Calvert Impact Capital™

Blended Finance: what is it, what it isn't and how to use it for maximum impact

Calvert Impact Capital™

Jennifer Pryce, President and CEO

Blended finance is the term du jour of impact investing. It's a panel at every conference, the topic of countless articles, several new courses, and dense white papers. It's the strategy, often confused with a structure, on which the impact investing industry is pinning its hopes to achieve the elusive goal of scale.

But while it's popular to talk about, it's less popular to practice. One of the fund managers we work with puts it succinctly: "everyone wants to be blended, but no one wants to blend."

It has several different definitions, but at its core, "to blend" means to mix in concessionary capital that will reduce the difference between the perceived risk and the real risk of a deal, thereby incentivizing additional private investment.

Blended finance is a term that's used casually but needs to be enacted specifically. Like any investing, it requires a deep understanding of finance and market context. But unlike any investing, blended finance requires investors who are willing and able to provide catalytic capital – capital that will take outsized risk without commensurate return – for the express purpose of crowding in more commercial senior investors. If we as an impact investing community really want to tap private capital at scale and close the $2.5 trillion investment gap to achieve the SDGs, activating catalytic capital is crucial.

The success of blended finance hinges on catalytic capital providers embracing their role and playing it strategically. It is both an art and a science and involves not only structuring for an individual deal effectively, but also for the broader market. It requires understanding how impact markets evolve and knowing the roles that different investors play in spurring that evolution.

Not all investors can provide catalytic capital. In order to realize the potential of blended finance, we have to eliminate confusion and enable investors to use it effectively.

We've updated the Financial Supply Chain framework --a map for impact investors to understand their position within the context of growing and strengthening impact markets to unlock traditional capital—to illustrate the role of catalytic capital providers. We hope this framework, along with two questions outlined below, provide clarity on who can practice blended finance and how to do it effectively.

1. What is the role of catalytic capital and who provides It?

Catalytic capital providers have a unique ability to fuel the evolution of markets along the financial supply chain. The role of catalytic capital is to reduce the gap between real and perceived risk of an investment for the purposes of activating additional investment dollars that otherwise wouldn't participate due to perceived market failures or barriers. These barriers could be things like investing in a region with a recent history of political instability (e.g. Arab Spring countries), a new, market-specific business model (e.g. paygo solar), or an unfamiliar customer base like low-income consumers in Latin America. Catalytic capital providers can take outsized risk without commensurate return; their primary motivation is not financial return but leverage and scale. They focus on crowding in additional capital to develop new and unproven markets; prove the viability of new markets and new business models to other investors and multiply impact outcomes by leveraging greater volumes of capital than would otherwise be available. They often provide capital in the form of grants, guarantees, low-interest loans or subordinate capital -- particularly the type of capital that is most scarce at the given stage of the investment.

Catalytic capital providers are typically philanthropic investors or public institutions. They have the proper motivation and risk appetite, and face different legal, operating and regulatory realities than other private or commercial investors.

But catalytic capital in itself isn't enough to blend effectively; it has to be deployed and sized properly.

2. How do you blend?

First, catalytic capital providers need to determine where their capital can be used most effectively to achieve their goals. If an investor's goal is to catalyze commercial capital, then focusing on the late stage of the financial supply chain is most appropriate. It's important to note that simply providing more concessionary capital at an early stage does not crowd in commercial capital. Commercial capital requires the scale and track record that later stage investments demonstrate. If an investor's goal is to demonstrate proof of concept for a new business model in a nascent sector, then early stage investments is a better place to focus.

Next, investors must determine the proper amount of catalytic capital. It is important to be clear that catalytic capital is required to lessen the gap between real and perceived risk. It is not used to blend pricing down to a specific rate for either investors or borrowers, but rather to create the right risk entry point for private capital; i.e. to reduce the risk of non-payment so that they can get the risk-adjusted return they require.

The financial supply chain provided below attempts to give some context and examples of how to do this based on our experience investing debt in enterprises, projects and intermediaries at various stages of growth across nine sectors and 100 countries. As markets evolve through the financial supply chain, track records are built and patterns are established that make the unfamiliar become recognizable. The gap between real and perceived risk shrinks and the amount of catalytic capital needed for certain sectors and regions can be reduced.

There are no iron laws governing the exact amount of catalytic capital required to activate additional investment. It is ultimately a function of the specific deal, the market context, and the risks associated. However, there's much to be learned from existing blended finance vehicles and no need to reinvent the wheel deal by deal. It's important for the impact investing industry to build on what works to develop the infrastructure, patterns, and structures that commercial investors need to move more capital.

Moving Forward

The current impact investing industry focus on blended finance is positive, but it needs to be redirected. Blended finance is not a silver bullet; no such thing exists. Our challenge is to properly use the many tools and tactics, blended finance included, that we have at our disposal to maximize their utility. Together, we can activate more than enough capital to achieve the SDGs and create a better world.

Calvert Impact Capital

FINANCIAL SUPPLY CHAIN FRAMEWORK

			Impact Capital Markets						Traditional Finance	
STAGE	Seed		Early		Mid		Late			
WHAT: Type of Capital is Needed	Grant , Prize Money, Sweat Equity		Grant, Investment (Equity, Mezzanine Debt, Debt)		Grant, Investment (Equity, Mezzanine Debt, Debt)		Investment (Equity, Debt)		Investment (Equity, Debt)	
WHAT: Type of Capital is Scarce	Grant, Equity		Grant, Equity* *Equity is most scarce type of capital at this stage*		Equity, Subordinated Debt (Junior, Mezzanine)* *Subordinated Debt is most scarce type of capital at this stage*		Equity, Debt at scale* *Debt at scale is most scarce type of capital at this stage*		* not applicable	
WHO: Investor Type	Accelerators, HNW Investors, Foundations, Friends + Family, Crowdfunding Platforms		Foundations, HNW Investors, DFIs, some Private Investors		Foundations, HNW Investors, Private and Institutional Investors, DFIs		Foundations, Private and Institutional Investors, DFIs		Retail, Accredited, Institutional Investors	
HOW: Investment Route	Direct	Indirect	Direct	Indirect	Direct	Indirect	Direct	Indirect	Direct	Indirect
WHAT: Investment Structure (What are you investing in?)	Enterprise, Project	Accelerator, Fund (e.g. Seed Fund)	Enterprise, Project	Intermediary (e.g. Venture Fund)	Enterprise, Project	Intermediary, (e.g. Structured Fund, SPV)	Enterprise, Project	Intermediary (e.g. Structured Fund, SPV, LP.)	Enterprise, Project	Intermediary (e.g. Banks, Multual Funds Structured Fund, SPV, etc)
HOW:Examples	Grant to renewable energy business to invest in a geospatial technology to locate off grid households	Investment in a fund that provides equity to women-led start-ups	Equity Investment to an operating business running rural health clinics in India to hire new medical staff	Equity investment in a fund that lends to small scale fisheries in Latin America	Patient debt financing to a solar energy company expand distribution of solar home systems in Tanzania	Junior debt to a loan fund onlending to SMEs across impact sectors in Asia	Growth capital in the form of equity or debt financing to a company for regional expansion (bridge to capital markets)	Senior debt at scale to a structured fund issuing local currency bonds for companies working in financial inclusion, energy and sustainable agriculture in Africa	Scale capital through individual shares in a public company	Scale debt capital to a international bank lending to large enterprises
IMPACT										
Investor Role	Innovation + testing new business models		Innovation + demonstrating proof of concept for new business models	Innovation + demonstrating opportunity for financial intermediation capacity	Supporting growth	Sector growth + building financial intermediation capacity	Supporting scale	Scaling sectors + crowding in private capital through intermediaries	Scale	
Impact Return	Creation of new solutions to a social and/or environmental challenge		Direct business outputs (i.e. jobs created, homes built, customers served)	Leverage, multiplying business outputs	Direct business outputs (i.e. jobs created, homes built, customers served)	Leverage, systems change, multiplying business outputs	Direct business outputs (i.e. jobs created, homes built, customers served)	Leverage, systems change, multiplying business outputs	Scale + multiplying business outputs	
CATALYTIC CAPITAL PROVIDERS (Public + Philanthropic investors) - Strengthening market infrastructure and advancing sectors by crowding in/providing capital that is scarce									n/a	
Pipeline (size and volume of deals)	*n/a*	Small	*n/a*	Small	*n/a*	Small/medium	*n/a*	Medium	Large	
Risk of deals	*For direct investments, these considerations are specific to individual deals, making it challenging to generalize; it is possible to provide catalytic capital for direct deals, however the impact is not on market infrastructure and advancing entire sectors, but provides a critical demonstration effect for proving out new business models, which often operate in new sectors*	High	*For direct investments, these considerations are specific to individual deals, making it challenging to generalize; it is possible to provide catalytic capital for direct deals, however the impact is not on market infrastructure and advancing entire sectors, but provides a critical demonstration effect for proving out new business models, which often operate in nascent sectors*	High	*For direct investments, these considerations are specific to individual deals, making it challenging to generalize; it is possible to provide catalytic capital for direct deals, however the impact is not on market infrastructure and advancing entire sectors, but provides a critical demonstration effect for proving out new business models, which often operate in nascent sectors*	Medium/high	*For direct investments, these considerations are specific to individual deals, making it challenging to generalize; it is possible to provide catalytic capital for direct deals, however the impact is not on market infrastructure and advancing entire sectors, but provides a critical demonstration effect for proving out new business models, which often operate in nascent sectors*	Medium	Low	
Capital Stack - % range* of soft or subordinated (*this is not perscriptive - varies depending on context*)		Roughly 100%		60-100%		30-60%		0-40%	Capital is stacked, but risk is appropriately priced	
Capital Stack - % range of senior (*this is not perscriptive - varies depending on context*)		n/a		0-40%		40-70%		60-100%		
Tools	*Grant*	Grant	*Grant/recoverable grant, low interest loan, subordinate capital (junior, mezzanine)*	Grant/recoverable grant, guarantee, low interest loan, subordinate capital (junior, mezzanine, first-loss)	*Grant/recoverable grant, low interest loan, subordinate capital (junior, mezzanine)*	Grant/recoverable grant, guarantee, low interest loan, subordinate capital (junior, mezzanine, first-loss)	*Grant/recoverable grant, low interest loan, subordinate capital (junior, mezzanine)*	Guarantee, subordinate capital (junior, mezzanine, first-loss)		

GLOSSARY

This list is not an attempt to redefine terms, but to enable a common understanding when using the framework

Seed: The first stage of financing. Seed stage financings are often comparatively modest amounts of capital provided to entrepreneurs and projects to finance the early development of a new product or service. Primarily grant and equity funded.

Early: This type of financing is usually provided to entrepreneurs, projects, intermediaries that have a limited track record. For example, most early-stage companies have been in business less than three years, are not yet profitable, and have a product or service in testing or pilot stage. From a sector financing perspective, minimal financial intermediation is happening in this stage due to limited pipeline of deals and lack of track record of enterprises. Typically, philantropic and development finance capital are most prominent, active capital providers. Private capital is not typically being crowded-in in meaningful amounts at this stage unless the business model has potential for significant growth and a relatively near term exit.

Mid: This type of financing is usually provided to entrepreneurs, projects, intermediaries that have been in business for 3-5 years, have demonstrated proof of concept and sold their product/services at some volume in the marketplace. At this stage, the enterprise has either generated some profit or has a clear path to generating profit (reaching "breakeven"). This is often when the enterprise secures its first private debt investors. In this stage, intermediaries start blending philanthropic and/or public money to attract private capital (blended finance vehicles).

Late: This type of financing is usually provided to entrepreneurs, projects, intermediaries that have demonstrated market viability and are on track for commercial viability (e.g. demonstrates significant revenue growth). Enterprises at this stage have typically been in business for more than 5 years and capital is provided mainly for growth (geographic or business line growth) and scale (e.g expansion, including physical plant expansion, product improvement and marketing). From a sector growth perspective, intermediation of capital through structures likes loan funds and structured funds, is needed. Blended finance strategies are more focused on ultilizing higher volumes of private capital as the gap between investor's perceived vs. real risk has shrunk due to track record established in earlier stages.

Traditional Finance: Financing provided under commercial terms following strict requirements, regulations and patterns accepted by the banking industry and capital markets.

HNW Investor: High net worth individual (HNW) is a classification used by the financial services industry to denote an individual (or a family) with high net worth, typically defined as individuals holding finanical assets with a value exceeding $1million, excluding their primary residence.

Blended Finance: The strategic use of development finance and philanthropic capital to leverage private capital into a deal. Blended finance investments are made to drive social, envrionmental and economic progress and provide financial returns to private investors in line with market expectations. These structures exist to align/stack different sources of capital to get to the leverage and risk/return profile needed.

DFIs: National and international development finance institutions are specialized development banks or subsidiaries set up to support private sector development in developing countries. They are usually majority-owned by national governments and source their capital from national or international development funds or benefit from government guarantees. This ensures their creditworthiness, which enables them to raise large amounts of money on international capital markets and provide financing on very competitive terms.

Intermediary: A financial intermediary is an entity that facilitates the channeling of capital between investors and investees/borrowers by aggregating and deploying the capital in an efficient manner and in accordance with a certain investment strategy. Typical intermediaries in impact investing include community banks, loan or equity funds, structured funds, etc.

Structured Fund: A type of intermediary that combines both equity and fixed-income products to provide investors with a degree of both capital protection and capital appreciation.

SPV: A Special Purpose Vehicle (SPV) is a legal entity created for a specific purpose. In the context of raising capital, a SPV (usually structured as LLC) can be used as a funding structure by which all investors are pooled together into a single entity.

LP: Limited Partnership (LP) Funds are created to raise investments on pari passu terms from Limited Partners and invest that capital primarily in equity or equity-like instrunments. However, this model has also been used for debt financing in later stage sectors/companies where investors are comfortable with pooling and sharing the risk equally.

Catalytic Capital Providers: are focused on crowding in additional capital to help advance a market/sector/business model, particularly the type of capital that is most scarce to the respective stage. This is not a role that all investors can play; catalytic capital providers are typically philanthropic investors or public capital providers as they have proper risk appetite and motivation (often non-financial). Catalytic capital providers can help strengthen intermediation capacity and infrastructure in new/unproven markets; they can provide an important demonstration effect of markets/sectors/ business models; and can help multiply impact outcomes by leveraging greater volumes of capital than would otherwise be available.

Soft/Subordinated Capital: is the form of capital that catalytic capital providers offer; it is willing to take a junior position, to assume greater risk for the purpose of crowding in additional investment capital. Common types of soft capital include grant, equity, subordinated debt (junior, mezzanine), guarantees, etc. Properly applied soft capital can help "de-risk" investments and meet appropriate risk/return required to crowd in additional, more senior capital.

The amount of soft/suborinated capital required differs by stage, and is dependent on a variety of factors, including, but not limited to the pipeline available (the size and the volume of deals) and the risk of those deals. In general, the percentage of soft/suborinate capital in an investment structure declines in later stages of the supply chain.

This section is intended to help catalytic capital providers determine where their capital can be used most effectively to achieve their goals. If an investors goal is to catalyze **traditional capital**, then providing soft capital in the **late stage** of the supply chain is most appropriate. It's important to note that simply providing *more* soft capital at an early stage **does not** crowd in traditional capital, which requires scale and track record that late stage investments demonstrate.