DATA BRIEF | FEBRUARY 2023

Blended Finance & Leveraging Concessionality

HIGHLIGHTS

- Leverage ratios, placed into context with other considerations, can help to determine how effective concessional capital has been within blended finance transactions to date.
- Leverage ratios are defined as the amount of commercial capital mobilized by each dollar of concessional capital, where commercial capital includes capital deployed by private, public, and philanthropic investors.
- Based on a sample of 340 transactions from Convergence's database, every dollar of concessional capital has mobilized on average $4.1 in commercially priced capital, of which just under half ($1.8) on average has been sourced from private sector investors.
- Transactions targeting Latin America (4.7) have recorded the highest leverage ratios by region.
- SDGs 9 (Industry, Innovation, and Infrastructure), 7 (Affordable & Clean Energy), 12 (Responsible Consumption), and 8 (Decent Work & Economic Growth) had the highest average leverage ratios.
- Larger blended transactions have leveraged higher amounts of commercial capital per dollar of concessional funding. Average leverage ratios almost perfectly increase with transaction sizes through to the $1 billion plus range, where average leverage ratios reach 7.6. Meanwhile, transactions structured as bonds (5.7), projects (4.5), and companies (4.4) had higher leverage ratios.
- Transactions sponsored by commercial investors (4.6) had the highest average leverage ratios, while those sponsored by foundations / NGOs (2.9) had the lowest.
- To mobilize capital from private sector investors more effectively, providers of concessional capital must adopt private sector mobilization strategies and increase their transparency on financial terms and impact.

CONVERGENCE
BLENDING GLOBAL FINANCE

Introduction

EACH DOLLAR OF CONCESSIONAL CAPITAL DEPLOYED TO A BLENDED FINANCE TRANSACTION HAS MOBILIZED, ON AVERAGE, $4.1 IN COMMERCIALLY PRICED CAPITAL

With the annual financing gap for the Sustainable Development Goals (SDGs) rising from $2.5 trillion to $4.2 trillion in part because of the impact of the COVID-19 pandemic on developing economies, the use of catalytic capital from public or philanthropic sources to increase private sector investment in developing countries is one critically important approach to mobilizing new sources of capital for the SDGs. With annual blended finance flows currently far below what is needed to achieve the "billions to trillions" agenda, leverage ratios can help determine how effective concessional capital (i.e. capital priced below market terms) has been within blended finance transactions to date. Leverage ratios are defined here as the amount of commercial capital mobilized by each dollar of concessional capital, where commercial capital includes capital deployed by private, public (e.g., Multilateral Development Banks (MDBs) and Development Finance Institutions (DFIs)) and philanthropic investors at market rates.

This Brief updates a study published by Convergence in 2018 that benchmarked leverage ratios for a sample of 72 blended finance funds. The study found that, on average, blended finance funds had leveraged $4 of commercial capital for every dollar of concessional capital, with only a fraction of this commercial capital ($1.10) coming from private sector investors. This Brief expands the universe of transactions under study to 340, including transactions structured with blending archetypes other than concessional debt and equity, like guarantees and technical assistance. With donors not having prioritized and budgeted private sector mobilization as a necessity to significantly narrow the SDG financing gap, and the size distribution of blended transactions remaining constant, the average leverage ratio for blended finance transactions remains in line with what was recorded in 2018, at 4.1. This is also comparable with other estimates; for example, a study of ten German BMZ-backed structured funds mostly active in middle-income countries estimated their average leverage ratio to be 3.5. In this Brief, leverage ratios (excluding outliers) ranged from a minimum of 0.01 to a maximum of 18, with a median of 2.5.

Finally, this Brief also examines 'private sector mobilization', which refers to the amount of commercial capital specifically from private sector investors that has been leveraged by concessional capital. The average private sector mobilization ratio has been 1.8 (median = 0.6), suggesting that just under half of the commercial financing mobilized by each dollar of concessional financing has come from from private sector sources, with the remainder coming from MDBs, DFIs, and philanthropic investors.

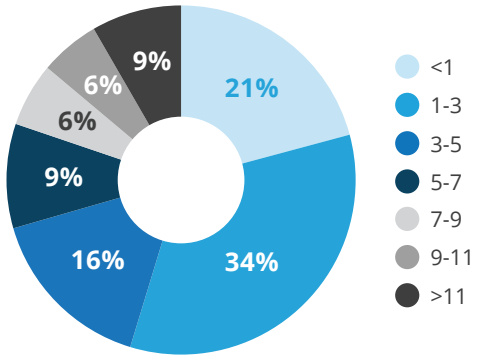

Figure 1: Leverage ratios of 340 blended finance transactions

Analysis

LATAM HAS THE HIGHEST AVERAGE LEVERAGE RATIOS, WHILE GLOBAL & EAST ASIA LAG

Average leverage ratios were highest in Latin America and the Caribbean (4.7), while transactions targeting Global (3.1) and East Asia and Pacific (3.0) recorded the lowest average leverage ratios. Latin America remains a popular area of interest for blended finance practitioners, with just under half (47%) of the fundraising transactions showcased on Convergence's deal-matchmaking platform targeting the region. Average private sector mobilization ratios were highest in South Asia (2.1), Latin America and the Caribbean (1.8), and Sub-Saharan Africa (1.8), but private capital as a proportion of total commercial financing leveraged was highest for transactions targeting Global (1.7; 56%) and East Asia and Pacific (1.6; 53%). That is, blended transactions targeting these regions mobilized levels of private capital near the average (1.8), but closed with less subsidization of public institutions. This suggests that in other regions, the presence of DFIs / MDBs may be needed for deals to close, or that their presence may be crowding out private sector capital (more, however, cannot be inferred).

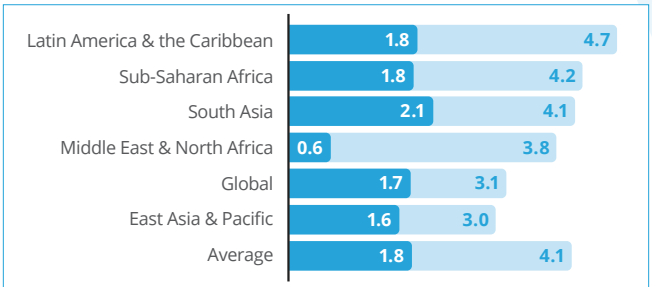

Figure 2: Average leverage ratios (light blue) and private sector mobilization ratios (dark blue) by target region(s)

TELECOMMUNICATIONS INFRASTRUCTURE & MANUFACTURING HAVE THE HIGHEST AVERAGE LEVERAGE RATIOS

While Industry and Trade (5.9), General (4.3), and Energy (4.2) were the only sectors with leverage ratios above the market average, when considering sub-sectors targeted by at least ten transactions, telecommunications infrastructure (7.3) and manufacturing (7.1) recorded the highest average leverage ratios. With up to 95% of telecommunications infrastructure worldwide being private-sector funded, telecommunications infrastructure has also seen the highest average private sector mobilization ratio amongst these sub-sectors (5.4), suggesting that three quarters (74%) of every commercial dollar leveraged in this sub-sector came from private sector sources.

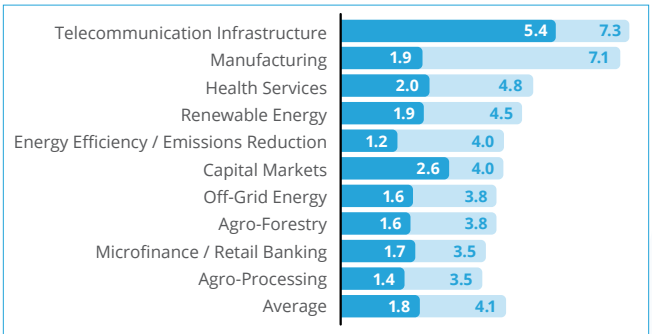

Figure 3: Average leverage ratios (light blue) and private sector mobilization ratios (dark blue) by target sub-sector(s) (n>10)

LARGER TRANSACTIONS LEVERAGE MORE COMMERCIAL CAPITAL ON AVERAGE

Larger blended transactions have leveraged higher amounts of commercial capital per dollar of concessional funding, with average leverage ratios almost perfectly increasing with transaction size through to the $1 billion plus range, where average leverage ratios reach 7.6. Convergence has long made a case for launching proven and replicable blended finance structures and aggregation vehicles, given their appeal among private sector investors. Indeed, private capital as a proportion of total commercial capital leveraged has been highest for transactions in the $500-1000 million range (4.5; 70%). There is, however, an interesting pattern at the other end of the scale. PE / VC firms and corporations have been active in very small transactions, with the private sector being the critical source of commercial funding in the <$5 million range (1.2; 65%). DFIs / MDBs have largely been absent in direct deals at this end of the spectrum.

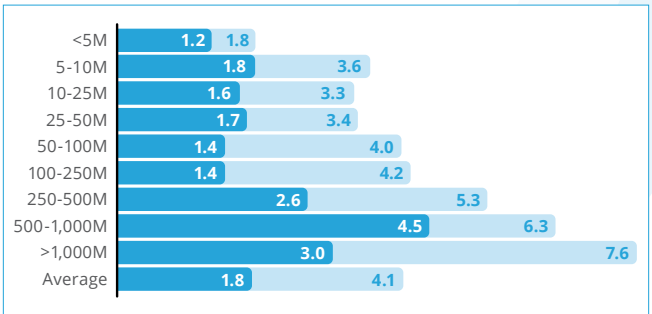

Figure 4: Average leverage ratios (light blue) and private sector mobilization ratios (dark blue) by deal size

BONDS, PROJECTS & COMPANIES HAVE HIGHER LEVERAGE RATIOS ON AVERAGE

Bonds (5.7), projects (4.5), and companies (4.4) yielded leverage ratios above the market average. Private capital accounted for the highest proportions of commercial capital leveraged amongst bonds (5.0, 88%), facilities (1.9; 57%), and companies (2.5; 56%), while commercial financing leveraged by fund structures appears to be sourced primarily from MDBs, DFIs, and philanthropic funders rather than the private sector (1.0; 28%). Private debt instruments are the most frequently deployed instruments in development finance and impact investing. Bonds, being relatively easy to design, negotiate, and enforce in most jurisdictions are particularly attractive to private sector investors.

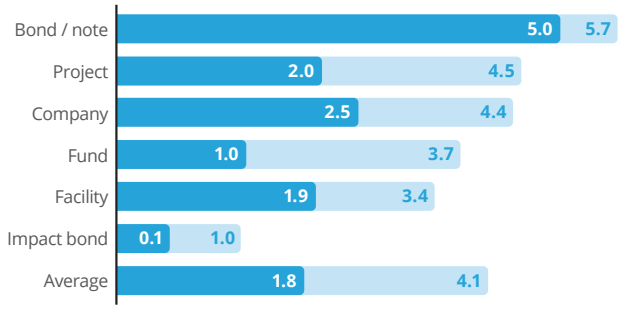

Figure 5: Average leverage ratios (light blue) and private sector mobilization ratios (dark blue) by vehicle type

INFRASTRUCTURE & RENEWABLE ENERGY SDGS HAVE THE HIGHEST AVERAGE LEVERAGE RATIOS

Blended finance is best suited to the subset of SDGs that can generate commercial revenues. The SDGs that have leveraged commercial financing at levels in line with or above the market average have been SDGs 9 (Industry, Innovation, and Infrastructure), 7 (Affordable & Clean Energy), 12 (Responsible Consumption), and 8 (Decent Work & Economic Growth). These SDGs, focused on infrastructure, renewable energy, economic growth, and job creation, have received the bulk of attention from investors in blended finance to date.

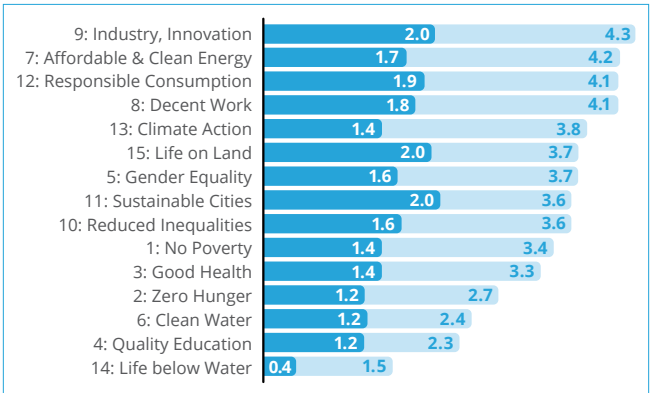

Figure 6: Average leverage ratios (light blue) and private sector mobilization ratios (dark blue) by SDG

CONCESSIONAL DEBT & EQUITY HAVE THE HIGHEST AVERAGE LEVERAGE RATIOS

The deployment of catalytic capital in the form of concessional debt and equity is the most common archetype in blended finance; it is present in 69% of all blended transactions. Among transactions containing concessional debt / equity, concessional commitments often take the form of investment-stage grants (17%), first-loss equity (12%), and subordinate debt (12%) (alongside other sub-instruments like technical assistance grants if the transaction includes additional archetypes). Concessional debt / equity has been the most effective archetype in leveraging commercial capital, with an average leverage ratio of 4.1. Transactions structured with guarantees (3.4), meanwhile, are considered capital efficient since guarantors do not make an immediate outflow of funds, yet their contingent commitment gives commercial investors the benefit of their credit ratings, projects' reduced risk profiles, and lower capital costs. Transactions structured with technical assistance facilities (3.1), design-stage grants (2.9), and results-based financing (2.8) have also leveraged commercial financing at levels below the market average (4.1). However, private capital mobilized as a proportion of total commercial financing has been similar for transactions structured with concessional debt and equity (1.8; 43%) and guarantees (1.5; 44%), and high for those structured with design-stage grants and results-based financing (both 1.5; 53%).

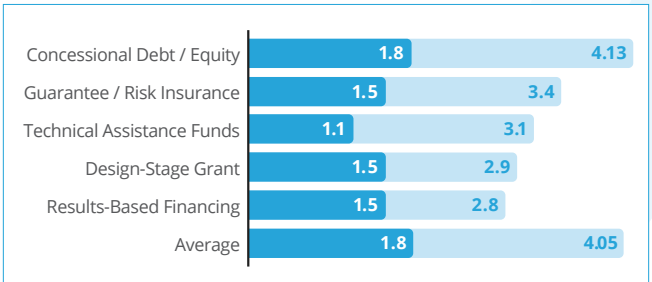

Figure 7: Average leverage ratios (light blue) and private sector mobilization ratios (dark blue) by archetype(s)

COMMERCIAL INVESTORS ORIGINATE DEALS WITH HIGH LEVERAGE RATIOS

Blended transactions originated or led by commercial investors (4.6) have had the highest average leverage ratios on average, followed by development agencies (3.9) and impact investors (3.7), while those originated or led by foundations / NGOs (2.9) have had the lowest. Foundations / NGOs as deal sponsors have also mobilized the smallest amount of private capital as a proportion of commercial financing leveraged (0.9 average private sector mobilization ratio; 29% of commercial financing leveraged). Private sector mobilization is not often an express goal of foundations; leveraging additional capital has been identified as one of five uses of catalytic capital, including facilitating innovation and safeguarding impact. Meanwhile, commercial investors (1.9; 42%), development agencies (1.5; 38%), and impact investors (1.6; 44%) as deal sponsors have mobilized similar amounts of private capital as proportions of commercial financing leveraged.

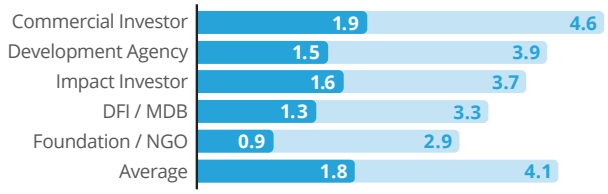

Figure 8: Average leverage ratios (light blue) and private sector mobilization ratios (dark blue) by deal sponsor type

DEVELOPMENT AGENCIES PROVIDE MOST CONCESSIONAL FINANCE

Development agencies, including multi-donor trust funds, provide the bulk (43% of all concessional commitments) of concessional financing to blended finance transactions. They are followed by DFIs and MDBs (27%), who most often operate on a commercial basis but can also act as providers of concessional capital sourced from specific pools of donor funding, and then by foundations and NGOs (21%). Meanwhile, commercial commitments to blended transactions have most commonly been sourced from commercial investors (41%) and DFIs / MDBs (34%). Private sector mobilization hasn't been mainstreamed within many donor governments, however, with only around 2-3% of official development assistance (ODA) allocated annually to private sector mobilization.

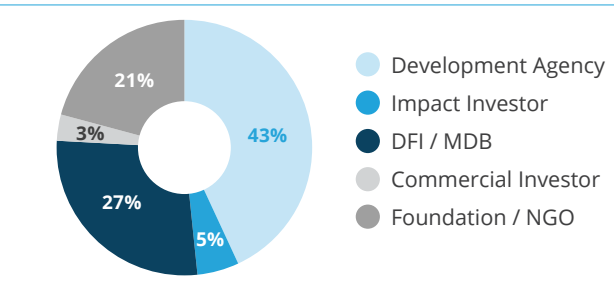

Figure 9: Concessional commitments to blended transactions, by %

Reflections

While leverage ratios are critical indicators, they should be contextualized alongside other factors when evaluating blended finance transactions. As others have noted, what leverage can be achieved depends on the country, sector, and past returns. For instance, high leverage ratios may indicate low hanging fruits and unnecessary subsidies, and thus low levels of financial additionality. Thinking beyond leverage, the concern of donors is more often focused on the question of whether transactions could have proceeded without catalytic financing, and if not, what was the minimum level of concessionality required? That is, what amount of catalytic capital is required to attract commercial investment and what forms of concessionality (seniority, returns, tenor, support with technical assistance, management fees, or other items beyond the capital stack) are most often needed?

Convergence has noted the need for the donor community to implement a strategy where a known amount of development funds can be allocated annually to blended finance transactions, with private sector mobilization made an essential pillar of their strategy. However, addressing the question of minimum concessionality will also require the donor community to publicly disclose blended finance data at the transaction level. The lack of disclosure by concessional capital providers of the financial terms and ex-post development impact of their transactions is hindering the provision of concessional funding by these same parties, who need this information to prove and benchmark the effectiveness of using ODA for blended finance.

Ultimately, to shift the focus of blended finance away from blending concessional capital with commercial capital from DFIs and MDBs towards effectively mobilizing private sector investment, donors will have to become more strategic, increasing the amount of ODA they allocate to private sector mobilization, instituting KPIs within DFIs/MDBs that reorient them towards private sector mobilization, and providing more data on the financial terms and ex-post development impact of their transactions.

Methodology & Notes

1. **Convergence's database:** Convergence maintains the largest and most detailed database of blended finance transactions that have reached financial close. Given the current state of information sharing, it is not possible for this database to be fully comprehensive. We have made efforts to capture all relevant blended finance transactions; however, there are likely to be more transactions that have not been captured.
2. **Deal selection:** The analysis contained within this brief is based on a sample of 340 blended transactions drawn from Convergence's database. The dataset only includes the transactions for which Convergence's database has recorded concessional and non-concessional investment values equal to at least 50% of the total transaction value. Transactions without information on total transaction value, concessional investment values, or non-concessional investment values, and outliers (i.e., leverage ratios above 20), were excluded from the dataset.
3. **Calculation of leverage ratio and mobilization rates:** i) Leverage ratios are calculated as the ratio of commercial capital to concessional capital, including commercial (i.e., non-concessional) capital from public, philanthropic, and private sources. ii) Private sector mobilization rates are calculated as the ratio of private commercial capital mobilized by each dollar of concessional capital. The word "concessional" in this report refers to investments bearing below-market risk-return.
4. **Target regions and countries:** Convergence tracks region and country data by stated region(s) and countries of focus at the time of financial close, not actual investment flows. Often, regions and countries of eligibility are broader than those explicitly stated.

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CONVERGENCE
BLENDING GLOBAL FINANCE

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.