CASE STUDY

DANISH CLIMATE INVESTMENT FUND

SEPTEMBER 2017

EXECUTIVE SUMMARY

The Danish state and IFU (The Danish Investment Fund for Developing Countries) established the Danish Climate Investment Fund (KIF) in 2012 to attract institutional capital to investments in low-carbon and climate-resilient projects in developing countries. KIF aims to support the achievement of the goals of the Copenhagen Accord.

KIF represents a best-practice example of utilizing blended finance—specifically a preferred return structure—to attract institutional investors to sustainable development investments. Under KIF's unique preferred return structure, institutional investors receive preferential upside of up to 6% per annum, without exposing public money to disproportionate downside losses.

KIF presents several insights useful for others looking to create or invest in similar structures:

- Open and regular communication between government and public pension funds builds trust and common language;
- A collaborative design process is critical to understanding investors' requirements and ensuring the capital structure is catalytic;
- In blended finance, public investors often deploy instruments to reduce private investor risk; however, leveraging public money to alter the return profile is also a smart approach to attracting private capital; and
- A deeply networked and experienced general partner–such as a development finance institution–is critical to attracting institutional capital to invest in markets where they do not have experience.

SYNOPSIS

Fund manager	IFU (The Danish Investment Fund for Developing Countries)
Fund vintage	2012
Mandate	Invest in projects that contribute to reducing greenhouse gases and/or adapting to climate change in developing countries.
Size	DKK 1.4B (~USD 220M)
Capital structure	• General Partners: IFU (DKK 250M), Danish state (DKK 225M) • Private Limited Partners (PLPs): PensionDanmark (DKK 200M), PKA (DKK 200M), PBU (DKK 175M), Dansk Vækstkapital (DKK 150M), Aage V. Jensen Charity Foundation (DKK 50M)
Preferred return structure (blending approach)	Overall IRR target of 12% per annum (p.a.), with preferred return schedule: • All parties receive distributions until invested amounts are returned • PLPs receive returns up to 6% p.a. • Danish state benefits from a catch-up period after PLPs receive 6% p.a., until all parties have received 12% p.a. • Returns above 12% p.a. distributed pro rata, with premium to Danish state
Fees	Market-based management fee
Fund term	10 years (+2 year potential extension)
Instruments	Equity and mezzanine debt
Investment size	DKK 35-50M average, DKK 10M minimum
Fundraising status	Closed
Example impact metrics	Emissions avoided, climate-related costs, jobs created

INTRODUCTION

The Copenhagen Accord is a political agreement struck by world leaders at the 2009 United Nations Climate Change Conference in Copenhagen. This represented the first time that all the world's major economies offered explicit international climate pledges. Key elements of the Copenhagen Accord included: i) an aspirational goal of limiting global temperature increase to 2 degrees Celsius; ii) a collective commitment by developed countries for USD 30B in "new and additional" resources in 2010-2012 to help developing countries reduce emissions, preserve forests, and adapt to climate change; and iii) a goal of mobilizing USD 100B a year in public and private finance by 2020 to address developing country needs.

Following the Copenhagen Accord, the Danish state established the Danish Climate Investment Fund (KIF) to catalyze public and private capital flows to encourage low-carbon and climate-resilient development. Launched in 2012, KIF offers risk capital and advice for climate investments designed to reduce greenhouse gas (GHG) emissions in official development assistance (ODA)-eligible countries. KIF provides equity and mezzanine financing to projects that are then co-financed by additional international and local investors. In addition, there is a requirement for Danish investors or expertise, services or technology to be included in each project.

KIF represents a best-practice example of utilizing blended finance—specifically a preferred return structure—to attract institutional investors to sustainable development investments in developing countries.

DESIGN AND FUNDRAISING

KIF was designed and is managed by IFU (The Investment Fund for Developing Countries, or Investeringsfonden for Udviklingslande), a self-governing investment fund for developing countries established by the Danish state. As the most experienced emerging market investor in Denmark, IFU has invested more than DKK 10B (~USD 1.8B) in 787 projects in 85 countries since 1967.

The political salience of climate change among the Danish public—including the membership of the Danish pension funds—played an important role in the establishment of KIF. There were two main motivations underlying the establishment of KIF by IFU and the Danish state: i) to contribute to the Copenhagen Accord commitment to mobilize additional resources for climate and ii) to formally crowd-in Danish institutional capital into developing countries.

In addition to the timely focus on climate change, KIF capitalized on the already growing appetite for emerging market investment opportunities among private investors. Institutional investors had participated informally in previous IFU funds, most notably through the IFU Investment Partner (IIP) fund, established by two Danish pension funds—PBU and PKA. Through the IIP, the Danish pension funds had the option—but not the obligation—to provide additional capital for large investments undertaken by IFU. KIF represents the first time institutional investors invested capital in an-IFU managed fund.

The design process for KIF was iterative and collaborative, benefitting from an open relationship between the Danish state—including the Ministry of Foreign Affairs—and the Danish pension funds. The resulting fund was a true public-private partnership that balanced the motivations and obligations of all investors—public and private. The fund began as a standard private equity (PE) fund, with minor modifications agreed upon through a series of IFU-led discussions with the Danish state and institutional investors. Key features of the resulting fund structure include a management fee and carried interest on market terms, an external Investment Committee (IC) with veto-powers, and a preferential return schedule.

The preferential return schedule sets KIF apart from other emerging market-focused funds and was critical for catalyzing investment from institutional investors. This unique structure provides a boost of confidence to the institutional investors, given the novelty of commercial investment in a development finance institution (DFI) and the need to justify the investment to their membership. KIF leveraged a preferential return schedule, instead of a more traditional mechanism like first-loss capital, because the Danish state wanted to crowd-in additional capital for emerging markets without providing undue subsidy to the private sector. In addition, first-loss capital may give the appearance that the investment is not commercial.

IFU successfully mobilized investment from four of Denmark's major pension funds, committing DKK 775M (~USD 133M) collectively, or 60% of the total fund. To ensure additionality—or to test for additionality—IFU offered a second closing to all pension funds in Denmark on the same terms as the initial group of investors. One additional institutional investor came on board through this process, resulting in a total capitalization of DKK 1.4B (~USD 274M). The fact that only one additional institutional investor, not all institutional investors in Denmark, participated in the second offering indicated that KIFs terms and pricing were fair and not excessively profitable.

STRUCTURE AND GOVERNANCE

CAPITAL STRUCTURE

The Danish state and IFU established KIF, contributing DKK 225M (~USD 40M) and DKK 250M (~USD 44M) respectively. The Danish state contributed capital through a managed account, in order to allow these public funds to be invested in a commercial fund structure. As fund manager and general partner (GP), IFU earns a management fee as well as carried interest. PensionDanmark, PKA, Pædagogernes Pensionskasse (PBU), Dansk Vækstkapital, and Aage V. Jensen Charity Foundation are invested as private limited partners (PLPs), contributing DKK 200M (~USD 35M), DKK 200M (~USD 35M), DKK 175M (~USD 31M), DKK 150M (~USD 27M), and DKK 50M (~USD 9M), respectively, to total DKK 775M (~USD 137M).

As detailed above, the KIF structure allows the Danish state and the five PLPs to meet individual objectives and requirements. Most notably, this resulted in a unique, preferred return model that ensures an acceptable risk-adjusted return for institutional investors. Specifically, the return schedule is as follows:

- Principal: All investors are repaid their investment capital pari passu; losses are shared equally.
- Returns: Overall internal rate of return (IRR) target of 12% per annum (based on IFU historical performance), with a preferred return schedule.
    - PLPs receive all initial returns up to 6% per annum.
    - After PLPs receive initial preferred returns, the Danish state benefits from catch-up period until all parties have received a 12% return per annum (during this period the Danish state receives disproportionately higher return).
    - After the Danish state, IFU, and PLPs have received equivalent return of 12% per annum, all additional returns are distributed pari passu, but with a 10% premium paid to the Danish state.

KIF does not have an associated technical assistance facility. However, the Danish state established the Project Development Programme in 2016. This DKK 50M (~USD 8.8M) fund can provide soft capital to early-stage, high potential projects, thereby reducing the financial risk for Danish partners and developers who want to launch commercial projects in developing countries.

LEGAL STRUCTURE AND GOVERNANCE

KIF is incorporated as a Danish limited partnership, with one GP and multiple PLPs. The GP is also incorporated and 100% owned by IFU. The GP and fund manager, IFU, has full authority to direct the activities of the Fund, in addition to being responsible for all administration and investment management services. All other investors are PLPs. A general meeting is held once a year to approve the annual audited accounts, elect the advisory board, and elect the auditor.

A strong governance model was important to the institutional investors. The PLPs elect an advisory board consisting of up to seven members. The advisory board monitors the governance and activities of KIF, including questions of conflict of interest. Investments are approved by an external Investment Committee (IC) consisting of three investment professionals appointed by, but independent from, the fund manager and of two representatives of the institutional investors.

The two representatives of the institutional investors on the IC are the CEOs of PensionDanmark and PKA. Beyond the benefits of their extensive financial expertise, the involvement at the executive level in KIF has helped IFU build stronger relationships with these institutions as well as adjust the perception of risk associated with investing in emerging markets and impact-focused sectors. The open relationship between the Danish state and Danish pension funds is unique among its peers.

OPERATIONS

INVESTMENT CRITERIA

KIF aims to be an active minority shareholder (between 5-49%) in private sector companies addressing climate mitigation or adaptation. Investee companies are predominantly private sector companies producing energy or manufacturing components or systems where the use of the product has a positive impact on GHGs. Based on the initial recommended pipeline, 60% of the investments will focus on energy production and 40% on manufacturing. Eligible types of investee companies include:

- Renewable energy projects,
- Suppliers to renewable energy projects,
- Energy efficiency projects,
- Alternative energy projects,
- Transport projects,
- Material and equipment providers, and
- Other projects that contribute to reduction in GHG emissions.

Where possible, KIF enters at par value in greenfield operations and holds ownership for five to seven years. Quasi-equity investments such as convertible or subordinated loans may also be used and debt will be considered if the project offers a reasonable return and risk relation, and if debt is required to achieve the desired equity participation. KIF cannot invest more than 20% of its capital in a single project and 30% in a single country. The minimum commitment is DKK 10M (~USD 1.8M), averaging between DKK 35-50M (~USD 6-8.8M).

KIF requires each investment to contain some Danish economic interest. Projects must have either a Danish company acting as co-investor or a Danish company being involved as supplier of technology or services. Further, Danish technology components and involvement must be substantial and key to the success of the project. This requirement is beneficial to both parties—Danish companies and project implementers. Danish companies export DKK 63B (~USD 11B) worth of energy technology annually, which is 10.5% of total exports and well above the average (6.3%) for European countries. It is IFU's experience that active involvement from the Danish partner markedly increases the project's performance and reduces overall project risk.

Beyond the institutional capital mobilized through the preferred return model, KIF catalyzes additional private sector co-financing. Each project is established in collaboration with strong local or international sponsors, such as Danish partners or local banks. The leverage—or amount of additional private sector investment mobilized by KIF's investment—varies according to the project type and geography, but on average KIF achieves a 5x leverage rate.

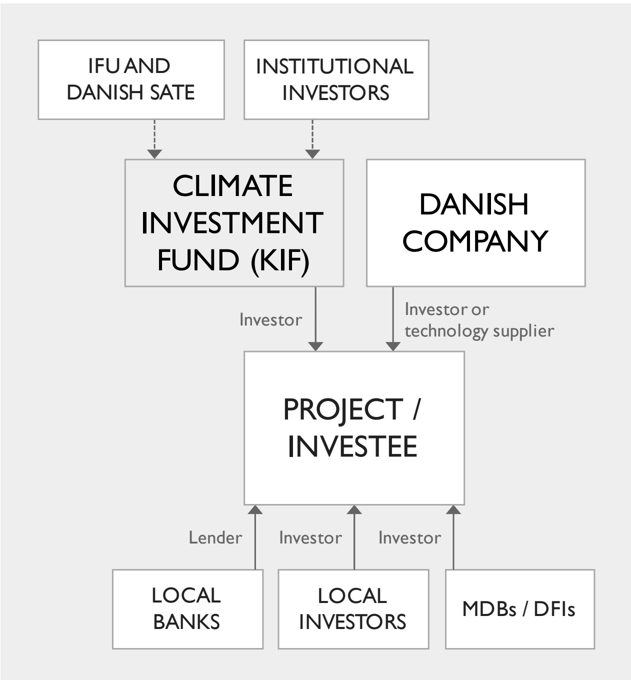

Figure 1: Key stakeholders in KIF-supported projects/investments

INVESTMENT PROCESS

KIF benefits from IFU's deal sourcing and standard two-step appraisal process. Deal sourcing is based on IFU's local presence in Africa, Asia, and Latin America, as well as strategic cooperation with government (e.g., Danida Business, Denmark's Export Credit Agency), international finance institutions, and project developers (e.g., Nordic Power Partners).

IFU's two-step appraisal process looks at the commercial viability of the project as well as the legal and financial structure, market, technology, and CSR. In the first phase, IFU evaluates the background and financial accounts of all partners, business idea and rationale, project country analysis, indicative financing structure, ownership structure, and CSR policies. High potential projects are then reviewed by the IC and successful projects receive a clearance in principle.

Projects that receive clearance in principle enter the second phase. The second phase analysis is done together with the sponsor and Danish partners. The objective is to develop a full business plan, a 10-year financial model, financial statements, and term sheets. During this phase, IFU also completes a sensitivity analysis, CSR review, and assesses the project's climate impact and employment effects. The outcome of the appraisal is then presented to the IC once more for a binding commitment.

Depending on the nature of the project and the country in question, time from positive appraisal to investment can be 12 to 36 months.

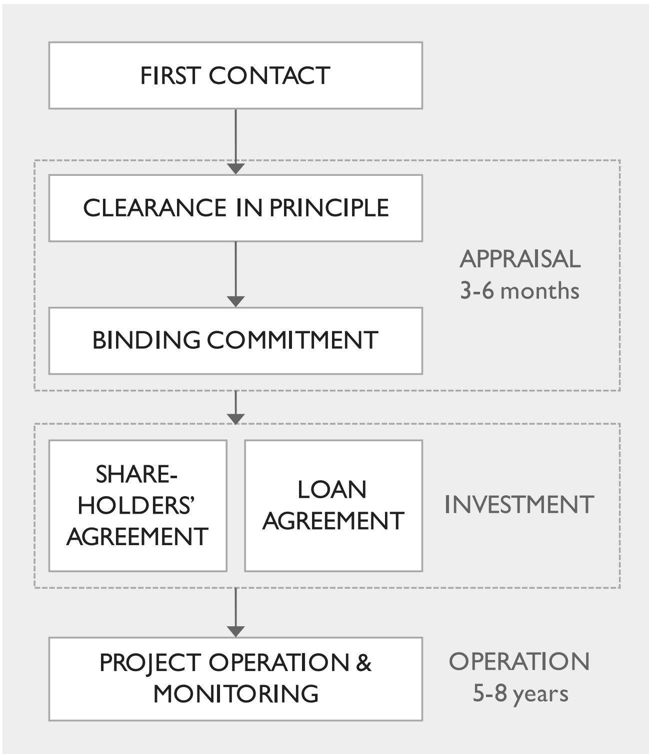

Figure 2: Key steps in investment process

A pre-determined exit strategy for each investment is key to the success of KIF. The exit strategy varies depending on project ownership and project development. KIF can enter into agreements with either i) a Danish company, ii) a majority investor, or iii) a third party, to sell their stake if certain pre-conditions are met. These agreements are executed prior to project completion. KIF can also sell its shareholding to a third party post project completion.

INVESTMENT ACTIVITY TO-DATE

As of June 2017, KIF has committed and invested DKK 947M (~USD 167M) in 18 projects and expects to be completely invested in 2017. In 2016, KIF made three new investments totaling DKK 161M (~USD 28M) and provided DKK 26M (~USD 5M) in additional financing for two ongoing projects. KIF has invested in multiple countries, including Brazil, India, Kenya, Mali, Mongolia, and Ukraine.

LAKE TURKANA KENYA

Project type: Wind farm

Country: Kenya

Fund participation: DKK 107M (~USD 19M)

Expected total project size: DKK 4.8B (~USD 484M)

Exit strategy: Trade sale or issue fund investors redeemable shares

Additional information:

- The Lake Turkana Wind Power project is the largest wind park in sub-Saharan Africa. The 300MW wind farm will produce around 20% of Kenya's current installed electricity generating capacity at reduced prices and will replace significant fuel imports annually.
- The Lake Turkana site was selected because of the remoteness of the area and the strong predictable wind streams between Lake Turkana and the desert hinterland.
- The Danish company Vestas has supplied the 365 wind turbines. In addition to the wind farm, the project includes a 428km double circuit 400kW transmission line to deliver the electricity to the national grid and 200km of upgraded access roads.
- The wind farm is now constructed and will provide power to the grid when the transmission line is functional.

Figure 3: KIF Investment in Lake Turkana

IMPACT METRICS

KIF reports metrics across three dimensions: project-specific metrics (either mitigation or adaptation), CSR performance, and development impact. The first set of metrics—the project-specific metrics—differ according to whether the project is related to mitigation or adaptation.

1a: Climate-related impact of mitigation projects

The aggregated volume of GHG emissions avoided during the lifetime of new projects contracted for a given financial year is reported where relevant and possible. GHG emissions avoided by a project is calculated as the difference between baseline emissions and project emissions, where the baseline emissions refer to the emissions that would probably occur in a reference scenario if the project was not implemented.

1b: Climate-related impact of adaptation projects

The climate-related impact of adaptation projects requires a thorough understanding of how climate change affects project design, including quantification of the incremental investment and operating costs due to climate change, and disentangling such costs from those that are not climate-related. The aggregated estimate of the climate-related costs as compared to the total project costs of projects contracted in each year is reported.

2: CSR performance

CSR performance is assessed on an annual basis throughout the duration of the investment and again when the project is exited. The internal assessment of each project's compliance with IFU's CSR policy is made across four issue areas: i) environment, ii) occupational health and safety, iii) human rights and labour practices, and iv) anti-corruption. Aggregated results of CSR performance are reported for active projects.

3: Development impact

The development impact of a project is assessed during project appraisal and when the project is exited in accordance with IFU procedures. Indicators have been developed for this purpose and include:

- Direct employment created,
- Workers trained in environmental matter,
- Partner mobilisation, and
- Project sustainability and profitability.

Aggregated results of development impacts are reported for new projects. Exited projects are subject to a final evaluation report.

FOLLOW-ON STRUCTURE

IFU and the Danish state are currently structuring and fundraising for a Sustainable Development Goals (SDG) Investment Fund. The SDG Fund will be approximately DKK 2.5-3B (~USD 442-530M), which will be matched by IFU to create DKK 5-6B in total investment capacity over a three-year period. The purpose of the SDG Fund is to mobilize additional capital by a targeted factor of seven, meaning that the Fund and IFU in total will promote investments of an estimated DKK 30B.

The key outcome of the SDG Fund will be the financing, implementation, and management of 50 SDG-relevant projects in developing countries. The SDG Fund aims to significantly contribute to the achievement of several of the SDGs. The indicated outcomes of the fund include:

- Total mobilization of DKK 30B in private investment,
- Creation of 30,000 direct jobs and 30,000-60,000 indirect jobs,
- Comprehensive installation of renewable energy measured in MW,
- Comprehensive reduction of GHG emission from sustainable energy investments based on a conservative estimate of about 4,100 tons CO_2 equivalent/invested DKK 1M during the lifetime of the investment, and
- Annual tax contribution from investment projects to public authorities, transfer of modern technology and expertise.

KEY INSIGHTS

KIF presents several insights useful for others looking to create or invest in similar funds that attract institutional investors:

- Open and regular communication between government and public pension funds builds trust and common language: Open and regular communication between the Danish state and Danish pension funds created the foundation for building a relationship, identifying mutually beneficial opportunities, and co-financing an investment vehicle. Further, it allowed IFU to build a better understanding of the appropriate sales pitch to institutional investors. Executive level engagement in KIF's IC demonstrates the value of the relationship between the Danish state and pension funds.

- A collaborative design process is critical to understanding investors' requirements and ensuring the capital structure is catalytic: While blended finance holds great potential to crowd-in institutional investors, there are still only a few examples of blended finance structures attracting institutional investors at scale. Engaging institutional investors early and adapting terms and pricing to meet the needs of both the public and private investors were keys to success for KIF. The institutional investors proposed specific requirements around the risk-return profile and governance of KIF that were instrumental in ensuring their participation.

- In blended finance, public investors often deploy instruments to reduce private investor risk; however, leveraging public money to alter the return profile is also a smart approach to attracting private capital: While many blended finance transactions look to reduce the risk exposure for private sector investors, KIF takes an alternative approach by boosting return expectations for certain investors. This structure can ensure the avoidance of undue subsidy from the public sector to the private sector as well as of the appearance that the investment is not on commercial terms.

- A deeply networked and experienced GP—in this case a DFI—is critical to attracting institutional capital to invest in markets in which they do not have experience: The ability of KIF to attract institutional capital rests mainly on the track record and relationships built by IFU. This includes a deep track record in the targeted countries and sector, which allowed the institutional investors to get comfortable with targeted returns and the proposed portfolio of investments.

SOURCES

Interviews with the Danish Government, IFU, and PKA.

IFU documentation.

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ABOUT CONVERGENCE