EMCompass
Fresh Ideas about Business in Emerging Markets

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BLENDING PUBLIC AND PRIVATE FINANCE

What Lessons Can be Learned from IFC's Experience?

Following international agreement on the Sustainable Development Goals, governments are now confronting the critical issue of funding the enormous investments—especially in infrastructure—required to meet those goals. Yet governments clearly lack the fiscal space to finance all the investments, as well as the skills needed to design and manage them. So the focus is on how to 'crowd in' private investment and private management. Since not enough private investment is flowing today, donor governments are exploring how to 'blend' public aid money with private finance to make aid spending go further and crowd in more private investment.

As more public funds are applied to private sector projects, the term 'blended finance' has come to mean different things to different people. In general, blended finance connotes a combination of public and private finance, which may or may not involve a form of subsidy. There are many shapes and forms in which public and private sector funds can be combined—or 'blended'—within the scope of one project. When applied indiscriminately, blended finance can subject projects and sectors to numerous pitfalls including market distortion and inappropriate risk allocation.

The proper deployment of blended finance requires a careful understanding and navigation of these potential pitfalls. But the payoff is worth it: When done well, blended finance has proved a highly effective catalyst to jump-start high-risk, nascent markets in developing countries.

A DISCIPLINED APPROACH

Blended finance approaches should not be attempted lightly. There are not enough bankers, lawyers, and donor officials to run every investment through a complex blended finance structure, and the incorrect application of blended finance can waste significant resources on dead-end projects while sending erroneous market signals. Discipline and strategic deployment are crucial.

Before choosing to use blended finance to increase funding in a priority area, several questions must be addressed. First, are the fundamentals in place to produce financeable transactions? Blended finance will not make a financially unsustainable activity sustainable. Nor will it render unaffordable infrastructure suddenly affordable. All it will do is make subsidies opaque and quite likely sub-optimal.

As Michael Klein has noted, on average power tariffs in emerging markets cover 80 percent of cost, while water tariffs cover 20 percent. Private investment is not going to flow into power and water assets on this basis–it is simply not a viable investment. Governments can either transparently address this viability gap by closing it (raise prices and/or cut costs) or by filling it with a subsidy. Either method is transparent and provides a basis for attracting private investment so long as the solution is sustainable. Blended finance can sometimes be helpful to tip the balance in marginally profitable, risky projects toward attracting commercial investment, but it cannot alter the fundamental economics of an industry. To scale up finance, we need to build an investment climate and regulatory framework that generates robust project structures on a replicable basis. Blended finance can help key investments proceed, but should be seen as a stepping stone to more comprehensive reforms.

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MANAGING PROJECT RISK

Where the fundamentals of project economics and investment climate are in place, blended finance can make the difference in moving a project forward. To do so, it is important to think carefully about how to mitigate project risk. Note that risk transference is not the same as risk mitigation. While it is possible to use public money for guarantees, mezzanine tranches and other structures to buy down part of the project risk, that approach does not make a project less risky, it merely transfers exposure to that risk to the public sector contributor. In the long term it is preferable to pursue risk allocation structures which align risk exposure to the ability to manage that risk—thus providing incentives to actually reduce the risk. Private investors do not mind taking risk, so long as they can diversify and hedge it, but they will want to be compensated for the risks they are taking—resulting in more costly, less affordable infrastructure. In contrast, structuring to reduce risk strengthens the economic fundamentals and makes infrastructure more affordable.

Good project structuring allocates risks to parties best able to manage them, hence reducing overall project risk. Public institutions with a relationship with the government, such as the Multilateral Development Banks, are better placed to manage political risk than are private investors. For example, Multilateral Investment Guarantee Agency (MIGA) offers affordable Political Risk Insurance because its member governments provide a counter-guarantee. Good risk allocation also allocates risks based on the different risk appetites of different parties. A key value addition of public finance is that it brings different risk appetites and time horizons into the transaction. This offers opportunities for blending public and private finance in ways that structure assets to meet private sector risk and time profiles. For example, public money may have a longer time horizon, and so can offer longer tenors or deferral features, allowing private investors to take shorter term risk. Or the public sector can take the construction risk (which it may be better able to monitor and manage) and then sell down assets to private investors post-construction when those risks are past. Before using subsidies, donors can consider what could be achieved simply through patient capital.

Risk appetites are constrained by the size of balance sheets. Investors decide how much capital they want to put at risk for different risk exposures. Hence, a constraint to getting large investments financed is that the ticket size for each investor may exceed their risk limits, either for that deal or for their total investment portfolio of that asset type. Financial intermediaries can help by distributing assets across multiple investors to reduce the risk exposure of each investor, as in syndicated loan programs. But at the portfolio level, investors may soon fill their appetites for certain risks (e.g. small countries, fragile states) while many investment needs remain unmet. Blending public finance can play an important role in expanding the risk appetite of private investors by partially guaranteeing their exposure or by helping rebalance their risk-reward expectations. At its simplest, a 50:50 risk sharing arrangement can double the exposure that an investor is willing to take in a certain type of investment. But it can do more than that: By introducing investors to new classes of risk that they have not previously had exposure to, it can help them calibrate their risk perceptions—as their perception of risk comes down, the share of risk or the incentive support which public finance needs to take or provide can also decline.

Most investments, especially in infrastructure, generate revenues in local currencies related to the performance of the local economy. So financing these investments from local banks and capital markets can be a good way to remove currency risk. Governments and development finance institutions should look at ways to mobilize domestic savings pools—which are increasing as populations age and more people save for retirement, and as growing middle classes save more and purchase more insurance. These savings can be intermediated through domestic bond markets, through domestic financial institutions, and through domestic corporates that finance infrastructure and other investments on-balance sheet through corporate finance. Of course this works better in larger emerging markets where financial institutions and capital markets are large enough to intermediate significant capital flows. For smaller countries, regional financial institutions and capital markets can play a similar role, but unless the region shares a common currency, some currency risk will remain.

STREAMLINING PROJECT PREPARATION

One-off deals are often too costly to appraise and offer too much risk concentration. Aggregating assets allows for risk diversification and can create large enough ticket sizes to attract developed market pension funds, insurance companies, sovereign wealth funds, and endowments. Public finance can have a larger impact by participating in structured finance transactions for portfolios of assets rather than project-by-project financing. In smaller, frontier markets, donors are interested in supporting ‘capacity building’, but more attention should be given to streamlining origination—making it simpler to assemble projects, rather than support complex processes. This means more attention to standardization of deal terms and instruments, to common appraisal standards, and to debottlenecking government and regulatory approvals. IFC has effectively incorporated blended finance as part of its investment procedures, allowing for its effective deployment in private sector operations (see section on lessons from IFC's experience below).

IFC'S EXPERIENCE

Over a decade, IFC has developed a targeted and disciplined blended finance approach that relies on non-grant instruments (loans both senior and mezzanine, equity, and guarantees) from donors to help the private sector overcome the financing challenges endemic in many of the over 100 developing markets in which IFC operates. We have seen first-hand how often commercial banks have avoided investing in risky sectors, especially climate, in frontier markets. Regulatory, political, currency, and other risks, in addition to reputational risks stemming from complex environment and social challenges, keep banks and investors from volunteering to be the first to jump into a market.

Investors generally look for successful first-of-their-kind demonstration projects in a particular sector to ensure that a market segment has been sufficiently de-risked before allocating large amounts of capital for follow-on projects. And for years, blended finance has provided exactly that.

Since 2009, IFC has blended $385 million in concessional investment capital to support 67 investment projects that have leveraged over $4 billion in third party financing. These investments have supported pioneering projects including innovative energy efficiency financing in Turkey and catalytic solar photovoltaic facilities in Thailand.

Blended finance was the ideal tool to help support these high-impact, transformational projects in sectors that were unable to attract commercial financing, but had the potential to become commercially viable over time. By blending public sector funds in the form of co-investments in private sector projects, IFC not only directly enabled these important projects, but also helped demonstrate to private developers and financiers that these sectors were in fact profitable, stimulating a series of follow-on investments.

LESSONS FROM IFC'S EXPERIENCE

In IFC's own blended finance operations, we have identified two elements that are critically important to effectively apply blended finance in frontier markets. First, strong governance: IFC has a mature and well established set of board-endorsed principles for governing its blending operations. At the individual project level, IFC applies the same standards when investing on behalf of donor partners as it does with respect to the administration and management of IFC's own affairs, including the application of integrity due diligence and environmental and social safeguards. IFC has also established a senior committee to approve the use, structure, and terms of donor-funded concessional finance used as part of the overall blended financial package provided to the client. In addition to strong governance and transparency, IFC uses a targeted and disciplined approach for its blended finance investments through the following: (i) Focusing on projects where IFC financing alone is unable to make the project happen; (ii) Minimizing concessionality to avoid market distortion; and (iii) Supporting sectors that could achieve financial sustainability in the medium term.

Second, effective execution: Over the past decade, following the successful deployment of pilot projects, IFC has created a dedicated blended finance product offering. This has enabled IFC to build a track record as a disciplined investor of concessional donor funds, employing well defined procedures that encompass all stages of the project cycle, from project due diligence/approval to monitoring and evaluation. IFC's blended finance operations allow IFC, as well as its donor partners, to engage in new sectors, technologies, and countries sooner and/or at a larger scale than without blending. This approach has made donors comfortable with delegating authority to IFC for project approvals, maximizing efficiency in the support of impactful projects.

KEY FINDINGS

Blended finance is not a silver bullet and should be used only as part of a broader strategy that includes regulatory and pricing reforms. But overall, blended finance has proved an effective element of the development finance toolkit and will continue to be going forward.

Blended finance investment solutions capitalize on partnerships among a multitude of development and private sector partners: international organizations, donor agencies, and private enterprise. For this multi-stakeholder partnership to have the desired development impact, public institutional expertise and emerging-market knowledge are essential to identify and structure projects that can demonstrate market and sector sustainability in the long run. ■

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BLENDED FINANCE IN PRACTICE

Global Agriculture & Food Security Program (GAFSP)

GAFSP's Private Sector Window (PrSW) is managed by IFC and provides innovative financing to enhance the commercial potential of smallholder farmers and medium and small enterprises. Among its approaches is a blended finance mechanism to crowd-in private sector investment funding by enhancing the risk and return profile of projects that might not otherwise attract commercial funding. GAFSP funding is co-invested alongside IFC funding, with concessional funds allowing investments to target market failures and invest in early-stage, risky projects with sound business plans and a high degree of development impact. Every one dollar of PrSW funding leverages eight dollars of private sector funding, and since 2015 this has seen the deployment of $174.8 million in funding to support 26 investment projects with a total size of $930 million.

Blended finance for climate change mitigation and adaptation

IFC's Blended Climate Finance (BCF) unit manages roughly $700 million in concessional donor funds, to be deployed in conjunction with IFC's commercial funds, to catalyze climate-smart investments with high development impact that would not occur under normal market conditions. Using concessional financial instruments such as soft senior or mezzanine loans, direct equity investments or private equity funds investments, and guarantees, IFC addresses market barriers in order to facilitate pioneering projects that combat climate change and provide powerful demonstration effects. Since 2010, the BCF unit has committed $281 million in donor finance to mobilize $1.1 billion in IFC financing and $3.7 billion in private sector investment. In South Africa, the BCF unit invested $41.5 million in two concentrated solar power plants that will avoid 442,000 MTCO2 emissions per year, the first of its kind in Sub-Saharan Africa.

Global SME Finance Facility

Small and medium enterprises in emerging markets face a trillion-dollar financing gap. While banks in some markets are beginning to move into SME lending there are segments that remain almost totally underserved. This includes SMEs in fragile and conflict-affected markets, women-owned businesses, education and healthcare SMEs, and firms in rural markets. This Facility helps increase the access to finance for such SMEs by providing financial intermediaries with dedicated SME lending windows and guaranteeing loans made to SMEs using blended finance. The Facility also shares best SME lending practices and provides advice to enhance banks' SME operations in areas such as product development and risk management. This alleviates the real or perceived risks that prevent commercial financing of projects in a sector.
Expected Impact by March 2021:

- Improve SME's access to finance by facilitating the disbursement of $8 billion in loans to at least 200,000 SMEs (of which 50,000 are women-owned businesses).
- Support the creation of one million jobs.

IFC - Goldman Sachs' Women Entrepreneurs Opportunity Facility (10,000 Women)

Blended finance investment solutions capitalize on partnerships among diverse actors, including international organizations, development co-operation agencies, and private enterprise. An example of such a partnership is the Women Entrepreneurs Opportunity Facility, launched in March 2014 by the International Finance Corporation and Goldman Sachs' 10,000 Women. This is a first-of-its-kind global facility dedicated to expanding access to capital for women-owned small and medium enterprises. Through the facility, IFC aims to invest up to $600 million in financial institutions that are committed to expanding their financial services to small and medium enterprises owned by women in emerging markets. It also aims to signal the relevance of this asset class to the broader investor market. The funding for the facility includes $50 million of blended finance from Goldman Sachs' 10,000 Women to create performance incentives for financial institutions to boost their lending to this segment, and to support capacity building among financial institutions and women borrowers.

Michael Klein (2015) 'Public-Private Partnerships: Promise and Hype' *World Bank Policy Research Working Paper*