



The GIZ Finance Guide

Navigating the world of finance

Imprint

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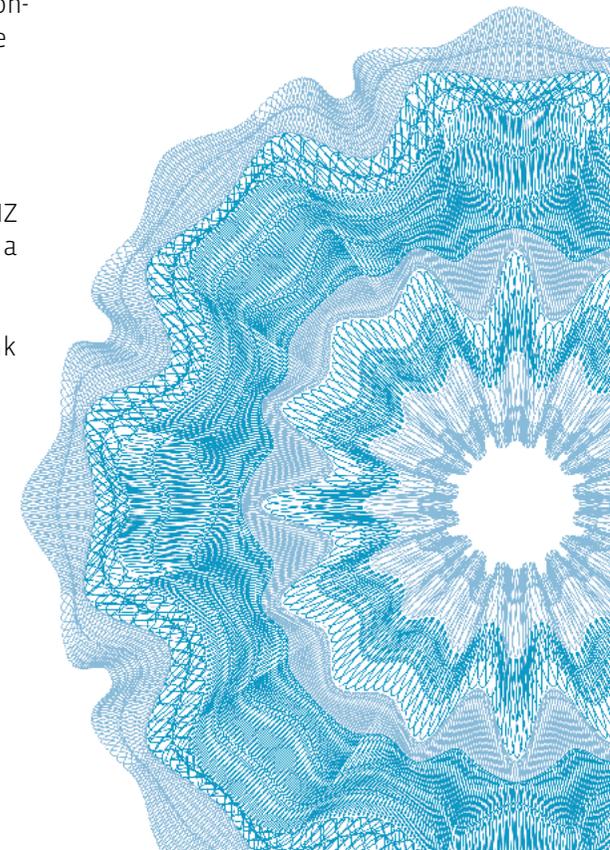
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List of abbreviations

ADB Asian Development Bank	GCF Green Climate Fund	MoFPED Ministry of Finance, Planning and Economic Development	SDG Sustainable Development Goals
AEPC Alternative Energy Promotion Center	GCPF Global Climate Partnership Fund	NAMA Nationally Appropriate Mitigation Actions	SIDO Small Industries Development Organization
AfD French Development Agency	GDP gross domestic product	NDA National designated authority	SME Small and medium-sized enterprises
AfDB African Development Bank	GHG greenhouse gases	NESP Nigerian Energy Support Program	SPV Special-purpose vehicle
AMC Advance market commitments	GIFTS Guimaras-Iloilo Ferry Terminal System	NPV Net present value	SRI Socially responsible investment
BEL Bujagali Energy Limited	GIIN Global Impact Investing Network	OBA Output based aid	USAID United States Agency for International Development
BFRIC Banking Sector Financial Reporting Standards Implementation Committee	ICMA International Capital Market Association	ODA Official development assistance	UNEP United Nations Environment Programme
BoU Bank of Uganda	IDA International Development Association	OPIC Overseas Private Investment Corporation	UNDP United Nations Development Programme
CARI Competitive African Rice Initiative	IDB Inter-American Development Bank	PFS Pre-feasibility Study	VPO Venture philanthropy organizations
CBM Central Bank of Myanmar	IFC International Finance Corporation	PRI Principles for Responsible Investment	WPU Wealth Preservation Unit
CDIA Cities Development Initiative for Asia	IFRS International financial-reporting and auditing standards	PV Present value	YUE Yangon University of Economics
CFI Cooperative financial institutions	IPO Initial public offering	RBF Results-based financing	
CFP crowdfunding platforms	M&A Merger-and-acquisition	RE Renewable-energy	
DCF Discounted cash flow	MDB Multilateral development bank	RECP Renewable Energy Cooperation Program	
DFI Development-finance institutions	MHDF Micro Hydro Debt Fund	ROA Return on assets	
EIB European Investment Bank	MHP Micro-hydro power	ROCE Return on capital employed	
ESG Environmental, social and governance	MIGA Multilateral Investment Guarantee Agency	ROE Return on equity	
FI Financial institutions			

Introduction to the Finance Guide

The Finance Guide is an introduction to the basics of commercial finance and investment in the context of development cooperation. The objective is to enable readers with limited or no prior exposure to finance topics to understand some key aspects in the public and private sector. Given the increasing importance of mobilizing private capital for development purposes, the Finance Guide is intended to provide orientation to the reader when considering the role of commercial finance in designing and implementing development programs. In addition, when working with

implementing partners or businesses looking for finance, the reader will be able to assume a more substantial role in supporting such local partners and entrepreneurs in developing bankable and investment-ready projects or businesses. Finally, the guide will help readers interact and communicate with financial-sector entities by providing the relevant concepts and terminology.

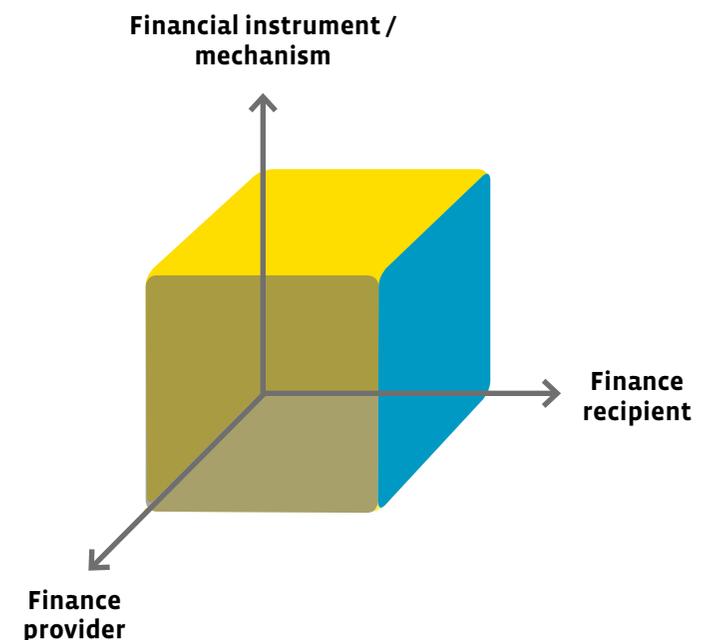
Finance is a complex topic, with several dimensions and levels. If imagined as a three-dimensional figure, actual financing activities would be located on the axis of the finance recipient, the axis of the finance provider and in the dimension of the actual financial instrument or mechanism used (see Figure 1). Additional details such as the economic sector, regional specifications and local regulatory frameworks add additional complexity to the picture. Disentangling these aspects into accessible and understandable pieces is the ambition of **Modules 1 to 4** of this guide. These chapters address the following questions:

- ▶ What is the overall finance landscape in which businesses operate?
- ▶ Who are typical finance recipients and what are their needs?
- ▶ What are the different types of finance providers? What are their

mindsets, and how do they differ in terms of specific interests and financial instruments?

- ▶ What finance mechanisms are used to link the above entities and factors in different levels of complexity?

FIG 1 Financial instruments, mechanisms, recipients and providers



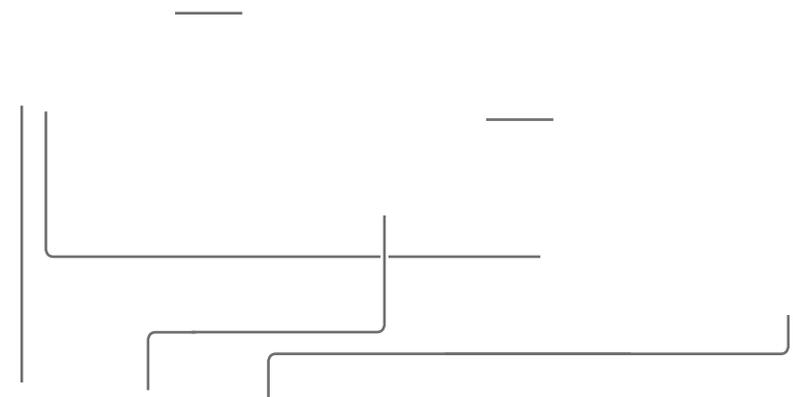
How to use the Finance Guide

The Finance Guide is designed in a modular way, allowing for selective or modular reading. However, readers are encouraged to increase their financial-sector knowledge by reading Module 1 and the introductory sections of Modules 2, 3 and 4 before diving into greater detail. The attentive reader may identify some redundancies, which are due to the modular approach and the intention of keeping individual sections independently readable and understandable.

In addition to the main text body, the Finance Guide features several boxes on specific standalone topics intended to provide quick and targeted answers on questions such as: “What is blended finance?”, “What is the Green Climate Fund?” or “What is the difference between corporate and project finance?”

Several experts from the finance and consulting sectors, as well as from within GIZ, have contributed to this guide. It therefore reflects a variety of experiences within and views of the financial world, a diversity that reflects the complexity of the topic itself. While considerable effort has been expended in seeking to provide content that is both comprehensive and reasonably detailed, we encourage readers to provide feedback if they believe important information or topics are missing. Since the world of finance is constantly evolving, this Finance Guide is by intention a living digital-only document, which can and will be updated on a regular basis.

FIG 2 Finance Guide structure



1

Understanding the finance landscape

Achieving the Sustainable Development Goals (SDGs) by 2030 will inevitably require vast investment. Considering the limited availability of public funds and the enormous investment needs, commercial finance and investment sources will have an increasingly important role to play.

However, many projects and firms in developing countries are not deemed bankable or commercially viable. The lack of a pipeline of bankable projects and firms constrains the deployment of available public and private funds, and limits progress with regard to economic development and the achievement of the SDGs. In addition, financial-sector activities within developing countries are often not well developed, which further constrains growth and development prospects.

This module provides an overview of financial sectors within developing countries, shedding light on the actors themselves, their interactions and the challenges often encountered in these contexts.



LEARNING OBJECTIVES:

- ▶ Obtain an overview of financial sectors within developing countries
- ▶ Recognize the key actors and their interactions within the financial sector
- ▶ Understand financial-market inefficiencies in developing countries
- ▶ Understand the role of financial service providers



THIS SECTION'S TOPICS:

- 1.1 The current development-needs finance gap
- 1.2 The financial sector

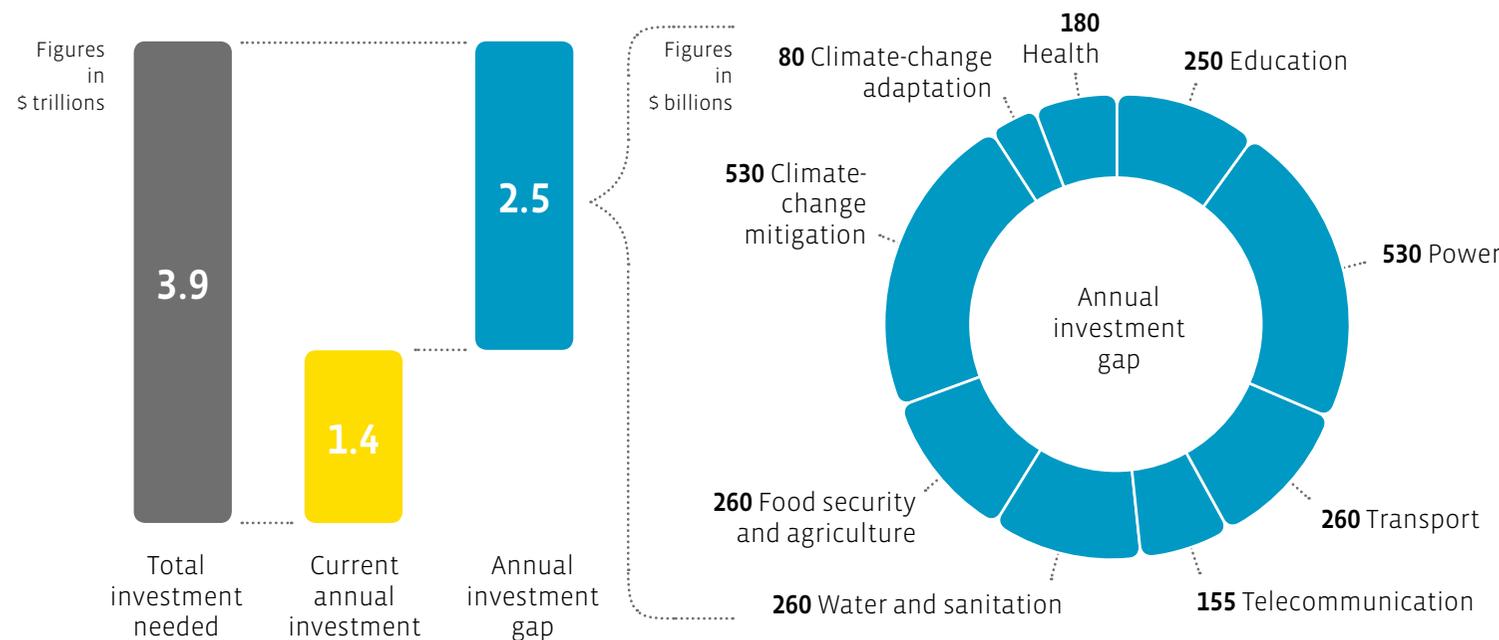
1.1. The SDG financing gap

Achieving the SDGs is expected to entail a very significant resource requirement. The gap between current funding levels across various SDG sectors in developing countries and the total amount expected to be needed is on the order of \$2.5 trillion¹ per year. However, there is a

potential for the global financial system, comprising various actors and institutions, to mobilize commercial finance and investment to bridge this SDG funding gap.

FIG 3 SDG financing gap

Source: UNCTAD (2014): World Investment Report



It is estimated that the private-sector share of investments in SDG areas will cover only \$900 billion^{1,2} of the \$2.5 trillion yearly gap, leaving a gap of \$1.6 trillion to be covered by the public sector (including ODA). However, the participation of the private sector in SDG financing in developing countries could potentially cover a larger part of the gap if the relative share of private-sector investment in SDG areas in developing countries increased to levels observed in developed countries.

1. UNCTAD (2014): World Investment Report. Retrieved from https://unctad.org/en/PublicationsLibrary/wir2014_overview_en.pdf. Accessed on 31.10.2017
 2. Please note that, unless otherwise noted, all dollar (\$) amounts listed are USD

1.2. The financial sector

The **financial sector** facilitates the flow of funds by pooling funds and channeling them into productive end uses. A well-functioning financial sector plays an important role in overall economic growth and development. It is comprised of **financial markets**, **financial intermediaries** and a number of other entities that either supply funds to other finan-

Actors contributing funds to the financial sector include households, businesses, governments and foreign investors. In addition, charities, non-profit organizations, development-finance institutions (DFIs) and multilateral development banks (MDBs) play an important role supplying funding in the sector within the context of developing countries. They contribute by providing loans, by making savings available, or by making investments or donations, for example.

Finance recipients draw funds from the financial sector and put it to various uses. Such entities can include households, business firms, governments, public-sector organizations or foreign companies.

Financial intermediaries play an important role by providing liquidity services, promoting risk sharing and solving information problems inherent in the financial sector. They help in improving economic efficiency by channeling funds from those who contribute funding to

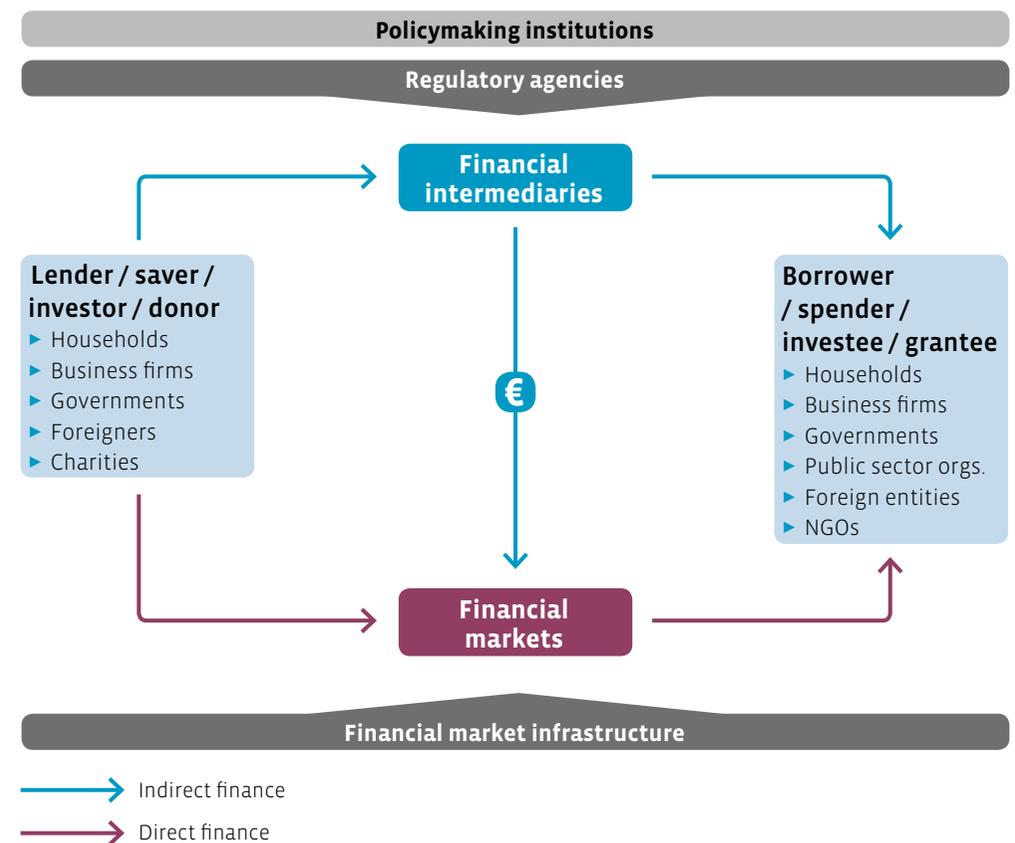
the financial sector to those with productive investment opportunities. These intermediaries include financial institutions that provide financial services for their clients or members, and are of several kinds, including:

- 1) **Depository institutions** (e.g., commercial banks, cooperative financial institutions, savings associations) that obtain funds mainly through deposits from the public; and
- 2) **Non-depository institutions** (e.g., finance companies, mutual funds, insurance companies, pension funds) that finance their investment activities from the sale of securities or insurance products and services.

There are two ways in which funds can be conveyed from the suppliers to the end recipients. In the case of **direct finance**, recipients receive funds directly from lenders, investors, savers or donors in financial markets, through specific financial instruments such as loans, bonds, equity, quasi-equity or grants. In

cial actors or draw funds from them for various purposes. Financial transactions take place among these various actors within the financial markets. **Financial institution** is also a widely used umbrella term to describe any actor engaged in the business of financial transactions, including financial intermediation.

FIG 4 The financial sector, adapted from Mishkin and Eakins (2012)



the case of **indirect finance**, funds can also be conveyed to end recipients by financial intermediaries that aggregate funds from primary savers or investors, and then in turn provide these funds to end recipients using a financial instrument. The interactions among the various actors in the financial sector are often facilitated by various service providers, and influenced by overall economic, political and regulatory factors.

The financial sector is generally tightly regulated. The objectives of this stringent oversight and supervision are to ensure the stability and efficiency of the financial system, to promote more transparency, and to prevent misconduct on the part of various actors. **Central banks** (e.g., the Deutsche Bundesbank in Germany) play an important role in regulating and supervising the financial sector, and particularly their local country's banking sector. However, there are also international standards, such as the Basel banking norms enacted by the Bank for International Settlements, which provide an international banking framework designed to ensure international financial stability and harmonize banking regulations in an increasingly globalized world. Similarly, **securities regulators** (e.g., the Securities and Exchange Commission in the case of the United States, or the Bundesanstalt für Finanzdienstleistungsaufsicht in Germany's case) oversee all capital-market transactions.

Lastly, an important part of the financial sector is the **financial infrastructure**. The World Bank defines this as “the underlying foundation for the financial system, including the institutions, information, technologies and rules and standards which enable financial intermediation.” Credit bureaus, collateral registries and payment-, remittance- and securities-settlement systems are all vital parts of a country's financial infrastructure. When financial infrastructure is available, efficient and reliable, the cost of financial intermediation falls. Financial products and services become accessible to greater numbers of citizens, while lenders and investors have greater confidence in their ability to evaluate and guard against risk.

BOX 1 The role of informal financial markets in developing countries

According to the World Bank, around 2 billion people globally don't use formal financial services and more than 50% of adults in the poorest households are unbanked.³ In developing countries, the informal sector plays an important role, ameliorating inefficiencies in the distribution of formal institutions.

Informal finance-sector service providers are typically non-institutional actors that are mostly self-organized and operate outside established regulatory or legal systems. They consist mainly of friends and relatives, local moneylenders, traders, pawnbrokers, and landlords. Informal financial-sector transactions are generally small, and are often found in contexts such as rural areas or informal city settlements, addressing issues such as agricultural contracts or small entrepreneurial ventures mounted by households or individuals. They rely on social networks to substitute for the lack of formal information or collateral, and to manage the risks that often prevent formal institutions from serving small-scale finance recipients. The International Finance Corporation estimates that 65 million formal micro, small or medium-sized enterprises (MSMEs) in emerging economies lack access to financing sufficient to enable them to thrive and grow.⁴ These MSMEs may rely on friends and families in order to meet immediate financing requirements such as working capital or capital expenditures. Only once they have developed a track record can they turn to formal sources of finance, if available, as provided by micro-finance institutions (MFIs), commercial banks, private-equity investors or venture capitalists.

In addition, informal markets operate directly in recipients' communities and have comparatively simple application procedures, swift financing-decision times and a focus on the local market, thus enabling them to address the needs of poor clients. However, borrowing within the informal sector can also have unfavorable outcomes for recipients. Such activity is often characterized by a high financing cost (e.g., high interest rates charged by local moneylenders, often known as “loan sharks”) and the lack of any legal recourse for borrowers.

3. Source: World Bank. Financial Inclusion. Retrieved from <http://www.worldbank.org/en/topic/financialinclusion/overview>. Accessed on 31.10.2017

4. Source: World Bank. Small and Medium Enterprises (SMEs) Finance. Retrieved from <https://www.worldbank.org/en/topic/smefinance>. Accessed 26.06.2020

1.2.1. Role of financial services

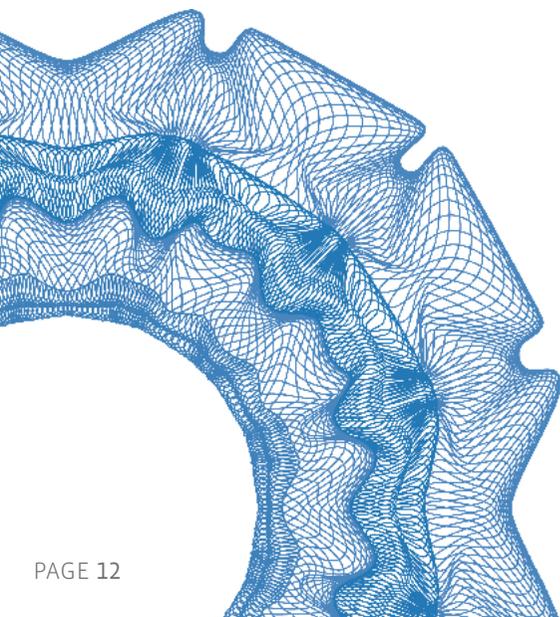
Financial services include a wide range of services that enable the financial sector to work efficiently. For example, they may facilitate the flow of market information, lend operational efficiency, match demand and supply,

enable better risk management, provide human capital, or provide policy and regulatory support. The table below lists some of the important roles played by these financial-service providers:

While the penetration of financial-service providers in developing countries is increasing, it remains low overall. This often deters various actors from participating actively in these market's financial sectors.

TABLE 1 Types of financial services

Role	Description	Example
Information provision	Finance providers need access to substantial information as they make decisions. This information helps them evaluate the potential for earning a return and understand recipient's inherent risk characteristics. Such information is often provided by organizations such as independent research institutions (e.g., industry / sector research), rating agencies or credit bureaus.	Standard & Poor's is a global rating agency that rates borrowing entities' ability to repay debt in a timely manner, as well as the likelihood of default. The other two large credit-rating agencies are Moody's and Fitch.
Brokerage	Brokers act on behalf of their clients to buy or sell securities through a stock market or over-the-counter for a fee or a commission. Clients can include but are not limited to households or other financial institutions. At times, brokers can also take on an investment-adviser role and provide their clients with advice on which securities to invest in. Brokers mostly operate in secondary markets.	Most large financial institutions (e.g., Deutsche Bank, JP Morgan, Goldman Sachs) offer a wide range of services including brokerage functions. In addition, many smaller firms offer only brokerage and / or investment-advisory services.
Investment banking	Investment bankers assist their clients (mainly firms and governments) in raising financing through the issuance of securities in the primary capital markets. This could include, but is not limited to, initial public offerings, private placements or bond issues. Investment bankers may also provide assistance in carrying out merger-and-acquisition (M&A) transactions or debt restructuring.	Large financial institutions also provide a range of investment banking services. Smaller institutions (such as boutique investment banks) often provide only a selection of such services.
Professional-services provision	Specialized service providers such as audit firms, business advisers, incubators and accelerators provide important services to various actors in the financial sector. Financial technology (fintech) companies are playing an increasingly important role in providing services such as digital payment systems, mobile banking, money transfers and fundraising.	Mobile wallet services such as M-Pesa (Kenya) provide an alternate digital payment system that allows people to carry out monetary transactions using their mobile phones.
Enabling markets	Market enablers operate at the ecosystem level and help in improving the capacities of other actors to catalyze market activity. Examples include educational institutions, knowledge-based organizations providing policy research and analysis, and professional networks.	The financial-infrastructure arm of the International Finance Corporation (IFC) helps to develop appropriate legal and institutional frameworks that in turn facilitate the establishment of institutions such as local credit bureaus and securities exchanges.



1.2.2. Financial-sector challenges in developing countries

A well-functioning financial sector pools and channels available funding so that it can be used productively. In addition to facilitating transactions, the financial sector serves a number of purposes including:

- ▶ Solving financial and risk-management problems;
- ▶ Allowing transactions to take place with low transaction costs (i.e., in an operationally efficient manner);
- ▶ Allowing transactions to take place quickly (i.e., providing liquidity); and
- ▶ Providing timely information (i.e., enabling informational efficiency).

Financial sectors in developed countries usually perform better on these parameters than do their counterparts in developing countries, providing for efficient and effective operations. In contrast, financial sectors in developing countries often face numerous challenges, as explained in Table 2.

TABLE 2 Financial sector challenges in developing countries

Challenge	Implication
High risk	Given a higher level of inherent risk, finance providers often look for higher returns in developing countries than in developed countries. If the risk-return profile is unattractive, the provider may decide to invest in safer assets such as government bonds or opt not to provide financing at all.
Information asymmetry (Information inefficiency)	Financial sectors in developing countries are often characterized by a lack of adequate information flow. This often results in information asymmetry between the finance provider and the recipient, and consequently more conservative behavior on the part of finance providers in their decision-making process.
High transaction costs (Operational inefficiency)	Financial-sector transactions in developing countries are often associated with high costs due to factors such as bureaucratic hurdles, red tape and monitoring expenses. High transaction costs result in diminished returns for providers.
Lack of financial infrastructure	In many developing countries, poor financial infrastructures make it difficult for financial institutions to expand their services and create risks for the financial system as a whole.
Low liquidity	Formal financial sectors in developing countries often lack liquidity, making it difficult for financial transactions to take place quickly without affecting the price of the financial asset being transacted. This particularly deters equity investors from participating in development-related projects, since they may not be able to exit their investment easily and may have to settle for lower than expected prices.
Underdeveloped financial markets	Financial markets in developing countries often lack supporting financial institutions and service providers that can help counter market inefficiencies by providing risk-management solutions, facilitating information flows or providing liquidity, among other tasks.
Unfavorable regulatory / policy framework	Weak, inappropriate or unstable laws, policies, regulatory frameworks and enforcement mechanisms can make it difficult for finance providers to operate or increase their perception of risk. For instance, a lack of property-rights enforcement, frequent changes in laws, or fuzzy and unclear legal frameworks could deter providers from participating in the financial sector.
Lack of appropriate financial instruments	In many cases, traditional financial instruments and mechanisms may not completely address the needs of finance recipients. While financing for large corporations may be relatively easy to find, there might not be suitable instruments available for financing MSMEs, along with a lack of expertise and/or willingness to serve this market segment.
Exchange-rate volatility	Local currencies in developing countries are often very volatile, meaning that their value vis-à-vis other currencies such as USD or EUR show substantial fluctuation. This can deter foreign finance providers whose returns from the provision of loans or equity investments can be affected by such fluctuations.

1.2.3. Role of DFIs in commercial finance

Development finance institution (DFIs) are institutions established and owned by governments with the mission of contributing to sustainable development goals in developing and emerging countries around the world. They provide finance, technical assistance and advisory services

The private sector is an important partner and co-funder in the context of development cooperation. However, to attract such private funding and involvement, DFIs need to play a catalytic role. Commercial banks may have no interest in financing a project or company if the proposed undertaking doesn't meet the bank's risk-return expectations even when it has strong expected social and development effects. The risk might be too high or the return too low. In addition, local commercial banks frequently contend that they lack the technical skills to understand and assess specific programs or business models, or they lack the financial flexibility to enter into higher-risk and longer-term financing, since their primary investment activity is holding or trading low-risk, short-term government bonds. Nevertheless, the involvement of the local financial industry is ultimately crucial in order to trigger a virtuous cycle of locally financed private-sector activities within an economy.

In cases when local financial entities are reluctant to participate, DFIs can use various tools to “adjust” the risk-return pro-

file of the program, investment or commercial activity in such a way that it fits the criteria of the private-sector capital provider. Such tools can include:

- **Furnishing guarantees:** DFIs can reduce the risk by providing (partial) credit guarantees for commercial loans. This protects local financial institutions against excessive losses in case of defaults.
- **Co-investing in structured finance arrangements:** DFIs can act as a co-investor in a fund structure, taking the first-loss tranche (thus, taking responsibility for all losses up to a specified amount). This reduces the participating bank's commercial risk and increases the commercial return.
- **Mobilizing blended finance:** Through so-called blended financing mechanisms, DFIs can provide additional financing instruments that reduce risks for the commercial finance provider and/or increase repayment times or flexibility for the finance recipients. For example, subordinated concessional mezzanine funding can

to companies, projects and governments. In addition to deploying public funds for the purposes of development, DFIs are increasingly seen as key actors in leveraging private capital to mobilize commercial finance.

be provided with extended grace periods and flexible repayment terms to give the commercial financing time to become effective and the business to pick up, or agreements can be made to convert a portion of the debt into equity capital if repayment is proving difficult or commercial banks have to be served first.

- **Providing equity investment:** DFIs can acquire direct equity stakes, becoming direct owners of a percentage of a company, project or a fund. The money provided for this purpose provides funding for the project, but also demonstrates a visible level of confidence in the project and provides other assurance for investors. DFIs pursuing this model thus engage in early-stage financing or co-financing in conjunction with venture-capital entities or impact investors until the business matures and becomes attractive and eligible for commercial financing.
- **Providing technical assistance:** In some cases, DFIs can help lower transaction costs and risks linked to new

projects or existing projects entering new territories. In some cases, they can also help improve the quality of the project itself, for example by funding impact studies, thus increasing the likelihood of success or expanding the development impact.

- **Funding investment grants:** DFIs can fund specific costs and activities, thus serving to decrease the costs paid by the project organizers and increasing the chances of success. This strategy is primarily used for purchasing or upgrading existing fixed capital such as tools or facilities. Some specific forms such as interest-rate subsidies can help lower the costs of finance.
- **Extending credit lines:** DFIs can provide credit lines to commercial finance providers to support specific sectors that are either of a high priority (e.g., climate-related activities) or often ignored by formal finance institutions (e.g., small-and-medium enterprises, or SMEs).

2

Understanding the needs of finance recipients

Financial markets are comprised of a diverse range of finance recipients and finance providers. The providers make financing available using various financial instruments including equity, quasi-equity, debt, bonds and grants. Finance recipients put financing to productive uses. However, the amount of financing, along with the suitability of the financial instrument and finance provider, will depend on several factors.

Before providing support to a company or public entity seeking to raise financing, a few basic questions must be addressed, such as the nature of the finance recipient, the purpose of the financing, and the amount and characteristics of the financing sought. Once all of these questions have been answered, finding a suitable finance provider will be easier (see Module 3).



LEARNING OBJECTIVES:

- ▶ Understand the differences between the various categories of finance recipients
- ▶ Understand the differences in the purpose of finance recipients' financing needs and what this means for financing amounts
- ▶ Develop a basic understanding of the differences between common financial instruments including equity investments, quasi-equity, bank loans, bonds and grants



THIS SECTION'S TOPICS:

- 2.1 Finance recipients and the purpose and amount of finance
- 2.2 Commonly used sources of finance and financial instruments

2.1. Finance recipients, and the purpose and amount of finance

Finance recipients include all entities that receive financing and put it to productive use. These recipients seek different amounts of financing and for different reasons. Table 3 below lists some of these entities, highlighting typical uses of acquired funds and desired financing

amounts. Understanding the type of finance recipient can help in identifying what sources of financing could be most suitable. However, it should be noted that some recipients (e.g., corporations) can in certain cases also act as finance providers.

TABLE 3 Types of finance recipients

FUNDRAISING ENTITY	Start-ups	Small and medium enterprises	Corporates	Investment funds	Producer cooperatives	Projects and PPPs	Public and municipal enterprises	Sub-national governments	National governments
PURPOSE	<ul style="list-style-type: none"> ▶ Establish direction & goals ▶ Market research ▶ Product, service, and / or technology development and launch ▶ Team creation 	<ul style="list-style-type: none"> ▶ Geographical expansion ▶ Technology and product upgradation ▶ Capital expenditure ▶ Working capital ▶ New product lines ▶ Trade finance 	<ul style="list-style-type: none"> ▶ Geographical expansion ▶ Capital expenditure ▶ Mergers and acquisitions ▶ Working capital ▶ Recapitalization / debt repayments ▶ Trade finance 	<ul style="list-style-type: none"> ▶ Capitalization of fund ▶ Technical assistance facility 	<ul style="list-style-type: none"> ▶ Input finance ▶ Harvest ▶ Equipment upgrades ▶ Risk mitigation and insurance 	<ul style="list-style-type: none"> ▶ Engineering, procurement and construction contracts ▶ Concession ▶ Operations and maintenance 	<ul style="list-style-type: none"> ▶ Funding public services ▶ Provision of local infrastructure services 	<ul style="list-style-type: none"> ▶ Finance operations ▶ Finance capital needs ▶ Repay previous lenders 	<ul style="list-style-type: none"> ▶ Finance operations ▶ Finance capital needs ▶ Repay previous lenders ▶ Macroeconomic stability (e.g., foreign currency mismatch or inflation etc.)
TICKET SIZE	\$	\$\$	\$\$\$	\$\$\$	\$	\$\$\$	\$\$\$	\$\$\$	\$\$\$\$
TYPICAL INSTRUMENTS	E G Q	E G L Q	B E G L Q	E	E G L	B E L	B L	B L	B L

B Bonds **E** Equity **G** Grants **L** Loans **Q** Quasi equity

Note: The list of purposes identified above is not exhaustive. The exact scope of financial need will vary depending on the context. The table above seeks to rank needs within a given context.

2.2. Commonly used sources of finance and financial instruments

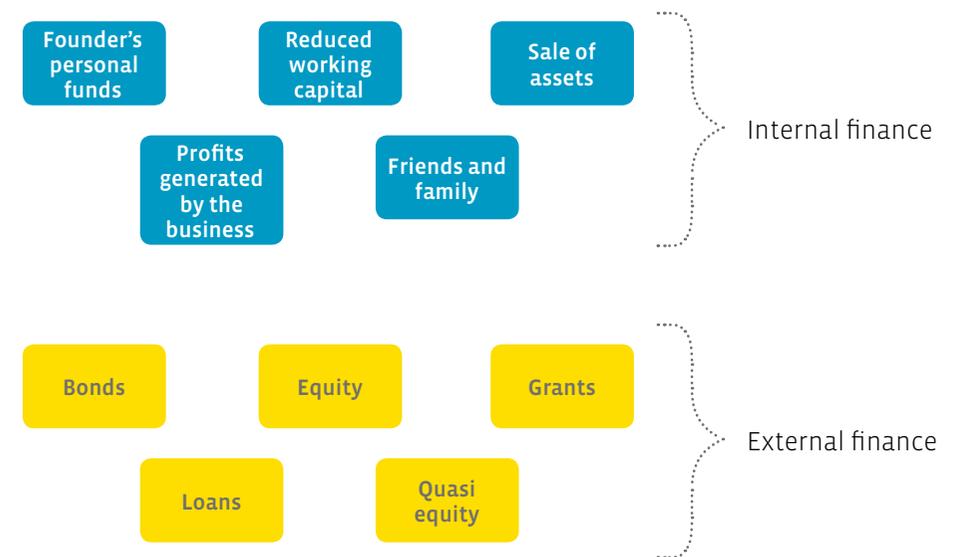
Potential finance recipients can generate financing through two channels: external and internal financing. The recipients could generate internal financing through their own operations, for example in the form of profits. For instance, a solar-lamp company could retain all profits earned by selling solar lamps and use these funds for financing its expansion needs instead of distributing the profits to its shareholders. Internal sources of finance could also include financing produced

Financial return (or simply “return”) is a term used to measure the reward received by a provider as specified by a given financial instrument. Return is usually measured in terms of a percentage of the original amount of funds provided per year, which is called the “rate of return.” For instance, if the value of the shares acquired through an equity-financing transaction of €100 increased by €5 after one year, the rate of return would be 5%. If the original finance provider sold these shares to another investor at this stage, it would be realizing the returns; by contrast, if it kept holding

the shares in expectation of additional returns in following time periods, the returns would remain unrealized. This type of return is called a capital gain (or loss), and is derived from the increase (or decrease) in the market value of the financial instrument, particularly in the case of equity, quasi-equity and bonds. The other possible way of being rewarded for an investment is through income returns, which are periodic cash payments by the finance recipient (e.g., loan interest, bond coupon payments, or equity dividends).

by the sale of existing assets or contributed by a business founder’s friends and family. By contrast, a potential recipient could also acquire external finance through various financial instruments such as equity investments, bank loans, bonds, quasi-equity and grants. These types of instruments are provided by an external individual or organization that in turn receives a reward depending on the nature of the instrument.

FIG 5 Sources of finance



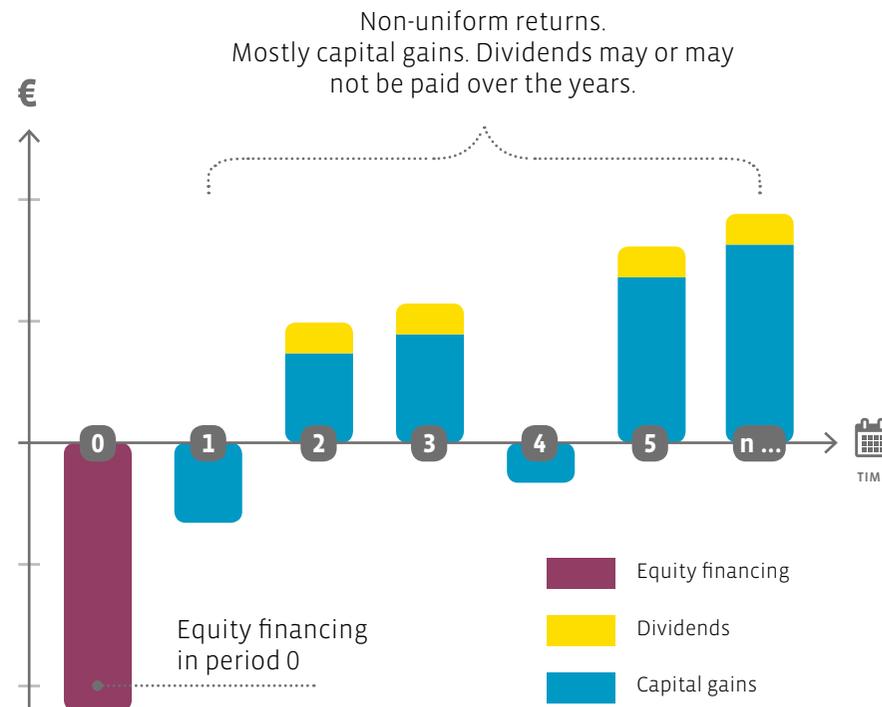
2.2.1 Equity

Equity investment is financing provided to the finance recipient by an investor in exchange for partial or full ownership of an underlying object (often a for-profit company), typically in the form of the acquisition of shares. Shares in the object are acquired by an investor based on an agreed-upon valuation (see Box 7). The provider (called a shareholder after acquiring the shares) can at a later stage either sell these shares to another investor or sell them back to the recipient in order to realize the gains, if any.

However, financial markets in developing countries, often have low liquidity and depth, making it difficult for the investors to exit their equity investments. In some cases, the recipient may also reward the shareholder by paying periodic cash payments called dividends, but this is usually the case only with large and established corporations.

This type of financing can take the form of either private or public equity. Private equity is provided through privately negotiated transactions between the provider and the recipient. Public equity, on the contrary, refers to financing raised from retail investors (or the general public) and institutional investors by offering the shares for sale on a stock market (also referred to as “listing” the entity) in an initial public offering (IPO). This is mostly done by larger companies. These companies, called public listed companies after the IPO, can subsequently approach the general public or private-equity providers for additional financing.

FIG 6 Equity returns



← The non-uniform returns associated with equity investments are due to the finance recipient’s fluctuating performance. The equity holder can sell shares at the current price/valuation at any point in time (subject to contract terms and liquidity restraints). However, while the provider may have return expectations based on ex ante assumptions, actual performance may turn out very different.

2.2.2 Bank loans

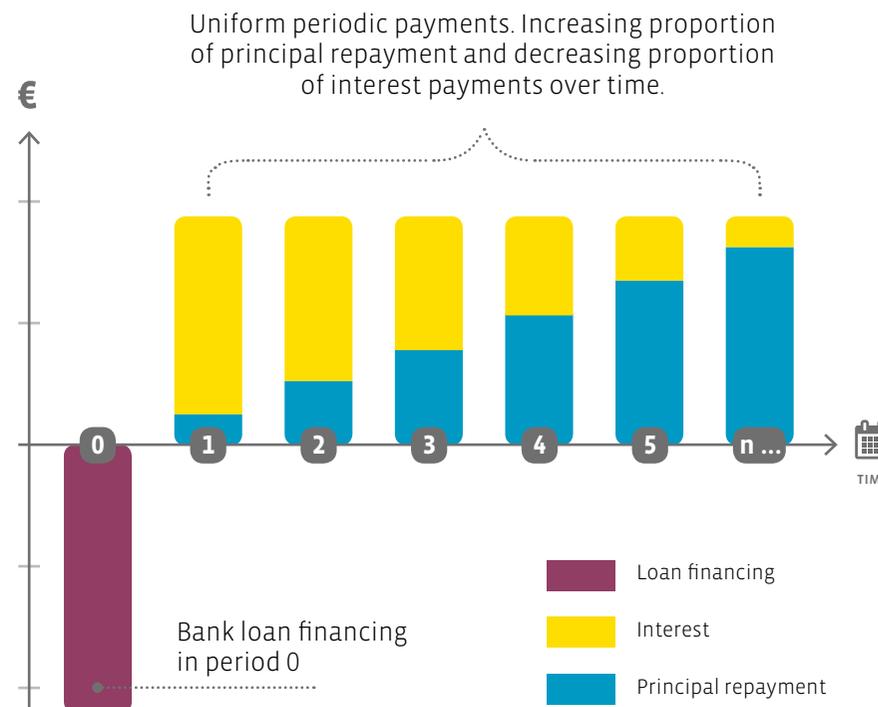
Bank loans are a type of debt instrument in which the amount (principal) borrowed from a bank must be repaid by the recipient with interest. Bank loans have a fixed time period for repayment, along with fixed or variable rates of interest that is payable periodically. Usually, repayment starts immediately after the loan is taken out by a recipient.

However, there might in some cases be a grace period (also known as moratorium period) during which no repayments are required, but during which interest nevertheless continues to accrue. Loans can be secured (which means the recipient's assets are provided as security or collateral) or unsecured (in which case no security is provided).

Bank loans are “senior” to equity financing – that is, loan repayment is given priority over repayment of equity and other financing sources if the loan recipient enters bankruptcy. In addition to commercial banks, other institutions such as corporations (in the form of intercorporate loans or deposits), development-finance institutions and microfinance institutions also provide loans.

In countries with low levels of economic development, commercial banks that provide bank loans tend to dominate the financial sector, while at higher levels, stock markets tend to become more active and efficient.

FIG 7 Loan repayment



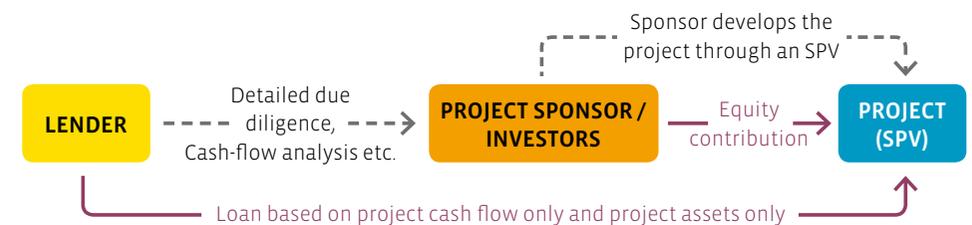
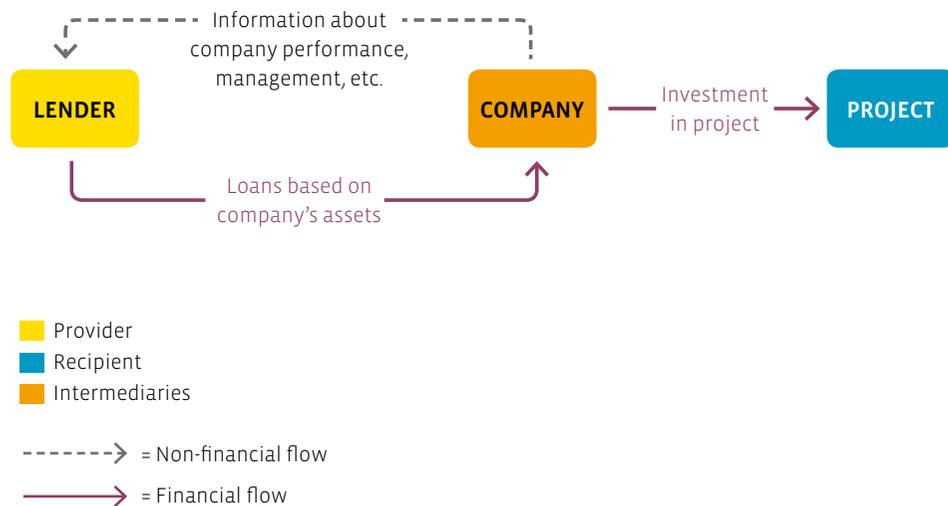
← The loan provider typically receives a pre-fixed payment from the borrower each year, which includes an interest component and a principal-repayment component. Over time, the principal repayment component of this sum increases, and the interest component decreases (due to shrinking amount of remaining principal). This is usually captured in the debt repayment schedule (or amortization schedule). However, some loans have repayment structures different than the one illustrated here. For instance, some may include a grace period (as explained in section 2.2) and/or a bullet-payment structure, in which the entire principal amount is due at the end of the loan term.

BOX 2 Project finance versus corporate finance

Companies commonly adopt one of two distinct approaches when raising external financing for project implementation:

1) Corporate finance: Also known as balance-sheet finance, corporate finance is the conventional way by which private companies raise financing for implementing projects. Under this model, the company obtains financing by demonstrating to finance providers, typically lenders, that it has sufficient assets on its balance sheets to use as collateral. The lenders have recourse to the assets of the company if the company defaults on the debt. In other words, the lenders can sell the company's assets and use the proceeds to recover their loans.

2) Project finance: In project finance, the financing is tied to a standalone and clearly demarcated project, and is backed by the cash flows generated from the project. It involves the formation of a new company by the private project developer (which can also be called a project sponsor) for the purpose of carrying out the project. Known as a shell company or special-purpose vehicle (SPV), this new company raises project-specific financing using a mix of instruments such as equity (from the project developer and/or other finance providers), bonds and bank loans. This mechanism allows for what is known as “ringfencing,” a situation in which the project's financing is decoupled from the project developer's assets and liabilities. Under this model, the finance providers have either no or only limited recourse to the assets of project developer in case of a default. In addition to private-sector projects, PPPs such as infrastructure projects typically raise funds through the project finance mechanism.



2.2.3 Bonds

Bonds, also known as fixed-income instruments, are a type of debt instrument in which the bond issuer (i.e., the finance recipient) borrows a sum from the bond purchaser (i.e., the finance provider), and returns that sum to the purchaser (or current bond holder) upon the maturity of

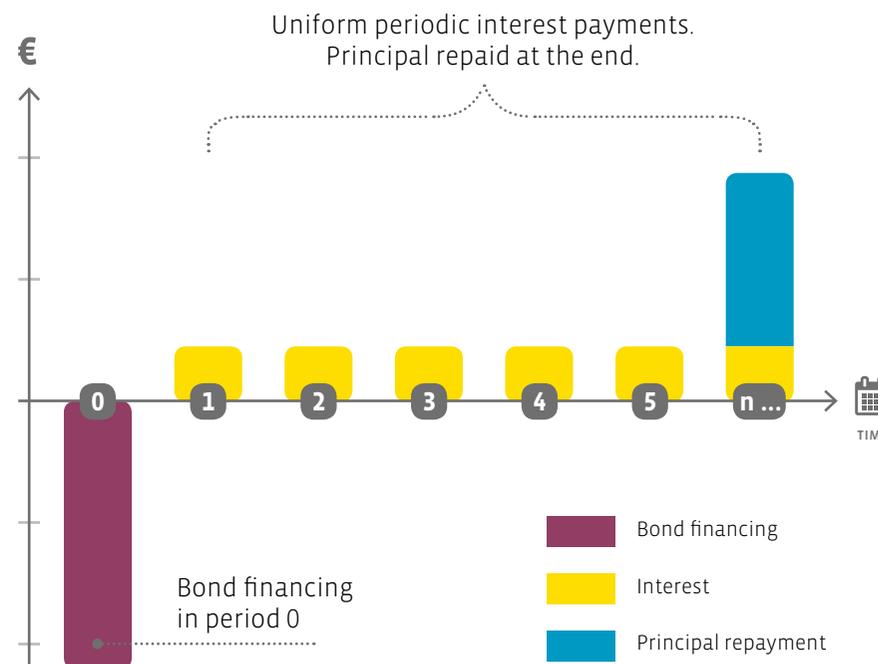
the bond, while additionally paying periodic sums of interest. Bonds are more commonly used in developed countries, but there is increasing use of this instrument in developing countries as well.

Bonds can be issued by various types of entities including governments, municipal organizations, state-owned enterprises (SOEs), and corporations. Bonds are increasingly also issued by commercial banks, DFIs and MDBs for specific purposes such as climate-change mitigation or social activities, and are then called “green bonds,” “social bonds” or something similar (see section 4.1.6). DFIs often play a catalytic role in helping to establish such new specific-purpose bonds.

There are two key differences between bonds and bank loans:

- ▶ Bonds typically have a longer duration than loans; and
- ▶ There is a market where bonds can be bought and sold among investors.

FIG 8 Bond returns



← For most bonds, the principal is not repaid until the end of the tenure – that is, when the bond matures. However, since the entire principal amount remains outstanding, the recipient continues to pay the same interest sum (usually called the “coupon”) every year until that point. Other models are also possible; for example, a finance recipient may not be required to pay any interest until the bond is fully mature. All interest would then be cumulative, and paid along with the principal.

2.2.4 Grants

Grants are financial transfers typically provided by the public sector, charitable organizations or foundations. The money does not have to be repaid and is usually exempt from tax. Grants can fill financing gaps

Grant financing is often restricted to the implementation of a specific project, rather than being applicable to broader uses such as general operating or capital expenditures.

Grants providers use various strategies to disburse grants. These could broadly be classified as follows:

Responsive grantmaking: Responsive grant providers are open to accepting unsolicited proposals from potential recipients which fall within the mission and guidelines of the provider. The provider waits for proposals and is less likely to initiate new programs. Such grant-making, in effect, allows the recipients to drive the agenda.

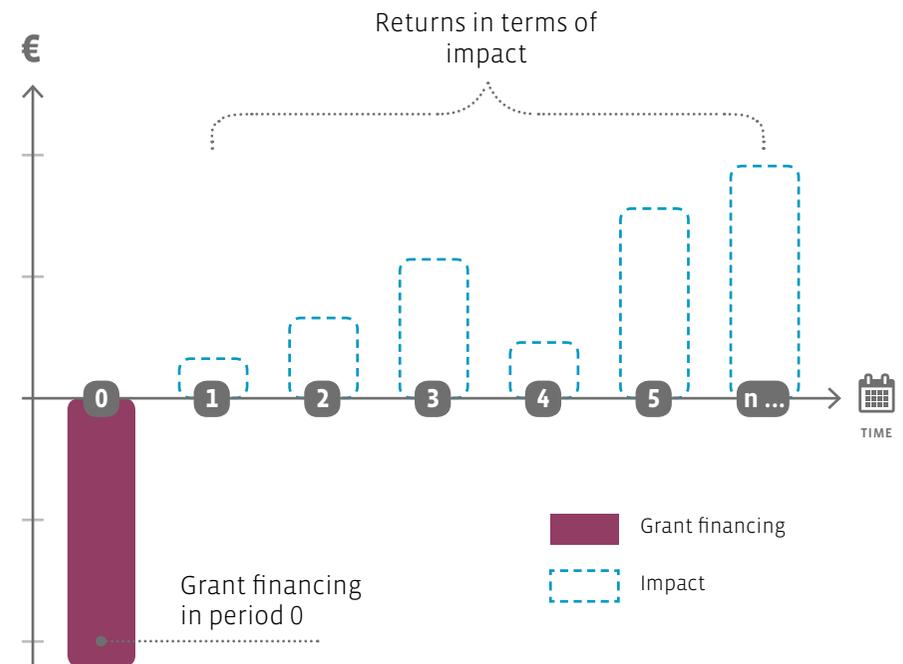
Proactive grantmaking: Proactive grant providers have more focused goals and strategies for accomplishing those goals. In these cases, it's often the grant provider who drives the agenda. In order to identify potential recipients, the provider issues a request for proposal or contacts the potential recipient directly.

It is also common to find grant providers who use approaches which combine features of proactive and responsive strategies.

Grant providers do not expect any financial returns. However, they closely monitor the development impact of programs they have financed. For the purposes of this illustration, the impact is quantified and depicted as a “return” – in fact there is no financial return to the grant provider.

when other sources of capital are not easily available or accessible. They can also be used in structures such as results-based financing or blended finance.

FIG 9 Grant returns



2.2.5 Quasi-equity

Quasi-equity (or mezzanine finance) is a collective term for instruments that combine the features of debt and equity instruments. Technically, this falls under the category of debt taken on by a company, but also

Repayment depends on the recipient's future performance or cash flow. This alternative is often used when neither debt nor equity financing are available or desirable options.

Examples of quasi-equity include:

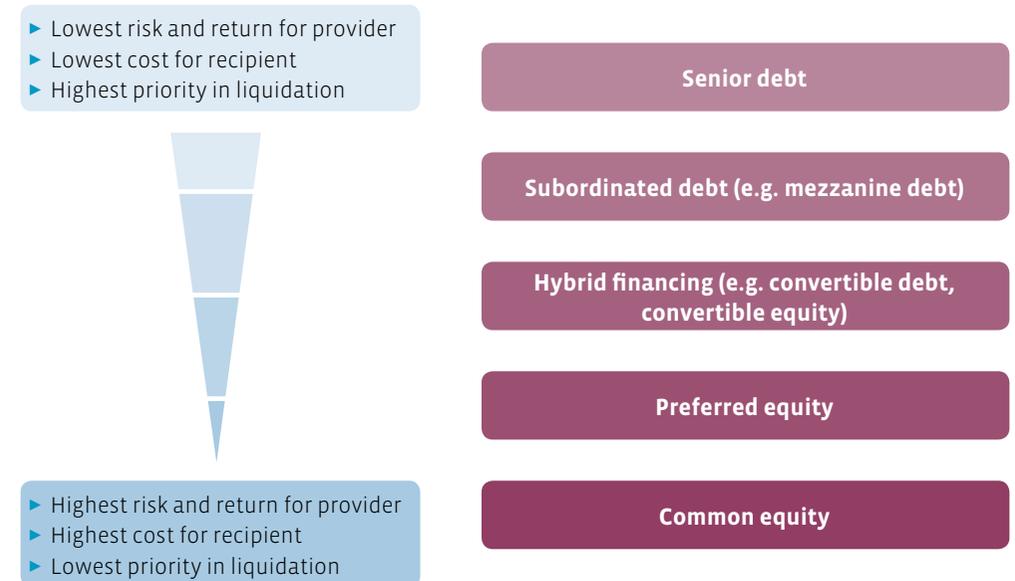
- ▶ Convertible bonds, which are a type of bond that can be converted into shares of common stock in the issuing company, or into cash of an equivalent value;
- ▶ Subordinated loans, which are loans that take a lower repayment priority than bank loans (in case of bankruptcy) but provide priority over equity investors.

Typically, the returns earned on quasi-equity are higher than those on traditional bank loans, and lower than those on equity investments.

The returns on quasi-equity are based on the design of the instrument and the performance of the recipient.

has some of the characteristics of equity financing, such as flexible repayment options or a lack of collateral requirements.

FIG 10 Quasi equity



2.2.6 Differences between financial instruments

Financial instruments vary significantly with regard to aspects such as their effect on ownership, level of operational influence, costs, risks, degree of liquidity and tenure (the typical time the investment is held, or before repayment is due). Determining the suitability of a specific financing instrument thus entails an evaluation of the finance recipi-

ent's characteristics, needs and limitations. The table below presents a comparative overview of key financial instruments and various parameters that need to be kept in mind when deciding on an appropriate financing instrument. These instruments can be used alone or in combination with each other.

TABLE 4 Comparison of financing instruments⁵

	Equity investment	Quasi-equity (Mezzanine finance)	Bank loans	Bonds	Grants
Acquisition of ownership	Yes	Sometimes	No	No	No
Board representation	Sometimes	No	No	No	Sometimes
Strategic support	Sometimes	Sometimes	No	No	Sometimes
Risk sharing taken by finance provider	High	Medium	Low	Low	-
Form of returns for finance provider	Gains/losses following resale of shares (based on increase/decrease in share prices); dividends	Interest payments; if debt converted into equity, then also gains/losses based on increase/decrease in share prices	Interest payments as annual percentage of principal	Fixed interest payments, possible market-based sale of bond to other investors (with gains based on changes in market price of bond)	No monetary returns expected
Cost of financing (or cost of capital)	\$\$\$\$\$	\$\$\$\$	\$\$\$	\$\$	-
Tenure	Usually 5 – 7 years	Flexible repayment schedule	Depends on the purpose (can be as low as a few months, and as high as 15 years or longer)	Mostly long-term, but bonds with shorter tenures also exist	Not applicable
Use of funds	Mostly unrestricted	Mostly unrestricted	Often restricted	Sometimes restricted (e.g., for green bonds, only certain uses of proceeds are eligible)	Generally restricted

⁵ Please see Annex for a more detailed version of this table.



Finance providers

Finance providers mobilize financing and pass it on to the recipients. They take numerous considerations into account in this process. These considerations differ based on the type of provider.

This module is focused on understanding the perspective of finance providers and delves into some major aspects of the financing processes pursued by the providers. It first provides an overview of risk and return considerations used by finance providers in their decision-making procedures, and then profiles different types of finance providers based on their preferred financial instruments, targets, approach to risk, return and impact, and typical financing process.

The finance providers profiled in this section include private equity funds, angels and venture capital funds, commercial banks, development finance institutions, micro-finance institutions, cooperative financial institutions, pension and sovereign funds, corporates, and venture philanthropists and foundations.



LEARNING OBJECTIVES:

- ▶ Understand the meaning of returns, and how financial instruments provide returns
- ▶ Understand the roles of risk and risk management, as well as the relationship between risk and the expected level of returns
- ▶ Understand the nature of relevant commercial and non-commercial finance providers



THIS SECTION'S TOPICS:

- 3.1 The mindset of commercial finance providers
- 3.2 Risk considerations made by finance providers
- 3.3 Profiles of select commercial and non-commercial finance providers

3.1 Mindset of commercial finance providers

The trade-off between risk and expected return is the most fundamental consideration for a finance provider. In the commercial finance world, risk implies the chance that the actual return will be different

The risk-return trade-off is the balance between the desire for the lowest possible risk and the highest possible return. A typical finance provider pursues one of the two following strategies:

- ▶ Maximizing the returns for a given level of risk; or
- ▶ Minimizing risk for a given level of returns.

Risk levels will vary depending on the type of finance recipient and/or the instrument being used. Correspondingly, the cost at which the financing is provided will to a great extent depend on the provider's perception of risk. For instance, a bond issued by the German government entails a much lower risk (thus offering a lower return) than one issued by the government of a developing country, because the repayment ability of the latter might be constrained by economic or political factors. Similarly, the higher risk associated with equity financing as compared to debt financing implies a higher capital cost (as well as higher return expectations) even if the recipient is the same. These factors

may also motivate certain finance providers – generally those who are willing to accept higher risk levels in search of higher rewards (or returns) – to invest in developing countries or in comparatively high-risk instruments.

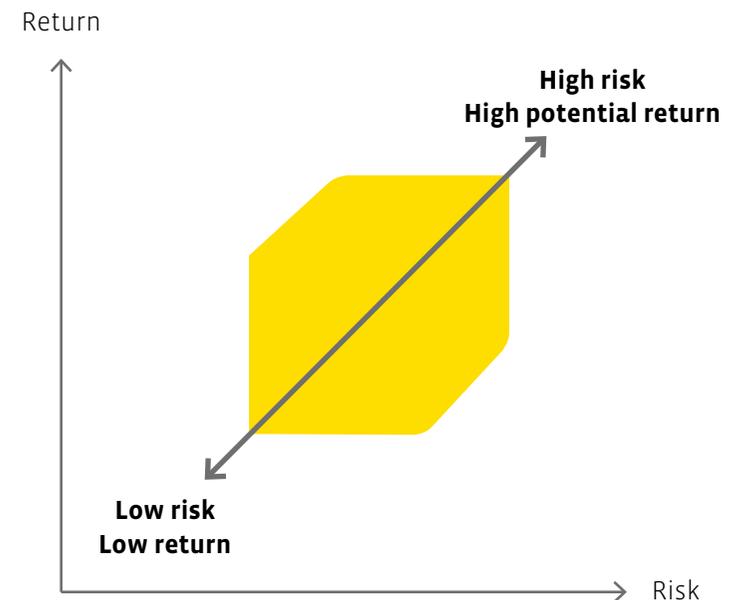
Finally, risk perception on the part of finance providers can in many cases be detached from the actual risk inherent in a finance recipient. Transparent and reliable information and data are often not readily available in developing countries. In addition, providers may lack the experience and ground-level knowledge about developing countries necessary to make an accurate assessment. All of these factors may lead providers to overestimate risk levels. As a consequence, they may either act conservatively while providing financing, or apply a high price tag for what is provided.

than expected. Low levels of uncertainty (low risk) are usually associated with low potential returns and vice versa.

While the risk-return trade-off dominates the decision-making process for most investors, a third dimension – impact – can be added to the calculus if the investor also takes into account the economic, environmental and/or social impact made by the investment proj-

ect. Although this is by no means common practice, it is an aspect becoming increasingly relevant for various types of investors, and is also making an appearance on political agendas pushing for implementation of the SDGs and the Paris Agreement goals.

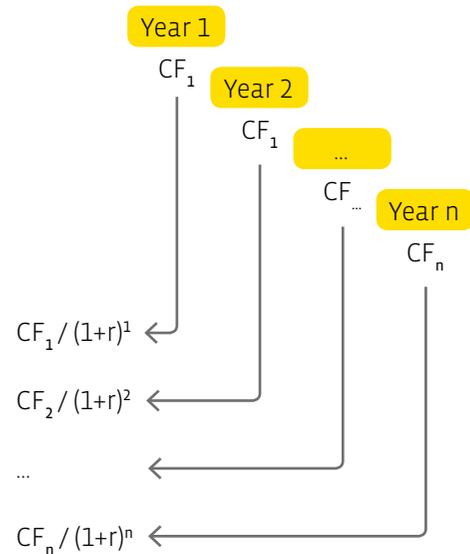
FIG 11 Risk-return trade-off



BOX 3 Cash-flow analysis and net present value

A technique called net present value (NPV) analysis is commonly used to determine a project’s prospective financial return and likelihood of profitability.

Net present value analysis compares a project’s expected future gains with the investment required for the project.



The present value (PV) calculates the current worth of a stream of cash flows expected to be earned sometime in the future. To arrive at the present value, the future cash flows are simply discounted by an appropriate discount rate. This is visually demonstrated in the adjoining figure in which cash flows in year 2 (i.e., CF₂), for example, are discounted by (1+r)²; where “r” is the appropriate discount rate, which is usually based on the cost of capital. It can be mathematically expressed as:

$$\text{Present value} = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \dots + \frac{CF_n}{(1+r)^n}$$

CF_n=Cash flow in period n
r=discount rate

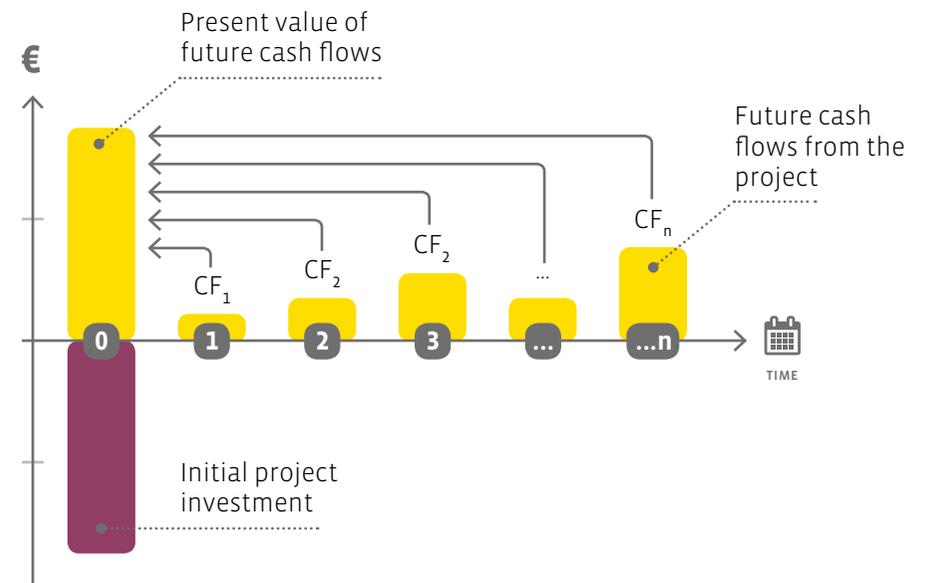
Present value relies on the assumption that receiving a sum of money now is worth more than receiving the same sum sometime in the future. This is because receiving that sum of money today enables the recipient to save, invest or lend the money, thus receiving an additional return in the future.

The NPV is an extension of the present value concept, and is often used to analyze the financial viability of projects.

It is calculated simply as the difference between the present value of future cash flows and the initial investment made for the project. This is demonstrated in the adjoining figure. A positive NPV – that is, a condition in which the present value of future cash flows is greater than the initial project investment, indicates that the expected financial gains from the project exceed its costs.

Generally, an investment with a positive NPV will be a profitable one, and one with a negative NPV will result in a net loss.

NPV analysis is often used when making project investment decisions. Projects that have a positive NPV are more likely to receive financing.



3.1.1 Impact Investing

Impact investments are investments made in companies, organizations or funds with the dual goal of achieving a measurable positive social and/or environmental impact and of earning a financial return. Impact

Investing is a relatively new term, used to describe investments made across many asset classes, sectors, and regions. The growing impact investment market provides capital to address the world’s most pressing challenges in sectors such as sustainable agriculture, renewable energy, conservation, micro-finance, and affordable and accessible basic services including housing, health-care, and education.

According to the Global Impact Investing Network (GIIN) core characteristics of impact investing are:

- **Intentionality:** The investor’s intention is to achieve a positive social or environmental impact, as opposed to the singular focus on financial returns as in the case of traditional investments.
- **Return expectation:** Impact investments are expected to generate positive financial returns on their initial investments, or at minimum generate the return of the initial investment (i.e., recovery of the original amount invested, with no additional returns).

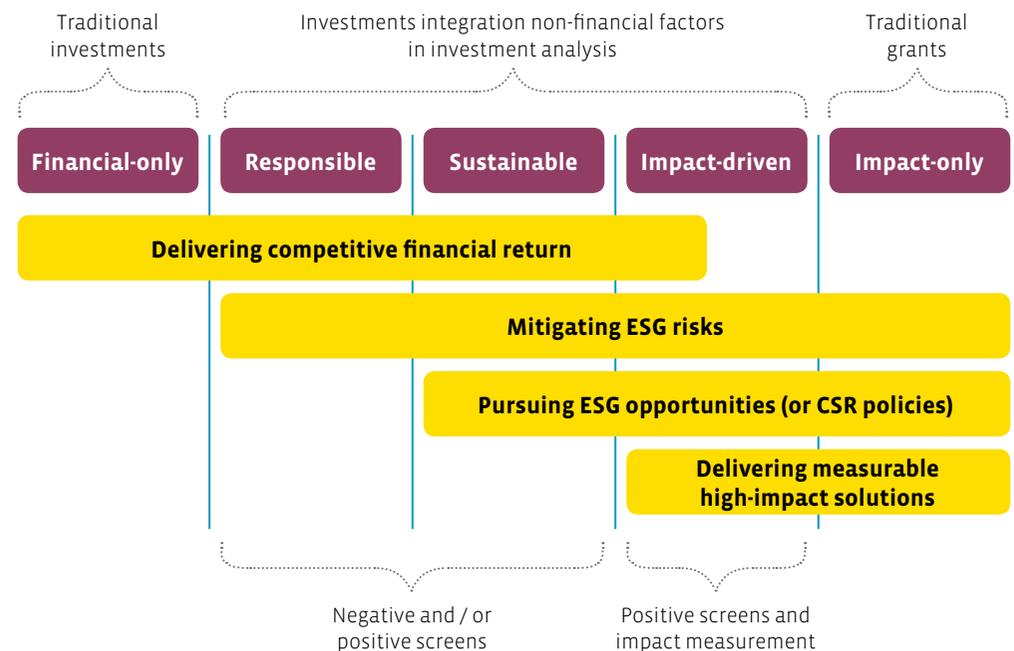
- **Range of return expectations and asset classes:** Impact investments can be made using a range of instruments (equity, loans and quasi-equity) expected to earn a financial return, thus taking the form of private debt or private equity. Return expectations may thus range from below-market to market rates. This distinguishes impact investments from donations or grants that do not yield financial returns, and where the initial provision of capital is not paid back to the finance provider.

- **Impact measurement:** In contrast to investors that make sustainable or socially responsible investments by using decision factors such as the use of exclusion lists to avoid negative effects (e.g., by avoiding investment in tobacco-related companies), preferences for best-in-class-approaches (e.g., investing in the car manufacturer with the lowest CO₂ emission rates), or preferences for sustainability-oriented sectors (e.g., renewable energies), impact investors measure and report the social and/or environmental performance of their investments.

investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending on investors’ strategic goals.

According to the GIIN, almost \$502 billion is managed by impact investors globally.⁶ The main investment fields are sustainable agriculture, health, financial services, renewable energy and energy efficiency, and affordable housing.

FIG 12 Overview on investment profiles and the impact investment bracket



6. Source: GIIN (2019). Sizing the Impact Investing Market. Retrieved from https://thegiin.org/assets/Sizing%20the%20Impact%20Investing%20Market_webfile.pdf. Accessed on 26.05.2020

BOX 4 Company valuation principles

Valuation is the process of determining an enterprise's current worth. It is particularly useful in determining the price of each equity share of a company. Individual share values are obtained by dividing the total value of a company by the total number of equity shares. This can also be interpreted in terms of percentages. For instance, a 5% share of a company whose worth is determined to be \$100 million would be \$5 million. Two of the most commonly used techniques for valuation of companies are discounted cash flow and comparable company analysis.

1) Discounted cash flow (DCF) analysis

In principle, DCF analysis is similar to present value analysis. An enterprise generates cash from sales revenues, loan proceeds, investment returns and the sale of assets, and loses cash due to operating expenses, debt repayments, and the purchase of assets, among others reasons. When valuing a company using this method, certain assumptions are used to estimate the total volume of net cash flows in future years. These cash flows are then discounted by an applicable discount rate that reflects the cost of capital for the company in question. Mathematically, this can be expressed as:

$$\text{DCF value} = \frac{\text{CF1}}{(1+r)^1} + \frac{\text{CF2}}{(1+r)^2} + \dots + \frac{\text{CFn}}{(1+r)^n}$$

CFn=Cash flow in period n
r=discount rate

2) Comparable-company analysis

The second widely used method relies on a comparison with the metrics of other businesses with similar attributes such as size, industry, type of goods produced, or services offered, and region served. The basic premise is that the value of a company should resemble that of other similar companies within a similar category. The analysis thus starts with selecting a peer group consisting of similar companies, and then proceeds by comparing the company in question to the peer group. This comparison typically entails examination of several key financial ratios, including:

- Enterprise value – EBITDA ratio: Known as the enterprise multiple, this is obtained by dividing the entire value of the business by its total earnings before interest, tax, depreciation and amortization (i.e., EBITDA).
- Price-to-earnings ratio: Often known as the price multiple or earnings multiple, this ratio compares the current share price of a publicly listed company to its earnings (i.e., profits) per share.

Several other profitability ratios are also used for valuations. These could include return on equity (ROE), return on assets (ROA), return on capital employed (ROCE), and return on investment, among others.

3.2 Risk considerations made by finance providers

In daily life, risk is usually presumed to be something that should be avoided at all costs. In the finance world, however, risk is inseparable from financial performance. It is one of the most important considerations for any finance provider. Finance providers form their return expectations and determine the cost at which to provide financing

based on their perceptions of risk inherent in a potential finance recipient, firm or project. Based on the types of risk identified, specific risk mitigation mechanisms can be applied and may in some cases also be required by the finance providers.

Risk and cost of capital

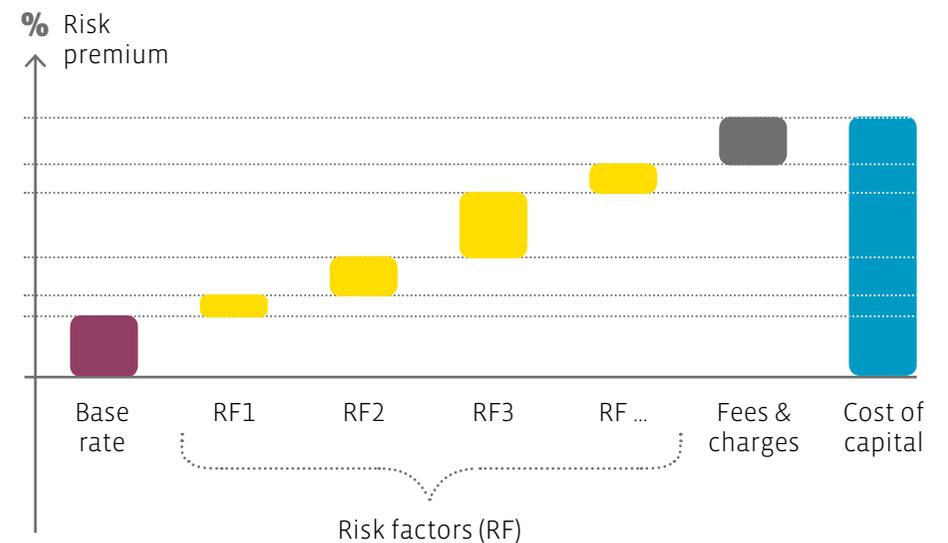
Risk levels are closely associated with the cost of capital. Higher levels of assessed risk will lead to higher expected returns and higher financing costs in order to compensate for the risk. It is for this reason that most finance providers expect to earn higher returns in developing countries, where risks are perceived to be comparatively high, than would be true for a similar financing transaction in developed countries.

The overall risk can be broken down into various different risk factors. Finance providers may ask for a different degree of compensation, called a risk premium, for each individual risk factor. These premia are then added to the risk-free rate or base rate to arrive at the total cost of capital. This is called risk-based pricing, and is illustrated in Figure 13.

The risk-free rate is the return earned by investing in instruments that are considered free from credit risk, such as gov-

ernment bonds with an excellent credit rating. While the existence of risk-free rate is easily observable, estimating risk premia for the various risk factors mentioned above requires finance providers to make numerous assumptions, and will also be influenced by the specific nature of the finance recipient. Factors evaluated will likely include (but will not be limited to) country risk, business risk, industry risk, management risk and currency risk.

FIG 13 Risk premia and the cost of capital



BOX 5 Sovereign ratings and credit risk

One way of estimating the level of risk inherent in an investment is to use the ratings issued by credit-rating agencies such as S&P, Fitch and Moody's. Different agencies use different scales and methodologies to assign ratings to a broad range of entities, both public and private, that raise debt financing.

Ratings are essentially the agency's assessment of the probability that the entity will meet its debt obligations in time and in full. For instance, when a government raises debt financing, these risks are reflected in sovereign ratings produced by rating agencies. The adjoining table presents the long-term ratings assigned to several countries, with "AAA" reflecting the best-possible credit quality, and "CC"/"CCC+" close to the worst (rating agencies also assign a "D" rating, which is the lowest rating and reflects failure in meeting debt obligations. However, none of the countries in the table has been assigned a "D"). Sovereign credit ratings also reflect the investor community's opinion regarding the state's capacity to repay lenders. As can be seen from the table, most developing countries have lower credit ratings than developed countries. This implies that developed-country govern-

ments usually have access to finance in the international market on better terms than their counterparts in developing countries.

Similarly, credit ratings are also assigned to companies raising funds through debt instruments such as bank loans or bonds. These are known as corporate credit ratings and just as in case of sovereign ratings, these also reflect the opinion of the credit rating agency about the likelihood that the company will repay its debt obligations in time and in full. Though different rating agencies adopt different rating methodologies for assigning corporate credit ratings, in principle, they try to assess the adequacy of company's future cash flows and investments to meet the debt obligations when they fall due. In order to do so, rating agencies assess the business and financial risk that the company might be exposed to. The estimation of business risk, for instance, could encompass the evaluation of strengths / weaknesses of the operations of the company (including market position, geographic diversification, sector strengths / weaknesses, market cyclicity, and competitive dynamics). The financial risk could encompass

evaluation of the financial flexibility of the company (including: total sales and profitability measures, margins, growth expectations, liquidity, funding diversity and financial forecasts).

However, it must be noted that ratings are only one way of estimating risk. Many companies, particularly small ones, do not have outstanding credit ratings. Finance providers thus use internal rating systems in addition to the external ratings, when available.

Long-term credit ratings⁷

Country	Fitch	S&P
Bangladesh	BB-	BB-
Bolivia	BB-	BB
China	A+	AA-
Colombia	BBB	BBB+
Congo (DRC)	CC	CCC+
Egypt	B	B-
Ethiopia	B	B
Germany	AAA	AAA
Ghana	B	B-
India	BBB-	BBB-
Indonesia	BBB-	BBB-
Kenya	B+	B+
Mexico	BBB+	-
Namibia	BBB-	-
Nigeria	B+	B
Pakistan	B	B
Rwanda	B+	B
South Africa	BB+	BBB-
Sri Lanka	B+	B+
Uganda	B+	B
USA	AAA	AA+
Vietnam	BB-	BB-

7. Long-term credit ratings as of 19 September 2017. Selected countries.

Types of risk

Finance providers are exposed to multiple sources of risk, which they in turn weigh differently. All sources of risk can impinge on financial instruments' performance, in that they can result in lower-than-expected returns or even the complete loss of the sum provided as financing. The willingness and ability to accept risk (jointly called "risk appetite") varies among providers. Moreover, different recipients possess different risk characteristics, all of which can be exacerbated in developing countries.

The overall risk faced by finance providers can be divided into two categories:

1) Systematic risk: Systematic risk is macro in nature, and influences all potential finance recipients in a given country. It arises due to factors over which a recipient has no control. Sources of systematic risk could include political, regulatory or macro-economic factors (e.g., inflation risk, currency risk, interest-rate risk). For example, political instability and the resulting uncertainty could have a profound effect on all businesses operating within the country; alternatively, a strong depreciation of the local currency could undermine investment returns as imported machines or input factors become more expen-

sive for the company (since more local currency will subsequently be needed to buy the same amount of the foreign currency needed to pay for imports).

2) Unsystematic risk: Micro in nature, this is sometimes also referred to as "specific risk." These risk factors are related to the unique characteristics of the finance recipient or the sector in which the recipient operates, and thus affect only the company in question or a small number of similar entities, not the entire market. Possible examples include:

- Business risk that arises due to the likelihood of future employee strikes against a specific company, thus threatening future revenues. Business risk that arises due to business cycles or technological changes resulting in lower-than-expected sales.
- Credit risk that arises due the inability of a recipient to repay any borrowed amount.
- Industry risk that could arise due to industry cycles or government policies that affect recipients within a given industry.

Commercial finance providers will only invest in assets with comparatively high levels of risk if they expect to be rewarded in the form of returns greater than those associated with lower-risk assets.

► **Finance-recipient perspective:** Potential finance recipients should incorporate measures reducing inherent risk characteristics as early as possible. When conceptualizing new projects or initiatives, entities seeking funding should carefully analyze all potential risk factors associated with their new project or initiative. This is particularly relevant for unsystematic risks that are unique to the potential finance recipient. This can help in the development and implementation of measures aimed at mitigating some of the risk elements, and can also lead to a more focused approach when looking for financing. Arranging for a financial guarantee from a credible actor, thus reducing default risk, may make it easier to raise financing and reduce the cost of capital. However, third-party risk-mitigation instruments should be only the closing element of a broader risk-minimization strategy. Potential finance recipients must fully understand their inherent risk before they can qualify as a partner for risk allocation with third parties.

► **Finance-provider perspective:** Various strategies for managing and mitigating financial risks are available to finance providers. For instance, a bank providing a loan may ask for a security (or collateral) in the form of the finance recipient's land and building. Finance providers such as private-equity funds may mitigate some risk by providing financing to recipients with differing risk profiles, thus balancing high-risk with low-risk investments. This is known as diversification. Insurance, derivatives and guarantees are other mechanisms that providers use to mitigate risk. The key message is that different providers have different levels of return expectations and risk appetites that need to be carefully considered by a recipient while looking for financing.

Risk-mitigation mechanisms

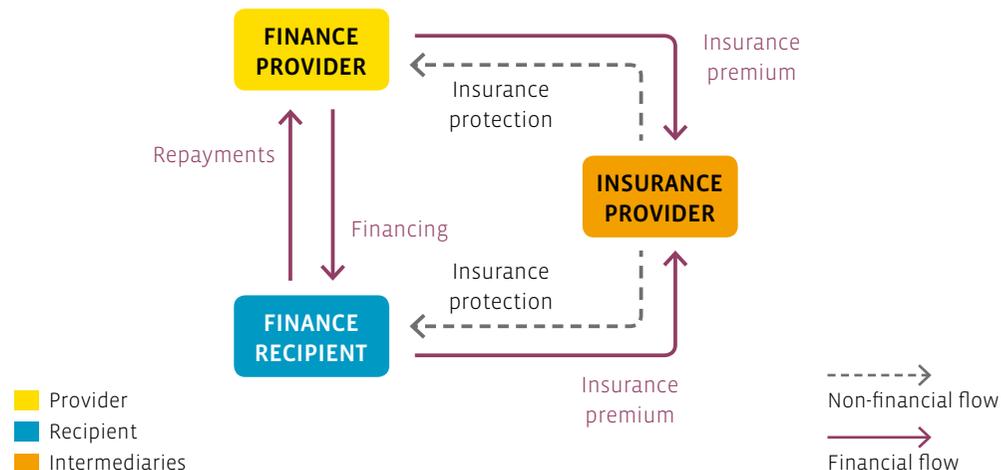
Risk-mitigation mechanisms transfer certain defined risks from finance providers to other parties (e.g., guarantors or insurers) that have a better capacity to accept such risks. The availability of appropriate risk-mitigation mechanisms allows private-sector providers to shed risks perceived as excessive, beyond their control, or otherwise unacceptable. By redistributing or reducing the level of risk, appropriate risk-mitigation mechanisms increase the chances that commercially viable but comparatively high-risk projects will obtain financing. However, there is no one-size-fits-all risk-mitigation mechanism able to eliminate all risks associated with a financing agreement. Insurance and guarantees are the most commonly used risk-mitigation instruments. DFIs and other specialized financial institutions can also provide guarantees and various insurance products.

1) Insurance: Insurance provides protection against potential financial loss. The buyer of insurance-based protection pays a sum of money, known as an insurance premium, to the insurance provider to buy protection against financial losses emerging from a set of predefined events. The contract between the insurance buyer and insurance provider also stipulates the extent of loss covered (i.e., the sum insured) and the duration for which the protection is provided. Insurance products can be designed for a range of purposes. As shown in the figure, for example, finance providers can

purchase insurance cover against certain events (or risks) that threaten the recovery of their investments. For instance, political-risk insurance can provide investors, lenders, contractors, exporters and NGOs with insurance protection against currency inconvertibility, expropriation, political violence and other more targeted risks. Insurance protection can also be purchased by a potential finance recipient. For instance, a technical insurance policy can provide protection to a project under construction or to installed machinery or equipment. Several additional examples of relevant insurance products are listed below.

- The African Trade Insurance Agency offers trade-credit insurance covering non-payment risks (credit default), and political-risk insurance that covers expropriation, currency inconvertibility and exchange transfer cover, contract frustration, political violence and trade embargoes.
- The Overseas Private Investment Corporation (OPIC) provides insurance products covering losses to tangible assets, investment value and earnings that result from political perils such as currency inconvertibility, expropriation and political violence.
- Germany’s Euler Hermes Kreditversicherung provides political-risk coverage for trade if the German trading partner applies for protection. Economic risk can also be covered if a local partner from a developing country applies. This includes credit-default-risk coverage.
- Numerous private insurance companies (e.g., Alexander Forbes) also cover systematic risks such as credit-default risk.

FIG 14 Insurance mechanism



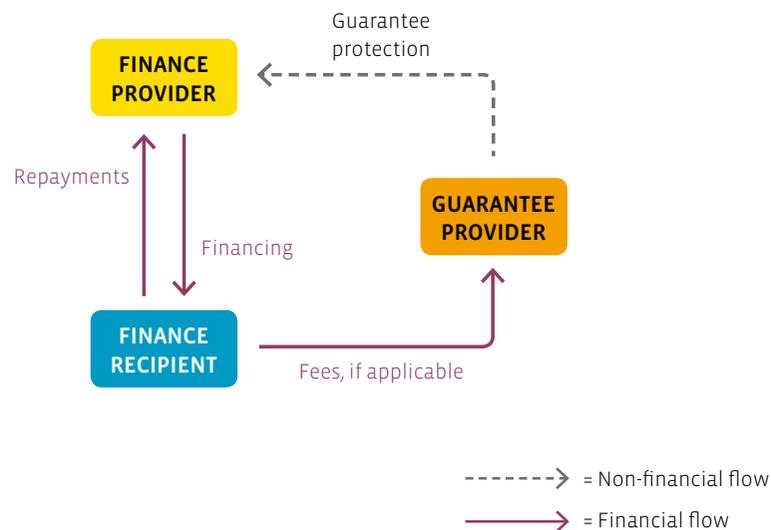
2) Guarantees: A guarantee is a promise of performance to a beneficiary – in this case to a finance provider – in the event that the finance recipient fails to meet contractual payment obligations toward that beneficiary. Guarantees can cover political and/or commercial (e.g., credit, regulatory/contractual) risks that investors are unwilling or unable to bear. Developmental guarantees help in mobilizing private resources for development purposes. They facilitate funding flows to developing countries and

high-risk sectors, and thus mobilize additional resources beyond what financial markets would normally provide. They are thus a comparatively efficient use of scarce public funds. As demonstrated in the figure, a recipient might have to buy a guarantee against predefined risks before a provider makes financing available. However, the guarantee provider could also be a DFI that provides a guarantee to the finance provider without any fees. Several examples of relevant guarantee mechanisms are listed below.

- GuarantCo is a special guarantee facility which provides local-currency guarantees to infrastructure projects in low-income countries in order to mitigate credit risks for local banks, thereby promoting domestic infrastructure financing and capital-market development.
- The Multilateral Investment Guarantee Agency (MIGA), a part of the World Bank Group, provides guarantees for large investments regarding force majeure risks, but also has a Small Investment Program and a Private Equity Fund Insurance (limited to political risk) offer; while the agency does cover barriers to the conversion and transfer of currency, it does not cover currency-exchange risks.

- The African Guarantee Fund, aimed at small and medium-sized enterprises, is oriented toward the mitigation of transactional risk, offering guarantees addressing conditions such as a lack of collateral or a lack of solvency, or a need to strengthen SME management skills. Requests for guarantees must be submitted by the financial institution providing the financing.
- Currency-exchange risk is hard to calculate, and can have a direct impact on the profitability of a cross-border investment in the short term. There is also no general solution to counter this. The Currency Exchange Fund (TCX) was set up by DFIs as one means of addressing the risk, but can be involved only if a DFI is a co-financier.

FIG 15 Guarantee mechanism



3.3 Profiles of select commercial and non-commercial finance providers

Different finance providers have different risk appetites and return expectations. As a consequence, they provide financing via different financial instruments that reflect these differences. In addition, depending on the type of financing provided and the nature of the pro-

vider's operations, approaching different providers entails different processes, which are summarized in the following sections. The table below provides an overview of finance providers and the instruments they typically use to provide funding.

TABLE 5 Finance providers and typical financial instruments

		FINANCIAL INSTRUMENTS				
		Equity capital	Quasi equity	Loans	Bonds	Grants
FINANCE PROVIDERS	1. Private equity funds	●	●			
	2. Angels and venture capital funds	●	●			●
	3. Commercial banks			●		
	4. Development finance institutions	●	●	●	●	●
	5. Microfinance institutions			●		
	6. Cooperative financial institutions			●		
	7. Pension and sovereign funds	●			●	
	8. Corporates (venturing)	●	●	●	●	●
	9. Venture philanthropists and foundations	●	●			●

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COST OF CAPITAL

3.3.1 Angels and venture capitalists

Angel and venture-capital investors acquire shares in start-up companies. They usually want to resell the shares thus obtained after two or three years, and move on to the next start-up company. Hence, exit scenarios – that is, descriptions of how and when the investor will be able to sell its shares – may be included directly in the investment’s terms

TYPES:

Angel investors can be individuals, also called “business angels,” or specialized investment companies (acting on behalf of other angels and venture capitalists) or funds. So-called incubators also play a significant role as angel investors. In addition to financing, they provide infrastructure and technical assistance that helps start-up entrepreneurs create a business.

In many cases, incubators are publicly funded or co-funded with the aim of promoting entrepreneurship. In sub-Saharan Africa, for instance, more than 50 incubators have emerged and gained significance over the course of the last decade; the World Bank’s InfoDev organization alone maintains 12 in the region.⁸ In Tanzania, the Small Industries Development Organization (SIDO) maintains one incubator in each of the country’s 19 administrative regions.

Another category that has emerged in recent years is company builders, which provide professional technical assis-

tance in business-model design and development, seed funding, fundraising support and other services.

Venture-capital providers are usually organized as specialized investment companies or funds. They usually have a well-structured professional team in place that includes finance and management experts, as well as industry specialists.

PREFERRED FINANCING INSTRUMENTS:

Angel investors provide financing shortly after, during or even before the process of incorporation. Since the investee usually lacks revenues at this stage, it is typically difficult to find an entity that will provide debt-based financing (with its attendant repayment obligations). Hence, angel investors usually provide equity capital in return for shares, and join the founders in sharing risk. Investment volumes can be as low as \$5,000 to \$10,000. Some private angel investors provide grants of similar amounts.

and conditions. In this regard, establishing this “how” can be particularly challenging for young developing-country companies that are not listed on a stock exchange, as it can be difficult to find follow-up investors or financiers.

Venture-capital investors usually work purely on an equity basis, without providing grants. As they enter the process at a later stage than angels, they don’t share the seed-stage risk; however, since the start-up has typically passed the proof-of-concept phase by the point of their entry, these entities are typically confident enough to provide larger investments of up to several hundreds of thousands of dollars.

IDEAL TARGET:

Ideal targets for angel investors and venture-capital companies are usually innovative technology-driven companies with a unique selling proposition and a capable founder and team. Angel investors and venture capitalists try to identify the champions of tomorrow, and would rather invest in an original innovator than in adopters or replicators during the process of up-scaling. This is important to consider when engaging in an up-scaling program.

RISK-RETURN APPROACH:

The ambition of angel investors is to identify promising innovative companies and support them as they become ready for market. Since angels invest in the venture’s initial and early stages, they take on the same substantial level of risk as the founders. Hence, their goal is to maximize their financial return after the venture has developed to a stage where it generates a continuous stream of revenues, potentially even before it becomes profitable. Strong and fast growth in revenues will give follow-up investors confidence that the venture has the capability to reach profitability, thus increasing the price per share and maximizing returns for existing investors seeking to sell their shares. The risk-return profile of angel investors and venture investors varies in such a way that angel investors actually take on a higher level of risk by entering at the seed stage, and consequently expect

higher returns. Venture-capital investors take on a lower level of risk by entering at a later stage of the company’s development; their rate of return will thus be more moderate, but can still clearly exceed 20% per year.

Q APPROACH TO IMPACT:

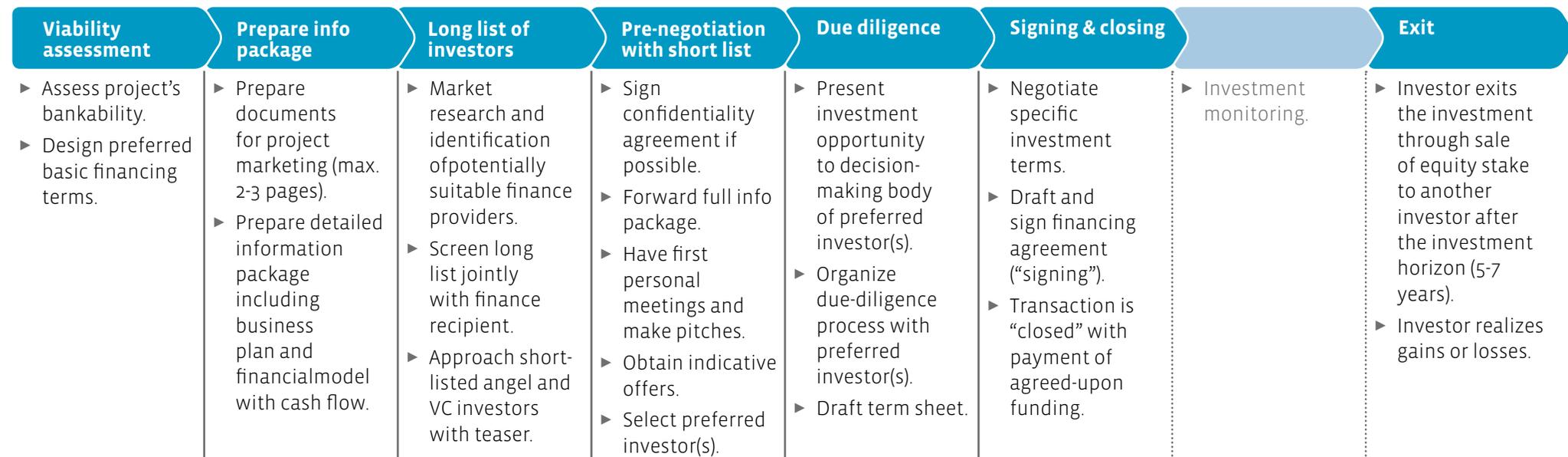
Traditional angel and venture-capital investors are typically above all interested in financial returns, and usually focus primarily on developed-world countries with developed financial industries in order to facilitate exit strategies and secondary markets (i.e., markets in which shares in companies not yet listed on a stock market can be traded). In the developing world, they often compete with venture philan-

thropy, public grants and investors with a broader mindset. The need for innovative business models able to solve social problems in developing countries, for example through innovations in health care, information technology, agribusiness or renewable energies, has in some cases attracted impact-oriented high-net-worth individuals and specialized impact-investment companies that provide business-development assistance and financial resources to early-stage ventures. Sub-Saharan African incuba-

tors often focus on specific impact-related themes such as climate change or ICT.

FIG 16 Financing process (Angels and venture capitalists)

FINANCING PROCESS



3.3.2 Private-equity funds

Private-equity (PE) investors buy shares in a company in return for the capital provided. The relationship between the financing amount and the percentage of shares acquired depends on the company's financial valuation. Private-equity investors usually invest at a later stage than venture-capital investors; they are more comfortable providing funds

TYPES:

Private-equity providers typically have one of two different motivations. Financial investors buy and sell shares as their core business activity, taking a medium-term investment perspective, while strategic investors are more typically established business-sector companies seeking to grow their operations over the long term through the acquisition of competitors or newcomers. Financial investors may seek to specify an exit scenario when negotiating the terms and conditions of an initial investment, especially in developing countries.

Private-equity capital providers are usually organized as specialized investment companies or funds, and usually have a well-structured professional team in place. The providers may themselves take the form of limited liability companies or funds, but also appear as trusts, holding companies, and public limited or listed stock companies. In terms of investment

strategies, private-equity funds may act either as growth equity funds (i.e., seeking investments in slightly later-stage companies that are already generating significant revenue and are looking to increase the scale of their operations) or buyout funds (i.e., seeking investments that give them controlling stakes in large and mature companies).

PREFERRED FINANCING INSTRUMENTS:

Private-equity investors usually provide pure equity investment. However, as they enter the growth process at a later stage than do angel or venture capitalists, other instruments such as quasi-equity sometimes become applicable. Indeed, quasi-equity is preferred by some new entrants in developing countries or risky environments that want to start with a lower risk profile, but who also want the option of staying involved over the longer term.

when the investment has matured enough to generate a steady flow of revenues, or has even reached profitability.

Private-equity investment is obtained through privately negotiated transactions between the provider and the recipient.

Investment volumes in developing countries may start at \$100,000, and rise to several millions of dollars per investment. Larger sums can be obtained when several entities invest together, which is also called a “club deal.”

IDEAL TARGET:

Ideal targets for private-equity investors are established companies with a proven business model and strong growth potential.

RISK-RETURN APPROACH:

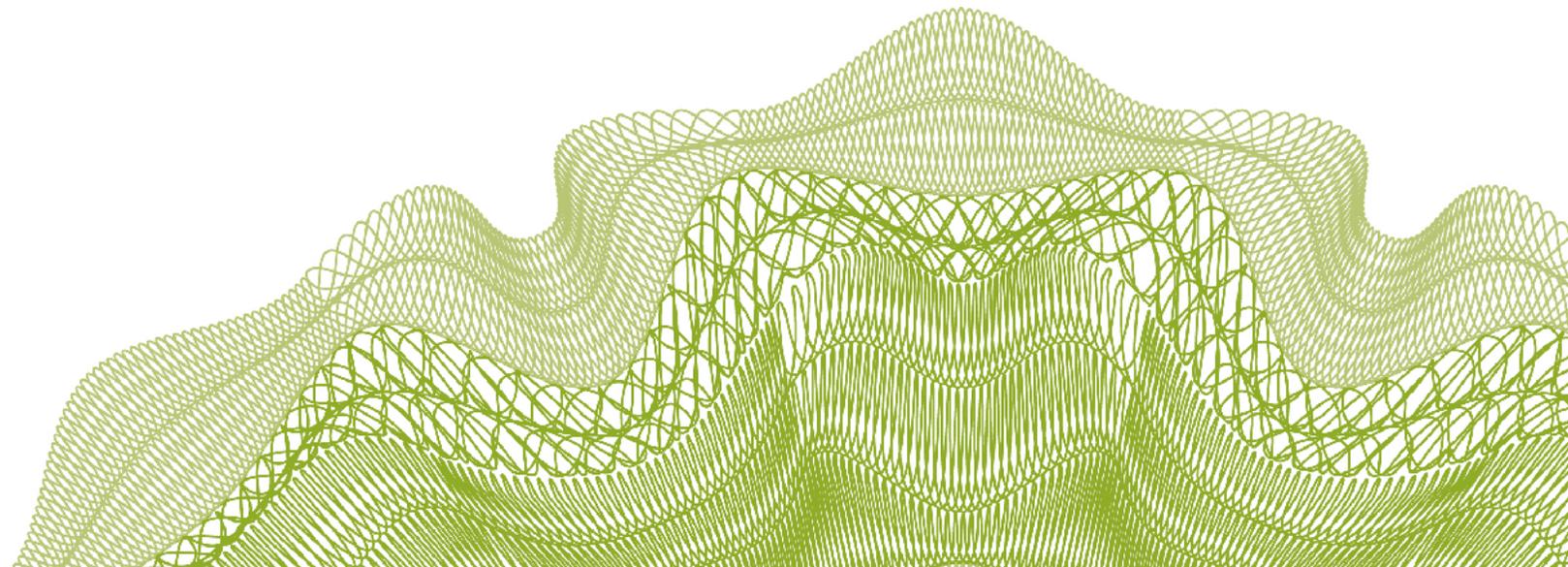
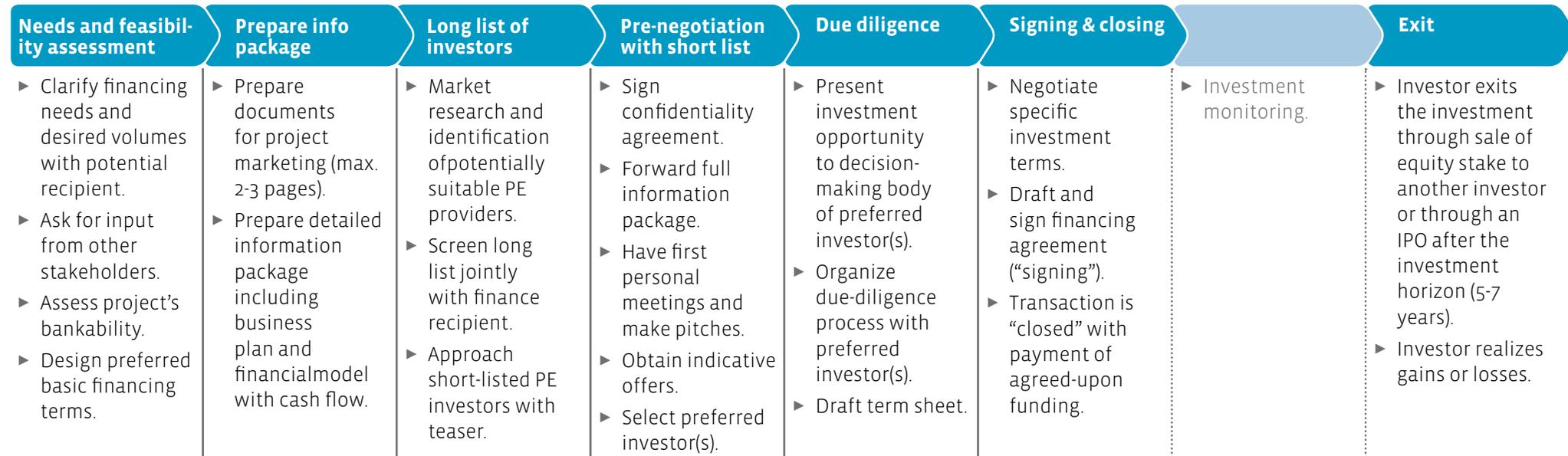
The ambition of private-equity investors is predominantly to make money. Even impact investors in this category may select rather low-risk cases. This means that private-equity investors are usually rather risk averse, with only marginally more risk appetite than banks. The technical assessment, or “due diligence,” prior to the investment can be extensive. PE investors seek a low failure rate, but return expectations of 20% are not unusual.

APPROACH TO IMPACT:

There is a lot of hope and expectations linked to private-equity investors in developing countries when it comes to purposeful investments which promote development goals. Since private-equity investors may retain their stake in a company for more than five years, they are also regarded as long-term or “patient capital” providers, which gives the investee time to work toward generating the desired social impact as well as financial returns.

FIG 17 Financing process (Private-equity funds)

⚙️ FINANCING PROCESS



3.3.3 Banks

The financial sectors of many developing countries are dominated by banks. This means that a large, and indeed often a commanding share of the total assets making up the country's financial sector is owned by banks, with other elements of the financial system such as capital markets, pension funds and insurance companies playing a relatively smaller

TYPES:

A bank is a depository financial institution that receives deposits from and extends loans to individuals and organizations. On the one hand, it acts as a custodian for funds received from the depositors (individuals and organizations), repaying these funds upon demand or after the expiry of an agreed fixed period. On the other hand, it lends money to individuals and organizations for various purposes. While a bank pays interest to depositors on the funds deposited by them, it receives interest from borrowers. The interest charged on loans is usually higher than that paid on deposits. In addition to drawing on the funds deposited by savers, banks can also use the credit lines or risk guarantees offered by DFIs to provide loans to finance recipients (particularly to MSMEs).

Banks can be publicly owned (state banks), privately owned or have mixed ownership, including ownership stakes held by foreign (private) investors. In

most countries, the privatization of state banks has markedly reduced public ownership and government influence in the banking sector (e.g., in the form of directed lending policies favoring individual sectors).

Banks can also be classified based on the nature of services offered. Most common are commercial or retail banks. These are financial institutions that take deposits, make loans and offer other services to their clients. Cooperative banks too can act like commercial banks, but are typically much smaller in size and are run as cooperatives. National banking sectors are governed by central banks, which carry out national monetary policies and are in charge of banking regulation and supervision.

It should be noted that investment banks, though also called “banks,” do not typically accept deposits or engage in lending activities. In addition, some institutions may exist that provide loans to individuals and organizations but do not accept deposits. These can be called

non-banking financial institutions or non-depository institutions. Banks thus play a crucial role that ranges from providing loans to local enterprises and supplying trade finance to participating in larger syndicates alongside other banks in tasks such as financing infrastructure projects.

non-banking financial institutions or non-depository institutions.

PREFERRED FINANCING INSTRUMENTS:

Banks deal both with individuals and organizations, in both the private and public sectors. Given the scope of this guide, this section focuses only on instruments that involve organizations as a potential recipient.

Banks usually provide loans, with varying terms and security requirements. Long-term loans are commonly used to purchase, improve or expand fixed assets such as plants, facilities, major equipment and real estate. Short-term loans are used for working-capital purposes. The interest rate charged by banks on long-term loans is usually higher than for short-term loans, due to the higher inherent risk associated with the longer time period.

Loans can be either secured or unsecured. Unsecured loans are instruments that are not backed by any collateral on the part of

the finance recipient. Secured loans are in contrast backed by collateral such as an asset, for instance the plant, machinery or equipment of a manufacturing MSME. The banks can assume ownership of the collateral if the recipient does not repay the loan as agreed in the terms and conditions. The provision of collateral to back a loan reduces the risk for the lender; thus, interest rates are usually lower for secured loans than for unsecured loans.

In addition to loans with fixed repayment periods, banks may also offer revolving loans for working-capital purposes. Under a revolving loan arrangement, the loan amount can be withdrawn, repaid and redrawn again in any manner and any number of times until the arrangement expires.

IDEAL TARGET:

Banks offer a wide range of tailored loans for different purposes. This can range from a loan offered to an individual for the purchase of an automobile to a loan offered to a power company to establish a large power plant. Before extending any loan, banks determine a potential borrower's creditworthiness. This is essentially an analysis of the likelihood that the borrower will repay the loan in time and in full, as measured by the probability of default. The higher the probability of default, the less likely it is that a bank will offer a loan.

RISK-RETURN APPROACH:

Banks are in the business of making profits. They do so mainly by ensuring there is a positive difference between the interest received from borrowers and the interest paid to depositors, while maintaining an acceptable level of overall risk.

The interest rates charged by banks vary substantially across contexts. For instance, interest rates charged by banks in developing countries are usually much higher than those charged in developed countries. This phenomenon is determined by a large number of economic, regulatory, policy and risk factors that are beyond the scope of this guide.

Banks are among the most risk-averse finance providers. Differences in the interest rate charged to different borrowers within a particular context reflect differences in the level of risk perceived by the bank. For instance, start-up companies will find it much more difficult than mature companies to obtain a bank loan, due to their lack of established creditworthiness and the risks inherent at the start-up stage.

The framework applied by banks in determining potential borrowers' creditworthiness largely draws on a framework dubbed the "4Cs of credit."

These include:

- Capacity to repay: the borrower's ability to repay the loan, based on a comparison of the loan amount with expected future income.
- Collateral: the assets offered as security.
- Capital: the contribution made by the borrower toward the total financing requirement.
- Character: the borrower's reputation and track record with regard to paying debts.

A potential borrower who is evaluated unfavorably on these factors is considered riskier than one who is evaluated relatively favorably. Risky borrowers are likely to be refused loans or asked to pay higher interest rates.

Banks in developing countries have started offering cash-flow-based lending. In the absence of formal collateral, which is often the case, the bank may accept proof of a stable income as sufficient evidence of creditworthiness to extend the loan.

Q APPROACH TO IMPACT:

Traditionally, impact has not played a significant role in the decision-making of commercial banks. According to a 2014 World Wildlife Fund study,⁹ environmental, social and governance (ESG) issues and risks may be more prevalent in developing countries for reasons such as less mature, comprehensive and robust regulations; weaker enforcement; lower levels of external scrutiny. Moreover, banks and in turn their clients may have lower awareness of and capacity to manage ESG issues in these areas.

However, banks, including those in developing countries, have in recent years started to incorporate ESG criteria into their lending frameworks and strategies. This has been driven by factors such as regulatory changes, reputation-management efforts, enhanced risk-management strategies and efforts to improve environmental and social sustainability. For example, the worldwide financial community has produced the Equator Principles, which are collectively a risk-management framework adopted

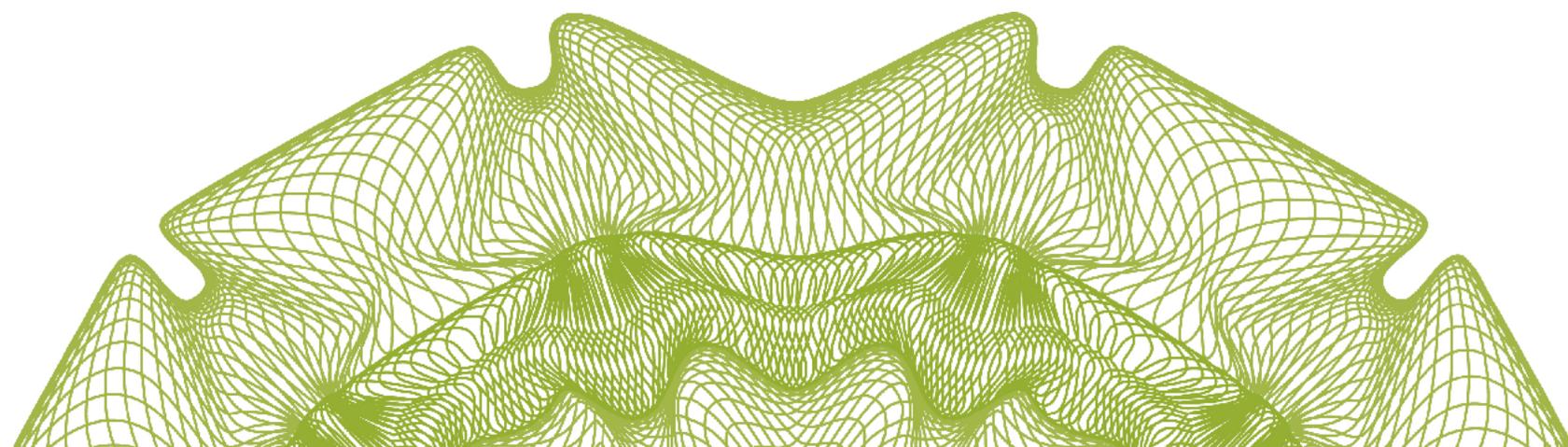
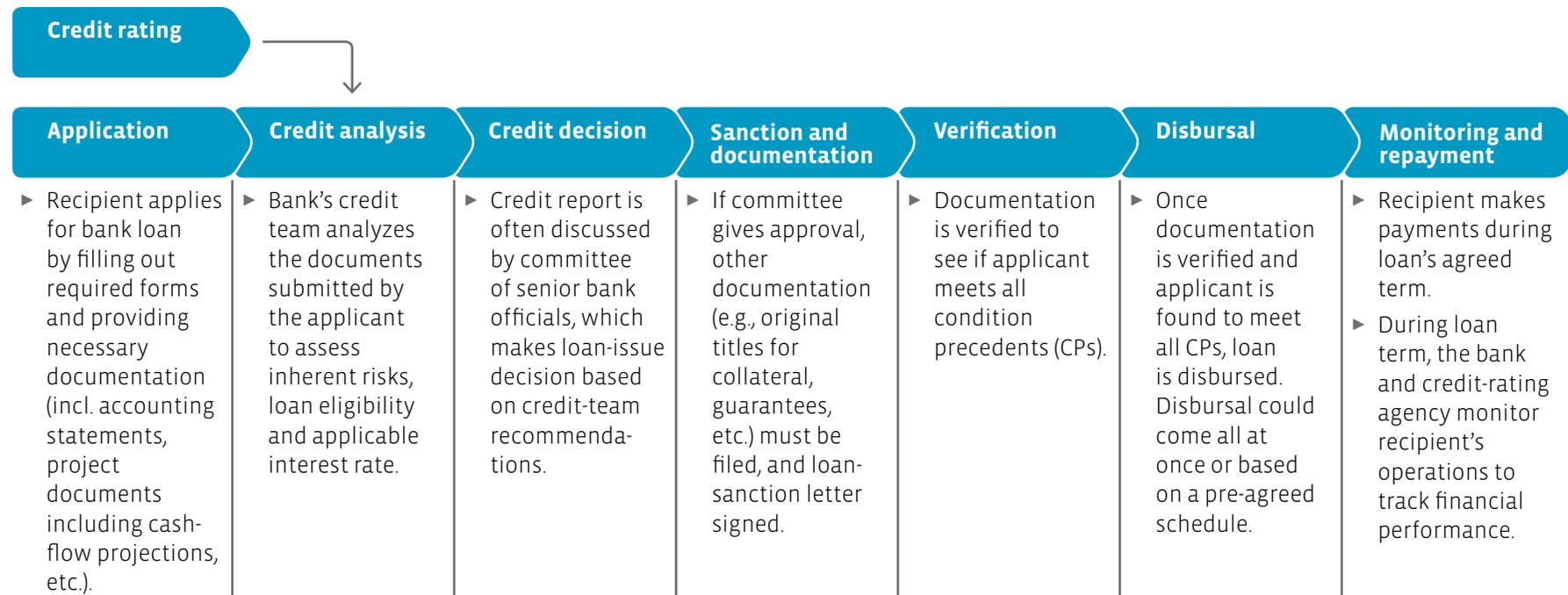
by financial institutions for determining, assessing, and managing environmental and social risk in projects. As of May 2020, 105 financial institutions in 38 countries, including several banks, had officially adopted the principals.¹⁰ Some of the leading credit-rating agencies (including Moody's Corporation and Standard & Poor's) have also started incorporating ESG considerations in their frameworks for assessing the creditworthiness of borrowing entities, in this case by joining the United Nations' Principles for Responsible Investment initiative. Similar ESG-oriented frameworks have also been included in the UNEP's Finance Initiative.

9. Source: WWF (2014). Environmental, Social and Governance Integration for Banks: A Guide to Starting Implementation. Retrieved from <https://wwf.panda.org/?226990>. Accessed on 31.10.2017

10. Source: Equator Principles. About the Equator Principles. Retrieved from <https://equator-principles.com/about>. Accessed on 26.05.2020

FIG 18 Financing process (Banks)

⚙️ FINANCING PROCESS



3.3.4 Cooperative financial institutions (credit unions / cooperative banks)

Cooperative financial institutions (CFIs) are present in most countries. These are financial institutions that are owned and democratically controlled by their customers or members. To become a member, an individual needs to purchase at least one share in the CFI, the cost of which varies according to the size and type of the CFI.

TYPES:

CFIs can take numerous different names, including financial cooperatives, credit unions, savings and credit cooperatives, and cooperative banks. They also vary significantly in terms of size, ranging from volunteer operations with a handful of members to organizations with several billions of dollars in assets and hundreds of thousands of members.

Institutional structures and governance mechanisms, legal and regulatory statuses, scale, and service portfolios also vary across regions and especially between developing and developed countries.

PREFERRED FINANCING INSTRUMENTS:

CFIs provide financing for different purposes using various types of loans. These loans can be secured or unsecured, with a wide range of possible terms and conditions. The volume of funding offered by cooperative banks is usually smaller than that offered by commercial banks.

IDEAL TARGET:

In most cases, CFIs provide loans only to their own members. These members could be individuals or small organizations. In urban areas, CFIs often finance local entrepreneurs, small businesses, industries and self-employed individuals, while also providing loans for home purchases and education. In rural areas, CFIs may also support agriculture-related activities such as farming, live-stock raising, dairies and hatcheries.

RISK-RETURN APPROACH:

CFIs are formed to meet the needs of their members. The members usually share a common bond such as belonging to a specific community, region, organization, religion or place of employment. Providing services to their members takes priority over earning greater profits and providing higher returns to their investors.

As mentioned above, CFIs can be organized on a for-profit or not-for-profit

basis. Like banks, CFIs are in the business of accepting deposits, and also offer loans and other financial services to their customers. However, CFIs are typically much smaller in size. They may be organized on a for-profit or a non-profit basis.

While the provision of service to members is their prime objective, they still must make enough money to cover their operations. They do not strive to generate higher profits or to realize higher returns for their investors. This allows for lower fees, higher interest rates for savings, and lower interest rates for borrowing members. However, when evaluating a loan applicant's creditworthiness, CFIs may adopt an approach similar to that of banks, based on the capital, collateral, character and repayment capacity of the potential finance recipient.

APPROACH TO IMPACT:

CFIs are deeply rooted in local communities, and their members usually belong to the communities in which activities are exercised. They are often present in areas where other banks do not maintain a local presence. By including lower-income groups, micro and small enterprises, and farmers in rural areas, they contribute to the financial inclusion of underserved populations.

FINANCING PROCESS

The financing process for a cooperative making a lending decision resembles that followed by banks. However, CFIs usually lend only to their members – that is, only to those individuals who own shares in the institution.

3.3.5 Development finance institutions

Development finance institutions (DFIs; also called international financial institutions, or IFIs) are financial institutions established and owned by governments with the mission of contributing to sustainable development goals in developing countries around the world. They provide finance, technical assistance and advisory services primarily to

governments and (infrastructure) projects, and at times to companies. DFIs also help to develop and implement standards, strengthen financial markets, and make ecosystems more conducive to business, often supporting regulatory reforms and acting as conveners.

TYPES:

Several different types of DFIs exist, including multilateral development banks (MDBs) such as the World Bank, regional financing institutions such as the Inter-American Development Bank, the African Development Bank (AfDB), the Asian Development Bank (ADB) and the European Bank for Reconstruction and Development, and bilateral development finance institutions such as Germany's KfW and the French Development Agency (Afd). Some developing countries such as Brazil or China have their own development banks.

Some DFIs have been set up with the sole mandate of financing private-sector activities (e.g., the Netherlands Development Finance Company (FMO), Germany's DEG, Britain's CDC Group, Denmark's Investeringsskandelen for Udviklingslande and the U.S. Overseas Private Investment Corporation (OPIC)). Others have a private-sector arm with the rest of the organization providing developmental loans and grants to gov-

ernments and state-owned entities (e.g., the European Investment Bank (EIB) and the AfDB).

The World Bank Group, commonly referred to as the World Bank, consists of five legal entities including the International Bank for Reconstruction and Development and the International Development Association (IDA), and provides non-concessional as well as concessional lending and grants to governments in middle income countries and low-income countries. The International Finance Cooperation (IFC), the private-sector arm of the World Bank Group, invests in companies, mobilizes capital for development and provides advisory services to companies, investors and governments. In Germany, the KfW Group's DEG subsidiary invests in private companies in a manner similar to the IFC.

Some bilateral development agencies such as the Swedish International Development Cooperation Agency (Sida), the Danish International Development

Agency (Danida) and the United States Agency for International Development (USAID) offer guarantees and debt financing in addition to their core mandate of providing technical assistance and advisory support.

PREFERRED FINANCING INSTRUMENTS:

DFIs provide a mix of instruments including debt, equity, quasi-equity (or mezzanine finance), Islamic finance, local-currency loans, guarantees and political-risk insurance. Debt financing is most common, but large variations exist between DFIs with regard to instruments used depending on sector, target geography and the individual organizations' policies. Most DFIs limit their participation in projects, companies and investment vehicles to well under 50% with a view to encouraging the participation of local and international co-investors and funders.

IDEAL TARGET:

DFIs typically have a mandate to engage in situations where alternative sources of funding for impactful and financially-attractive projects and companies are scarce, but their results can be improved with adequate finance, risk mitigation instruments, advisory services and technical assistance.

On average, DFIs tend to focus on comparatively large deal sizes, which in some cases can start at €5 million, but more typically start at €15 million or €20 million. Large companies in a growth phase, infrastructure projects, investment funds, financial institutions, and projects in the energy, financial-services or manufacturing sectors are attractive targets due to their ability to absorb large amounts of financing and their potential to have a positive impact on growth and development. Small-scale private-sector activities are often ineligible for DFI support. Though there are also some DFIs

(e.g., the Belgian Investment Company for Developing Countries (BIO)) that also make smaller investments and loans, most support such small-scale activities only indirectly, for instance, through an SME credit line provided to a local commercial bank or a fund structure such as a layered fund designed specifically for the purpose.

RISK-RETURN APPROACH:

Most DFIs acquire financial resources in the form of capital provided by their members and from the returns generated by the funding they provide, as well as by borrowing on international capital markets (e.g., using thematic bonds). Thanks to their strong credit ratings (typically AAA), they can raise large amounts of financing at comparatively low interest rates. DFIs are also able to assess risks in certain transaction in a better way than commercial finance providers. This in turn enables them to provide financing to their clients on highly competitive terms, while still charging certain risk premia to account for the elevated risk profile of most DFI clients, as well as to satisfy regulators' capital requirements.

DFIs typically seek market-rate returns, especially for private-sector projects. This prevents DFIs from crowding out commercial finance providers due to providing “cheap” finance, while also making it easier to mobilize additional private-sector resources. Furthermore, DFIs can encourage private-sector engagement by “de-risking” investments through the use of instruments such as political-risk insurance, project-based guarantees, blended finance or local-currency-denominated loans for investment activities in markets where currency hedging is limited.

Additionally, some DFIs have corporate policies that require them to direct a certain proportion of their financing portfolio to low-income countries or specific programs or governments, thus providing these entities with concessional finance allowing implementation of high-risk, high-impact programs. Concessional financing is extended on terms substantially more favorable than what is otherwise typically available on the market, and even more favorable than that offered to “regular” clients of the DFI, for instance by including longer repayment grace periods, maturity periods and/or interest-rate subsidies.

APPROACH TO IMPACT:

Developmental impact is at the core of all DFIs' mandates, and is enshrined in the organizations' statutes and regulations. As a basic principle, DFIs measure the impact of the financing provided on the basis of indicators such as additional jobs, employee income or tax income gains, or CO₂ emission reductions.

DFIs typically provide support for their recipients in setting up environmental and social-performance management systems, and make adherence to international social and environmental standards a condition of the financing.

DFIs increasingly deploy their scarce financial resources, know-how and public-sector credibility strategically with the aim of catalyzing new investors engaging in private-sector financing, building new markets, and investing in sectors or projects that have a major effect on growth or particularly affect the poor but are underserved by the market (so-called additionality).

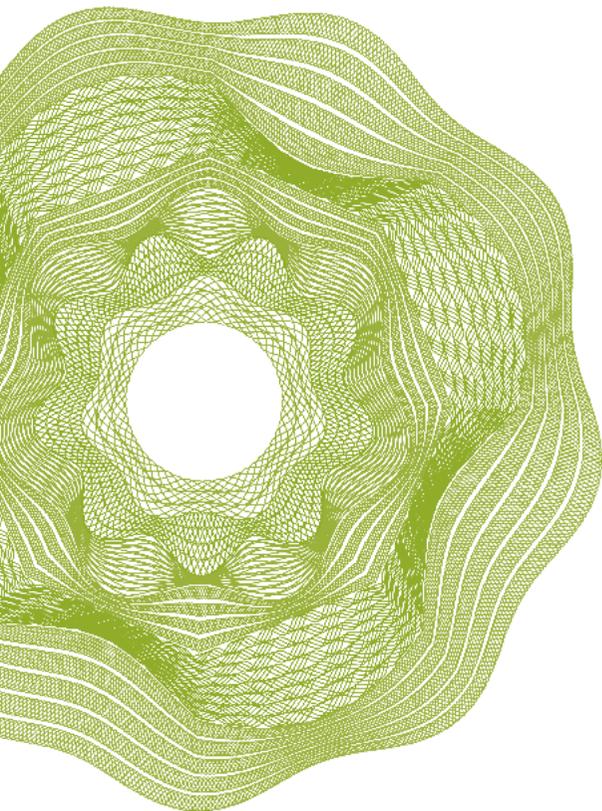
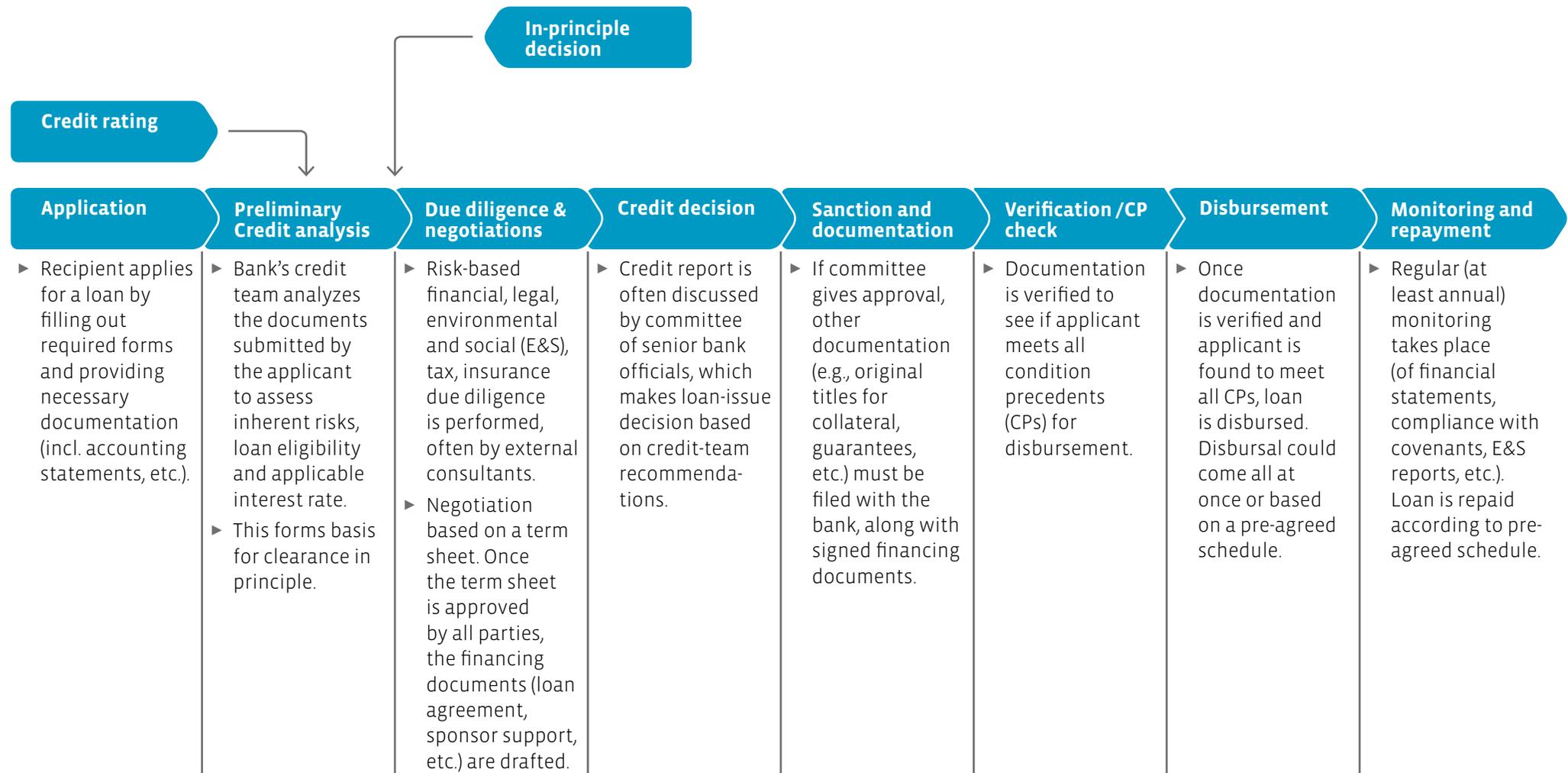


FIG 19 Financing process (DFIs)

FINANCING PROCESS



3.3.6 Microfinance institutions (MFIs)

MFIs provide small loans to low-income populations in developing countries primarily for the purposes of financing income-generating activities such as small-scale business activities. While the provision of such loans has a long history, the success of institutions such as Grameen Bank, founded in 1983, has in recent years shed light on the potential held by microfinance. The main advantage of MFIs is their ability to offer interest rates lower than those available through informal channels or offered by local loan sharks. This is due to the reductions in transac-

tion costs produced by an efficient, financially sustainable and scalable organizational structure. However, financing obtained from MFIs may still be more expensive than that offered by larger commercial banks or cooperative financial institutions. The World Bank estimates the size of the microfinance industry as being between \$60 billion and \$100 billion worldwide, with as many as 200 million clients.

TYPES:

Though MFI entities were initially set up to provide small loans to the low-income population, their activities have diversified over time. For example, some MFIs also provide a range of other financial services such as insurance, saving accounts, money transfers and remittances. Savings accounts in particular help MFIs to refinance themselves independently, as they otherwise typically rely on international funding from DFIs or specialized microcredit funds like OikoCredit, while themselves suffering from limited creditworthiness.

A wide range of entities, including member-owned organizations, cooperatives and NGOs, can provide MFI services. While some MFIs are profit-driven, others may use returns only for the purpose of refinancing themselves. A small number of MFIs, including some stock-mar-

ket-listed companies, are official banking institutions.

PREFERRED FINANCING INSTRUMENTS:

MFIs typically provide small loans. In most cases, sums are less than \$100, but this can also range to above \$1,000. These loans are provided without any collateral and are short term in nature. MFIs typically process a large number of small loans, implying high transaction and operations costs. All these factors lead to interest rates higher than those offered by other formal finance providers such as commercial banks.

IDEAL TARGET:

Traditionally, MFIs have targeted small businesses, smallholder farmers and other low-income households that lack collateral or credit history. In order to reach these population segments, MFIs have traditionally used two types of lending schemes:

- 1) relationship-based banking for individual entrepreneurs and small businesses; and
- 2) group-based models, in which several entrepreneurs join together to apply for loans and other services as a group. Reaching out to multiple borrowers through a single group reduces transaction costs for MFIs and contributes to more efficient credit scoring, lending and monitoring procedures. Group-based models are especially efficient in urban areas where it is easier to pool borrowers

due to the high population density. In many parts of the world, groups composed solely of women have proven to be the most reliable and therefore preferred target group.

RISK-RETURN APPROACH:

MFIs assess risks differently from other financial institutions, offering loans to people whose low creditworthiness excludes them from the conventional financial system. The group-based model, small loan amounts and repayment flexibility help in mitigating default risk.

The average interest rate charged by MFIs globally is estimated to be 35%, but rates can be as high as 70% in some cases.¹¹ As mentioned earlier, this is often preferable to the other financing alter-

11. Source: CGAP (2008). Variation in Microcredit Interest Rates. Retrieved from <http://www.cgap.org/publications/variations-microcredit-interest-rates>. Accessed on 09.11.2017

natives available to low-income populations, but still higher than rates charged by other formal finance providers such as commercial banks.

Credit scoring and new technologies (e.g., mobile-phone based tools) facilitating the collection and compilation of borrowers' data are gaining increased attention for their ability to mitigate credit-default risks and manage transaction costs, especially in remote rural areas. The internet has also expanded refinancing options for many MFIs, by providing access to

crowdfunding platforms like Kiva and by making the international MFI community more transparent.

Q APPROACH TO IMPACT:

MFIs focus mainly on those groups in the population that have been left out of the financial system and lack the access to financial services. These primarily low-income customers are often members of marginalized groups such as women or rural households. MFIs therefore build socioeconomic considerations into the

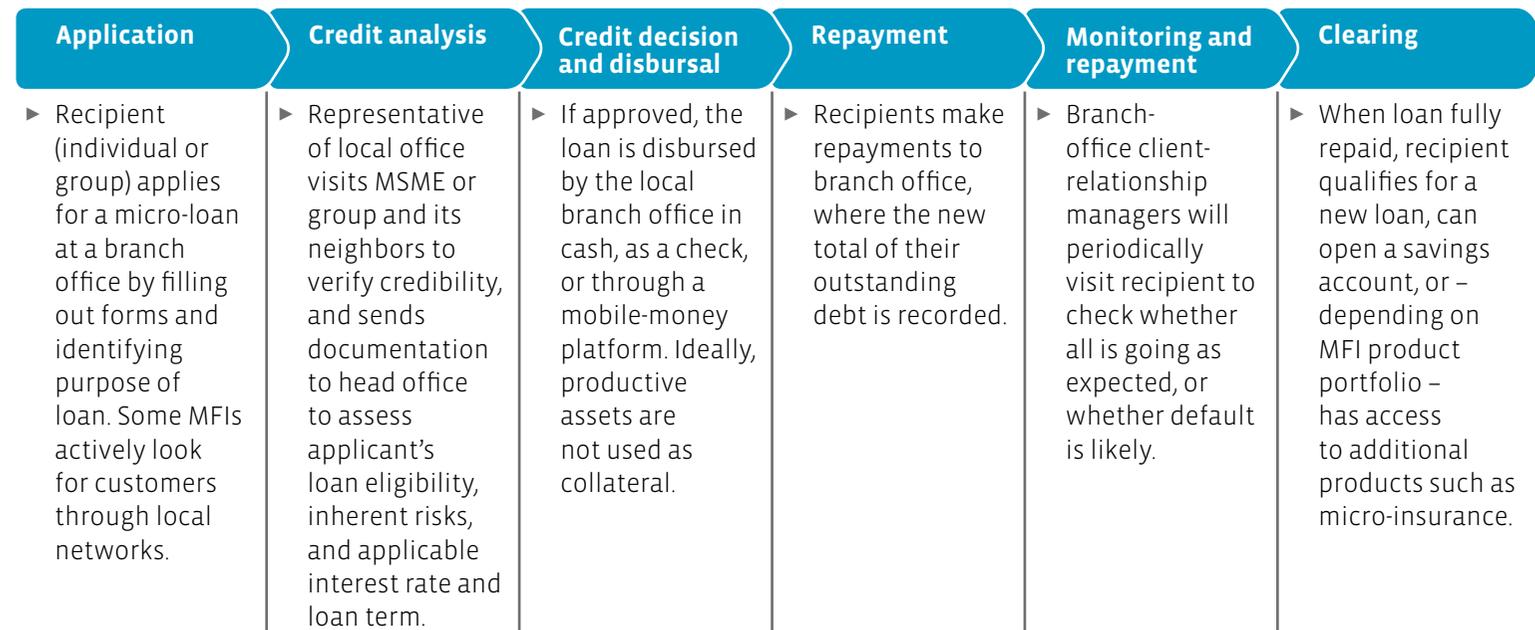
design of their instruments.

By improving access to financial services, MFIs aim to help low-income clients pave their way out of poverty. This approach has also been seen as a win-win situation because low-income clients can use loans to invest in income-generating activities and improve their living standards while MFIs can earn high returns since the markets are largely underserved and borrowers have been willing to pay high interest rates.

However, there is an ongoing concern about the “mission drift” of MFIs that emerges when MFIs try to maximize their financial performance, often at the expense of clients. The initial enthusiasm about MFIs' potential has since given way to a broad consensus on the need for complementary factors in having a positive impact on poverty reduction.

FIG 20 Financing process (MFIs)

FINANCING PROCESS



3.3.7 Institutional investors (pension funds, insurance funds and sovereign funds)

Pension funds, insurers and sovereign-wealth funds are part of the large array of institutional investors that pool money and purchase debt or equity securities and real estate, while also originating loans. Given the volume of assets under management by pension funds (about \$44.1 trillion in 2018),¹² sovereign-wealth funds (about \$8.1 trillion in 2018)¹³ and insurers (\$29 trillion in 2013),¹⁴ institutional investors could potentially help to fill the long-term SDG financing gap. Indeed, the sheer amount of existing assets tends to raise very high expectations. To date, most of

the capital controlled by these investors has been deployed in developed countries and is focused on long-term stable assets such as government bonds. Investment by institutional investors in the long-term illiquid assets necessary for sustainable development has been limited both in developed and developing countries. However, some pension funds and insurers in Europe and North America have started building up their holdings in infrastructure and renewable-energy projects in developing economies.

TYPES:

Pension and insurance funds are similar in the sense that they channel retirement and insurance savings into productive investments with a predictable profile of payouts. By contrast, sovereign-wealth funds typically collect revenues from the sale of natural physical resources such as oil or gas, and invest these in financial assets. Insurers are mostly privately owned and managed, whereas pension funds and sovereign-wealth funds are often publicly owned and/or subject to tight government regulation. In these latter cases, investment decisions may be made based on factors other than the pure financial interest of account holders, and may include investments in high-priority sectors, infrastructure, or investments with expected economic or social benefits.

PREFERRED FINANCING INSTRUMENTS:

These types of investors typically have a strong preference for fixed-income instruments such as bonds or bond funds, or any other financing instrument that allows them to invest over a long-term horizon with limited risk and without substantial engagement with the investment target (see discussion of thematic bonds in section 4.1.6). At times, they also seek out (unlisted) equity investments in infrastructure or similar assets because of their attractive risk-return profiles and ability to absorb large investment volumes.

IDEAL TARGET:

Institutional investors prefer large-scale, low risk and long-term investments that yield market-rate returns and have clear exit pathways. Thus, these investors have traditionally preferred bonds issued by sovereign entities, companies, MDBs or DFIs through capital markets. Although it is uncommon, there are some instances of these investors investing in infrastructure projects, real estate or unlisted investment opportunities.

The insurance industry has demonstrated an increased propensity to engage in green and climate-change investment, driven by the opportunity to directly or indirectly offset such investments against expected long-term savings deriving from fewer insurance claims arising from related risks (e.g., climate risks).

Only the largest funds have the capability to invest directly in infrastructure projects; smaller institutional investors by contrast use pooled investment vehicles to diversify the risk associated with large individual infrastructure deals. Some institutional investors have begun using investment vehicles to engage in developing countries, mostly targeting infrastructure or renewable-energy projects or microfinance institutions. However, many investors in this class still perceive developing-country risks as being too high given that opportunities tend to be smaller in size and shorter term in nature, with exit prospects often unclear.

12. Source: OECD (2019). Pension Markets in Focus. Retrieved from <http://www.oecd.org/daf/fin/private-pensions/Pension-Markets-in-Focus-2019.pdf>. Accessed on 26.05.2020

13. Source: SWF Institute. Top 91 Largest Sovereign Wealth Fund Rankings by Total Assets. Retrieved from <https://www.swfinstitute.org/fund-rankings/sovereign-wealth-fund>. Accessed on 26.05.2020

14. Source: The City UK. UK Fund Management 2014. Retrieved from <https://www.thecityuk.com/assets/2014/Reports-PDF/0499c2cc1f/UK-Fund-Management-2014.pdf>. Accessed on 26.05.2020

🔄 RISK-RETURN APPROACH:

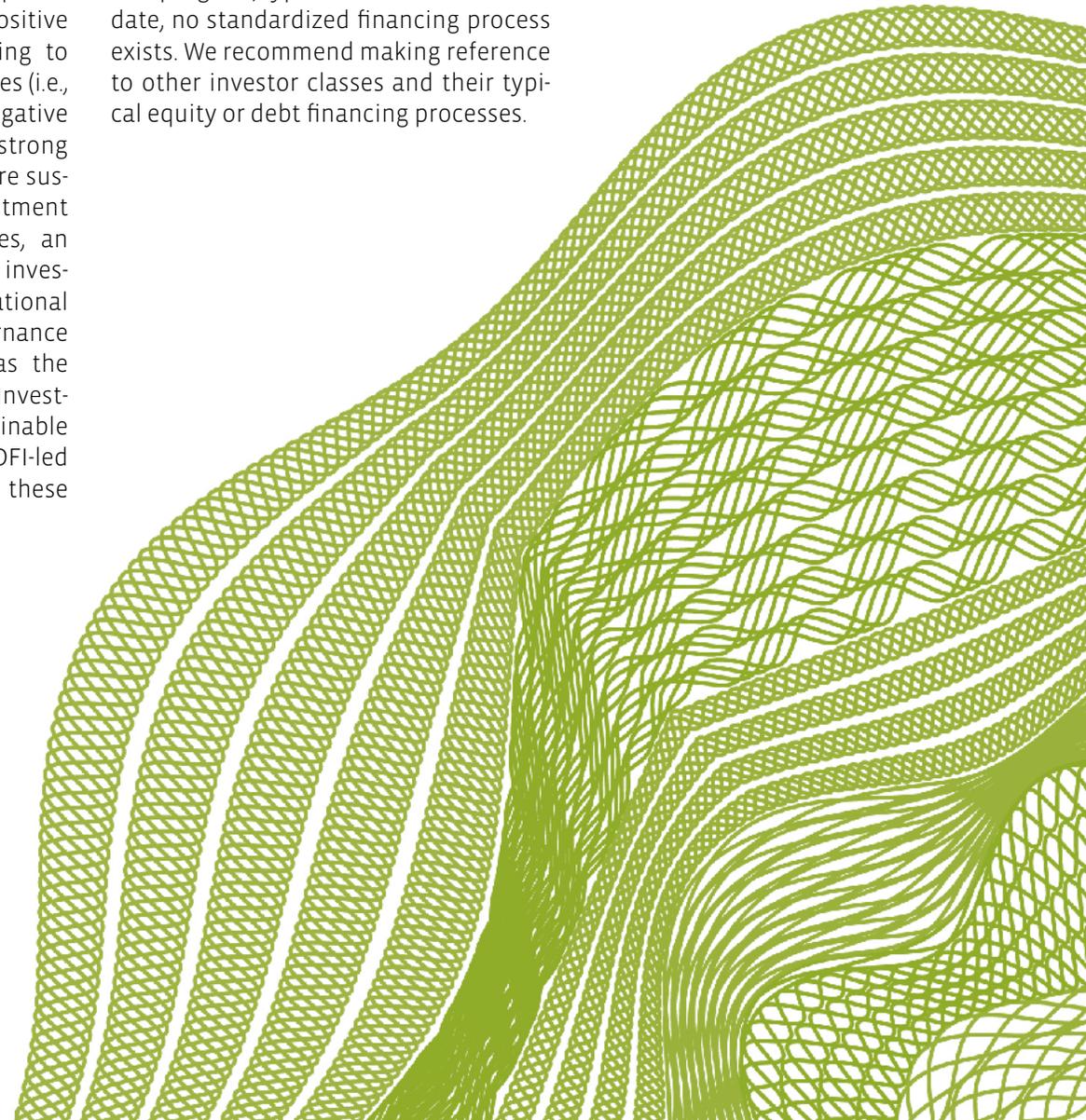
As stewards of the savings and pensions entrusted to them by their members and account holders, asset managers for pension funds and insurers have a fiduciary duty to prioritize capital growth while ensuring protection against high downside risk. Without a clarification of their fiduciary duties by government or industry bodies, many institutional investors shy away from considering alternative investment opportunities. Those that have engaged in DFI-led investment vehicles see this as an opportunity to diversify their portfolios, while regarding the DFI engagement as a means of protecting their portfolio from political and financial risk.

🔍 APPROACH TO IMPACT:

A few pioneers in this class have allocated funding to investment opportunities that actively generate a positive impact rather than simply seeking to avoid negative investment practices (i.e., positive screening instead of negative screening). Responding to the strong demand by their members for more sustainable and transparent investment practices and regulatory changes, an increasing number of institutional investors have committed to international environmental, social and governance principles and standards such as the UN's Principles for Responsible Investment (PRI) and Principles for Sustainable Insurance, and are seeking out DFI-led investment opportunities where these standards are in place.

⚙️ FINANCING PROCESS

Since the approach depends on the specific program, type of fund and fund mandate, no standardized financing process exists. We recommend making reference to other investor classes and their typical equity or debt financing processes.



3.3.8 Corporate venturing

The corporate sector plays an important role in development not only due to the large pools of financial resources now controlled by corporations, but also because of the strategic value they can provide in low-income countries. Corporations can facilitate technological transfer, bring in new management capabilities, deliver skills-based knowledge programs,

Corporate venturing is one way in which corporations combine their own strengths with those of local pro-poor businesses. It is an umbrella term that encompasses all corporate-controlled pro-poor ventures generating financial, strategic and social and/or environmental returns. By holding a portfolio of strategic investments, corporations can hedge risks, and may eventually acquire local businesses in order to strengthen their own operations and growth potential. For their part, local businesses receiving corporate investment gain opportunities to scale their business models, attract additional funding, benefit from corporate business expertise, and advance their social-impact objectives.

TYPES:

Corporate venturing can take two forms, either providing capital to or forming strategic alliances with local pro-poor businesses. However, both categories include the provision of non-financial resources in addition to a financial investment or strategic partnership. These non-financial resources can include managerial and technical expertise as well as access to corporate employees and training. This provision of non-financial resources is mutually beneficial; the local business profits from accelerated growth, while the investing corporation reduces the risk that its initiative will fail.

open up new markets for local industries and generate new employment opportunities. For example, Unilever, the global consumer-goods giant, provided 5,000 people in Indonesia with jobs and created a further 300,000 jobs in the company's value chain.¹⁵

PREFERRED FINANCING INSTRUMENTS AND

IDEAL TARGET

In the case of direct capital provision, corporations invest in local businesses with the expectation of realizing financial, strategic, social and/or environmental returns. Equity investments and loans are the most common forms of corporate impact venture capital, and can be initiated at various stages of the target business' growth cycle. To minimize the risk of investment failure, some corporations wait to invest until the target business reaches maturity.

Corporations typically provide capital through one of three mechanisms: direct investments, self-managed funds or third-party funds. Some corporations choose to invest directly in a particular target business; they then assign relevant business units to manage processes, extract strategic advantages and investigate opportunities to achieve further added value. Such direct investments provide target businesses with funds drawn from the corporation's primary accounts, with the

investment thus listed on the investing corporation's annual balance sheet.

In a self-managed fund, the corporate sets up an investment company or creates a captive venture-capital fund – that is, a fund financed entirely by the parent corporation. The corporation exercises control by holding a position on the fund's board, by appointing the fund's management team, or by doing both. The fund or firm may invest in multiple projects that align with its investment strategy and the corporation's core business. Both internal staff and external venture-capital experts may be employed to run the fund.

Other corporations take a more hands-off approach, employing intermediaries such as venture philanthropy organizations or impact-investment firms. When using external intermediaries to select and manage investments, little internal expertise is required. Using a third-party fund may help corporations starting out in such activities learn the ropes before

starting their own self-managed fund or making direct investments or partnerships.

🔄 RISK-RETURN APPROACH:

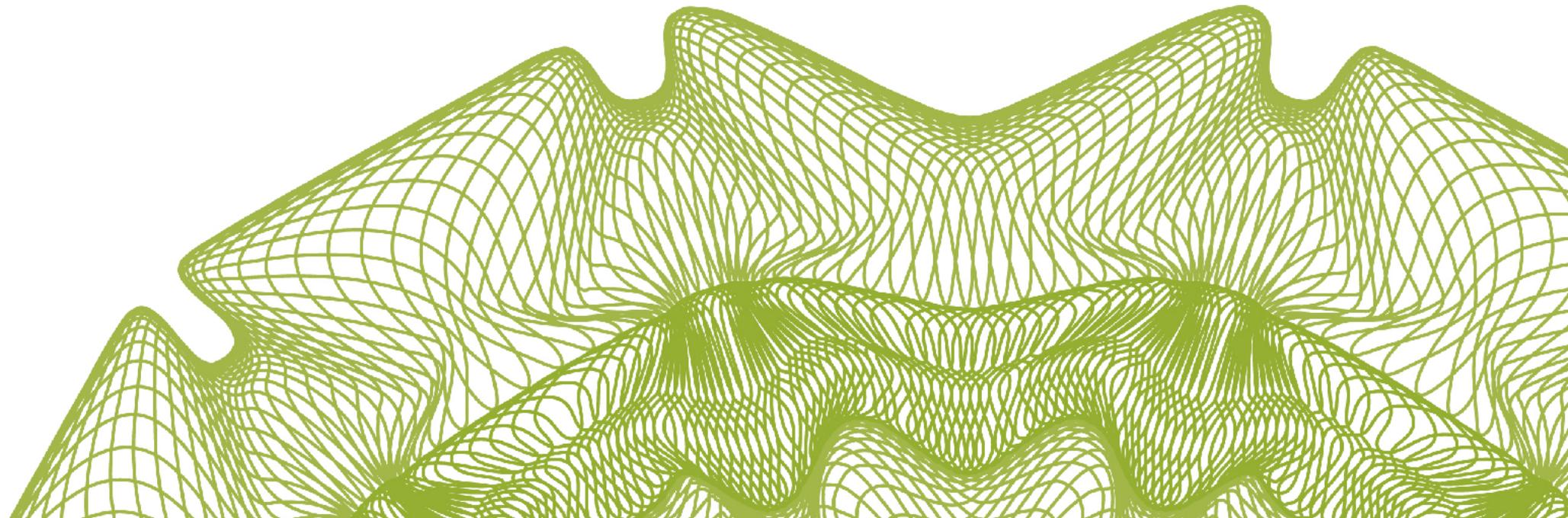
When engaging in venturing activities, corporations typically expect both financial and strategic returns. For instance, they can gain direct business and technological experience and insight in developing countries, gain access to emerging-market technologies, obtain input for R&D projects, or forward the company's corporate social responsibility strategy. The financial return could derive from the access gained to new markets and new sales opportunities, the development of cost-effective production capabilities, or from other synergies emerging from the association.

🔍 APPROACH TO IMPACT:

Corporations have been often criticized for their singular focus on profit maximization, with a questionable impact on sustainability factors. However, an increasing number of corporations are taking ESG factors into account when formulating and implementing their corporate strategy. This is due to reputational issues and a growing demand from shareholders and customers that consider ESG factors in their own decision-making process.

⚙️ FINANCING PROCESS

Since the approach will depend on the specific program, there is no standardized financing process associated with corporate venturing.



3.3.9 Venture philanthropy organizations and foundations

Venture philanthropy organizations (VPOs) take concepts and techniques from the venture-capital finance and business-management fields and apply them to philanthropic goals. They provide recipients with tailored financing and hands-on non-financial support, including access to networks, coaching, mentoring, training, strategic advice, and impact-man-

agement and measurement support. VPOs tend to invest in green and sustainable finance products more often than do traditional foundations, philanthropists and grant providers. VPOs invest in line with their organizational missions (mission investing), an approach somewhat similar to that taken by impact investors.

TYPES:

VPOs are often structured as independent or corporate foundations, companies with charitable status, not-for-profit or registered charities, corporations, or fund-management companies. Sometimes, a further distinction is made between venture philanthropists that engage in concessionary program-related investments and those that pursue only mission-related investments. In contrast to philanthropic grants, program-related investments are a form of repayable finance that yields below-market rates of financial return, while being counted toward a foundation's legal obligation to distribute a part of its endowment for charitable purposes, as required by some jurisdictions in order to retain a tax-exempt status. Mission-related investments are by contrast financial investments from the organization's endowment that fundamentally seek market-rate returns while still furthering the organization's social goals. Like more conventional (institutional) investments, this latter model must meet pru-

dent investment standards such as the preservation of assets and avoidance of excessively risky investments.

PREFERRED FINANCING INSTRUMENTS:

VPOs use grant instruments, a variety of debt instruments and – to a smaller extent – equity, quasi-equity and hybrid instruments, often tailoring the financial instruments used to funding recipients' specific needs. One specific commonly used financial instrument is a convertible loan, which offers the option to convert debt into an equity stake in pre-defined situations when the prospect of loan repayment drops below earlier expectations. This offers the recipient the ability to shed a liability and convert it instead into a form of funding that does not require repayment.

VPOs sometimes use finance in a catalytic sense, seeking to mobilize additional financing. In doing so, they offer guarantees, provide grants or loans, or make equity investments in first-loss tranches (i.e., in the event of a default,

the VPO will absorb losses prior to other finance providers). For mission investing or investment from an endowment, VPOs – like other institutional investors – have a preference for real estate and infrastructure-based fixed-income instruments (i.e., bonds), as well as listed or private equity.

IDEAL TARGET:

In the past, the majority of venture philanthropists have primarily deployed capital in their neighboring regions or domestically, but around one-third are now active in developing countries. European venture philanthropists' preferred target sectors include economic and social-development projects, financial inclusion programs and education. Children and youth, people in poverty, and women are the main beneficiaries of venture-philanthropy financing. Social enterprises, social businesses, and non-profits with track records of three to five years are the preferred target for those venture philanthropists that aim to generate both a financial return

and social impact. Some venture philanthropists also engage strategically in supporting market intermediaries and ecosystem builders, using finance in a catalytic sense to encourage the entry of more commercially oriented investors.

RISK-RETURN APPROACH:

While a majority of VPOs expect to generate positive returns, or at least aim to recover the original sum of capital invested, VPOs rarely prioritize financial over social returns. Their general approach to financial returns falls within one of three categories: 1) societal returns may be considered to be of

higher priority, while financial returns are accepted; 2) financial returns and social returns may be given an equal priority; or 3) financial returns may not be sought at all (e.g., for VPOs that only provide grants). In some cases, VPOs seek a strong role in funding innovation and in catalyzing the entry of additional commercial funding, but these remain an exception.

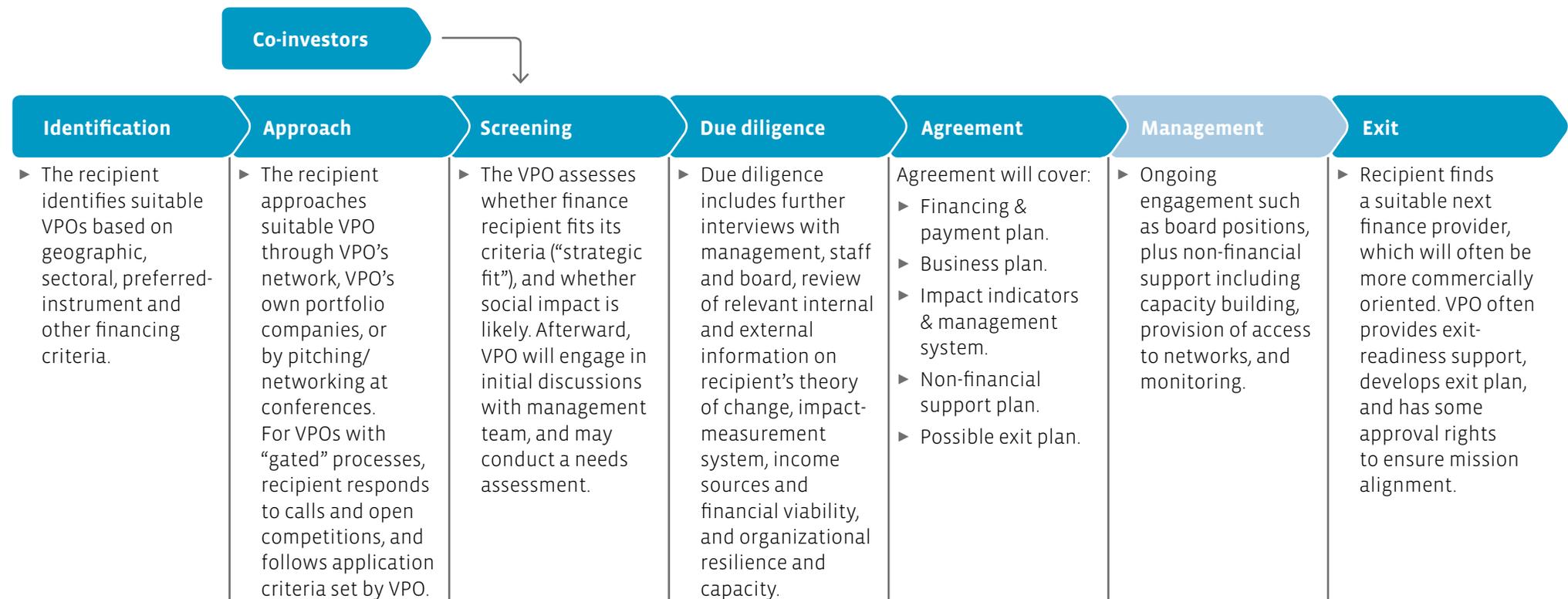
APPROACH TO IMPACT:

Planning, managing and measuring for impact is an integral part of venture philanthropy. Many VPOs help finance recipients to tighten their impact focus and strengthen their impact-management and reporting systems. Many VPOs make successful impact performance a condition for the disbursement of

funds or for unlocking additional funding. Some VPOs also actively assess their own impact as impact-oriented finance providers.

FIG 21 Financing process (Venture philanthropy and foundations)

FINANCING PROCESS



4

Financial mechanisms

Various mechanisms are deployed in different sectors to raise financing for the implementation of new or existing development-related projects. These mechanisms represent innovative structures that often combine multiple financial instruments or bring together multiple finance providers. By doing so, they also help to mitigate risk and/or distribute risk among various stakeholders such as private-sector finance providers, public entities and DFIs. While some mechanisms can be used for a wide range of purposes and sectors, others are applicable only to specific financial niches.

This module provides an overview of some of the relevant financing mechanisms, their flow of funds, advantages and pitfalls. The mechanisms covered include public-private partnerships, agricultural value-chain finance, blended finance, project finance, results-based finance, thematic bonds and crowdfunding.



LEARNING OBJECTIVES:

- ▶ Understand what constitutes a financing mechanism
- ▶ Obtain an overview of various mechanisms and their applicability, including how the flow of funds works as well as the advantages and pitfalls of each mechanism



THIS SECTION'S TOPICS:

- 4.1 Public-private partnerships (PPP)
- 4.2 Agricultural value-chain finance
- 4.3 Blended finance
- 4.4 Project finance
- 4.5 Results-based financing
- 4.6 Thematic bonds
- 4.7 Crowdfunding

Overview of financial mechanisms

A financial instrument is the modality through which a provider makes financing available to a recipient, while in turn accepting the associated risk and collecting the associated reward. As a rule of thumb, instruments with higher levels of inherent risk produce greater returns. Financial mechanisms are innovative structures that modify this tradi-

tional risk-return relationship by sharing and distributing risk among the participating actors. Thus, finance providers participating in these mechanisms either accept more risk than is typical for a given level of return, or a lower level of return for a given level of risk.

Financial mechanisms may combine two or more financing instruments, by involving different kinds of finance providers, or by establish structures that share risk among the various stakeholders. In a public-private partnership arrangement, for instance, the risk is shared between the public- and private-sector actors – including various finance providers and the company that develops the project.

The guide focuses on a selection of mechanisms that are deemed most relevant for GIZ, presented below along with the sectors in which they are typically deployed. However, it should be noted that the association between specific mechanisms and sectors is not set in stone, and is for illustration purposes only; new mechanisms are routinely developed, and existing mechanisms are over time adopted in an increasingly wide range of sectors.

TABLE 6 Financial mechanisms and sectors

	PPP	Value-chain finance	Blended finance	Project finance	Results-based finance	Thematic bonds	Crowdfunding
1. Agriculture		●					●
2. MSMEs		●	●	●	●	●	●
3. Forestry and biodiversity			●			●	●
4. Information & communication technology	●						●
5. Roads, bridges and other infrastructure	●			●			
6. Power & renewable energy	●		●	●	●		●
7. Water and sanitation	●				●	●	●
8. Waste management	●						
9. Social sector	●				●		
10. Urban development	●		●		●	●	

4.1 Public-private partnerships (PPP)

Public infrastructure is a backbone of economic growth and development. However, developing countries often face constraints with regard to infrastructure provision. These can emanate from sources such as a lack of public funds, inadequate planning or weak analysis in the process of project preparation.

PPPs are increasingly being used to overcome these constraints by mobilizing private-sector financial resources and expertise to improve project preparation, execution and management. PPPs help to share risks and responsibilities between the private and public sectors, and are often used to develop infrastructure projects in the transportation, water and waste management, power, and social-services sectors.

* INTRODUCTION:

PPPs can take a wide range of forms, with the extent of involvement and responsibility assumed by the private party varying. For example, they can range from a simple management contract, in which the private-sector actor manages a range of activities for a relatively short time period, to arrangements with a much greater private-sector role including significant design and construction responsibilities and long-term operational authority over the newly built infrastructure project. The greater the private-sector involvement, the greater the amount of risk taken on by the private-sector partner or partners. Thus, it is important to determine whether these private-sector actors indeed have the ability and willingness to take on or share the risks inherent in the project.

► FLOW OF FUNDS:

In a PPP arrangement, a government authority enters into a contract with a special-purpose vehicle (SPV), a private project company formed by the private-sector project developer specifically to finance, build and operate the infrastructure project for a period of time of up to 30 years. This is typically a cash-flow-based arrangement in which anticipated cash flows from the project are a key consideration in the provision of financing. A generalized schematic of the various financial flows taking place under a PPP structure is presented in figure 22.

Finance recipient: The finance recipient in a PPP is the SPV. The private party that has been awarded the contract is responsible for identifying the finance providers. This may include equity investments provided by the SPV's shareholders, loans provided by banks, proceeds from the sale of bonds or other financial instruments (e.g., mezzanine finance).

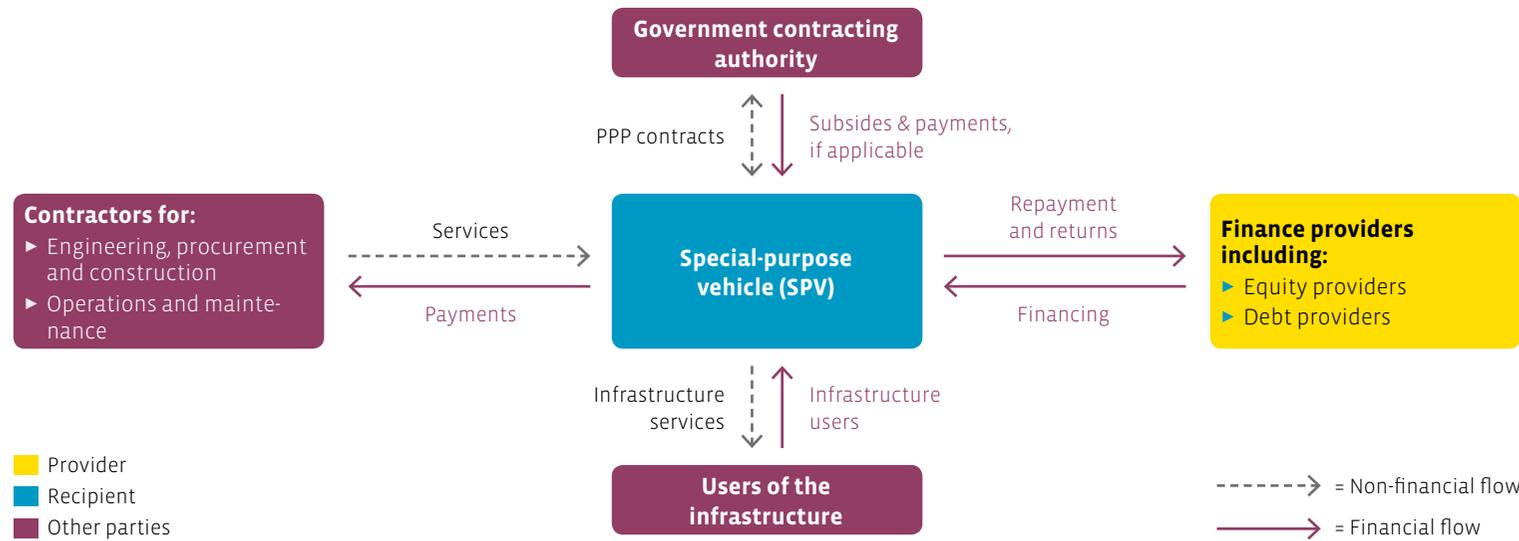
📌 EXAMPLE

Water treatment project PPP to clean up Ganga river in India

The Ganga river is a sacred place for worship in India, as well as a lifeline for the entire country. The river provides one quarter of India's fresh water supply and is therefore essential to people's livelihoods in various sectors ranging from fisheries to transportation. Yet the river is heavily polluted by sewage and industrial wastewater. In light of this, the Indian government has stepped up efforts to clean up the river through water treatment facilities.

Several programs carried out since the 1970s, including the construction of wastewater treatment plants, have not shown the expected results. Consequently, the government requested the World Bank's support for the Clean Ganga program through private involvement by setting up a PPP to build and operate sewage treatment plants. As a part of the agreement, the government pays 40% of the project costs to private developers upon completion of construction and the remaining costs annually, in addition to operation and maintenance costs, linked to the plants' performance. By doing so, the focus moved from the construction to the actual outcome. Furthermore, the operators were able to generate environmentally friendly revenues, for instance, through selling treated wastewater or generating power through biogas, while all payment responsibilities were agreed to undertaken under the contract by the government, a major bankability issue. This lowered the risk for private investors, ultimately attracting additional investments.

FIG 22 Flow of funds involving PPPs



Though often created merely for project-backed fundraising purposes, SPVs sometimes also carry out engineering, design, construction and procurement tasks, among others.

The underlying revenue model provides SPVs with the opportunity to generate cash flows sufficient to recover its costs and pay the finance providers. The SPV can generate revenues through one of three primary modalities used alone or in combination:

- 1) Payment by public authorities: This modality applies to sectors and/or large projects that are very capital intensive, and in which covering costs solely through user payments would be nearly impossible. It could also be applied to areas in which future project cash flows are uncertain. One example would be the €1.32 billion project in the Netherlands, awarded to Infraspeed BV, to design, build, finance and maintain new railway tracks through 2030.¹⁶
- 2) User fees or tariffs: In these cases, the private party is paid directly by the users of the infrastructure asset. A typical example would be large renew-

able-energy projects that are paid by the local power company based on a feed-in tariff set by the local regulator.

- 3) Shadow fees/tolls: An intermediate way of allowing the private-sector partner to share in the financial benefits of the project is to base the public payment on shadow fees or tolls. While in this case, the actual users do not directly pay anything for using the infrastructure asset, public authorities pay the private partners based on the number of users benefiting from the asset. This mechanism is often used for road projects.

Finance providers: Funding for PPP projects can include both equity- and debt-capital providers. Equity investors may include the owners of the SPV (typically the project’s developers, the engineering or construction companies involved, and any relevant infrastructure-management companies) and external private-equity funds.

Unlike other infrastructure financing mechanisms, PPPs typically have a large debt component that may be as high as 70% to 90% of the total project cost. A higher proportion of debt in the overall funding structure means that the equity providers have a higher potential for return, since debt is cheaper than equity. The lenders to PPP projects in developing countries may include commercial banks, DFIs, multilateral institutions, or institutional investors such as pension and sovereign funds. In assessing the project’s financial viability, lenders assess whether expected revenues (as ascertained by the project’s payment modality, as explained above) will be sufficient to cover the interest and loan-repayment amounts. If the project is expected to generate robust and certain future revenues, lenders tend to be more willing to provide financing.

⊕ ADVANTAGES OF PPPs

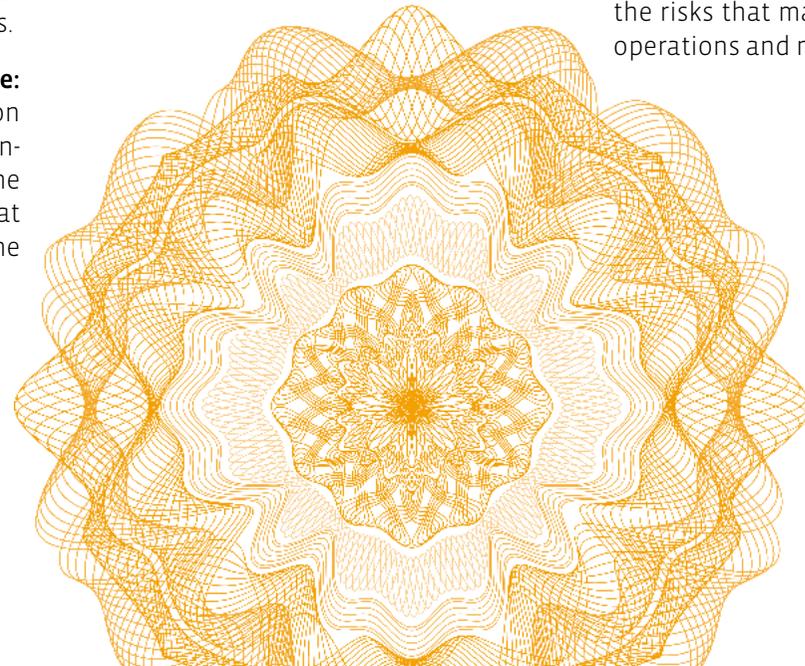
Public-private partnerships have several advantages over conventional infrastructure-procurement models. Some of these include:

- ▶ **Increased funding for infrastructure:** Since the private sector finances the construction of the project and is reimbursed by the project's cash flows, PPPs reduce the financing burden for the government, and increase the overall universe of funding available for infrastructure financing.
- ▶ **Risk shared with private sector:** PPPs transfer a part of the project's risk to the private-sector companies involved, and directly result in improved public-sector control of the overall project cost, delivery time frame and end-product quality. The risks pertaining to these factors are passed on to the private sector participants, which may be better equipped to manage them.
- ▶ **Increased efficiency through private-sector participation:** Public-sector authorities often lack in-house capabilities related to the construction, operation and maintenance of infrastructure projects. Specialized infrastructure companies can introduce the management and technical expertise needed to innovate and carry out complex projects.
- ▶ **Development of local private-sector capabilities:** By engaging in joint or cooperative ventures, and serving as subcontractors for larger and more technologically advanced international players, local private-sector companies can develop capabilities in areas such as civil and electrical engineering, facilities management, security services or maintenance services.
- ▶ **Improved quality and maintenance:** PPPs bundle construction, operation and maintenance tasks into one contract. This provides incentives for the private company to build the asset at a high level of quality, reducing the subsequent need for maintenance.

🔍 PITFALLS:

- ▶ **High level of complexity:** Under traditional public-sector procurement models, the government specifies the quantity and quality of the service, while the infrastructure is constructed by private companies that have been awarded project responsibility in a tender process. Once construction is finished, the asset is transferred to and operated by the government. PPPs are substantially more complex than this traditional procurement model, and require special skills and expertise on the part of the public authorities.

- ▶ **Bankability and risk allocation:** If too much risk has been allocated to the private-sector party, lenders will reduce the amount they are prepared to lend. When this happens, more equity investment will be needed.
- ▶ **Larger potential for (negative) contingencies:** Given the long-term nature of these projects and the complexity associated, it is difficult to identify all possible contingencies during project development. Thus, issues may arise that were not anticipated at the time the PPP contract was concluded.
- ▶ **Higher cost of finance:** PPPs are more expensive than traditional procurement, since the return expected by private-sector participants reflects the risks that may emerge during the operations and maintenance period.



4.2 Agricultural value-chain finance

A value chain is defined as the sequence of value-adding entities and activities that stretches from the point of production to the point of consumption. The flows of funds to and among the various links in a value chain comprise what is known as value-chain finance.

* INTRODUCTION:

Value-chain finance can be internal or external to the chain itself:

- 1) **Internal value-chain finance:** These are financing arrangements taking place within a value chain, directly between two value-chain actors. These arrangements do not require the participation of an external financial institution. An example would be a credit provided by an input supplier to a smallholder farmer.
- 2) **External value-chain finance:** These are arrangements where financing is provided by an external third party based upon the recipient's value-chain relationships and activities. For example, a bank may provide a loan to a farmer to buy inputs based on the farmer's sales contract with a trusted buyer. This buyer may pay the farmer through the bank, which would then deduct the scheduled loan payments before releasing the net proceeds to the farmer.

Value-chain finance does not include conventional agriculture-sector financing, which predominantly takes the form of collateral-based bank loans, unless there is a direct relation to the value chain as mentioned above.

►► FLOW OF FUNDS:

While goods always flow in one direction through a value chain, the direction of the flow of financing varies. Actors within the chain can be both recipients and providers of finance, depending on the nature of the chain. Figure 23 presents a generalized version of agricultural value-chain financial flows. The exact nature of and role played by actors will depend on the agricultural commodity in question.

Finance recipient: Every actor in a value chain recovers the expenses it incurs or repays the financing it has received by selling its outputs to the next actors in the chain. While products flow in one direction, value-chain finance can flow in either direction, often depending on whether the financing is received from internal or external sources.

Value-chain finance is designed to meet the specific financing needs of the actors along the chain. It supplements informal credit sources, and fills the gaps left by conventional, collateral-based financing provided by banks and other formal finance providers.

EXAMPLE

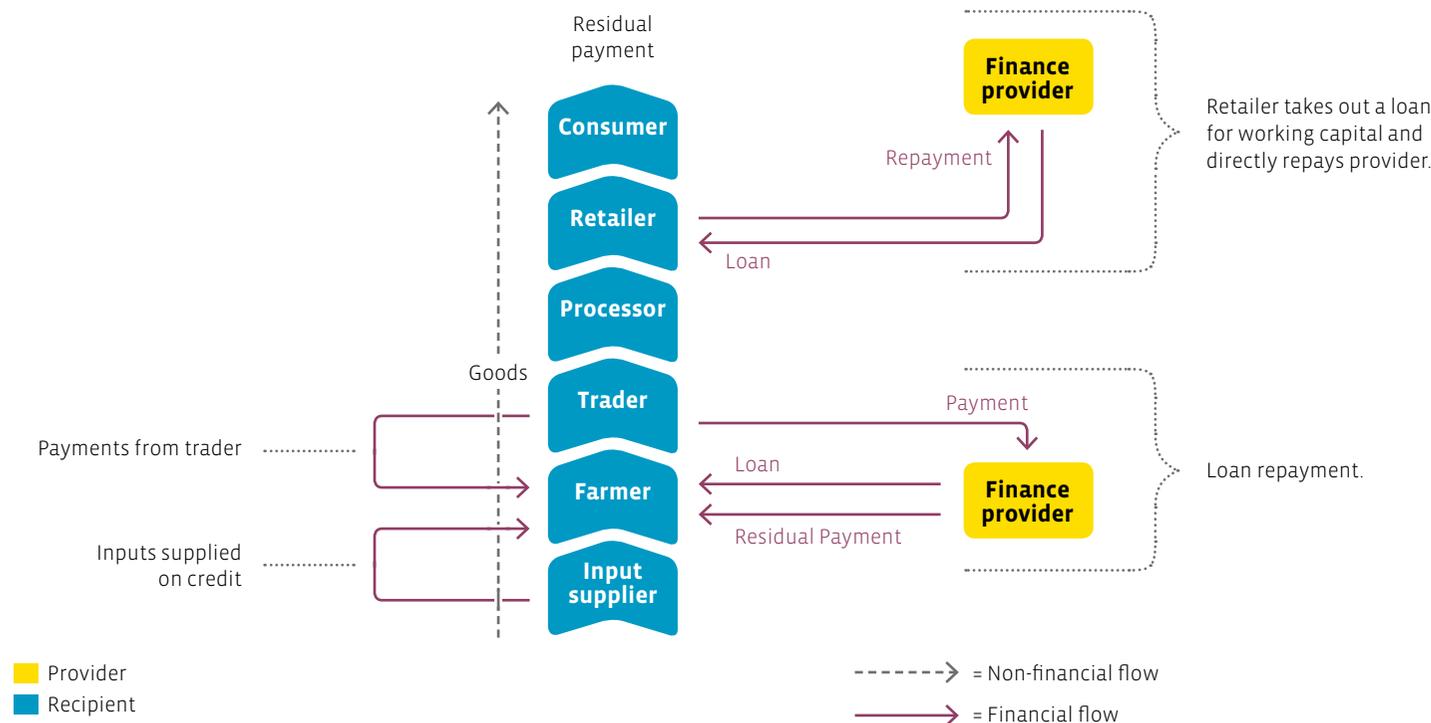
GIZ's Competitive African Rice Initiative (CARI)

Rice value chains exhibit considerable weak points, including low capacities at rice mills and the often insufficient or unreliable supply of raw products produced by smallholder farmers. GIZ's CARI project aims to establish stable value chains in the rice sector, while additionally seeking to improve access to financial services for local enterprises and smallholder rice farmers in Nigeria, Burkina Faso and Tanzania.

GIZ manages a matching fund that allows local rice mills to train associated smallholder farmers in areas including good agricultural practices, financial planning, business and marketing skills, procurement practices and crop diversification. The farmers are also trained in contract practices under which smallholder farmers receive advance payments from rice millers, enabling them to buy high-quality seeds, fertilizers and agrochemicals.

Furthermore, CARI has signed several memoranda of understanding with local financial institutions (FIs), with the goal of enhancing access to finance for rice processors (millers, off-takers). A part of this workstream includes elements such as digital financial services, training programs for local FIs, consultative meetings with chief executive officers at FIs, as well as trust building activities between agriculture-led entities in the rice sector and local FIs through match-making events.

FIG 23 Flow of funds involving internal and external agricultural value-chain finance



In the case of internal value-chain financing, the flow of financing can take place in the same direction as the flow of goods or in the opposite direction. The nature of this flow depends on the particular value chain (rice, cocoa, cashews, etc.), region and the dynamics of the participants involved. The figure also indicates that those within the value

chain can be either finance recipients or providers, or both. For example, in the rice value chain, large wholesalers often provide financing to traders, who in turn provide advance payments to farmers. At the same time, many processors make only a partial payment when receiving unprocessed rice from farmers, with the understanding that final payment will

be made after the rice is processed and sold. In this case, the farmers serve as finance providers to their rice millers.

In case of external financing, an external party acts as a financier. This finance provider can be repaid in two ways: A provider may be directly repaid by the finance recipient, or there could be an arrangement under which a payment

from a downstream player is routed through the finance provider, which in turn keeps a portion of it as repayment of the loan.

Finance providers: Finance providers within agricultural value chains mainly offer loans. While conventional loan providers rely heavily on analysis of a potential recipient’s creditworthiness when extending a loan, providers of external value-chain financing focus more on the commercial arrangements between two actors within the chain. Decisions about financing are based on the quality and strength of the entire value chain, not just on the individual borrower’s characteristics.

An external finance provider may provide a recipient with up to 70%¹⁷ of the estimated market value of the product up front in order to prevent repayment problems in case of a disappointing harvest. They also take into account the predictability of cash flows and the strength of linkages in the chain.

In the case of internal value-chain finance, finance providers largely rely on mutually negotiated formal or informal terms for the provision of credit.

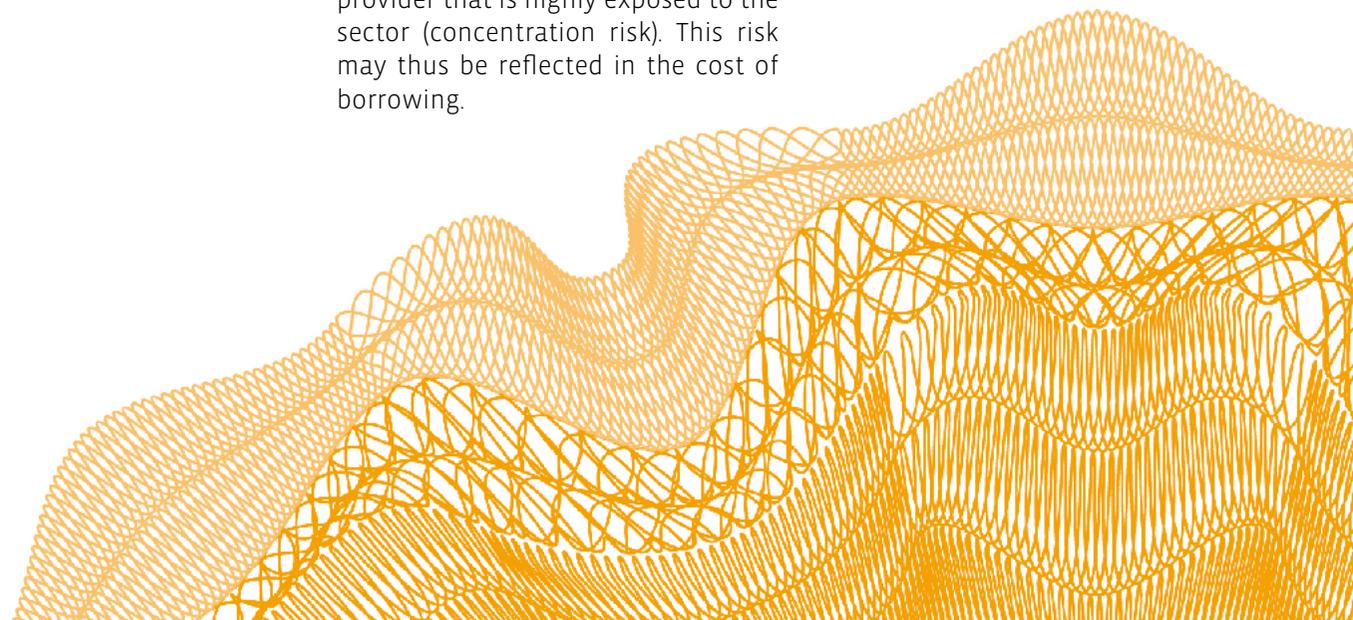
➤ ADVANTAGES

- ▶ **Expanded financing opportunities:** Conventional bank loans are usually out of reach for farmers and other MSMEs in agricultural value chains due to factors such as the finance recipient's small size, the lack of banking services in rural areas and inadequate recipient collateral; however, value-chain finance can overcome these issues.
- ▶ **Better-suited financial products:** Value-chain finance promotes the development of financial products tailored to fit the needs of participants in the chain, since finance providers look beyond the direct recipient and take the sector as a whole into account when crafting suitable products.
- ▶ **Strengthened value chains:** By focusing on the value-chain linkages and offering tailored products, value-chain financing helps strengthen the linkages further, thereby creating a virtuous cycle.

- ▶ **Reduced information asymmetries:** Information asymmetries are substantially reduced, because finance providers are able to utilize partnerships or contracts with value-chain actors to acquire information that would be unavailable or expensive to obtain for parties outside the value chain.
- ▶ **Lower costs:** Finance providers can pass on the benefits from reduced information asymmetries, transaction costs and lower risk assessments to recipients in form of lower interest rates and fees.

➤ PITFALLS:

- ▶ **Informal and trust-based relationships:** Agricultural value-chain linkages may depend on informal and trust-based relationships that may be difficult for external finance providers to incorporate into their assessments of potential finance recipients.
- ▶ **Correlated risks in agriculture:** Agriculture faces a high degree of correlated risk (i.e., a high probability that a single negative event will affect multiple actors in a value chain or sector) stemming from the sector's price volatility as well as from weather risks that can affect whole regions at a time. These issues can affect the entire value chain at once, and be perceived as a substantial threat by a finance provider that is highly exposed to the sector (concentration risk). This risk may thus be reflected in the cost of borrowing.
- ▶ **Lack of financial education:** Farmers and other value-chain actors may not understand exactly how the financing mechanism works, and thus be unaware of its costs and implications.
- ▶ **Allocation of capital:** Agribusinesses such as traders and processors may need to allocate significant resources to financing suppliers rather than to their core business.



4.3 Blended finance

Given the limited government funding available and the significant consequent financing gap for the SDGs, blended-finance mechanisms have become a high priority for governments and development actors around the world. Blended-finance mechanisms use public and philanthropic funds to mobilize additional (private) capital for the purposes of sustainable development. Blended-finance vehicles are often set up not only by DFIs such as KfW, the EIB, the World Bank, the ADB and the UK

* INTRODUCTION:

Blended finance aimed at catalyzing private-sector activity can take numerous forms, including tools that facilitate financing flows by providing support mechanisms (grants, guarantees) or as complementary financing (grants, equity, debt). All of these help to create stronger incentives for private entities to invest in strategic sectors. Examples of such instruments include:

- Guarantees from DFIs that help reduce the risk inherent in project.
- Grants that can be used to defray the costs of setting up an investment vehicle.
- Concessional finance with below-market terms or rates for the borrower, which can help lower overall project costs and/or enhance potential risk-adjusted returns.

- A junior equity position in a co-financing structure that absorbs a higher level of risk than what other investors are willing to assume.

The objectives of blending are often achieved in combination with non-financial instruments. These could include a range of technical-assistance interventions such as facilitating access to information and data; supporting financial-product development and feasibility studies; providing technical assistance to recipients, fund managers, governments and other market players; and facilitating networking and policy dialog.

DFIs need to clearly demonstrate additivity as they use public funds to intervene in market activities in any way that could lead to market distortions and/or the waste of limited resources (see Box 10).

Department for International Development, but also by private-sector entities such as Deutsche Bank and Ecosphere. Examples include the European Fund for Southeast Europe, the Green for Growth Fund, the Althelia Climate Fund, the Danish Climate Investment Fund, the Global Health Investment Fund and the Africa Guarantee Fund, to name a few.

EXAMPLE

Global Climate Partnership Fund (GCPF)

The GCPF uses public funding to leverage private capital in order to mitigate climate change and drive sustainable growth in developing and emerging markets. The fund primarily works through local financial institutions, but in some cases also makes direct investments. The GCPF finances projects targeting small and medium-sized businesses and private households, with a specific focus on:

- Energy-efficiency projects that reduce projected greenhouse-gas (GHG) emissions by at least 20%; and
- Renewable-energy generation projects.

A technical-assistance facility has also been established to provide technical assistance, primarily to assist fund investees in their development and growth, but also to facilitate new fund investments and protect existing ones. The GCPF prioritizes countries with the most significant GHG emissions and the greatest potential to increase efficiency.

As of May 2020, the GCPF has invested \$656 million in projects in 25 countries.

▶▶ FLOW OF FUNDS:

One of the commonly used mechanisms within blended finance involves different loss tranches. In this model, equity- or debt-capital investments are divided into different tranches, with a view to attracting investors with different risk appetites. In so-called waterfall structures (as illustrated in figure 24), higher or “senior” tiers receive repayment deriving from lending or investing activities first, and are thus safer investments, while lower or “junior” tiers receive payment only after the higher-tiered finance providers are paid in full. In the case of losses, the lowest tranche – the equity/first-loss tranche (C shares as illustrated Figure 24, often bought by the government or philanthropic organization) – absorbs the initial losses, followed by the mezzanine tranches (commonly bought by DFIs), again followed by more senior tranches. The senior tranches are attractive for risk-averse investors such as pension funds or insurers, as finance providers with a more senior position are expected to be insulated from default risk through the absorption of losses by the more junior tranches.

Rather than financing individual projects or companies directly, blended-finance investment vehicles often channel funding to local intermediaries for on-lending, or provide matching investments to existing funds with the aim of encouraging the participation of additional finance providers.

🔍 ADVANTAGES

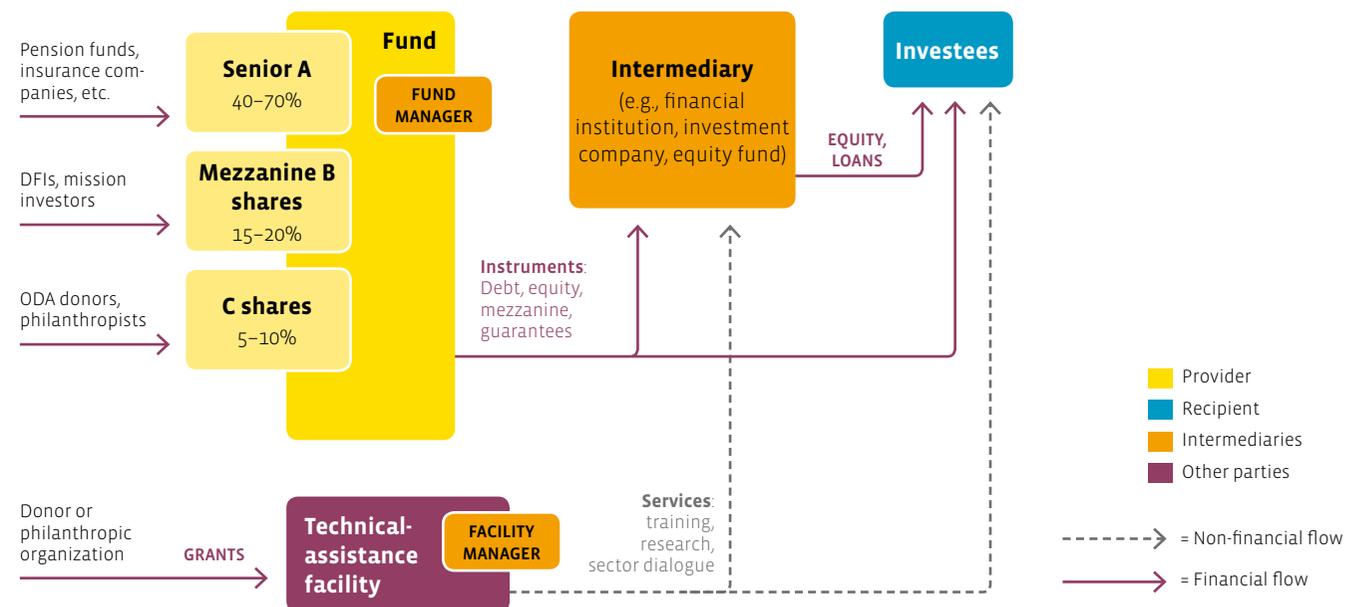
▶ **Private-sector capital mobilized for development purposes:** Blended-finance vehicles increase the reach of limited public development-finance and philanthropic funds, as they are used strategically to encourage the participation of larger volumes of private capital. Through the provision of investment opportunities for a variety of investors with different risk, return and impact profiles, private capital is channeled into investments with high development impact.

- ▶ **Combined public- and private-sector expertise:** Bringing together the complementary skill sets, knowledge and other resources held by public, philanthropic and private investors can increase the scope, range and effectiveness of development-related investments.
- ▶ **Increased private-sector investment in socially and environmentally beneficial projects:** The provision of incentives encourages private-sector capital to enter sectors and markets that might otherwise be avoided by traditionally commercial investors. This is

achieved by de-risking investments and by demonstrating financial viability and technical feasibility.

- ▶ **Improved financial discipline:** The involvement of private-sector capital can have a positive effect on financial discipline within projects.
- ▶ **Expanded ability to reuse development funds:** The entry of private-sector capital enables donors to realize financial returns and thus recycle scarce development funding for other development purposes.

FIG 24 Flow of funds involving a blended finance vehicle with waterfall structure



Q PITFALLS:

- **Risk of crowding out private investments:** Public-sector engagement in blended finance – particularly if a concessional finance model is used – can crowd out other local or international commercial finance providers that would only be able to provide finance at higher rates.
- **Risk of market distortions:** Providing access to support and/or finance to selected investors or companies gives these recipients a competitive advantage relative to other investors or companies, thus potentially distorting the market.
- **Risk of wasting scarce public resources:** Any time public-sector aid is provided, there is a risk of supporting an activity that would have happened anyway, or of providing much more support than required to mobilize the private sector.
- **Difficulty of proving, measuring additionality:** As yet, no guidelines for assessing additionality when working with private financial sectors exist. Measuring and comparing financial and developmental additionality presents numerous methodological challenges, and it is not a common practice to assess additionality on both an ex ante and ex post basis. This also makes it challenging to understand the cost-effectiveness of blended-finance initiatives as compared to alternatives.
- **Difficulty of balancing private, public interests:** A fine balance must be struck between ensuring the confidentiality required by private investors and ensuring transparency in the use of public funds
- **Mission drift:** There is a danger that public and philanthropic sectors may seek to bring in purely commercially oriented investors at any cost, and/or focus too heavily on easily attained goals in order to make the project or vehicle more financially attractive.



BOX 6 Green Climate Fund (GCF)

INTRODUCTION

Responding to the climate-change challenge requires collective action from all countries, including by both the public and private sectors. The GCF helps developing countries limit or reduce their greenhouse gas (GHG) emissions and adapt to climate change. The Fund’s investments can take the form of grants, concessional loans, subordinated debt, equity or guarantees.

The Fund aims for a 50:50 balance between mitigation and adaptation investments over time. It also aims allocating at least 50% of the adaptation funding within particularly vulnerable countries. The GCF’s core focus is on areas that lead to reduced emissions (e.g., energy access and power generation; low-emission transport, forestry and land use) and/or increased resilience (e.g., climate-resilient crops, efficient irrigation systems, ecosystem conservation and management).

One of the distinctive features of the GCF is the provision for developing countries to access financial resources through national entities (direct access modality). The Fund also provides early-stage support for local preparatory activities through its Readiness Program.

FLOW OF FUNDS

The GCF does not itself make direct project investments; rather, accredited entities can submit funding proposals to access GCF financial resources. Private, public, non-governmental, sub-national, national, regional or international organizations can apply for

accreditation. For private-sector partners, the Fund works through its Private Sector Facility (PSF). The PSF can fund and mobilize institutional investors and leverage GCF’s funds to encourage corporates to co-invest. PSF is actively engaging with pension funds, insurance companies, corporations, local and regional financial intermediaries, and the capital markets.

ACCREDITED ENTITIES

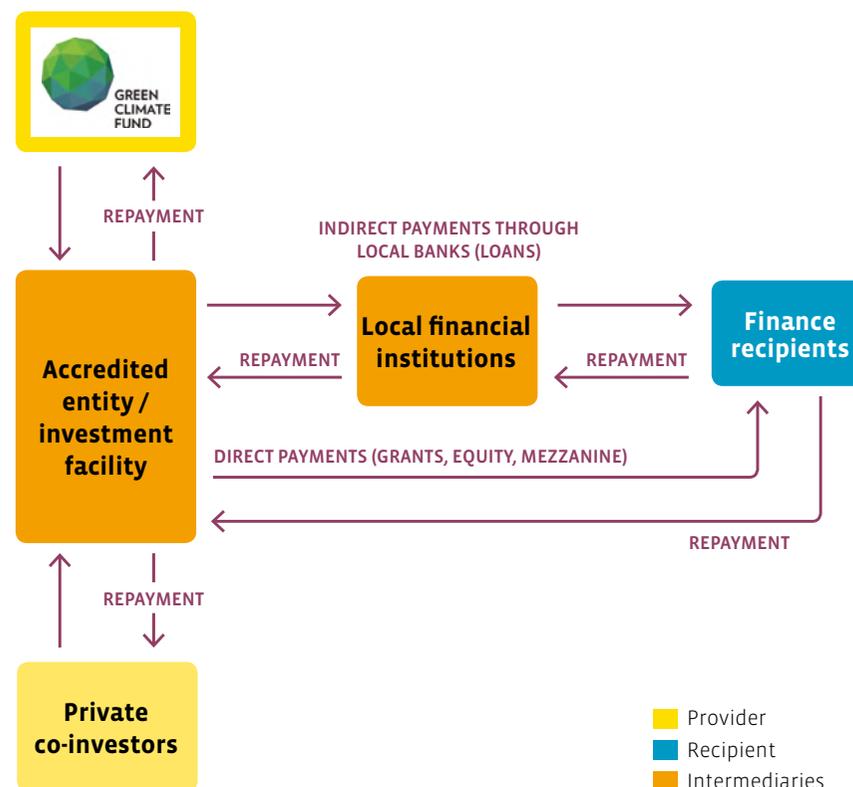
Accredited entities must develop their specific investment concepts and strategies in line with the GCF’s investment strategy, framework and criteria, policies, environmental and social standards, gender policy, and other requirements. The GCF provides funds to the accredited entity which in some cases are finance providers themselves or work via them. The accredited entity may look for additional funding if desired; as a catalytic fund, the GCF prefers the accredited entity to mobilize other public or private co-investors.

Since the investment entity managed by the accredited entity can be an international entity, the participation of local banks is in some cases advisable in order to disburse the funds to the finance recipients. Alternately, the funds can be distributed directly from the accredited entity to the final recipients or indirectly through intermediaries (so called executing entities). In order to keep asset classes and risk-return profiles consistent, debt financing from the GCF is provided to end recipients as debt, grants as grants, and equity investment as equity investment.

FINANCE RECIPIENT

Finance recipients (e.g., NGOs, start-ups, SMEs, cooperatives) must apply to accredited entities (or executing entities) for funding. Potential recipients can determine whether a suitable financing facility

exists by exploring the various GCF-funded projects and programs as listed at <https://www.greenclimate.fund/what-we-do/projects-programmes>. Finance recipients may not apply directly to the GCF, unless they are accredited.



BOX 7 Concept of additionality

An intervention is additional if the intervention is necessary to make a project or an investment happen – that is, if the investor would not have engaged in the absence of public-sector involvement (financial additionality), or the intervention increases the project’s development impact and sustainability in such a way as to have implications for growth and poverty reduction (developmental additionality). Additionality is a central analytical concept for donors and public-sector agents seeking to understand when it is useful to engage with the private sector, or trying to determine what to do when mobilizing and deploying private-sector capital for the purposes of sustainable development. It is also a useful measuring stick for all finance providers when considering their own impact in terms of the additional value they add compared to an impact-neutral finance provider. There are various types of additionality in blended finance, including:

- **Financial:** Public-sector investors can offer longer debt maturities or lower capital costs, take a subordinated equity position, hold riskier portfolios than their private-sector peers, provide targeted subsidies, or offer guarantees to enhance returns and reduce risks.
- **Aggregation:** By supporting projects at the regional or global level, public-sector investors can help aggregate opportunities, diversify risk and facilitate the cross-border sharing of experience.
- **Signaling:** By engaging with a project, market or sector, public-sector investors can provide a stamp of approval, providing sufficient credibility to attract other investors – thus serving as an honest broker.
- **Knowledge:** Public-sector investors can strengthen the quality of a given investment model or technology, help local partners build capacity, facilitate technology transfer, and publicly share experiences and lessons learned.
- **Demonstration:** Public-sector investors can support innovative entities by helping to mitigate risk in new business models, or by attracting funding to fragile low-income countries and developing markets that are not (yet) able to attract a significant level of commercial capital.
- **Poverty focus:** Public-sector investors can influence project designs to ensure that they reach lower-income market segments, thus helping to reduce inequalities, bolster local participation, and generate employment among low-income or disadvantaged populations.
- **Standards:** Public-sector investors can promote the use of high environmental, social and governance standards in investee companies, financial institutions and funds, and at the industry level.
- **Market-building:** Public-sector investors can help strengthen policy environments and business ecosystems, support the development of market infrastructure, generate market data, and support industry research.



4.4 Project finance

Project finance is a mechanism often used for providing long-term financing for the development of infrastructure, public services and some industrial projects. A key distinguishing feature of project finance is that the financing is tied to a standalone and clearly demarcated project, including its assets and future cash flows. Usually, the financing involves the

* INTRODUCTION:

Project finance differs from traditional corporate financing arrangements in which financing is based on the assets, liabilities and business reputation of the project developer. Project finance allows for what is known as ringfencing, by decoupling the project's financing from the project developer's assets, liabilities and cash flows. Thus, it is also called off-balance-sheet finance. In corporate finance, if a project fails, the finance providers do not necessarily suffer as long as the company owning the project remains financially viable.

In project finance, however, if the project fails or the SPV fails to meet its obligations, the finance providers can expect significant losses. In such cases, finance providers seeking to recover their investments have recourse only to the assets of the SPV. This is called non-recourse finance. More common, however, is limited-recourse finance in which the pro-

viders have some (limited) recourse to the sponsor's assets beyond the assets of the SPV.

Project finance provides the opportunity to provide long-term financing as long as the project in question is well-structured and economically viable, even if the developer's own resources are insufficient to carry out the project. Through the use of various contracts, insurance products, and complex financing and risk-mitigation structures, it allows for the allocation of project risk among those who are best able to manage and control that exposure.

formation of a new company by the private project developer solely for the purpose of carrying out the project. Known as a shell company or a special-purpose vehicle, this new company raises project-specific financing using a mix of instruments such as equity investment (supplied by the project developer and/or other finance providers), bonds and bank loans.

EXAMPLE

Bujagali Hydropower Project, Uganda

Built at the Bujagali waterfalls in Uganda, the Bujagali Hydropower Project is the biggest run-of-the-river power station in all of sub-Saharan Africa, and began operation in mid-June 2012. The five-turbine power plant at the source of the Nile now generates more than 250 MW of electricity, powering about 5 million households. The project was carried out at a cost of \$900 million.

Bujagali Energy Limited (BEL), a project-specific company (i.e., an SPV), was formed to develop and operate the project. The company was in turn owned by companies associated with the Aga Khan Fund for Economic Development and the Blackstone Group, which provided the equity financing for the project. The debt financing was provided by a number of entities including the IFC, the EIB, Barclays, and the AfDB, among others. The project involved the negotiation of an offtake agreement between BEL and the government of Uganda. The presence of several DFI lenders, in addition to guarantees in the form of an International Development Association partial risk guarantee (IDA PRG) and Multilateral Investment Guarantee Agency political-risk insurance policy (MIGA PRI), reduced investors' perceived risk, and served to limit any losses associated with potential political-risk events.

►► **FLOW OF FUNDS:**

Project finance usually includes a large up-front investment, a long utilization term and a long repayment term. The financing is usually provided in the form of long-term loans to the SPV, is secured by the project's assets and repaid from the project's cash flows. The flow of funds is illustrated in the graph below.

Finance recipient: For project finance, the finance recipient is the SPV set up to implement a task, such as a large infrastructure-development project. The project-owning company thus has no assets other than the project itself.

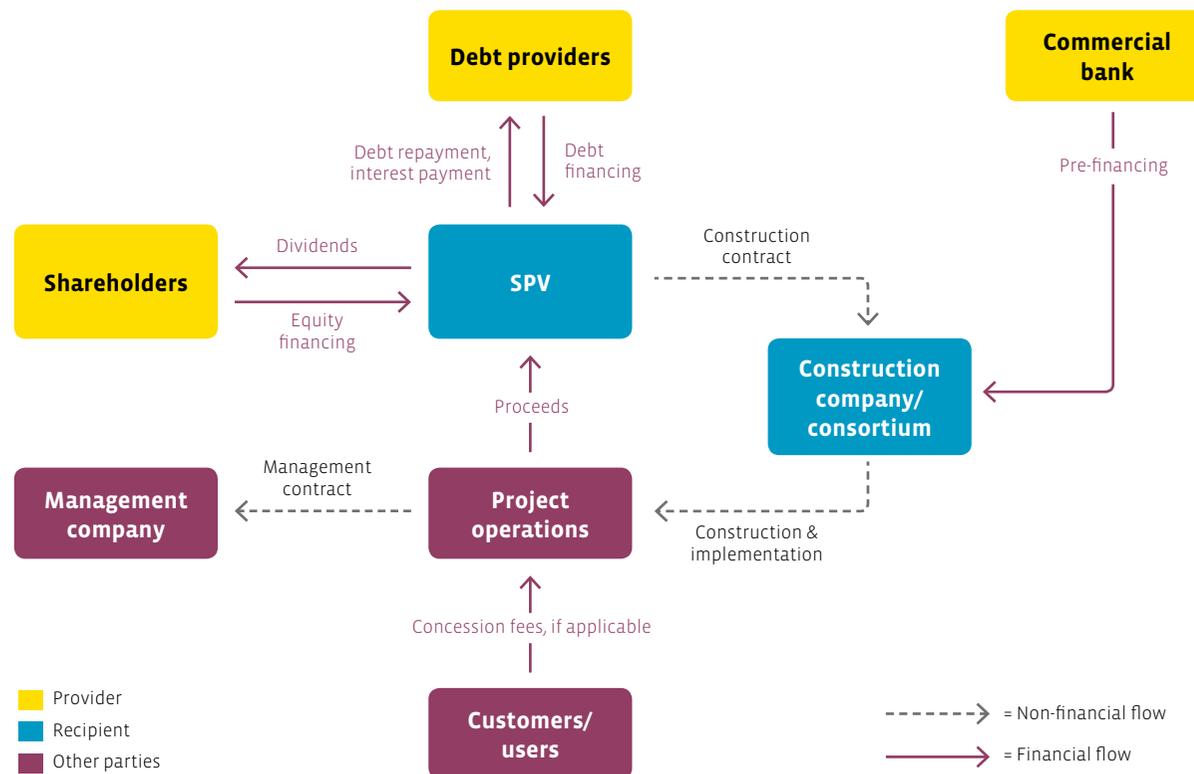
The SPV will typically use a public-tender process to hire a construction company to build the project to the point of opera-

tional readiness. Depending on the project's size and complexity, construction can also be performed by a consortium of companies under a general manager. The entire structure of financing agreements can get quite complex.

Once constructed, the project is typically managed by a professional management company, and is expected to

generate enough cash flow to pay back the loan principal and interest to the banks, as well as to generate a dividend for the shareholders. The cash flows come from the income generated by the project operations, for instance in the form of concession fees in the case of a road, airport or port, or from the sales of electricity from a hydropower plant. Due to its complex structure and long-term commitment, project financing requires sound financial modeling.

FIG 25 Flow of funds involving case of project finance



Finance providers: Financing can come both from public and private sources, and in many cases entails a syndicate of funders. The shareholders contributing equity capital (also called “sponsors”) may form a public-private partnership (see section 4.1.1). Moreover, the identity of key shareholders may change over time; for instance, a private company may own the project during the lifetime of the loans, and for as long afterward as the project's cash flow continues to generate dividends. Thereafter, it may transfer ownership to the government or another public owner.

Risk identification and allocation is a key component of project finance. Projects may be subject to a number of technical, environmental, economic and political risks, particularly in developing countries.

➤ ADVANTAGES

- **Long-term financing enabled:** Project finance enables long-term financing to be raised for projects that entail huge capital expenditures. Thus, companies whose financial position is not strong enough to raise the necessary finance to invest in a project on their own can potentially acquire sufficient financing on a project-finance basis.
- **New sources of capital mobilized:** Projects can be structured so as to attract a wide range of finance providers, thus supplementing or even substituting for banks. Project finance helps in accessing a large spectrum of providers with different risk-return profiles, particularly given the globalization of financial markets. For instance, private-equity investors, who tend to take a long-term view of their investments and are often willing to take on more risk than banks in anticipation of higher returns, are increasingly taking an interest in project finance.

- **Risk allocated efficiently:** By properly allocating risk among a group of actors, project finance allows a project developer to undertake a project with more risk than the sponsor is independently capable of assuming (or willing to assume).
- **Ringfencing protections created:** The risks of the new project are separated from the project developer's existing business. This means that if the project fails, the project-finance structure insulates the developer from having to use existing assets to repay either the project debt or any liabilities incurred through the failure of the project.

➤ PITFALLS:

- **Complex structure:** Given the complex nature of project finance, considerable time and effort must be invested in structuring and creating a detailed appraisal of the project, for instance with the help of financial and legal advisers and other experts. This adds to the cost of setting up the project and may delay its implementation.
- **Unforeseen risks:** Given the long-term nature of project finance, this model contains several inherent risk factors. Since the viability of the project-finance structure depends on the strength of the project itself, the project's technical, financial, environmental and economic viability are of paramount concern. Any risk factors that weaken the project are also likely to weaken the financial returns received by investors and creditors. Therefore, an essential early-stage task is to identify and analyze the project's risks, then to allocate and mitigate them.
- **High cost of capital:** Project finance usually involves a high proportion of debt. The non-recourse (or limited-recourse) nature of this debt increases the cost at which it is provided, thereby pushing up overall capital costs.



4.5 Results-based financing

Results-based finance (RBF) mechanisms are used by developing-country governments (national or local), state agencies and donor agencies to provide incentives for the provision of goods or services, to create or expand markets, and to stimulate innovation. Previously, related approaches

* INTRODUCTION:

RBF seeks to mobilize additional financing from investors that would not normally consider investing in the social sector due to low expected returns. Despite the variety of models, RBF mechanisms are based on a few common principles, identified below.

- Disbursement of funds is contingent on the delivery of predetermined outcomes.
- The private sector (and non-profit sector) has discretion over how results are achieved, thus allowing for product and service innovation.
- Independent verification acts as the trigger for disbursement.

Different types of RBF mechanisms have been piloted or mainstreamed in recent years, including:

- **Output based aid (OBA):** OBA is an approach to increasing access to basic services such as water, health care and education within low-income communities in developing countries. OBA links the payment of public funds

to the private sector to the delivery of outputs such as connections to electricity grids or the provision of solar-based home power systems. OBA projects generally assess outputs rather than outcomes.

- **Advance market commitments (AMCs):** Governments, donors or philanthropists guarantee a fixed offtake quantity, price or revenue in order to establish a viable market. The objective is to stimulate research, product development and private investment into areas and sectors that the private sector would otherwise consider unattractive. In 2007, five countries (Canada, Italy, Norway, Russia and the United Kingdom) along with the Bill & Melinda Gates Foundation committed \$1.5 billion to launching the first AMC designed to help speed the development and availability of a vaccine targeting pneumococcal disease, a major cause of pneumonia and meningitis. AMC mechanisms are also indirectly applied within the low-carbon power-generation sector, for example through the establish-

were used as a means of improving aid effectiveness and cost-efficiency in the provision of public services (payment by results). Results-based finance mechanisms seek in various forms to align public- and private sector interests by linking outcomes to financial returns.

EXAMPLE

Energising Development (EnDev) energy access program

Since 2013, EnDev is implementing the DFID-financed RBF Facility (RBFF) that offers incentive payments to private sector actors in the low-carbon off-grid energy sector in developing countries. The RBF approach aims at overcoming market barriers constraining the private sector delivery of decentralized renewable energy systems providing modern energy services to the poor. It also seeks to improve access to finance, to support private companies along the whole value chain and remove temporary financial barriers faced by private sector energy suppliers.

The key principles applied within the RBFF are as follows: 1) Participants will agree beforehand on a set of expected results to encourage product and service innovation, while leaving flexibility to the participants on how to achieve them; 2) All eligible service providers will be able to participate on a competitive basis; 3) Monitoring and verification systems will serve as the trigger for incentive disbursement based on achieved results; and 4) Private participants are expected to take the full risk until the delivery of the pre-agreed results.

During the implementation period from 2013-2020, the RBFF encompassed a total of 17 projects in 14 countries (in Africa, Asia and Latin America), covering a wide range of technologies such as solar PV systems, mini-grids, cookstoves and biogas digesters. The RBFF is meant to be a large-scale learning project on how to catalyse private sector development in energy access markets. As a result, the portfolio covers a broad range of sub-sectors, technologies, private sector actors, RBF designs and countries. Building on the RBFF experience, EnDev has integrated RBF as a technical assistance financing modality into its interventions. It also continues to develop and implement new and innovative RBF approaches and designs. These include focusing specifically on poor target groups and rural/remote areas as well as moving result payments from outputs towards measurable outcomes and impacts.

ment of feed-in tariffs, the creation of renewable obligations or through commitments to green public procurement.

► **Impact bonds:** Impact bonds combine impact investing, results-based finance and public-private partnership concepts. In an impact bond, private investors provide up-front capital for social services and are repaid by an outcome funder if the agreed-upon outcomes have been achieved. Various types of impact bonds have been developed in different jurisdictions and geographies, including social-impact bonds in the United Kingdom, pay-for-success contracts in the United States, social-benefit bonds in Australia, and development-impact bonds and humanitarian-impact bonds in developing and emerging countries.¹⁸

New and promising approaches to outcome-based financing apply the experience gained using impact bonds for social-sector activities to early-stage entrepreneurship development. Here, companies are paid for the impact generated during a certain transitory period of time, thus increasing the attractiveness to potential investors. Examples include the Social Success Note developed by Yunus Social Business in cooperation with the Rockefeller Foundation, as well

as the Social Impact Incentives platform developed by Roots of Impact and piloted in Latin America in cooperation with the Inter-American Development Bank (IDB) and the Swiss Development Cooperation, with the Acumen Fund in the energy sector, and with Root Capital for early-stage agripreneurs.

►► **FLOW OF FUNDS:**

The flow of funds under this model depends on the exact nature of the RBF mechanism. For the purposes of illustration, this section describes impact bonds, which are increasing in importance in both the social and development sectors.

Most impact bonds involve three types of actors: the investors, who are typi-

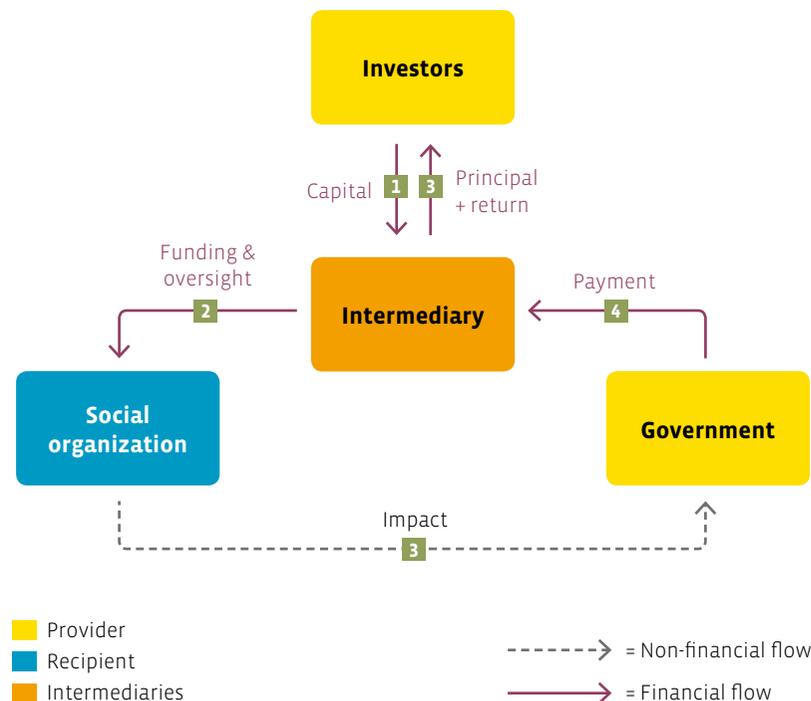
cally return-seeking impact investors or venture philanthropists that provide up-front capital to social organizations; a non-profit organization or social enterprise, often called a service provider, that deliver products and services to the target group; and the outcome funder, usually a government, development agency or philanthropic organization that promises to repay the investors if the agreed outcome is achieved with the addition of an predetermined bonus representing the return on investment.

Other actors in this model include evaluators that verify whether agreed-upon outcomes have been achieved, and intermediaries that perform tasks such as designing the bond, helping to raise capital and arranging negotiations among the participants. In many cases, external legal and technical know-how is required from lawyers and sector or impact experts, sometimes called technical-assistance providers or simply experts.

Figure 26 explains the process and the flow of funds using the structure and process of the first social-impact bonds in the UK as an example:

- An intermediary issues a bond to a (social) investor and receives the capital (step 1).
- The intermediary transfers the money to one or several social organizations (step 2).

FIG 26 Flow of funds involving case of impact bonds



18. Impact bonds are not a fixed-income instrument like traditional bonds; instead, their income depends on the outcomes achieved. As such, the term is misleading, which is why different terms such as "pay-for-success" have been used in some jurisdictions.

- ▶ Social organizations use the funds as working capital to scale and improve the outcome of a preventive program. The work can be coordinated and monitored by an intermediary (step 3).
- ▶ At the end of the contract period (3–10 years), an independent evaluator determines whether the agreed-upon outcomes have been achieved based on the government contract. If a positive evaluation is provided, the intermediary is paid a previously agreed amount. This may take the form of a percentage of the government savings created through the achievement of the outcomes, for example. If the evaluation is negative, the government (i.e., the outcome payer) funder does not owe anything (step 4).
- ▶ Only in the case of success would the intermediary then repay the original (social) investor the equivalent of the principal and a return on investment, the size of which may vary depending on the service providers' performance (step 5).

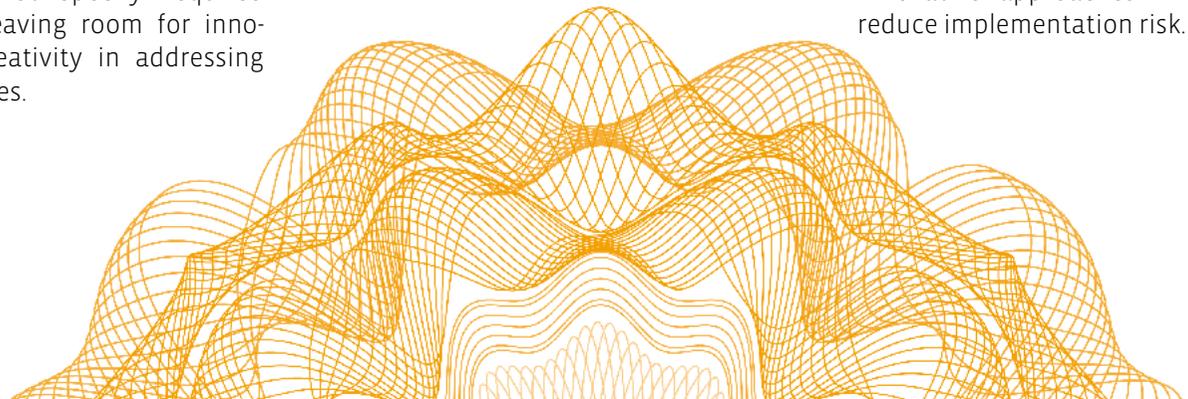
📌 ADVANTAGES

- ▶ **Focus on prevention created:** By design, impact bonds are focused on early-intervention programs that are preventive in nature. This reduces the need for subsequent and more expensive remedial measures in the future.
- ▶ **Outcome orientation established:** Success is measured by outcomes, not by outputs as in the case of a performance contract, or by financial performance as is true of a typical investment. This helps to orient the intervention toward the results that ultimately matter for beneficiaries and the government.
- ▶ **Risk capital harnessed:** Impact bonds are expected to raise capital for innovative programs involving risks that governments (or development agencies) are not able (or unwilling due to political reasons) to assume, and are often unable to budget for.
- ▶ **Innovation enabled:** Government agencies do not specify required inputs, thus leaving room for innovation and creativity in addressing social challenges.

- ▶ **Up-front working capital provided:** Service-delivery organizations are provided with up-front working capital.
- ▶ **Long-term predictability established:** Funding levels are predictable and sustained over a comparatively long period of time, reducing the need for costly fundraising.

🔍 PITFALLS:

- ▶ **Target-group definition:** The target group has to be well defined, and data on their preferences and needs has to be available.
- ▶ **Need to measure outcomes:** Outcomes have to be measurable, and have to translate into government savings substantial enough to pay for the work of the social organization and intermediary, as well as the original investors' return.
- ▶ **Range of capacities needed:** Social organizations must have the capacity both to attract investors and to deliver the promised outcomes.
- ▶ **Potentially high risk level:** Investors need to be ready to face uncertainty and assume a high level of risk, as the process will largely unfold outside of their control once the service provider begins offering services. Critics have warned that investors may push for the use of conventional rather than innovative approaches in order to reduce implementation risk.



4.6 Thematic bonds

Bonds are widely used by governments and large companies to raise long-term financing. The entity raising financing through bonds is called a bond issuer (or simply an “issuer”), while those providing the financing are called bond investors. Bonds are typically traded through privately

negotiated transactions between the issuer and the bond investor, or among various bond investors. These transactions are usually mediated by specialized financial institutions such as investment bankers.

* INTRODUCTION:

Bonds are debt financing instruments. Bond investors usually earn returns in the form of interest paid by the issuer (called “coupon” in case of bonds), with additional gains possible by selling the bonds to other investors following a change in the bonds’ market value.

With the launch of green bonds by the European Investment Bank and World Bank in 2007/08, bonds took on a new prominence in the area of development cooperation. Thematic in nature, this type of bond is geared toward financing a specific environmental, social and/or governance-related area within the development context.

Thematic bonds of this type have since been issued by DFIs, MDBs and commercial entities. Examples include social bonds (IFC); SDG bonds (World Bank); health bonds (ADB); education, youth and employment bonds (Inter-American Development Bank); clean-energy bonds (ADB); water bonds (ADB); and forest bonds (IFC). Similar examples exist in the private sector as well. French industrial

gas company Air Liquide issued so-called socially responsible investment (SRI) bonds in 2012 to raise financing for its health activities, while Münchener Hypotheken Bank issued bonds to support social housing.

Some initiatives have tried to standardize the scope of such thematic bonds. One of the most prominent definitions is provided by the International Capital Market Association’s (ICMA’s) green-bond principles. This is a set of voluntary, non-prescriptive guidelines to be considered by green-bond issuers, investors and underwriters, aimed at improving market transparency and accountability. The ICMA has also published guidelines for sustainability bonds and social bonds.

EXAMPLE

African Development Bank (AfDB) social bond program

In 2017 the AfDB issued its first 7-year Social Bond, raising €500 million (almost \$550 million) to expand financing programs that meet critical development challenges. Since then, the AfDB has issued three more social bonds.

In April 2020, the AfDB’s “Fight Covid-19” social bond was listed in the London Stock Exchange’s (LSE’s) dedicated Sustainability Bond Market (SBM). It seeks to alleviate the negative consequences of the COVID 19-Pandemic in African countries. It has raised \$3 billion from central banks, bank treasuries and asset managers, including ESG investors. This bond has a maturity of 3 years and offers an interest rate of 0.75%. The LSE has waived admission fees for an initial period of three months of bonds that seek to mitigate the negative effects of COVID-19.

►► **FLOW OF FUNDS:**

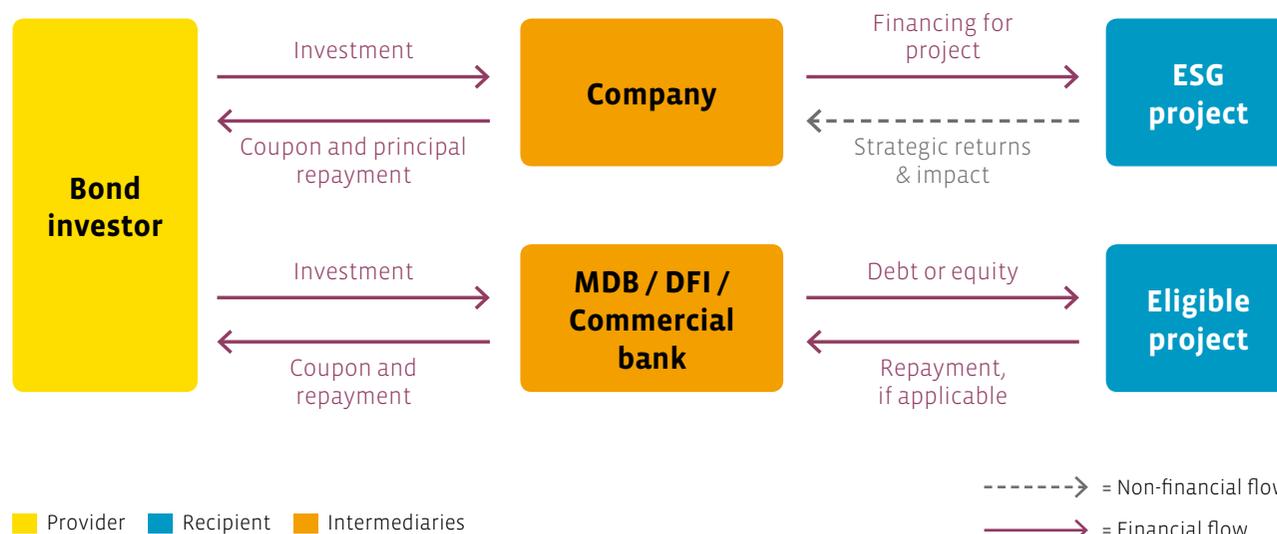
Thematic bonds can be used in two different ways. First, MDBs, DFIs and commercial banks can raise financing by using a thematic bond, and provide the funds thus acquired to projects eligible under the bond program’s guidelines. Second, a company could raise financing by issuing a thematic bond and use the proceeds to finance its own ESG project.

Finance provider: Investors may finance thematic bonds for several reasons. One salient driver is the increasing public and political mobilization around social and environmental issues. The returns on thematic bonds often match those of conventional bonds (depending on factors such as the credit risk of the issuer and broader macroeconomic factors). Investors investing in thematic bonds include institutional investors comfortable with long time horizons. These could include pension funds, sovereign funds, family offices, insurance companies and other socially responsible investors.

Financing provided by the sale of thematic bonds can be direct or indirect. Investors could directly provide financing to a company issuing the bonds to fund an ESG-oriented project. Alternatively, the investors could buy thematic bonds issued by an MDB, DFI or commercial bank, with the issuing entity subsequently providing financing to eligible projects based on predefined criteria. This latter option is the model underlying IFC’s social bonds and KfW’s green bonds.

Finance recipient: Thematic bonds can be used by a range of potential recipients, depending on whether the financing is direct or indirect. Issuing bonds and raising funds directly is often a long and a cumbersome process. It involves different financial-service companies, and also entails significant cost. This avenue is thus used only by large companies or government entities that are experienced and have the means to undergo such a process. For instance, consumer goods company Unilever raised £250 million by issuing green bonds for the establishment of a number of new factories expected to halve the amount of waste, water usage and greenhouse-gas emissions produced by existing factories.

FIG 27 Flow of funds involving thematic bonds



SMEs and start-ups, if implementing an eligible project, could also access funding from thematic-bond programs led by DFIs, MDBs or commercial banks. For instance, through its Inclusive Business Bonds program (now merged with the Social Bonds program), IFC provided \$4 million to Pearl Dairy (Uganda) in order to establish new milk-collection centers and a cold-storage infrastructure facilitating milk collection from small-scale farmers.

+ ADVANTAGES:

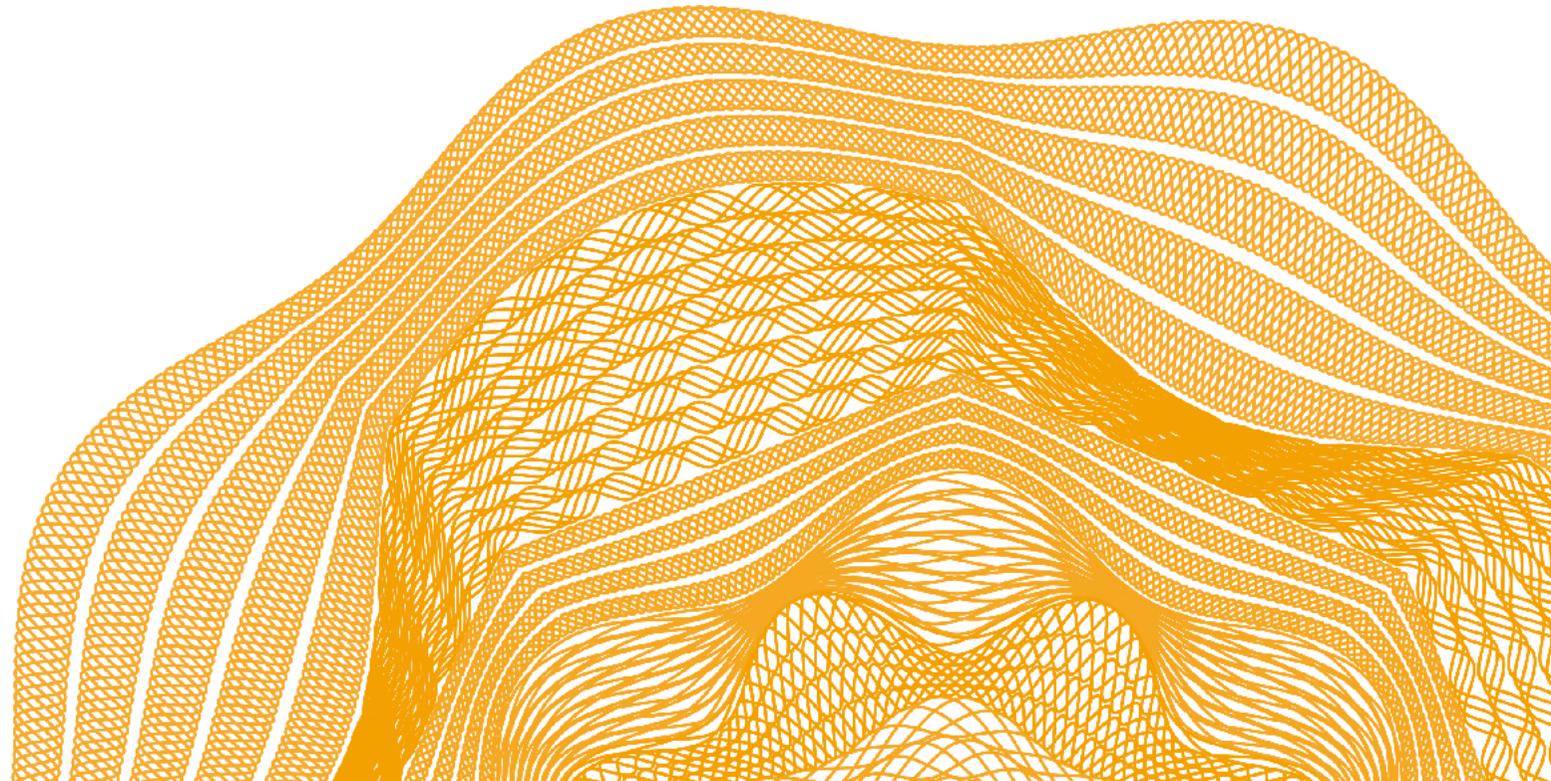
- **Additional sources of financing mobilized:** Institutional investors (such as pension funds, insurance companies and sovereign-wealth funds), who manage a very substantial share of the available global capital, are among the largest investors in bonds. These investors have a preference for low-risk financial instruments. Thematic bonds help to mobilize these institutional investors for development-oriented purposes.
- **Investor demands met:** Many investors globally are increasingly incorporating ESG factors into their investment decisions. From an investor's point of view, thematic bonds provide an opportunity to meet these demands.
- **Financing provided that is cheaper and longer-term than bank loans:** Banks are inevitably subject to regulatory compliance costs. They also need to take into account the duration of their liabilities (i.e., their customers' savings), which are rather short term. Bonds, by contrast, do not have such costs (or at least have lower costs), resulting in lower interest rates, and are by design preferred by investors with longer-term horizons.

- **Large amounts of funding raised:** The amount of financing provided by a single bank can be limited by the degree of risk exposure that bank is willing and allowed to accept. By contrast, by involving a larger investor base, bonds can help to raise much larger amounts.

+ PITFALLS:

- **Additional costs of issuing thematic bonds:** Bond issuers have to bear the additional costs entailed in the issue of a thematic bond, while still providing returns comparable to a normal bond. These additional costs derive from defining the criteria, monitoring and evaluating, and transparently communicating performance to investors over the lifetime of the bonds.

- **Lack of universally accepted frameworks:** The proliferation of different standards, frameworks and guidelines, along with the diversity of market practices in terms of definitions and requirement can create confusion among issuers and investors.
- **Nascent market:** The market for thematic bonds (for example green bonds), albeit growing, is still small. This limits liquidity and the ease with which investors can trade bonds among themselves.



4.7 Crowdfunding

Crowdfunding refers to mass funding efforts in which large numbers of people (i.e., funders or campaign backers) jointly finance projects, ideas or companies. The funding is usually facilitated by online platforms (called

crowdfunding platforms, or CFPs), with social-media campaigns supporting the funding effort to make people aware of the opportunity.

* INTRODUCTION:

In its various manifestations, crowdfunding is being used in international development as well, as a tool to raise funds for causes and to communicate with donors and supporters. For example, online crowdfunding platform Indiegogo offers private campaigners and NGOs special categories for cause-related projects, for instance in areas such as health care, education or community development.

The amounts raised through crowdfunding tend to be much smaller than those associated with the other mechanisms described in this document. Among all successful crowdfunding campaigns on Kickstarter, also a CFP, almost 33% of all campaigns raised amounts greater than \$10,000. However, only 0.2% of successful projects raised \$1 million or above.¹⁹

Four main types of crowdfunding models are widely used:

► **Lending-based:** Funders receive a fixed amount of periodic income and

expect repayment of the original principal, just as in the case of a bank loan or a bond. This model is also known as peer-to-peer (P2P) or social lending.

► **Reward-based:** Funders gain a non-financial benefit in return for financial contributions. These rewards often take the form of a token of appreciation or the right to pre-purchase the product or service for which the funds are being raised. For instance, in the adjoining example, WakaWaka offered its campaign backers a pocket-sized solar LED light and phone charger.

► **Donation-based:** This provides funders with a way to donate to causes they want to support, with no expected compensation (i.e., a philanthropic or sponsorship-based incentive). Funders are motivated by the potential for impact.

► **Equity-based:** Also known as crowdinvesting. Here, funders receive equity shares in the venture that they fund. In some cases, this may be subject to securities and banking regulation.

* EXAMPLE

Ecoligo Crowdinvesting

Ecoligo.investments is a German crowdfunding platform managed by the company ecoligo invest GmbH. The company is a subsidiary of ecoligo GmbH which is specialized in the development and implementation of solar and energy efficiency projects for commercial and industrial clients in developing markets. ecoligo GmbH focuses on the identification and selection of projects advertised on the crowdfunding platform. Its clients pay a monthly fee until the project is finalized, after which they own the project, and are saved the need to raise equity capital. In order to guarantee high quality projects, ecoligo also works with local operating partners as well as with international partners such as Allianz insurance.

Ecoligo has the same interests as crowd investors. It makes a profit only when the project is successful and meets its monthly interest and repayment obligations to the investors.

For the campaign “Zena Roses” the ecoligo subsidiary, ecoligo Ltd., concluded a leasing-contract with a term of 10 years with the end customer “Zena Roses”. Zena Roses owns three flower farms in Kenya and exports flowers internationally. The objective of the project was to build a 120 kWp solar energy plant for one farm in Kenya to become less reliant on the unstable national energy supply and simultaneously save up to 124t of CO₂-emissions per year. While Zena Roses has to pay off its leasing rates to eventually own the solar plant, ecoligo continues to be responsible for the maintenance of the solar plant.

►► **FLOW OF FUNDS:**

Crowdfunding platforms play a very important role in the crowdfunding process. These platforms serve as intermediaries between the potential finance providers and recipients. They also lend legitimacy to projects by reviewing the potential recipient and its information and projects, and employ various anti-fraud procedures to assure safety for the users. Examples of platforms include Indiegogo and Kickstarter (both reward-based), GlobalGiving and BetterPlace (both donation-based), Kiva and Zedisha

(both lending-based), and GrowVC and Innovatr (both equity-based). The platforms typically charge commissions of 5% to 10% of the total amount raised.

Finance provider: In crowdfunding situations, finance providers are mainly individuals, although other entities are not necessarily excluded. When funding a crowdfunding campaign, multiple individuals come together and share the financial risk, and therefore limit the extent of the potential financial loss faced by any single individual (any loss will be shared among all finance provid-

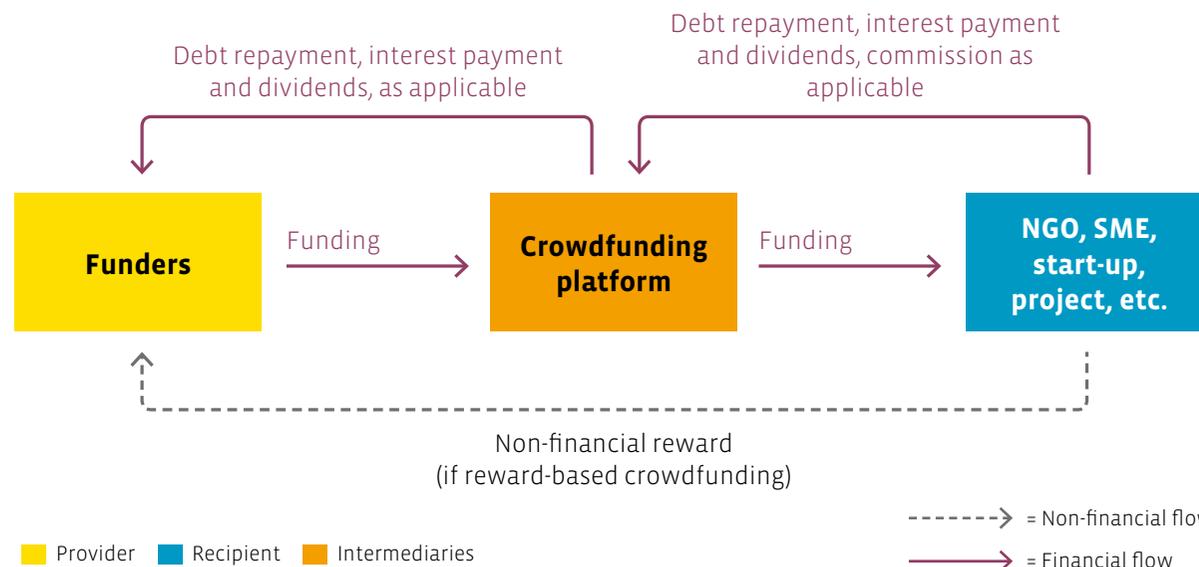
ers). These individuals may participate for different reasons, ranging from profit-oriented to philanthropic motivations. These various outlooks in turn influence the perception of what constitutes a successful project.

Backers who participate in debt and equity projects mostly look for monetary returns, while those participating in reward-based crowdfunding expect a non-monetary reward. However, all may expect a certain degree of philanthropic or impact potential in the campaigns they support. Backers participating in

donation-based campaigns are driven by philanthropic motivations. They are primarily seeking to support a cause that is congruent with their personal beliefs.

Finance recipient: The recipients also vary depending on the nature of the crowdfunding campaign. Lending and equity-based models are used by recipients who have a business proposition. For instance, start-ups and SMEs often pursue equity-based crowdfunding campaigns, which may or may not involve the subsequent payment of dividends. Lending-based campaigns require the recipient to repay the loans and make interest payments, just as in the case of an ordinary bank loan. These are used by micro-businesses in developing countries for microfinancing. There may also be models in which no interest is payable. Reward-based campaigns are used by non-profit initiatives, small companies in the product-development phase, and creative and cultural projects. Finally, donation-based campaigns are typically used for non-profit initiatives, disaster relief, and cultural, religious or private matters.

FIG 28 Flow of funds involving crowdfunding



➤ ADVANTAGES:

- ▶ **Access to finance provided:** Crowdfunding can provide access to debt or equity capital, particularly for SMEs and start-ups that face constraints in tapping other sources of finance such as banks, private-equity investors or venture capitalists.
- ▶ **Large base of funders/investors created:** A diversified investor base can be beneficial for a recipient seeking to scale up funding, while also reducing dependence on any single finance provider.
- ▶ **Risk shared widely:** For the providers, the “crowd” constitutes a risk-sharing mechanism, since any losses are distributed across all funders.
- ▶ **Non-monetary value created for recipients:** Through crowdfunding, potential finance recipients (e.g., entrepreneurs and SMEs) can also utilize the crowd to obtain ideas, feedback, volunteer support, debate and access to open-innovation processes.

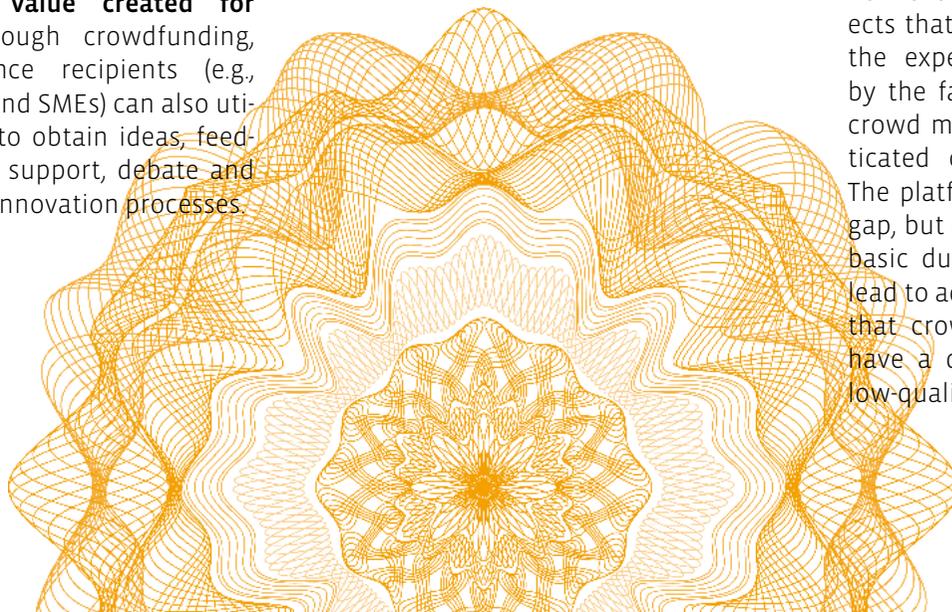
- ▶ **Quick and inexpensive:** Compared to raising funding through traditional channels such as banks, grant makers or private-equity investors, crowdfunding is a quick process that entails lower administrative costs.
- ▶ **Efficient for investors:** It allows investors to investigate numerous potential investments online at one time and determine quickly whether the company fits their portfolio strategy, risk appetite, or other criteria.

➤ PITFALLS:

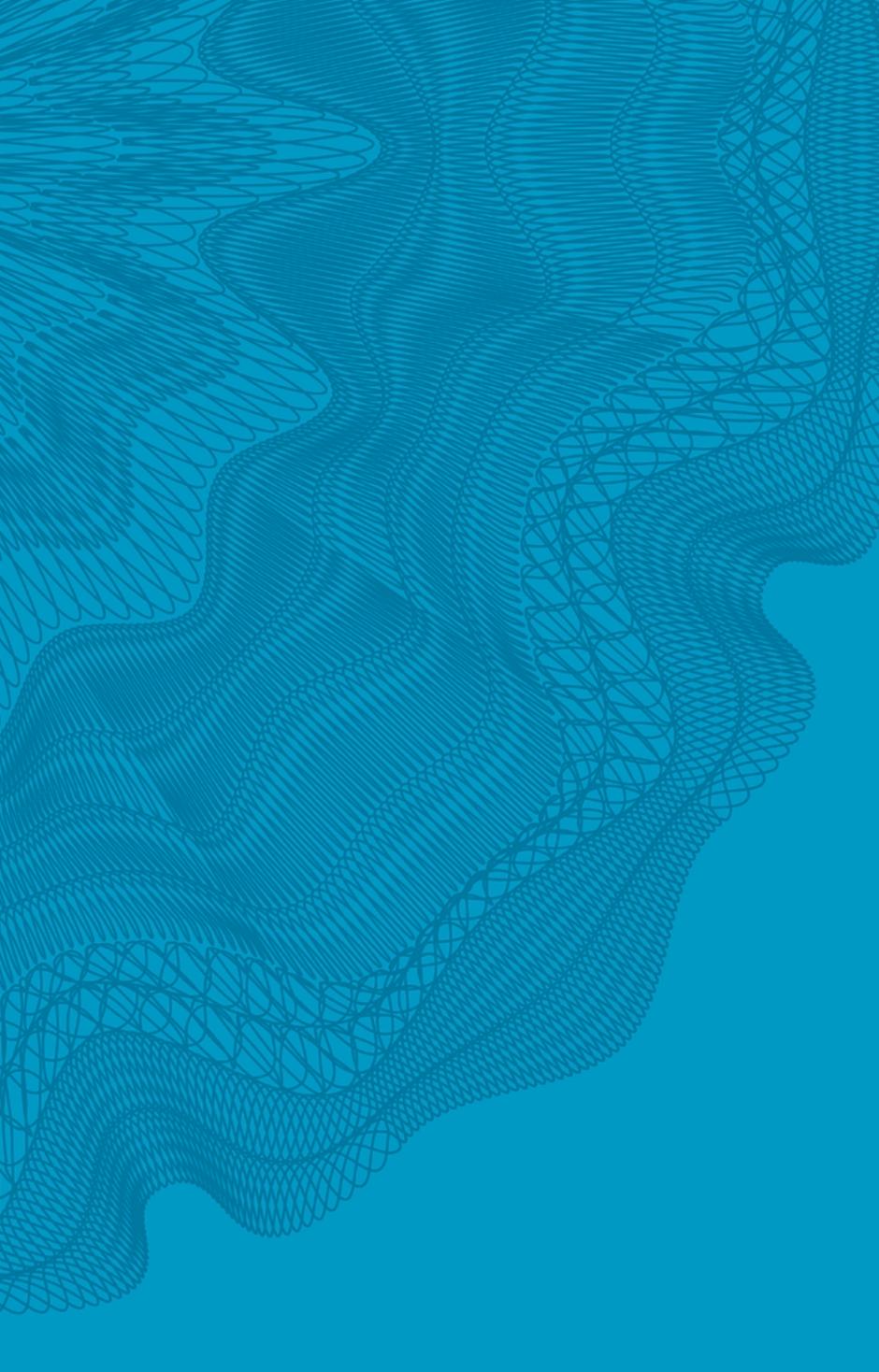
- ▶ **Project risk:** Crowdfunding often deals with early-stage initiatives that are subject to high levels of uncertainty as to future performance. In the case of project failure, platforms or external firms may attempt to recover a portion of the investments, but have not always been successful in doing so. Investors may not have access to borrowers’ assets in the case of project failure.
- ▶ **Asymmetric Information, lack of proper due diligence, risk of loss:** The difference in the information possessed by a potential recipient and that by a funder plays a substantial role in crowdfunding, hampering the latter’s ability to accurately estimate risk levels. The risk of choosing projects that subsequently fail to deliver the expected benefits is amplified by the fact that the majority of the crowd may be made up of unsophisticated or inexperienced investors. The platforms may try to bridge this gap, but often conduct no more than basic due diligence. This could also lead to adverse selection. This implies that crowdfunding platforms might have a disproportionate number of low-quality projects, as the manag-

ers of high-quality projects typically submit themselves to the stricter due diligence carried out by traditional investors in order to differentiate themselves. As a result of these factors, finance providers working through crowdfunding platforms face the risk of choosing projects that end up underperforming or failing.

- ▶ **Impact measurement:** Rigorous reporting and development-impact verification mechanisms are rare. This is a structural challenge, as projects listed on any crowdfunding platform are usually small, numerous, diverse and geographically scattered, making proper impact measurement and reporting costly and often impractical.
- ▶ **Nascent regulation:** The regulatory regime for crowdfunding within and across various countries is still in its early stages. This creates a bottleneck for platforms operating at a global level, and is particularly the case for cross-border and debt- and equity-based crowdfunding.



Appendix



Detailed comparison of financing instruments

	Equity investment	Quasi-equity (mezzanine finance)	Bank loans (secured and unsecured)	Bonds	Grants
Ownership acquisition: Is the entity raising funds open to ownership participation by the finance provider?	Always involves acquisition of ownership stake.	May involve acquisition of ownership stake.	No ownership-stake acquisition.	No ownership-stake acquisition.	No ownership-stake acquisition.
Board representation and influence How much influence and control is the entity raising funds willing to relinquish? Could a board seat be offered to a finance provider?	Typically involves board seat or the ability to nominate a board member in order to influence key strategic and management decisions.	No board representation.	No board representation, but provider exercises influence through debt covenants.	No board representation.	Some grant makers will require a board seat, especially if they are one of the primary funders.
Strategic support Does the entity raising funds need any strategic support? Is the funding mechanism associated with the right kind of strategic support?	Finance provider might provide strategic and management support.	Finance provider might provide strategic and management support.	Finance provider does not provide strategic support.	Finance provider does not provide strategic support.	Finance provider may provide strategic support.
Degree of risk sharing How much risk is shared between finance provider and recipient?	High	Medium	Low	Low	-
Cost of capital / return How is the finance provider rewarded?	Cost of capital depends on finance providers' return expectations, plus cost of fundraising. Mature companies that generate enough cash surplus may also pay periodic dividends.	May involve periodic interest payments, depending on the performance or cash flows of the finance recipient.	Debt repayment schedule includes periodic interest payments (such as monthly or quarterly) based on agreed terms with the lender.	Interest (called coupons in case of bonds) may be paid periodically (usually annually) or accumulated and paid in full at bond maturity.	Only fundraising costs.
Repayment / exit Does the entity raising funds need to repay the finance provider? If so, how does the finance provider expect to be repaid? Is the entity raising funds expected to have enough financial resources to do so?	Finance provider realizes returns by selling equity shares acquired as part of investment (exit strategy).	Finance provider may yield rewards that are based on the recipient's financial performance.	Principal must be repaid according to an agreed repayment schedule along with interest. Periodic payment includes repayment of principal and interest	Principal must be repaid along with interest according to an agreed repayment schedule. Periodic payments may include no more than interest, with principal repaid all at once upon bond maturity.	Not applicable.

	Equity investment	Quasi-equity (mezzanine finance)	Bank loans (secured and unsecured)	Bonds	Grants
Repayment period (tenure) / exit period For how long does the finance provider provide funding?	Exit usually in 5 – 7 years.	Varies.	Long term for loans focusing on asset purchase (or capital expenditure); short term for loans supporting day-to-day operations (working capital).	Usually 10 years or more.	Not applicable.
Purpose What is the purpose of funding provided by the finance provider?	Working capital or capital expenditure; use of funds mostly unrestricted.	Working capital or capital expenditure; use of funds mostly unrestricted.	Working capital or capital expenditure; use of funds often tied to the purpose stated in the loan agreement.	Working capital or capital expenditure; use of funds sometimes restricted.	Often programmatic, with use of funds restricted to a specific project.

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Glossary

A

Additionality: An intervention is additional if the intervention is necessary to make a project or an investment happen – that is, if the investor would not have engaged in the absence of public-sector involvement (financial additionality), or the intervention increases the project’s development impact and sustainability in such a way as to have implications for growth and poverty reduction (developmental additionality). Additionality is a central analytical concept for donors and public-sector agents seeking to understand when it is useful to engage with the private sector, or trying to determine how to mobilize and deploy private-sector capital for the purposes of sustainable development. It is also a useful measuring stick for all finance providers when considering their own impact in terms of the additional value they add compared to an impact-neutral finance provider.

Agent banking: Agent banking takes place when an entity acts on behalf of another bank by providing limited-scale banking and financial services to the underserved within the framework of a valid agency agreement.

Amortization schedule: see Debt repayment schedule

B

Balance sheet: A financial statement that summarizes a company’s assets, liabilities and shareholder equity at a specific point in time. These three balance sheet segments give investors an idea of what the company owns and owes, as well as the amount invested by shareholders.

The balance sheet adheres to the following formula:

Assets = Liabilities + Shareholder Equity

Base rate: See Risk-free rate.

Bond maturity: The date on which the life of the bond ends. When a bond matures, the borrower is required to repay the full amount of the outstanding principal plus any applicable interest to the lender.

Bookkeeping and accounting:

- **Bookkeeping:** The process of accumulating, organizing, storing and accessing an entity’s financial information.
- **Accounting:** The process of registering and analyzing the financial aspects of an entity’s transactions, operations or other activities. Furthermore, accounting includes the process of making financial reports, including measures of value and performance, to those that need the information.

Bonds: Also known as fixed-income instruments, bonds are a type of debt security in which the bond issuer effectively borrows a sum from the bond purchaser, and returns that sum to the purchaser (or current bond holder) upon the maturity of the bond, while paying periodic sums of interest. Bonds differ from loans in that they are usually longer term, and are often tradable in securities markets.

Bullet payment: A lump-sum payment for the entirety of a loan amount paid at maturity. Distinguished from repayment form used for amortized loans, in which the principal is paid down progressively over the life of the loan.

C

Capital appreciation: A rise in the value of an asset based on a rise in market price. It occurs when the market price for an asset is higher than what the investor originally paid for it.

Capital gain: An increase in the value of a capital asset (investment or real estate) that renders the market price higher than the original purchase price. The gain is not realized until the asset is sold.

Capital market: A financial market in which equity and debt instruments are sold. Capital markets channel savings and investment between suppliers of capital, such as retail investors and institutional investors, and users of capital, such as businesses, governments and individuals. The capital-market category includes primary markets, in which new stock and bond issues are sold to investors, and secondary markets, in which existing securities are traded.

Capital protection: Protection provided to an investor against any significant loss on the amount invested in a derivative financial instrument. Such protection is usually a minimum repayment guarantee of 100% of the invested amount, payable at the end of the instrument’s term.

Central bank: A national-level institution given privileged control over the production and distribution of money and credit. In modern economies, the central bank is usually responsible for the formulation of monetary policy and the regulation of banks operating within the national financial market.

Covenants: In the context of a loan agreement, rules governing what a finance recipient can or cannot do under the terms of an agreement or contract. A covenant involves a promise that certain activities will or will not be carried out. For example, the terms of a loan document may limit the degree to which the borrower can on-lend the money. Covenants are put in place by lenders to protect themselves from borrowers defaulting on their obligations due to financial actions detrimental to themselves or their business.

Collateral: A piece of property or other asset that a borrower offers a lender to secure a loan, which will be seized by the lender in the event of a default.

Collateral registry: A publicly available database of interests in or ownership of assets, which allows borrowers to prove their creditworthiness and enables potential lenders to assess their ranking priority with regard to potential claims against a particular piece of collateral.

Cooperative bank: A bank owned and operated by its members. The goal of a financial cooperative is to provide traditional banking services on behalf of a unified group.

Concessional finance: Financing provided on terms that are more favorable than those available from the market,

including financing with a longer maturity period, subsidy elements or the use of specific risk-mitigation instruments, as well as finance provided for market-building purposes or to create demonstration effects.

Credit bureau: An entity that collects and provides information (e.g., individuals' borrowing and bill-payment habits) needed by lenders in their decision-making process.

Creditworthiness: An assessment, typically performed by lenders, of the likelihood of borrower's default. As an example, someone who is creditworthy is deemed likely to repay debts in full. The analysis of creditworthiness considers factors such as repayment history and credit score. Lending institutions also consider the amount of available assets and the amount of liabilities in determining the probability of a customer's default.

Currency risk: A risk deriving from future changes in price of one currency in relation to another. Investors or companies that have assets or business operations across national borders are exposed to currency risk that may create unpredictable profits and losses.

D

Debt: An amount of money borrowed by one party from another. Common forms include loans and bonds.

Debt repayment schedule: A complete table of periodic loan payments, showing the amount of principal and the amount of interest that will comprise each payment until the loan is paid off at the end of its term. While each periodic payment is typically a constant amount early in the schedule, the majority of each such payment is interest; later in the schedule, the majority of each payment covers the loan's principal.

Debt restructuring: A process that allows a private or public company or a sovereign entity facing cash-flow problems and financial distress to reduce and renegotiate its excessive debts, thus improving or restoring liquidity so that it can continue its operations.

Default guarantee: A promise by a guarantor to a beneficiary that in the event of a specified default by a borrower, the guarantor will pay the beneficiary a specified amount. Typically, guarantees cover lenders or bond investors against payment defaults by a borrower.

Deposit: Either a transaction involving a transfer of funds to another party for safekeeping, or an amount of money used as security or collateral for the delivery of a good.

Depreciation: The loss of value of a country's currency with respect to one or more foreign reference currencies.

Depth: The ability of a the securities market to absorb buy and sell orders without the stock price dramatically moving in either direction. Depth is closely related to the degree of market liquidity. Thus, a deep market can be expected to absorb larger buy and sell orders before the order changes the asset price.

Development finance institution (DFIs): Institutions established and owned by governments with the mission of contributing to sustainable development goals in developing and emerging countries around the world. They provide finance, technical assistance and advisory services to companies, (infrastructure) projects and governments. In addition to financing, DFIs help develop and implement standards, strengthen financial markets and business ecosystems, support regulatory reforms, and act as conveners. On a global scale, DFI-related private-sector financing amounts for about 5% of capital flows to developing countries (around 10% to sub-Saharan Africa and the Middle East).

Digital payment system: An electronic platform that enables value transfers to be initiated and/or received, using electronic devices and channels to transmit the instructions.

Dividend: A sum of money (or other value-holding object such as stock shares or other property) distributed as a portion of a company's earnings to a class of its shareholders, typically upon approval of the board of directors.

E

EBITDA: Earnings before interest, taxes, depreciation and amortization; thus, essentially net income with the sums spent for interest, taxes, depreciation and amortization added back to the total.

Enterprise value: A measure of a company's total value. Also, the theoretical takeover price if the company were to be bought.

Equity: An equity ownership stake in an underlying object (often a for-profit company), typically in the form of shares. Equity financing gives an investor a partial or full ownership stake in the object in return for the provision of funding.

External financing: Funding obtained from sources outside of a given firm, as opposed to from internal sources such as profits (see Internal financing).

F

Financial infrastructure: The set of economic institutions that enables the effective operation of financial intermediaries. This includes such elements as payment systems, credit bureaus and collateral registries. More broadly, financial infrastructure encompasses the existing legal and regulatory framework for financial-sector operations.

Financial intermediaries: Agents who help transfer funds between entities. They do this by aggregating funds from primary savers or investors and then providing these funds to recipients through the vehicle of a financial instrument.

Intermediaries play numerous important roles, providing liquidity services, promoting risk sharing, and solving information problems inherent in financial markets. They improve overall economic efficiency by helping financial markets channel funds from savers and investors to those with productive investment opportunities. Intermediaries include financial institutions that provide financial services for their clients or members. Two categories can be distinguished, including:

1. Depository institutions (e.g., commercial banks, savings institutions, credit unions) that obtain funds mainly through deposits from the public; and,
2. Non-depository institutions (e.g., finance companies, mutual funds, insurance companies, pension funds)

that finance their investment activities through the sale of securities or insurance products.

Financial instrument: A financial contract between two parties, reflecting the modality by which financing is channeled to a receiving entity.

Financial guarantee: A non-cancellable indemnity bond that is backed by an insurer in order to provide investors with a guarantee that principal and interest payments will be made. Many insurance companies specialize in financial guarantees and similar products that are used by debt issuers as a way of attracting investors. The guarantee provides investors with an additional level of comfort that the investment will be repaid in the event that the securities issuer is unable to fulfill the contractual obligation to make timely payments. It also lowers the cost of financing for security issuers, because the guarantee typically earns the security a higher credit rating and therefore enables lower interest rates.

Finance providers: For the purpose of this guide, finance providers are defined as financial intermediaries that make financing available to finance recipients. The funds thus conveyed could originate from the providers' own sources or through the aggregation of funds obtained from other actors in the financial sector.

Finance recipient: For the purpose of this guide, finance recipients are defined as entities that receive financing and put it to productive uses.

Fixed-income instrument: An investment (such as a bond) that provides a return in the form of fixed periodic payments and the eventual return of principal at maturity. The payments associated with a fixed-income security are known in advance.

Foreign direct investment: An investment made by a company or individual from one country in business interests in another country. This may take the form either of establishing business operations in the other country, or of acquiring business assets there, for instance by purchasing or taking a controlling interest in a foreign company. The key feature of foreign direct investment is that it establishes either effective control or substantial influence over a foreign business.

Foreign exchange: The exchange of one currency for another, or the conversion of one currency into another currency.

Futures contract: A legal agreement to buy or sell a particular commodity or financial instrument at a predetermined price at a specified time in the future. Futures contracts can detail the quality and quantity of the commodity. Such contracts are often established or traded on a futures exchange.

6

Grace period: A time period after the official end of a loan term, during which a borrower is allowed to continue paying back the loan despite the official end of the loan term.

I

Inflation risk: The risk associated with a possible decrease in the real value of a security due to inflation.

Initial public offering (IPO): The first time that the stock of a private company is offered for sale to the public. IPOs are often issued by comparatively small, young companies seeking capital to expand, but they can also be performed by large privately owned companies looking to become publicly traded.

Institutional investor: An entity that pools money to purchase securities, real property, or other investment assets, or to originate loans. Institutional investors include banks, insurance companies, pensions, hedge funds, real-estate investment trusts, investment advisers, endowments and mutual funds.

Interest: The cost of borrowing money, typically expressed as annual percentage rate. Interest can also refer to the size of an ownership stake held in a company, and is usually expressed as a percentage.

Interest-rate risk: The risk that arises for bond holders related to fluctuating interest rates. The degree of interest-rate risk associated with a bond depends on how sensitive its price is to market interest-rate changes. This sensitivity typically depends both on the bond's time to maturity, and the coupon rate of the bond.

Internal financing: Financing obtained through the use of a firm's profits as a source of capital for new investment. Contrasted with the acquisition of capital from an external source (see External financing).

Investment vehicle: A product used to channel funding with the intention of gaining positive (usually financial) returns in the future. Investment vehicles can be low risk, such as certificates of deposit or bonds, or carry a greater degree of risk, as is the case with stocks, options and futures. Other types of investment vehicles include annuities; collectibles such as art or coins; mutual funds; and exchange-traded funds.

Investor: Any person or entity that commits capital with the expectation of financial returns.

Islamic finance: A finance system based on the principles of Islamic law, also referred to as Shariah law, and guided by Islamic economics. Two basic principles behind Islamic banking are the sharing of profit and loss and the prohibition on

the collection and payment of interest by lenders and investors.

L

Liquidity: The degree to which an asset or security can be quickly bought or sold in a market without affecting the asset's price.

Loans: A type of debt in which the amount borrowed (the principal) must be repaid by the recipient, typically with interest. Loans usually have a fixed time period for repayment, fixed or variable interest rates, and periodic payment schedules.

M

Mergers and acquisitions (M&A): Transactions in which ownership stakes in companies, other business organizations or their operating units are transferred or combined. As an aspect of strategic management, M&A activities can allow enterprises to grow or shrink, while changing the nature of their business or competitive position.

Mission investing: A model or strategy in which investments are made by foundations or other mission-based organizations to further their philanthropic goals. Mission investments fall into two distinct categories. Market-rate mission investments, also known as "mission-related investments," are drawn from a foundation's endowment and have a positive social or environmental impact while

still contributing to the foundation's long-term financial stability and growth. Below-market mission investments, also known as "program-related investments," are designed to achieve specific program objectives while possibly earning a below-market-rate financial return.

Moratorium period: The time between the disbursement of a loan and the moment the borrower is required to start paying monthly installments.

Multilateral development bank (MDB): A financial institution that provides financing for purposes of national development. An MDB is established by a group of countries consisting both of donor and borrowing nations. The most notable example is the World Bank.

N

Net present value: A sum calculated as the difference between the present value of future cash flows and the initial investment made for a project.

O

Over-the-counter: A security is sold over-the-counter when the transaction does not go through the formal stock market.

P

Present value: A sum reflecting the current worth of a stream of cash flows expected to be earned in sometime in the future. To arrive at the present value, future cash flows are discounted by an appropriate discount rate.

Primary capital market: A capital market in which investors buy securities directly from the issuing company.

Principal: The original sum of money borrowed in a loan or put into an investment. It can also refer to the face value of a bond.

Private placement: The sale of securities to a relatively small number of select investors as a way of raising capital. Investors involved in private placements are usually large banks, mutual funds, insurance companies and pension funds. A private placement is different from a public issue, in which securities are made available for sale on the open market to any type of investor.

Public listed company: A company that has issued securities through an IPO, and whose shares are traded on at least one stock exchange or the over-the-counter market. Although only a small percentage of shares may be initially sold to the public, becoming a public company allows the market to determine the value of the entire company through the prices produced by daily trading.

R

Rating agency: A company that assigns credit ratings, which in turn assess a debtor's ability to pay back debt and make timely interest payments, as well as the likelihood of default. A rating agency may rate the creditworthiness of entities issuing debt obligations or debt instruments, and in some cases the services of the underlying debt, but not that of individual consumers.

Realized return: A capital gain (or loss, in the case of a negative return) that results from exiting an investment, or from receiving periodic payments such as interest from an investment. A realized return is directly available for use by the investor as cash, as opposed to an unrealized return (which remain only potential financial gains/losses).

Recourse: A legal right, as specified in a contractual agreement, under which the lender can make a claim against a borrower's assets beyond the pledged collateral in the event the borrower is unable to satisfy a debt obligation. A loan is described as limited recourse if the lender has only limited ability to make further claim against a defaulting borrower if the collateral does not cover the amount of the debt.

Return: The (generally financial) reward associated with the functioning of a financial instrument. Returns are usually measured in terms of a percentage of the

original investment per year; this percentage is and called the "rate of return." For instance, if the total value of shares acquired through an equity investment of €100 increases by €5 after one year, the rate of return would be 5%.

Return on assets (ROA): An indicator of how profitable a company is relative to the value of its total assets. ROA also provides some idea as to the management's efficiency in using its assets to generate earnings. Calculated by dividing a company's net income by its total assets, ROA is displayed as a percentage.

Return on capital employed (ROCE): A financial ratio that measures a company's profitability and the efficiency with which its capital is employed. Calculated by dividing earnings before interest and taxes by the total capital employed (calculated as the sum of total assets minus current liabilities, or the sum of shareholders' equity and debt liabilities).

Return on equity (ROE): A financial ratio measuring an entity's profitability, obtained by dividing net income by total value of shareholder equity.

Return on investment (ROI): A measure of investment performance obtained by contrasting the investment's returns with its cost. Thus, the benefits of an investment are divided by its total cost, and the result is expressed as either a percentage or ratio. The measure is

widely used to evaluate the efficiency of an investment, or to compare the efficiency of a number of different investments.

Revolving credit: A type of credit that does not have a fixed number of payments, as would be typical with an installment-based loan. Revolving credit allows the loan amount to be withdrawn, repaid, and redrawn again in any manner and any number of times until the arrangement expires. Credit-card loans and overdrafts are revolving loans. Also known as an evergreen loan.

Ringfencing: In the context of project financing, a characteristic of a legal agreement that decouples the project's financing from the project developer's assets, liabilities and cash flows through the creation of a special-purpose vehicle for the purposes of financing the project. If the project fails, or the SPV fails to meet its obligations, funders seeking repayment have recourse only to the assets of the SPV, not those of the project developer. For this reason, this model is also known as off-balance sheet finance.

Risk-free rate: The theoretical rate of return of an investment with no risk of financial loss. Since all other investments are by definition associated with a higher risk of loss, higher rates of return are necessary in order to induce investors to hold them. Risk-free bonds are typically issued by governments or agencies whose risks of default are so low as to be negligible.

Risk premium: The difference between a risky investment's expected rate of return and the risk-free rate of return. This additional return is necessary to induce investors to hold the risky asset rather than the risk-free asset.

S

Secondary capital market: A capital market in which investors trade securities among themselves, without the company or entity that issued the security participating in the transaction.

Secured loan: A loan in which the borrower identifies an object of value as collateral, and the lender has the legal right to take possession of the collateral if the borrower fails to repay the loan.

Security: A market-tradable financial instrument that denotes an ownership interest relative to the issuing entity. It may represent an ownership position in a publicly traded corporation (in the form of stock), a creditor relationship

with a public-sector body or corporation (in the form of a bond), or rights to ownership of an object or commodity (in the form of an option).

Senior loan: A loan that is given legal priority over equity investment and other ("junior") debt obligations in the case of dilution or company bankruptcy.

Sovereign rating: The credit rating assigned to a country or sovereign entity. Sovereign credit ratings give investors insight into the level of risk associated with investing in a particular country, and take political risks into account. Credit-rating agencies will evaluate a country's economic and political environment to determine a representative credit rating at the request of the country.

Sponsor: An entity which is involved (often with others) in originating and structuring a project and who will (usually) be a shareholder or owner of all or a part of the facility or project.

Stock market: A market or exchange in which equities (the stock of publicly held companies) are issued and traded by the public. This may be a formal exchange or an over-the-counter market. Used loosely, the term can also refer to the aggregate of such markets, or even the aggregate of all markets and exchanges where stocks, bonds and other sorts of securities are issued and traded.

T

Trade finance: The process of financing activities related to commerce and international trade. Trade finance includes mechanisms such as lending, the issue of letters of credit, factoring, export credit and insurance. Companies engaging in trade finance either as finance recipients or finance providers include importers and exporters, banks, insurers, and export-credit agencies, among other service providers.

U

Underwriter: A company or other entity that administers the public issuance and distribution of securities by a corporation or other issuing body. An underwriter works closely with the issuing body to determine the offering price of the securities, buys them from the issuer, and sells them to investors through its own distribution network. Underwriters generally receive underwriting fees from their issuing clients, but can earn profits when selling the underwritten shares to investors.

Unrealized return: A capital gain or loss associated with the rise or fall in value of an investment, but which has not yet been translated into cash. For example, if the price of a €100 stock rises by €5, the return remains unrealized until the stock is actually sold (at which point the return becomes realized).

Unsecured loan: A loan that is not backed by collateral. Thus, if the borrower fails to repay the loan, the lender does not have a pre-agreed claim on a piece of the borrower's property.

V

Valuation: The process of determining the current worth of an asset or a company.

Volatile: Tending to exhibit wide swings in value. In the context of currencies, volatility refers to the tendency of a country's currency to exhibit strong and frequent changes in value relative either to a basket of other currencies or a set of index currencies such as the dollar or euro.

W

Wealth management: A professional service that combines financial and investment advice, accounting and tax services, retirement planning, and legal or estate planning for a set fee. Clients work with a single wealth manager who coordinates input from various financial experts. May include coordinating advice from the client's own attorney, accountants and insurance agent.

