LSFI
Luxembourg
Sustainable Finance
Initiative

Blended Finance

What it is, how it works, challenges and best practices

Summary Report from LSFI's Masterclass

September 2023

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About the Summary Report

This whitepaper is the outcome of the Masterclass on Blended Finance organised in June 2023 by the Luxembourg Sustainable Finance Initiative (LSFI) with the aim to upskill Luxembourg finance professionals on sustainable finance. The white paper provides a high-level overview of this topic, leveraging on the learnings shared during the Masterclass, and seeking to share these with a broader public.

It is not intended to be comprehensive or be used as financial or business advice by the reader.

We would like to express our gratitude to the masterclass speakers for their insights and for sharing their in-depth expertise in this matter with the masterclass audience and the LSFI:

- Alessandra Nibbio – Head of Blended Finance, BlueOrchard
- Arnaud Gillin – Co-founding Partner, Innpact
- Chris Clubb – Managing Director, Convergence
- Dmitry Vassiljev – Investment Officer, European Investment Bank
- Lucie Bernatkova – Vice President, Portfolio Manager, Allianz Global Investors GmbH

1. Introduction to Blended Finance

1.1. What it is

A significant scale-up of investment is required today to achieve the Sustainable Development Goals (SDGs). Current development financing levels are insufficient, with a currently estimated $4.2 trillion funding gap[1] per annum to realize the SDGs in developing countries alone. Blended finance is one fundamental, yet underused, approach to mobilizing new sources of capital for the SDGs.

As per the OECD definition, **blended finance** consists of the strategic use of development finance for the mobilization of additional finance towards sustainable development in developing countries. It attracts commercial capital towards projects that contribute to sustainable development, while providing financial returns to investors. This approach helps enlarge the total amount of resources available to developing countries, complementing their own investments and **official development assistance (ODA)** inflows to fill their SDG financing gap and support the implementation of the Paris Agreement[2].

In this context, **development finance** is defined as public and private finance that is being deployed with a development mandate**; and additional finance** refers to commercial finance that does not primarily target development outcomes in developing countries. **Official development assistance (ODA)** is defined as government aid that promotes and specifically targets the economic development and welfare of developing countries[3].

In particular, **development finance** can take two forms:

- **Concessional finance**[4]: it mobilizes non-concessional development finance, private investment and philanthropic funding.
- **Non-concessional finance**: it mobilizes other non-concessional development finance, including multilateral, bilateral and commercial creditors as well as international bond markets, and private investment.

Blended finance is not an investment strategy; it is a **structuring approach** that can take various shapes which allows organizations with different objectives to invest alongside each other while achieving their own goals - whether financial return, social impact, or a blend of both.

In short, this structuring approach of blended finance has three main characteristics[5]:

- The transaction contributes towards achieving the SDGs. However, not every participant needs to have that development objective. Private investors in a blended finance structure may simply be seeking a market-rate financial return.

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[1]Data source: https://news.un.org/en/story/2023/07/1138352
[2]Blended finance definition source: https://www.oecd.org/dac/financing-sustainable-development/blended-finance-principles/
[3]Source: https://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/OECD-Blended-Finance-Principles.pdf
[4]According to the World Bank concessional finance is defined as “Below market rate finance provided by major financial institutions, such as development banks and multilateral funds, to developing countries to accelerate development objectives.”. Source: https://www.worldbank.org/en/news/feature/2021/09/16/what-you-need-to-know-about-concessional-finance-for-climate-action
[5] Blended Finance characteristics by Covergence: https://www.convergence.finance/blended-finance

- Overall, the transaction expects to yield a positive financial return. Different investors in a blended finance structure will have different return expectations, ranging from concessional to market rate.
- The public and/or philanthropic parties are catalytic. Participation from these parties improves the risk/return profile of the transaction to attract involvement from the private sector.

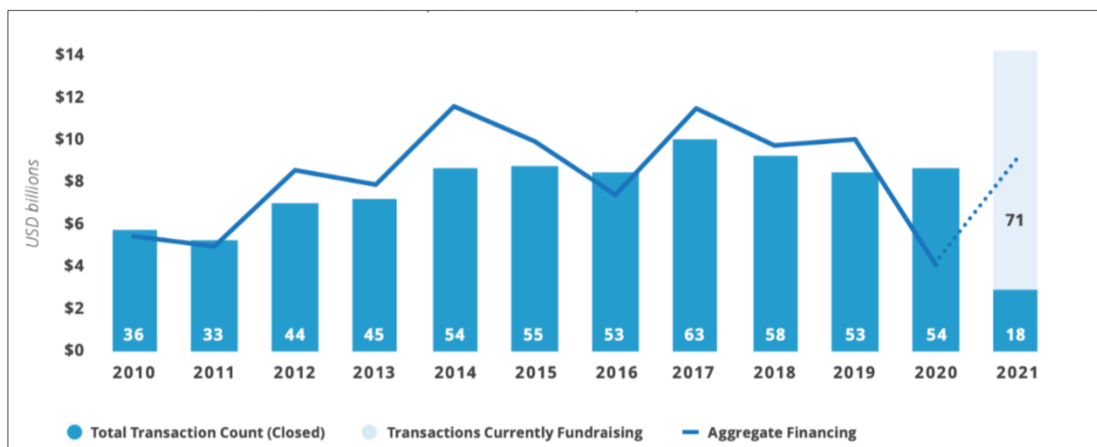
1.2. Added value of blended finance

Besides its pivotal role in further pushing investments into achieving the SDGs, this structuring approach has additional and substantial added value for the investors, regions and projects where it is used. Some of these **added value features** are:

- It generates a catalytic effect: a small contribution from donor or public sources can foster a larger-scale investment.
- The donors obtain a high impact from their contributions since it's impact-focused.
- It mobilizes and engages private capital.
- It generates market-based risk-adjusted returns for private investors that meet business goals and fiduciary duties.
- It fosters protection for private investors.
- The investments work towards delivering social, environmental and economic impact.
- The investment strategy is usually long-term and provides support for the project where it is deployed.
- Blended finance structures are ideal for innovative strategies.

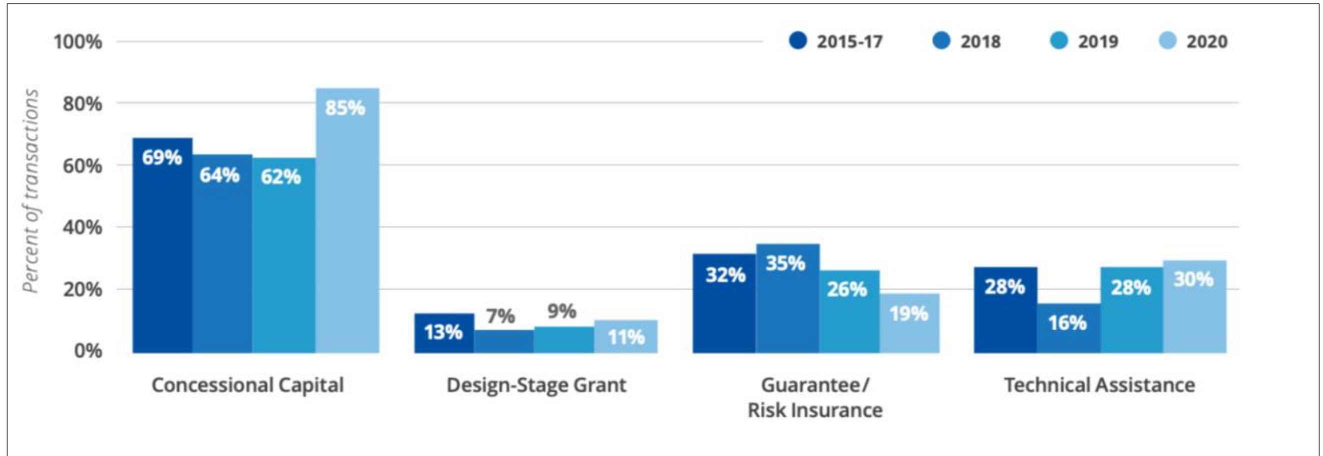
1.3. Key figures

Overall blended finance market (2010 – 2021)



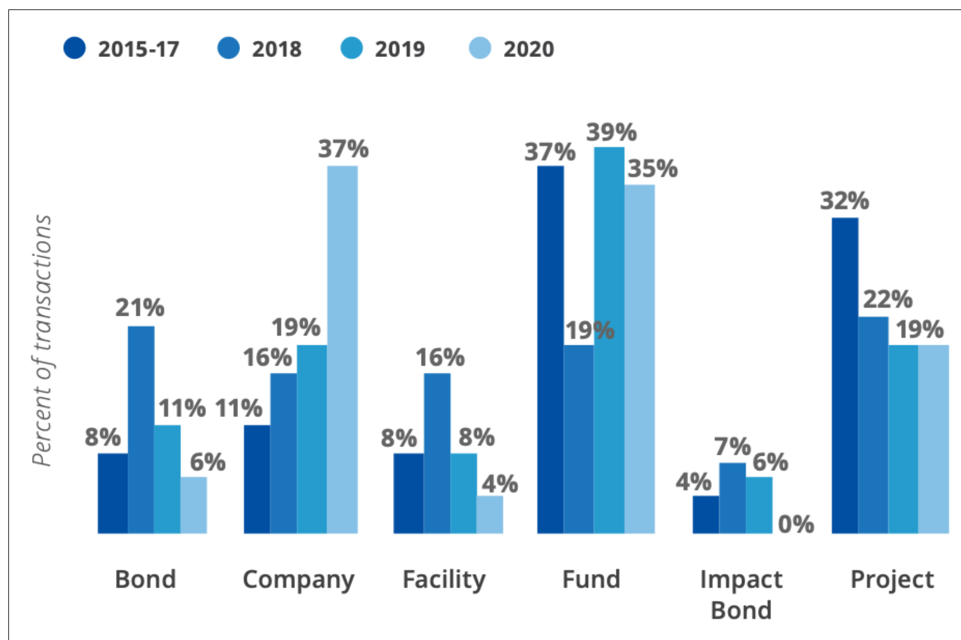
Source: https://www.convergence.finance/resource/the-state-of-blended-finance-2021/view

Proportion of closed transactions by blending approach



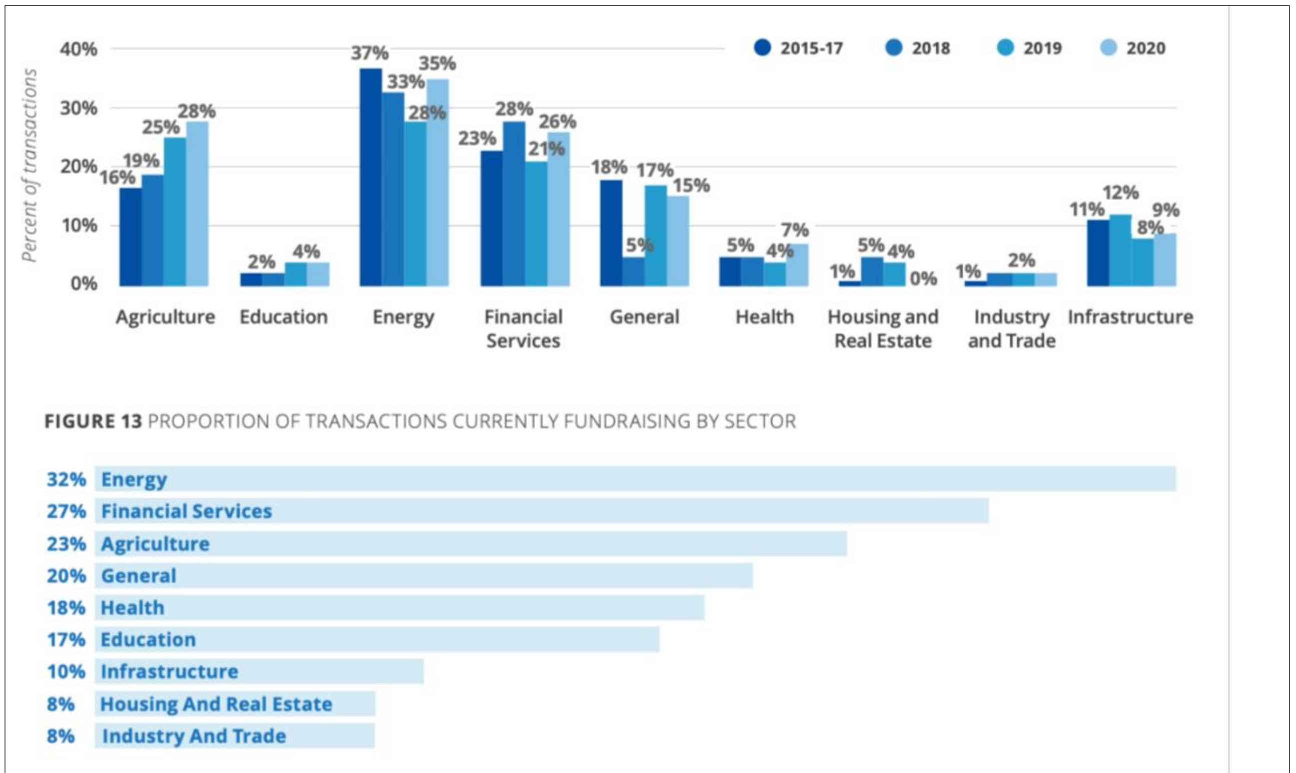
Source: https://www.convergence.finance/resource/the-state-of-blended-finance-2021/view

Proportion of closed transactions by vehicle type



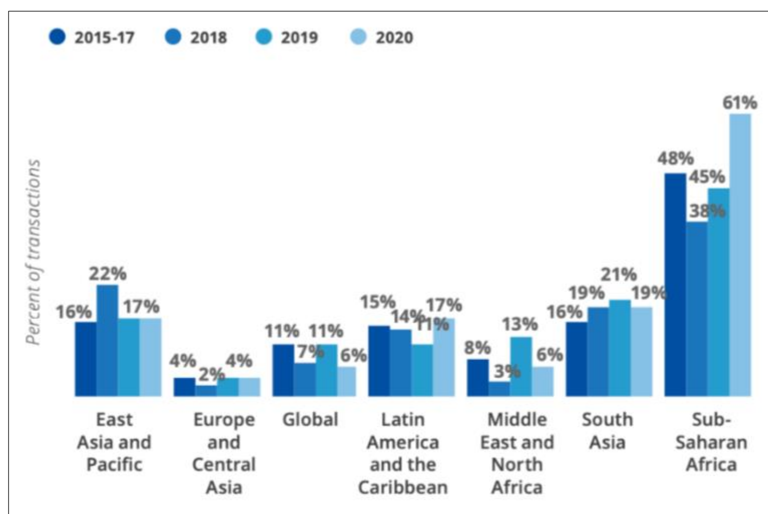
Source: https://www.convergence.finance/resource/the-state-of-blended-finance-2021/view

Proportion of closed transactions by sector



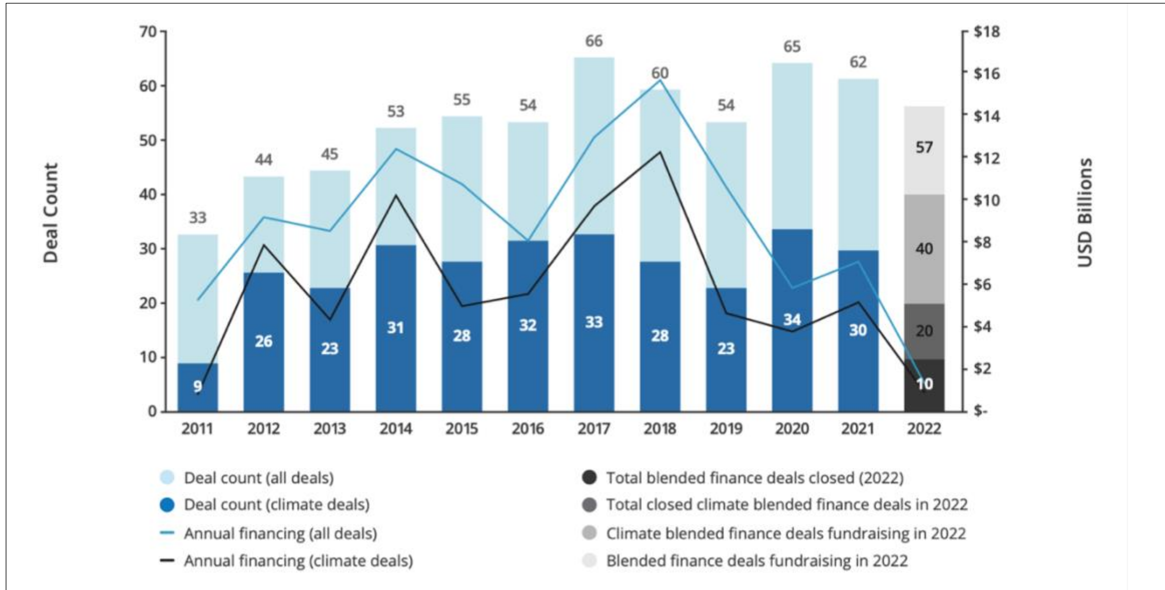
Source: https://www.convergence.finance/resource/the-state-of-blended-finance-2021/view

Proportion of closed transactions by region



Source: https://www.convergence.finance/resource/the-state-of-blended-finance-2021/view

Overall blended climate finance market relative to the overall market (2011 – 2022)



Source: https://www.convergence.finance/resource/state-of-blended-finance-2022/view

2. Type of Structures

2.1. Main structuring approaches

As previously mentioned, blended finance is not an investment approach or instrument, it is a structuring approach. The most common blended finance structures are the following[6]:

- **Private equity or debt funds** with concessional public or philanthropic funding attracting institutional investment. See the example below:

- Bond or note issuances with **concessionally priced guarantees** or insurances from public or philanthropic funders. See the example below:

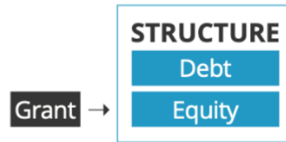
In these two above-mentioned structures, concessional capital and guarantees are used by the public or philanthropic sector to create an investment opportunity with acceptable risk-return profiles for the private sector by de-risking the investment or improving the risk-return profile by bringing it in line with the market for capital.

- Grant funding from public or philanthropic funders to build capacity around the investments via a **Technical Assistance Facility (TAF)** to achieve expected financial and social returns. See the example below:

Technical assistance (TA) funds operate outside the capital structure and have as a goal to foster the viability of the projects, as well as to facilitate impact measurement.

[6] Examples have been extracted from Convergence – State of Blended Finance 2022: https://www.convergence.finance/resource/state-of-blended-finance-2022/view

- **Grant funding** from public or philanthropic funders to design or structure projects to attract institutional investment. See the example below:

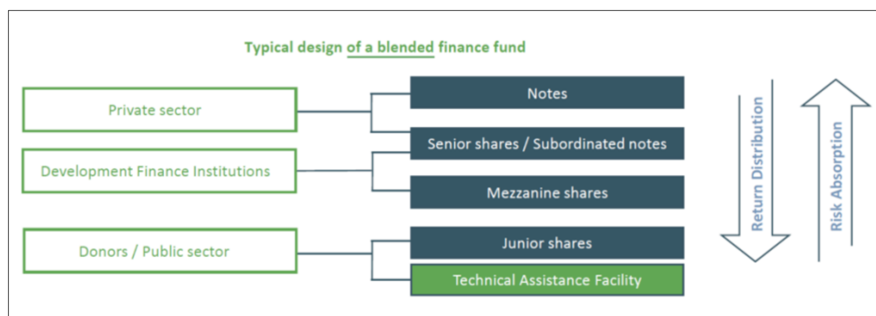


In the case of grants, while they are also not direct investments in the capital structure, they aim to improve the transaction's probability of achieving bankability and financial close.

2.2. Blended finance equity and debt funds

When focusing on private equity or debt funds, these follow a similar design which is characterized by the presence of several actors (e.g., private sector, development finance institutions and donor or public sector) and the division of the **capital structure into several tiers**, following a waterfall structure[7].

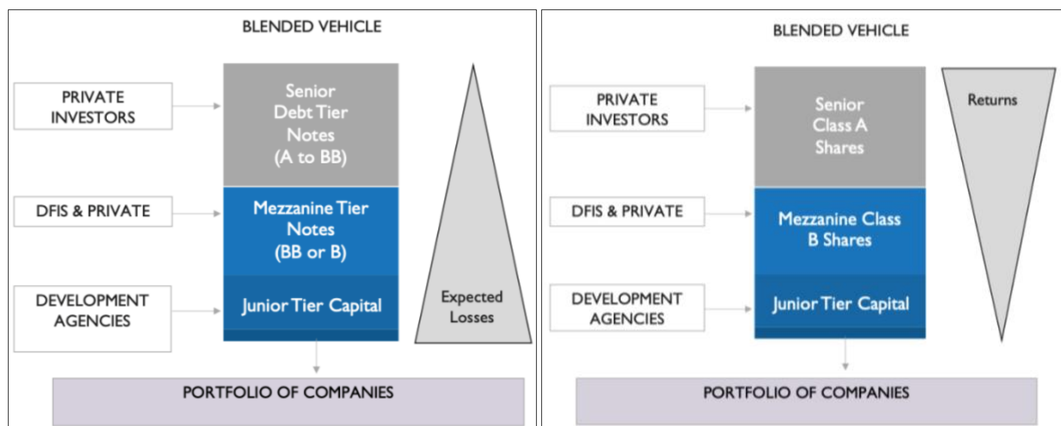
The role of the public sector and/or donors is to support the junior shares of the fund and or contribute to the technical assistance facilities. Development finance institutions are involved in the mezzanine or senior shares. Finally, the private sector invests in senior shares, in subordinated notes or notes. Generally, the junior shares provide 'first loss' capital which serves as a catalytic risk buffer to encourage private investment in more senior share classes. Private investors benefit from this reduced risk that the waterfall structure provides which enables them to invest in sectors and regions with high development potential and higher perceived risk.



Source: Innpact - https://innpact.com

[7]A waterfall structure is understood as an structure that combines different asset classes with various risk and return profiles.

While the above-mentioned design is the general approach, some differences can be found between debt and equity funds. While the actors and the capital tiers structuring might coincide, there are differences in the distribution and role of the returns and expected losses.



Source: Convergence - https://www.convergence.finance

In blended finance debt funds, the accent is put on the potential losses, being expected that the majority would fall under those investing in the junior tier capital (i.e. donors, public sector, development agencies). Junior-tier capital investors also accept low-interest debt to increase the internal rate of return for private investors. In the case of blended finance equity funds, the accent is put on the return; on this occasion, it is foreseen that the investors contributing to the junior tier capital to get the lowest return with those investing in senior class A shares (i.e. private investors) to receive the higher returns. In addition, returns for junior-tier capital investors can be put into reserve to create a more significant risk cushion for private investors.

2.3. The Technical Assistance Facility

As anticipated, blended finance structures often come accompanied by establishing a **Technical Assistance Facility (TAF).**

Technical assistance is a development tool that can be deployed to mobilize additional sources of finance for the Sustainable Development Goals (SDGs), including supporting project preparation, project implementation, or the broader business environment (e.g., improving the legal environment). Generally, blended finance transactions have more commonly deployed technical assistance in low-income countries, which may reflect its potential to strengthen markets and build the capacity of local stakeholders.

2.4. The Guarantees

Guarantees are commitments in which a guarantor commits to pay all/part of an underlying financial instrument (usually a bond or a loan) to the investor of the instrument, or make payment on behalf of the primary obligor that has not made the payment.

Guarantees can mitigate the risk of attracting debt capital on terms that are unfeasible for the project. They provide investors a secondary level of comfort that investment will be repaid if the obligors cannot fulfil contractual obligations (payments). In addition, they help narrow the gap between real and perceived risk.

3. Best practices – Case Study examples

As anticipated, blended finance can be implemented through different structures and can be accompanied by different instruments. The below section highlights some blended finance case studies which were presented during the Masterclass on Blended Finance organised in June 2023 by the Luxembourg Sustainable Finance Initiative (LSFI). These present several particularities: a **blended finance fund**, a blended finance **fund of funds** and an example of a **technical assistance facility**.

Land Degradation Neutrality Fund (LDN Fund)

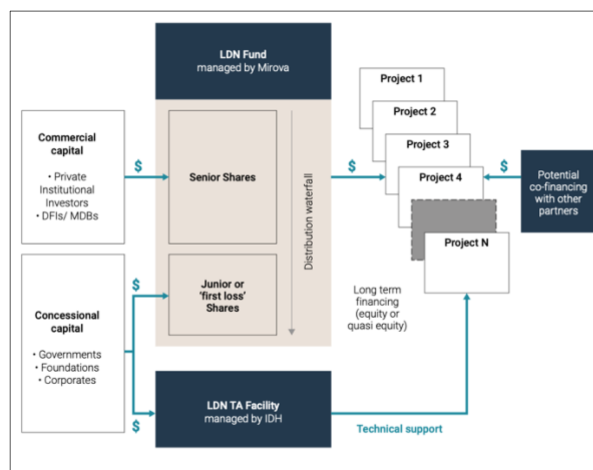
The Land Degradation Neutrality (LDN) Fund, initiated by the United Nations Convention to Combat Desertification, is an impact investment fund that uses a blended finance structure. It is a fund investing primarily in debt with selective allocations to equity investments that invests in projects protecting and restoring nature. It held a first close in 2018 and have raised USD 208m from public and private investors, including governments, institutional investors and impact investors. The LDN is managed by Mirova, a French fund management company.

Structure

Through its blended finance structure, the LDN Fund aims to attract private investors that may otherwise not have invested in sustainable land management projects. It uses a **layered capital structure** to offer appropriate risk-return profiles for different investors. It counts of two layers:

- Junior or first loss shares: Investors contributing to this layer provide concessional capital, taking a first-loss position in the fund and thus partially protecting senior investors. These investors are typically public organizations such as national development agencies, climate funds, or private foundations and corporates. These investors include the French Development Agency, the UK department for environment food and rural affairs (DEFRA), Global Affairs Canada (GAC) and the European Investment Bank (EIB) under the mandate from the Government of Luxembourg.
- Senior Shares: Commercial capital is typically provided by institutional investors such as pension funds, insurance companies, and development banks. Generally, these investors require market financial returns with a low-risk profile while are also interested in the positive impacts of the fund.

A snapshot of the layered structure can be found below:



Source: https://www.mirova.com/sites/default/files/2021-07/LDN%20Report%202021.pdf

In this case, the role of concessional capital is pivotal for the fund's success as it demonstrates the **endorsement of the fund objective by the public sector**, and it partially de-risks the senior investment providing a more balanced risk/return profile, especially for these private investors.

Investments and impact

The fund supports private sector-led projects that promote sustainable land management and use and the restoration of degraded land worldwide (especially African, Caribbean, Pacific States "ACP", Asia and Latin America). Its main targeted sectors are planted forest, agroforestry and regenerative agriculture.

An example of the supported projects is "Miro Forestry", a company that operates sustainable forest plantations in Ghana and Sierra Leone that focuses on replanting degraded lands and offers income opportunities to the communities living in these landscapes. Miro Forestry operates FSC® certified plantations that combine commercial timber species and conservation areas. These projects aim to help revert the large-scale deforestation that West Africa experiences, often as a result of illegal logging, unsustainable agricultural practices, mining and poor land governance.

In general terms, the LDN Fund is expected to **foster the restoration and rehabilitation of around 350.000 hectares of degraded land** and reduce CO2 emissions by 25 million tonnes[8].

Emerging Market Climate Action Fund (EMCAF)

The Emerging Market Climate Action Fund (EMCAF), initiated by AllianzGI and the European Investment Bank (EIB) with the Governments of Germany and Luxembourg, is a blended finance fund of funds. It provides highly catalytic early-stage equity financing to greenfield climate mitigation and adaptation projects in emerging and developing markets by backing fund managers and project developers active in this area. The fund is managed by Allianz Global Investors, with the EIB supporting as an investment advisor.

Structure

The fund is a risk-layered blended finance vehicle designed to mobilize 2/3 of private capital based on a seed investment of 1/3 by public investors. As with previous examples, the fund is structured in 2 layers: a junior and a senior tranche. The junior tranche counts on the Luxembourg Government as investor.

Projects financed and impact

It invests in funds providing funding to **climate mitigation and climate adaptation**, as well as environmental sustainability projects in developing countries. In particular, it invests in OECD Development Assistance Committee (DAC) list countries only.

The fund principally supports electricity production from low-carbon sources, thus aiming to reduce carbon emissions and air pollution. Capital is to be deployed to funds with a focus on renewable energy, mostly solar photovoltaics (32%), onshore wind (22%) and hydropower (17%), as well as other renewable energy projects such as geothermal energy and biomass, resource efficiency projects (mainly energy efficiency), and environmental sustainability

[8]Source: Impact-Report-LDN-2022-EN-web.pdf (mirova.com)

projects (e.g. sustainable transport, forestry, rehabilitation/restoration of degraded land, water supply and wastewater, and circular economy).

Some examples of invested funds are:

- Sub-Saharan Africa: Fund developing and constructing greenfield energy-efficient cold chain infrastructure assets in Sub-Saharan Africa.
- European Neighborhood: Fund financing development and construction of greenfield renewable energy projects in the Middle East and North Africa.
- Sub-Saharan Africa: Pan-African fund strategy focused on financing the expansion of energy access (on- and off-grid) and resource efficiency.

The Emerging Market Climate Action Fund will contribute to **achieving several Sustainable Development Goals** (7 and 13 mainly, but also 6, 8, 9, 11, 14, 15, 17). The fund aims to create a long-lasting tangible impact by building up real assets on the ground, as well as fueling private market ecosystems that will sustain a low carbon economy over the long term, allowing the target countries to become energy independent and resilient.

Regional Education Finance Fund for Africa (REFFA)

The Regional Education Finance Fund for Africa (REFFA) is a blended finance fund initiated by KfW and funded by Germany Federal Ministry for Economic Cooperation and Development (BMZ) in 2012.

REFFA was created as a Public-Private Partnership (PPP) structured fund, where funds from Development Finance Institutions (DFIs) and private investors are blended into one legal structure based in Luxembourg. By providing first-loss capital, BMZ’s funding has been catalytic in attracting financing from development finance institutions and private sector investors that share the fund's objectives and can benefit from the credit enhancement provided by the junior tranche. BlueOrchard acts as the investment manager and the Technical Assistance Facility manager.

The fund aims at increasing the access of lower-income households in target countries to affordable education, as well as improving the quality of education by increasing the availability of education finance products.

REFFA Technical Assistance Facility

To **maximize the intended development impact**, REFFA has a Technical Assistance Facility (TAF). This grant funding contributes to creating and enhancing the education ecosystem through capacity building and active stakeholders’ engagement.

The TAF aims to increase the intended development impact of the strategy by:

- Enhancing institutional capacity of investees for education lending in Africa.
- Creating and supporting knowledge and skills sharing.
- Providing market information to the strategy and its partners.
- Fostering innovation.

The TAF is endowed with approximately USD 5.0 million from public and private grant funds and **has supported almost 50 projects in 13 countries**. More in detail, typical TAF projects include the development of education finance products tailored to the financial needs of (private) education providers, as well as those of learners and their families. The use of the

TAF grant funds is overseen by a committee where the main donors are represented to steer the allocation of funds. Financial institutions benefiting from TAF services participate in the costs via a cost-sharing contribution.

4. Challenges and Needs

Developing countries face several barriers when it comes to **mobilizing capital.** These are related to limited liquidity, risk being too high, local financial markets often not functioning efficiently, and private investors having knowledge and capability gaps. While blended finance is key to pushing investment into those markets, it faces challenges and needs to be covered to scale up this structuring approach.

One of these is related to capital. On the one hand, there is limited availability of concessional capital which is the foundation of any of these structures. In this regard, the question lies in how to convince key public sector organizations to prioritize private investment mobilization. In addition, large institutional investors do not currently allocate equity financing at scale to these markets due to the perception of sub-optimal risk-return profiles and small-scale investment vehicles.

Another challenge is linked to **coordination**. Blended finance gathers players with different profiles and objectives. It can thus be both challenging and very time-consuming to align the requirements and expectations of many different actors among public and private investors. Besides, a concrete, coordinated, and collaborative action agenda is necessary to increase the quantity and quality of investments.

As previously mentioned, the **risk profile of the countries** and the investments also plays a detrimental role. The high level of perceived risk in developing regions is a constant barrier to private sector investments. Given the minimal number of tools available to manage this risk, private investors require public sector support to mitigate it.

Low data availability also creates challenges for structuring and reporting. Convergence's 2022 report signaled in this regard that there is a mismatch between demand for climate data and availability of those data in the market. In particular, there is a growing demand for investors to disclose the impact of their investments on climate change to prevent greenwashing and improve the functioning of the market, also given the regulatory requirements. However, this demand not always coincide with the data available in the market.

Besides the ones above, there are other challenges and needs linked to:

- Structuring, being this highly complex and tailor-made.
- Funds life, as there are generally longer transaction lead times.
- Lack of bankable projects/companies.

5. Lessons Learned

Despite the several challenges which are to be addressed, blended finance is fundamental to reaching the SDGs and supporting emerging markets. This structuring approach now counts with over two decades of expertise and continues growing over the years; allowing for some relevant lessons learned. In particular on how to structure and run these vehicles, but also how to scale them up to have blended finance increasingly being successfully used.

- **Involve the investors from the beginning:** A first recommendation is to identify and engage with the anchor junior investor as early as possible, as these will be the foundation of these vehicles. Likewise, it is also relevant to involve private investors gradually both after the ramp-up and in the fund design.
- **Gather a tangible pipeline of projects:** The overall objective of this is to build substantially diversified scalable portfolios in order to attract in a more accessible way investors, if the projects are insufficient or not viable, investors might refrain from committing capital.
- **Simplification:** Keep the capital and governance structure as simple as possible. In addition, balancing scalability and individualization is key in blended finance as institutional investors prefer standardized financial instruments.
- **Leverage:** Considering the challenges and lengthy processes, leveraging on existing solutions supporting the creation of blended funds is recommended. Also in this line, it can be worth seeking for larger funds in terms of fund size since there is a significant effort to be put upfront in these structures.
- **Coordination:** Institutional investors and development banks usually pursue different objectives. Keeping both types of players coordinated, not making assumptions and asking questions can help ensure the process is smoother.
- **Targets:** Define precise theory of change, impact targets and realistic reporting frameworks focusing on financial and impact objectives that enable large-scale investments.
- **Transparency:** This is crucial for fair competition in blended finance. Public development finance interventions must be transparent to ensure fair competition among private sector participants.

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