- The extent and sophistication of financial intermediation systems can be a key constraint in emerging economies' financial sectors. **Examples of financial intermediaries include:**
  - Commercial Banks
  - Investment Banks
  - Stockbrokers
  - Pooled Investment Funds
  - Stock Exchanges
- Developing economies are often highly reliant on the **traditional banking sector** as the primary financial intermediaries. Thus, the development of a broader range of **capital and securities exchanges** can provide an alternative to the banking sector as a source of financing. They can also serve as a market to trade (i.e., buy and sell) financial instruments, providing liquidity which is of great value to investors, and determining share prices for publicly-owned firms. Thereby, capital and securities exchanges impose 'market discipline' upon firm management.

Recently, new types of financial **intermediators** and **facilitators** have begun to appear, including **crowdfunding** websites, **matchmaking platforms** and a range of financial services providers making use of **mobile and digital technology** (termed "fintech"). These private and public entities are often not formal "financial intermediaries" but are in the business of encouraging or facilitating transactions which have development impact. They can be grouped into:

<sup>41</sup> Graphic developed by Deloitte and owned by USAID PCM

- **Matchmakers, Fintech, Funds and Facilities:** A number of crowdfunding and matchmaking platforms have been launched to fill the gaps traditional intermediaries do not cover, several of which offer equity or debt financing for start-ups and/or SMEs directly. Some have a strong development focus while others are purely commercial. **Fintech** is also changing the landscape, including by introducing new ways to provide financial services, often competing with, or in partnership with, traditional intermediaries. There has also been a surge in launching specialized funds and facilities, established specifically to channel finance for areas not served by traditional financial intermediaries, such as in the space between pure debt and pure equity.
- **Advocacy, Convening and Investment Promotion:** Many countries have some form of Investment Promotion Agency which have the potential to play a large role in identifying and promoting investment opportunities. USAID and other development agencies can have a strong impact in convening, creating forums and events in which those seeking finance can engage with finance providers. USAID has been successful in building interest in and generating financial commitments for development priorities, such as through the Feed the Future<sup>42</sup> and Power Africa<sup>43</sup> programs.

In USAID presence and other developing countries, the financial sector infrastructure and the range of intermediaries tends to be less modern and complete, with consequences for economic development. For example, digital financial services can only reach scale when there are inter-operative platforms which allow for funds to be transferred between multiple telecommunications providers and multiple banks. Without **credit bureaus**, finance providers must use staff time and other resources to assess the credit worthiness of each borrower. Without effective, transparent collateral registries, lenders are unable to check if collateral being offered as security for a loan has already been pledged to another lender.

Constraints related to “Enabling Conditions,” “Intermediators / Facilitators,” and “Financial Sector Infrastructure” relate to the system overall and not specific financial transactions. These are **systemic constraints**, and push up transaction costs. Interventions related to systemic constraints should establish the conditions through which a broad range of transactions can occur more efficiently and cost-effectively, deepening and broadening financial markets so more people and businesses can access finance.

**Transactional constraints** represent obstacles for specific transactions, and are discussed in the following sections.

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<sup>42</sup> <https://www.feedthefuture.gov/>

<sup>43</sup> <https://www.usaid.gov/powerafrica>

## Finance Providers

Figure 13: Finance Providers<sup>44</sup>



Those *providing financing* cover a broad spectrum of individuals and organizations including but not limited to:

- Commercial and investment banks
- Institutional investors
- Diaspora investors
- Microfinance institutions
- Credit unions
- A wide array of investment funds
- Local pension funds
- Sovereign wealth funds

As described in previous sections, finance providers bundle or source funds and then provide them in the form of debt or equity to entities seeking financing.

However, as noted previously, the reality in USAID presence countries and emerging markets generally is that the spectrum of finance providers is narrow and thus less competitive than developed markets. Banks usually dominate the financial sectors, often accounting for 80% of financial assets. Financial institutions frequently have less depth, and less expertise in financial intermediation.

Beyond their own internal institutional capability, finance providers may be constrained by numerous external factors (i.e., enabling conditions discussed above). For example, these include:

- Unreliable audit and accounting standards
- Limited ability to gain credit history information
- Inability to secure an interest in collateral

These conditions serve to increase risks and costs to finance providers, and as a result many banks tend to focus on their best corporate clients and are less interested in reaching out to underserved areas or groups (e.g. small businesses) that may be more closely aligned to economic development objectives.

<sup>44</sup> Graphic developed by Deloitte and owned by USAID PCM

## Finance Seekers

Figure 14: Finance Seekers<sup>45</sup>



Those *seeking financing* include:

- Businesses
- Households
- Individuals
- Municipalities
- Special purpose vehicles

Most people seeking loans or equity investments are not finance experts. Instead they tend to be entrepreneurs with a good idea and/or skill set with which they want to start or grow a business such as Teo's. As such, many finance seekers do not naturally speak the language of finance and are not conversant with the requirements of investors or lenders. They may not know how to construct a [balance sheet](#) and/or to develop financial projections.

In developed countries such as the US, this problem is mitigated by an array of business services providers (accountants and business consultants) and local and national organizations whose focus is helping small businesses. In developing countries, these resources may not exist to the same extent.

A compounding problem is wealth. As noted previously (and explained more fully in Chapter 4), lenders require collateral and/or a layer of equity (someone else's capital) underneath the debt they will provide, in order to provide a cushion. Many entrepreneurs do not have the ability to provide this.

<sup>45</sup> Graphic developed by Deloitte, owned by USAID PCM

# Teo's Tractors - Loan Pricing and Enabling Conditions



2018 Finance needed:	
SAVINGS	\$200,000
INVESTMENT REQUIRED	\$1,000,000
<b>FINANCING NEEDED</b>	<b>\$800,000</b>

2018 Year Profit and Loss forecast:	
REVENUES	\$500,000
OPERATING COSTS	\$200,000
OPERATING INCOME	\$300,000



It is 2018, and Teo and Mary each want to start a tractor rental and servicing business. Mary is in Illinois, the United States of America and Teo is in Kumasi, Ghana.

\*Please refer to Chapter 4, Profit and Loss and Cashflow statements as you consider this vignette.

**Company Name:** Mary's Tractors  
**Location:** Illinois, USA  
**Financing Need:** \$800,000  
**Scenario:**

- With her tractor leasing company, Mary will make \$500,000 in gross revenue
- After operating expenses of \$200,000, she will have \$300,000 available annually

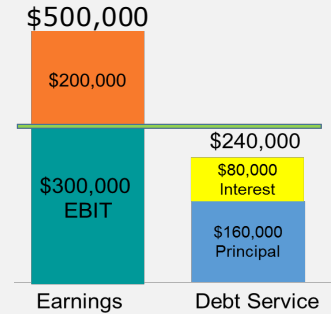
**Company Name:** Teo's Tractors  
**Location:** Kumasi, Ghana  
**Financing Needed:** \$800,000  
**Scenario:**

- Teo also wants to get into the tractor leasing business at a cost of \$1,000,000 and with \$200,000 saved, Teo also needs \$800,000 in financing
- Like Mary, Teo's revenues are expected to be \$500,000 from which he expects \$300,000 in operating income

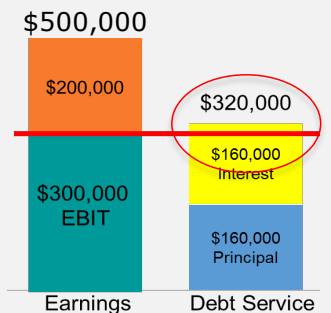
The Profit and Loss Statement shows the revenues, costs, and expenses incurred by an organization to arrive at Net Profit.

To apply for a loan, Teo must prepare a profit and loss statement as a snapshot of his business. Is Teo's Tractors an attractive investment opportunity?

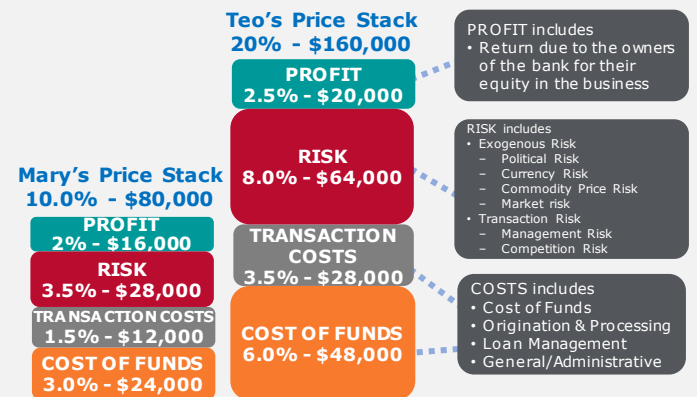
For Mary, the interest rate in the USA is 10%, so that the annual cost of an \$800,000 loan over five years is \$240,000 (\$160,000 capital repayment, plus \$80,000 interest). This is less than her \$300,000 operating income, so **she gets the loan.**



For Teo, the interest rate in Ghana is 20%. So his annual repayment cost is \$340,000 (\$160,000 in capital repayment and \$160,000 in interest). Since this exceeds his forecasts operating income of \$300,000, **Teo's does not get the loan** and his business does not get started - even though his business is forecast to be just as profitable as Mary's.



What does Teo's experience tell you about the significance of enabling conditions? (i.e. higher risk) enabling conditions in Ghana largely cause the higher interest rate there, this is a powerful illustration of why enabling conditions are important and how they directly impact economic growth and job creation.

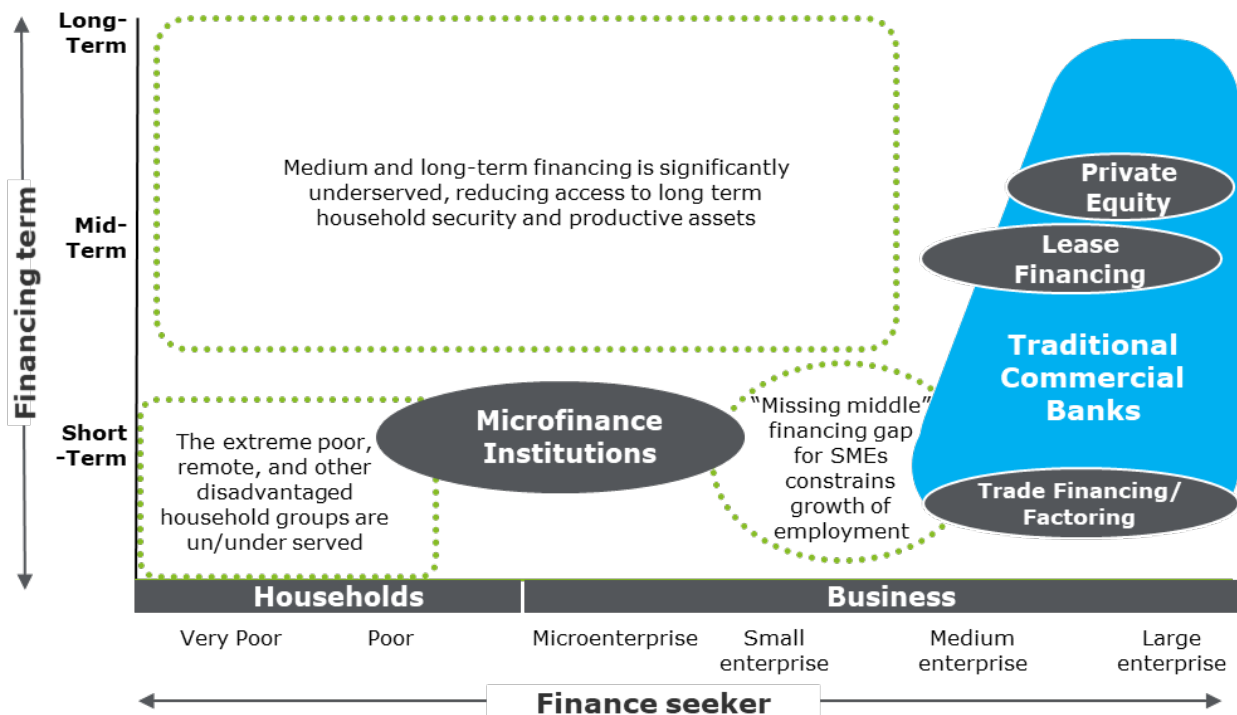




## The impact of financing constraints, and interventions to address them

One way of illustrating the cumulative effect of these constraints on financing in developing economies is shown in Figure 15:

**Figure 15: Illustrative gaps in short-, medium- and long-term financing for households and businesses<sup>46</sup>**



As shown in the above graphic, a likely cumulative impact of higher risks and less certainty is that the formal financial sector is reluctant to serve enterprises outside the large corporate sector.

Medium- and long-term financing is hard to come by for all but the more established, larger enterprises. While the expansion of microfinance has begun to serve low-income households and microenterprises, the very poor continue to be underserved. Smaller and medium-sized enterprises tend to be too large to be served by microfinance institutions and yet too small and high-risk to be attractive to the formal banking sector, resulting in what has been termed the “missing middle.”

This has significant development consequences because the majority of economic growth, and employment is created by small and medium enterprises (SMEs). Thus, their difficulty in accessing finance constrains overall economic growth.

<sup>46</sup> Graphic developed by Deloitte and owned by USAID PCM

### How can we overcome these constraints?

There are many ways in which USAID and other development agencies can and have intervened to mobilize the private financial sector, providing financing which otherwise might not have occurred and which advances development<sup>47</sup>. The art of becoming a successful “investment catalyst” is, in part, understanding the full range of intervention options, and being able to determine which intervention, or groups of interventions, are likely to be most effective in different circumstances.

It is effective to think of finance providers as “rational economic actors.”<sup>48</sup> They are in the business of extending financing. They will only do so when they expect a profit. Thus, they will be less likely to extend financing for transactions that do not provide them with an acceptable financial return, even though such transactions may have terrific social and economic benefits.

As we learned in Teo’s, the barrier to a successful loan or other financial transactions may not be the deal itself. The problem may be the higher returns required in developing countries necessary to cover higher costs and risk premiums. The same deal which would get approved in Illinois might be declined in Ghana, simply because of the higher returns required to cover the elevated financing costs and risks in Ghana.

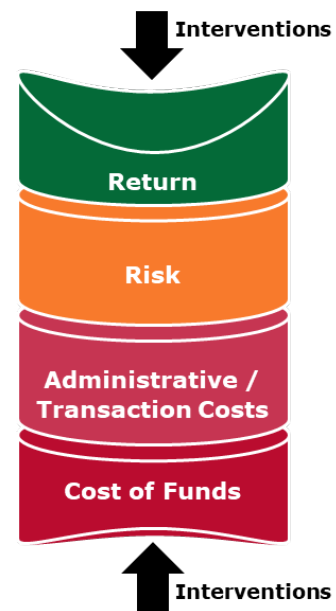
### What can development agencies such as USAID do to assist?

How can development organizations help to nudge beneficial transactions such as Teo’s across the finish line; transactions that have strong development benefits, but cannot quite meet the finance return requirement because the deal is in an emerging economy involving greater costs and risks?

As **investment catalysts**, there are several things development agencies such as USAID can do to facilitate these sorts of transactions. Each works by making the transaction more attractive in some manner, for example:

1. by reducing or offsetting cost and risk (i.e., “squeezing the pricing stack”); or
2. by increasing the financial return.

Figure 16: Pricing Stack<sup>49</sup>



<sup>47</sup> USAID Mobilizing Private Capital Project Vignettes Handbook

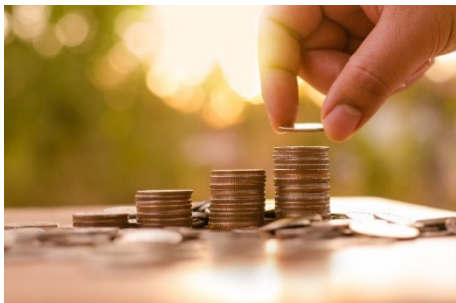
<sup>48</sup> There is an argument that the allocation of finance may be skewed by cultural norms and unconscious bias, with the results that some groups may be treated more favorably than others. However, as with much of economic theory for the purpose of this document considering economic actors as “rational” suffices

<sup>49</sup> (Refer to Chapter Four)

## Transaction-specific interventions

### Transaction-specific interventions oriented to Finance Seekers

Finance seekers may include the households, governmental entities and businesses such as Teo's which require funding. The following case studies draw on real projects, and a hypothetical example for Teo, showing how development organizations can intervene to help finance seekers qualify for private financing.



#### **Intervention example**<sup>50</sup>

Providing project preparation and advisory support services:

USAID has a long history of providing Business Advisory Services (BAS) to enterprises, both to assist them with making financing proposals, as well as in improving business skills in areas such as finance and marketing.

BAS services address a common complaint from banks and other finance providers in developing countries, that they are eager to increase their portfolios and make investments, but they rarely receive financing requests in an actionable form, with the data and analysis needed for them to make a financing decision.

Were the finance providers themselves to provide such assistance, they would need to hire additional staff, change their business model (which may have regulatory implications), and recover all of those costs from their customers/investees in the form of increased fees and interest rates.

Following the collapse of the USSR, USAID established business resource centers throughout the region to support former state-owned enterprises as well as new private businesses to understand how to operate in a competitive, market economy.

This approach has largely gone out of favor today, largely because it was expensive and was perceived to have had limited impact. Ensuring the quality a BAS provides is a challenge as it is difficult to ascertain the interest and or the real potential of enterprises served.

<sup>50</sup> USAID PCM experience, as published in Finance Vignette Handbook, a Financing Growth Training

### Teo's Tractors - How can providing partial grants and cost sharing help?



Teo had a solid business plan. His problem was that his debt level was too high for his cash flow to cover given the high interest rate. The provision of a **partial or matching grant** would have increased his effective equity and reduced the amount of debt he needed to borrow, making him a more attractive loan candidate.

Partial grants have the benefit of being fast-acting. The downside of partial grants is that it could be a very inefficient way of accomplishing the outcome. A matching grant is simple to execute but may not reflect the actual amount of USAID funds needed to catalyze the transaction.

For example, for Teo's, the shortfall between earnings and debt service was only \$20,000, but USAID may not know that and might provide a larger grant of for example \$80,000. Teo still gets the tractor, but perhaps the Agency could have also supported 3 other firms like Teo's with the \$80,000 for 4 times the development impact!

### Transaction-specific interventions oriented to Finance Providers

Finance providers are the many potential sources of debt and equity financing – and the “spectrum” of financing tools in between. Examples include:

- Merchant banks
- Leasing companies
- Investment funds
- Commercial banks
- Credit unions
- Microfinance institutions
- Family foundations

## How can overseas development agencies support commercial finance providers to provide financing to a small business like Teo's?

The following vignettes from actual USAID projects provide a few example strategies for intervening with finance providers. Then we again visit Teo's to consider what interventions might incentivize commercial finance providers to support his business:



### Intervention example

Strengthen capacity of financial intermediaries:<sup>51</sup>

USAID has invested heavily in providing training to financial intermediaries, particularly when trying to encourage them to enter specialized lending areas that are important to economic development in many countries, such as Microfinance; Agricultural finance; and Clean energy.

USAID has played a key role in launching microfinance, helping to stand up Microfinance Institutions (MFIs) and to provide training on lending and loan administration. The impact of training in other areas is not as well-documented beyond metrics such as number of trainings completed. Evidence suggests that training is more effective when it is combined with other support, and when recipients have financially contributed to receive that support.



### Intervention example

Provide blended capital and first loss:

One of the most immediate and direct ways to induce finance providers to extend financing is through provisions of blended capital. Blended capital is the combination of concessional funding (usually public funds) with impact or full-return private capital in a way which lowers the overall funding cost, or conversely, increases the **yield** for private capital. It can directly change the risk-return equation. Since the "concessional" capital requires a lower (sometimes zero) return, a higher return can be paid by the borrower to the private for-profit finance provider. Thus, the private finance provider is incentivized at the same or lower overall cost to the borrower. Blending capital is still relatively new. Until recently, providing concessional funds was considered a subsidy which would distort markets and financial decisions – but that perception is changing.

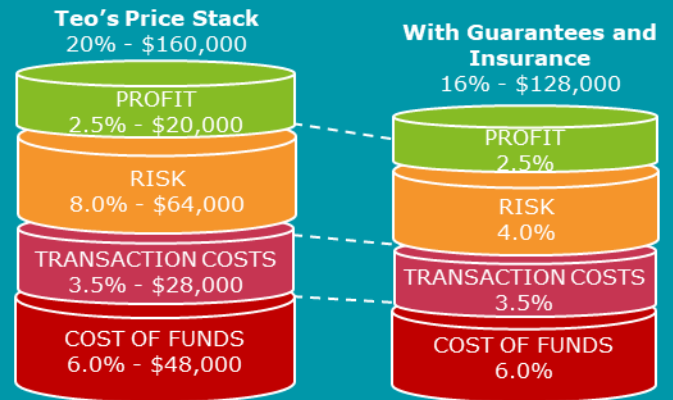
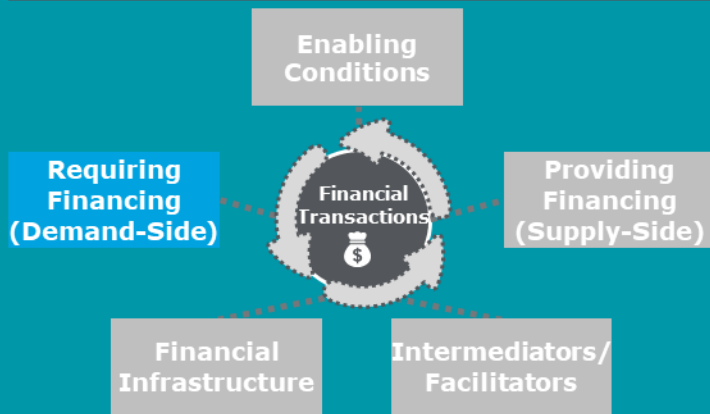
Several funds have been established in which USAID or others contribute concessional funds to attract private funds. However, there are other approaches that allow USAID to have more control over the transactions getting financed, as well as to minimize the amount of its funding used to catalyze transactions.

<sup>51</sup> [https://www.marketlinks.org/sites/default/files/resource/files/MPEP\\_Report2\\_V17.pdf](https://www.marketlinks.org/sites/default/files/resource/files/MPEP_Report2_V17.pdf)

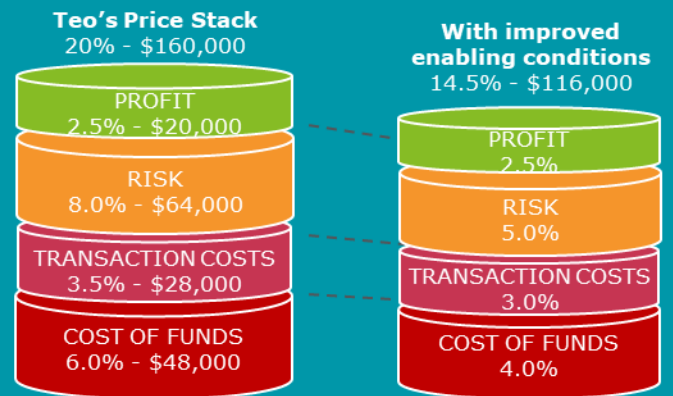
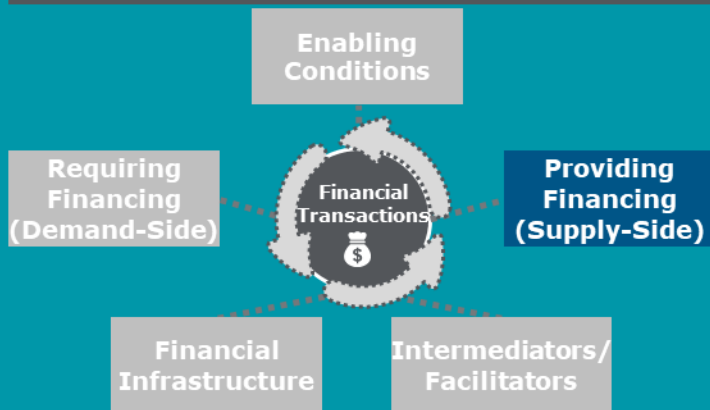
# Teo's Tractors – Intervention Options

Consider what types of interventions a development practitioner can make in each area of the five points framework. How can each potentially reduce the overall price of a loan to Teo? What elements of the loan pricing stack does each type of intervention affect?

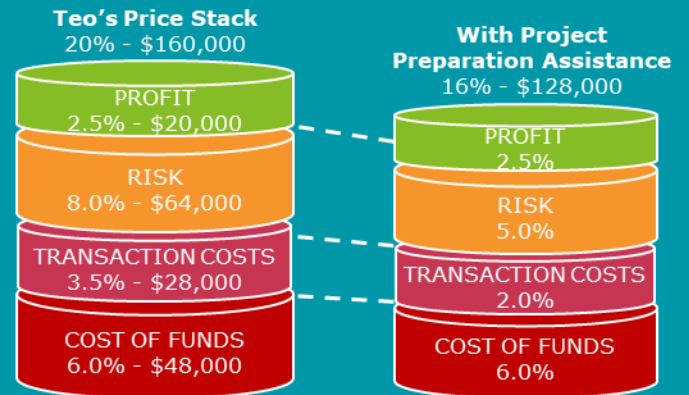
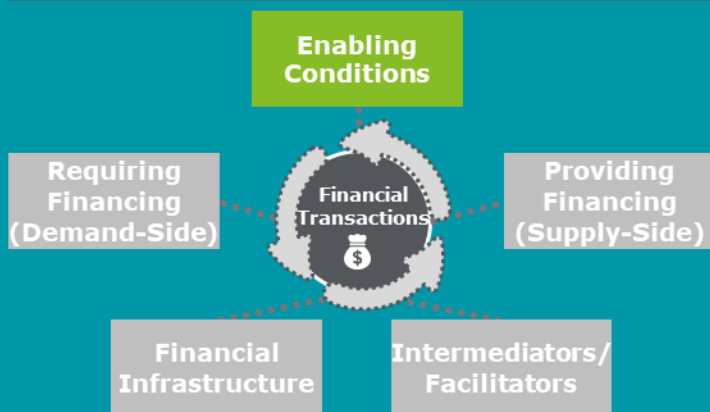
## Consider Demand Side Interventions:



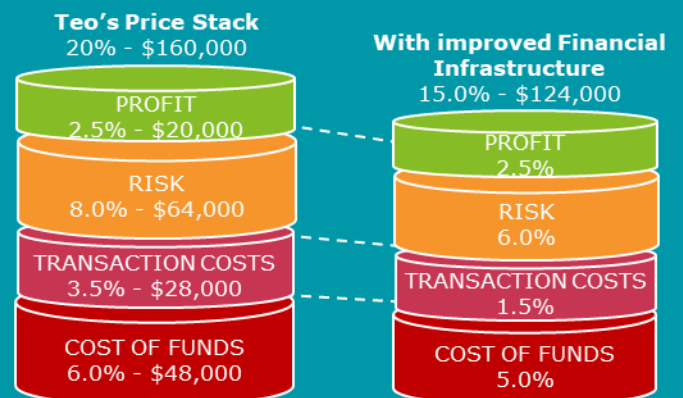
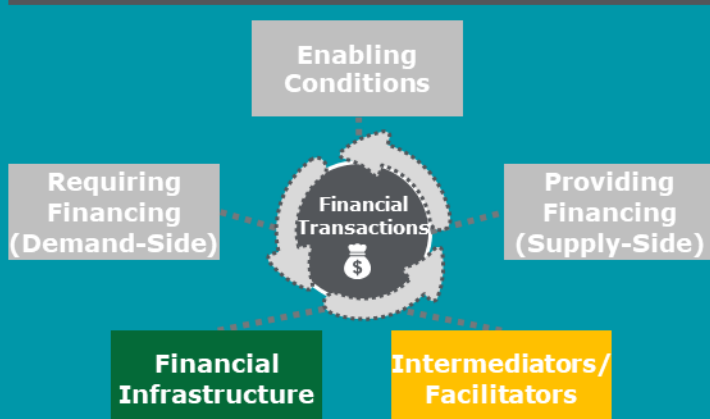
## Consider Finance Provider Interventions:



## Consider Enabling Conditions Interventions:



## Consider Financial Infrastructure and Intermediary Interventions:



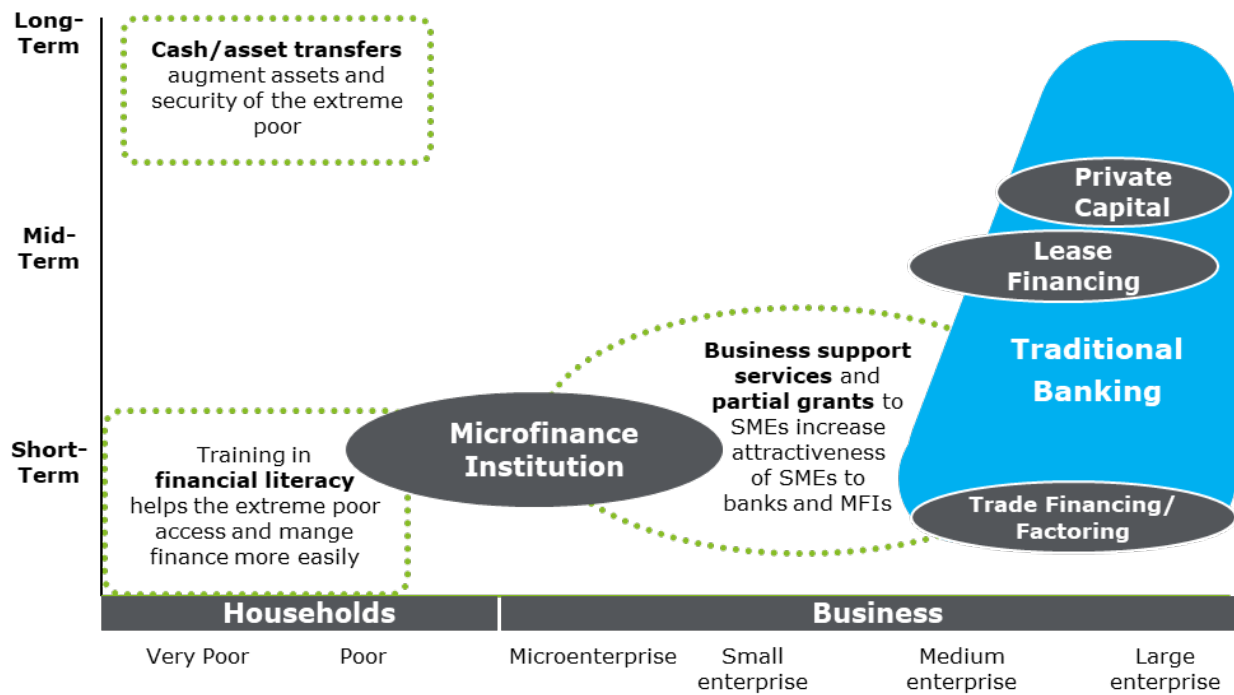
### The Impact of Transaction-Specific Interventions

The potential beneficial impact of interventions related to finance-providers and finance-seekers is illustrated in the following graphics.

#### Finance seeker interventions

Figure 17 illustrates how financial literacy training to poorer households and business advisory services to small businesses can prepare them to present their case to banks. Partial grants can reduce the overall volume and cost of private financing needed by small and medium businesses.

Figure 17: Illustrative Impact of Finance-Seeker Interventions:<sup>52</sup>

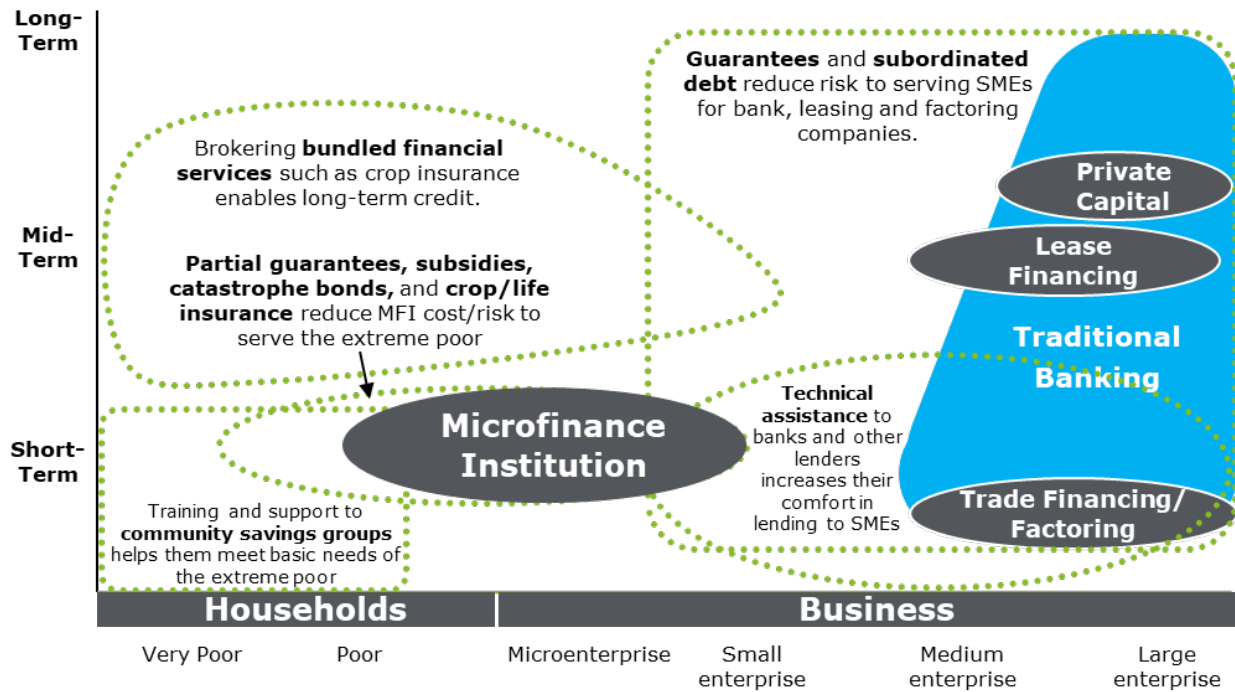


<sup>52</sup> Graphic developed by Deloitte, owned by USAID PCM

### Finance provider interventions

Figure 18 illustrates how technical assistance to finance providers of all sizes can help them more effectively serve marginal customer segments. Partial guarantees, blended finance/subordinated debt and various forms of insurance can lower the risk and thus the risk premium and cost-to-serve other segments.

Figure 18: Illustrative Impact of Finance-Provider Interventions<sup>53</sup>



<sup>53</sup> Graphic developed by Deloitte, owned by USAID PCM



## Systemic Interventions

### Enabling Conditions Interventions

As explained earlier in this Chapter, enabling conditions encompass the systemic factors that impact financial markets and transactions. They are not directly related to a specific transaction, but they are important because they impact the risk premium and transaction costs.

The following project vignettes are a few example strategies for intervening to improve enabling conditions:



#### Intervention example

Facilitate macroeconomic stability and conducive fiscal policy:<sup>54</sup>

Following the fall of the Soviet Union, the recommended course of action for countries making the transition from command-based to market-driven economies was seen as:

- Macroeconomic stabilization
- Privatization
- Liberalization

In other words:

- Create stable economic conditions
- Minimize the role of government in the economy
- Liberalize financial, trade and other markets

A relatively stable economic environment with consistent government policy provides the predictability and lower-risk environment needed for a financial sector to operate efficiently. This can result in lower **exogenous risk** and lower-risk premiums charged by finance providers. The net effect is a broad increase in access to affordable finance for a wider range of finance-seekers.

While USAID is no longer heavily engaged in macroeconomic policy, it continues to be deeply involved in fiscal policy and practice. Domestic resource mobilization and public financial management are considered key parts of the journey to self-reliance for USAID partner countries. Poor fiscal policy and systems can impact the cost of funds, pushing up interest rates due to governments borrowing to cover deficits. Areas of intervention include advisory support for tax policies, collection, and working with municipalities to establish better financial management systems.

<sup>54</sup> USAID project experience, as published in "Finance Vignette Handbook a Financing Growth Training"



**Intervention example**

Support property rights and rule of law:<sup>55</sup>

Financial instruments are contracts, and thus the ability to enforce those contracts in the event of default is critical. Shareholder rights are important to investors in the stock market. The ability to record ownership of property, as well as to pledge one's rights to that property as collateral, is essential to commerce.

USAID has deep experience in the broad area of strengthening judicial systems and timely enforcement.

Related to property rights, USAID has supported several countries in establishing secured transaction regimes, specifically the ability to register and pledge movable and intangible property. The interventions to enable this include establishment of accompanying regulations and platforms through which financial providers have access.

Examples of these types of property include:

- Accounts receivable
- Inventory
- Equipment



This approach can unlock a huge class of assets to be used as collateral and thus facilitate broader access to finance.

<sup>55</sup> USAID PCM project experience

### Financial Sector Infrastructure Interventions

Financial Sector Infrastructure is the set of systems which underpin and support effective operation of financial intermediaries. By supporting development of this infrastructure, development agencies like USAID can facilitate transactions broadly.

Figure 19: Financial Infrastructure Interventions<sup>56</sup>

	
Enabling Conditions (Institutions)	Outcome
Procedural formalism	<ul style="list-style-type: none"> <li>• Time to evict nonpaying tenant</li> <li>• Time to collect a bounced check</li> </ul>
Judicial independence	<ul style="list-style-type: none"> <li>• Security of property rights</li> <li>• Ease of contract enforcement</li> </ul>
Regulation	<ul style="list-style-type: none"> <li>• Size of unofficial economy</li> </ul>
Ownership & freedom of the media	<ul style="list-style-type: none"> <li>• Equality of information access</li> <li>• Civil pressure on governance</li> </ul>
Labor laws	<ul style="list-style-type: none"> <li>• Employment participation rates</li> <li>• Level of unemployment</li> </ul>
Company law/Security law	<ul style="list-style-type: none"> <li>• Stock market development</li> <li>• Firm valuation</li> <li>• Ownership structure</li> </ul>
Bankruptcy law	<ul style="list-style-type: none"> <li>• Private credit availability</li> <li>• Entrepreneurship rates</li> </ul>
Government ownership of banks	<ul style="list-style-type: none"> <li>• Interest rate spread, pricing signals</li> </ul>

### Financial Intermediators and Facilitators Interventions

Earlier, we introduced the concept of the financial marketplace, which is like other marketplaces but deals specifically in financial instruments. Some of the actors in that marketplace are financial intermediaries. They are in the business of supporting entities seeking financing. Besides family and friends, financial intermediaries fit primarily into three groups:

- Financial institutions (e.g., banks, MFIs, credit unions)
- Investment banks
- Pension funds

<sup>56</sup> Statements based on authors’ experience and observations

However, the lines as to what defines an intermediary have started to blur and are expected to continue to do so as technology and financial business models continue to evolve. New actors and approaches are trying new ways to bring together finance seekers and finance providers, many with the intended purpose of furthering development. More traditional approaches such as advocacy and investment promotion may be indirect, but they too can be very successful ways to catalyze transactions, perhaps even using less of USAID's financial resources.



**Intervention example**

Build [payment systems](#), credit bureaus, registries:<sup>57</sup>

Financial sector infrastructure can be considered “invisible” in the US. Even less visible are the complex systems and networks which enable even the simplest of financial transactions. However, this infrastructure is critical for:

- Efficient transfer of funds
- Intermediation
- Keeping transaction costs low

For example, if finance providers cannot efficiently get credit information on Teo's, or they need to manually file a security interest on Teo's collateral, this will potentially increase transaction costs and their risk premium. This will likely lead them to increase Teo's interest rate. As we've seen, this can result in Teo and other firms not having access to finance.



<sup>57</sup> Graphic owned by USAID PCM



**Intervention example**

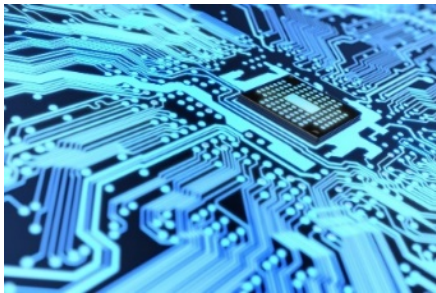
Advocacy, convening and investment promotion:<sup>58</sup>

Support can be provided for more indirect ways to catalyzing transactions. Many countries have some form of Investment Promotion Agency, which have the potential to play a larger role in identifying and promoting investment opportunities.

USAID and other development agencies can have a strong impact in convening, creating forums and events in which those seeking finance can engage with finance providers.

USAID has been successful in building interest in and generating financial commitments for key priorities, such as Feed the Future and Power Africa.

USAID has a strong reputation as an “honest broker” and can do a lot to bring parties together. As the largest overseas development donor, USAID’s advocacy can also be quite powerful.



**Intervention example**

Matchmaking, fintech, funds and facilities:<sup>59</sup>

A number of crowdfunding and matchmaking platforms have been launched to fill the gaps that traditional intermediaries do not cover. Several of these offer equity or debt financing for start-ups and/or SMEs in developing economies. Some have a strong development focus while others are purely commercial.

Fintech is also changing the landscape by introducing new ways to provide financial services, often competing with, or in partnership with traditional intermediaries.

There has also been a surge in the launch of specialized funds and facilities, established specifically to channel finance for purposes or to areas not served by traditional financial intermediaries.

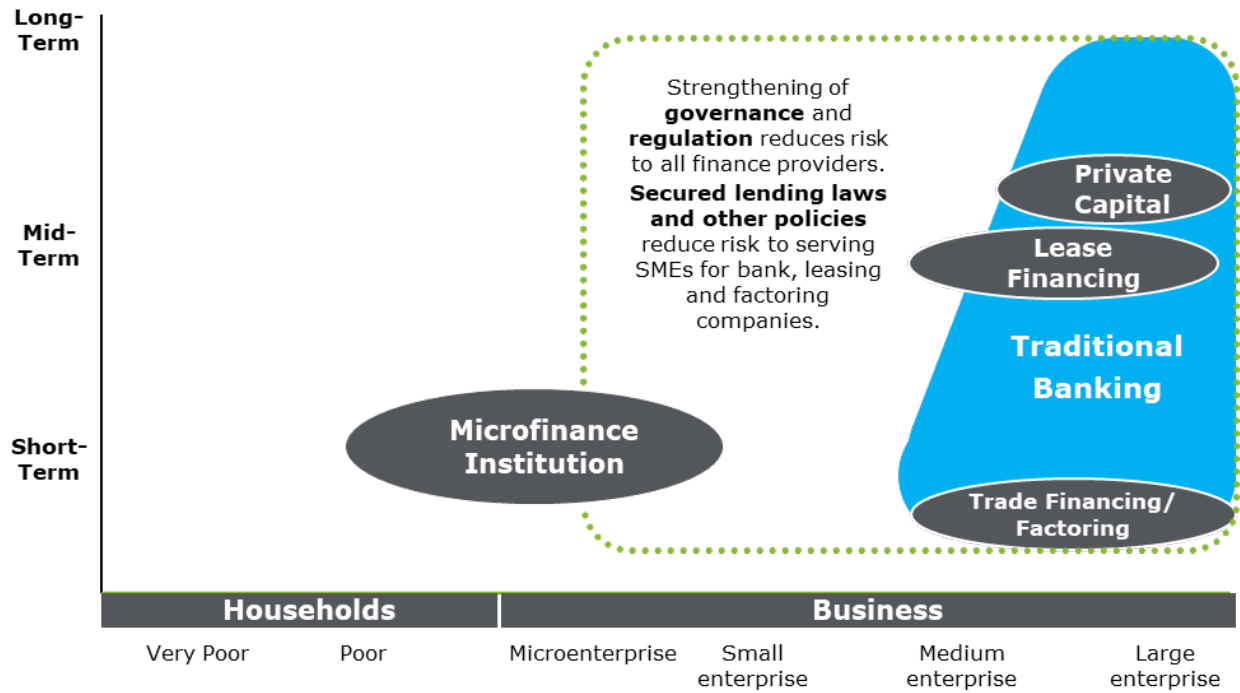
<sup>58</sup> USAID PCM project experience, as published in “Finance Vignette Handbook, A Financing Growth Training”

<sup>59</sup> USAID PCM project experience, as published in “Finance Vignette Handbook, A Financing Growth Training”

**How do combinations of systemic interventions change the financial landscape in developing countries?**

The potential impact of each type of systemic intervention is illustrated in the following graphics:

**Figure 20: Illustrative Impact of Enabling Conditions Interventions:<sup>60</sup>**



<sup>60</sup> Graphic developed by Deloitte, for USAID PCM

Figure 21: Illustrative Impact of Financial Infrastructure Interventions<sup>61</sup>

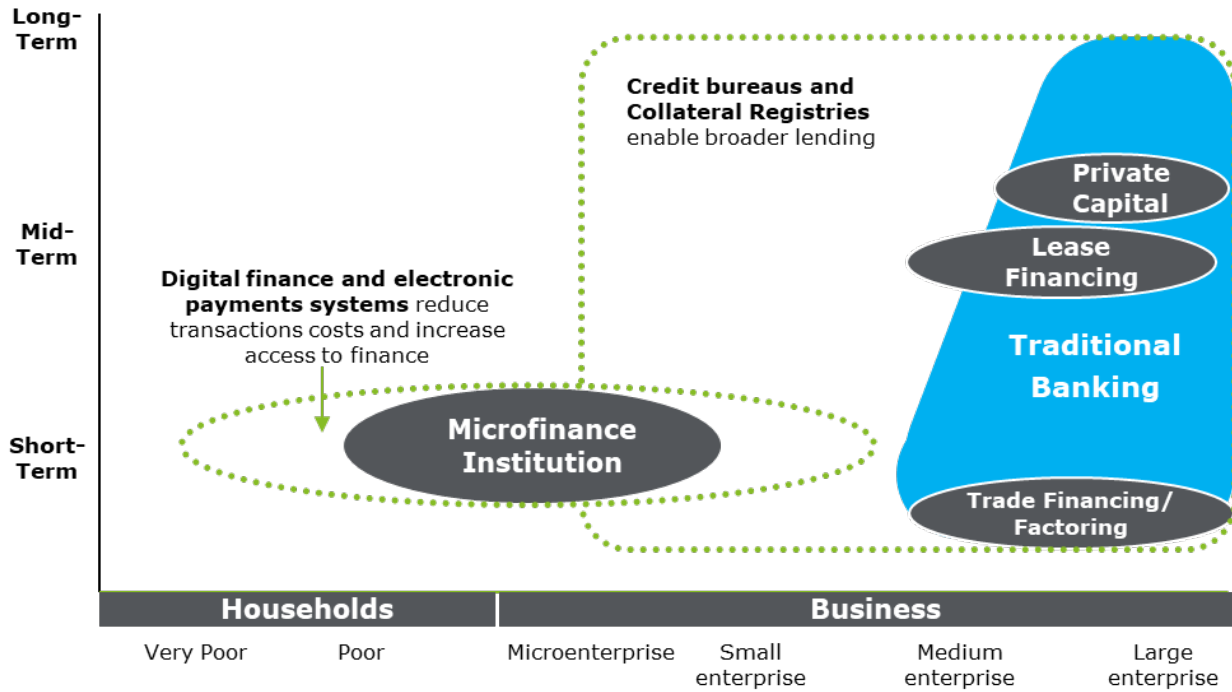
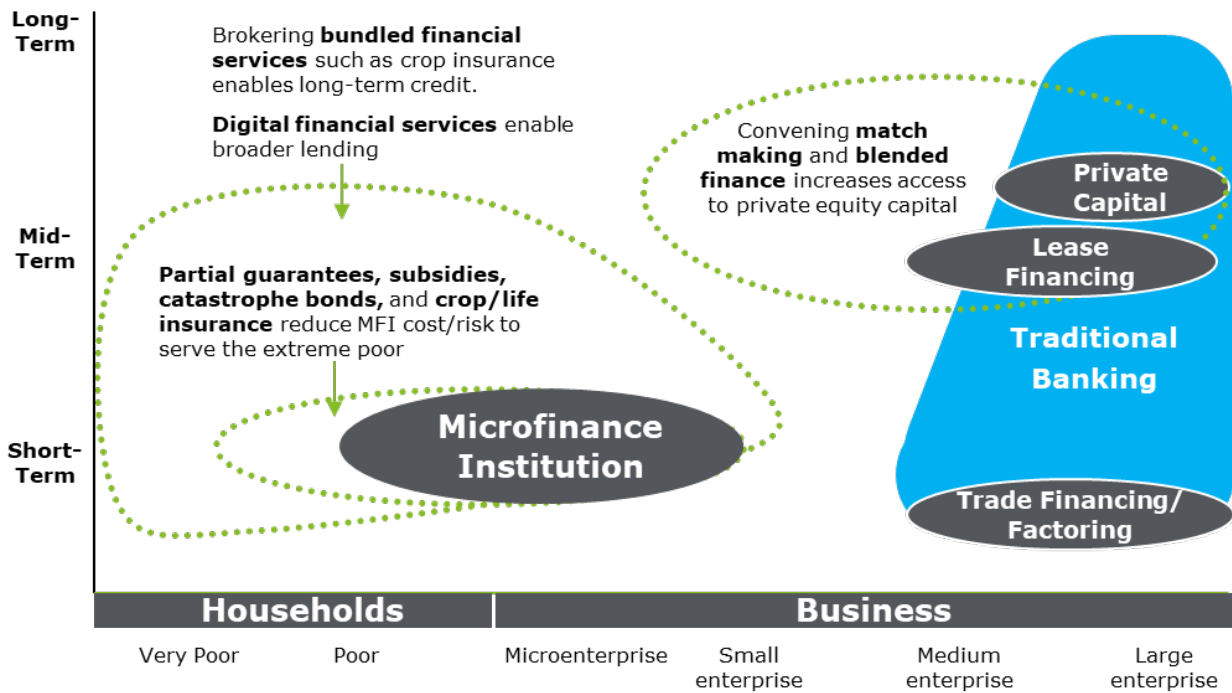


Figure 22: Illustrative Impact of Financial Intermediation Interventions<sup>62</sup>



<sup>61</sup> Graphic developed by Deloitte, for USAID PCM

<sup>62</sup> Graphic developed by Deloitte, for USAID PCM

Overall, while financial sector enabling conditions interventions have an indirect impact, and can take time periods of years or even decades to take effect, they can have significant impact in enabling a more efficient financial sector that is better able to support economic development:

- Improved financial sector policies, governance, and regulation can reduce risk to finance providers
- **Secured lending** laws and collateral registries can increase transparency and reduce risks and costs of collateral
- Credit bureaus and electronic funds transfer systems can increase security and transparency, further reducing risks and cost-to-serve
- Active participation in financial intermediation helps to match finance seekers and finance providers with appropriate financing approaches

## Chapter recap

In this chapter, we introduced the Five Points Framework and used it to explore the constraints that tend to impede finance and hinder investment in developing countries. We also considered a range of potential interventions which can mitigate these constraints and have the potential to enable private sector financing of development.



## Chapter Three:

# How can we integrate “mobilizing private finance” into development programming?

## Introduction

We have covered a great deal of territory so far. We have explored:

- **What finance is and why it is critical** for development – as well as why the time is ripe for engaging private enterprise in development
- **The Five Point Framework** to better understand the financial sector ecosystem and the different actors and instruments which can meet the varied financing needs of households, businesses and governments
- The **constraints** to financing and the different ways in which we can **intervene** to reduce or mitigate those constraints

Now, how do you incorporate an understanding of the financial system, its constraints and possible interventions into your development programs? In this section we will:

- Introduce a checklist with which to explore which interventions to catalyze financing are likely to be effective. We recognize that not all interventions will be appropriate in a given country or program context, nor at specific stages in the program cycle. We do not presume there is a “right” solution for any given challenge, much less a universal one.
- Suggest a process for developing a comprehensive, effective intervention strategy.
- Discuss some of the new procurement approaches for programs and projects, and explore some techniques for retrofitting these approaches to catalyzing financing into existing development programs and projects.
- Present some new and trending approaches to catalyzing finance, including pay-for-results, blended finance, and funds and facilities.

## Balancing trade-offs and the intervention checklist

When evaluating which interventions to employ to facilitate private capital, a range of factors should be considered.




### Balancing Trade-Offs

After having reviewed all elements of the **Five Point Framework in** relation to your project and having considered the various constraints it faces, you will likely have a long list of possible intervention options. *How do you know which intervention or set of interventions to use?*

It should be clear that USAID and other development agencies have the ability to facilitate transactions that might otherwise not occur. With this power comes responsibility: the responsibility to ensure that the intervention selected is most appropriate to the national context and other intervention goals.

### The Interventions Checklist

Figure 23: Intervention Checklist<sup>63</sup>

		Factors	✓	✗
<b>Time</b> 	}	Time to Impact		
		Sustainability		
<b>Impact</b> 	}	Cost-Benefit		
		Scalability		
		Minimize Market Distortions		
<b>Relevance</b> 	}	Additionality		
		Country Context		

The intervention checklist is a way to explore different considerations - with key factors being:

- **Time to Impact:** How quickly will the impact of an intervention be realized?
- **Sustainability:** How likely is it that this intervention will have a lasting impact, including beyond the completion of the specific development program?
- **Cost-Benefit:** How does the investment required for an intervention compare to the benefits expected?
- **Scalability:** How broad is the scope of impact the intervention will or can potentially have? How easily could the intervention be “scaled-up” or repeated?
- **Minimize Market Distortions:** The intervention should not result in financial market pricing of funding availability being significantly different than would result from a well-functioning financial market.

<sup>63</sup> Graphic developed by Deloitte, for USAID PCM

- **Additionality:** How confident are you that an intervention will have an effect, that might not have happened otherwise?
- **Country Context:** How relevant and appropriate is the intervention in the context of the presence country culture, systemic feasibility, etc.?

No single development intervention will score highly along all these dimensions. Strength in one area is often balanced with lower effectiveness in another. You must consider what your project/program goals are. For example, are you trying to catalyze financing for a specific transaction or for SMEs more broadly across all sectors?

## Developing an intervention strategy

Some readers of this Guide may have been hoping for clear, simple solutions. However, catalyzing capital is complicated. Not only is there a broad spectrum of financing needs *and* a broad range of finance providers, but there is a broad range of constraints as well, which differ according to country, and even individual project context.

Compounding this, there is also a broad array of potential interventions, each with different impact and different trade-offs in its effects. Becoming a successful investment catalyst requires the ability to look broadly at these intervention options and assemble the most effective combination and sequence of interventions in light of the development challenge and the country context.

Here are a set of suggested steps for assessing and developing your interventions to mobilize private capital for development:

1

**Define the development problem:** Consider “*What is the problem you are trying to solve? Why is it important?*” Using agriculture as an example, the challenge may be how to modernize agriculture in one of our presence countries.

2

**Identify the role of finance:** Consider “*What role does finance play in solving that problem?*”. As we know from the Teo’s example, accessing finance for investments in agriculture can be a challenge.

3

**Identify and evaluate the financing constraints:** Evaluate “*What is constraining the finance from being available for this purpose?*” Review all five elements of the Five-Point Framework to consider the balance of systemic vs transaction-specific factors. Consider the relative strength and relevance of each impediment to accessing private finance for the project purpose.

4

**Identify potential interventions:** Having thoroughly understood the issue, the role of finance and the constraints, next consider “*What are the potential interventions?*” Having diagnosed the problem, now list the many possible solutions available to solve that problem.

5

**Weigh the relative pros and cons of each potential intervention:** Next, narrow down the range of intervention options by evaluating “*Which are the most effective interventions?*” With the full range of available options, consider, “*Which are going to be most effective in addressing the constraint?*” The interventions checklist will help think through and assess these potential tradeoffs.

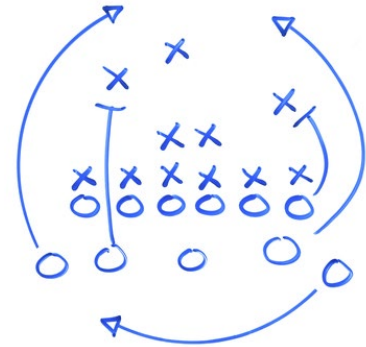
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**Develop your plan:** Finally, *create a final proposal for recommended interventions*, along with projected timeline and budget. This should include expected outcomes, or what will be accomplished through the interventions, along with spillover effects to be realized (e.g., jobs created or exports generated).

## Procurement strategies for mobilizing capital

Innovations in USAID’s approaches to procurement such as the *Broad Agency Announcement*<sup>64</sup> (BAA) and the forthcoming *Broad Ordering Agreement* (BOA) offer new avenues for seeking innovative solutions to catalyzing financing, and for engaging with new partners.

The BAA is a process for identifying new solutions to vexing development challenges and is notable for the ability to engage non-traditional and local actors, as well as to enable active co-creation of solutions with them. For example, USAID’s Ghana Mission<sup>65</sup> has explored issuing a BAA on identification of sustainable solutions for providing financing in agriculture, and the Haiti Mission<sup>66</sup> was successful in using the BAA process to launch a public/private effort to address financial inclusion.



When the BOA is launched, USAID Missions should be able to engage an even broader range of international and host country finance.

## New and trending approaches to catalyzing private finance

### Pay-for-Results

Pay-for-results is an umbrella term for initiatives that pay upon accomplishment of results rather than for the efforts to accomplish those results. The approach is also sometimes called “Pay-for-Performance” (PFR). In PFR, the principal or funder sets financial or other incentives for an entity (or individual in the case of cash transfers) to deliver predefined outcomes, and rewards the achievement of these results upon verification.

Interest in using “Pay-for-Results” strategies in development has risen sharply in recent years, in line with growing attention to the effectiveness of overseas aid and the need to use scarce funding resources most efficiently. AgResults is a good example of a [Pay for Results](https://agresults.org/) program (<https://agresults.org/>).

Pay-for-Results is a disruptor, providing an alternative to the traditional cost-reimbursement service procurement model, and offering the following potential benefits:

- **It encourages innovation in development** by rewarding successful outcomes rather than paying for specific activities. As a result, the implementer has more freedom to innovate in its approach to achieving the specified outcomes.
- **It can attract new funding sources** (including from the private sector) because of the possibility to earn a profit if the results can be delivered for a value lower than results-based payments.
- **It facilitates alignment of interests among funders and implementers** because payment occurs when results are achieved, meaning both the paying agency and the implementer are oriented towards achieving development outcomes, rather than inputs alone

<sup>64</sup> <https://www.usaid.gov/partnership-opportunities/respond-solicitation/broad-agency-announcements>

<sup>65</sup> <https://researchfunding.duke.edu/ghana-usaid-accra-broad-agency-announcement-mobilizing-financing-agriculture>

<sup>66</sup> <https://govtribe.com/opportunity/federal-contract-opportunity/usaidhaiti-broad-agency-announcement-advancing-financial-inclusion-in-haiti-baa521egad201501>

- **It fosters evidence-based development** because payment-for-results requires a clear measurement of when and whether results are achieved, it serves to incentivize program designers to build the program around clear collection of baseline and subsequent metrics.

PfR is especially promising to catalyze financing. As noted earlier, finance is primarily about calculating yield and ensuring that returns exceed the cost of capital. Marrying PfR with blended capital can provide a very efficient way to adjust the yield on a transaction as needed.

While Pay-for-Results has great potential to be used at a much broader scale, it has challenges that need to be considered. For example, there is currently little guidance on how to set and price performance metrics, and the incentives are not high within some development agencies for taking on the risk and challenges of designing pay-for-results projects. While sharing performance risk with implementers is appealing, this represents a significant change in the traditional relationship between aid agencies and implementers, and not all implementers will be willing or able to take on the upfront costs and risk of a PfR program.

Thus, widespread use of PfR will likely require the steady building and sharing of experience and expertise in aspects such as:

- Metrics definition
- Baseline and monitoring
- Cultural shifts in aid agencies and implementers

### Blended Finance

Blended finance, or blended capital, is a way of combining free or low-cost public, philanthropic, or private funds together with traditional profit-seeking private funds. This is done to achieve a lower average cost of capital, which can finance transactions which might otherwise not be able to produce the full commercial return required by for-profit private funds. In other words, it is subsidizing private capital with the objective of catalyzing investments which have important social and economic benefits.

There are more blended finance investment platforms which are seeking to employ blended financing to catalyze larger transactions. Other entities employ blended capital at the SME and micro level.

USAID Missions can also launch their own blended finance vehicles directly. One example is the Haiti HOME<sup>67</sup> project, in which USAID engages with housing providers to incentivize them to build affordable housing models. To encourage them into this less profitable space, the Mission covers a small portion of the cost as needed to make construction of the units profitable.

Blended capital is essentially a provision of a subsidy in the cost of financing to enable investments which otherwise would not happen. As such, determining the least amount of the subsidy needed to complete the transaction is critical. To date, the concept (at least with larger transactions) remains unproven.

### Funds and Facilities

There is growing interest in supporting debt and equity investment funds. Investment funds pool capital, and then invest or lend those funds with the intent to make a profit. For example, in the past several years, USAID has provided financing for the launch of several funds, including the Pakistan Private Investment Initiative (PPII)<sup>68</sup> and the Medical Credit Fund<sup>69</sup>.

<sup>67</sup> [https://www.woccu.org/programs/current\\_programs/haiti/haiti\\_home](https://www.woccu.org/programs/current_programs/haiti/haiti_home)

<sup>68</sup> <https://partnerships.usaid.gov/partnership/pakistan-private-investment-initiative-ppii-abraaj-capital>

<sup>69</sup> <https://www.medicalcreditfund.org/>

The rationale for supporting funds is that institutional and other wholesale investors may not have the local presence or deal flow needed to invest in USAID presence countries. They may be willing to invest if there is a trusted third-party Fund Manager who can source and oversee a portfolio of local investments. Development agencies such as USAID can support such funds directly through grants which can partially capitalize the funds (and provide a [risk mitigation](#) cushion), or through technical assistance (e.g. to assess potential investments in the developing country context).

Investment funds can be useful agents in catalyzing investments which are important to development agencies such as USAID. Logic dictates that an experienced Fund Manager will generally make good investment decisions (invest in transactions which are likely to succeed). However, subsidized investment funds can create distortion in the financial markets and even an unfair competitive edge if too highly subsidized. In addition, it can often be difficult to align USAID objectives with the objectives of the Fund Manager.

### Development Impact Bonds

Development Impact Bonds (DIBs) have come into prominence recently. In a DIB, the Organizer structures a project to address a development challenge, generally with innovative interventions and financing techniques to solve that problem. The Organizer raises funds from “Investors” by issuing them “bonds” (hence the name “Development Impact Bond.”) Investors in DIBs usually have a strong interest in the outcome sought, for the program and a Service Provider is engaged to implement it. Based upon the results, an Outcomes Funder reimburses the Investors the funds which they have advanced.

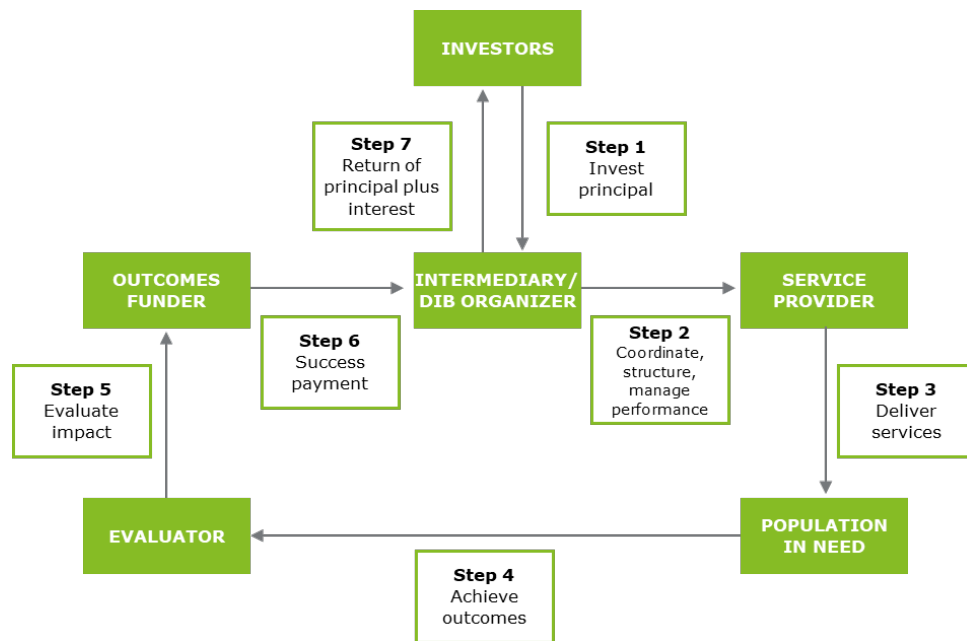
First launched in 2010, DIBs<sup>70</sup> are still new and costly to structure and very few have been launched in the developing world. The DIB concept has generated excitement and shines light on development challenges. Thus far, they have been costly to structure and solid evidence on impact has yet to accumulate. USAID has completed two DIBs as of 2018: the Utkrisht Maternal and Newborn Health DIB in India and the Village Enterprise DIB in sub-Saharan Africa.<sup>71</sup>

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<sup>70</sup> <https://www.usaid.gov/cii/indiadib>

<sup>71</sup> <https://www.devex.com/news/usaid-announces-a-new-development-impact-bond-91621>

Figure 24: Example Structure of a Development Impact Bond (DIB)<sup>72</sup>



### Fintech/digital finance

The term “Fintech” is used to describe a type of company focused on delivering financial services enabled by or delivered through digital and/or mobile technology. Although fintech products can be offered by banks and non-bank financial institutions alike, the last decade has seen the most innovation from fintech start-ups and non-banks. Notable examples relevant to international development include:

- Crowdfunding platforms (i.e., marketplace lending)
- Data analytics-enabled lending
- Mobile payments
- Financial management tools

Viewed from the standpoint of mobilizing capital, fintech innovations address some common barriers. For example, marketplace lending platforms connect large pools of capital (whether from a few large firms or many small investors) to a larger number of prospective borrowers, who might otherwise be considered too risky or too small to merit serving. Non-traditional data sources (such as cellphone service payment histories) can fill in the information gaps on prospective borrowers who lack traditional credit histories or well-documented collateral. Finally, secure digital payment channels facilitate the timely and secure access to money. From a regulatory standpoint, fintech services can prompt questions due to their unique ability to facilitate greater flows of capital across borders.

### Chapter recap

In this chapter, we suggested an approach for considering which interventions to undertake, and how to incorporate them into programming. We outlined the “pros and cons” for the use of ‘pay-for-results’ in programming, as well as other new approaches to engaging non-traditional partners.

<sup>72</sup>Pay for Results in Development, November 2017

## Chapter Four:

# Key finance concepts for development professionals

## Introduction

Throughout this text, we have referred to a wide range of financial terms and concepts which underlies the field of development finance. In this Chapter, we provide a brief overview and explanation of those concepts, as a resource for the reader. Our treatment is necessarily superficial, so we encourage the interested reader to seek other resources as needed.

This Chapter is organized into two sections:

**Financial Accounting Statements:** provides an overview of the most common financial statements used to summarize and communicate the financial performance of companies, according to the Generally Accepted Accounting Principles (GAAP). These are:

- The Profit and Loss Statement (also sometimes called the “Income Statement”)
- The Cashflow Statement
- The Balance Sheet

**Financing Concepts:** briefly explains key principles that underlie the functioning of the finance sector, such as risk, return and leverage.

Additionally, a **Glossary of Financial Terms** is provided in the Appendix. This provides short definitions of a wider range of finance terms that the reader may come across, but which cannot be fully explained in this text.

## Financial accounting statements

### The Profit and Loss Statement

The Profit and Loss Statement summarizes the **revenues**, **costs**, and **expenses** incurred by an organization over a set period (usually a year).












It is also known as the:

- [Income statement](#)
- Statement of earnings
- Statement of operations
- Statement of income

In the hypothetical Teo’s profit and loss statement below, the red bars represent costs taken out of the green revenue bar, to eventually result in the *Net Income after Taxes*, or Net Profit.



Figure 25: Hypothetical Teo's Profit and Loss Statement<sup>73</sup>

Teo's Profit and Loss Statement in 2019			
Revenue	\$500,000		
Cost of Goods Sold	\$120,000		
<i>Gross Profit</i>	<i>\$380,000</i>		
Operating Expenses			
Selling	\$35,000		
Administrative	\$45,000		
Total Operating Expenses	\$80,000		
<i>Operating Income</i>	<i>\$300,000</i>		
Other items	\$20,000		
Tax expense	\$5,000		
Total other expenses	\$25,000		
<b>Net Profit</b>	<b>\$275,000</b>		

### Interpreting the Profit and Loss Statement

Financial analysts look at the relative ratios of costs and revenues to help them understand the financial performance of a business. For example, the **Gross Profit** divided by Revenue is the "*Gross Profit Margin*", which reveals the proportion of money left over from revenues after accounting for the cost of goods sold.

**Net Profit** divided by the Revenue is the "*Net Profit Margin*", which tells us the percentage of revenue remaining after all operating expenses, interest, taxes and [preferred stock](#) dividends (but not [common stock](#) dividends) have been deducted from a company's total revenue.

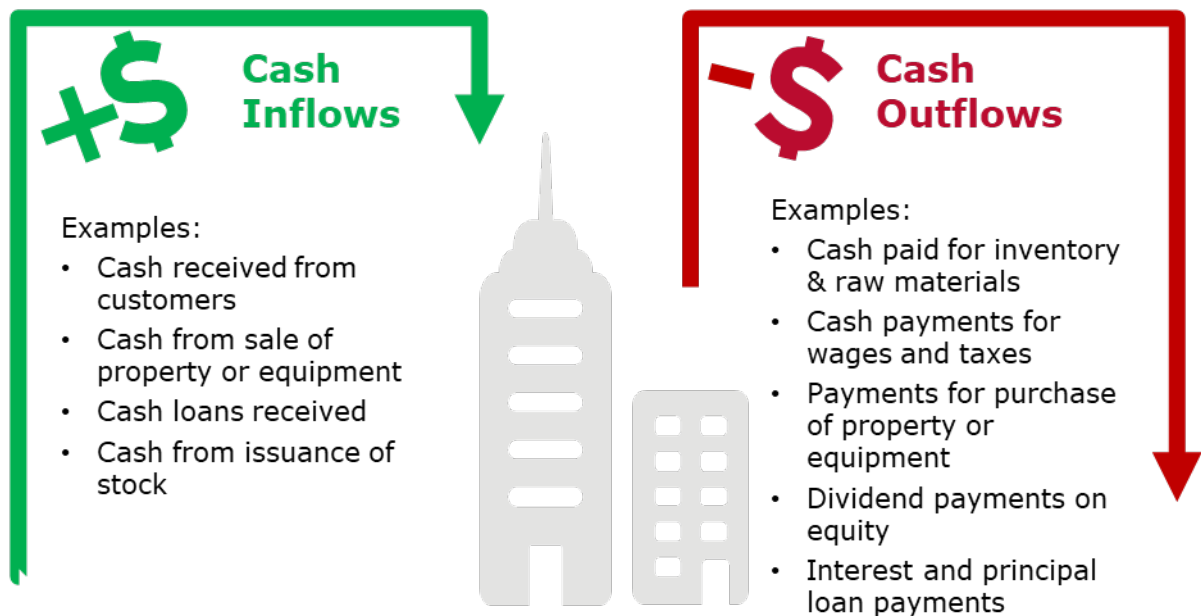
Comparing these ratios between businesses helps us understand how well they are managing their costs relative to revenues, and thus their relative financial performance.

<sup>73</sup> Graphic developed by Deloitte, for USAID PCM

## The Cashflow Statement

The **Cashflow Statement** details how money is coming into an organization and how it is spent over the accounting period. Examples of cash inflows/outflows are shown in Figure 26.

**Figure 26: Example Cash Inflows and Outflows**<sup>74</sup>









### Hypothetical Teo's Cashflow Statement (Figure 27)

- The red bars represent cash outflows which are taken out of the green cash receipts bar
- It is organized by the three categories of *operations*, *investments* and *financing*
- Net Cash Flow is shown at the bottom of the statement
- A more positive [Cash Flow Statement](#) indicates more funding available for business operations and investment

<sup>74</sup> Graphic developed by Deloitte, for USAID PCM

**Figure 27: Hypothetical Teo’s Cashflow Statement<sup>75</sup>**

	Teo’s cash flow in 2019	
<b>Cash Flow from Operations</b>		
Cash Receipts	\$650,000	
Cash Payments	\$360,000	
<i>Net CF from operations</i>	\$290,000	
<b>Cash Flow from Investing Activities</b>		
Receipts from Sales and Collections	\$0	
Payments for Property, Equipment	\$240,000	
Purchase of Investments	\$0	
<i>Net CF from Investing Activities</i>	\$240,000	
<b>Cash Flow from Financing Activities</b>		
Receipts from Issuing Equity and Borrowing	\$0	
Interest & Repayment of Loans	\$312,000	
Repurchase of Equity	\$0	
<i>Net CF from Financing Activities</i>	\$312,000	
<b>Net Cash Flow</b>	<b>\$262,000</b>	

### The difference between the Profit and Loss Statement and the Cashflow Statement

It is important to understand that the Cashflow Statement differs from the Profit & Loss Statement because:

- It includes financing activities (such as investment outlays and capital financing received and repaid) which are not operating revenues or costs (and thus are not included in the revenue statement)
- Revenue and costs are not received/paid immediately. Revenue may be invoiced (and thus included in the revenue statement) in one period, but payment may not be received until a later time (and will thus appear in a different period’s cash flow statement)
- These timing differences between invoicing and cash receipts/payments, cause cash inflows and outflows to differ from the revenue and cost flows in the profit and loss statement

### Interpreting the Cashflow Statement

The **Cashflow Statement** demonstrates how well a company produces cash to pay its debt obligations and fund its operating expenses. Finance providers and other possible creditors will look at a company’s Cashflow Statement to judge the company’s ability to repay the finance to potentially be provided. As with the **Profit and Loss Statement**, financial analysts look at ratios to help understand the health of a company’s cashflow.

The most common cashflow ratio is the **operating cash flow ratio**, also known as the **liquidity ratio**. This is calculated by dividing the cash flows generated from a company’s operations during a period by its total **current liabilities**. This ratio helps gauge how easily a company can repay all its short term liabilities. For example, if a company has generated cashflows double its near-term liabilities, there should be very little risk that it cannot pay its bills.

<sup>75</sup> Graphic developed by Deloitte, for USAID PCM

Another ratio is **debt coverage** – the ratio of operating cashflow to debt payments due. Debt coverage is monitored by lenders to assess the risk that they may not be repaid.

When assessing the financial health and performance of a business, it is important to look at both the **Revenue Statement** and the **Cashflow Statement**. It is possible for a business to be highly profitable and yet have a negative cashflow, and vice versa.

For example, a company that is growing very fast will see increasing revenues year-on-year and likely healthy profitability also. However, if it is extending lengthy credit terms to buyers or having to invest significantly in equipment and facilities to support that growth, its cash outflows could exceed inflows. Thus, a negative cashflow can result in a situation where a business is unable to pay all its bills, and thus put it at risk of bankruptcy even if it is growing and profitable. A positive cashflow drives the value of a business.

### Teo’s Tractors – Cashflow and Debt coverage in a growing business

*You may wish to refer to Section 4 on cashflows, balance sheet and leverage before considering this vignette.*

Back in 2018, USAID intervened to help Teo’s get his loan to start his business. It is now 2023, and Teo’s has been doing well in its first 5 years of business. Revenues have tripled to \$1.4 million and EBIT has gone up to \$891K. To support his growth, Teo has had to continue to invest in more tractors and facilities – keeping pace with his 30% a year growth.

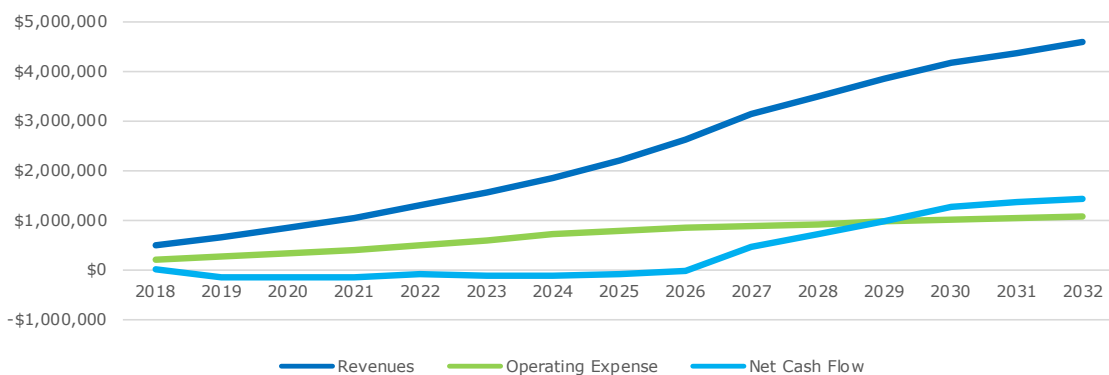
Teo’s business has been solidly profitable, and he has been investing heavily in new equipment to help him grow his business, resulting in the following profit and loss, and cashflow statements for 2023:

Teo’s Profit and Loss Statement in 2023

	2023
Revenues	\$1,584,375
Operating Expense	\$608,975
Operating Income	\$975,400

Teo’s Cash Flow Statement in 2023

	2023
Cash from Operations	\$975,400
Principal Payment	\$468,000
Interest Payment	\$234,000
Debt Service	\$702,000
Cash Flow	\$273,400
Cap Ex Growth	\$390,000
Net Cash Flow	-\$116,600



While Teo’s is profitable, his cashflow is negative, because the investment in assets needed to support his growth has exceeded his net profit, and he has accumulated debt to pay for those assets, resulting in increased interest payments and a negative net cash flow. (The appendix provides more information on how and why cash flow can differ from the profit and loss statement).

What does the situation of Teo’s in 2023 tell you about the importance of interventions such as USAID’s business partners program (which provides subordinated debt) match-making between businesses and potential equity investors? What other interventions are possible, for example to improve the depth of capital markets in a USAID presence country?

## The Balance Sheet

The **Balance Sheet** compares assets owned, liabilities owed, and the amount invested by shareholders, for a business or organization at a specific point in time, usually the end date for period covered by the accompanying Profit and Loss and Cashflow Statements. As its name implies, the assets must balance out with the liabilities and shareholder equity.

### Assets = Liabilities + Shareholders' Equity

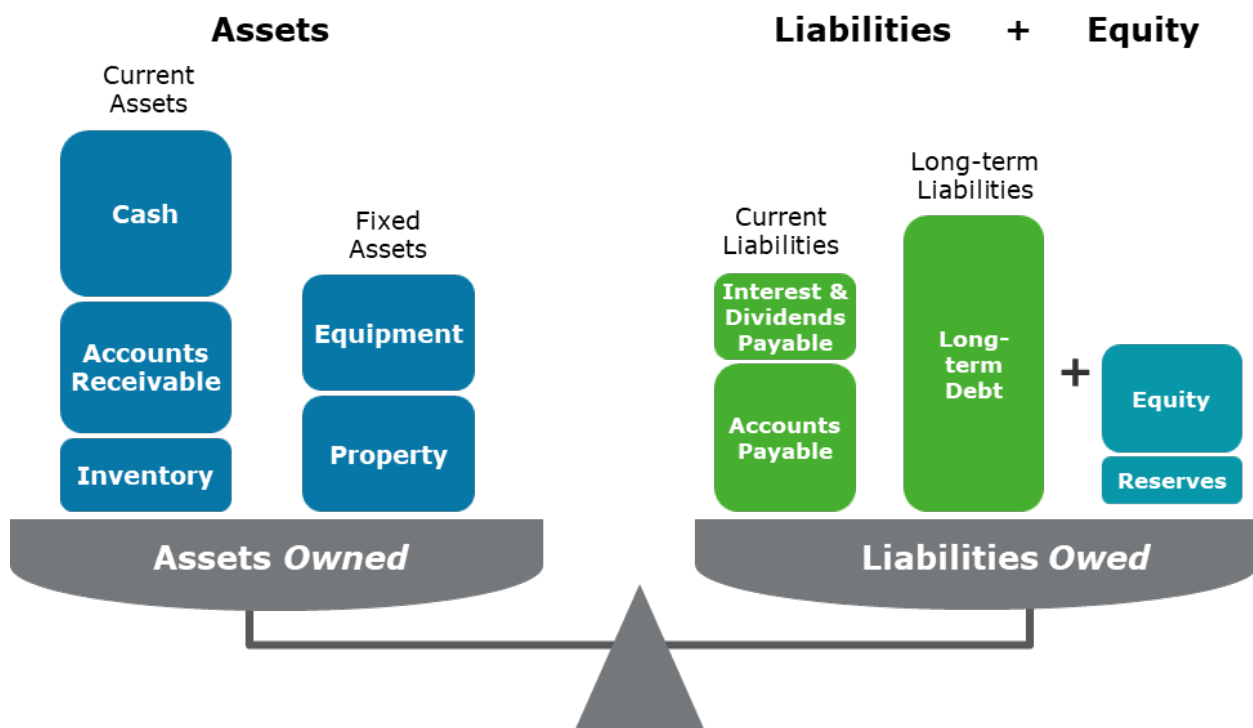
In the Balance Sheet, Assets are grouped into **Current Assets** and **Fixed Assets**. Current assets include cash and other assets (such as account receivable and inventory) that can easily be turned into cash. Fixed Assets are not readily converted into cash and include items such as buildings and equipment.

Liabilities are typically grouped into **Current Liabilities** (e.g., bills that should be paid relatively soon) and **Long-term Liabilities** (which usually should be paid further than a year out).

The liabilities side of a balance sheet also includes **Equity** and **Reserves**, which represent the amount invested by the business's owners and accumulated profits of the business over the years. These are considered liabilities because at some point in future they may be paid out to the business owners.

Equity and reserves "balance" out the excess of assets over liabilities, and are thus sometimes called "**Net Assets**." Overall, Assets and Liabilities in a Balance Sheet must balance each other out.

Figure 28: The Balance Sheet<sup>76</sup>



<sup>76</sup> Graphic developed by Deloitte, for USAID PCM

**Interpreting the Balance Sheet:** The Balance Sheet provides information needed to evaluate a company's **capital structure**. The two main aspects of this to be aware of are **Liquidity** and **Leverage**.

### Liquidity

Broadly, long term assets should be financed by longer term liabilities, short term (current) assets by shorter term liabilities. This indicates that cash is likely to become available on a timeline matching when liabilities become payable. Current assets divided by current liabilities is called the **Current ratio** (also called the **Acid Test Ratio** and **Working Capital Ratio**.) It indicates the ability of a company to pay its near-term bills, much like the operating cashflow ratio.

### Leverage

See the following section for an explanation of [financial leverage](#).

## Financing concepts

This section provides an overview of some key principles and concepts that underlie the functioning of the finance sector, such as **debt, equity and leverage; company valuation, risk, and return**.

### Debt and Equity

**Figure 29: Debt, Equity, and Leverage<sup>77</sup>**



<sup>77</sup> Graphic developed by Deloitte, for USAID PCM

**The difference between Debt and Equity financing:**

**Debt financing:** Debt is the raising of money by taking out a loan, selling bonds or via several other available means. It has several advantages for businesses, including:

- It can be simpler and cheaper than other financing, such as equity.
- It usually has a predictable cost, which is negotiated or contracted up front.
- It usually has tax advantages, being treated as an operating cost of the business
- The business's existing owners retain control because they do not have to sell some of their ownership in the business

Interest and principal on debt must be repaid according to the terms agreed to with the debt provider at the outset. Thus, debt providers receive fixed payments and interest based on the terms of the loan. When financing through debt, the finance seeker will usually want to lower their cost by **reducing the debt provider's exposure to risk**. This can be done through various mechanisms including cash covenants requiring minimum cash on hand (i.e., to cover interest payments), debt covenants limiting additional debt, and providing collateral.

**Equity finance:** Equity is raising money by selling an ownership stake in the business. Equity does not require a regular repayment or interest like debt does, since the equity providers receive their return through a residual claim on the firm's asset after payment of all other obligations.

A disadvantage of equity is that the existing business owners or managers incur a reduction in control of the business, which becomes shared with the new equity holders. Equity funders generally do not require a regular repayment or interest like debt does. They want to fund the business so that they will reap the benefits of profitable growth in the future.

Since equity holders own a stake in the business, and stand to benefit from the long-term profitable performance of a business or investment, they tend to take more risk. Examples of equity finance providers include private equity firms, investment banks, and angel investors. The type of equity investor most interested in a business will be influenced by its risk profile, its stage in development, among many other factors.

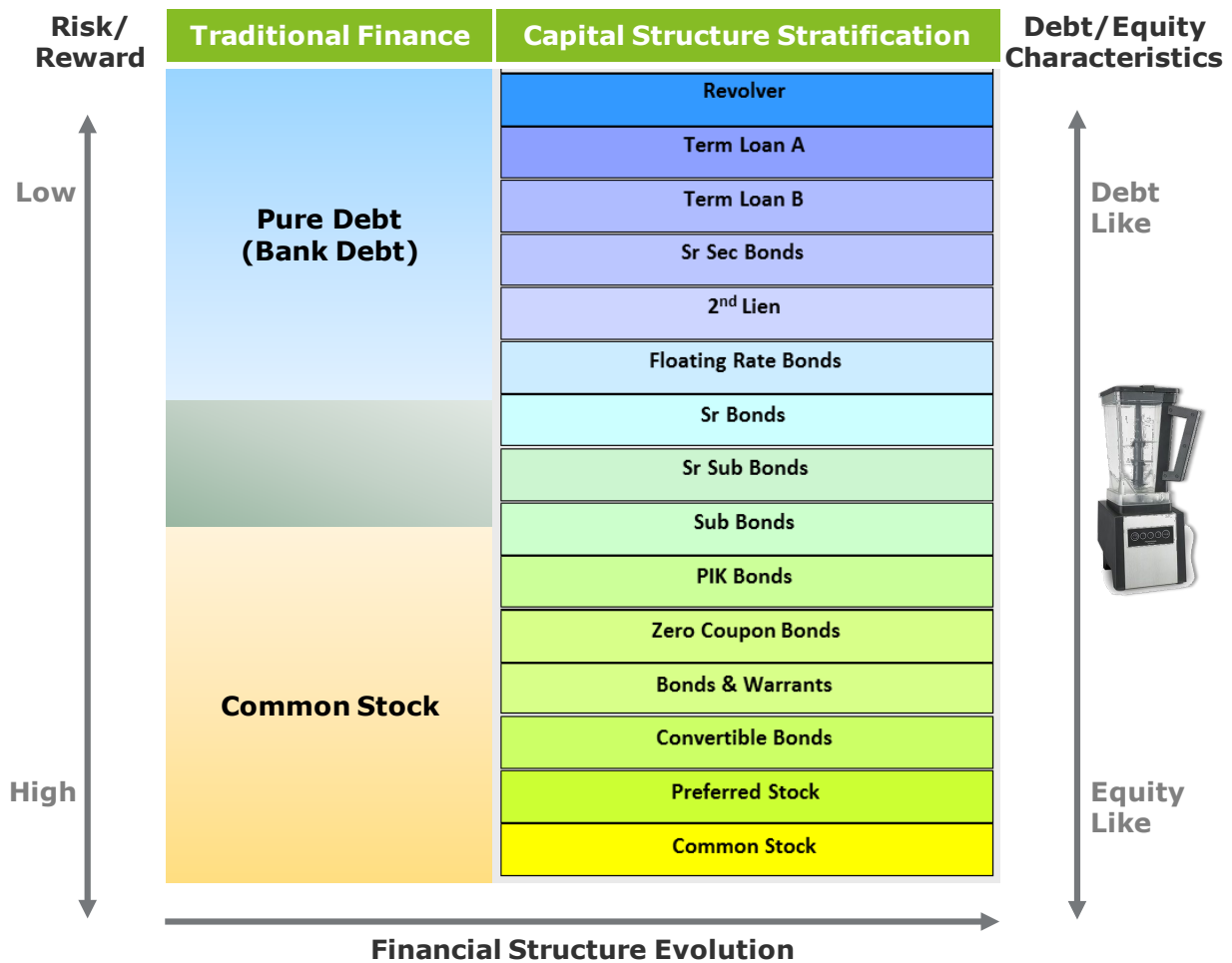
As evidenced through the various types of finance discussed throughout this text, there are many different types and sources of financing:

- Mortgages
- Bond issues
- Revolving credit
- Movable property lending
- Microfinance
- Grants
- Social impact investors
- Invoice lending and [factoring](#)
- Leases
- Rentals
- Equity

**Combining Debt and Equity finance:** Many of the complexities of finance flow from the need for firms to balance the levels of debt vs equity to meet their specific, and often complex financing needs. Complex mixes of different types of debt and equity appear in complex balance sheets because of the various nuances and other legal details around this basic principle.

While much of financing is represented by “pure” debt or equity, a wide range of debt-like and equity-like funding exists to meet different investors’ and finance seekers’ needs. This is illustrated in the **Figure 35**.

**Figure 35: The Spectrum of Debt-like and Equity-like financing**<sup>78</sup>



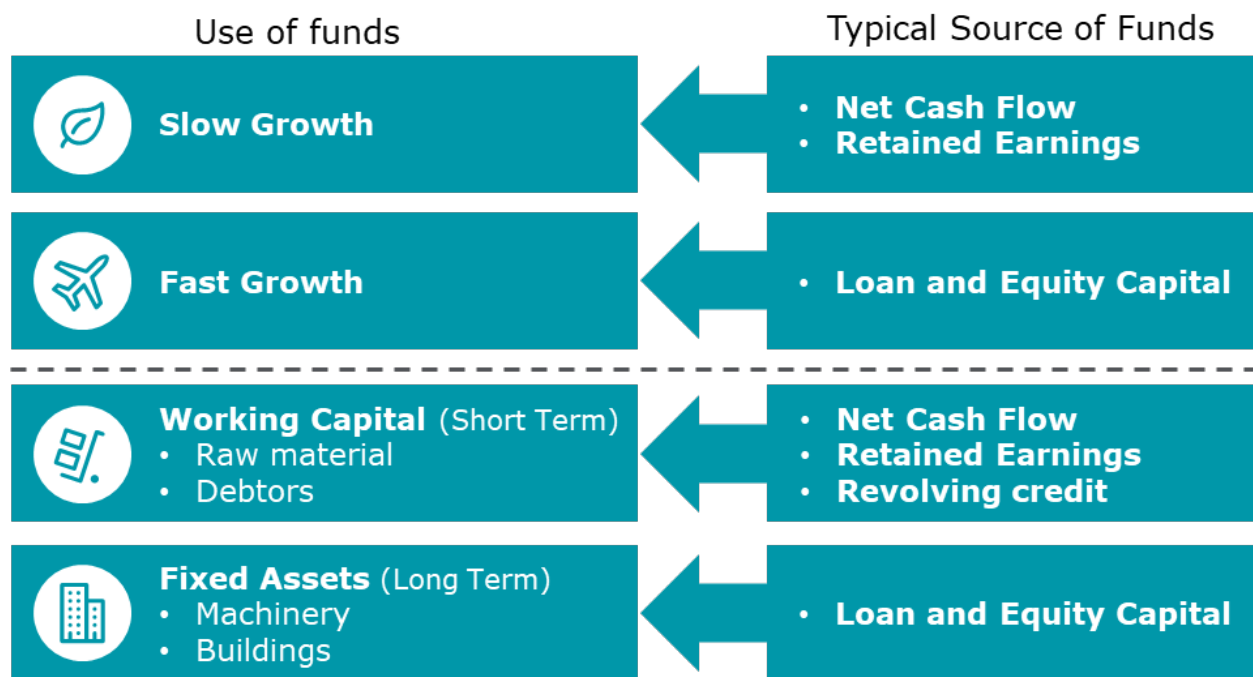
<sup>78</sup> Graphic developed by Deloitte, for USAID PCM



### Sources and uses of funds

In general, each category or source of finance is matched to a particular category of use. Slower growing businesses may be able to finance their investments from net cashflow and **retained earnings**, whereas faster growing companies are more likely to need increasing amounts of external debt and equity financing. Short term liabilities will typically be funded from net cashflows and short-term or revolving credit, while longer term investments and fixed assets will tend to be financed from longer term, external sources of debt and/or equity finance.

Figure 30: Use of Funds vs Source of Funds<sup>79</sup>

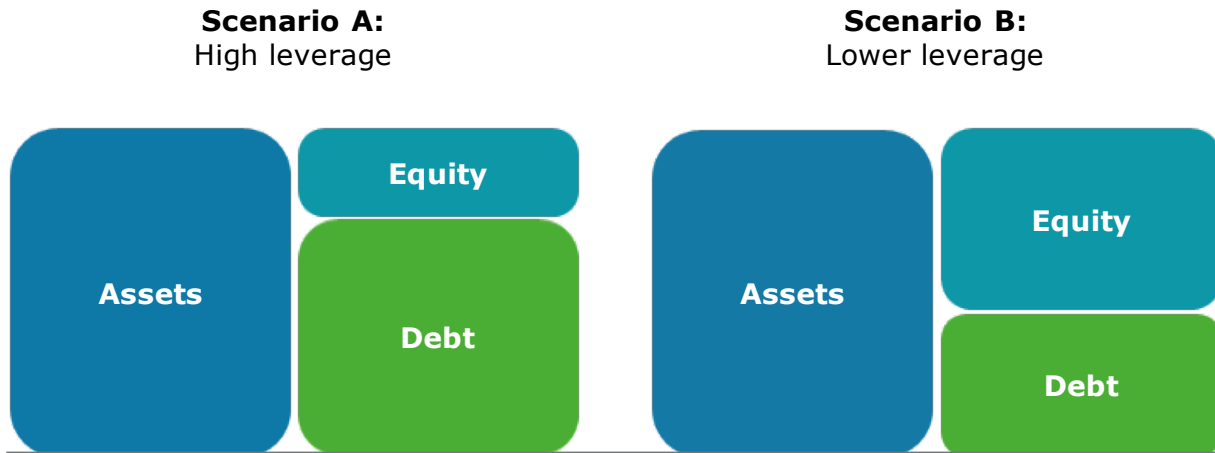


<sup>79</sup> Graphic developed by Deloitte, for USAID PCM

### Leverage

As noted earlier, **leverage** is the ratio of debt to equity in a firm’s balance sheet.

**Figure 31: Leverage Scenarios**<sup>80</sup>

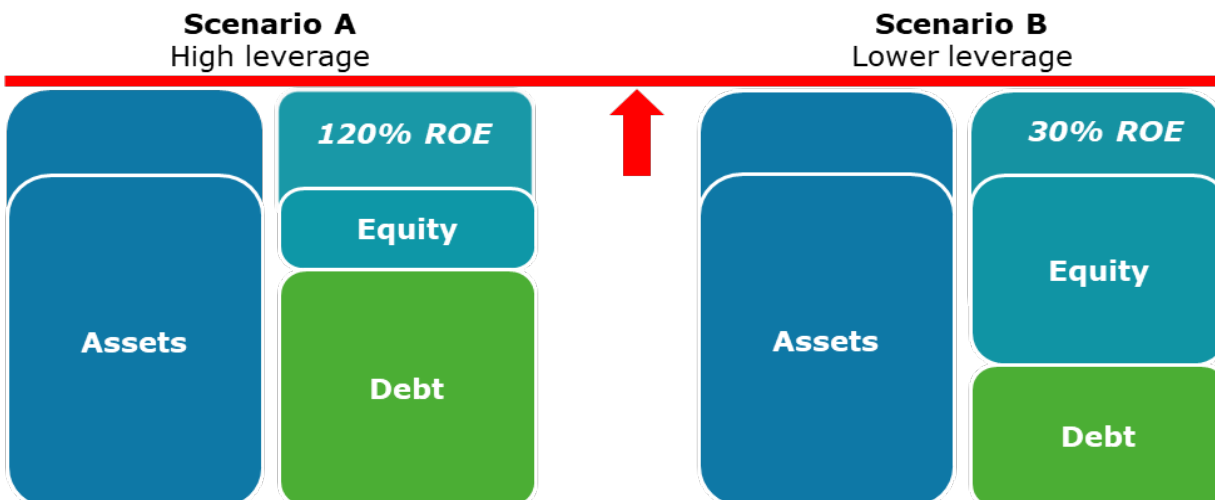


The importance of understanding and managing leverage can be illustrated via **Figure 31** by comparing the implications of high vs low leverage. **Figures 32** and **33** illustrate leverage under different business conditions (i.e., when the company is doing well and when business is doing poorly).

#### When business is doing well...

Under these conditions, equity holders in the high leverage scenario make a higher return on their investment than if they had lower leverage, as illustrated in Figure 32.

**Figure 32: Leverage Scenarios – Positive**<sup>81</sup>



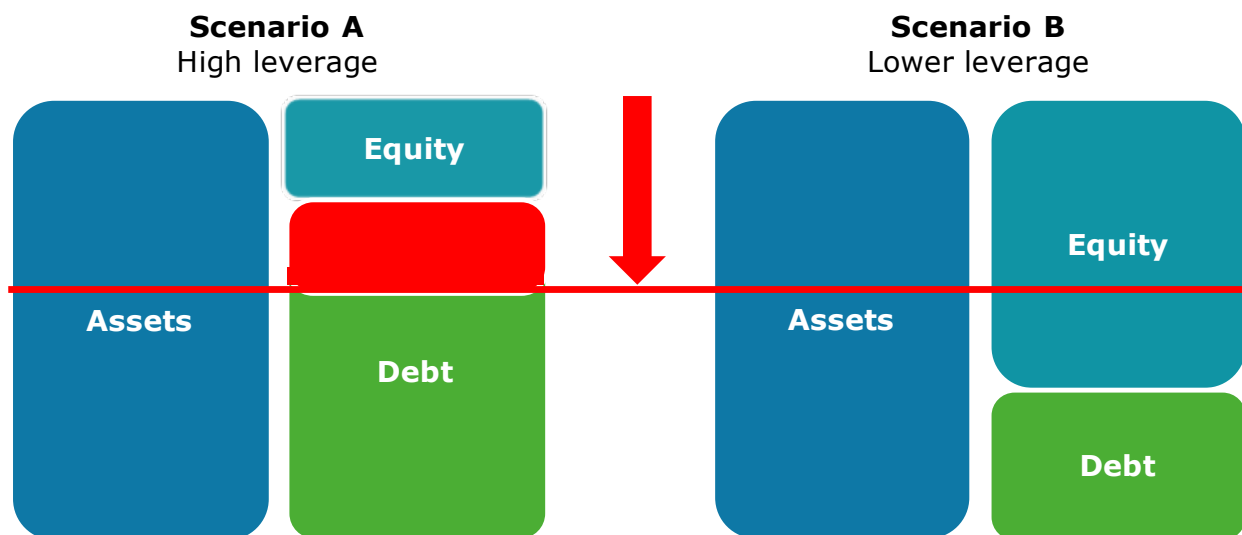
<sup>80</sup> Graphic developed by Deloitte, for USAID PCM

<sup>81</sup> Graphic developed by Deloitte, for USAID PCM

**When business is doing poorly...**

As illustrated in Figure 33, in a high leverage scenario there may be insufficient equity to absorb a negative shock to the business. Equity holders could lose their investment, and a business could be forced to default on some of its debt – potentially leading to bankruptcy and the loss of employment for the business’s workers. In contrast, the enterprise with lower leverage is able to absorb a period of poor business – equity devaluatrimon is sufficient to absorb the shock without the need to default on debtors.



**Figure 33: Leverage Scenarios – Negative<sup>82</sup>**



**Advantages and disadvantages of leverage:**

In general, business owners (equity holders) like some leverage because it increases their return. However, they do not want not too much, because they don’t want the firm to fail. In contrast, to reduce their risk of not being repaid, debt providers want a firm to minimize leverage.

**Figure 34: Advantages and Disadvantages of Leverage<sup>83</sup>**

<p><b>Advantages</b></p> 	<p><b>Disadvantages</b></p> 
<ul style="list-style-type: none"> <li>• Existing equity holders retain control</li> <li>• Boosts <b>return on equity</b> (plus, other cost, etc. advantages of debt)</li> </ul>	<ul style="list-style-type: none"> <li>• Debt has to be repaid, so leverage increases risk if cash flow reduces</li> <li>• Thus, leverage reduces resilience of the firm—e.g. if Teo’s experiences a drought year</li> </ul>

<sup>82</sup> Graphic developed by Deloitte, for USAID PCM

<sup>83</sup> Graphic developed by Deloitte, for USAID PCM

### Valuation, discounted cashflow, discount rate

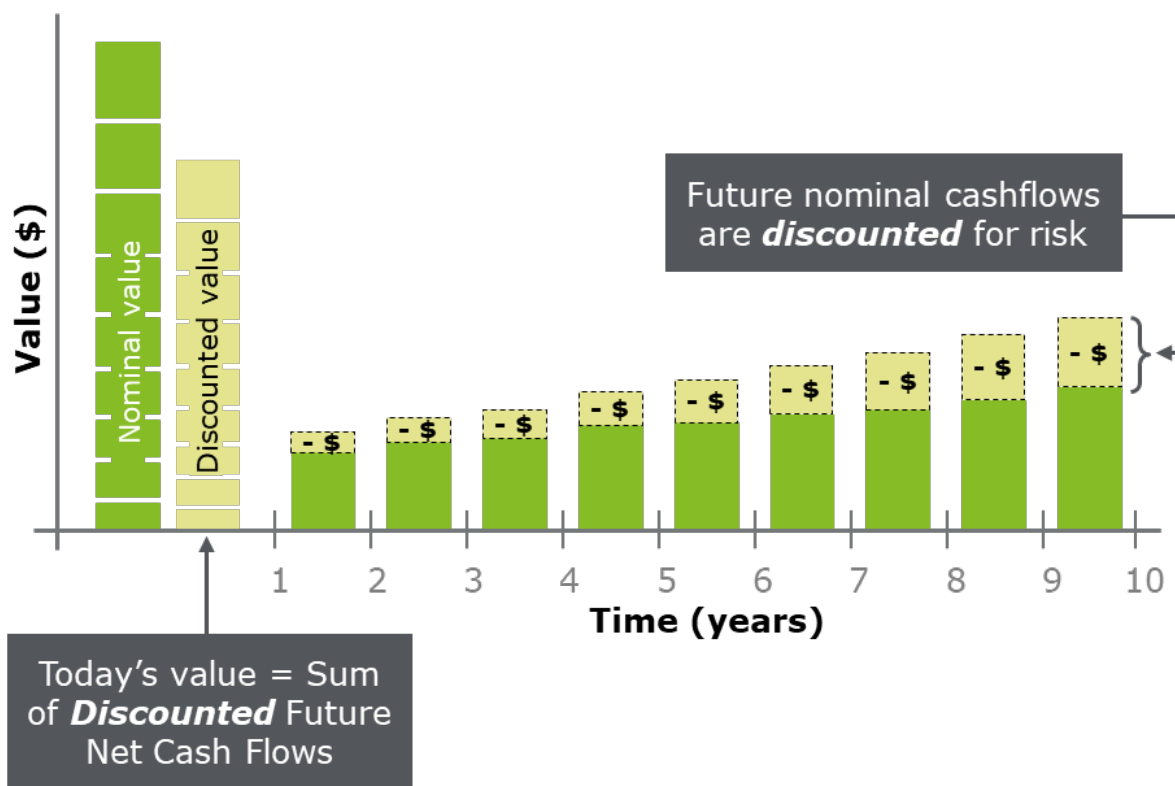
An earlier section of this chapter introduced the **Profit and Loss Statement**, the **Cashflow Statement** and the **Balance Sheet**. *How can we use these financial statements to understand how much a business is worth?*

For example, is the value of a business the value of its assets in the Balance Sheet, or perhaps related to the profit it shows in the Profit and Loss statement?

**In fact, the value of a business is most closely related to its expected future cash flows.**

However, there is a risk that the company will not be able to generate the cashflows as projected. Therefore, we discount the expected future cashflows by the interest rate (or discount rate) to reflect this risk. Higher perceived risks for a given company or investment will lead finance providers (such as equity investors) to use higher discount rates when assessing the present value of expected future cashflows.

**Figure 36: A business’s value is related to its anticipated future Cashflows<sup>84</sup>**



This means that companies that perform similarly, but are in countries that exhibit different risks, will have different values. This is because finance providers will apply a higher discount rate to the similar expected future cashflows, to reflect the higher risks of one country compared to another. This is one of the factors that causes challenges in securing private financing for development, and it explains why interventions intended to lower the exogenous risks by impacting the enabling environment can enable more cost-effective financing.

<sup>84</sup> Graphic developed by Deloitte, for USAID PCM

## Teo's Tractors – How much is Teo's business worth?

It is 2032, Teo's is now pan-African with revenues of over \$3 million. Teo is ready to retire. He is thinking of a buyout of the business or perhaps an IPO. But how much is the business worth?

How Much is Teo's Business Now Worth?

### Teo's Profit and Loss Statement in 2032

2032	
Revenues	\$4,584,968
Operating Expense	\$1,089,431
Operating Income	\$3,495,537

### Teo's Cash Flow Statement in 2032

2032	
Cash from Operations	\$3,495,537
Principal Payment	\$1,185,038
Interest Payment	\$592,519
Debt Service	\$1,777,557
Cash Flow	\$1,717,980
Cap Ex Growth	\$282,152
Net Cash Flow	\$1,435,828

### Teo's Balance Sheet in 2032

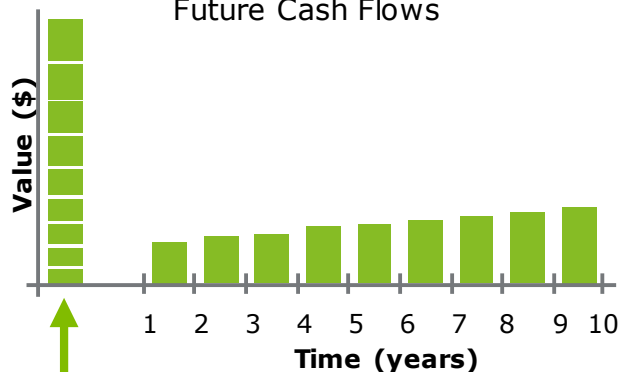
Assets		Liabilities	
Current Assets	\$0.5m	Equity	\$0.6m
Fixed Assets	\$3.2m	Debt	\$3.1m
<b>Total</b>	<b>\$3.7m</b>	<b>Total</b>	<b>\$3.7m</b>

What do you think Teo's business is worth?

1. \$0.6m – equity?
2. \$3.2m – fixed assets?
3. \$3.7m – balance sheet value?
4. \$0.6m – Balance sheet value less debt?
5. \$0.1m – Fixed assets less debt?

Investors in Teo's (or any business) will *relate* its value to the future net cashflows that may be paid to them

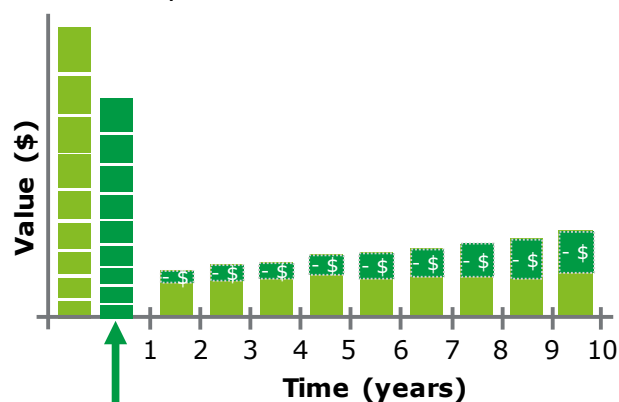
Teo's Value is Related to its Anticipated Future Cash Flows



Today's value = Sum of Future Net Cash Flows?

Because a dollar today is preferable to a dollar in the future, future net cashflows are *discounted* by the discount (or interest) rate

Teo's is Worth the Discounted Value of Its Anticipated Future Net Cash Flows




Today's value = Sum of **Discounted** Future Net Cash Flows

**Thus, the value of a business is the discounted value of its expected future net cashflows**


The above Teo’s vignette shows how the value of a business depends on its expected future cashflows. The following Teos vignette shows that enabling conditions also have an impact on the value of a company, due to the impact enabling conditions have on the discount rate.

### Teo’s Tractors – The role of enabling conditions in determining company values

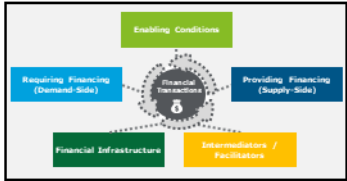


Mary  
Illinois,  
USA


- How do the environment and financial infrastructure differ between Mary’s (Iowa) and Teo’s (Ghana)?
- How do the risks faced by Mary’s differ from those faced by Teo’s?





Teo  
Kumasi,  
Ghana



The diagram shows a central circle labeled 'Financial Transactions' with a dollar sign. It is surrounded by four boxes: 'Enabling Conditions' (top), 'Requiring Financing (Demand-Side)' (left), 'Providing Financing (Supply-Side)' (right), and 'Financial Infrastructure' (bottom). Below the bottom box is another box labeled 'Intermediators / Facilitators'.



Mary  
Illinois,  
USA

Teo  
Kumasi,  
Ghana

Mary’s 2032 Valuation		Teo’s 2032 Valuation	
Annual net cashflow:	\$1.4m	Annual net cashflow:	\$1.4m
Period:	10 years	Period:	10 years
Discount rate:	<b>10%</b>	Discount rate:	<b>20%</b>
<b>Value based on FCF \$8,822,541</b>		<b>Value based on FCF \$6,019,669</b>	

**Because more favorable enabling conditions support lower interest rates, Mary’s business is worth more than Teo’s**

## Risk and its Role in Finance

### The taxonomy of risk:

Risk is the possibility of loss or injury, or the existence of someone or something that creates or suggests a hazard. In Finance, this concept translates to “Downside Risk,” which refers to the potential for financial loss and the uncertainty about its extent.

All investments carry some degree of risk: the probability that something goes wrong, and finance providers lose their money. For example, when buying stock in a company, an investor takes on the risk of that company becoming less successful and thus the purchased shares lose value. When finance providers assess the risk of an investment, they typically evaluate a range of endogenous and exogenous risks:

**Endogenous risks** are related directly to the specific characteristics of the investment or transaction. Examples of endogenous risks include:

- **Credit Risk** (the chance the borrower doesn’t pay the lender back)
- **Management Risk** (the chance that an investment’s managers do not perform well)
- **Competition Risk** (the chance that competition reduces the company’s success)

**Exogenous risks** are driven by factors outside the specific investment or transaction (i.e. enabling conditions) and are thus more difficult for finance providers and seekers to control.

Examples include:

- **Liquidity Risk** (the risk that the loan or investment can’t be traded in the market to prevent a loss)

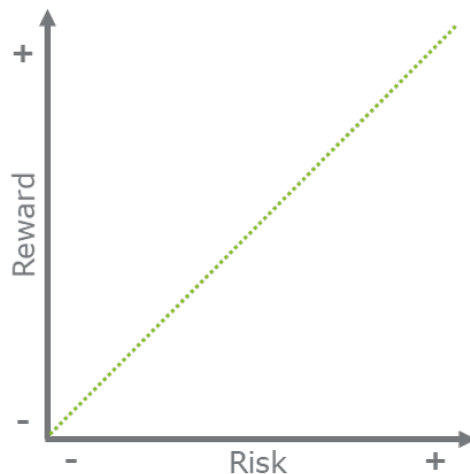
- **Interest Rate Risk** (the risk that interest rates will change, altering what the lender is paid in interest)
- **Currency Risk** (the chance that foreign exchange rates will change, affecting what the lender is repaid in their local currency)

### Risk in the financial sector:

Different finance providers are comfortable with different levels of risk and will expect a higher reward (e.g., interest rate on debt) for higher risks. For example, venture capital and angel investors are interested to support relatively high-risk early-phase, start-up businesses in exchange for the possibility of very high returns. Many pension and other investment funds are looking for more stable, longer-term investments that typically have lower risk.

Matching the risk tolerance of a finance provider to the risk level of a given project is one of the roles a development organization can play in enabling an investment.

**Figure 37: Finance Providers Want Returns (Reward) to Match Risks<sup>85</sup>**



### The Pricing Stack

Much of this text has focused on understanding the cost of finance, and what interventions can bring the cost of finance into line with what finance seekers can afford and thus enable a development investment to take place.

The elements of financial pricing mentioned in this text can be illustrated as a “**Pricing Stack**”. Each layer of the Pricing Stack represents an element of the cost associated with the price of the financing, such as a loan.

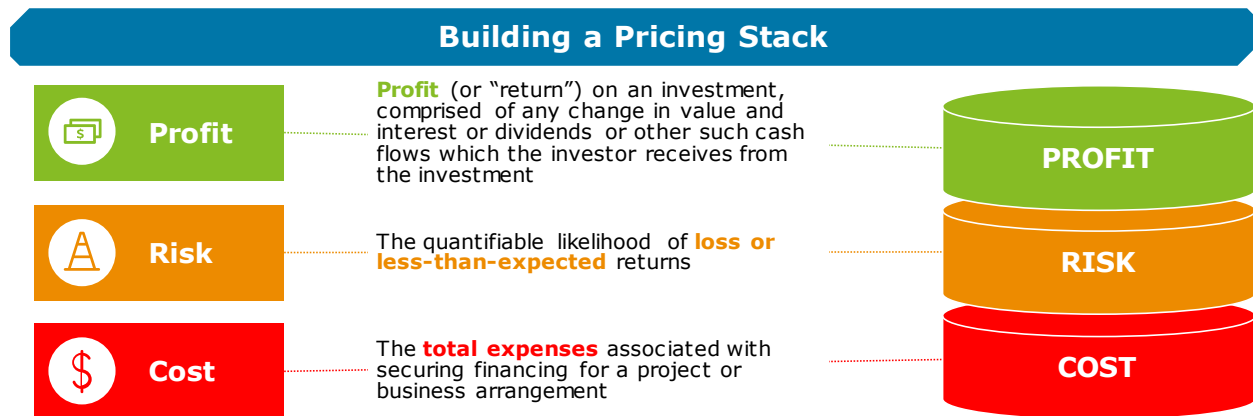
The three main layers of the Pricing Stack are:

- The **costs of providing finance** (this includes things like the cost of the funds themselves, and a portion of the operating and facilities costs of the finance provider)
- The **risk premium** (i.e. the additional return or profit that the finance provider requires to take on the risks associated with the investment)
- The **return** (or, profit) that the finance provider requires

<sup>85</sup> Graphic developed by Deloitte, for USAID PCM

Many interventions that development practitioners can make to enable private capital to fund a development investment work by reducing the size of one or more of the “layers” of the pricing stack – thus making it more likely that the returns from the development project will be sufficient to repay the source of financing and making the transaction possible.

Figure 38: Building a Pricing Stack<sup>86</sup>



## Chapter recap

In this chapter, we dived a bit deeper into the field of finance. We provided a guide to understanding the main financial accounting statements, and an overview of key finance concepts. A compendium of key finance terms is provided in the appendix. If nothing else, after reading this chapter we hope you can impress your friends by talking about how the *value of a business is the discounted value of its future net cashflows!*

<sup>86</sup> Graphic developed by Deloitte, for USAID PCM



# Conclusion

"We are embracing the creativity and the entrepreneurship that private enterprise brings. We are embracing the notion that the private sector, not donors and governments will be the ultimate driver and sustainer of development, and we know that we need to re-envision our role accordingly. We are embracing a model of enterprise-driven development."<sup>86</sup>

- USAID Administrator Mark Green

As noted in the introduction, *Mobilizing Finance for Development* promotes an alternative approach to how most public-sector development agencies have done business – enabling private enterprise to achieve development outcomes, with the agencies' role shifting from funder to facilitator. This approach acknowledges:

- The importance of a longer-term focus on systemic constraints to finance (the enabling conditions and the financial sector infrastructure and intermediaries) to make financing more broadly available, a critical component of the path to self-reliance
- The need for short-term transactional interventions (with direct financial support often the most immediate and cost-effective intervention) to offset the higher risk and transaction costs found in our presence countries
- The potential for the judicious use of financial support to private enterprise in circumstances in which financial returns can be aligned with social and economic benefits (i.e., last mile clean water delivery or smallholder farmer access to finance.)

Engaging the power of market-based, enterprise-led development is a key pillar of the Administrator's vision for USAID and of the journey to self-reliance – and is also being embraced by other leading global development agencies around the world.

This Guide, and the *Mobilizing Finance for Development* course, has demonstrated how development professionals at USAID and other development agencies can become investment catalysts, and thus help to accomplish this vision. Development agencies like USAID have much to offer private enterprise; it is not only possible, but desirable, to harness the profit objectives of private enterprise to accomplish our development goals.

USAID's Office of Private Capital and Microenterprise and Deloitte look forward to working with you.

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<sup>87</sup> <https://translations.state.gov/2018/03/01/usaid-administrator-mark-greens-remarks-at-the-%E2%80%AFfourth-annual-powering-africa-summit/>

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Chae Kim and Amanda Weidner at Deloitte also contributed to the content, graphics, and formatting of this Guide.

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## Resources

*The following sources may be useful to development practitioners wishing to learn more about the topics covered in this Guide:*

### **Philanthropic Funders (e.g. for blending finance with other providers)**

- Chronicle of Philanthropy. <https://www.philanthropy.com/>. Some resources are subscription based. <https://www.philanthropy.com/>
- Foundation Center <https://foundationcenter.org/>. Some resources require a subscription.

### **Assessment Tools**

- BizCLIR: assessment methodology reviews selected business enabling environment through four “lenses” – four dimensions: the legal framework, implementing institutions, supporting institutions, and social dynamics. <https://www.marketlinks.org/good-practice-center/value-chain-wiki/5210-bizclir-tool-framework>
- Due diligence, general: LAB’s Private Sector Engagement Toolbox <https://pages.usaid.gov/node/12221>
- Due diligence, investment fund specific: EMPEA...no existing link on PCM page yet
- Gender Equality Mainstreaming Framework – from MEDA and USAID

### **Data and Completed Assessments**

- World Bank’s Doing Business <http://www.doingbusiness.org/>
- World Bank data <https://data.worldbank.org/>
- IMF’s Financial Sector Stability Assessments <http://www.imf.org/external/np/fsap/fssa.aspx>
- IMF’s Financial System Stability Assessments <https://www.imf.org/external/np/fsap/fsap.aspx>

### **Sector-Specific Lending Toolkits for Banks**

- Agriculture <http://www.agrifinfacility.org/resource/agricultural-lending-toolkit>
- Health (beta to put on PCM website?)
- Clean Energy (beta to put on PCM website?)

### **USAID-specific tools**

- Pay for Results Primer <https://www.usaid.gov/documents/1865/pay-results-development>
- Global Development Lab/Center for Transformational Partnership’s Private Sector Engagement Toolbox <https://pages.usaid.gov/theLab/CTP/PSEToolbo>
- FS Share in course Google Drive.
  - Primers, Checklists, Sample SOWs, Guidelines, Technical Briefs, Case Studies, Examples, and Tools
    - Value Chain Finance, Credit Bureaus, Agricultural Finance, Health Sector Finance, Secured Financing Systems, Enabling Environment, Leasing, Bonds, SME Access to Finance, Asset-Based Finance, Capital Markets Assessment
  - GH/CII’s Report “Investing for Impact” <https://www.usaid.gov/cii/investing-impact>
- List of USAID-Presence countries <https://www.usaid.gov/where-we-work>

## Networks, Case Studies, Blogs, News and Additional Resources

- Global [Impact Investing](https://thegiin.org/) Network (GIIN) <https://thegiin.org/>
- Aspen Network of Development Entrepreneurs (ANDE). <http://www.andeglobal.org/>
- There are also many regional chapters. Contact Lab/CTP for membership access.
- Convergence <https://convergence.finance/>
- ImpactAlpha <https://news.impactalpha.com/>
- Business Fights Poverty <http://businessfightspoverty.org/>
- Case Foundation's Impact Investing Network Map <https://casefoundation.org/networkmap/>

## Deloitte research and tools

- Reaching deep in low-income markets: Enterprises achieving impact, sustainability, and scale at the base of the pyramid  
<https://www2.deloitte.com/us/en/pages/operations/articles/economic-sustainability-low-income-markets.html>
- Structuring Public-Private-Partnerships:  
<https://www2.deloitte.com/content/dam/Deloitte/ru/.../public.../partnering-for-value.pdf>
- Engaging local businesses in Africa's oil and gas industry:  
<https://www2.deloitte.com/content/dam/Deloitte/ng/Documents/energy-resources/ng-localisation-in-Africas-oil-and-gas-industry.pdf>
- Leading practices in infrastructure investment:  
<https://www2.deloitte.com/content/dam/Deloitte/us/Documents/risk/us-risk-infrastructure-investment-funding.pdf>

## Other

- "Expanding Institutional Investment into Emerging Markets via Currency Risk Mitigation" report [https://www.empea.org/app/uploads/2017/06/USAID\\_Report\\_Final\\_WEB.pdf](https://www.empea.org/app/uploads/2017/06/USAID_Report_Final_WEB.pdf)
- Glossary of key finance terms...to put on PCM website
- Impact Investing Indicators
- IRIS (<https://iris.thegiin.org/>)
- UN Principles for Responsible Investment <https://www.unpri.org/>
- Financing Smart Cities <https://www2.deloitte.com/global/en/pages/public-sector/articles/smart-cities-funding-and-financing-strategies.html>
- Innovative Finance in Energy  
[https://deloittenet.deloitte.com/pc/practicecomm/industries/hsg/federal/pages/innovative\\_finance\\_for\\_energy\\_innovation.aspx](https://deloittenet.deloitte.com/pc/practicecomm/industries/hsg/federal/pages/innovative_finance_for_energy_innovation.aspx)
- From Smallholders to Shareholders: A Guide to Optimizing Partnerships with the Private Sector for Smallholder Impact  
[https://www.agrilinks.org/sites/default/files/resources/fintrac\\_pimodels\\_toolkit\\_14oct14\\_fin\\_web.pdf](https://www.agrilinks.org/sites/default/files/resources/fintrac_pimodels_toolkit_14oct14_fin_web.pdf)

## Glossary of financial terms<sup>88</sup>

*For the purpose of this document, USAID PCM defines the terms used as follows:*

**Accelerator (for business)**—Organizations which are very similar to an [incubator](#) but differ in that they usually focus on businesses that made it through the start-up phase and are poised to grow. Business accelerators will generally offer all of the services offered by a business incubator. The key difference is the level of hands-on involvement by accelerator management and/or connections to venture capital which should increase the chances of success.

**Agency**—When one or more individuals (principals) hire another individual (agent) to perform a service on their behalf, such as the relationship between stockholders (owners) and managers of a firm.

**Amortization**—the periodic writing off on an account balance to expense; similar to [depreciation](#) and usually refers to the periodic writing off of an intangible asset.

**Angel Investor**—Also called informal investors, angel funders, private investors, seed investors or business angels, they invest in entrepreneurs and their businesses in the earliest phases. Angel investors typically invest their own money in exchange for equity or convertible debt. Because they are often closer to the entrepreneur, they may also provide some mentorship.

**Arbitrage**—The purchase of securities or commodities on one market for immediate resale on another in order to profit from a price discrepancy. Can also be done with currency.

Assets (current)		Liabilities	
	Cash		Accounts Payable
	Tools and Equipment		Notes Payable
	Accounts Receivable		Taxes Payable
Assets (non-current)		Owners' Equity	
	Land and Building		Capital Stock
	Machinery and Equipment		Retained Earnings

**Assets**—the economic resources of an entity that are owned, will provide future benefits, and can be reliably measured.

**Balance Sheet**—A financial statement that lists a firm's assets, liabilities and stockholders' equity at a point in time. A very basic example:

**Blended Finance**—the strategic use of development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets, resulting in positive results for both investors and communities.

**Bond**—a long-term debt instrument that promises to pay the lender a series of periodic interest payments in addition to returning the principal at maturity.

<sup>88</sup> Written and compiled by USAID PCM over the course of several years

**5 C's of Credit**—used by lenders to gauge the creditworthiness of potential borrowers.

- **Character or credit history**—the borrower's reputation or track record for repaying debts, information which appears on credit reports where there are credit bureaus.
- **Capacity**—measures the borrower's ability to repay a loan by comparing income against recurring debts and assessing the borrower's debt-to-income ratio. Lenders will often look at job stability as well.
- **Capital**—the co-investment of the borrower that will accompany the loan...larger contributions reduces the risk of default for the lender. For example, higher down-payments increase a borrower's chance to obtain a home mortgage.
- **Collateral**—property or other asset that borrowers offer as a way to secure a loan. Lenders can seize the collateral to recoup losses in the event of default.
- **Conditions**—conditions of the loan, which may include interest rate, principle and purpose of the loan (general vs. to obtain a specific productive asset).

**Capital Controls**—measures taken by governments, central banks, or other regulatory bodies to limit the flow of foreign capital in and out of domestic economies. These include: taxes, tariffs, volume restrictions and legislations.

**Capital Expenditure or CapEx**—are funds used by firms to acquire, upgrade, and maintain physical assets, such as Plant, Property and Equipment, or to undertake new projects or investments by the firm.

**Capital Markets**—financing sources, which are formalized when companies issue securities that are traded on organized exchanges; they are informal when companies are funded by private sources.

**Capital Structure**—the amount of permanent short-term debt, long-term debt, preferred stock, and common equity used to finance a firm.

**Cash**—an asset category representing the amount of a firm's available cash and funds on deposit at a bank in checking accounts and savings accounts.

**Cash Flow Statement or Statement of Cash Flows**—a financial statement showing a firm’s cash inflows and outflows for a specific period, classified into operating, investing, and financing categories. A very basic example:

Cash flows from (used in) operating activities		
Cash receipts from customers	9,500	
Cash paid to suppliers and employees	(2,000)	
Cash generated from operations (sum)	7,500	
Interest paid	(2,000)	
Income taxes paid	(3,000)	
Net cash flows from operating activities		2,500
Cash flows from (used in) investing activities		
Proceeds from the sale of equipment	7,500	
Dividends received	3,000	
Net cash flows from investing activities		10,500
Cash flows from (used in) financing activities		
Dividends paid	(2,500)	
Net cash flows used in financing activities		(2,500)
Net increase in cash and cash equivalents		10,500
Cash and cash equivalents, beginning of year		1,000
Cash and cash equivalents, end of year		\$11,500

**Catastrophe Bond (CAT bond)**—a high-yield debt instrument that is usually linked to insurance intended to raise money in case of a catastrophe such as a hurricane or earthquake. It is a means by which insurers and reinsurers can transfer risk to investors. CAT bonds will provide a payout to the insurance company if a defined event occurs, such as total loss greater than a specific amount or an earthquake of a certain magnitude or greater.

**Collateral Registry**—a record of legal claims to personal property used as collateral for a loan

**Commodity Price Risk**—the uncertainty that stems from changing prices that adversely affects the financial results of those who use and/or produce that commodity (such as cotton, maize, copper, and sugar). Commodity prices can be affected by political and regulatory changes, seasonal variations, weather, technology, and market conditions.

**Convertible Bonds**—A bond that may be exchanged for common stock at the holder’s option.

**Cost of Funds**—the interest rate paid by financial institutions for the funds they deploy in their business.

**Covenants**—contractual requirements put into loan or bond agreements by lenders.



**Credit Bureau**—an agency that researches and collects credit information on individuals and sells that information to creditors when they are making decisions on loans.

**Credit Enhancement**—methods firms take to obtain better terms for debts, and can include additional collateral, insurance, third-party guarantee, or to uphold higher solvency levels (i.e. lower financial leverage).

**Credit Union**—user-owned financial intermediaries. Members usually share a common bond based on a geographic area, employer, community, or other affiliation. Savings and credit are their principal services, although they can offer payment services, money transfers, and insurance as well. In development, savings and credit cooperatives can reach clients and areas that are unattractive to banks.

**Currency or Foreign-Exchange Risk**—the [financial risk](#) of investment's change in value due to changes in currency exchange rates.

**Current Assets**—short-term assets, including cash, marketable securities, accounts receivable, and inventory.

**Current Liabilities**—short-term liabilities, such as accounts payable and loans expected to be repaid within one year.

**Debt**—money borrowed by one party from another to be paid back at a later date, usually with interest. Bonds are a form of debt open to some companies that are not available to individuals.

**Default**—the nonpayment of interest and principal and/or the failure to adhere to the various terms and conditions of loan or bond agreements.

**Depreciation**—the decline in economic potential (using up) of assets from wear-and tear, deterioration, and obsolescence.

**Development Finance Institution (DFI)**—a specialized financial institution set up to support private sector development in developing countries, and includes multilateral development banks, bilateral development banks, community development financial institutions and revolving loan funds.

**Development Impact Bond**—provide upfront funding for development programs by private investors, who are remunerated by donors or host-country governments—and earn a return—if evidence shows that programs achieve pre-agreed outcomes.

**Discount Rate**—the rate of interest used on the process of finding present values; also called the required rate of return.

**EBIT**—Earnings Before Interest and Taxes, also called operating earnings.

**Endogenous Risk (or Unsystematic risk)**—risk that is unique to a firm.

**Equity**—generally, equity is the value of an asset less the amount of all liabilities on that asset (equity=assets-liability from the balance sheet structure). Public equities are shares of ownership in a firm, which are traded on public exchanges. Private equity is capital that is not listed on a public exchange.

**Exits**—means through which investors, traders, venture capitalists or business owners liquidate (or sell) a position in (or ownership of) a financial asset. Securities markets make exits relatively easy for public equities. Exits of private equity in more environments with limited activity is more challenging.

**Exogenous Risk (or Systematic Risk)**—that portion of the variability of an individual’s securities or firm’s returns that is caused by factors affecting the market as a whole.

**Expropriation**—The taking of a foreign property, with or without compensation, by a government.

**Factoring**—the sale of a firm’s accounts receivable to a financial institution known as a factor, for less than its face value.

**Financial Intermediary**—an entity that acts as the middleman between two or more parties in a financial transaction, such as a commercial bank, investment bank, mutual fund, or pension fund.

**Financial Leverage**—the extent to which a firm is financed by securities having fixed costs or charges, such as debt and preferred stock.

**Financial Markets**—a broad term describing any marketplace where trading of securities—including equities, bonds, currencies and derivatives—occurs.

**Financial Repression**—measures by which governments channel funds to themselves as a form of debt reduction, and includes directed lending to the government, caps on interest rates, regulation of capital movement between countries and a tighter association between government and banks.

**Financial Risk**—the additional variability of a company’s earnings per share and the increased probability of insolvency that result from the use of fixed-cost sources of funds, such as debt and preferred stock. In general, the more financial leverage a firm uses, the greater its financial risk.

**Financial Statements**—see Cash Flow Statement, Income Statement, and Balance Sheet, but may include others as well.

**Financial Depth**—a means by which to measure the size of the financial sector relative to a country’s economy and/or its population. It is an indication of the amount of financial liquidity in the system to support economic growth and access to finance more broadly.

**Fintech (Financial Technology)**—a broad term that has expanded to include virtually any technological innovation in the financial sector.

**Gender Lens Investing (GLI)**—a strategy that businesses and organizations use to increase investment and/or returns while focusing on gender balance, workforce policies supporting women, and products and services appropriate and affordable for women and girls. By shedding light in areas where there are gender imbalances, GLI supports women’s economic empowerment while also increasing company performance.

**Group Lending**—a practice used primarily in microfinance by which small groups borrow collectively and encourage each other to repay, in effect using peer pressure as a means to reduce risk for lenders.

**Guarantee, Loan**—a promise by one party (the guarantor) to assume the debt obligation of a borrower should the borrower default. For example, USAID’s DCA program typically provides a 50 percent guarantee on loan losses.

**Hurdle Rate**—the minimum acceptable rate of return from an investment project. For projects of average risk, it is usually equal to the firm’s cost of capital.

**Impact Investing**—Investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return. The extent of both social and environmental impact and financial return varies between impact investors.

**Income Statement**—a financial statement that indicates how a firm performed during a period of time. This is also often called a profit and loss statement. A very basic example:

		Year 1	Year 2
Operating Income			
	Sales		
	Costs of Goods Sold		
Gross Income		Net sales less costs of goods sold	
Expenses			
	Salaries		
	Rent		
	Advertising		
	Supplies		
	Interest Expense		
	Taxes		
	Phone and Internet		
Net Income		Gross Income less total expenses	

**Incubator (for business)**—An organization designed to accelerate the growth and success of entrepreneurial companies through an array of business support resources and services that could include physical space, capital, coaching, common services, and networking connections.

**Index Insurance**—an insurance product that pays out benefits on the basis of a predetermined index (e.g. rainfall level) for loss of assets and investments, primarily working capital, resulting from weather and catastrophic events, without requiring the traditional services of insurance claims assessors. It also allows for the claims settlement processes to be quicker and more objective.

**Insolvency**—lack of ability to meet obligations, especially to creditors.

**Institutional Investor**—an organization that invests on behalf of its members, such as endowment funds, commercial banks, mutual funds, hedge funds, pension funds and insurance companies.

**Intangible Assets**—a term applied to a group of long-term assets including patents, copyrights, franchises, trademarks, and goodwill that benefit an entity but do not have any physical substance.

**Interest**—the return earned by or the amount paid to an individual who forgoes current compensation or alternative investments and “rents” money to a business, bank, the government, some of other form of institution, or an individual.

**Intermediation**—the process of taking in funds from a depositor and lending them out to a borrower.

**Internal Rate of Return (IRR)**—a metric used to estimate the profitability of potential investments. It is found by setting a NPV of 0 and solving for  $r$  (the discount rate).

**Inventory**—the raw materials, work-in-progress products, and finished goods that are considered assets of a business that are ready or will be ready for sale.

**Investment**—an asset or item that is purchased with the idea that it will generate income or will appreciate in the future and sold at a higher price for profit.

**Investment Bank**—a financial institution that underwrites and sells new securities. In general, investment banks assist firms in obtaining new financing.

**Investor**—a person who commit capital with the expectation of financial returns. They have varying risk tolerances, styles, preferences, and timeframes.

**Joint Venture**—a business combination in which two unaffiliated companies contribute financial, physical, and/or personal assets to a new company formed to engage in a specific economic activity

**Lease**—a contract between a lessor (owner) and lessee (tenant) for the rental of property.

**Limited Liability**—a person’s financial liability is limited to a fixed sum, usually the value of a person’s investment in a company or partnership.

**Limited Partner**—a partner in a partnership whose liability is limited to the extent of the partner’s share of ownership.

**Liquidity**—For markets: the ability to readily exchange an asset for good or other assets at a known price, thereby facilitating economic transactions. For a firm: it is the ability for that firm to meet its cash obligations as they come due.

**Loan Guarantee**—a loan guarantee is a promise by one party (the guarantor) to assume the debt obligation of a borrower should the borrower default. For example, USAID’s DCA program typically provides a 50 percent guarantee on loan losses.

**Macroeconomic Environment**—the condition that exists in the economy, rather than in a particular sector or region. In general, the macro environment includes trends in gross domestic product (GDP), inflation, employment, spending, and monetary and fiscal policy.

**Management Risk**—risk associated with ineffective or underperforming management of a firm. It can also refer to risks associated with management of an investment fund.

**Market Infrastructure**—the infrastructure underlying operations of financial markets, including those that record, clear and settle financial transactions. If well-designed and reliable, they are sources of both financial stability and operational efficiency.

**Market Risk**—risk that an investment will face fluctuations and decline in value due to economic developments and other events that affect entire markets.

**Matchmaking Platforms**—platforms designed to connect finance providers with firms needing investments (typically SMEs) and provide resources to facilitate transactions while not becoming a party in those transactions.

**Mezzanine Financing**—Mezzanine financing is a hybrid of debt and equity financing that gives the lender the rights to convert to an ownership or equity interest in the company in case of default, after venture capital companies and other senior lenders are paid. Mezzanine financing, usually completed with little due diligence on the part of the lender and little or no collateral on the part of the borrower, is treated like equity on a company's balance sheet.

**Microenterprise (USAID's definition)**—A very small enterprise owned and operated by poor people, usually in the informal sector. For USAID program purposes, the term is restricted to enterprises with 10 or fewer workers, including the microentrepreneur and any unpaid family workers.

**Minority Interest/Shareholder**—the equity claim of a shareholder owning less than a majority or controlling interest in the company

**Municipal Bond**—a debt security issued by a municipality or county to finance its capital expenditures, such as construction of highways, bridges or schools.

**Net Present Value (NPV)**—the present value of the stream of net cash flows resulting from a project, discounted at the firm's cost of capital minus the project's net investment.

$C_t$  = net cash inflow during period  $t$   $C_0$  = total initial investment costs

$r$  = discount rate

$t$  = time period

$T$  = total number of time periods

$$NPV = \sum_{t=1}^T \frac{C_t}{(1+r)^t} - C_0$$

**Operating Costs or Expense**—the usual and customary costs that a company incurs to support its main business activities; these include a cost of goods sold, selling expenses, depreciation expense, amortization expense, research and development expense, and taxes on operating profits.

**Opportunity Cost**—the rate of return that can be earned on funds if they are invested in the next best alternative investment.

**Option**—A financial instrument that gives the holder the right—but not the obligation—to sell (put) or buy (call) another financial instrument at a set price and expiration date.

**Pay for Results (or performance/success/outcomes)**—is an umbrella term for initiatives that pay upon accomplishment of results rather than efforts to accomplish those results. In Pay for Results, the principal or funder sets financial or other incentives for an entity (or individual in the case of cash transfers) to deliver predefined outcomes, and rewards achievement of the results upon verification.

**Payment System**—mechanisms established to facilitate the clearing and settlement of monetary and other financial transactions. Secure, affordable and accessible payment systems and services promote development, support financial sustainability, and help expand financial inclusion.

**Plant, Property, Equipment (PPE)**—a category of assets that a firm uses in its operations, which includes land, building, equipment, vehicles, furniture and fixtures

**Pledge Registry** (see collateral registry)

**Political Risk**—risk that an investment's return or the value of a firm's asset could be affected by political instability or changes in a country

**Pooling**—the grouping together of resources (asset, equipment, personnel, effort, etc.) for the purposes of maximizing advantage or minimizing risk to participants

**Pricing Stack**—a term used in this course to understand the elements that comprise the cost of financing.

**Price Discovery**—the overall process, whether explicit or inferred, of setting the spot price of an asset or services—including a security, commodity, or currency—based on many factors. These include: supply and demand, investor risk tolerances, and the overall economic and geopolitical environment. Basically, it is the price agreed to by both a buyer and a seller.

**Program Income**—the gross income that is directly generated by an activity supported under an assistance award, or earned as a result of the award. It includes, but is not limited to: fees for services performed; the use of real or personal property acquired under USG-funded projects on other non-USG projects; sale of commodities or items fabricated under an award; or interest on loans made with award funds.

**Project Finance**—the financing of long-term infrastructure, industrial projects, and public services based upon a non-resource or limited recourse financial structure, in which project debt and equity used to finance the project are paid back from the cash flow generated by the project.

**Public-Private Partnership (the World Bank's PPP Knowledge Lab)**—a long-term contract between a private party and a government entity, for providing a public asset or service, in which the private party bears significant risk and management responsibility, and remuneration is linked to performance.

**Quota**—a government-imposed trade restriction that limits the number, or monetary value, of goods that can be imported or exported during a defined period.

**Real Asset**—a physical asset that has a value due to its substance and properties. For example, precious metals, commodities, real estate, agricultural land, machinery and oil.

**Receivables**—a type of asset that represents all debts, unsettled transactions or other monetary obligations owed to a company by its debtors and/or customers.

**Reserves**—profits which have been appropriated for a specific purpose, such as to purchase fixed assets, pay for repairs and maintenance, etc.

**Retained Earnings**—earned capital, the cumulative net income or loss, of the company (from its inception) that has not been paid to shareholders as dividends.

**Return on Equity (ROE)**—the ultimate measure of performance from the shareholders' perspective; computed as net income divided by the average equity.

**Return on Investment (ROI)**—the ratio obtained by dividing income by average investment.

**Risk**—the possibility that actual future returns will deviate from expected returns; the variability of returns.

**Risk Mitigation**—measures that reduce the severity of risk consequences, reduce the probability of the risk materializing, or reduce an organization’s or investor’s exposure to the risk.

**Risk Premium**—the difference between the required rate of return on a risky investment and the rate of return on a risk-free asset, such as U.S. Treasury bills.

**Savings and Credit Cooperatives (SACCOs)**—a form of a [Credit Union](#)

**Secured Lending**—when the borrower is required to give the lender collateral as a form of insurance against default. Because secured lending lowers risk to finance providers, it offers an alternative to borrowers unable to obtain an unsecured loan (due to lack of credit history, etc.) or to obtain a loan at lower interest rates.

**Securities Exchange**—an organized and regulated market facilitating the purchase and sale of securities.

**Social Impact Bond**—a contract with the public sector or governing authority, whereby it pays for better social outcomes in certain areas and passes on part of the savings achieved to investors.

**Special Purpose Vehicle or Entity (SPV/SPE)**—a legal entity created to fulfill a specific objective. It has an asset/liability structure and legal status that makes its obligations secure even if the parent company partner(s) goes bankrupt.

**Stock**—a type of security that signifies ownership in a corporation and represents a claim on part of the corporation’s assets and earnings. There are two main types:

- **Common**—shares in the ownership of a company. Common stock represents a residual form of ownership in that dividends are paid out only after more priority financial obligations are fulfilled, such as interest on debt.
- **Preferred**—a type of equity with a claim on earnings and assets of a firm—in the form of a (normally) fixed periodic dividend payment—that takes precedence over the claims of common stockholders.

**Structured Finance**—a highly involved financial instrument offered to large financial institutions or companies that have complex financing needs that do not match with conventional finance products.

**Subordinated Debt**—a loan or security that ranks below other loans or securities with regard to claims on assets or earnings.

**Term Loan**—long-term borrowing which is contracted with a single lender.

**Trade Finance**—represents monetary activities related to commerce and international trade. It includes lending, the issuance of letters of credit, factoring, export credit and insurance.

**Transaction Cost**—any cost in making any economic trade within a market. It includes costs associated with search and information (e.g. to assess credit worthiness), marketing and bargaining (e.g. sales and product development), and enforcement (e.g. recovery options in the event of breach of contract).

**Valuation**—the process determining the current worth of an asset or a company. Although somewhat subjective, components include a firm’s management, the composition of its capital structure, the prospect of future earnings, and the market value of its assets.

**Venture Capital**—financing provided to startup companies and small businesses that are believed to have long-term growth potential. For new companies with a limited operating history, venture capital can be an important source of capital, however the main downside is that the investors usually get equity in the company, and thus have a say in company decisions.

**Venture Philanthropy**—a strategic framing which coordinates and applies the concepts and approaches of philanthropy alongside those of venture capital to support a social good.

**Village Savings and Loan Association (VSLA)**—a form of a Credit Union.

**Weighted Average Cost of Capital**—the weighted average of the marginal costs of debt, equity, and preferred stock in proportion to their inclusion in the firm’s target capital structure.

**Working Capital**—the difference between a firm’s current assets and current liabilities.

**Yield**—the amount earned on an investment, also called return.





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