

# FRESH IDEAS ABOUT BUSINESS IN EMERGING MARKETS

# EM Compass

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## Blended Finance— A Stepping Stone to Creating Markets

At the heart of IFC's approach to blended finance are efforts to create and help sustain private markets with strong development impact. This note explores the role of blended finance in creating markets and looks at lessons from three blended finance projects and structures—and how each contributed to the creation of markets that are scalable, sustainable, and resilient. The projects illustrate the value of using blended finance to kick-start markets and to push to achieve long-term financing on commercial terms. They also carry important lessons for using and scaling up blended finance in the future.

At IFC, blended finance refers to a financing package made up of concessional funding provided by development partners, along with commercial funds from IFC's own resources, from other development finance institutions (DFIs), and from the private sector.

Driven by the adoption of the UN's Sustainable Development Goals (SDGs) and the renewed focus on the role of private sector capital and expertise, blended finance has attracted substantial interest in recent years, and substantially more concessional resources for blending have become available.<sup>1</sup> The SDGs have incentivized new thinking on innovative development finance, including how to blend public and private funds.<sup>2</sup>

Efforts to provide opportunities for private investors will be essential to mobilize the estimated \$4 trillion a year of investments needed to achieve the SDGs. Naturally, there is no silver bullet in development finance.<sup>3</sup> No single financing instrument can provide a viable long-term solution by itself. However, blended finance has the potential to be a catalytic part of many solutions.

This note explores how blended finance can play an essential role in creating new markets.<sup>4</sup> It highlights how blended finance projects can have development impact that

goes well beyond the impact of individual transactions. The blending of funds on commercial and concessional terms can make things happen that would otherwise not, and can spur positive developments toward competitive and sustainable markets.

### More Than a Decade of Learning

IFC's experience from more than a decade of using concessional finance for investments is that blended finance can support high-impact transformative projects in sectors that are initially unable to attract commercial finance but have the potential to become commercially viable over time. Between 2010 and 2016, IFC deployed more than \$560 million of concessional donor funds to support more than 100 projects in over 50 countries, leveraging around \$2 billion of IFC financing and \$4.6 billion from other private sources.

As shown in Table 1, projects representing a value of \$3.78 billion have been financed between 2014 to 2016, which reflects an increasing volume. In these projects, the ratio of total project volume to concessional donor funds has been greater than a factor of nine, which underscores the ability of blended finance to mobilize private capital.

**TABLE 1** IFC's Blended Finance Commitments 2014–2016

Total Project Volume (USD mn)	3779.2
Total Donor Contributions (USD mn)	404.3
Leverage Ratio (Total Project Volume/Concessional Finance)	9.35

**THE RATIONALE OF IFC BLENDED FINANCE PROJECTS\***

Creating Markets	97%
Reaching Underserved Beneficiaries	73%
Addressing Mispriced Environmental Externalities	27%
Addressing Affordability	3%

\*For each of the 64 projects IFC financed in 2014–2016, two main drivers (rationales) have been identified. This explains why the numbers above sum up to 200%. In absolute numbers, 62 out of 64 projects had creating markets as an explicit rationale.

Though the volume of blended finance is increasing and plays an enhanced role in financing development, it is important to highlight the fact that blended finance has been and should only be used in certain contexts.<sup>5</sup> Financing on commercial terms should always be the preferred option to avoid distorting markets or creating dependence of the private sector on subsidies. Blended finance is also not the solution to long-term structural issues where permanent subsidies are called for, or the solution for inadequate policies where reforms are needed.

Blended finance should only be used when the public benefit of a project exceeds the returns to private investors, usually because there are externalities, market failures, affordability constraints, or information deficiencies in the market that prevent dynamic development of the private sector. Even when blended finance is needed, its use should be limited and concessionality minimized as much as possible to help develop and encourage future sustainable commercial markets.

Development projects need different types of capital and financing at various stages of their evolution. For blended finance transactions, it is crucial not to provide higher subsidies than are needed (by using a “minimum concessionality” principle).

Blended finance should only be utilized to address transitory challenges in the marketplace, where a push is needed for the private sector to reach a stage where concessional funds are not needed. Consequently, blended finance is not the best solution to address externalities that require permanent subsidies.

Furthermore, it is critical that the specific instrument used for blended finance—whether it is debt, equity, a risk-sharing facility, a guarantee product, or a performance-based incentive structure—is clearly designed to meet the development challenge at hand. No one solution will fit all situations. To assess whether blended finance is needed and how it can be effectively structured, it is essential to understand the restrictions and market failures and the sectoral and country context, and to articulate how blended finance is supporting the creation of markets or is helping them move toward commercial sustainability.

Blended finance solutions must never be seen in isolation from the market context, and there should also be consideration of complementary tools other than blended finance—advisory services, regulatory reform, or public sector-financed infrastructure improvements—that may be sufficient to make projects commercially viable without the need to provide concessionality.

**Creating markets—the logic and phases**

To understand the contribution blended finance can make to the creation of markets, it is useful to think about a process that unfolds in three distinct phases:

In the first phase of creating markets, the focus is on the *initial triggers of market change*. These typically include pioneering investments, building market platforms, and adoption of new technologies and business models, in many cases in the context of uncertainty of legal and regulatory frameworks. In this initial phase, new products and services are introduced and producers and consumers are connected to form a market.

Blended finance often plays a central role in this phase to demonstrate the business case of pioneering investments to potential investors in commercially risky environments or nascent markets. In this phase, risk capital or guarantees could be an appropriate blended finance product to offer, in addition to policy advice and technical assistance programs.

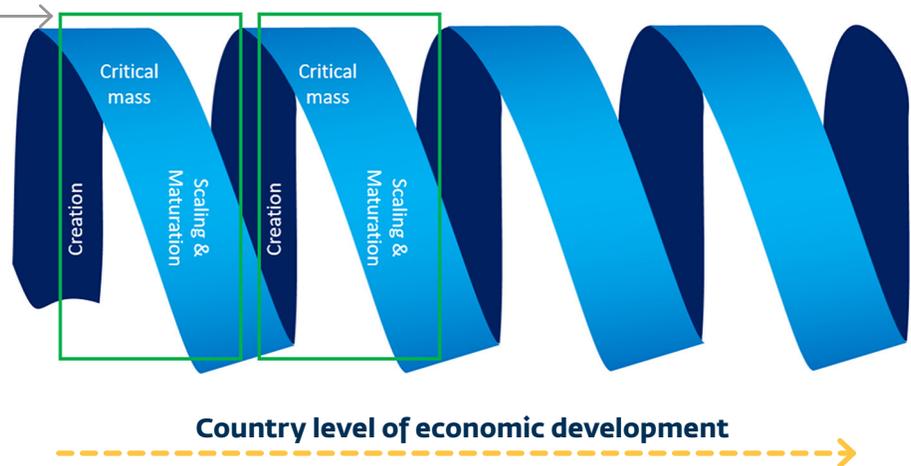
*As markets grow*, the second phase of creating markets is characterized by expansion and clustering of complementary investments and government action, which reinforces the change process and improves the market infrastructure for more efficient exchanges of goods or services.

During this phase, blended finance can also play an important role in reinforcing markets, particularly in supporting the introduction of innovative technologies and business processes.

## MARKETS TRANSFORM

1. MARKETS ARE CREATED, ACHIEVE CRITICAL MASS AND MATURE

2. MATURITY OF A MARKET TRIGGERS CREATION OF "ADJACENT" MARKETS & ADOPTION OF INNOVATION TO NEW AREAS



3. AS MORE MARKETS GET CREATED AND MATURE, THE ECONOMY DIVERSIFIES AND THE LEVEL OF ECONOMIC DEVELOPMENT INCREASES

**FIGURE 1** The Phases of Creating Markets

Source: IFC

However, as markets grow, the rationale needs to be very clear in terms of what would happen without some concessional financing. For expansions, concessional debt—senior or subordinated—may be the appropriate blended finance solution. In some cases, affordability considerations may also support the offering of solutions that allow for the ultimate beneficiary to access services at an affordable price.

In a third phase, *as markets mature*, business models are ideally scaled up and extended, new standards and market norms are established, new financing is mobilized as additional private players join, and efficiency and dynamism are further promoted. At this juncture, it becomes increasingly important to phase out financing on concessional terms and phase in financing on commercial terms. In such cases, some tailored de-risking structures (such as embedded deferrals in a loan or a guarantee with specific triggers) can be appropriate.

Figure 1 provides a simple overall illustration of the phases in creating markets.

### Early stage market creation—improving nutrition in Rwanda

A good example of a blended finance solution in an early stage of market creation is IFC's work to address chronic malnutrition and its negative impact on human capital development in Rwanda.

The project consists of financing a 45,000 ton/year processing plant to produce fortified cereals to treat malnutrition in nearly one million children and pregnant and nursing women. Using maize and soy sourced and grown locally by Rwandan farmers, the processing plant develops fortified food for young children and their mothers, supporting the prevention and treatment of malnutrition among this vulnerable population. The first phase of the project costs approximately \$65 million in capital expenditure and working capital.

Blended finance in the subordinated debt and equity was essential to allow the project to go ahead since extensive risk factors made financing on strictly commercial terms unachievable. The risks included greenfield and market risks, fluctuations of raw material commodity prices, a lack of consistent supplies of quality maize and soy, limited access to long-term capital, and an untested private partnership model in this sector. Advisory services were also an important component in the overall structure to strengthen sourcing and build the commercial market for the products.

A key lesson from the project was the early identification at the concept stage of the need for blended finance to move the transaction forward. This made it possible to create a strong partnership and align the project with the blended finance program's objectives of supporting food

security and rural incomes in a market with high risks for commercial investments. This blended finance project is supported by the Private Sector Window of the Global Agriculture and Food Security Program (GAFSP). Through the partnership, a ratio of nine was achieved on total project cost to the contribution from the donors.

By supporting local production of this fortified cereal, it is expected that the operating company will set a new standard in food production in the country and the region. It is also expected to strengthen the supply chain, as farmers learn to improve both productivity and quality of the key raw materials.

The success of this public-private partnership, in which the World Food Program and the Government of Rwanda are key off-takers in the initial years, can help demonstrate a new business model for addressing key development challenges such as malnutrition. The development of a commercial market for the product will help reduce the reliance on blended finance in the future.

The project provides a strong example of how blended finance can play a key role in kick-starting a new market and achieving strong long-term development impact. The success of the plant in Rwanda is expected to create a strong demonstration effect and provide a working model for other countries facing similar challenges.

### **Market expansion—scaling up solar energy in Thailand**

An example of the role of blended finance for market creation in a more mature and higher income situation is Thailand's nascent solar photovoltaic (PV) power market. This market was virtually non-existent a decade ago with solar energy accounting for less than 2 megawatts (MW) of installed capacity in Thailand. Despite falling technology costs and new Thai government incentives for renewable energy developers, the market remained subdued. However, there was recognition of a substantial potential for solar energy.

To leverage the government's efforts and to support a first mover company—Solar Power Company Group (SPCG)—to develop a utility scale solar PV power plant in Thailand, IFC initially provided an \$8 million loan from its own account. This was “blended” with \$4 million in concessional financing from the Clean Technology Fund, a multi-donor fund within the Climate Investment Funds that provides middle-income countries with concessional resources for climate change mitigation projects with high impact potential.

This blended finance structure enabled SPCG to mobilize enough capital from three local banks to develop two power plants with 12 MW of aggregate capacity.

The early support from IFC and the Clean Technology Fund has enabled SPCG to develop nearly 300 MW of installed capacity. So far, the company's solar farms have attracted more than \$800 million in clean energy investments while avoiding over 200,000 tons of CO<sub>2</sub> emissions annually. The success of SPCG sent positive signals to local financial markets and gave investors more confidence, providing a strong demonstration effect to markets.

The overall lesson is the importance of a timely blended finance package to help secure previously unavailable long-term financing in the solar PV segment. The project illustrates how concessional donor participation can reduce risks for investors, and enable a high-impact initiative.

In Thailand, investors were unfamiliar with Solar PV technology and were not convinced that the support provided by the Thai government was adequate, or would be sustained over the long term. This perception largely prevented long-term commercial capital to solar PV projects. Concessional donor participation in the project helped overcome this perception and provided enough comfort to local banks to engage in long-term financing of future projects.

The case from Thailand, however, also illustrates how a blended finance solution should never be seen in isolation from regulatory reforms. In this case a favorable regulatory regime provided the foundation for the market expansion and scale-up without further subsidies.

### **Small and medium size companies—bridging the finance gap in Africa**

A third example, and one that highlights the potential to create markets through blended finance, relates to IFC's strategic priority of promoting a sustainable architecture to improve access to finance and spur job creation in fragile and conflict-affected countries in Africa.

Small and medium size enterprises (SMEs) have traditionally been poorly served by the banking industry in Sub-Saharan Africa. Fewer than one-in-three medium sized firms in the region have a bank loan or a line of credit, according to World Bank data. For small firms it is fewer than one-in-five.<sup>6</sup>

To tackle these financial market restrictions for SMEs, IFC with support from the United Kingdom has signed a risk-sharing agreement with the European Investment Bank

and Ecobank, a pan-African commercial and investment banking group. This has helped to fill the gap in financing for the enterprises operating in fragile and conflict-affected states in West and Central Africa.<sup>7</sup>

This risk-sharing facility has helped to overcome the challenges of lending to smaller businesses by providing access to finance to enterprises in eight African countries: Burundi, Congo, Cote d'Ivoire, Democratic Republic of the Congo, Guinea, Mali, Chad, and Togo. A risk-sharing facility supports partner banks such as Ecobank to extend their SME lending by sharing some of the downside if there are significant losses.

The Global SME Facility, which supported the risk-sharing structure with Ecobank, operates as a comprehensive blended finance vehicle that integrates both investment and advisory services to help banks scale up SME lending and overcome market restrictions. The facility also provides the local partner, Ecobank, tools to build scale in SME lending, including advisory services and SME finance training. For Ecobank, the project helps to provide a broader customer base and, in time, stronger markets to lend to.

## The Way Forward

Donors and private investors are increasingly showing a willingness to work together in efforts to finance development by blending their resources. An essential objective of these common efforts is to create and reinforce private markets by de-risking and rebalancing risk-reward profiles to demonstrate commercial viability with a minimum use of concessional funds. By doing so, specific projects can help to crowd-in private investments and have a development impact far beyond individual transactions.

To make progress on this agenda, donors, investors, and development finance institutions must continue to learn from successful cases and experiences where projects have managed to create new opportunities and private markets. Similarly, experiences must be shared about avoiding pitfalls and applying too-high levels of concessional finance. An ongoing learning process and sharing of best practices is crucial to effective cooperation.

The IFC blended finance cases examined in this paper highlight three important lessons for the way forward in creating self-sustaining commercial markets:

- **Assess the need for concessional finance in the context of market restrictions.** Key questions in this regard include: What are the restrictions for commercial

financing? What could be the push factor for markets to really take off? Blended finance will often be an important part of the solution, but it should not be viewed in isolation from other efforts, as is evident in the example of scaling up of solar energy in Thailand.

- **Focus on first-of-a-kind investments and early stage market creation.** The example of improving nutrition in Rwanda shows how blended finance solutions can be essential to allow a project to go forward where extensive risk factors initially made financing on strictly commercial terms unachievable.
- **Coordinate better the efforts of various Development Finance Institutions.** The potential for creating markets by coordinating efforts is clear from the case of supporting SME access to finance in Africa. It is crucial that various development actors share and make use of past information about what works and what doesn't, and share knowledge about the obstacles that require blended finance, and how these obstacles have evolved over time.<sup>8</sup> ■

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Please see also this IFC Thought Leadership publication about blended finance: *Blending Public and Private Finance*, EM Compass Note 3, April 2016.

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- <sup>1</sup> In this note the term “Blended Finance” refers to the blending of concessional funds (often from governments or foundations) with non-concessional funds (often from DFIs or private investors), to stimulate investments in the private sector.
- <sup>2</sup> Keohane, Georgia Levensen and Saadia Madsbjerg. 2016. “The innovative Finance Revolution.” *Foreign Affairs*, July/August. [www.foreignaffairs.com/articles/2016-06-05/innovative-finance-revolution](http://www.foreignaffairs.com/articles/2016-06-05/innovative-finance-revolution).
- <sup>3</sup> For a useful overview see: Savoy, Conor M. and Aaron Milner. 2018. “Blended Finance and Aligning Private Investment with International Development.” Center for Strategic & International Studies. [www.csis.org/analysis/blended-finance-and-aligning-private-investment-global-development](http://www.csis.org/analysis/blended-finance-and-aligning-private-investment-global-development).
- <sup>4</sup> For a more general description of IFC’s approach to creating markets and the main channels see: Lauridsen, Morten Lykke and Florian Molders. 2017. “Creating Markets.” *Finance & Development* (54) 3: 54-55, International Monetary Fund.
- <sup>5</sup> Private Sector Development Roundtable. 2013. “DFI Guidance for Using Investment Concessional Finance in Private Sector Operations,” which defined five core principles for engagement: (1) Ensuring additionality; (ii) crowding-in private investments; (iii) promoting commercial sustainability; (iv) reinforcing markets; and (v) reinforcing high standards. See an updated Enhanced Principles Report at IFC’s homepage ([www.ifc.org](http://www.ifc.org))
- <sup>6</sup> IFC, 2016. “Transforming African Development: Partnerships and Risk Mitigation to Mobilize Private Investments on a New Scale.”
- <sup>7</sup> The lending package Ecobank put together with IFC and the European Investment Bank in 2015 was designed to overcome the challenges of lending to smaller business with high risk profiles in very poor countries. DFID participated through IFC’s Global SME Finance Facility.
- <sup>8</sup> The Multilateral Development Banks have set up a working group for blended finance that *inter alia* have shared best practices from particular projects. See footnote 4 for the link to the report of this working group.