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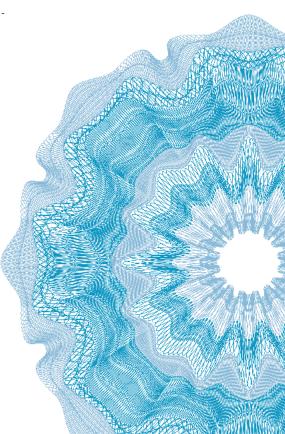
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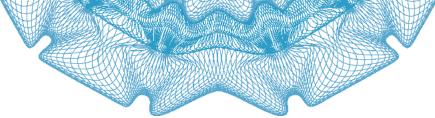
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List of abbreviations

ADB	Asian Development Bank
AEPC	Alternative Energy Promotion Center
AfD	French Development Agency
AfDB	African Development Bank
AMC	Advance market commitments
BEL	Bujagali Energy Limited
BFRIC	Banking Sector Financial Reporting Standards Implementation Committee
BoU	Bank of Uganda
CARI	Competitive African Rice Initiative
CBM	Central Bank of Myanmar
CDIA	Cities Development Initiative for Asia
CFI	Cooperative financial institutions
CFP	crowdfunding platforms
DCF	Discounted cash flow
DFI	Development-finance institutions
EIB	European Investment Bank
ESG	Environmental, social and governance
FI	Financial institutions

GCF	Green Climate Fund
GCPF	Global Climate Partnership Fund
GDP	gross domestic product
GHG	greenhouse gases
GIFTS	Guimaras-Iloilo Ferry Terminal System
GIIN	Global Impact Investing Network
ICMA	International Capital Market Association
IDA	International Development Association
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IFRS	International financial- reporting and auditing standards
IPO	Initial public offering
M&A	Merger-and-acquisition
MDB	Multilateral development bank
MHDF	Micro Hydro Debt Fund
MHP	Micro-hydro power
MIGA	Multilateral Investment

Guarantee Agency

Ministry of Finance, Planning and Economic Development
Nationally Appropriate Mitigation Actions
National designated authority
Nigerian Energy Support Program
Net present value
Output based aid
Official development assistance
Overseas Private Investment Corporation
Pre-feasibility Study
Public private partnerships
Principles for Responsible Investment
Present value
Results-based financing
Renewable-energy
Renewable Energy Cooperation Program
Return on assets
Return on capital employed
Return on equity

SDG	Sustainable Development Goals
SIDO	Small Industries Development Organization
SME	Small and medium-sized enterprises
SPV	Special-purpose vehicle
SRI	Socially responsible investment
USAID	United States Agency for International Development
UNEP	United Nations Environment Programme
UNDP	United Nations Developmen Programme
VPO	Venture philanthropy organizations
WPU	Wealth Preservation Unit
YUE	Yangon University of Economics

Dear colleagues,

In 2015, the German Government signed the Agenda 2030, thereby committing itself to work toward achieving the Sustainable Development Goals (SDGs) and fostering universal, inclusive economic prosperity and the improvement of people's well-being while protecting the environment. Combined with further ground-breaking international agreements such as the Paris Climate Agreement, the Agenda 2030 provides a comprehensive framework for international cooperation and has been the cornerstone of our work at GIZ

But achieving the SDGs by 2030 comes with a substantial price tag, and locating the necessary resources is challenging. We are all aware of the often-cited gap in financing: On top of the resources that are already made available for reaching the SDGs, an additional \$2.5 trillion annually will be required. Clearly, government resources and ODA commitments will not be enough to close this gap. Instead, drawing on all sources of finance – public and private, domestic and international – will prove crucial.

Mobilizing the necessary levels of public and private finance requires a clear understanding of what the financial sector and private investors need when deciding to take investment action. It is equally important to understand what exactly financing is needed for. In other

words, are we talking about a large-scale infrastructure project commissioned by the government, the working capital needs of a medium-sized enterprise, or support for a start-up entrepreneur to conduct market research?

In an effort to meet these needs, we initiated a "business opportunity" (GO) under coordination of the Sector Program Financial Systems Development to develop this Finance Guide. The task was a joint effort of many colleagues at AGE, GloBe and FMB and involved close dialogue with several of our projects and programs. The Finance Guide is designed to enable our staff from headquarters to local offices to develop a better understanding of the financing landscape, which involves gaining deeper knowledge of the specific financing needs of the finance recipients and the mind-set of the finance providers.

As demonstrated by Module 5 of this Finance Guide, GIZ – on behalf of various customers – is already successfully implementing several activities in financial systems development, business and project development, and in match-making with finance providers. Over the years, GIZ has supported both public and private sector actors in accessing financing from conventional and innovative sources of finance, thereby bringing projects and businesses forward while pre-

paring the ground for investments. Our activities operate in a variety of sectors and cater to the needs of a wide range of partners and clients, from households to start-up entrepreneurs or established businesses to large private and public ventures.

At the same time, our partners and customers increasingly demand us to move even closer to support and innovate finance solutions and in some cases require us to even act as a finance provider. This entails new areas of engagement that make a holistic understanding of the overall financing landscape imperative for continuing the successful and important work with our partners.

While the world of finance is complex, our aim with this Finance Guide is not to explain every aspect of finance in detail. Rather, this publication is designed to help GIZ staff understand key financial concepts and the motivations driving finance mechanisms. It will provide guidance when communicating with financial actors and institutions to help you speak their language and look at things from the perspective of a finance provider.

It will also support GIZ staff in advising projects, entrepreneurs, and public authorities when developing projects and activities. Because, for GIZ "Think-

ing Investment" should mean "Thinking Investment from the Start" by considering finance structures and requirements from the earliest stages of project development onward.

In addition to serving as a reference for finance activities in GIZ projects, the Finance Guide will provide the basis for a broader roll-out involving webinars and workshops that will foster an improved understanding of the world of finance, the actors involved and the instruments employed.

We look forward to seeing the successes this Guide will facilitate, and extend our sincere thanks to all colleagues and partners involved for their tireless efforts in developing this very helpful instrument for GIZ in what is proving to be a very important and partly new field of work.

Best regards,

Petra Warnecke
Director General of

Director General of Liaison and Business Development (AGE) Andreas Proksch Director General of Sector and Global

Programmes (GloBe)

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 GIZ staff when considering the role of commercial finance in designing and implementing technical-assistance 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 **Mod**ules 1 to 4 of this guide. These chapters address the following questions:

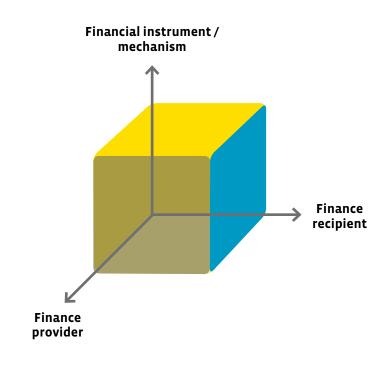
- ► What is the overall finance landscape in which businesses operate?
- ► Who are typical finance recipients and what are their needs?
- ► What are the different types of finance providers? What are their

- 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?

As this Finance Guide is specifically developed for GIZ staff, **Module 5** discusses how finance mechanisms and financial-sector expertise are put to work in the GIZ context.

In addition to offering an overview of typical finance-related GIZ services, this module also cites concrete examples drawn from GIZ programs and components in a variety of sectors and regions. It also provides an example of good practice in integrating financial-sector considerations into early project planning.

FIG 1 Financial instruments, mechanisms, recipients and providers



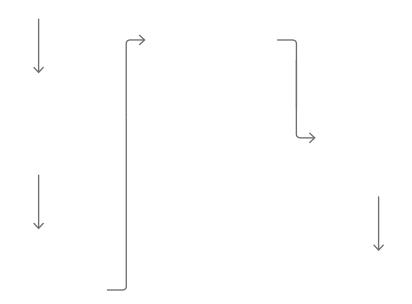
How to use the Finance Guide

Given the daily workload and level of activities typical within GIZ offices and projects, the authors are aware that few colleagues will be able to read this guide from cover to cover. With this in mind. 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 - and GIZ's role in it - 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





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



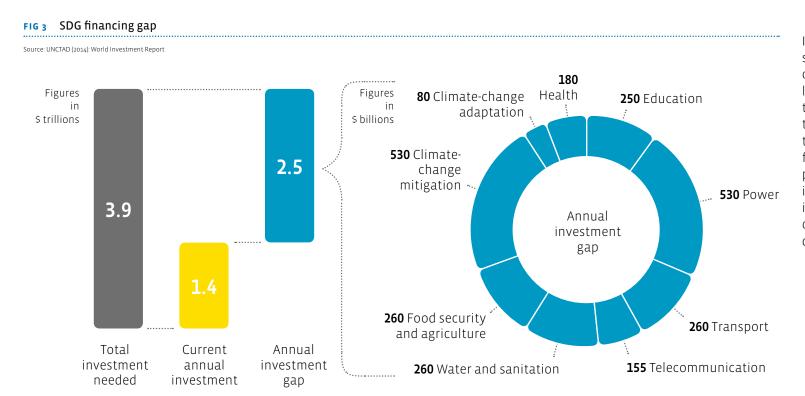
THIS SECTION'S TOPICS:

- 1.1 The current developmentneeds 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.



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.

^{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

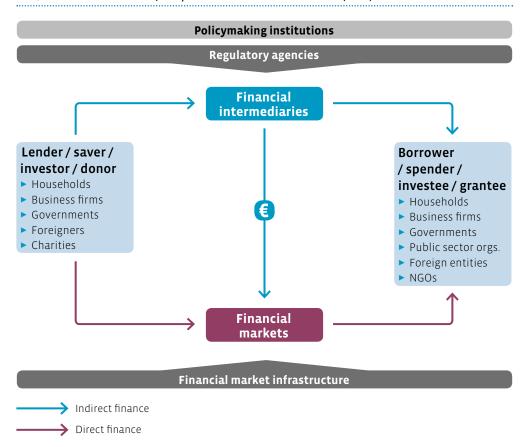
the financial sector to those with productive investment opportunities. These intermediaries include financial institutions that provide financial services for their clients or members, and are of several kinds, including:

- 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. According to World Bank estimates, more than 200 million formal and informal micro, small or medium-sized enterprises (MSMEs) in emerging economies lack access to financing sufficient to enable them to thrive and grow. 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 microfinance 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. World Bank. http://www.worldbank.org/en/topic/financialinclusion/overview. Accessed 31.10.201

1.2.1. Role of financial services

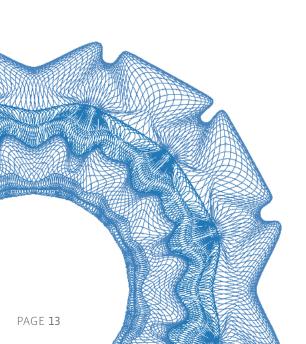
Financial services include a wide range of services that enable the financial sector to work efficiently. For example, they may facilitate the flow of market information, lend operational efficiency, match demand and sup-

ply, 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 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

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.

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

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).



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. GIZ works with various kinds of finance recipients in many economic sectors, all of which are seeking different amounts of financing, 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	Start-ups	Small and medium enterprises	Corporates	Investment funds	Producer cooperatives	Projects and PPPs	Public and municipal enterprises	Sub-national governments	National governments
PURPOSE	 Establish direction & goals Market research Product, service, and / or technology development and launch Team creation 	 Geographical expansion Technology and product upgradation Capital expenditure Working capital New product lines Trade finance 	 Geographical expansion Capital expenditure Mergers and acquisitions Working capital Recapitalization / debt repayments Trade finance 	 Capitalization of fund Technical assistance facility 	 Input finance Harvest Equipment upgrades Risk mitigation and insurance 	 Engineering, procurement and construction contracts Concession Operations and maintenance 	 Funding public services Provision of local infrastructure services 	 Finance operations Finance capital needs Repay previous lenders 	 Finance operations Finance capital needs Repay previous lenders Macroeconomic stability (e.g., foreign currency mismatch or inflation etc.)
TICKET SIZE	\$	s s	\$\$\$	\$\$\$	s	\$\$\$	\$\$\$	\$\$\$	\$\$\$\$
TYPICAL INSTRUMENTS	E G Q	E G 1 Q	B E G L	E	E G L	B E L	B L	B L	B L

B Bonds

E Equit

G

ants

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.

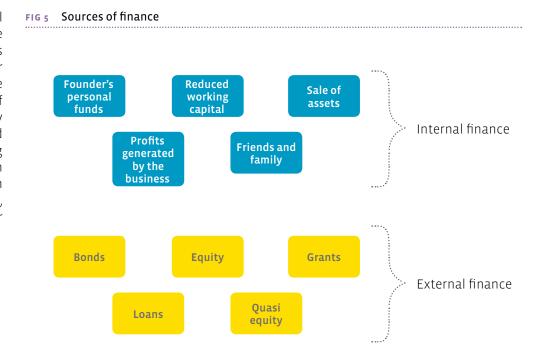
^{2.2.} Commonly used sources of finance and financial instruments

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

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.

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).



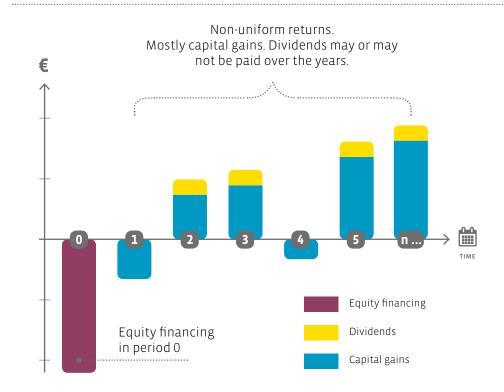
2.2.1 **Equity**

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

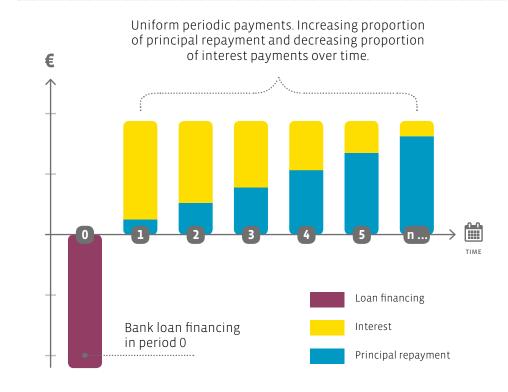
Bank loans are a type of debt instrument in which the amount (principal) borrowed from a bank must be repaid by the recipient with interest. Bank loans have a fixed time period for repayment, along with fixed or variable rates of interest that is payable periodically. Usually, repayment starts immediately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

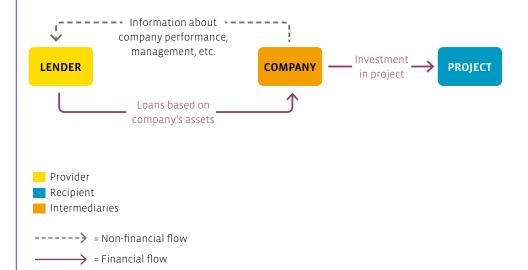


The loan provider typically receives a pre-fixed payment from the borrower each year, which includes an interest component and a principal-repayment component. Over time, the principal repayment component of this sum increases, and the interest component decreases (due to shrinking amount of remaining 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

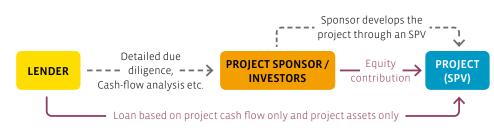
BOX 2 Project finance versus corporate finance

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

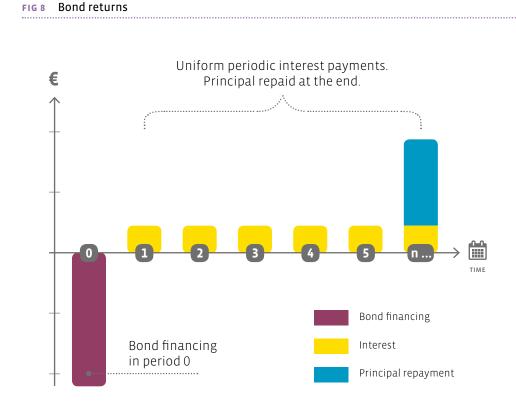
Bonds, also known as fixed-income instruments, are a type of debt instrument in which the bond issuer (i.e., the finance recipient) borrows a sum from the bond purchaser (i.e., the finance provider), and returns that sum to the purchaser (or current bond holder) upon the maturity of

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.



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.

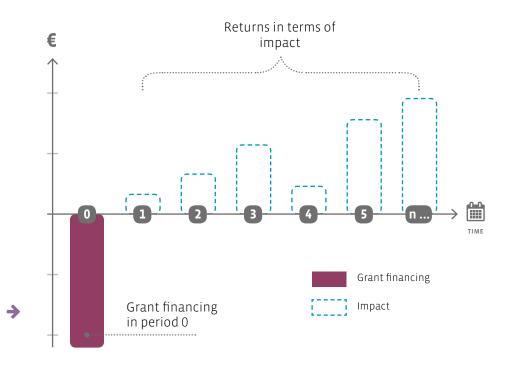
Proactive grantmaking: Proactive grant providers have more focused goals and strategies for accomplishing those goals. In these cases, it's often the grant provider who drives the agenda. In order to identify potential recipients, the provider issues a request for proposal or contacts the potential recipient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

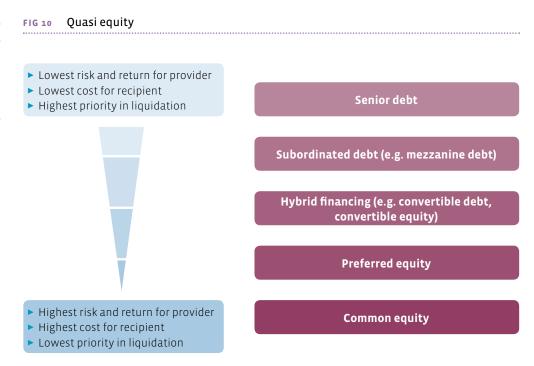
Repayment depends on the recipient's future performance or cash flow. This alternative is often used when neither debt nor equity financing are available or desirable options.

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.



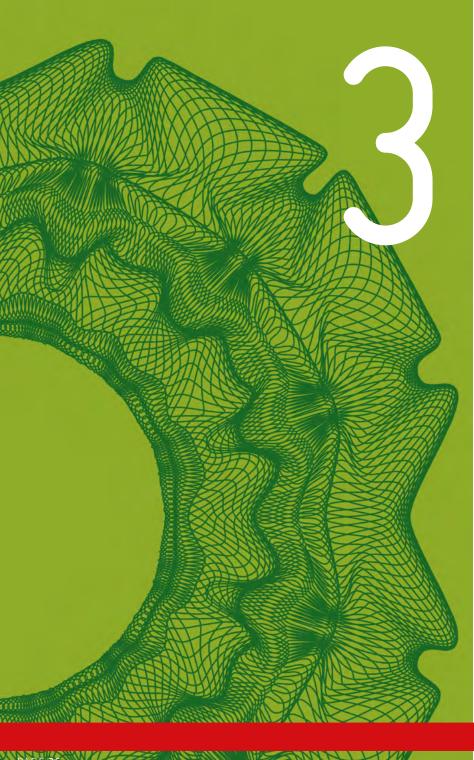
2.2.6 Differences between financial instruments

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 instruments⁴

	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); divi- dends	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)	SSSSS	\$\$\$\$	SSS	SS	-
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



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 noncommercial 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

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

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

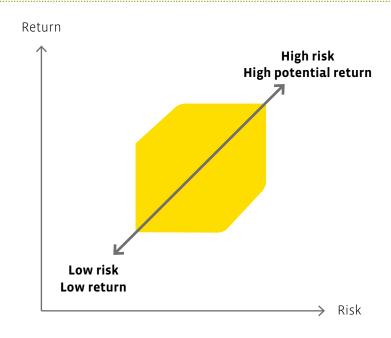
may also motivate certain finance providers – generally those who are willing to accept higher risk levels in search of higher rewards (or returns) – to invest in developing countries or in comparatively high-risk instruments.

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.

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.

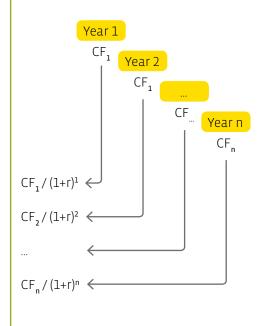
FIG 11 Risk-return trade-off



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:

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

CFn=Cash flow in period n r=discount rate

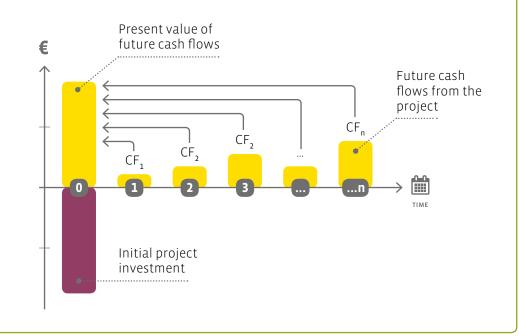
Present value relies on the assumption that receiving a sum of money now is worth more than receiving the same sum sometime in the future. This is because receiving that sum of money today enables the recipient to save, invest or lend the money, thus receiving an additional return in the future.

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

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, microfinance, and affordable and accessible basic services including housing, healthcare, and education.

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

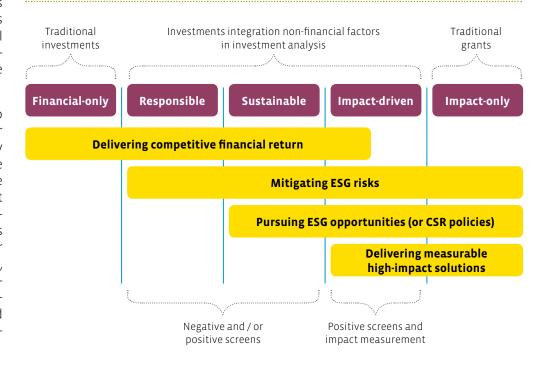
- ▶ Intentionality: The investor's intention is to achieve a positive social or environmental impact, as opposed to the singular focus on financial returns as in the case of traditional investments.
- ▶ Return expectation: Impact investments are expected to generate positive financial returns on their 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, more than \$114 billion is managed by impact investors globally. 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



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

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

expressed as:

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

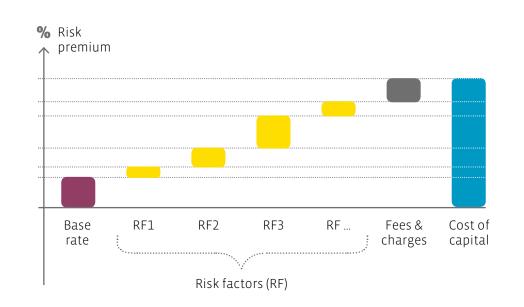
Risk levels are closely associated with the cost of capital. Higher levels of assessed risk will lead to higher expected returns and higher financing costs in order to compensate for the risk. It is for this reason that most finance providers expect to earn higher returns in developing countries, where 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 governments 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 cyclicality, 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 ratings⁵

Country	Fitch	S&P
Bangladesh	BB-	BB-
Bolivia	BB-	ВВ
China	A+	AA-
Colombia	BBB	BBB+
Congo (DRC)	СС	CCC+
Egypt	В	B-
Ethiopia	В	В
Germany	AAA	AAA
Ghana	В	B-
India	BBB-	BBB-
Indonesia	BBB-	BBB-
Kenya	B+	B+
Mexico	BBB+	-
Namibia	BBB-	-
Nigeria	B+	В
Pakistan	В	В
Rwanda	B+	В
South Africa	BB+	BBB-
Sri Lanka	B+	B+
Uganda	B+	В
USA	AAA	AA+
Vietnam	BB-	BB- ⁵

^{5.} 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 macroeconomic 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.

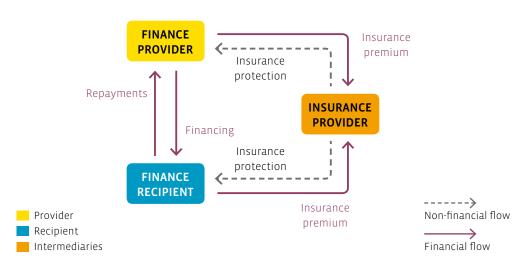
1) Insurance: Insurance provides protection against potential financial loss. The buver of insurance-based protection pays a sum of money, known as an insurance premium, to the insurance provider to buy protection against financial losses emerging from a set of predefined events. The contract between the insurance buver 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.

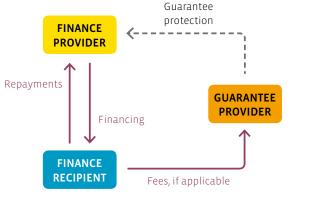
- ► The Overseas Private Investment Corporation (OPIC) provides insurance products covering losses to tangible assets, investment value and earnings that result from political perils such as currency inconvertibility, expropriation and political violence.
- ► Germany's Euler Hermes Kreditversicherung 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.

FIG 15 Guarantee mechanism



Provider
Recipient -----> = Non-financial flow
Intermediaries = Financial flow

- ► 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.

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		
1. Private equity funds							
Angels and venture capital funds							
3. Commercial banks							
4. Development finance		•	•		•		
4. Development finance institutions 5. Microfinance institutions 6. Cooperative financial institutions							
6. Cooperative financial institutions							
Pension and sovereign funds							
8. Corporates (venturing)							
9. Venture philanthro- pists and foundations	•						
	\$\$\$				s		
	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

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.

X 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.⁶ 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.

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.

DEAL 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.

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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.

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 highnet-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)

🗱 FIN

FINANCING PROCESS

Viability assessment	Prepare info package	Long list of investors	Pre-negotiation with short list	Due diligence	Signing & closing		Exit
 Assess project's bankability. Design preferred basic financing terms. 	 Prepare documents for project marketing (max. 2-3 pages). Prepare detailed information package including business plan and financialmodel with cash flow. 	 Market research and identification ofpotentially suitable finance providers. Screen long list jointly with finance recipient. Approach short- listed angel and VC investors with teaser. 	 Sign confidentiality agreement if possible. Forward full info package. Have first personal meetings and make pitches. Obtain indicative offers. Select preferred investor(s). 	 ▶ Present investment opportunity to decision- making body of preferred investor(s). ▶ Organize due-diligence process with preferred investor(s). ▶ Draft term sheet. 	 Negotiate specific investment terms. Draft and sign financing agreement ("signing"). Transaction is "closed" with payment of agreed-upon funding. 	► Investment monitoring.	 Investor exits the investment through sale of equity stake to another investor after the investment horizon (5-7 years). Investor realizes gains or losses.

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

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.

X 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.

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.

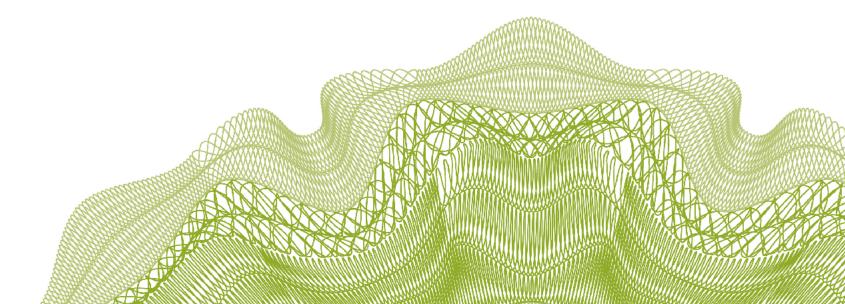
The ambition of private-equity investors is predominantly to make money. Even impact investors in this category may select rather low-risk cases. This means that private-equity investors are usually rather risk averse, with only marginally more risk appetite than banks. The technical assessment, or "due 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.

FINANCING PROCESS

Needs and feasibility assessment	Prepare info package	Long list of investors	Pre-negotiation with short list	Due diligence	Signing & closing		Exit
 Clarify financing needs and desired volumes with potential recipient. Ask for input from other stakeholders. Assess project's bankability. Design preferred basic financing terms. 	 Prepare documents for project marketing (max. 2-3 pages). Prepare detailed information package including business plan and financialmodel with cash flow. 	 Market research and identification ofpotentially suitable PE providers. Screen long list jointly with finance recipient. Approach short-listed PE investors with teaser. 	 Sign confidentiality agreement. Forward full information package. Have first personal meetings and make pitches. Obtain indicative offers. Select preferred investor(s). 	 ▶ Present investment opportunity to decision-making body of preferred investor(s). ▶ Organize due-diligence process with preferred investor(s). ▶ Draft term sheet. 	 Negotiate specific investment terms. Draft and sign financing agreement ("signing"). Transaction is "closed" with payment of agreed-upon funding. 	► Investment monitoring.	 ► Investor exits the investment through sale of equity stake to another investor or through an IPO after the investment horizon (5-7 years). ► Investor realizes gains or losses.



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

role. 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.

X 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.

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.

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,7 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 the time of writing, 91 financial institutions in 37 countries, including several banks, had officially adopted the principals. These institutions together account for more than 70% of existing international project-finance debt in emerging markets.8 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.

^{7.} WWF (2014). Environmental, Social and Governance Integration for Banks: A Guide to Starting Implementation

^{8.} Source: www.equator-principles.com. Accessed: 07.11.2017



FINANCING PROCESS

Credit rating

Credit analysis Application

Recipient applies for bank loan by filling out required forms and providing necessary documentation (incl. accounting statements, project documents including cashflow projections,

etc.).

- ▶ Bank's credit team analyzes the documents submitted by the applicant to assess inherent risks, loan eligibility and applicable interest rate.
- ► Credit report is often discussed by committee of senior bank officials, which makes loan-issue decision based on credit-team recommendations.

Credit decision

► If committee gives approval, other documentation (e.g., original titles for collateral, guarantees, etc.) must be filed, and loansanction letter

signed.

Sanction and documentation

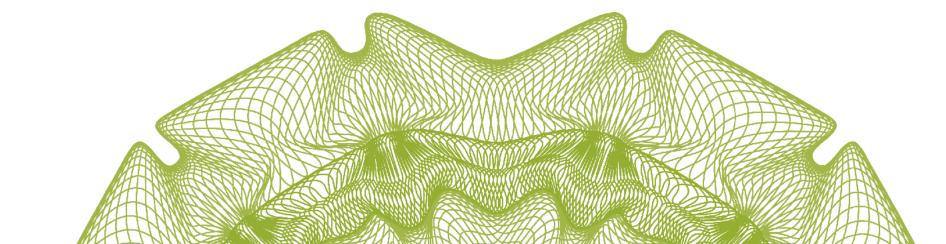
> ► Documentation is verified to see if applicant meets all condition precedents (CPs).

Verification

► Once documentation is verified and applicant is found to meet all CPs, loan is disbursed. Disbursal could come all at once or based on a pre-agreed schedule.

Disbursal

- Monitoring and repayment
- ► Recipient makes payments during loan's agreed term.
- ► During loan term, the bank and credit-rating agency monitor recipient's operations to track financial performance.



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.

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.

X 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 agriculturerelated activities such as farming, livestock raising, dairies and hatcheries.

S 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. 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.

Q 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 lowerincome 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.

X 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 Investeringsfonden 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.

ODEAL 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.

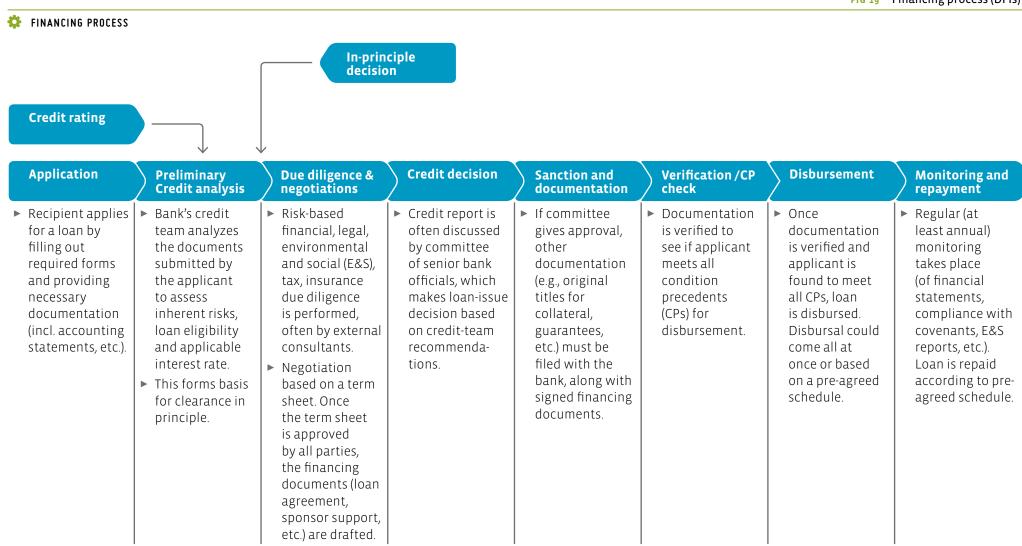
APPROACH TO IMPACT:

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 environmentaland 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)



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.

X 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.

ODEAL 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:

- 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.

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. As mentioned earlier, this is often

preferable to the other financing alternatives 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

Application Credit analysis Repayment Clearing **Monitoring and Credit decision** and disbursal repayment ► When loan fully ▶ Representative ► Recipients make Recipient ► If approved, the ▶ Branchloan is disbursed (individual or of local office repayments to office clientrepaid, recipient by the local qualifies for a branch office. group) applies visits MSMF or relationship group and its branch office in where the new managers will for a micro-loan new loan, can at a branch neighbors to cash, as a check, total of their periodically open a savings office by filling verify credibility, or through a outstanding visit recipient to account, or mobile-money debt is recorded. check whether depending on out forms and and sends identifying documentation platform. Ideally, all is going as MFI product purpose of productive portfolio to head office expected, or whether default loan. Some MFIs has access to assess assets are actively look applicant's not used as is likely. to additional loan eligibility, collateral. products such as for customers through local inherent risks, micro-insurance. networks. and applicable interest rate and loan term.

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 \$38 trillion in 2013), 11 sovereign-wealth funds (\$6.1 trillion in 2013) and insurers (\$29 trillion in 2013), 11 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.

X 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.

ODEAL 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.

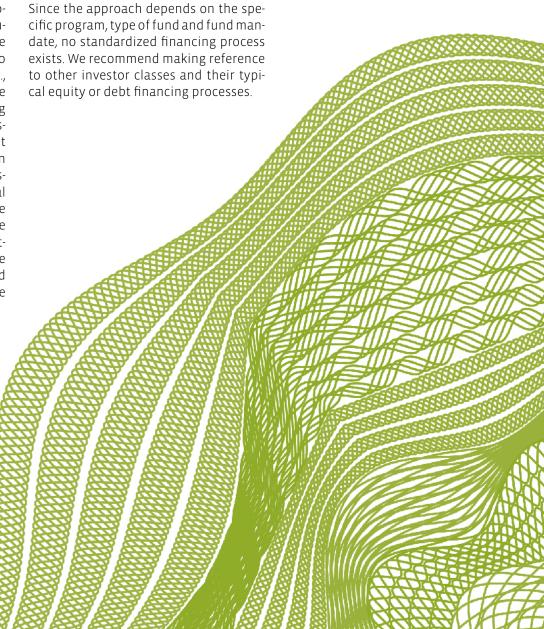
RISK-RETURN APPROACH:

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.

Q 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



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,

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.¹¹

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.

X 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.

PREFERRED FINANCING INSTRUMENTS AND DIDEAL 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 handsoff 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:

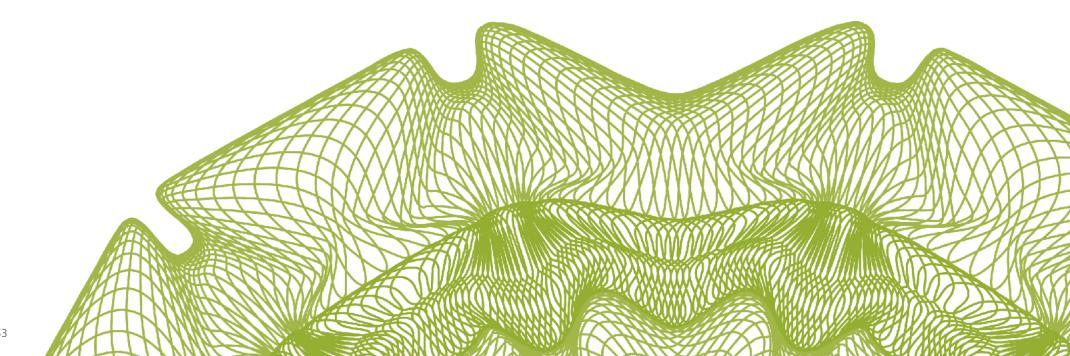
When engaging in venturing activities, corporations typically expect both financial and strategic returns. For instance, they can gain direct business and technological experience and insight in developing countries, gain access to emerging-market technologies, obtain input for R&D projects, or forward 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.

Q 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.

X 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 taxexempt 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 prudent 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 predefined 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.

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.

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 economicand 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

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

Co-investors

Identification

► The recipient identifies suitable VPOs based on geographic, sectoral, preferredinstrument and other financing criteria.

► The recipient approaches

Approach

suitable VPO through VPO's network, VPO's own portfolio companies, or by pitching/ networking at conferences. For VPOs with "gated" processes, recipient responds to calls and open competitions, and follows application criteria set by VPO.

Screening

► The VPO assesses whether finance recipient fits its criteria ("strategic fit"), and whether social impact is likely. Afterward, VPO will engage in initial discussions with management team, and may conduct a needs assessment

Due diligence

► Due diligence includes further interviews with management, staff and board, review of relevant internal and external information on recipient's theory of change, impactmeasurement system, income sources and financial viability, and organizational resilience and capacity.

Agreement

Agreement will cover:

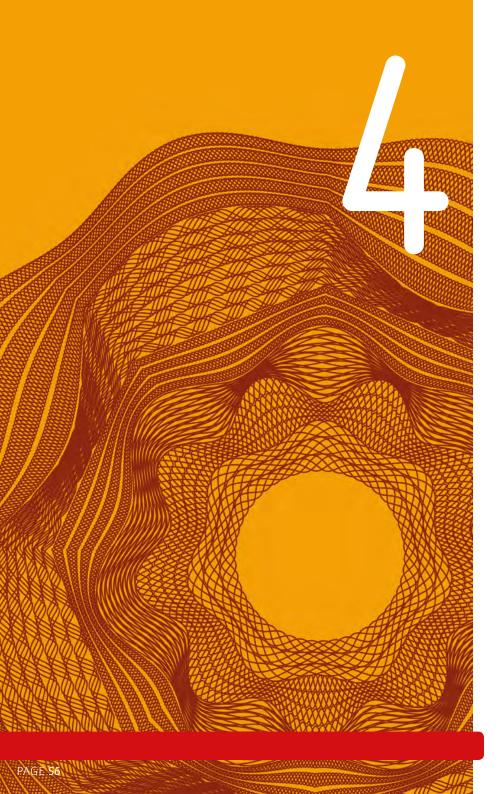
- Financing & payment plan.
- ► Business plan.
- ► Impact indicators & management system.
- ► Non-financial support plan.
- ► Possible exit plan.

▶ Ongoing

engagement such as board positions, plus non-financial support including capacity building, provision of access to networks, and monitoring.

Exit

► Recipient finds a suitable next finance provider, which will often be more commercially oriented, VPO often provides exitreadiness support, develops exit plan, and has some approval rights to ensure mission alignment.



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.

***** 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).

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.

EXAMPLE

Four generations of road project PPPs in Colombia

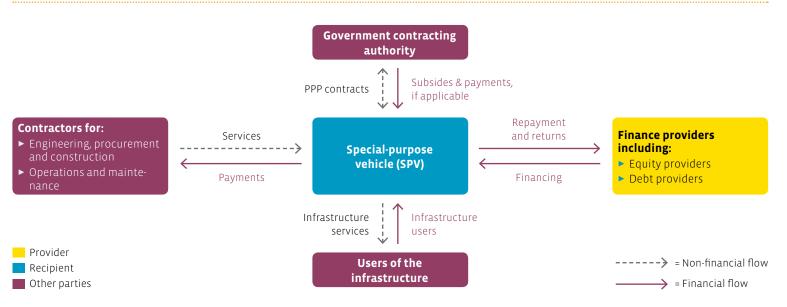
Four generations of road project PPPs in Colombia For many decades, Colombia has been using PPPs to expand its road network. Yet, many projects were not properly prepared and structured, suffering from concession contracts that created incentives to renegotiate signed contracts, and allocated excessive demand risk to the public sector. To address the shortcomings of the first generations of PPP road concessions, the government together with the World Bank's Transport Practice and IFC's Advisory Services developed the fourth generation of PPPs: a standardized mega-road program (4G) that operates under the country's new PPP law.

Besides standardizing PPP processes and contracts and strengthening the country's tendering processes, a key element of the effort to improve the performance and delivery of PPPs was to tackle institutional challenges through adapting Colombia's legal and institutional frameworks, and increasing transparency.

While the program has brought about many improvements in terms of risk allocation, alignment of incentives, and aspects such as consistency in contracting standards, many challenges remain. Some of them are fiscal discipline, securing long-term financing, and promoting coordinated planning through multi-stakeholder committees. To identify and address them will be crucial to ensure the success of Colombia's PPPs.

For more information, please refer to: https://blogs.worldbank.org/ppps/colombia-roads-more-traveled





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 2030.¹²
- 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:

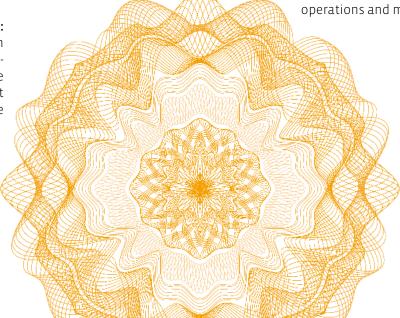
- ▶ Increased funding for infrastructure: Since the private sector finances the construction of the project and is reimbursed by the project's cash flows, PPPs reduce the financing burden for the government, and increase the overall universe of funding available for infrastructure financing.
- PPPs transfer 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.

Q 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

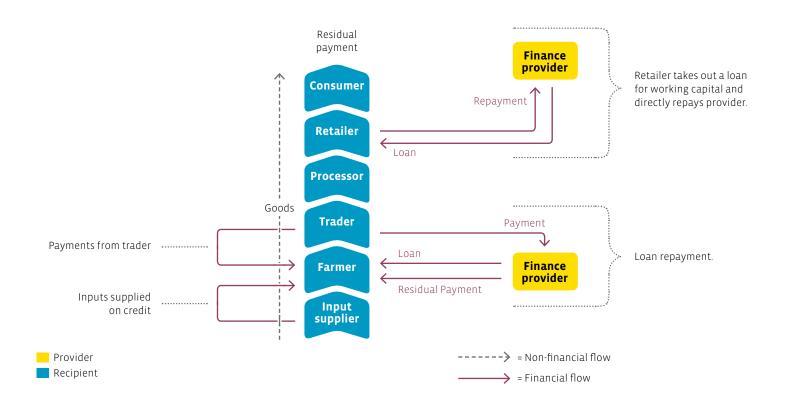
GIZ's Competitive African Rice Initiative (CARI)

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 at the establishment of 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, Ghana, Burkina Faso and Tanzania.

GIZ manages a matching fund that allows local rice mills to: train associated small-holder 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-farming practices under which small-holder farmers receive advance payments from rice millers, enabling them to buy high-quality seeds, fertilizers and agrochemicals.

CARI also entails memorandums of understanding with local financial institutions (FIs), with the goal of enhancing access to finance for rice mills. These programs include elements such as the provision of weather-based insurance so as to provide incentives for local FIs to offer credit to local rice-sector business; training programs for local FIs aimed at improving sector knowledge; and the offer of other financial services to the sector.

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%¹³ 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.

Q 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

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.

***** 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 belowmarket 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 additionality 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).

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.

To date, the GCPF has invested \$451 million in projects in 22 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-adverse 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.

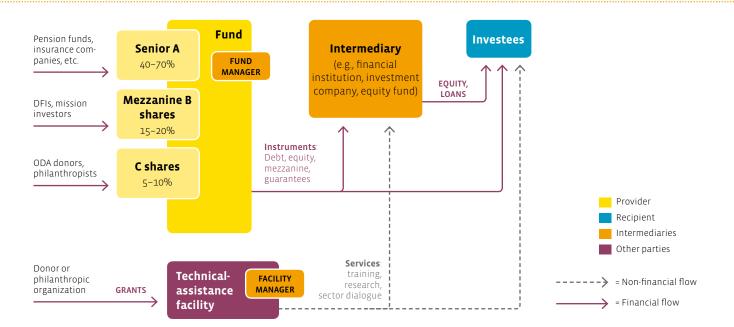
Rather than financing individual projects or companies directly, blended-finance investment vehicles often channel funding to local intermediaries for on-lending, or provide matching investments to existing funds with the aim of encouraging the participation of additional finance providers.

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

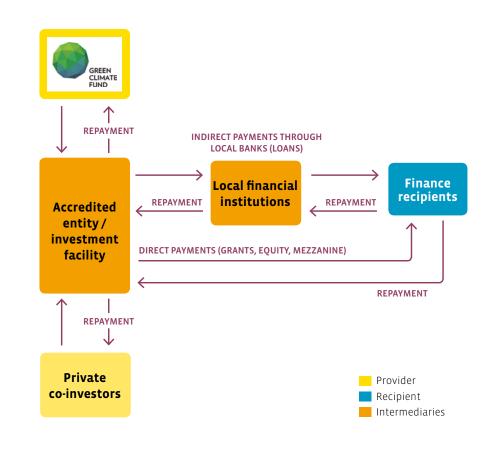
Accredited entities must develop their specific investment concepts and strategies in line with the GCF's investment strategy, framework and criteria, policies, environmental and social standards, gender policy, and other requirements. The GCF provides funds to the accredited entity which in some cases 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.

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.

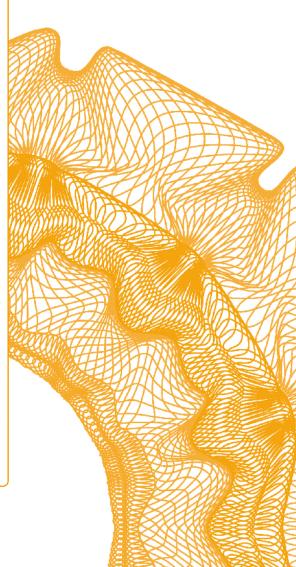


BOX 7 Concept of additionality

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.



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

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.

***** 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 providers 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.

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.

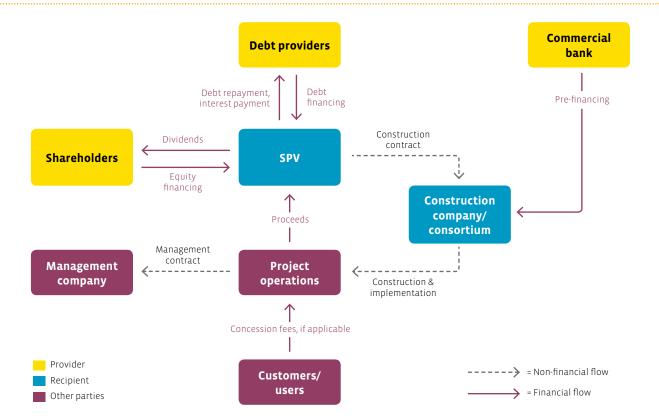
Once constructed, the project is typically managed by a professional management company, and is expected to

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.

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.

FIG 25 Flow of funds involving case of project finance



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.

Q PITFALLS:

- Property 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 longterm 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

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.

***** 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.

market commitments Advance (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-

EXAMPLE

Energizing Development Partnership (EnDev)

EnDev is piloting an RBF program that offers incentive payments to private-sector actors in the low-carbon off-grid energy sector in developing countries. The program aims at overcoming market barriers constraining the private-sector delivery of distributed renewable-energy systems providing modern energy services to the poor. It also seeks to improve access to the energy sector, to support private companies along the whole value chain and remove temporary financial barriers faced by private sector energy suppliers.

The program's key principles are as follows: 1) Participants will agree beforehand on a set of expected results broadly defined to encourage product and service innovation and provide flexibility; 2) all eligible service providers will be able to participate on a competitive basis; 3) monitoring and verification systems, including fraud-mitigation measures, will serve as the trigger for funds disbursement; and 4) disbursement will be contingent on the delivery of the predetermined and verified results. Private participants are expected to take the full risk until the delivery of the contracted results.

As of July 2016, EnDev encompasses 17 projects in 14 countries (in Africa, Asia and Latin America), covering a wide range of technologies.

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 14

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-

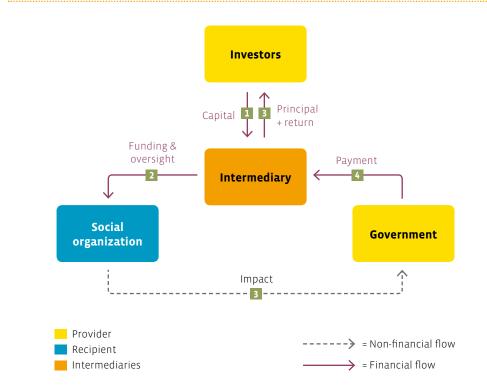
cally return-seeking impact investors or venture philanthropists that provide up-front capital to social organizations; a non-profit organization or social enterprise, often called a service provider, that deliver products and services to the target group; and the outcome funder, usually a government, 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



- 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.

Q 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) greenbond 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

IFC's Social Bond Program

In March 2017, the International Finance Corporation (IFC) raised \$500 million through its Social Bond Program to expand financing for projects that benefit women-owned enterprises and low-income communities in emerging markets. The bonds were purchased by more than 40 institutional investors across the world, including central banks, official institutions, pension funds and fund managers (such as Affirmative Investment Management, the California State Teachers' Retirement System, the International Fund for Agricultural Development, and the United Nations Entity for Gender Equality and the Empowerment of Women, among others). These bonds are issued for a period of three years and offer a coupon of 1.75% per year. Citi, Credit Agricole CIB and J.P. Morgan helped to manage the bond issuance process.

IFC plans to finance projects that help improve social outcomes. The funds will also be used to support financial institutions that lend to women-owned enterprises. Select examples of eligible projects include:

- ▶ Investments in companies that source directly from smallholder farmers.
- ▶ Investments in utilities (e.g., electricity, gas, water) that provide low-income households with better access to services.
- Investments in companies that provide health services, education services or housing to low-income populations in more affordable ways.
- ▶ Investments in companies that provide goods and services to low-income populations.
- ▶ Investments in companies that provide access to telecommunications services and payment platforms in markets that include the low-income segment.

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.

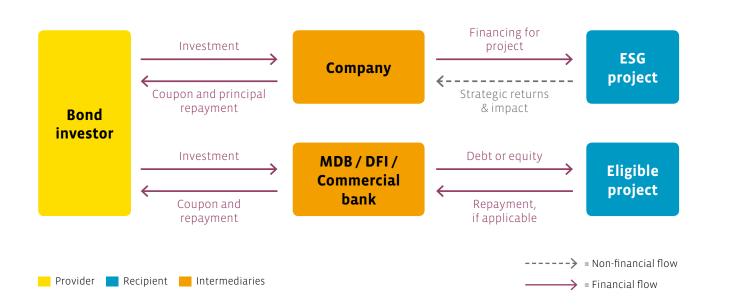
Finance provider: Investors may finance thematic bonds for several reasons. One salient driver is the increasing public and political mobilization around social and environmental issues. The returns on thematic bonds often match those of conventional bonds (depending on factors such as the credit risk 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.

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

FIG 27 Flow of funds involving thematic bonds



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

Q 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 32% of all campaigns raised amounts greater than \$10,000. However, only 0.2% of successful projects raised \$1 million or above. 15

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

WakaWaka's crowdfunding campaign

WakaWaka is a Dutch company that designs and manufactures a portable solar LED light and charger smaller than an iPhone. The company is pursuing a three-pronged business model: It sells products on a buy-one, give-one basis (where for each light purchased, another light is donated to a needy recipient), cross-subsidizes the purchase price for their units in off-grid communities, and provides give-away products during disaster relief through the WakaWaka Foundation. The company has launched a buy-one, give-one "Let's Light Up Haiti" campaign using the Kickstarter and OnePlanetCrowd crowdfunding platforms. The objective of the initiative was to raise money to construct an assembly plant in Haiti. The initiative raised \$700,000 from 7,000 investors around the world. 16

In return for a donation, WakaWaka offered campaign backers a pocket-sized solar LED light and phone charger. The success of this campaign relied largely on the crowd's perception of the reward's value. This was backed by a robust social-media outreach plan that included Twitter, Facebook, blogs and a network of family, friends and influential people.

> 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 antifraud procedures to assure safety for the users. Examples of platforms include Indiegogo and Kickstarter (both rewardbased), GlobalGiving and BetterPlace (both donation-based), Kiva and Zedisha

(both lending-based), and GrowVC and Innovatrs (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-

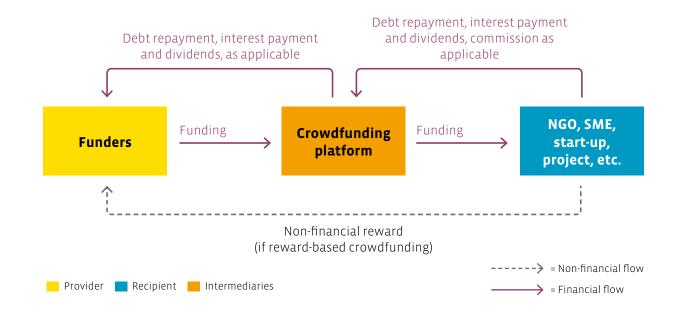
ers). These individuals may participate for different reasons, ranging from profit-oriented to philanthropic motivations. These various outlooks in turn influence the perception of what constitutes a successful project.

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.



GIZ services

in the world of finance

This module provides an overview of GIZ approaches and services related to financial system development and broader financing topics such as enabling and providing finance.

Chapter 5.1 provides a list of GIZ programs that include finance-related components and activities. Additional projects may be added in the future. Clustering these projects on the basis of related finance-associated activities allows for a good overview of these GIZ services.

Based on this stocktaking, and by highlighting select programs, Chapter 5.2 sets out GIZ's experience in building efficient, stable and inclusive financial systems – thus, in the overall area of financial system development. The traditional programs adopt a comprehensive or systems-development approach, often enhancing framework conditions and building capacity simultaneously at the macro, meso and micro levels. The focus of these programs is often on promoting financial inclusion. Chapter 5.3 describes a cluster of activities aimed at financing investments in specific enterprises, projects or sectors, referred to as "finance for growth." Chapter 5.4 looks at the emerging field of activities called "providing finance solutions," in which GIZ provides advice on structuring finance solutions or channels funds into financing vehicles.



LEARNING OBJECTIVES:

- Obtain an overview of current GIZ activities and project components in the area of finance
- Understand the specific services GIZ has provided in the example projects
- Understand the lessons learned from the showcase project on shade-tree finance in Costa Rica



THIS SECTION'S TOPICS:

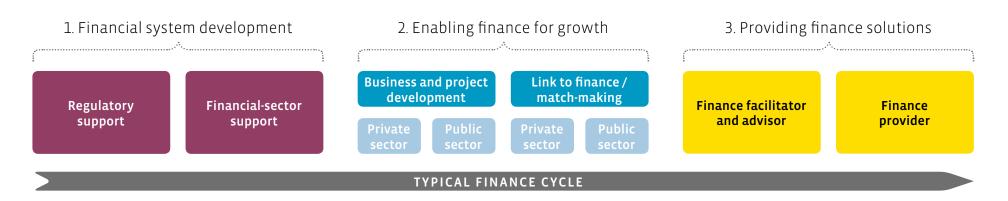
- 5.1 Stocktaking
- 5.2 Financial system development.
- 5.3 Enabling finance for growth
- 5.4 Providing finance solutions

5.1 Stocktaking

A review of the current GIZ portfolio results in a list of activities that are either standalone financial-sector programs, individual finance-program components or individual activities within larger programs that

focus on a different sector such as energy or agriculture. In an effort to classify these diverse activities, they are grouped into the following three clusters and six areas of intervention:





Financial system development: The first cluster encompasses an established and long-standing set of GIZ activities aimed at developing the key components of countries' financial systems in a holistic way by strengthening framework conditions, capacities and structures across financial sectors and their stakeholders. GIZ's programs in this cluster focus strongly on financial inclusion, but activities may also address financial-system stability, as well as efforts to deepen national financial sectors or help them and their attendant services function more efficiently and sustainably.

Finance for growth: The second cluster covers programs and activities that support the provision of appropriate types of finance for individual firms, projects and sectors. The project cycle includes the entire process from project and business development to the point of reaching out to finance providers for financing. Due to the varying characteristics of different projects, a distinction is made between private- and public-sector investees.

Finance solutions: The third cluster covers the latest area of GIZ activity, which focuses on providing support and advice to potential finance recipients that are seeking to structure and initiate financing deals. This may include the actual provision of finance if adequate financing is not available elsewhere in the market.

All three clusters are explained in more detail below and are illustrated with examples from the current GIZ portfolio. While they serve to structure GIZ's activities, it should be noted that programs may in fact be active across the clusters, and that static categories may not capture the full complexity of a constantly evolving portfolio.

The table below provides an overview of the GIZ project examples described in this guide in detail. It categorises them according to the clusters to show where they are located in the finance cycle.

Annex 3 provides a list of all GIZ projects with a strong financing component identified until January 2018.

TABLE 7: Project examples of GIZ

				Financial-	Business developn	and project ent	Link to fi match-m	nance/ aking	Finance facilitator	
Project	Country / Region	Description	Regulatory support		Private sector	Public sector	Private sector	Public sector	and advisor	Finance provider
Agricultural and Rural Finance Programme (AGRUFIN)	Uganda	Improve access to financial services for farmers	•	•			•			
Banking and Financial Systems Development	Myanmar	Support access to finance for SMEs	•	•	0 0 0 0 0 0 0 0 0 0 0 0 0 0 0 0 0 0 0 0		• • • • • • • • • • • • • • • • • • •			
Make-IT Africa	Africa	Support tech start-ups in early phase of growth and promote digital innovation for sustainable and inclusive economic growth			•					3 1 2 3 4 4 5 6 6 7 7 8 8 8 8 8 8 8 8 8 8 8 8 8 8 8 8
Cities Development Initiative for Asia (CDIA)	Asia	Asia-wide project preparation facility for urban infrastructure projects in medium-sized cities with clear development orientation and link to financing				•		•		
The Africa-EU Renewable Energy Cooperation Programme (RECP)	Africa	Mobilize African and European private sector and build pipeline of viable and bankable renewable energy investment projects	•		•		•		•	
Nigerian Energy Support Programme (NESP): Crowdfunding for RE Mini-Grids	Nigeria	Improve conditions for application of and invest- ments in renewable energy, energy efficiency and rural electrification		•			•		•	
Energising Development (EnDev): EnDev Nepal*	Global Nepal	Partnership for facilitating access to sustainable energy Micro Hydro Debt Fund, Grid Extension Fund, Results-based Financing		•			•	•	•	•

5.2 Financial system development

An efficient, inclusive and stable financial sector is a crucial ingredient for dynamic, sustainable growth and employment creation. GIZ offers a broad range of technical-assistance measures to promote access by poor populations and micro, small and medium-sized enterprises (MSMEs) to financial services such as savings accounts, payment systems, credit and insurance. For such enterprises, a lack of access to finance is often one of the main obstacles to growth. While GIZ cer-

tainly cares about access to finance per se, it is also strongly focused on how the finance is actually used, as well as on the appropriate design of financial products and services to ensure they meet clients' and firms' needs. GIZ therefore also promotes financial education and consumer protection, jointly referred to as responsible finance.

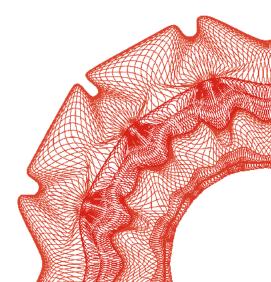
The rationale behind GIZ's approach to developing financial systems in a holistic way is that sustainable, structural change often requires simultaneous action on various levels. As a result, programs in this category tend to focus on two broad areas of intervention.

First, legal, regulatory and supervisory support measures assist partner countries in establishing a legal, regulatory and supervisory environment conducive to the smooth functioning of the financial sector – whether this be the microfinance industry, the banking sector, insurance companies or capital markets. GIZ advises governments, central banks, regulatory and supervisory authorities in the process of developing national strategies (e.g., financial-inclusion or green-finance strategies) and adopting international standards and good practices for the regulation and supervision

of the financial sector. GIZ helps adapt international standards and good practices to local conditions in each partner country. In some instances, this requires striking a balance between financial stability and financial-development considerations, as overly rigid regulation and supervision may stifle innovation. The objective is to design legal and regulatory frameworks in a way that is suitable to the local context and provides an enabling environment for financial-sector development while still safeguarding financial stability and protecting consumers. To achieve effective implementation, GIZ provides capacity-building services to government employees, regulators and supervisors.

Second, financial-sector support measures seek to enhance financial-sector infrastructures and build capacity within local financial industries as well as among finance recipients. GIZ works with networks and associations to build capacity across national financial sectors, for example by establishing or further developing training centers. Since the lack of credit histories is a major impediment for financial institutions to serve new customers, GIZ helps establish credit-information bureaus and supports the development of rating methodologies. To increase the efficiency and stability of financial systems, GIZ supports the upgrading of payment systems and helps train people in the required technical skills. At the micro level, GIZ engages with individual financial institutions - including microfinance institutions, cooperatives, banks and insurance companies - to strengthen capacities in

fields such as SME finance, green finance, agricultural and rural finance. Specific topics addressed include risk assessment, credit-scoring methodologies, digitization of services, the design of new financial products for underserved market segments, and more.



5.2.1 Project example: Agricultural and Rural Finance Program (AGRUFIN), Uganda

⊘ IN A NUTSHELL

AGRUFIN follows a holistic multi-level approach to supporting the development of stable, sustainable and flexible financial services for Uganda's rural population and agricultural sector, contributing to overall **financial system development**. By supporting financial institutions' development of tailored financial products and facilitating their contact with potential customers, the project also provides a **link to financing**.

	AL SYSTEM DPMENT	ENABLING FINANCE FOR GROWTH					G FINANCE FIONS
Dogulatory Financia	Financial-sector	Business and proj	ect development	velopment Link to finance / match-making			Finance
Regulatory support	support	Private sector	Public sector	Private sector	Public sector	facilitator and advisor	provider
•	•			•			

SECTOR: Financial system development (focus: agriculture and rural areas)

PARTNER: Uganda's Ministry of Finance, Planning and Economic Development (political partner); Bank of Uganda (main implementing partner)

MAIN ACTORS: GIZ, KfW
REGION / COUNTRY: Uganda

AVERAGE TICKET SIZE: Not applicable

WEB www.giz.de/en/worldwide/19361.html

O CONTEXT:

Agriculture is a key component of the Ugandan economy. Yet the sector accounts for only 22% of GDP, and food production barely satisfies the demand of the rapidly growing population. Unlocking potential in rural areas requires the provision of appropriate financial services that support productive activities along the agricultural value chain and minimize the financial risks caused by crop failure. In Uganda, however, only 11% of bank investment takes place within the agricultural sector, and only 16% of people in rural areas have access to formal financial products. The causes for these gaps can be traced back to the political, legal and regulatory framework, as well as to the institutional capacity of financial service providers. In addition, due to a low degree of financial literacy on the demand side, rural populations are unable to lobby for suitable financial services or take proper advantage of those that are available.

In its efforts to support the development of the rural economy and increase access to finance for Uganda's rural population, AGRUFIN employs a holistic multilevel (macro-meso-micro) and multi-actor approach. Working jointly with the Bank of Uganda (BoU) and the Ministry of Finance, Planning and Economic Development (MoFPED), the program addresses three key areas: 1) the regulatory framework for financial institutions (FIs) in rural areas (macro); 2) capacity development for FIs in the area of rural and agricultural finance, with a focus on related product development (meso and micro); and 3) financial literacy within the rural population (meso and micro).

PROJECT:

BoU and MoFPED have been provided with support in making appropriate changes to financial-sector and microfinance legislation and regulations (e.g., the 2016 Financial Institutions Act Amendment), as well as in the development of a regulatory framework for innovative financial distribution mechanisms. Mobile-phone-based money-transfer systems and agent banking are key factors in providing cost-effective services in rural areas through a network of agents.

Moreover, AGRUFIN has worked extensively to support capacity development and knowledge generation in the area of agricultural finance. Together with the Uganda Institute of Banking and Financial Services, it developed an agricultural value-chain finance course for local FIs. This has been vital in promot-

ing FI outreach to rural areas, and has helped the program work with various FIs to develop and implement tailored financial products for farming businesses and households. For instance, Pride Microfinance, a local microfinance bank, now offers a production loan for small sunflower-seed farmers, enabling increased earnings. Another milestone has been the regular publication of the Agricultural Finance Yearbook, a publication now widely accepted and well recognized even beyond Uganda's financial sector. In addition, working in close cooperation with KfW and BoU, GIZ has supported the development of a holistic credit-reference system that has led to significant improvements in terms of credit access and financial system stability.

On the demand side, GIZ has been instrumental in developing and implementing a national financial-literacy strategy and financial-consumer protection guidelines. These measures aim at enhancing the awareness, knowledge and skills of financial-service users, and seek to better protect them against non-transparent and unfair financial-service-provider practices. Key messages on financial literacy have been disseminated through various channels including schools, media, associations and informal local groups. Overall, more than 150,000 people have benefited from these activities. In addition, financial literacy has been integrated into the new curriculum for secondary schools that is being taught to more than 1.2 million students.





5.2.2 Project example: Banking and Financial-Sector Development Program, Myanmar

⊘ IN A NUTSHELL

GIZ provides holistic support to Myanmar with the aim of strengthening the country's overall **financial system development**, with the particular goal of promoting SME finance in order to ensure sustainable and inclusive economic development.

SECTOR: Financial system development (focus: SMEs)

PARTNER: Myanmar's Ministry of Planning and Finance, Central Bank of Myanmar, Banking Sector Financial Reporting Standards Implementation Committee, Deutsche Bank

MAIN ACTORS: GIZ

REGION / COUNTRY: Myanmar

AVERAGE TICKET SIZE: Not applicable

WEB www.giz.de/en/worldwide/17772.html

O CONTEXT:

Since Myanmar began to open up in 2011, the country has been undergoing wide-ranging economic reforms. However, the sustainability of economic development is heavily constrained by a lack of adequate financial services and a financial sector that is largely underdeveloped by international standards. This is mainly due to the restrictive regulations applied to the banking sector, a lack of skilled personnel within the financial sector, and local commercial banks' institutional and technical shortcomings. These factors hamper Myanmar's private-sector activities and are particularly harmful for the country's small and medium-sized enterprises (SMEs), as they often lack access to alternative financing sources.

FINANCIAL SYSTEM DEVELOPMENT			PROVIDING FINANCE SOLUTIONS					
Regulatory	Financial-sector	Business and proj	ect development	Link to finance,	/ match-making	Finance facilitator	Finance	
support	support	Private sector	Public sector	Private sector	Public sector	and advisor	provider	
•	•							
	•				•			

SMEs account for a substantial share of private-sector economic activity in Myanmar; thus, their limited access to financial services is problematic for the entire economy, and poses a substantial risk to the sustainability of the country's growth path. For this reason, the Banking and Financial-Sector Development Program seeks to support Myanmar's banking sector in offering sustainable and demand-oriented credits to SMEs. To do so, it follows a multi-level approach focusing on four mutually reinforcing areas: 1) the development of a regulatory and supervisory framework for the banking sector (macro); 2) the development of financial-reporting practices (macro, meso, micro); 3) the development of human resources in the banking sector (meso); and 4) the support of SME-finance pilot projects in selected banks (micro).

PROJECT:

The Central Bank of Myanmar (CBM) and the Myanmar parliament have been provided with support in creating and enforcing stable and enabling framework conditions for banks. This support has mainly consisted of capacity development for CBM employees in the regulation and supervision departments, and advisory services for the Parliamentary Committee on Banking and Monetary Affairs. In particular, GIZ helped in the regulation-drafting process by providing technical advice to lawmakers, and exposing regulators to international best practices through study tours and workshops. These activities led to the revision of the Accountancy Law in 2015 and the Banking Law in 2016. Additionally, GIZ supported the Banking Sector Financial Reporting Standards Implementation Committee (BFRIC) in developing and implementing a country strategy and action plan designed to enforce international financial-reporting and auditing standards (IFRS). These were launched in 2015, and BFRIC and GIZ will jointly promote their implementation by commercial banks.

With regard to meso-level activities to strengthen the financial infrastructure in Myanmar, GIZ provides comprehensive support for centralized training providers for financial institution/s (FIs) that help develop human resources in the banking industry. Today there is a certificate-level course in SME financing that is regularly offered to FI employees, as well as courses on IFRS implementation. To ensure the sustainability and scalability of these courses, GIZ follows a train-thetrainer approach for select FI employees, and has supported the establishment of a bank-training unit at the Yangon University of Economics (YUE) that follows international standards. Furthermore, GIZ has initiated a developPP program jointly with Deutsche Bank designed to upgrade and enhance the quality of bank- and finance-related masters programs at YUE.

Likewise, GIZ has provided support to four selected banks in the areas of expanding SME portfolios and implementing IFRS. The volume of the supported partner banks' gross SME loan portfolios increased by a factor of 12 during the previous project phase (with over 15,000 SMEs receiving loans). This has already brought about positive signaling and demonstration effects, and the lessons learned in the process will be further disseminated throughout the entire banking sector through publications and workshops.





5.3 Enabling finance for growth

In addition to the area of financial system development, GIZ activities have more recently also focused on enabling finance for growth, which effectively means enabling businesses, projects or public institutions to prepare bankable projects or business concepts to the point at which

they can qualify for commercial bank finance, and ultimately obtain financing. A strong focus has been placed on "green finance," or in more general terms, sustainable finance.

In many GIZ partner countries, there is a lack of local project-planning capacity in areas such as technical planning, the legal and financial structure of projects, risk-mitigation strategies, and long-term planning regarding demand for and maintenance of infrastructure. This is due both to limited experience in the relevant sectors and the limited capacity of local education systems to build the relevant skills. Supporting local capacities in the private and public sectors is therefore an important prerequisite to enabling more investments in sustainable projects and businesses. As the following projects show, this can be achieved with a mix of capacity-building in the area of project planning and development in order to prepare projects ready for bank financing, and by facilitating links to finance providers.

Activities in the area of **mobilizing finance for growth** help on two levels, by mobilizing private capital for sustainable investments and by channeling investments in the right direction. This latter category implies, for example, that funding will be guided toward the con-

struction of environmentally friendly infrastructure such as public transport rather than toward high-emission private-transport networks.

GIZ activities here are linked to the various phases of a typical project or enterprise financing cycle. Following the approach outlined in this Finance Guide (i.e., understanding the view of the finance provider), activities in this GIZ service cluster follow the primary aspects of a typical project cycle and the related finance cycle. While each step in the different cycles requires specific attention, the overall focus of GIZ activities is on the following two areas:

Business and project development:
Support is provided to individual projects, SMEs, project developers, or public entities regarding project preparation and pipeline development as well as pipeline prioritization. The latter is particularly relevant for public sector partners. It is typically based on supporting long-term investment planning capacities and improving the development of overall policy strategies (e.g., urban infrastructure

strategy) that eventually lead to project proposals. In addition, training programs are provided to the private sector focusing on business development and the development of bankable projects.

▶ Link to finance/match-making: Participants are given assistance in obtaining finance, including commercial finance, climate finance (e.g., REDD+, GCF), or development finance. Services offered by GIZ range from organizing match-making events between finance providers and finance recipients to supporting public agencies in accreditation processes for climate finance resources such as the GCF.

In this context, it is important to reiterate that – as noted in Module 3 – every finance provider follows its own internal logic during the financing cycle. However, the ways in which various finance providers evaluate projects' financial viability fall broadly into two categories:

 Financing enterprises or businesses for purposes of growth (working capital or fixed assets): Here, finance providers will assess the entire venture, its available collateral, its track record and future business prospects, its overall market environment, and its benchmark data relative to competitors, along with other related data.

► Financing infrastructure and large assets (buying or contracting for equipment or construction services):

Here, finance providers will take a detailed look only at the underlying project and its related cash flows, contractual relationships, and specific risks.

The example projects in the next section illustrate GIZ services for both types of financing. In addition, especially in the case of finance provided for large infrastructure projects, finance recipients can be either public, private or mixed (PPP) entities. Project examples are cited from each area in order to illustrate the difference.

Finally, a shade-tree project in Costa Rica is described as a "good practice" with regard to involving the financial sector early on in the GIZ project-development cycle.

5.3.1 Project example: Tech Entrepreneurship Initiative Make-IT, Africa

⊘ IN A NUTSHELL

Make-IT is a tech-entrepreneurship initiative that aims to strengthen the overall business ecosystem for tech start-ups, as well as the start-ups' managerial and project development capacities, so as to help them reach bankability and facilitate their access to financing. Match-making activities and the creation of platforms serving both entrepreneurs and investors also facilitate the successful link to finance opportunities.

	AL SYSTEM OPMENT	ENABLING FINANCE FOR GROWTH			PROVIDING SOLUT	G FINANCE FIONS	
Regulatory F	Financial-sector	Business and pro	ject development	Link to finance	/ match-making	Finance facilitator	Finance
support	support	Private sector	Public sector	Private sector	Public sector	and advisor	provider
		•		•			

SECTOR: Technology

PARTNER: Tech start-ups; Ministry of Industry, Trade and Cooperatives (Kenya); Federal Ministry of Budget and National Planning (Nigeria); broad range of European industry partners

MAIN ACTORS: GIZ

REGION / COUNTRY: Kenya, Nigeria **AVERAGE TICKET SIZE:** Not applicable

WEB www.giz.de/en/worldwide/57293.html

CONTEXT:

Tech entrepreneurship is a key driver of the digital revolution in Africa, offering considerable potential to modernize the continent's economies and societies and develop innovative solutions to development challenges. However, many young tech companies fail to reach international market readiness due to a lack of capital, customers, appropriately trained staff and digital infrastructure. For entrepreneurs to be successful, they need a well-functioning business ecosystem with a strong customer base, key clients, investors, business support and partners able to provide training. In sub-Saharan Africa, many business ecosystems are patchy, meaning that tech start-ups have no access to key contact persons, (follow-on) financing or growth opportunities.

Make-IT Africa was established in February 2017 with the aim of boosting digital innovation for sustainable and inclusive development in Sub-Saharan Africa. In close collaboration with more than 20 corporate and financing partners, social enterprises, hubs and networks, 'Make-IT in Africa' promotes the development of business ecosystems and supports tech start-ups in expanding their growth opportunities and ability to sustainably contribute to their countries' development, by providing better access to finance, markets and skills.

PROJECT:

Make-IT Africa is being developed and implemented in two pilot countries, Nigeria and Kenya. Here, digital innovation in health, agriculture, fin-tech and energy play a key role for development, applying technologies such as innovative app solutions, internet of things, 3D printing, or block chain. The project currently covers three areas of activity: 1) fostering the business ecosystem; 2) business contact support; and 3) individual-level technical and capacity support for selected tech businesses. The focus is on start-ups in an early stage of growth which are particularly dependent on demand-oriented services and support. While creating and maintaining a vital business ecosystem is a long-term task, Make-IT is designed to provide the initial support that will help these ecosystems grow, with the ultimate aim of benefiting all tech start-ups in the region. Key measures include the production of advice manuals on entrepreneurship, the launch of a platform offering information on financing and support services (such as business angel networks, public support programs, bank financing, and accelerator and incubator programs), and the creation of links between the private sector, public institutions, investors, innovation hubs, associations and networks. The program seeks to strengthen the ecosystem as a whole, and ensure a transparent and accessible environment for start-ups.

In parallel, these activities will make it easier for investors and European companies interested in partnering with local start-ups to find adequate investment opportunities. Business-contact support will be provided by match-making activities that take place through the Make-IT platform, as well as through online competitions (e.g., hackathons) and individually organized contacts and meetings at trade fairs and international conferences.

To make start-ups investment-ready and prepare them for investor contact, it is also crucial to improve their technical, entrepreneurial and strategic capacities. Innovative start-ups must provide investors with adequate business and financial models, as well as sound financial statements and further company-related information if required. Working with experienced local and international partners, Make-IT will provide support to 50 selected tech start-ups by offering training and mentoring sessions in areas such as investor readiness, technology, management, and business-model and product development.

RESULTS (AS OF NOVEMBER 2017):

Given that the initiative was launched in late 2017, it is difficult to deduce lessons learned at such an early stage. Nevertheless, there has been substantial attention from financial institutions and other investors on the one hand, and from promising start-ups on the other, indicating that there is a high level of demand for this type of advisory service and assistance for project developers and companies.



5.3.2 Project example: Cities Development Initiative Asia (CDIA)

⊘ IN A NUTSHELL

CDIA is an early-stage **infrastructure-project preparation facility**. It provides capacity development for public-sector employees in areas such as investment planning and prioritization, the identification of adequate funding sources, and the preparation of required financial and technical documents such as pre-feasibility studies. The CDIA also supports its clients in the actual search for finance providers, and has successfully created **links to finance** for several infrastructure projects in the region.

	AL SYSTEM OPMENT		PROVIDING FINANCE SOLUTIONS				
Regulatory Financial-sect	Financial-sector	Business and proj	ject development	Link to finance /	match-making	Finance facilitator	Finance
support		Private sector	Public sector	Private sector	Public sector	and advisor	provider
			•		•		

SECTOR: Infrastructure

PARTNER: Medium-sized cities, municipalities

MAIN ACTORS: GIZ, ADB
REGION / COUNTRY: Asia

AVERAGE TICKET SIZE: €5million to €533million,

depending on sector and project

WEB www.giz.de/en/worldwide/14338.html

O CONTEXT:

In the next 20 years, Asian cities must be ready to provide infrastructure and services to an expected 1 billion additional urban citizens. According to the ADB, this will require investment of around \$100 billion per year through 2030. Currently, the region's annual investment in social and technical infrastructure in urban areas totals around \$40 billion, leaving a 60% financing deficit that needs to be filled if cities are to remain engines of growth and contribute to sustainable development.

CDIA was established as a response to this challenge in 2007, and works directly with medium-sized Asian cities to bridge the gap between their development plans and the current implementation of their infrastructure-investment projects.

PROJECT:

In addition to the considerable investment deficit in the area of infrastructure projects, many medium-sized cities lack urban-planning strategies and have limited implementation and planning capacities. This makes it difficult to plan and implement sustainable infrastructure projects in the first place, but is also a substantial impediment to the acquisition of appropriate and sufficient financing. As a result, even where financing is available, a lack of well-designed and planned (i.e., bankable) projects prevents the readily available public and private financial resources from being usefully applied to urban-infrastructure financing needs. With the goal of overcoming this mismatch and ensuring the successful implementation of infrastructure projects, CDIA seeks to improve local capacities to prepare urban infrastructure projects to the point of finance-readiness, and supports its clients in identifying and tapping appropriate financing sources.

CDIA comes in at an early stage of the infrastructure-project planning and financing cycle. The organization provides its clients with a broad variety of services such as: 1) helping cities develop infrastructure-investment priorities, for example by updating city-development plans, helping to analyze investment budgets and prioritizing alternative infrastructure projects; 2) providing consultancy support in the conduct of pre-feasibility studies (PFS); and 3) identifying potential finance providers within domestic and international financial markets – thus linking infrastructure

projects to finance. Additionally, the CDIA works with the cities' national and regional partner organizations to ensure that advisory support will persist beyond CDIA's intervention, as well as to further strengthen local capacities.

RESULTS (AS OF NOVEMBER 2017):

The CDIA has achieved impressive results in its 10 years of existence. It has supported 138 cities in 18 Asian countries, conducting 52 prioritization exercises and 85 PFS, of which more than 50% could be linked to finance with a total investment value amounting to \$6.8 billion.

While around half of the financial commitments obtained thus far have been proffered by international financial institutions (FIs) such as the ADB, KfW and the World Bank, the other half has been provided by national FIs or through PPP structures with local project developers.

A key lesson has been that standards and requirements for feasibility studies and PFS vary by finance provider, and are impossible to generalize beyond a basic overall structure. It is crucial to integrate financial planning and the search for funding opportunities into the project-planning process at a at a very early stage, thus ensuring that finance-related provisions are considered from the beginning. Today, the CDIA conducts a PFS only once a potential finance provider has been identified and has expressed initial interest in the project. Otherwise, there is a substantial risk of carrying out a resource-intensive PFS that does not meet the financier's provisions, and that will consequently need to be redone.





5.3.3 Good practice:

Integrating finance considerations into project preparation — Shade trees in Costa Rica

In 2017, GIZ's forestry and climate-change team began exploring the potential for agroforestry investments within Costa Rica, specifically

examining ways to help coffee and cocoa farmers plant shade and/or timber trees that would improve their crop output.

Shade trees planted on coffee plantations can help to improve the quality of soil and thus of coffee production, while additionally playing an important climate-change mitigation and adaptation role. In mountainous regions with steep slopes, the use of trees is very important for reducing soil erosion, which can negatively affect coffee-plant productivity and interfere with downstream hydroelectric dams. Moreover, the coffee plant in particular can benefit from the temperature control and shade provided by trees in mixed systems.

Members of the GIZ finance team were involved in this project from an early stage, since it was recognized that introducing shade trees would require a significant finance element. Given the importance of conceptualizing investment components as early as possible, the team deemed it crucial to understand the viewpoints of potential finance providers on this issue from the beginning, and to include finance considerations throughout the whole process.

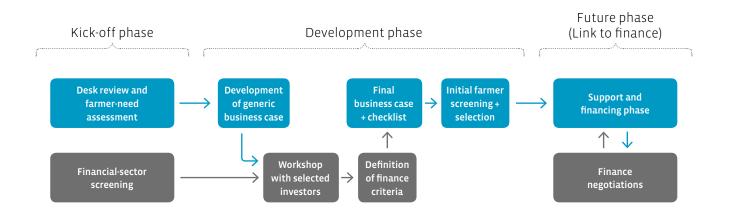
Thus, a comprehensive study and initial pilot project was carried out to assess whether the promotion of shade trees was worth pursuing, and if so, what requirements and project specifications – including from the perspective of finance providers – would be necessary. The general approach is outlined in the graph below:

KICK-OFF PHASE

In a first step, the country context, including Costa Rica's agricultural and forestry sectors, existing agroforestry activities, and financial sector, were evaluated in a process of desk research combined with interviews. This included a thorough assessment of farmers' needs and a rigorous screening of Costa Rica's financial sector. This in-depth analysis made clear that agroforestry practices could be highly beneficial from both a financial and environmental perspective, but that they were not yet widely implemented at a commercial scale.

The research also revealed a low level of overall lending to Costa Rica's agricultural sector, despite the existence of a variety of financing institutions, impact investors and public programs that promoted green lending; moreover, the volume of investment originating from the private sector was particularly low. A significant hurdle here was the inability of conventional financial instruments, with their comparatively short investment tenures and grace periods, to support the long-term repayment periods

FIG 30 Project approach which integrates finance considerations



needed for agroforestry projects. Other barriers included a widespread lack of knowledge regarding agroforestry systems, an insufficiency of funding for public subsidy programs, and the small ticket sizes for the kind of agroforestry investments envisioned, which prevented international impact investors and local banks from investing directly.

DEVELOPMENT PHASE

A generic business case for a shade-tree project was developed using the initial research findings in combination with a hypothetical cash-flow model. As can be seen in the figure below, annual cash flow is envisioned as being negative

during the first, second and third years, with the agroforestry system's establishment being the greatest single cost. Coffee plants become productive in year three, but production at this point remains relatively low, and is not substantial enough to offset maintenance and harvest costs. Annual cash flow becomes positive in year four, when coffee plants are fully productive. The project then breaks even in year five, when cumulative coffee revenues finally exceed cumulative establishment, maintenance and harvest costs.

This generic case shows that the underlying investment requirements create

significant financing challenges. The primary hurdle is the timing of revenues. Since the agroforestry systems will be cash-flow negative in early years, they will not be able to repay capital until they reach the break-even point. This means that any loan used to support such investments must provide generous grace periods between two and four years for combined systems. Loan tenures must also be generous, with maturities of between four and 10 years needed.

Generally speaking, few investors make their specific investment terms publicly available. Thus, in order to develop the proposed business model further, the GIZ project team at this point had to go beyond desk research and talk to potential finance providers in order to understand their funding terms, required documentation and overall investment interests. In this phase, feedback and recommendations from potential investors were successfully obtained either through individual interviews or in the context of workshops. This information showed that most credit products offered in Costa Rica were not wellsuited to farmers' financing and investment needs, largely due to agroforestry systems' projected cash-flow characteristics. Flexible structures such as "bullet payment," in which repayment is back-loaded or even delayed until the loan's final year of maturity, would better match the cash-flow profiles typical

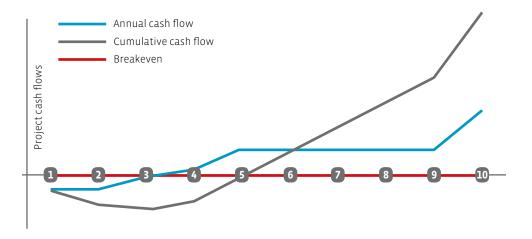
of the sector, but these were not readily available in the market.

Aside from the issue of financing structures, potential investors also identified additional risks associated with this business case, including:

- Credit risk (associated both with the investment type and the business sector involved): Agricultural-commodity prices are highly volatile, creating risk associated with finance recipients' ability to repay loans through earnings. In addition, insurance programs for this kind of crop are rare.
- Production risk: Disease, pests, fire and other disasters, by destroying all or part of a crop or plantation, can reduce or entirely eliminate the value of an investment in a short period of time
- ► Finance-recipient risk: Many agroforestry producers are small in terms of annual turnover, and have little in the way of existing assets that could be used as loan collateral.

This analysis confirmed the deskresearch finding that a key impediment to the implementation of agroforestry systems is the mismatch between potential finance recipients' investment needs

FIG 31 Cash flow profile of typical coffee and timber agroforestry system



and profiles and the available financial instruments. However, the interviews and workshops also established that certain investors would be willing to consider such investments further if certain preconditions were met.

Based on this feedback, a checklist of factors relevant to finance providers' investment decisions was prepared. The table below offers an overview of relevant criteria.

TABLE 8:
Relevant criteria for investment decisions

Issue	Examples (non-exhaustive)
Legal	► Borrower legal status
	► Land title
Business	▶ Track record
background	Revenue and
	profitability
	► Collateral
	► Leverage
Desired	► Ticket size
investment	Payback period
	► Capital type
Market and	► Access to markets
production	► Price fluctuations for
risk	commodities
	▶ Production risk

In a final step, potential farmers and their specific business cases were screened using the checklist as well as a standardized Excel cash-flow tool, identifying those that were ready to apply for financing and those that had additional support needs.

In three of 10 cases screened, it was established that the proposed investment projects were viable and that potential barriers could be addressed cost-effectively. This enabled the next step to be taken, which entailed the development of business models and investment proposals based on the investors' criteria.

While this represented the end of the pilot project, a larger, future GIZ project—as yet to be developed and funded—could provide additional support in this final phase, along with further capacity building for cases deemed generally viable but which still face substantial hurdles. The larger project could also provide match-making assistance, actively linking finance recipients with finance providers.

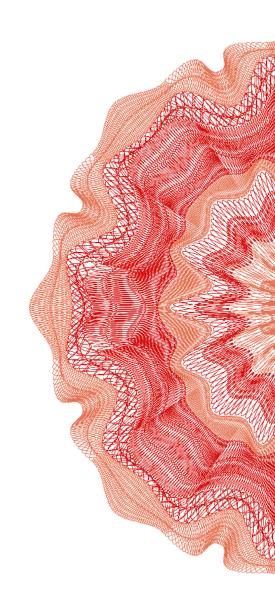
INITIAL RESULTS

Although the business-screening process was based on a limited sample of only 10 projects or farms, three businesses were identified as qualifying for the second round of in-depth business-case analysis and investment-proposal development. While two of the projects are still working to meet the investment criteria, one is now already in active finance negotiations thanks to the GIZ intervention.

The development of the generic business case, investment-criteria checklist and cash-flow model has provided a solid basis for future project evaluation. In addition, strong contacts have been established within the Costa Rican financial sector, which means the match-making phase can also be started soon.

In sum, the work to date has laid the groundwork for a successful future project on a larger scale, potentially extending beyond Costa Rica to other countries in the region. It has also demonstrated the importance of directly engaging with the financial sector from the beginning, and of integrating financing and business-model considerations as early as possible.

For more information, please refer to the joint GIZ and UNIQUE publication "Agroforestry business models: Investment opportunities in Costa Rica" (2017).



5.3.3 Project example: The Africa-EU Renewable Energy Cooperation Program (RECP)

⊘ IN A NUTSHELL

The RECP supports **project preparation** and assists private-sector driven decentralized renewable energy projects in **accessing finance** through its key service, the Finance Catalyst. As a core support activity, the Finance Catalyst advises project developers on how to structure finance and supports negotiations with potential finance providers. In addition, the RECP builds the capacity of key actors, particularly public-sector stakeholders, to invest in decentralized renewable energy.

	AL SYSTEM OPMENT		PROVIDING FINANCE SOLUTIONS				
Pagulatani Sinancialar	Financial-sector	Business and proj	ect development	Link to finance ,	/ match-making	Finance facilitator	Finance
Regulatory support	support	Private sector	Public sector	Private sector	Public sector	and advisor	provider
•		•		•		•	

SECTOR: Renewable energy

PARTNER: Project developers and companies (both local and international); associations, finance providers (both local and international); similar project and financing support facilities

MAIN ACTORS: GIZ

REGION / COUNTRY: Africa

AVERAGE TICKET SIZE: €4.5 million - €50 million,

depending on market segment

WEB www.africa-eu-renewables.org

CONTEXT:

For most African countries, providing universal access to energy services remains a crucial objective and a prerequisite for developmental progress. Renewable energy sources are abundant on the continent and hold huge social-and economic-development potential. Yet despite the great opportunity presented by Renewable energy, efforts to exploit its potential have been patchy to date, with interconnected barriers inhibiting progress. Much more investment is needed, and public resources alone will not suffice to meet the investments requirements.

Designed to mobilize the private sector while supporting project and pipeline development, the RECP: 1) offers project preparation support for RE project developers and facilitates their access to financing through the Finance Catalyst; 2) provides information about market and financing opportunities; 3) matches African companies and financiers with European counterparts; 4) works with regulators to address regulatory needs; and 5) supports local skills development.

PROJECT:

The RECP focuses on decentralized renewable energy projects, both on- and off-grid. Decentralized renewables have a huge potential for energy access and job creation. However, prospective financiers tend to be hesitant to invest due to the relatively small ticket sizes and limited experience concerning the respective technologies and business models. On the other hand, many developers lack experience and capacity to develop viable projects, and they lack the network and time to identify appropriate funding sources. As a result, few viable and promising projects reach financial close and receive external financing.

The RECP aims to fill this gap; its key service in terms of project development support – the Finance Catalyst – focuses

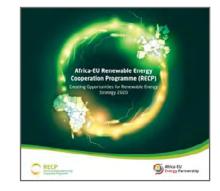
on assisting viable project ideas as they become investment opportunities (i.e., reach bankability) and facilitate their access to finance.

In doing so, RECP acts as an "honest broker," by 1) providing project developers with advice on identifying and accessing appropriate financing instruments and 2) providing potential finance providers with advice on the viability of these projects. Project proposals are submitted online and screened by the Catalyst's expert team. Once a project is selected, it is eligible for support of up to 20 days. The key service consists of tailored hands-on coaching, which includes early-stage project-development support, advice on business-case and financial models, assistance in identifying financing options, aid in aligning project documentation with potential finance providers' specific requirements, and assistance in contractual negotiations, including the production of term sheets and the fulfillment of conditions precedent. Additionally, in many cases, the RECP acts also as an integrator of various other existing support facilities.

RESULTS (AS OF NOVEMBER 2017):

Since August 2016, more than 240 applications have been submitted to the Catalyst, 35 of which have received support. Thanks to the substantial expertise of the team of senior finance and project-development experts, in addition to close cooperation with finance providers from the beginning, the initiative has successfully served as a match-maker between projects and finance providers: currently three projects have been handed over financiers.

Thus far, the intervention's support has consisted of a 20-day coaching period for each successful applicant. As coaching support is often not enough, the RECP is currently discussing with donors whether and how to deepen support through more comprehensive capacity-building facilities and other project-related support (e.g., with feasibility studies).





5.4 Providing finance solutions

The latest area of GIZ activities aims at facilitating or providing financing solutions. An important distinction to be made in all such activities is that new or alternative financing solutions should be provided only if no other adequate financing is available in the market – thus in the presence of well-documented market failures. Therefore, the precondi-

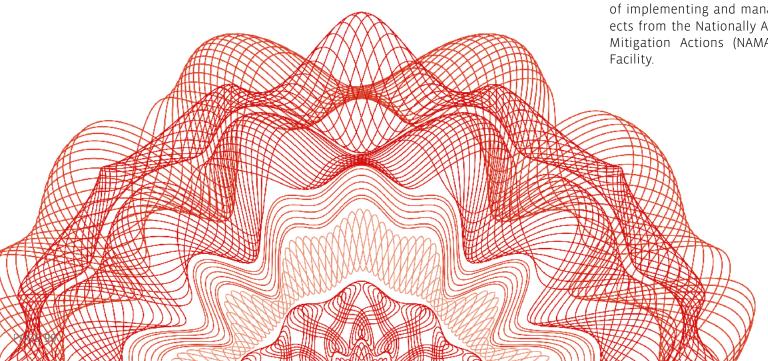
While this type of service is a recent addition and an emerging area for GIZ, some specific activities are already being implemented, with the organization taking one of several roles:

► Finance facilitator and advisor: Here, GIZ plays an advisory role in structuring finance solutions such as funds or crowdfunding structures, provides legal or administrative support in creating pass-through vehicles for third-party funding sources.

tion for providing suitable services is a thorough analysis of all hurdles preventing the use of established financing providers and mechanisms. Only once these have been found to be insufficient or not suitable for a specific purpose should new and innovative finance solutions either be supported or even created from the outset.

▶ Finance provider: In this case, the organization provides access to third-party resources that are channeled via GIZ and its own financial statements. This will become more relevant with the accreditation of GIZ for the GCF grant window. Some initial experience has been gained in the context of implementing and managing projects from the Nationally Appropriate Mitigation Actions (NAMA) Support Facility.

Overall, it should be noted that this new area of providing finance solutions more directly will require changes in GIZ's legal, monitoring and finance-structuring capacities. While the number of such activities is growing, every project in this area will continue to be specific and complex, and will require special attention from experts with different skill sets within GIZ as well as from outside advisers.



5.4.1 Project example: Crowdfunding as part of the Nigerian Energy Support Program (NESP)

⊘ IN A NUTSHELL

Given the lack of local financing for renewable energy mini-grids in Nigeria, the Nigerian Energy Support Program (NESP) supported the **establishment of a innovative financing mechanism** to mobilize financing for promising mini-grid project. The NESP initiated and facilitated the market entry of a crowdfunding platform and paved the way for further crowdfunding activities by sharing technical, financial and legal lessons learned in the course of this activity, thereby **strengthening the local financial system**. NESP also supported crowdfunding platform

bettervest in finding suitable projects – thus, **linking promising projects with adequate funding**.

	AL SYSTEM OPMENT	ENABLING FINANCE FOR GROWTH				PROVIDING FINAN SOLUTIONS	
Regulatory	Regulatory Financial-sector	Business and proj	ject development	Link to finance	/ match-making	Finance facilitator	Finance
support	support	Private sector	Public sector	Private sector	Public sector	and advisor	provider
	•			•		•	

SECTOR: Renewable energy

PARTNER: Local project developers **MAIN ACTORS:** GIZ, USAID, bettervest

REGION / COUNTRY: Nigeria

AVERAGE TICKET SIZE: €250,000 per mini-grid

project

WEB www.africa-eu-renewables.org

O CONTEXT:

Although Nigeria has vast oil resources and huge potential for RE production, more than half the country's population lacks access to electricity. Moreover, those who are connected to the grid suffer from frequent blackouts. For this reason, many households and businesses rely on expensive and ecologically harmful petrol- or diesel-burning generators.

The Nigerian Energy Support Program (NESP) advises the country's government on how best to provide reliable and sustainable electricity to its people. While NESP engages in a variety of interventions, this section describes the crowdfunding component implemented in 2016/17.

PROJECT:

NESP estimates that up to 26 million Nigerians who lack access to electricity live in areas suitable for photovoltaic (PV) mini-grids. Despite this potential, the mini-grid sector in Nigeria is still in its infancy. A key barrier is the difficulty faced by project developers in accessing the finance needed to pilot and roll out their business models. The conditions under which commercial loans are granted in Nigeria are inappropriate for financing small-scale infrastructure installations, while access to concessional finance for such projects is very limited.

Realizing the potential for off-grid solar mini-grids, and identifying the lack of appropriate financing as the main hurdle to their deployment, NESP launched a campaign to attract investors into renewable energy mini-grid financing in 2015. Feedback was particularly strong from local commercial banks and crowdfunding platforms such as bettervest, which had previous experience in financing off-grid renewable energy projects in Africa. However, the banks pulled back due to a prolonged recession in 2016, and only bettervest ultimately proved willing to invest. It became clear that the general advantages of crowdfunding would also be useful for financing renewable energy mini-grids in Nigeria, given that crowdfunding platforms: 1) are able to provide funding where banks are hesitant (given the return expectations of impact investors vs. traditional investors); 2) act more quickly than banks; and 3) do not require collateral.

However, in order to create a crowdfunding pilot project in the Nigerian market, bettervest faced high up-front costs and risks regarding the establishment of an enabling framework for crowdfunding in Nigeria, as well as in the identification of suitable projects. To offset those initial costs and risks, NESP set up an Integrated Development Partnership to offer legal, technical and financial advice to bettervest.

NESP provided support to bettervest in a number of ways, including by 1) adjusting the platform's contractual framework to Nigerian law; 2) generating guidelines for the performance of credit checks on local mini-grid developers in Nigeria; 3) identifying appropriate projects and supporting technical due diligence; and 4) more generally, training bettervest in issues related to mini-grid finance.

RESULTS (AS OF AUGUST 2017):

In less than six months, bettervest raised €459,000 in debt capital for two mini-grid projects. These seven-year loans constituted approximately 40% of each project's financing and were complemented by an equity investment from project developers equaling 10% and partial infrastructure procurement of the minigrid by NESP amounting to 50% of the project finance. In this case, loans were chosen instead of equity because bettervest exclusively offers debt financing.



5.4.2 Project example: EnDev Nepal and the Micro Hydro Debt Fund

⊘ IN A NUTSHELL

EnDev Nepal **advised its donors to create a revolving fund** to fill the financing gap that prevents communities from implementing viable micro-hydropower projects. To enhance local capacities, the fund is managed by commercial financial institutions (FIs) that along with AEPC also supervise and select projects for the fund. Given the novelty of the approach and sector, EnDev provides training to the FIs and supports the project-selection process. This **strengthens the financial sector** and facilitates the **link to financing** for rural communities.

	IAL SYSTEM LOPMENT	ENABLING FINANCE FOR GROWTH					FINANCE TIONS	
Degulatory Figure is least to	Financial-sector	Business and proj	ect development	Link to finance ,	/ match-making	Finance facilitator	Finance	
Regulatory support	support	Private sector	Public sector	Private sector	Public sector	and advisor	provider	
	•			•	•	•		

SECTOR: Renewable energy

PARTNER: AEPC, partner banks acting as fund managers, MHP project developers

MAIN ACTORS: GIZ

REGION / COUNTRY: Nepal

AVERAGE TICKET SIZE: €16,500 per mini-grid

project

WEB www.giz.de/en/worldwide/17859.html

CONTEXT:

Around 67% of the Nepalese population benefit from access to electricity through the national grid, with approximately 43% in rural areas. Those without access to grid electricity rely predominantly on traditional sources of energy, including the use of kerosene and candles for lighting, or diesel generators. Increasingly also Pico PV equipment has entered the market.

EnDev Nepal supports access to modern energy services through grid-based electrification, and additionally facilitates access to financing for micro-hydropower (MHP) projects. While the project consists of several finance-related components, the focus here will be on the Micro Hydro Debt Fund (MHDF).

PROJECT:

Off-grid electrification and micro-hydro power (MHP) have long been promoted by the government as a means of supplying power in rural areas. The Alternative Energy Promotion Center (AEPC), a government agency, implements two major support programs for MHP that are funded by UNDP and the World Bank. These programs provide subsidies for MHP project developers (typically local communities) that cover up to 50% of the total investment. The remaining gap is financed by the developers' own resources and/or by external sources. Given that many rural communities are unable to provide sufficient equity capital, recourse to external resources is often inevitable, calling for the involvement of local FIs. Yet, due to insufficient experience with renewable-energy projects and rural-area lending, local FIs perceive lending to MHP projects as being risky, and either refuse to lend altogether or ask for substantial collateral and high interest rates, making borrowing prohibitively costly for developers. This leads to a situation in which viable MHP projects cannot be implemented despite the presence of several multi-donor subsidy schemes. Seeking to address this problem, EnDev Nepal set up the MHDF in 2010 to support Nepal's rural off-grid electrification efforts.

The MHDF is a revolving fund that complements public resources by providing loans of up to 30% of the total MHP investment, significantly lowering the project developer's equity contribution. Funding is provided on a project-finance

basis and risk is mitigated through a mandatory plant insurance policy and risk-sharing between the fund supervisor and fund managers. In addition, the revolving-fund structure allows further MHP projects to be financed in the future.

Capacity development and advisory services represent further key elements in the MHDF's successful intervention. To enhance local capacity and ensure that local actors take ownerhsip in the projects, AEPC was assigned the role of fund supervisor shortly after the MHDF was set up, and after a public tendering process, two local commercial banks became responsible for fund management and the selection and supervision of eligible MHP projects. The banks receive training in the performance of in-house risk assessment for new projects, and are also provided with field-visit support. Additionally, capacity-building programs within local communities offer training in construction and maintenance for the MHP plants as well as in financial planning.

RESULTS (AS OF AUGUST 2017):

The MHDF has supported 27 MHP plants that deliver electricity to 25,444 persons by feeding into mini-grids. The establishment of the fund has improved the efficiency of public-subsidy schemes, increased energy access in rural Nepal, and improved access to credit for the purposes of rural electrification in Nepal.

To ensure the sustainability of the supported projects and the MHDF more broadly, bottlenecks especially in the repayment process will be identified. In addition, additional training sessions on loan repayment and MHP plant maintenance are planned for local communities.





Appendix

^{A1} 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 acqui- sition.
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 sched- ule 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.

APPENDIX ► A1 **Detailed comparison of financing instruments**

	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.	expenditure; use of funds	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.

A2 List of relevant GIZ projects

				Financial-	Business an developme		Link to fina match-mak		Finance	
Project	Country / Region	Description	Regulatory support	sector support	Private sector	Public sector	Private sector	Public sector	facilitator and advisor	Finance provider
Cities Development Initiative for Asia (CDIA)	Asia	Project preparation facility for urban infrastruc- ture projects in medium-sized cities				•		•		
C40 Cities Financing Facility (C40 CFF)	Global	Facilitating access to finance for infrastructure projects in mega-cities				•		•		
Mobilise your City	Global	Supports national and local governments in plan- ning sustainable urban mobility				•				
Financing Energy for Low-carbon Investment - Cities Advisory Facility (FELICITY)	China Brazil Mexico	Project preparation facility to advise cities, project developers and national partner banks on setting up and implementing mitigation projects that qualify for EIB financing				•		•		
Promotion of MSMEs (TAM)	Morocco	Improve access to finance for MSMEs, start-ups and self-employed	•		•		•			
Make-IT Africa	Africa	Support tech start-ups in early phase of growth and promote digital innovation for sustainable and inclusive economic growth			•		•			
The Africa-EU Renewable Energy Cooperation Programme (RECP)	Africa	Mobilize African and European private sector and build pipeline of viable, bankable renewable energy investment projects	•		•		•		•	
Private Sector Adaptation to Climate Change (PSACC)	Global	Develop instruments for awareness-raising and provide advisory services on the impact of climate change for the private sector			•		•			
Project Development Programme (PDP)	Global	Support partnerships between local and German businesses and develop reference projects for renewable energy sector	•		•		•			
NAMA Support	Costa Rica	Enable coffee producers and coffee mills to make investments in low-emission or sustainable technologies and practices		•	•		•		•	•
Responsible Enterprise Finance	India	Support and improve supply of risk capital and loans for sustainability-oriented investments of MSMEs	•	•	•		•			
Banking and Financial Systems Development	Myanmar	Support access to finance for SMEs	•	•						

Project	Country/ Region	Description	Regulatory support	Financial- sector support	Business and project development		Link to finance / match-making		Finance	
					Private sector	Public sector	Private sector	Public sector	facilitator and advisor	Finance provider
Promotion of Access to Financial Services for SMEs	Egypt	Strengthen financial services offered to SMEs by non-bank financial institutions (NBFIs)	•	•						
Microfinance in Rural Areas - Access to Finance for the Poor	Laos	Improve access to finance for rural population, focus on provision of financial services by MFI-supported and supervised village banks	•	•						
Promotion of Inclusive Financial Systems in the MENA Region	MENA	Strengthen framework conditions for poor people to access appropriate financial services	•	•						
Promotion of the Microfinance Sector	Tunisia	Improve regulatory and institutional frameworks to enable development of the microfinance sector	•							
Program for Financial Systems Development	DR Congo	Enhance central bank capacities and strengthen responsible finance framework and initiatives	•	•						
Promotion of safety retrofits and environmental upgrades in the textile and garment sector	Bangla- desh	Improve training opportunities and information services that focus on investments in safety and environmental measures for Fís and textile factories		•	•					
Strategic Alliance — Green Bond Market Development in G20 Emerging Economies	Global	Strategic alliance with SEB to jointly promote the development of green bond markets in G20 emerging economies	•	•						
Chile-Solar-Fund	Chile	Strategic alliance with Soventix GmbH for financ- ing small to mid-size solar ready-to-build photo- voltaic projects		•			•		•	
Nigerian Energy Support Programme (NESP): Crowdfunding for RE Mini-Grids	Nigeria	Improve conditions for application of and invest- ments in renewable energy, energy efficiency and rural electrification		•			•		•	
Promotion of rural electrification through renewable energies (PERER)	Madagas- car	Improve framework conditions for investments in renewable energy and improve access to electricity from renewable energy sources	•	•	•		•			
Energising Development (EnDev): EnDev Nepal*	Global Nepal	Partnership for facilitating access to sustainable energy Micro Hydro Debt Fund, Grid Extension Fund, Results-based Financing		•			•	•	•	•

Project	Country/ Region	Description	Regulatory support	Financial- sector support	Business and project development		Link to finance / match-making		Finance	
					Private sector	Public sector	Private sector	Public sector	facilitator and advisor	Finance provider
Climate Finance Readiness Programme (CF Ready): Finance mechanisms for low-carbon development (FinanCC), Peru*	Global Peru	Advise countries on how to access international climate finance and improve conditions for their efficient use		•				•		
Indonesia Climate Change Trust Fund (ICCTF)	Indonesia	Strategic partnership for supported NAMAs and climate finance: support for the ICCTF				•		•		
National Survival Fund Philippines	Philip- pines	Support the country in shaping and implementing the international climate regime	•			•		•		
Amazon Forest Conservation and Climate Fund	Brazil	Support fund's institutional and financial sustainability						•		
REDD Early Movers (Reducing Emissions from Deforestation and Forest Degradation)	Global	Support REDD bridging finance (REDD Early Movers (REM): global program combining carbon finance from KfW with operational support from GIZ)						•		
AgroBanco Peru - Forest Finance Development	Peru	Support AgroBanco Peru towards diverse green portfolio		•						
Competitive African Cotton Initiative (COMPACI)	Africa	Support smallholder farmers in sub-Saharan Africa to enhance productivity of cotton and staple food production		•	•		•			
Competitive African Rice Initiative (CARI)	Africa	Improve access to financial services for local enterprises in rice-sector value chain and small-holder rice farmers		•	•		•		•	
Sustainable Smallholder Agribusiness (SSA)	Africa	Improve access to financial services for small- holder agribusiness		•	•		•			
Agricultural and Rural Finance Programme (AGRUFIN)	Uganda	Improve access to financial services for farmers	•	•			•			

^{*}These are project examples.

Private sector: companies, start-ups etc.
Public sector: national / subnational authorities etc.

Services reflect finance-related GIZ services, not the entire range of services provided by the respective program / initiative.

Regulatory support: regulatory / legislative support for investment related policies, financial sector regulation, supervision, capacity building for public sector employees on financial markets, etc.

Financial-sector support: capacity building for FIs, introduction of new financial products for underserved market segments, market development, financial literacy trainings etc.

Business and project development: project preparation support, business development training, development of infrastructure strategies leading to project proposals, support for long-term investment planning and project prioritization etc.

Link to finance / Match-making: facilitation of access to finance (e.g., commercial finance, climate finance like REDD+ and GCF, development finance etc.) through services such as match-making events between investors and investees (e.g., project developers, start-ups), link to potential investors for municipal infrastructure projects, accreditation support for climate finance resources such as the GCF etc.

Finance facilitator & adviser: GIZ takes advisory role in structuring finance solutions such as funds and crowdfunding structures, legal and administrative support in creating passthrough vehicles for third-party resources, etc.

Finance provider: GIZ provides third-party resources that are recorded on GIZ financial statements (e.g., NAMA Facility)

Collected by SV Finanzsystementwicklung (01/2018)

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Glossary

Α

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

В

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.

С

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.

F

EBITDA: Earnings before interest, taxes, depreciation and amortization; thus, essentially net income with the sums spend 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:

- 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.

G

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

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.

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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.

М

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.

0

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 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.

п

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 \in 100 stock rises by \in 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.

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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.

