CASE STUDY

WATERCREDIT INVESTMENT FUND 3 (WCIF3)

JULY 2019

EXECUTIVE SUMMARY

WaterCredit Investment Fund 3 (WCIF3) is a blended fund that provides debt financing to financial institutions and enterprises serving the water and sanitation needs of families living in poverty in Asia. WCIF3 was launched by WaterEquity, an impact investment manager established by Water.org co-founders Gary White and Matt Damon. WaterEquity is the first impact investment manager dedicated to ending the global water crisis. WCIF3 is WaterEquity's first fund to use blended finance and is comprised of tiers of equity, catalytic debt facilities including multiple zero- and low-interest loans, and a first-loss guarantee.

WCIF3 achieved its final close at $50 million in March 2019, attracting investments from a range of impact investors, including foundations, high-net-worth individuals, and development finance institutions. WCIF3 began disbursing capital immediately after close, deploying seven loans to microfinance institutions, resulting in 60,000 microloans to families living in poverty. WCIF3 has also deployed one loan to a water and sanitation enterprise in India. WCIF3 provides several insights for others looking to create or invest in blended vehicles in the water and sanitation sector:

- Blended finance works for solutions that have an underlying market
- Blended finance often takes an iterative approach or is the result of iteration
- A compelling impact narrative can go a long way in blended finance transactions
- Leverage and additionality are context and project specific
- Non-governmental organizations (NGOs) can serve as meaningful partners and a source of pipeline

SYNOPSIS

Fund manager	WaterEquity	
Fund vintage	2018	
Mandate	To invest in financial institutions and enterprises that increase access to safe water or sanitation services in emerging markets	
Target borrowers	Financial institutions, including microfinance institutions, and enterprises providing water and sanitation loans, products, or services to families living in poverty	
Priority countries	India, Indonesia, Cambodia, and the Philippines	
Size	$50 million	
Capital structure	Equity	$22.5 million
	Manager & General Partner (Class III)	*$400,000*
	Common Equity (Class II)	*$6 million*
	Preferred Equity (Class I)	*$16.1 million*
	Debt (via loan facilities)	$27.5 million
	First-Loss Guarantee	$5 million
Investment instruments	Senior debt, subordinated debt (financial institutions only)	
Investment sizes	Minimum $250,000 for enterprises; minimum $500,000 for financial institutions	
Sample Impact metrics	Loans disbursed; % of borrowers living in poverty; % of women borrowers; new connections / products sold; volume of wastewater treated	
Impact to date	• 60,000 microloans made by investees; 93% of borrowers are women • 224,100 people with access to sanitation • 39,700 people with access to water • 9,373 with access to water & sanitation	

INTRODUCTION

Access to safe water and sanitation is core to sustainable development and a key determinant of improved health outcomes, gender equality, and overall economic growth. The importance of access to safe water and sanitation has been recognized by the international community as a basic human right and enshrined in Sustainable Development Goal (SDG) 6 (*Clean Water and Sanitation)*, which aims to ensure universal access and sustainable management of water and sanitation services and resources by 2030. Despite modest progress in developing water and sanitation sectors, there are 785 million people globally without access to safe drinking water and 2 billion people without access to basic sanitation. The World Bank estimates that $114 billion in additional funding is needed per year. There is a growing recognition that traditional aid and philanthropy must be complemented with additional sources of financing to achieve Goal 6 (*Clean Water & Sanitation*) by 2030.

Against this backdrop, Water.org established WaterEquity as the first impact investment manager dedicated to ending the global water crisis, with an exclusive focus on raising and deploying capital to financial institutions and water and sanitation enterprises serving families living in poverty. This case study focuses on WaterCredit Investment Fund 3 (WCIF3), a blended fund managed by WaterEquity that leverages a first-loss guarantee to mobilize capital from impact investors. WCIF3 demonstrates the value of blended finance in scaling proven market-based solutions for families living in poverty, attracting additional financing while ensuring the sustainability and affordability of products and services offered to the end consumer.

DESIGN AND FUNDRAISING

Water.org has a long history of promoting market-based solutions to increase access to safe water or sanitation in developing countries. Water.org was co-founded by Gary White and Matt Damon in 2009 to apply microfinance principles to the water and sanitation sector, recognizing (i) the lack of affordable access to local water and sanitation services, and (ii) the limited reach and sustainability of traditional approaches like drilling wells. Water.org pioneered WaterCredit to address the estimated $18 billion in demand from individuals for affordable financing, such as microloans, to meet their water and sanitation needs. Through this market-based model, Water.org provides philanthropic financial support and technical assistance to microfinance institutions to help them develop water and sanitation microloan portfolios for families in need.

Through WaterCredit, Water.org developed a strong track record of financial and developmental results. Water.org's microfinance partners have made 4.6 million WaterCredit loans, unlocking access to safe water and sanitation services for more than 20 million people. With an average loan size of $362 and repayment rates of 99%, the program's results are compelling from a creditor perspective. Despite the economics behind these financial products, existing investment managers were unwilling to launch a dedicated water and sanitation fund targeting the scale-up of WaterCredit. Water.org recognized the need to fill this gap and established an impact investing initiative called WaterEquity, which later became a separate legal entity.

With more than $60 million in current assets under management, WaterEquity has launched and managed a series of impact investment funds to help Water.org's microfinance partners and additional financial institutions scale their water and sanitation microloan portfolios for families living in poverty. WaterCredit Investment Fund 1 (WCIF1), WaterEquity's first impact investment fund, was launched in 2014 to provide debt financing to top performing Water.org microfinance institution partners. WaterEquity raised $11 million for WCIF1 with commitments from a number of impact-oriented investors (e.g., Conrad N. Hilton and Skoll Foundations). The second fund, WaterCredit Investment Fund 2 (WCIF2), was launched in 2017 as a crowdfunding platform to pool zero interest loans from individuals (minimum $100) to provide additional debt financing to Water.org's partners. Following the launch of WCIF2, WaterEquity became a legally separate entity, building its own brand and expertise as a fund manager.

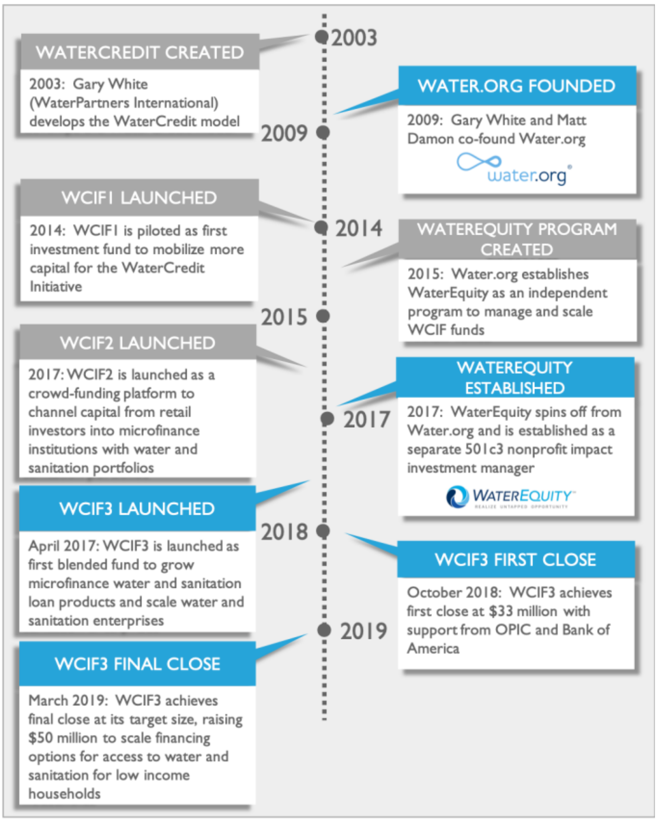

Figure 1: Timeline of Water.org and WaterEquity

In 2017, WaterEquity launched WCIF3. Through this fund, WaterEquity sought to mobilize $50 million from impact investors including foundations, high-net-worth individuals, and development finance institutions with their largest fundraising effort to date. To attract additional financing from investors, WCIF3 deploys a tiered equity structure with common and preferred positions and is covered by a first-loss guarantee for up to $5 million, extended by WaterEquity. Moreover, WCIF3 is unique in that it uses multiple zero- and low-interest secured and unsecured loan facilities to enhance the fund's core activities. The substantial use of blended risk mitigation instruments in WCIF3's capital structure allowed the fund to meet the risk-return requirements of its investor base. In addition to a blended finance structure, WCIF3 also has a broadened scope, expanding (i) eligible investees beyond financial institutions to water and sanitation enterprises, and (ii) geographic remit to include three countries in addition to India: Indonesia, Cambodia, and the Philippines.

	WCIF1	WCIF2	WCIF3
FUND SIZE	$11 million	$50,000	$50 million
TARGET INVESTEE	Microfinance institutions	Financial institutions, including microfinance institutions	Financial institutions, including microfinance institutions, and water and sanitation enterprises
FUND STRUCTURE	Impact investment fund with two shareholder classes	Pooled zero-interest loans from retail investors	Blended finance, including concessional equity, and a first-loss guarantee
TARGET INVESTORS	Accredited investors	Non-accredited investors/ retail investors	Accredited investors

Table 1: Comparison of WaterEquity's Funds To Date

WCIF3 appealed to impact investors looking for opportunities to further build and scale markets, as well as the specific impact narrative (e.g., affordable financing for the water and sanitation sector). Impact investors, including foundations and high-net-worth individuals with strongly aligned mandates (e.g., focus on the water and sanitation sector), invested in the equity classes. In addition to previous Water.org supporters (e.g., Conrad N. Hilton Foundation, Skoll Foundation, and Niagara Cares), WCIF3 attracted a diverse set of new equity investors, achieving the goal of mobilizing additional sources of financing. WCIF3 also received early interest from several investors, including development finance institutions, looking to provide debt rather than equity. WaterEquity established individually-negotiated loan facilities with interested debt providers, including the Overseas Private Investment Corporation (OPIC) and Bank of America, a long-standing supporter of Water.org.

WCIF3 reached a final close in March 2019 at its target size of $50 million, following a second close of $47.6 million in November 2018. Ultimately, WCIF3 received considerable investment interest and had to turn down a number of interested investors as it did not have sufficient guarantee coverage to meet its capital cushion requirements for commitments exceeding its target size.

STRUCTURE AND GOVERNANCE

CAPITAL STRUCTURE

WCIF3 has multiple equity classes with a first-loss guarantee. This guarantee covers first losses of principal and returns up to $5 million. The equity tiers share the same target upside gains, but have different capital cushions and seniority of repayment. WCIF3 also benefits from debt provided through multiple zero- and low-interest loan facilities.

WCIF3 is comprised of three classes of shareholders:

- Manager & General Partner (Class III): This share class is held solely by the Manager and General Partner (GP) and is pari passu with Class II. The Manager and GP have committed to provide capitalization for certain start-up costs relating to the Manager and General Partner and their respective operations, up to $400,000.

- Common Equity (Class II): WCIF3 raised $6 million in common equity from impact investors including foundations and high-net-worth individuals. Class II shares have a targeted 3.5% per annum compounded return, paid annually, subordinate to Class I, and will benefit from any upside potential created by favorable currency fluctuation or fund efficiencies. Class II is supported by a minimum 10% cushion of reserve capital over the first-loss guarantee.

- Preferred Equity (Class I): WCIF3 raised $16.1 million in preferred equity – the most senior equity position in the fund – from additional impact investors including foundations and high-net-worth individuals. Class I shares have a targeted 3.5% per annum compounded return, paid annually, on a priority basis ahead of Class II and III partners. Class I is supported by a minimum 20% cushion of reserve capital over Class II and Class III and the first-loss guarantee.

Debt: WCIF3 leveraged up the equity contributions through the use of several zero- and low-interest secured and unsecured loan facilities. Terms for the loan facilities were individually negotiated and rank in priority to all other investment classes. In total, WaterEquity negotiated four loan facilities worth $27.5 million. These facilities included a $5 million zero-interest facility provided by Bank of America; a $20 million facility provided by OPIC; a $2 million zero-interest facility provided by the IKEA Foundation; and other lenders.

First-loss guarantee: WCIF3 benefits from a first-loss guarantee on all three classes of shareholder capital as well as the loan facilities to provide assurance to senior capital providers given the assumed underlying risks on the portfolio. The guarantee covers the fund's principal and returns up to $5 million, backstopped via philanthropic funding raised by WaterEquity from foundations and high-net-worth individuals such as Niagara Cares, Skoll Foundation, and Matt Damon, among others. The first-loss guarantee amount can be drawn down, in whole or in part, at the fund's maturity to cover any shortfalls. In the case of losses, the guarantee will first be used in repayment of the Bank of America loan facility; second, in the repayment of unsecured indebtedness owed by the fund (apart from OPIC, who forwent the guarantee but took a pledge on the receivables of the portfolio); third, by Class I shareholders; and lastly, by Class II and III shareholders paid pro-rata.

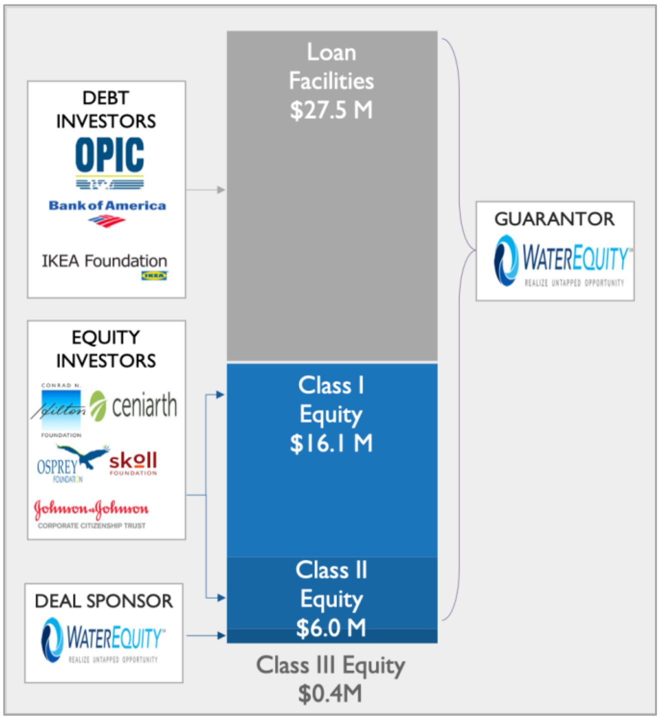

Figure 2: WCIF3 Capital Structure

LEGAL STRUCTURE AND GOVERNANCE

WCIF3 is incorporated as a Delaware limited partnership. The fund is managed by WaterCredit LLC, a Delaware limited liability company wholly owned by WaterEquity. WaterEquity was initially established as an initiative within Water.org and became an independent 501c3 charitable organization in 2017. WaterEquity is solely responsible for the management of WCIF1, WCIF2, WCIF3, and future funds, and works closely with Water.org (e.g., fundraising and in-country staff) as needed. WaterCredit GP LLC was established as the general partner for WCIF3, whose sole shareholder is WaterCredit LLC. Initially structured as an LLC, WCIF3 converted to a LP structure after attracting investments from the United Kingdom.

WCIF3 is governed by the following bodies:

- Board of Managers: WaterCredit LLC is wholly owned by WaterEquity and is governed by a Board of Managers.
- Stakeholder Advisory Committee: Class I and Class II shareholders are represented by a Stakeholder Advisory Committee, consisting of four persons who are not members of the Board of Managers, General Partner, or employed by WaterEquity.
- Investment Committee: WCIF3's Investment Committee is responsible for conducting due diligence on all potential investments and monitoring the WCIF3 portfolio. The Investment Committee is comprised of three to five persons and includes WaterEquity senior staff and board advisors.

OPERATIONS

INVESTMENT CRITERIA

WCIF3 invests in financial institutions and enterprises that expand access to safe water and sanitation products, services, or financing for families living in poverty. WCIF3 is targeting four countries in Asia, with the largest intended exposure in India (45%), followed by Cambodia (30%), Indonesia (20%), and the Philippines (5%). WCIF3 will not invest more than 50% of its portfolio in a single country; 15% in a single financial institution; 30% as subordinated loans; or 10% cumulatively directly in enterprises. Loans will be primarily extended for tenors up to 36 months, with the potential for tenors of up to 60 months. WCIF3 offers both local currency and U.S. dollar-denominated loans. As per its hedging policy, at least 33% of the portfolio must be U.S. dollar-denominated or hedged to the U.S. dollar.

Approximately 90% of WCIF3's disbursable capital is earmarked for 20-25 financial institutions. WCIF3 will prioritize financial institutions, primarily microfinance institutions, that are current or graduated partners of the WaterCredit initiative. In addition, WCIF3 will also consider investments in other financial institutions including banks, non-bank financial institutions, and savings and credit cooperatives. Financial institutions must have been operational for at least five years, with three years of profitability, a total gross loan portfolio greater than $2.5 million, and a history of providing financing for water and sanitation as demonstrated by at least $100,000 outstanding in its water and sanitation loan portfolio. WCIF3 will primarily provide senior debt, but may consider subordinate debt for financial institutions with a gross loan portfolio of more than $50 million. The fund can invest a minimum amount of $500,000 and no more than 25% of the financial institution's total assets.

WCIF3 can also lend directly to eight to 10 enterprises providing access to safe water and sanitation products, services, or financing to families living in poverty. Eligible water and sanitation enterprises include toilet product manufacturers, product retailers, construction companies, micro-utilities, or other types of service providers. WCIF3 will provide senior loans to water and sanitation enterprises that have been operating for at least two years and achieved financial breakeven. The minimum loan size is $250,000. Enterprises must have annual revenues exceeding $250,000 and total assets exceeding $400,000.

INVESTMENT PROCESS

WaterEquity is responsible for the development and management of WCIF3's pipeline, but the fund primarily invests in existing or past WaterCredit partners. WaterEquity leverages its close relationship with Water.org to source pipeline opportunities, including through a strategic alliance agreement and in-country Water.org microfinance partners. The fund also sources investment opportunities from relevant networks, including Water.org's national WaterCredit forums and referrals from existing partners and investees.

Once identified, there is a five step investment process for potential investees:

1. Initial screening: WaterEquity conducts an initial screening of prospective investees for (i) eligibility, (ii) required loan size and terms, and (iii) credit risk, ESG compliance, and development impact.

2. Loan application and due diligence: Once successfully screened, potential investees are invited to submit a formal loan application, with specific applications for financial institutions and social enterprises respectively. The loan application and due diligence include desk research, on-site visits, and/or interviews with external sources (e.g., clients, suppliers, creditors, and auditors). During this phase, WaterEquity reviews the potential investees for:
   - Risk factors and investment rationale
   - Operational and financial performance (i.e., growth, profitability, and efficiency)
   - Management and governance
   - Capital structure and lender base
   - Strategy and competitive position
   - Credit score based on a proprietary scorecard
   - Development impact, including with standards selected from IRIS+
   - Country risk score, which is focused around four primary risk areas: political risk, economic risk, financial system, and business environment
   - ESG score, based on a proprietary scorecard

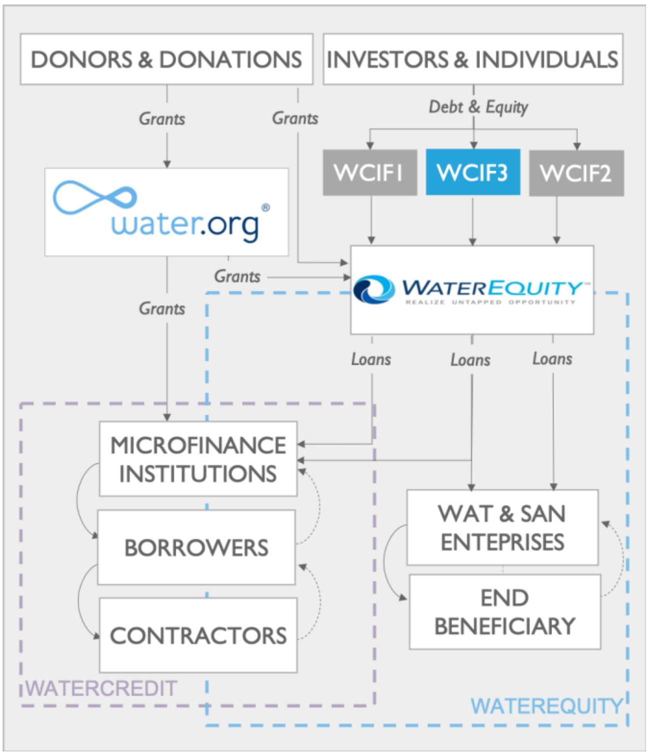

Figure 3: WCIF3 Structure

3. Investment structuring: WCIF3 invests in two ways: loans (types vary by country) and bond subscriptions (India only). The transaction documents for all investments are drafted around credit risk and repayment capacity, use of proceeds, country and currency risk, local rules and regulations, and potential impact. WaterEquity works with potential investees to establish social impact targets, which are then written into the agreements to ensure use of proceeds support expansion of access to safe water and sanitation products, services, or financing for families living in poverty. The fund offers both amortizing and bullet loan structures, with grace periods available for amortizing loans. For loan agreements, the fund determines the interest using the "actual/actual" method, which calculates a daily interest rate, and fixed or floating interest rates are considered in special circumstances.

4. Investment Committee approval: Following completion of due diligence and investment structuring, WaterEquity submits a comprehensive investment memo to the Investment Committee for approval. The

Investment Committee may alter terms and conditions, including the tenor, repayment rates, fees, and/or security.

5. **Portfolio monitoring:** Regular updates must be provided to the Investment Committee on the fund's portfolio performance. Quarterly reporting is completed on financial, operational, and social indicators and also includes an annual review of audited financial statements and on-site visits conducted on an as-needed basis.

INVESTMENT ACTIVITY TO-DATE

WCIF3 reached first close and began disbursing capital in October 2018. As of March 31, 2019, WCIF3 has provided eight loans to investees, including seven financial institutions and one water and sanitation enterprise. These commitments represent $30.2 million across India (52% of capital disbursed), Cambodia (19.9%), and Indonesia (28.1%). WCIF3 has provided these loans primarily in local currencies, including all loans made to investees in India and Indonesia. In Q2 2019, the WCIF3 Investment Committee approved an additional five loans totaling $10.5 million, bringing total approved WCIF3 investments to $40.3 million.

Although it is still early in the deployment stage, WCIF3 has already supported 60,000 microloans across India, Indonesia, and Cambodia, reaching more than 273,000 people. This includes 39,700 people with improved water; 224,100 people with improved sanitation; and 9,400 people with improved water and sanitation. To date, 78% of borrowers of WCIF3 investees are people living in poverty and 93% have been women. WCIF3 seeks to impact 4.6 million people in total.

IMPACT METRICS

To monitor portfolio performance, WaterEquity leverages standardized IRIS+ metrics. Launched by the Global Impact Investing Network (GIIN), IRIS+ is a catalogue of over 400 performance metrics that can be tailored across sectors and the investment value chain. WCIF3 also draws on additional impact monitoring tools, including those developed in partnership with the Efficient Impact Frontier Collaborative, Impact Management Project, and the IFC Operating Principles for Impact Management, where relevant.

In addition to individual deal monitoring, WaterEquity tracks impact at a portfolio level, according to both financial targets (e.g., target return) and social targets (e.g., number of people reached with safe water and sanitation). WaterEquity also collects feedback from end clients through surveys and on-site visits to validate the data provided by investees. This includes verifying that reported clients have received water and sanitation microloans or services, as well as collecting information on client usage and satisfaction. Feedback from borrowers is used to provide insights into WaterEquity's investment strategy as well as to provide useful feedback for investees.

INVESTEE	SAMPLE IRIS+ METRICS
Financial institutions	• Number of new loans disbursed • Percentage of borrowers living in poverty • Percentage of women borrowers • Average interest rate on loans offered • Growth of outstanding water and sanitation loan portfolio
Water and sanitation enterprises	• Number of new connections or products sold • Percentage of people living in poverty • Percentage of women reached • Growth of sales revenues

Table 2: WCIF3 Sample Impact Metrics

FOLLOW-ON STRUCTURE

WaterEquity continues to build its unique brand as the world's leading impact investment manager focused on the water and sanitation sector. WaterEquity will continue to invest and manage WCIF3, with the aim of reaching 4.6 million people across India, Indonesia, Cambodia, and the Philippines. WaterEquity is currently developing its next investment fund, the Global Access Fund, which will also invest in financial institutions to increase access to safe water or sanitation among families living in poverty, using blended finance, with an anticipated target size of $75 million+. WaterEquity's Global Access Fund will expand its geographic focus to include Africa and Latin America.

KEY INSIGHTS

WCIF3 provides several useful insights for others looking to create or invest in blended finance vehicles focused on the water and sanitation sector:

- **Blended finance works for solutions that have an underlying market**: The WaterCredit initiative demonstrated strong potential for a sustainable market-based solution, which supported local efforts to provide affordable, safe water and sanitation services to people living in poverty. WaterCredit has supported 4.6 million loans totaling over $1.7 billion in total value with an average repayment rate of 99%. WCIF3 was established, following WCIF1, to crowd in additional – and more sustainable – sources of financing for safe water or sanitation services for those living in poverty, accelerating impact and reach. WCIF3 raised $50 million by leveraging blended finance to mobilize investments from a diverse set of investors. Importantly, the Fund was able to do so because the underlying projects had revenues from which to repay investors. Blended finance can also be an important form of gap financing for transactions such as WCIF3 that have revenue potential but are not yet fully commercial.

- Blended finance often takes an iterative approach or is the result of iteration: Blended finance is not a one-size-fits-all solution for financing development projects. WaterEquity is one example of an organization that has used blended finance to further its mandate to expand access to safe water or sanitation in developing countries. WCIF1, WCIF2, and WCIF3 each had distinct, fit-for-purpose approaches and structures. WaterEquity piloted a blended finance approach to mobilize additional capital from the private sector while maintaining affordable costs for the end consumer. WaterEquity's experience is similar to that of certain other fund managers, who have used blended finance as a tool to expand the scope of their activities following more traditional financing approaches. Blended finance solutions should only be used if they are appropriate for the goals and objectives of the particular investment structure.

- A compelling impact narrative can go a long way in blended finance transactions: A clear impact narrative can be a compelling incentive for investors, even those that are more commercially-oriented. Over the course of its history, Water.org and WaterEquity have developed a clear and strong impact narrative, unlocking financing for safe water and sanitation services that have benefited more than 20 million people, while demonstrating financial sustainability. Building on this foundation, WCIF3 was able to attract a mix of impact investors – including foundations, high-net-worth individuals, and development finance institutions – who identified with the fund's impact mandate and demonstrated history. A compelling impact narrative – especially one that is core to the investment strategy and has demonstrable value – can be a key differentiator in the success of a blended finance vehicle.

- Leverage and additionality are context and project specific: WCIF3 is taking a sustainable market-based approach to increase access to safe water or sanitation services for families living in poverty. By employing a blended finance approach, WaterEquity was able to access additional sources of financing – beyond the philanthropic community – to scale the WaterCredit initiative and accelerate impact. To effectively and sustainably scale impact in this sector and among this target demographic, WCIF3 benefitted from multiple forms of concessional capital (i.e., capital priced at a below-market rate), including concessional equity, zero- or low-interest debt facilities, and a first-loss guarantee. Blended finance practitioners should recognize that mobilization is just one aspect of a successful solution and must be right-sized to the context and underlying project(s). An undue focus on leverage would have been inappropriate given the context and could have undermined WCIF3's focus on its target development outcomes.

- Non-governmental organizations (NGOs) can serve as meaningful partners and a source of pipeline: While investors are looking for compelling investment opportunities, they often lack the boots on the ground needed to develop strong pipeline opportunities. In contrast, NGOs work closely with local organizations, facilitating strong partnerships with deep local knowledge. WCIF3 is an example of a fund that benefitted from having a close NGO partner, Water.org, to identify a scalable pipeline with sustainable impact outcomes – WaterEquity selected its pipeline for WCIF3 primarily from top-performing Water.org microfinance partners. As demonstrated by WCIF3, NGOs can serve as valuable partners when leveraged for core strengths such as strong local reach and, where appropriate, the ability to translate client knowledge to a market context.

SOURCES

Interviews with Bank of America, Conrad N. Hilton Foundation, OPIC, Rean Watertech Private Ltd., WaterEquity.

Documentation provided by WaterEquity.

Water.org Annual Reports. Available here.

Water.org. WaterCredit Overview (2019). Available here.

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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