CONVERGENCE
BLENDING GLOBAL FINANCE

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THE IMPACT PROGRAMME

RESEARCH REPORT

HOW TO MOBILIZE PRIVATE INVESTMENT AT SCALE IN BLENDED FINANCE

APRIL 2020

EXECUTIVE SUMMARY

The UK Department for International Development (DFID) and Convergence have convened a Working Group of development-focused organizations to collaborate on "scale" blended finance initiatives. DFID has commissioned Convergence to draft three reports: (1) Scaling Blended Finance for the SDGs (December 2019), (2) How to Mobilize Private Investment At Scale in Blended Finance (April 2020), and (3) Optimal Risk Mitigation Approaches in Blended Finance (*forthcoming*). Collectively, these three reports provide key information on how to build a more effective and efficient blended finance market that can mobilize private investment at scale.

DFID and Convergence engage closely with all relevant stakeholder groups for blended finance, including blended finance policymakers and practitioners, development agencies, development finance institutions (DFIs) and multilateral banks (MDBs), philanthropic foundations, and private investors. These stakeholders have communicated three systemic challenges this report – and the upcoming report on "Optimal Risk Mitigation Approaches in Blended Finance" – strives to address:

1. Development organizations, specifically development agencies (e.g., DFID) and philanthropic foundations (e.g., Rockefeller Foundation), seek a deeper understanding of (i) which private investors have the highest propensity to invest in blended finance, (ii) the specific investment criteria of these private investors, (iii) the most appropriate blended finance structures needed to mobilize private investors, and (iv) the optimal allocation of their funds to concurrently achieve their development objectives and mobilize financing to the Sustainable Development Goals (SDG).
2. Private sector investors seek better and more transparent blended finance solutions that create investible assets that meet their investment criteria and unique preferences;
3. 2020 marks the Decade of Action, with only 10 years left to achieve the SDGs. While some progress has been made, action to meet the SDGs is not advancing at the speed or scale required. Current blended finance flows will result in "billions to billions" rather than the needed "billions to trillions." The development community must move beyond rhetoric to mobilize private investment at scale.

In this report, Convergence, DFID, and stakeholders, re-visit Convergence's 2018 Report: Who is the Private Sector?. Convergence has convened a group of over 20 leading global private sector investors to reflect on the current state of blended finance to identify key recommendations needed to accelerate the market.

Convergence thanks DFID for commissioning this Report to build a more effective and efficient blended finance market. Convergence will work with partners within the development community and private sector to ensure the findings are well communicated and lead to more efficient blended finance practices, as best possible.

INTRODUCTION

The Sustainable Development Goals (SDGs) serve as the North Star for sustainable development, for developed and developing countries. In addition to its development mandate, the SDGs offer good business and investment opportunities for the private sector. According to analysis conducted by the Business and Sustainable Development Commission (BSDC), the SDGs have the potential to create at least US$12 trillion in opportunities for the private sector globally across four key economic systems: (i) food and agriculture, (ii) cities, (iii) energy and materials, and, (iv) health and well-being. However, private sector investors face significant constraints to invest in SDG projects in developing countries. Investors commonly cite three main barriers: (i) high perceived and actual risk, (ii) low returns for the risk (relative to investment in developed countries), and (iii) small investment sizes.

Global capital markets comprise around US$185 trillion, yet less than 1% is estimated to be deployed in developing countries. Arguably, there is an over-supply of capital relative to demand in developed countries, and an under-supply in developing countries. Blended finance is increasingly used as a structuring approach to mobilize new sources of capital to the SDGs in developing countries - mostly for private sector projects. While blended finance has mobilized a significant amount of capital (approximately $15 billion annually), it only represents a small percentage of the total financing needed for the SDGs in developing countries. To date, the majority of private sector investment in blended finance has been on an opportunistic basis, with little sustained movement towards strategic, active scaled investment. However, the potential is immense if the right investment opportunities can be created to direct private sector capital to SDG projects in developing countries.

Meanwhile, the sustainable investment landscape is growing, presenting unprecedented momentum for investing in the SDGs and leveraging blended finance. Increasingly, many private sector investors seek investments that meet both financial objectives and non-financial objectives. These investment strategies include Sustainable Finance, Environmental, Social, and Governance (ESG) Investment, Responsible Investment, Impact Investment and Green Finance. While different in mandate and scope, these investment strategies aim to achieve positive social, environmental or developmental outcomes in addition to financial returns. Blended finance can benefit from the momentum behind these investment strategies. Since all blended finance transactions are funded in-part by development-focused organizations, 100% of these transactions should align with one or more of these investment strategies.

Private investors are a diverse group of institutions, each operating with different mandates, investment criteria, risk-adjusted return targets and regulations. Yet, they are often treated by the development community as a homogeneous group. To mobilize private investment at scale, it is important to identify the unique investment criteria and barriers faced by different private sector segments. This report provides an analysis of the investment motivations, requirements, and constraints of five segments of institutional investors: i) financial institutions (e.g., banks), ii) asset / wealth managers, iii) private equity firms, iv) insurance companies, and v) pension funds.

This Report has five sections:

- Section I provides a summary and background on blended finance
- Section II reviews alignment between current private sector investment trends and blended finance based on Convergence's 2018 Report
- Section III summarizes existing trends in private sector investment in blended finance based on Convergence's database of 500 blended finance transactions
- Section IV reviews key opportunities and challenges faced by key segments of the private investment sector
- Section V presents key takeaways based on observations and recommendations from more than 20 private sector investors

SECTION I: BLENDED FINANCE

Blended finance is the use of catalytic capital from public or philanthropic sources to increase private sector investment in sustainable development. The key financial objective of blended finance is to create investment opportunities in developing countries that have an acceptable risk/return profile for private investors, by leveraging development funding at below-market terms (i.e., concessional). In blended finance transactions, all parties achieve their unique objectives; public and philanthropic parties achieve their development objectives, while private sector investors achieve their risk-adjusted return requirements. Figure 1 highlights typical blended finance structures:

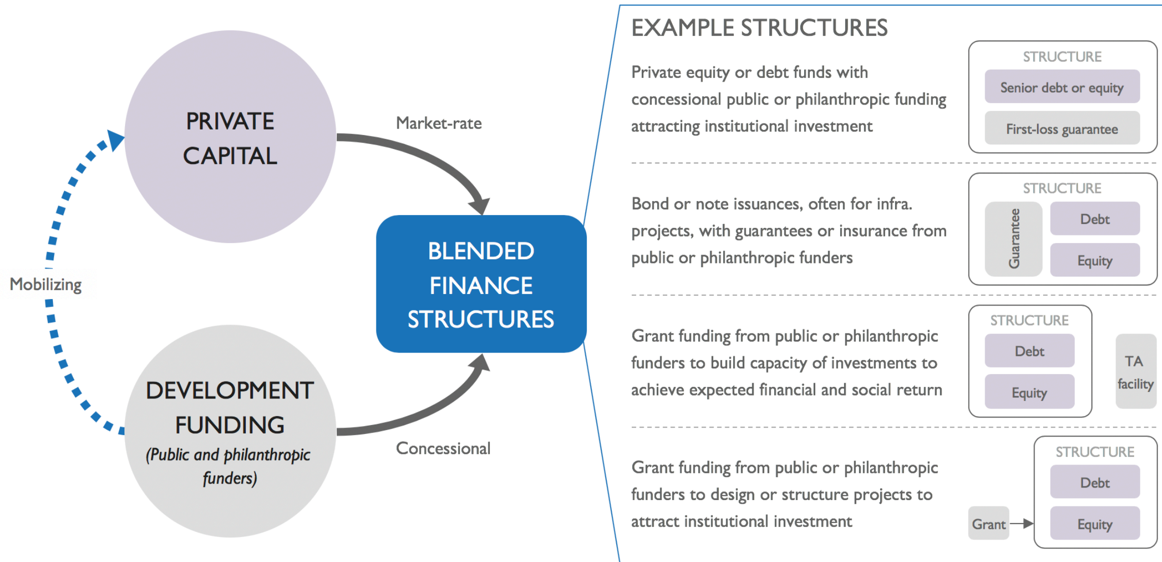

Figure 1: Typical blended finance structures and mechanics

Blended finance exists to mobilize investment to SDG projects that are bankable "as is" or require a level of risk mitigation to make them bankable. Table 1 below outlines the types of transactions blended finance should be used to support; specifically, transactions in Category I and II, while foregoing transactions in Category III.

Transaction Category	Description	Blended Finance Solution
I) Bankable	Project is bankable on commercial terms – *financial intermediaries are prepared to finance the project on normal, market-based terms with no external support required.*	Many bankable SDG projects in developing countries go unfinanced due to a lack of capital. Blended finance solutions increase the supply of capital available to financial intermediaries, thereby increasing the number of SDG projects that can receive financing get off the ground.
II) Near-Bankable	Project is mostly bankable "as is," but requires a level of risk mitigation – *financial intermediaries require some risk mitigation to finance the project.*	Without some risk mitigation to make the project bankable, these near-bankable projects will not receive financing and will not be implemented. Examples could include an SME that has the necessary cashflows to obtain a loan but lacks the collateral to pledge to a domestic bank. Blended finance solutions can provide risk mitigation solutions to credit enhance

		transactions, transforming near-bankable projects to bankable initiatives.
III) Unbankable	Project is unbankable, probability of failure and financial loss is unacceptably high - *financial intermediaries would require a full guarantee to finance the project.*	There are many projects financial intermediaries would determine to be unbankable. Blended finance solutions are not intended to mobilize finance to these types of projects.

Table 1: Transactions that can benefit from blended finance

Blended finance can support transactions at one of two levels: the project level (e.g., a project or company) or the portfolio level (e.g., a pooled fund or facility). Table 2 highlights this dichotomy below:

Level	Summary	Example
I) Project Level	Single Project: Solutions to mitigate risk for an individual project to mobilize a financial intermediary to finance the project – generally for Category 2 Projects.	This type of risk mitigation is resource intensive and practiced only when efficient, usually for projects that require large amounts of finance, such as infrastructure, public-private- partnerships (PPP) and project finance transactions. Typical approaches are to credit-enhance specific risks or all risks, through a guarantee or indemnification. For example, GuarantCo provides guarantees to credit-enhance infrastructure projects to an acceptable level for domestic investors to finance the project.
	Multiple Projects: Solutions to mitigate risk for multiple projects to mobilize financial intermediary to finance multiple Category 1 and / or Category 2 Projects.	This type of risk mitigation is practiced when the underlying financing amount is small and a Single Project intervention is inefficient. Typical approaches would be to provide a partial guarantee for a portfolio of projects. For example, the African Guarantee Fund provides guarantees to local banks to expand their SME loan portfolios, with AGF providing a guarantee for 50% of each loan.
II)Portfolio Level	Solutions to mobilize private investors to invest in a portfolio of investments through a pooled vehicle, such as a blended fund or facility, with the portfolio investing in Category 1 Projects.	This approach is the most prevalent in blended finance. In this approach, development organizations provide funding to the vehicle (e.g., a fund) at below-market terms to mobilize private investors to invest in the vehicle. The blended finance vehicle then extends financing to a portfolio of projects in developing countries.

Table 2: Blended finance at project and portfolio level

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SECTION II: PRIVATE SECTOR INVESTMENT TRENDS

In January 2018, Convergence published a Working Paper titled *Who is the Private Sector? Key Considerations for Mobilizing Institutional Capital Through Blended Finance*. The Paper explored six segments of the private sector that accounted for more than US$200 trillion in Assets Under Management (AUM): commercial banks, investment banks, asset / wealth managers, pension funds, insurance companies, and sovereign wealth funds. Financial institutions (i.e., both commercial and investment banks) and asset / wealth managers are the two largest segments by AUM, followed by pension funds and insurance companies. Private equity firms and sovereign wealth funds are the smallest segments, with tendencies to have specialized / narrow investment mandates. Most of the largest private sector investors are based in North America and Europe, except for financial institutions, since many of the world's largest financial institutions are in China.

In the 2018 report, Convergence and private sector investors agreed their existing and potential investments aligned to blended finance would not fall within their main investment book, but would fall under their "alternative assets" mandate. Convergence estimated the aggregate investments made by the six segments in alternative assets aligned to blended finance were approximately US$6 trillion, globally. Pension funds and sovereign wealth funds allocate the largest average share to alternatives at 19% and 18%, respectively, followed by asset / wealth managers (12%) and insurance companies (9%). Private equity firms, by nature, are fully dedicated to alternative investments. Financial institutions have the lowest allocation to alternatives. Within alternative investment portfolios, real estate generally represents the largest average allocation (37%), followed by private equity (19%) and illiquid credit (13%). Most often, infrastructure is the smallest allocation within these alternative investment portfolios (8%).

Convergence estimated private sector investors allocate approximately US$2 trillion – or 1% of total assets – to alternative assets aligned to blended finance in developing countries. Approximately 30% of alternative investment portfolios were invested in developing countries. Excluding private equity firms, the remaining five private sector segments, on average, allocate 31% of their alternative investment portfolios to developing countries. Private equity firms on average allocate 34% of their portfolios to developing countries. It should be noted here that developing countries primarily refers to the middle-income countries or countries with sovereign risk ratings of investment grade or higher. Little private sector investment is directed to low-income countries, or those with sovereign risk ratings below investment grade outside of blended finance and other impact-oriented initiatives.

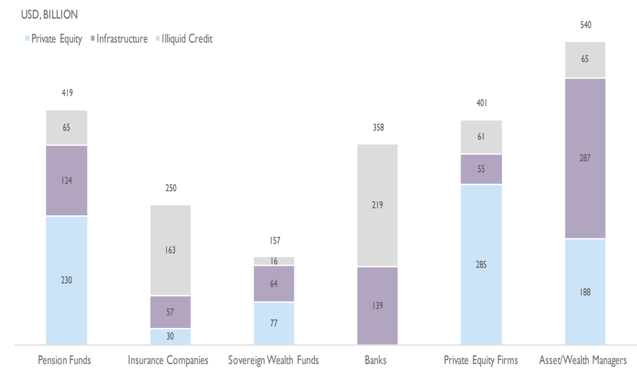

Figure 2: Allocation to alternative assets in developing countries (Source: Institutional Investors)

Convergence's research also found that private sector investors are looking to increase allocations to both alternative asset classes and developing countries. Alternative investments are increasingly viewed as an attractive way to generate strong returns and further diversify portfolios, with a strong growth trajectory currently forecasted. Approximately 39% of private sector investors state they expect to increase future allocation to alternative investments moderately or significantly. Developing country markets have a more mixed outlook, especially since the 2008 financial crisis, but have taken an upturn since 2015. Private sector investors, on average, expect to increase alternative investment allocation in developing countries from 31% to 34%.

Moreover, the private sector is increasingly investing in projects and transactions aligned to investment strategies beyond risk-return, such as impact investing, sustainable

finance, responsible investment, green finance, and SDG investment. Three examples of this trend include: (i) the Global Impact Investment Network (GIIN) estimates that US$550 billion in AUM is invested subject to an "impactive investing;" growing 20% annually; (ii) the IFC estimates total global demand for "impact investing assets" is US$26 trillion; and (iii) more than 2,400 organizations who manage approximately US$90 trillion of AUM have signed the UN Principles for Responsible Investing (PRI). These trends reveal there is a crucial opportunity today to influence private sector capital flows toward developing countries.

Some level of private sector capital will flow naturally at market terms to SDG projects in developing countries without blended finance. In 2019, the OECD reported that annual cross-border flows to the 145 Official Development Assistance (ODA)-eligible developing countries included US$559 trillion in foreign direct investment (FDI) and US$111 billion in portfolio investment. However, blended finance is one important approach for mobilizing greater volumes of private sector capital, given current allocations and both real and perceived risks associated with investing in developing countries. Given the track record of blended finance over that past decade, it is realistic to target mobilization of private sector investment at material levels, subject to the right enabling environment, investment opportunities and incentives. Investment in developing countries equal to around 1% of global capital markets is enough to eliminate the SDG financing gap.

SECTION III: PRIVATE SECTOR INVESTMENT IN BLENDED FINANCE

Commercial investors face significant constraints to investing in projects in developing countries, including high risk for low perceived returns, small investment sizes and insufficient liquidity. To date, the majority of private sector investors have participated in blended finance on an opportunistic basis, with little sustained movement towards active and scaled investment. Still, Convergence's The State of Blended Finance 2019 identifies a number of positive signals. For example, the private sector has been providing an increasing share of financial commitments to blended finance transactions. Commercial investors accounted for 27% of financial commitments (both concessional and commercial) made to blended finance transactions established in 2016-2018, compared to only 19% of financial commitments made to blended finance established in 2010-2012 (See Figure 3 below).

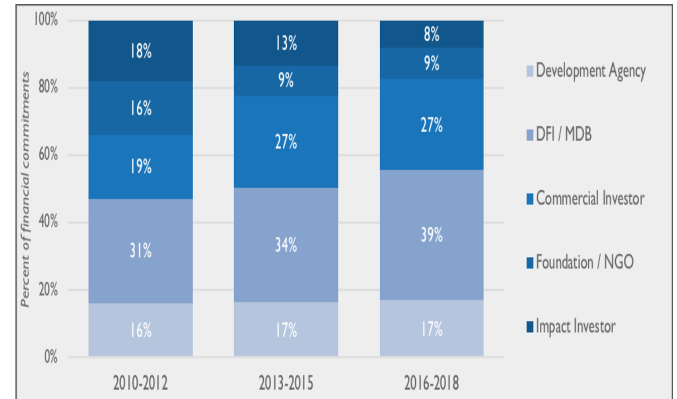

Figure 3: Sources of financial commitments to blended finance

To date, blended finance has mobilized the greatest investment amounts from financial institutions (i.e., commercial banks) and corporates (i.e., multinational companies). The proportion of private sector commitments to blended finance transactions from commercial banks has steadily increased over the past decade, from 36% of private sector investments in 2010-2012 to 46% of private sector investments in blended finance transactions in 2016-2018 (by count). In addition, corporates represent a greater share of private sector investments in blended finance transactions today, from 23% of private sector investments in 2010-2012 to 29% in 2016- 2018. Corporates are particularly active in their respective sector; for example, multinational food and beverage companies have been most active in the agriculture sector.

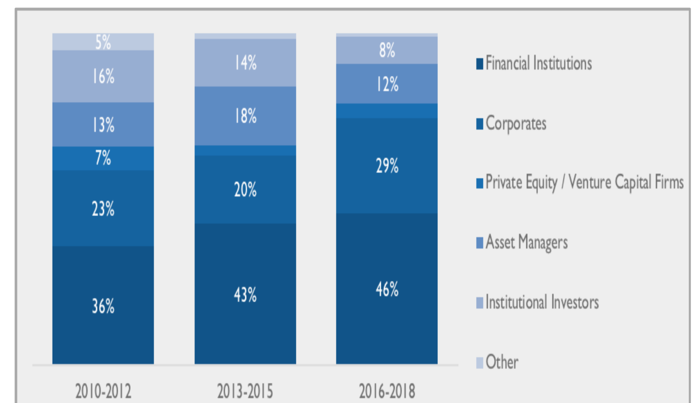

Figure 4: Financial commitments from commercial investors

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In contrast, institutional investment in blended finance has been limited. Many institutional investors have invested in one or two blended finance transactions, but very few can be classified as active investors. Private equity / venture capital firms, asset managers, and other institutional investors (e.g., insurance companies and pension funds) represent declining proportions of private sector investments in blended finance transactions, between 2010-2018. This may reflect the current outsized role of financial institutions in blended finance transactions, the mismatch between their investment preferences and current investment opportunities (e.g., transaction size and type), as well as the downturn in investments in emerging markets in recent years. Moreover, private equity firms and asset managers have an important role to play in blended finance beyond investors. For example, these segments can play an important role in blended finance as intermediaries, including by structuring blended funds as General Partners and fund managers. Nevertheless, blended finance needs to attract institutional investors at scale – growing participation from one or two transactions to more regular investment activity.

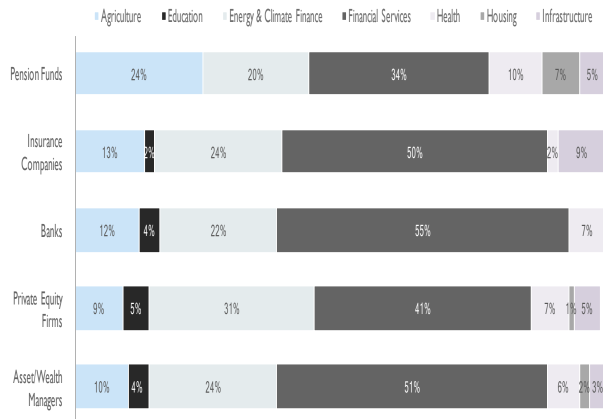

Figure 5: Institutional investor activity in blended finance in developing countries by sector based on Convergence deal database

Where institutional investors have participated in blended finance, the majority of transactions have focused on financial services and energy. Financial services comprise a significant portion of private sector investment in blended finance, comprising between 30% and 55% of blended finance activity across the segments. Energy is the next most common blended finance sector for private sector investors, comprising between 20% and 31% of blended finance activity. Infrastructure projects have attracted a relatively small portion of private sector investments in blended finance, with insurance companies participating most often (9% of their total activity). Pension funds have participated in the widest set of sectors, including investments in agriculture. The previous figure (*Figure 5)* details private sector investor activity in blended finance by sector.

Ultimately, the amount of commercial investment mobilized by blended finance varies greatly across vehicle types and sizes, structuring approaches, and target sectors and countries. Convergence conducted an initial analysis of 56 blended finance transactions that use concessional debt / equity to attract commercial investment. On average, leverage – the volume of commercial capital catalyzed by $1 of concessional capital – across these funds has been 2.6, with a minimum leverage ratio of 0.32 and a maximum leverage ratio of 24. In this analysis, commercial investment includes both private investment and commercial DFI investment, and calculations are based on multiple estimates. These figures should be taken as indicative trends only, as further analysis is required to understand leverage ratios across structure types, and sizes, focus sectors, and target countries.

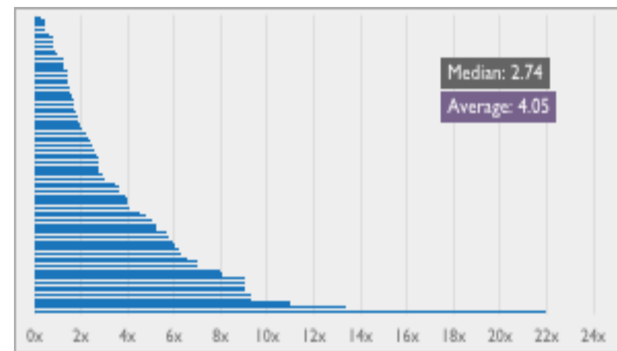

Figure 6: Leverage ratios across a sample blended finance funds

There are a few signals that suggest institutional investors may be gaining familiarity with blended finance as a structuring tool. including Teachers Insurance and Annuity Association's (TIAA) presence on the list of most active commercial investors, and Allianz' US$120 million commitment to the Emerging Africa Infrastructure Fund (EAIF). In the past year, the world's largest asset manager, BlackRock, announced its participation in the Climate Finance Partnership (CFP), alongside leading philanthropic organizations and governments. The Ocean Fund, launched by Circulate Capital in June 2019, has raised more than US$100 million from corporates such as

Unilever, P&G, and Danone, to invest in solutions to plastic pollution in South and Southeast Asia. Financial institutions such as Credit Suisse and Bank of America have also scaled up their blended finance activities. For example, Bank of America announced a 'Blended Finance Catalyst Pool', with an initial allotment of US$60 million to essentially encourage 'private on private' blending for developed and developing countries.

SECTION IV: OPPORTUNITIES AND CHALLENGES BY SEGMENT

KEY CONSIDERATIONS

Blended finance practitioners must create investable assets that fit within the mandates, constraints, and risk-adjusted return requirements of the specific private sector investor segment(s). Convergence identifies five key considerations that determine how much a private sector investor can participate in blended finance projects:

1. Mandate: Organizational-wide mandate from the top to support the SDGs through investment
2. Allocation and capacity: Allocation of capital to, and expertise to participate in, alternative asset classes in developing countries relevant to blended finance
3. Policy and regulation: Global and national constraints and disincentives for investing in certain asset classes or regions
4. Transactional factors: Investment attractiveness based on an opportunity's risk-adjusted return profile, structure, and co-investors
5. Ease and availability of procuring concessional capital aligned to private sector needs: Communicating investment opportunities using clear and familiar language and framing blended finance as a means to structuring opportunities

First and second, investment mandates and allocation should be used as key determinants of appetite for blended finance. An investment mandate to support the SDGs is generally driven by leadership and / or stakeholders at individual institutions as opposed to forces affecting broad segments. In most cases, this mandate has been directed by senior leadership (e.g., CEO) and / or other stakeholders (e.g., shareholders, client). Allocation to assets aligned to blended finance is an equally important consideration. There is significant variation between segments, and within segments regarding allocations to alternative asset classes in developing countries, as well as the expertise to analyze and manage alternative assets.
Third, the importance of regulatory constraints cannot be understated. A plethora of global and national policies and regulations affect private sector investors, several of which present constraints and disincentives limiting investor appetite for assets created by blended finance transactions. Key policy and regulatory considerations for each segment are outlined in Table 1.

Fourth, there are multiple transactional factors that impact attractiveness of blended finance opportunities for private sector investors. Commonly cited developing country risks (e.g., political / country, liquidity, and FX risks) are generally seen as the largest risks to blended finance transactions in developing countries. While risk-adjusted return expectations vary by asset class, private sector investors generally expect a premium for alternative asset classes in developing countries, typically 25-200 basis points above benchmarks in developed countries.. As expected, and well documented, private sector investors require large deal sizes. Tenor / investment horizon preferences depend on underlying asset class, with some trends across segments for debt-related investments. Many solutions - some of them within the definition of blended finance - to address these factors already exist and should be refined and / or scaled up.

Finally, investments should be communicated in a way that is consistent with asset classes that are familiar to and understood by private sector investors, to appropriately describe the investment opportunities available in developing countries that would also drive progress towards the SDGs. Nearly all private sector investors that have participated in a blended finance transaction comment on the need for improved coordination among co-investors, in particular with development finance institutions (DFIs). Blended finance structures are often complex, and the unique nature of each transaction is also a challenge for private sector investors. Private sector investors often prefer to partner with institutions to originate, arrange, and manage investments in developing countries. DFIs are well positioned to play this role but are not sufficiently incentivized to do so.

Ultimately, each consideration varies among and within each private sector investor segment. For example, policy and regulation is relatively more important for banks than private equity firms. Considerations are often interlinked or interdependent – the most effective communication approach will depend on the organizational mandate.

FINANCIAL INSTITUTIONS

Commercial banks, often business units within diversified financial institutions, provide financial services to a range of businesses, both small and large. The primary offering of commercial banks is loans and other credit products. Commercial banks are unlike other private sector segments since they do not invest, but provide financing to businesses. Investment banks, also often business units within diversified financial institutions, primarily provide services to large businesses and investors. Investment banks specialize in large and complex financial transactions, as underwriters, intermediaries between securities issuers and the investing public, facilitators of mergers and other corporate reorganizations, and brokers and / or financial advisers for institutional clients. Investment banks may also deploy capital into transactions as an investor, although on a more limited basis than traditional asset owners. Commercial and investment banking is highly regulated.

As highlighted above, to date, blended finance transactions financed have achieved the greatest traction with financial institutions. Commercial banks and investment banks often have the strongest capacity to participate in asset classes in developing countries relevant to blended finance. Banks typically do not have allocations but rather advise their clients on their allocations. Generally, banks have a strong capacity to participate in blended finance transactions as arrangers and distributors, with the ability to leverage expertise from various divisions (e.g., debt capital markets, asset management, research), as well as broader global networks and subsidiaries. That being said, the organizational structure of commercial banks can also present a challenge for engaging in blended finance, requiring siloed divisions to work closely together. In addition, financial institutions that have an established network in developing countries are more familiar with the processes for underwriting and sourcing opportunities in developing countries and therefore better positioned than their counterparts whose networks remain in developed markets.

Despite this capacity and appetite, financial institutions face significant regulatory constraints, including capital charges for risky assets and / or assets with longer tenors, requirements for investment grade risk ratings, and liquidity requirements. Under Basel III (a global regulatory framework on bank capital adequacy, stress testing, and market liquidity risk), commercial banks are required to allocate high levels of capital when lending to high risk borrowers, particularly in countries with non-investment grade sovereign risk ratings. In addition, International Financial Reporting Standard (IFRS) 9 (an international financial reporting standard accounting for financial instruments) requires the full expected loss of a loan to be recorded to profit and loss immediately, as opposed to over the life of the loan. These regulatory constraints present as disincentives and limit appetite for the types of assets created by blended finance transactions.

ASSET / WEALTH MANAGERS

Asset / wealth managers coordinate and oversee investment portfolios for their clients according to specified investment objectives and requirements. Asset / wealth managers are often hired by institutional investors like pension funds and insurance companies, as well as high net worth individuals. They also act on behalf of retail investors, typically through collective investment schemes, such as mutual funds and exchange traded funds. Asset / wealth managers invest in a range of assets, primarily public equities and bonds, but also increasingly in alternative asset classes. Their allocations are driven by the interests of their clients, and face increasing pressure to build out capacity to offer alternative product offerings, including products aligned to impact investing, responsible or sustainable investment, green finance, and the SDGs.

Although asset / wealth managers represent a relatively small segment within the private sector, there is strong alignment between this segment and blended finance. Asset / wealth managers often have a relatively good understanding of developing country investments given they have dedicated teams – a factor of their large size. Therefore, asset / wealth managers can be leveraged by asset owners to allocate resources to alternative investments where the asset owner does not have the capacity to execute themselves. Moreover, there is growth among asset / wealth managers that specialize in alternative assets, assets in emerging markets, and even

investments aligned to the SDGs (e.g., responsAbility, Blue Orchard). These asset managers have been most prominent in blended finance to date. However, there is a growing number of asset / wealth managers that are responding to clients' interests in the SDGs and blended finance as one pathway to impact. Examples include Allianz, BlackRock, and UBS. Notably, the Schroders Group acquired a majority stake of BlueOrchard to support the expansion of BlueOrchard's SDG activities.

By nature of their business model, asset / wealth managers are primarily restricted from a regulatory perspective by the regulations that are applied to their clients (e.g., pension funds and insurance companies). Asset / wealth managers are indirectly yet strongly impacted by policy and regulations, depending on the type and nature of their primary clientele. This complicates the ability of this private sector investor segment to champion investing in the SDGs through blended finance. For example, asset / wealth managers may struggle to find client demand for investments in non-investment grade countries given current regulatory conditions and fiduciary duties. Asset / wealth managers may also have more diversified skillsets and lack the expertise and resources to navigate blended finance transactions.

PRIVATE EQUITY FIRMS

Private equity firms invest directly in private companies or engage in buyouts of public companies, resulting in the de-listing of public equity. Institutional clients and accredited individual investors provide capital to private equity firms. Private equity firms typically invest their own capital alongside that of their clients. Private equity firms invest capital over long holding periods and exit investments through initial public offerings or sales to other companies or funds. Private equity provides better access to high-growth sectors (e.g., manufacturing, healthcare), relative to listed markets. The opportunities for private equity firms in emerging markets has developed significantly in the two last decades, in both scale and quality.

Private equity firms typically have well-aligned allocations and capacity for participating in blended finance, albeit many of these investors are already operating in certain markets (e.g., sectors, countries) on commercial terms. Beyond their role as commercial investors, private equity firms also play an important role in blended finance, as key structuring agents and intermediaries. As investors, these firms tend to focus on either on developed or developing markets; therefore, it is a question of how to harness the potential of private equity firms focused on developing countries. There is also potential to attract larger private equity firms, like KKR, that have traditionally focused on developed markets, but are increasingly investing in developing countries. For private equity firms, developing countries can offer an effective diversification tool.

Typically, private equity firms face the least amount of constraints and disincentives for participating in blended finance transactions relative to other private sector investor segments. While asset owners like pension funds and insurance companies are restricted in how much they can be allocate to private equity, once that allocation is determined, private equity firms have relative freedom in their investment activities. One of the key disincentives for private equity firms investing in developing countries is the lack of liquidity. Additional concerns may be the absence of a tried and tested regulatory regime, an efficient enabling legislation, political risk, weak corporate governance, and insufficient investor protections.

INSURANCE COMPANIES

Insurance companies collect premiums to protect policy holders from various types of risk. Premiums are invested to provide a source of future claims for policy holders, and a profit for the insurer. Insurance companies are typically classified into life insurers and property / casualty ("non-life") insurers. In most countries, life and non-life insurers are subject to different investment regulation: life insurance is long- term in nature, while non-life insurances usually cover a shorter period (e.g., one year). Insurance companies, along with pension funds, are key targets of public and philanthropic organizations seeking to mobilize additional sources of financing for the SDGs given their size and business model.

Insurance companies tend to allocate to asset classes in developing countries relevant to blended finance, and typically have stronger capacity to invest in these markets. By nature, the allocations of life insurers are well-aligned to blended finance given their desire to match long-term liabilities with long-term assets, and there are multiple examples of insurers participating in emerging market investments and investments aligned to the SDGs. It is

important to note that insurance companies typically allocate a significant portion of their balance sheets to fixed income. While insurance companies currently have a relatively small allocation to alternatives, trends indicate an uptick in allocation going forward.

At the same time, insurance companies face the most significant regulatory constraints, including capital charges for risky assets and / or assets with longer tenors, requirements for investment grade risk ratings, and liquidity requirements. Insurance regulation has evolved to risk-based requirements for capital. In contrast to strict quantitative limits, risk-based requirements do not impose hard restrictions on investment, but do impose a higher capital charge for investments with a greater level of risk. Equity and non-investment grade debt result in significant capital charges. Further, Solvency II creates constraints on insurance companies outsourcing investment decisions and portfolio management to entities that are not regulated, making it difficult for European insurance companies to participate in transactions that are managed by DFIs / MDBs, which are not regulated. In some situations, blended finance can help navigate certain regulatory requirements through strategic structuring.

PENSION FUNDS

Pension funds source capital from the pooled contributions of employers, unions, or other organizations. The pool of funds is invested on the contributors' behalf, and the earnings on the investments generate income for the contributor upon retirement. Pension funds often represent the largest institutional investors in many countries, and as a result, their investment activities often dominate the stock markets in which they are invested. Pension funds are often able to allocate a small portion of their portfolios to alternative asset classes, though face significant risk and liquidity constraints. In many cases, pension funds have direct relationships with government and may be incentivized to contribute to public objectives (e.g., climate finance).

Pension funds have the potential appetite to participate in asset classes in developing countries relevant to blended finance, but their capacity may be a barrier in the short-term. Pension funds have strong fiduciary duties to their policyholders, and can face significant levels of public scrutiny. While pension funds have the highest allocation among asset owners to alternatives, they often have few investment staff familiar with developing country investment environments. There are, however, several examples of pension funds that are increasingly investing in alternative assets - primarily infrastructure - in developing countries. For example, multiple Danish pension funds (e.g., PensionDanmark and PKA) have gained exposure to investing in developing countries through Danish-led blended finance vehicles (e.g., Danish Climate Investment Fund and Danish Agricultural Investment Fund).

Key constraints and disincentives for this segment to participate in blended finance transactions include the ability to sell illiquid assets, restrictions in some asset classes, and geographies. Pension funds have traditionally been subject to investment limits in certain asset classes and geographies, as a means to mitigate potential risks for shareholders. These limits have been further reduced in many jurisdictions in recent years. Moreover, pension funds must be able to show assets can be sold in the event of a market downturn. This is a key barrier for a majority of blended finance transactions, which typically do not provide sufficient liquidity to meet this requirement. However, blended finance as a tool can offer the solution. For example, there are potential learnings from developed markets approaches to creating liquidity through the establishment of secondary markets

SECTION V: PRIVATE INVESTOR OBSERVATIONS & RECOMMENDATIONS FOR A MORE EFFECTIVE BLENDED FINANCE MARKET

This Report identifies six private investor segments most relevant for blended finance to mobilize private investment at scale. In Q1 of 2020, Convergence engaged with 20 institutional investors (listed in Annex I) across these segments to hear their observations and recommendations to improve the blended finance market. Our engagement found there is broad consensus across private sector segments on the required next steps needed for scaling blended finance activity. In principle, there is a good appetite from investors if blended finance can create investible/bankable opportunities that meet their investment criteria – but the current blended finance market has many challenges that impede investment flows. In accordance with these observations, this section is set out as follows:

- Section V.1 highlights key takeaways from private investors to improve the blended finance market
- Section V.2 highlights secondary takeaways from private investors to improve the blended finance market
- Table 3 identifies the mandate and appetite for organizations to invest in assets produced by blended finance
- Table 4 identifies the Top 5 investment assets organizations in each segment are most likely to invest in

This Report will be followed by a related report. Convergence will produce a report providing insights and guidance to the blended finance market on the most optimal risk mitigation and risk-return enhancement approaches to mobilize private investment to developing countries. This report will build off an April 6, 2020 Research Report by Moody's Investors Service, *Sustainable finance innovations to boost private investment in emerging markets,* which highlights transactions across a range of financial structures and countries that have incorporated blended finance techniques to provide material credit risk reduction. The Reports will provide valuable insights and lessons to support the next generation of blended finance projects to achieve scale development impact and scale mobilization.

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V.1 PRIMARY TAKEAWAYS FOR SCALING INVESTMENT IN BLENDED FINANCE

1. Investing in developing countries is high risk, beyond the mandate of most investors. To mobilize at scale, risk mitigation and / or risk-return enhancement is needed

Observations: There are significant differences between *developing countries* and *emerging markets*. The development community allocates development funds to a sub-set of *emerging market countries*. These countries are among the 145 *developing countries* listed for ODA by the OECD and the Development Assistance Committee (DAC). Countries on this list are eligible for ODA (where Gross Domestic Product (GDP) per capita is less than US$12,235 per annum). Only 85 of the DAC List countries are rated by one of the Big 3 rating agencies (Standard & Poor's, Moody's, Fitch Group), with a median rating of "B." For example, less than half of DAC countries are listed on the JP Morgan Emerging Markets Bond Index, the leading debt index globally for emerging markets. Similarly, the MSCI Emerging Market Index, the leading equity index globally for emerging markets, includes publicly-listed equities from 26 countries, of which only 14 are on the DAC List.

Recommendation: The high credit risk in developing countries is beyond the mandate of most debt investors, precluding most from investing. The high country risk (and transaction risk) precludes most equity investors. Blended finance's top priority should be to allocate development funds to alter the risk-return of investments from unacceptable to acceptable to mobilize private investors towards developing countries. With this as a priority, blended finance makes developing countries investible for private investors.

2. Only a small proportion of development funds are deployed towards blended finance, therefore maximizing efficiency and effectiveness is critical

Observation: Despite the discussion on blended finance and mobilization, there remains only a limited amount of concessional funds committed to blended finance. Additionally, private sector investors identify a high degree of fragmentation and proliferation in blended finance, with only a limited supply of investments meeting their criteria.

Recommendation*:* Development funds should be allocated to a limited number of simplified and standardized blended finance solutions that meet the investment criteria of large pools of private capital**.** While innovation in blended finance is needed to build a track record for unexplored sectors and frontier markets, if development funds directed at blended finance remain at low levels, resources should then be focused on scaling proven solutions that can mobilize capital in the near term and maximize replicability.

3. Portfolio approaches are preferred to stand-alone projects to mobilize investors at scale

Observation: Portfolio approaches (*See Section 1*) are more effective for mobilizing investment at scale for three key reasons:

I. Only a small number of stand-alone projects are large enough. Private investors are looking for larger investment sizes (e.g., US$10-15 million), but few projects in developing countries will have sufficient scale on stand-alone basis to warrant a sizable investment. Aggregating multiple projects can achieve the required critical mass.
II. Diversification across projects reduces risk and risk-return variance for investors. Indicatively, the Big 3 rating agencies' methodology allows for a two-notch upgrade for diversification across multiple borrowers in Non-Investment Grade Countries – that is a portfolio of "B" projects can be enhanced to "BB-," simply though diversification. In countries with very high country risk (e.g. Low-Income Countries), diversification across multiple countries is highly beneficial.
III. Development organizations have a long project approval cycle regardless of project size. According to investors, it is only worth experiencing the long approval cycle for large amounts – and size can only be achieved on portfolio basis.

Recommendation: Investors state development organizations should prioritize a limited number of portfolio level solutions to mobilize debt and equity investors. Most important ingredients include:

- Aggregation of development funds and commercial funds through a pooled Blended Finance Vehicle (e.g., a tiered fund or facility)
- Asymmetrical risk-return profile for development funds and commercial funds – designed to create acceptable risk-return profile for private investors
- Diversified of underlying assets, meeting Category I in Table I

Box I: Bayfront Infrastructure Capital

Securitization structures have served as one blended tool for achieving scale while diversifying assets for private investors. For example, Bayfront Infrastructure Capital Pte. Ltd issued the first Asia-Pacific collateralized loan obligation (CLO), backed by a portfolio of 37 infrastructure loans. Around 30% of the portfolio benefits from external credit support by cover providers including the Ministry of Finance of Singapore. The capital structure is comprised of four tranches of notes, including three that are rated and listed on the Singapore Exchange; Class A Notes (Aaa), Class B Notes (Aa3), and Class C Notes (Baa3). In addition, Clifford Capital, the project sponsor, has subscribed to the first-loss equity tranche (unrated).

4. Risk mitigation to mobilize debt investors is superior to return enhancement

Observation: Debt investors can invest in blended finance at the project level and the portfolio level. At the portfolio level, debt investors can invest in blended finance vehicles that extend debt, equity or guarantees to individual projects. Most vehicles providing debt to SDG projects are mostly capitalized by debt. Private debt investors consider two core risk factors when committing capital: i) probability of default, and ii) loss given default. Generally, the credit risk in developing countries is considered too high for debt investors (e.g., probability of default and expected loss beyond acceptable thresholds). This high risk (i) precludes debt investors from investing at all, or (ii) limits their investment to a small portion of their investment portfolio (e.g., alternative assets).

Recommendation: Blended finance solutions seeking to mobilize debt investors should use development funds to mitigate risk to acceptable levels of expected probability of default and loss. This could include a blended fund with multiple tiers of capital, whereby the junior capital reduces probability of default for the senior tier of capital while boosting the credit rating of the vehicle.

Box 2: Example Blended Solution for Debt Investors

Although there are many approaches, private investors' majority view is that the following approach is most efficient to standardize to mobilize debt investors at scale:

- Establish a Blended Finance Vehicle (such as a fund) capitalized by two or three tiers of capital: the junior tier subscribed by development organizations
- The Vehicle invests in a portfolio of debt investments (e.g., loans or bonds issued by projects, companies and financial institutions in developing countries)
- The diversification and subordination substantially reduces the probability of default and expected losses for the senior tier investors. For example, a portfolio of debt investments rated "B" could allow the most senior tier capital to gain an implied credit rating of investment grade (e.g., A or BBB) or strong non-investment grade (e.g., BB)
- By creating a three tier capital structure, the senior tier can achieve implied investment grade rating (e.g., A or BBB) and the mezzanine tier medium non-investment grade rating (e.g., BB) – allowing the vehicle to raise debt from different investors

- Investment grade ratings opens up blended finance to a large universe of investors restricted by an investment grade mandate
- The size of the junior tier of capital depends on the riskiness of the debt portfolio. For example, a portfolio of loans rated "B" would require a higher amount of junior capital than a portfolio of loans rated "BB"

The junior capital reduces probability of default and loss given default, substantially reducing expected loss.

5. Return enhancement to mobilize equity investors is superior to risk mitigation

Observation: Blended finance vehicles mobilizing equity investors too often inappropriately import "risk mitigation" solutions from vehicles mobilizing debt investors, such as first-loss protection. Equity investors have different financial considerations than debt investors. Since return for debt investors is capped at principal plus interest, debt investors are highly motivated to reduce downside risk. Equity investors seek expected returns (e.g., a median of distributions) at a premium to benchmarks, while limiting downside. (Note: Equity investors can invest in blended finance at the project level and the portfolio level. At the portfolio level, equity investors can invest in blended finance vehicles that extend debt, equity or guarantees to individual projects. Most vehicles providing equity to SDG projects are mostly capitalized by equity).

Recommendation: Blended finance solutions seeking to mobilize equity investors should use development funds to create an expected return that is a premium to benchmarks, and reduces likelihood of earning a loss (i.e., "preferred return structure).

Box 3: Example Blended Solution For Equity Investors

Although there are many approaches, private investors' majority view is that the following approach is most efficient to standardize to mobilize equity investors at scale:

- Establish a Blended Finance Vehicle (such as a fund) capitalised by two tiers of capital: the senior tier subscriber by private investors and the junior tier subscribed by development organizations
- The Vehicle invests in a portfolio of equity investments (e.g., shares in projects, companies and financial institutions in developing countries)
- As the Vehicle earns dividends and divests from its investments, cash is generated at the Vehicle level
- The Vehicle distributes cash to the two tiers of capital asymmetrically to enhance the return of senior, commercial investors. A typical example would be (i) first distributions to senior investors until zero IRR, then (ii) second distributions to development organizations to zero IRR, then (iii) third distributions to commercial investors until a pre-agreed IRR is achieved, and then (iv) fourth distribution proportionately to all investors

6. Blended finance should align with investment strategies pursued by institutional investors

Observation: All investors allocate capital subject to investment opportunities meeting their risk-return criteria. But, investors are increasingly allocating capital to investment strategies with non-financial "returns" such as Responsible Investing, Sustainable Finance, ESG Investing, Impact Investing, SDG Investing, and Green Finance. All investment assets derived by blended finance include funding from development organizations that only commit if good development objectives are targeted. As a result, all investment assets produced by blended finance meet the criteria of one, some, or all of these investment strategies.

Recommendation: Blended finance projects should clearly demonstrate alignment to the investment strategies pursued by investors. Practically, all blended finance solutions should identify whether the investment meets the criteria of one or more

of the investment strategies identified above, and clearly articulate that alignment when approaching the private sector. This may require better understanding the unique investment strategy subscribed to by that individual organization, or intermediaries who can facilitate this match-making.

7. Standardized investment assets should be pursued aggressively

Observation: Private sector debt investors repeatedly state there is too much fragmentation and confusion in blended finance. Project sponsor and private investors identify a disconnect between the donor community, who are increasingly looking for innovative vehicles which showcase complex and additional forms of concessional capital, and institutional investors who seek standardized products that are familiar and accessible. Investors recommend simplification around a limited number of blended finance approaches, and standardization of the investment assets available for investment.

Recommendation: Investors recommend development organizations interested in scale should shift away from creating new solutions, and towards scaling up or refining existing solutions. Blended finance structures should aim to reduce complexity by designing standardized structures to attract private investors at scale. For example, Convergence's database has more than 500 blended finance transactions. Investors hold the view that scale is better achieved by development organizations supporting established blended finance structures that can achieve scale. The scope of this report does not include in-depth research on standardization.

8. The gap between development organizations and private investors needs to be narrowed

Observation: Investors state the landscape of development organizations allocating concessional capital to blended finance is fragmented and opaque. The result is extreme inefficiencies turning project sponsors and investors away from investing in blended finance projects in developing countries. Specifically:

- There is uncertainty on which SDG, sector, region and country, donor institutions prioritize
- It is difficult to identify what types of concessional capital are available from each organization, including what instruments each organization can deploy (e.g., grants, risk capital such as debt and equity, and guarantees)
- Within individual development organizations, it is difficult to identify which person / team is best to contact
- The decision-making process of development organizations is too long and uncertain
- It may be complicated to have several development organizations allocating funds in the same vehicle given different priorities

Recommendation: Concessional capital providers should clearly communicate the terms, availability, and criteria for providing concessional capital to blended finance transactions. Streamlined processes will reduce the burden on private sector investors associated with identifying relevant sources of concessional capital. This will also allow private investors to structure projects that align with the types of concessional capital available (and vice versa). Moreover, concessional capital providers should provide capital based on market need, including moving beyond grant funding to more sophisticated market instruments such as loans and equity.

9. Investors seek easier access to investments

Observation: Investors identify they have limited access to investment assets produced by blended finance.

Recommendation: Investors seek a central source to gain access to investment opportunities produced by blended finance. Investors recommend all investible assets be profiled at 1-2 sources, and the platform readily identify the assets by specific investment criteria required by investors. The Convergence Match-Making Platform currently has 72 blended finance transactions seeking around US$8 billion of finance. Of the US$8 billion, around, (i) US$2.5 billion has already been committed with the incremental US$5.5 billion sought, and (ii) US$2 billion sought from development organizations, and US$6 billion for private / commercial investors.

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10. Currency risk mitigation is critical to mobilize sustainable debt and equity investment at scale, and is best addressed at the portfolio level

Observation: Currency risks (foreign exchange risks) associated with cross-border investments are a pervasive challenge for private debt and equity investors in emerging and frontier markets. Blended finance solutions can mitigate local currency risks for investors, and be delivered at project level or portfolio level.

Recommendation: To attract private investors, currency risk should be best managed so that the project bears no / limited FX risk. FX risk mitigation is most efficient when undertaken at a portfolio level vs, project level. Project-specific FX risk mitigation solutions are inefficient and higher-risk; portfolio solutions reduce risk through diversification and increase efficiency by supporting many projects.

Box 4: The Currency Exchange Fund (TCX)

TCX

The Currency Exchange Fund (TCX) is a good example of a blended finance solution implemented at a portfolio level. TCX offers hedges for currencies and tenors not served by commercial banks because of innovative macro-risk pricing tools and blended capital. TCX has two tiers of capital: common equity contributed development agencies (first-loss capital) and subordinated convertible debt contributed primarily by DFIs. First loss capital contributes to capital stability and increases risk bearing capacity by guaranteeing a minimum return of USD Libor to equity holders over lifetime of TCX. TCX uses market / risk-reflective pricing to minimize distortions and to improve risk allocation, and shares "easier" parts of its risk portfolio with the private sector. TCX is rated A- by S&P. TCX is able to leverage ~US$700 million in capital to support US$2 billion of currency exposure.

11. Limited guarantee capacity is needed more at the project level to move near-bankable projects to bankable

Observation: The development community is increasingly deploying guarantees within blended finance. Guarantees are most often used to ensure borrowers receive loans to projects, companies and financial institutions. Private sector investors welcome the prospective increased deployment of guarantees. However, since guarantees do not count towards development agencies' Official Development Assistance (e.g., aid), private sector investors expect guarantees from development agencies will remain in scarce supply. The group of local financial institutions, investors, and project sponsors state guarantees are better deployed to improve near-bankable projects to become bankable - creating a larger universe of bankable SDG projects to achieve the SDGs. Benefits of guarantees include (i) issuance on a temporary basis; to bridge the gap between the time a project is near-bankable to when it is bankable (e.g., project physical completion for infrastructure projects), and (ii) ability to cover one or some specific risks impeding private investment (e.g., political risk or offtake risk).

Recommendation: Development organizations should focus their limited guarantee capacity to risk mitigation at the project level to increase the number of bankable SDG projects receiving finance. Using guarantees to mitigate risk for investors into Blended Finance Vehicles at the portfolio level should be a secondary, lower priority use, since (i) the guarantee at portfolio level does not have any effect on improving an individual project from near-bankable to bankable, and (ii) the risk mitigation approaches and risk-return enhancement approach described above, are more efficient for mobilizing investors at portfolio level.

12. Investors do not require "AAA" and "AA" guarantors; "A" and "BBB" rated guarantors are a more efficient use of risk capital from development agencies (and MDBs and DFIs)

Observation: Guarantees are only useful if the guarantor has a better credit risk than the guaranteed party. In developing countries, the implied credit risk of many companies would be "B" – well below acceptable threshold for most investors. Guarantees to mitigate risk at the project level can be issued by three types of organizations:

1. Development agencies (e.g., Australian Department of Foreign Affairs and Trade (DFAT)) – usually rated AAA and AA

2. MDBs (e.g., AfDB) and DFIs (e.g., CDC) – usually rated AAA and AA
3. Organizations established to issues guarantees (e.g., African Guarantee Fund) – usually rated A

Recommendations: Beneficiaries of guarantees, including investors at the project level (e.g., a financial institution) and investors at the portfolio level, do not require the highest possible credit rating in order to invest. Most financial institutions providing financing at the project level seek enhancement to strong non-investment grade (e.g., BB) or exceptionally to low investment grade (e.g., BBB). Similarly, most investors considering investing in blended finance vehicles prefer guarantors that can enhance their risk to investment grade level, but do not require credit enhanced to AAA and AA levels. Development organizations (e.g., MDBs and DFIs) should establish and capitalize intermediaries that can issue guarantees at the rating sought by investors – around "A" – as opposed to issuing guarantees directly. For example, GuarantCo (A1 rated) is funded by a group of development agencies, including DFID, DFAT, Swiss State for Secretariat for Economic Affairs (SECO), and Swedish International Development Coordination Agency (Sida) to provide guarantees (mostly) for specific projects. These organizations are also capital-efficient; they can lever their capital 3-4 times, while maintaining an "A" rating e.g., GuarantCo is able to leverage 3x for each $1 of donor capital in the form of guarantees.

V.2 SECONDARY TAKEAWAYS FOR SCALING INVESTMENT IN BLENDED FINANCE

1. Blended finance should create debt investments that meet investor Investment Grade (IG) mandates in addition to current Non-Investment Grade mandates

Observation: To date, most debt investments in blended finance have not been rated, and have not been investment grade (rated or implied). This loses a large portion of assets owners and asset managers that have IG mandates.

Recommendation: When possible, blended finance should strive to create some debt investment assets with investment grade attributes (rated or implied). This is best achieved by (i) creating entities that can issue investment grade guarantees (e.g., GuarantCo), and / or (ii) creating layered investment vehicles with sufficient subordination of funds to credit-enhance most senior tranche to investment grade. In addition, many investors have some tolerance for high-yield investments, but require high return expectation (high single digits to mid-teens). In such cases, practitioners must be realistic about the potential of these structures to mobilize institutional investors, and assess whether the concessionality required by donors to provide the desired risk-return profile for these investors is the most efficient use of capital.

2. Concessional capital providers should prioritize blended solutions that align with SDGs conducive to private sector investment

Observation: Private sector investors will only invest in assets with high expectation of earning the targeted returns, so blended finance vehicles must fund projects, companies, financial institutions with revenues that can be directed to remunerate private sector investors.

Recommendation: Blended finance can only address a subset of SDG targets – those which align with activities that generate revenues to repay investors an acceptable market-based return on capital. Convergence has identified the SDGs for which blended finance solutions can be deployed in the short-term to mobilize additional investment at scale, including: Goals 1 (No Poverty), 3 (Good Health & Well-Being), 5 (Gender Equality), 11 (Sustainable Cities), Goals 7 (Affordable & Clean Energy), 8 (Decent Work & Economic Growth), 9 (Industry, Innovation & Infrastructure), and 13 (Climate Action). Concessional capital providers interested in scale should prioritize solutions aligning with these SDGs. In turn, concessional capital providers should focus on bespoke blended finance vehicles (e.g., non-standardized) on SDGs where scale is likely not possible / very difficult.

3. Different approaches are needed for high-risk countries, such as LDCs and fragile and conflict–affected countries vis-à-vis middle-income countries

Observation: Private sector investors are already constrained with the high risk of 145 developing countries (B median sovereign rating). Segmenting the countries into middle and low-risk arrives at median sovereign ratings of BB- for Middle Income Countries and B- for Low-Income Countries. LDCs and fragile countries are even lower. The high country risk of LDCs and fragile countries is very challenging to attract private investors, and difficult to mobilize out of developed country investment.

Recommendation: LDCs and fragile countries should either (i) create bespoke blended finance vehicles for these countries, and target impact investors focused on impact, or (ii) add those exposures to portfolios in Middle Income Countries capped at 5-10% of exposure, but then prove higher amounts of donor subordinated funding (e.g., first loss).

Box 5: Investisseurs & Partenaires (I&P) Blended Funds

I&P is an impact investing group providing small equity investments to SMEs in Sub Saharan Africa. Since 2002, I&P has raised €200 million of blended finance, supported close to 150 companies operating in Francophone Africa primarily, and grown a team of 70+ impact investment professionals located in 7 offices across the continent. Providing equity investments to African companies, at all sizes, requires a tailor made approach. This customized approach is a major challenge to scale-up the industry through standardized processes and represents important costs compared to the size of some small transactions. I&P aims to scale up its practices and contribute to the overall ecosystem through (i) the creation of multiple impact funds including an incubator / sponsor of African impact funds using I&P's tools and methodologies, and (ii) a deep and proactive advocacy policy based on concrete examples of successful case studies and rigorous impact measurement practices.

4. Blended finance should align with institutional investor asset allocations

Observation: To date, large majority of assets generated by blended finance do not meet mainstream criteria of institutional investors and fall within "alternative assets" allocation, including illiquid credit, private debt and equity, high-yield debt, and infrastructure. Given significantly reduced mandates for alternative assets, this has limited the (i) number of investors that can invest in assets produced by blended finance, and (ii) quantity of investment available.

Recommendation: Blended finance should clearly identify the two general investment mandates – mainstream assets and alternative assets – and create blended finance vehicles that produce assets catering to the investment demand in both classes. Feasible, efficient solutions that meet mainstream criteria are likely senior debt assets, including public, listed, and tradable debt and equity. For alternative asset allocations, develop simple, clear investment opportunities that compare well to existing alternative asset investments, such as Private Equity and Illiquid.

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Table 3: Mandate and Appetite for Investment Assets by Investor Segment

Segment	DEBT										EQUITY				
	Publicly Traded (Liquidity)	Private Debt (Illiquid Credit)	Project	Portfolio	Unrated	AAA and AA	A and BBB	BB	B and lower	Long Term (7+ years)	Publicly Listed (Liquidity)	Private Equity	Non-Investment Grade Country	Direct	Fund
Pension Funds	High	Medium	Medium	High	Medium	High	High	Medium	Low	High	High	Low	Low	Low	Med
Insurance Companies	High	Low	Low	Medium	Low	High	High	Low	No	High	Low	Low	Low	Low	Med
Sovereign Wealth Funds	High	Medium	Medium	High	Medium	Medium	High	Medium	Low	Medium	Medium	Medium	Medium	Medium	Med
Financial Institutions - Commercial Banks	Low	High	High	Low	High	Medium	High	High	Low	Low	Low	Low	Low	Low	Low
Financial Institutions – Investment Banks	High	Medium	Low	Low	Medium	High	High	Medium	Low	Low	High	Medium	Low	High	Low
Private Equity Firms	No	No	No	No	No	No	No	No	No	No	Medium	High	Medium	High	Med
Asset Managers - Debt	High	High	Medium	Medium	Medium	Medium	High	Medium	Low	Medium	No	No	No	No	No
Asset Managers - Equity	No	No	No	No	No	No	No	No	No	No	High	Medium	Medium	Medium	High

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Table 4: Top Five Investment Assets produced by Blended Finance for each Segment

Segment	DEBT								EQUITY			
	PROJECT SPECIFIC				PORTFOLIO				PROJECT SPECIFIC		PORTFOLIO	
	Publicly Traded – Investment Grade	Private Debt – Investment Grade	Publicly Traded – BB-rated	Private Debt – BB-rated	Publicly Traded – Investment Grade	Private Debt – Investment Grade	Publicly Traded – BB-rated	Private Debt – BB-rated	Publicly Listed (Liquidity)	Private Equity	Publicly Listed (Liquidity)	Private Equity
Pension Funds		✓			✓	✓		✓				✓
Insurance Companies	✓				✓	✓	✓	✓				
Sovereign Wealth Funds					✓	✓	✓	✓				✓
Financial Institutions – Commercial Banks		✓		✓	✓	✓		✓				
Financial Institutions – Investment Banks	✓	✓			✓	✓				✓		
Private Equity Firms									✓	✓	✓	✓
Asset / Wealth Managers - Debt		✓		✓		✓	✓	✓				
Asset / Wealth Managers - Equity									✓	✓	✓	✓

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Annex: I

Convergence engaged with the following private sector institutions to produce this report:

- AlphaMundi
- AP4 (The Fourth Swedish National Pension Fund)
- 17 Asset Management
- Bank of America
- BlueOrchard
- BNP Paribas
- Ceniarth, LLC
- Credit Suisse
- Development Bank of Southern Africa (DBSA)
- Finance in Motion
- Fondacion
- The GIIN (Global Impact Investing Forum)
- GroFin
- Investisseurs & Partneaires (I&P)
- Meridiam
- M&G Investments
- Old Mutual Limited
- Private Infrastructure Development Group (PIDG)
- responsAbility Investments AG
- Standard Chartered

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METHODOLOGY AND NOTES

1. Convergence's database: Convergence maintains the largest and most detailed database of historical blended finance solutions in the market. Given the current state of information sharing, it is not possible for this database to be fully comprehensive, but it is the best depository there is to understand blended finance scale and trends. This Summary Note includes analysis completed for the State of Blended Finance 2019, which analyzes approximately 500 historical blended finance transactions.
2. Private Sector Investment Trends: This section is based on research and calculations published in a January 2018 report called *Who is the Private Sector? Key Considerations for Mobilizing Institutional Capital Through Blended Finance*. For additional information on key assumptions and methodology, please refer to the full report.
3. Leverage calculation: The data and methodology for Convergence's leverage calculations and analysis is outlined in our first data brief here. These calculations are based on multiple estimates and should be taken as indicative trends only. Commercial investment includes both private investment and commercial DFI investment; private and commercial DFI investment is not disaggregated because of a lack of data.

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ABOUT CONVERGENCE

CONVERGENCE is the global network for blended finance. We generate blended finance data, intelligence, and deal flow to increase private sector investment in developing countries.

BLENDED FINANCE uses catalytic capital from public or philanthropic sources to scale up private sector investment in emerging markets to realize the SDGs.

Our GLOBAL MEMBERSHIP includes public, private, and philanthropic investors as well as sponsors of transactions and funds. We offer this community a curated, online platform to connect with each other on blended finance transactions in progress, as well as exclusive access to original market intelligence and knowledge products such as case studies, reports, trainings, and webinars. To accelerate advances in the field, Convergence also provides grants for the design of vehicles that could attract private capital to global development at scale.

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