The Pitfalls of Innovative Private Sector Financing

Emerging lessons from benchmarking of investment funds supported by aid agencies

Summary Report

commons consultants

25 August 2015

Executive summary

Aid agencies have widely embraced cooperation with the private sector as a top priority in international development policies over the past decade. The private sector drives job creation and growth, and private sector investments are critical for reaching development goals in the poorer countries.

A key approach to promoting the private sector focus has been *blended finance* - where the public aid agencies invest alongside private institutional investors in commercially sustainable private sector projects in developing countries.

There has been a lot of experimentation in this area. European aid agencies have collectively invested more than EUR 10 billion over the past 10 years in more than 100 innovative *blending funds* that finance private sector projects.

In these investments, the aid agencies often support "innovative financing mechanisms" in order to catalyse participation from private investors. These mechanisms often involve giving risk coverage and preferential returns to the private investors. Donors also subsidise expenses related to setting up funds and finding good projects.

A recent study demonstrates the valuable contribution that the most successful of these funds will make to developmental impacts. But the study also highlights a number of pitfalls that responsible donor agencies will want to avoid in future:

- High fund management costs
- Excessive incentives, risk coverage and preferential returns to private investors
- Excessive upside to private fund managers
- Extended time horizons for mobilising capital
- Uncertain additionality of the investments
- Complex set-ups that are hard to supervise
- "Ownerless money risk" and inefficient donor practices

1 Introduction

This summary report looks at the emerging lessons after a decade of experimentation with innovative private sector financing. The report builds principally on two studies that Commons Consultants has conducted recently. The first study mapped the landscape of blending funds supported by European aid agencies. The second study benchmarked a number of development finance institutions (DFIs) and investments by Nordic aid agencies in blending funds with a focus on the energy sector.

The report starts with a brief overview of the role of the private sector in international development before taking stock of the landscape of blending funds supported by European aid agencies over the past decade.

The report then presents the results of the benchmarking study and examines what these may indicate about the effectiveness of aid agencies' investments in blending funds.

The final section looks at the potential implications of the studies in terms of a number of pitfalls for aid agencies investing in blending funds.

2 The Private Sector and Development

The private sector plays a critical role in creating jobs and driving growth in developing countries. Nine out of ten employment opportunities in developing countries are created by private enterprise.[1] The tax revenues from private enterprises are critical for the expansion of domestic sources of government revenue.

Private investment has also become an increasingly important source of financing for developing countries' development.

Previously, international development policy was focused on the direct use of official overseas development assistance (ODA). But today development policy has to mobilise private capital in order to be effective. ODA is now less than 10 % of financial flows heading to developing countries. Even in Africa foreign direct investment exceeds ODA. 50 years ago ODA for governments and NGOs was practically the sole source of finance supporting development. In 1970, ODA was around two-thirds of financial flows to developing countries.

Aid agencies have widely embraced cooperation with the private sector. In recent discussions about the financing for efforts to achieve the new 2030 Sustainable Development Goals (SDG), there is a wide recognition of the pivotal role of private sector investment. This is particularly the case in capital-heavy sectors with a high developmental impact such as energy and climate-related investments, and in other basic infrastructure (transport, water and sanitation).

According to one estimate, provided by the United Nations, it will only be possible to reach the SDGs if private investment in developing countries grows at an even higher rate than it did over the past decade. In the poorest countries, where investment needs are most acute and financing capacity the lowest, a doubling of the growth rate will be needed to give private investment a meaningful complementary financing role next to public investment and ODA.[2]

It is evident that strategies that help ODA attain a very effective catalytic effect will be critical for meeting these ambitious development goals.

Northern European aid agencies have placed a particular priority on the role of ODA in mobilising private capital. The Nordic countries, together with the United Kingdom and the Netherlands, have been at the forefront of the promotion of innovative private sector financing mechanisms.

3 More than 100 Innovative Investment Facilities

European aid agencies have engaged in significant experimentation around innovative financing facilities for private sector projects over the past decade. The goal of these efforts has been to mobilise more private capital for investment in developing countries than has been possible with traditional instruments. This has led to the launch of many new investment facilities managed both by new private fund managers and by more established DFIs.

3.1 Upswing in Innovative Investment Facilities

The renewed focus on cooperation with the private sector has spurred a wave of institutional experimentation. Aid agencies have allocated a significant amount of ODA to many new investment facilities, often alongside private investors.

A recent mapping of donor financing of blending funds illustrates this growth.[3] European donors made financial commitments to 118 different new blended finance facilities between 2002 and 2014. This corresponds to 10 new facilities being launched and receiving financial support from aid agencies every year over the period.

The total commitments were in excess of EUR 12 billion. This represents 2-3 % of the ODA commitments of these European donors over the period. The trend is still significant. European donors only supported a handful of such funds prior to 2002.

It is estimated that 34 % of the commitments were made for concessional funding, i.e. grants and technical assistance, and 66 % as investments, i.e. equity, loans and guarantees.

Roughly half of these blending funds are managed by private fund managers.

3.2 Engagement of DFIs in Blended Finance

DFIs have traditionally been the main channel for ODA to private sector projects in developing countries. The DFIs provide risk capital in the form of equity, loans and guarantees on market terms in sectors and countries that would otherwise be unable to attract capital.

The DFIs are still the most important channel in terms of assets under management. But over the past decade many European aid agencies have prioritised innovation through experimentation with new investment facilities rather than working through the DFIs.

In Europe, there are 15 bilateral development finance institutions. These institutions, jointly known as the EDFIs (through their European association), had a combined portfolio of approximately EUR 33 billion at the end of 2014. The EDFIs are revolving funds and the portfolio more than doubled over the past decade, mostly thanks to reinvestment of proceeds from projects. The governments of the United Kingdom, Norway, Sweden and Finland have also made significant capital injections in their DFIs in recent years.

Bilateral development finance institutions are the fund managers in fewer than one-in-ten of the new blending funds that have received financial support from European aid agencies over the past decade. The governments of the Netherlands, France, the United Kingdom and Denmark have the biggest investments in new funds managed by their DFIs in recent years.

European aid agencies have also been among the key investors in new blended finance facilities launched by the private sector arms of multilateral development banks (MDB), such as the IFC and regional development banks. The European Commission has placed more than EUR 3 billion of ODA funds in investment facilities for private sector projects, managed by the European Investment Bank. European aid agencies have also committed more than EUR 1 billion to other new MDB-managed funds.

DFIs have engaged more with the blending funds than is suggested only by looking at the fund management mandates that they have taken up. The European DFIs have made more than 25 investments, collectively, in blending funds that benefit from first loss cover or project support funding from ODA. While the DFIs invest in these funds alongside aid agencies they typically do so on the same terms as the private investors.

4 Use of Innovative Financing Mechanisms to Mobilise Private Investors

Aid agencies promote private sector development policies in order to have a positive impact in poor countries. The outcomes are typically measured in terms of job creation, tax payments and services that benefit the local population.

DFIs and other blended finance facilities follow a similar approach to reach these policy goals. There are essentially three roles that allow investors in private sector projects to have long-term development impact:

- **Additional** – *going where other investors don't go*: investing in underserved geographies (LDCs, Africa, post-conflict and conflict states), sectors (financial sector, energy, agribusiness) and segments (SMEs) by taking a long-run approach that permits higher risks.

- **Catalytic** – *paving the way for others to follow:* mobilising other investors by sharing risk, being first-movers demonstrating to other investors how to invest in high risk projects, and by sharing expertise.

- **Sustainable** – *reducing the dependence on aid*: helping build sustainable sources of jobs and tax income by investing in financially self-sustainable projects on market terms, and by applying responsible business standards for environmental, social and governance concerns.

An analysis of the 100+ blending funds also shows that aid agencies apply a few common "innovative financing" mechanisms for their participation in the blending funds:

- **Investment:** participating in funds with committed capital (equity and debt), alongside private investors.

- **Subsidy:** covering expenses, primarily related to fund establishment and project support, on behalf of fund managers and other investors.

- **Risk-sharing and incentive:** investing on unequal terms in relation to investment proceeds compared to fund managers and other investors in the funds. Such mechanisms may include "first loss cover" (foregoing distributions until other investors have been repaid their original investment in full), other lower preferences in the distributions waterfall, or capped returns with excess proceeds distributed to other investors.

The mechanisms relating to risk-sharing and incentives can be particularly complex.

5 Benchmarking DFIs and Blending Funds

A recent benchmarking study compared a sample of DFIs and blending funds in terms of costs and returns.[4]

The benchmarking study focused on investments made by Nordic governments in funds that invest in projects in the energy, energy-efficiency / climate, and infrastructure sectors.

The sample used in the study included three Nordic DFIs and six blending funds supported by Nordic aid agencies. This sample comprises all of the recent investments in this area made by Denmark, Norway and Sweden in funds focused on commercially sustainable private sector projects in these sectors.

5.1 Significant Differences in Costs and Net Returns on Investment

All of the funds in the sample invest in commercially sustainable projects. The return-risk profiles in the investment strategies of DFIs and the blending funds appear to be quite similar. The DFIs had achieved an average gross portfolio return of 10.2% p.a., while the average target gross portfolio return of the blending funds was 11.7 % p.a. This indicates that there was no significant difference in the target return for the investments that the two groups of funds make.

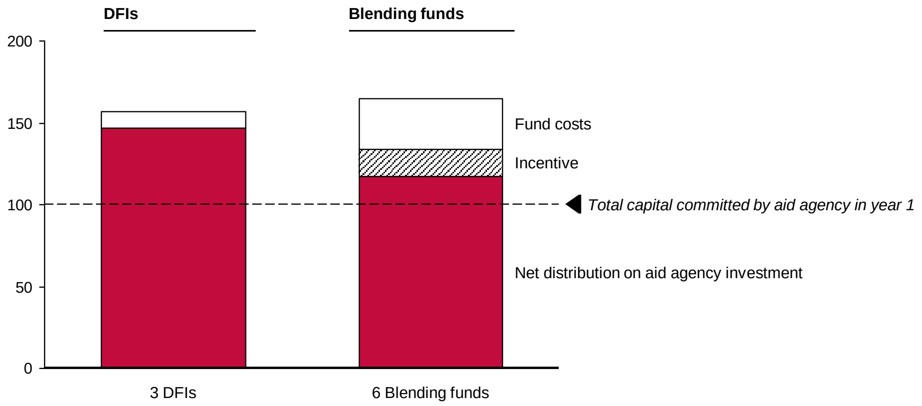
But there was a significant difference at the level of net returns. The net returns earned by governments as owners of the DFIs were more than twice as high as the net return that the aid agencies could expect to earn on their investments in the blending funds. The DFIs in the sample had realised an average net return of 6.7 % p.a. while the aid agencies had an expected net return in the blending funds of 2.6 % p.a. on average.

The figure below shows how these average costs and net returns would play out in nominal terms over a seven year investment cycle. A capital commitment of 100 is, on average, projected to become net distributions of app. 145 in the DFIs and app. 115 in the blending funds after a typical investment cycle of seven years.

A variety of costs contribute to this significant difference in net returns between the DFIs and the blending funds:

Comparison of key benchmarks for DFIs and blending funds

Nomical costs and net distribution over investment period*



Key benchmarks

	3 DFIs	6 Blending funds
Gross portfolio return, p.a.	10.2%	11.7%
Fund costs, p.a.	1.1%	2.9%
Net return to aid agency**, p.a.	6.7%	2.6%

* Projections based on IRR benchmarks over a period of 7 years and standardised around an ODA commitment of 100.
** Chart does not show costs related to subsidy to project support and delay between donor commitment and fund disbursement.
Source: Fund documents; interviews with donors and funds; Commons Consultants Analysis

- **Fund costs** in the blending funds were nearly three times higher than in the DFIs. These are primarily costs related to fund administration and operational expenses. They also cover subsidies to fund managers, e.g., for the establishment of the funds. Over an investment cycle of seven years, the DFIs had incurred fund costs corresponding to approximately 10% of the investment or app. 1.1 % p.a. In comparison, the projected fund costs in the blending funds were on average 27 % of the capital committed by aid agencies, or app. 2.9 % p.a. The primary driver of this difference is that the fees earned by fund managers in the blending funds are much higher than the DFIs' comparable costs.

- The **investment ratio** in the blending funds was also significantly lower than for the DFIs. The blending funds typically set aside the fund costs prior to making the investments. Only around three-quarters of the capital committed by aid agencies in the blending funds are invested in projects. In comparison, DFIs finance fund costs from the proceeds. This combined with the lower level of fund costs allows them to invest a much higher share of the committed capital.

- The **incentives** that the aid agencies offer to fund managers and private institutional investors in the blending funds also have a significant impact on net returns that they can expect to earn. On average, the aid agencies are expected to transfer half of the net return on their investments to other partners in the blending funds. Most of this incentive is given in the form of preferences to private institutional investors in the blending funds' distribution waterfalls. The aid agencies typically only have a small participation in the carried interest offered to fund managers. In comparison, the DFIs do not pay these incentives to other investors.

Benchmarking study in brief

6 funds	Funds for private sector projects with donor funding from Denmark, Norway and Sweden, totalling ~€150m: – African Renewable Energy Fund (AREF) – Danish Climate Investment Fund (DCIF) – Global Energy Efficiency and Renewable Energy Fund (GEEREF) – Green Africa Power (GAP) – IFC Catalyst Fund – Private Infrastructure Development Group (PIDG)
DFIs	Nordic DFIs from Denmark, Norway and Sweden, with total investment of ~€450m. The DFIs comprise IFU, Norfund and Swedfund.
Sectors	Focus on energy, climate and infrastructure projects due to emerging interest from donors and use of new financing channels.
Products	Funds targeting financial sustainability, i.e. offering equity, loans, and guarantees.

For the aid agencies, these higher fund costs and incentives in the blending funds are a matter of intentional policy. The aid agencies agree to incur these costs in order to increase the development impact of their investments. The aid agencies are mandated to care more about increased development impact than about direct financial returns on their investments. The intention is for the added impact to be achieved either by catalysing increased participation from the private institutional investors or by getting the blending funds to invest in geographies and sectors that they would otherwise not invest in.

6 The Effectiveness of Innovative Financing Mechanisms

The study went on to assess whether there was evidence that the innovative financing mechanisms employed by blending funds contribute to higher leverage from private institutional investors or to higher additionality.

The study finds that the aid agencies' investments have in some cases succeeded in mobilising private capital. But the innovative financing mechanisms do not appear to be the primary driver of this catalytic effect. High fund costs and generous incentives even appear to discourage participation from private investors.

It is instructive to look at two groups of blending funds within the benchmarking sample.

6.1 Blending Funds with High Catalytic Effect

In the benchmarking sample there were three funds that had achieved a relatively high catalytic effect. In these three funds the estimated leverage ratio of private institutional investors to public sector investors (including DFIs) is app. six times, on average. There is high participation of private investors both at the fund level (app. 50%) and at the project level.

It turns out that the innovative financing component in these three "highly catalytic" blending funds is relatively modest. That is, the aid agencies invest on terms that are quite similar to the private investors. While average fund costs are 2.4 % p.a., less than one-third of the net returns are transferred to private institutional investors and fund managers.

Indeed there is one of the funds, among these three, that has achieved a high leverage ratio despite the aid agency paying relatively low fund costs and without any preferred returns to the private institutional investors.

The more significant factor in these blending funds appears to be the level of financial participation by the fund managers in the funds, at app. 16 %, on average. This is quite high compared to general benchmarks in the fund management industry. The fund managers for these funds are also publicly backed, one bilateral DFI and two multilateral DFIs.

The Danish Climate Investment Fund (DCIF) is a good example of a highly catalytic fund targeted at the clean energy and energy efficiency sectors. The fund is managed by the Danish DFI, IFU, and supported by the Danish government. Already at its first close in 2014 the fund had a 60% participation from private institutional investors, principally pension funds. IFU has made a sizeable investment as fund manager but the fund management costs and preferential return incentives are relatively modest. It appears that the pension funds have chosen to invest in this fund due to the track-record and significant investment made by IFU rather than due to the preferential return that they can expect to earn.

6.2 Blending Funds Seeking High Additionality

Another group of three blending funds from the benchmarking sample did not achieve a high catalytic effect. In these three funds the estimated leverage ratio of private institutional investors to public sector investors is less than two times, on average. There is relatively low participation of private investors both at the fund level (less than 10%) and at the project level. This compares to an estimated average leverage ratio for the three DFIs in the sample of three times (where there is no participation at all from private investors at the fund level).

To date, the investors in these three funds have principally been aid agencies and DFIs. It is quite common in these funds that the incentive offered by the aid agencies end up supporting DFIs, often from other donor countries, rather than private institutional investors.

At the same time, the innovative financing component in these three "highly additional" blending funds is quite aggressive. Average fund costs are 3.4 % p.a. which is more than three times the level of the DFIs. The incentive is also very high with an estimated 98% of the net returns expected to be transferred from aid agencies to private institutional investors and fund managers.

The aid agencies' high subsidy of fund costs and the aggressive incentives in these funds have not succeeded in securing the participation of private institutional investors. At the same time, it is quite possible that the level of financial participation by fund managers in the funds, at only 1 % on average, is discouraging private institutional investors from signing up.

These three funds are more focused on additionality than the three "highly catalytic" funds in the sample. All three of them are focused on projects in Africa. All three also have fund managers from the private sector. These fund managers may have required relatively high fees and incentives to take up a fund management mandate in regions that were not so familiar to them.

But it is worth recalling that these three blending funds are also investing on market terms in commercially sustainable projects. Their targeted gross portfolio returns are on par with the levels achieved by the DFIs.

Indeed, it appears that these funds so far have tended to invest in projects that had already secured financing from DFIs. The market analysis and investment strategies of these funds have typically been under way for several years before the funds start investing and it appears to be difficult for the new funds to keep up with the opportunities in the markets.

As a result, the study indicates that half of the funds in the sample are unlikely to be successful in terms of their development impact. This is principally due to their relatively low expected catalytic effect. This challenge appears to be most significant when fund costs and incentives are the highest.

It should be noted that it is still too early to know exactly what the results of these blending funds will look like. Most of the funds in the sample are still in their investment period and the benchmarking study did not do a detailed examination of each of the projects that they have invested in. In particular, the funds may turn out to invest in projects with a particularly significant demonstration effect and they may yet raise additional financing from private institutional investors.

6.3 Aid Agencies' Funding Practices and "Ownerless Money"

The benchmarking study also found that aid agencies could close a considerable part of the cost gap between blending funds and DFIs by changing some of their investments practices. The most important steps would be to disburse investments when they are needed by the blending funds rather than well ahead of time, and to contain costs by reducing investments in funds-of-funds. Over time, the potential returns on investment that are lost due to inefficient practices or excessive costs and incentives can add up to significant sums.

There is also a significant risk that proceeds from donor investments end up as "ownerless money". The benchmarking study showed that aid agencies have typically not made arrangements for what will happen to distributions at the completion of the investment cycle. A clear agreement on the responsibility for re-investing the money and on investment terms would help ensure the most effective use of the funds from a development policy perspective.

7 Potential Implications and the Way Forward

The benchmarking study suggests that Nordic donors' experience with innovative financing mechanisms in blending funds in the energy sector has been quite mixed.

The study shows that some new funds have been successful in mobilising participation from private investors and in making investments in good projects. But the study also points to a number of pitfalls that the responsible donor agency will want to avoid in future. In particular:

- High fund management costs: fund costs in the blending funds are nearly three times as high as in the DFIs.

- Excessive incentives, risk coverage and preferential returns to private investors: it is difficult to demonstrate that first loss cover and other preferential return mechanisms are effective means of mobilising a high level of participation from private institutional investors. There is also a risk that aid agencies end up primarily subsidising unintended beneficiaries such as DFIs and other donors.

- Excessive upside to private fund managers: some blending funds supported by aid agencies pay fund managers high management fees and do not require them to make a significant investment in the fund. These practices appear to discourage participation from private investors.

- Extended time horizons for mobilising capital: the timing of funding commitments is critical to establish catalytic effect. In some cases, aid agencies have disbursed their funds several years before private investors make their commitments. In other cases aid agencies have come in after private investors agreed to invest in the fund.

- Uncertain additionality of the investments: in some cases it is evident that the blending funds succeed in making energy sector investments in new geographies. But often it appears that the funds invest in projects that already have high participation from DFIs.

- Complex set-ups that are hard to supervise: it is often difficult for aid agencies to participate effectively in negotiations and governance processes. It is rare that blending funds are subjected to rigorous evaluations by the aid agencies.

- "Ownerless money" risk and inefficient donor practices: aid agencies tend to disburse investments to blending funds too far ahead of the time when they are needed and without a clear plan for what will happen to the funds at the end of the investment cycle.

Overall, there are good reasons for aid agencies to scrutinise their next investments in blending funds very carefully. Aid agencies may at times have been animated by a drive to be part of creating new, innovative private sector financing mechanisms. After a decade of experimentation, they are now in a position to incorporate the emerging lessons in their investment decisions. This will help them avoid the pitfalls and focus more on what has been proven to work.

Data and experiences, such as the ones that emerge from this benchmarking study, can help guide aid agencies in future investments in blending funds. A particularly important lesson appears to be that aid agencies are most successful at mobilising participation from private investors when funds align as closely with market terms as possible, with respect to fund costs, incentives and fund managers' own investment in the funds.

Ultimately, private sector financing has to focus as much on scaling up what works as on experimenting with innovative mechanisms. The bilateral DFIs have experience, track-record and working relationships with private institutional investors which can be very valuable in scaling up what works. In some cases the DFIs already work closely with aid agencies to move this agenda forward. In other countries DFIs could assume a more dynamic role to help shape and guide private sector financing for the next decade.

Acknowledgements

This report summarises two recent research projects carried out by our research team at Commons Consultants.

The European Association of Development Finance Institutions (EDFI) supported the mapping study of ODA for blended finance in private sector projects which allowed us to do the detailed mapping of European aid agencies' investments in blending funds over the past decade.

Norfund supported the benchmarking study which allowed us to do a detailed examination of three Nordic DFIs and a sample of six blending funds that have received financing from Nordic aid agencies.

We are grateful for the contributions of many colleagues who helped generously with the research. Both studies benefited tremendously from their insights, perspectives, and the data that they have helped us access. In addition to several EDFI member institutions, contributors to the mapping study included representatives of AFD, EBRD, EIB, and KfW. In addition to Norfund, the benchmarking study benefited from cooperation from representatives of IFU, Swedfund, the Danish and Norwegian ministries of foreign affairs, Norad, SIDA, as well as staff in several of the blending funds covered by the study.

This report does not represent the official views of EDFI, Norfund, nor any of the other institutions that contributed to the study. All remaining errors are our own.

End notes

[1] "IFC Jobs Study: Assessing Private Sector Contributions to Job Creation and Poverty Reduction". IFC, January 2013.

[2] "World Investment Report 2014: Investing in the SDGs: An Action Plan". United Nations Conference on Trade and Development, 2014.

[3] "Study of ODA for Blended Finance in Private Sector Projects". Commons Consultants, 3 February 2015.

[4] "Benchmarking study: Donor investments in private sector projects". Commons Consultants, 26 June 2015.

Our team members will be pleased to answer your queries and share more information:

Commons Consultants
Kronprinsessegade 36B, Copenhagen, 1306 K, Denmark
Tel. +45 3296 2030, Email: info@commonsconsultants.com