



PRINCIPLES AND PRACTICES OF PRIVATE SECTOR FINANCE

Types of Private Sector Investors

THREE CATEGORIES OF PRIVATE SECTOR ORGANIZATIONS THAT CAN INVEST IN DEVELOPING COUNTRIES

Investor Type	Domestic Investors	Regional Investors	International Investors
Real Economy Companies	An Indonesian agribusiness company investing domestically	An Indian telecoms company investing in Nepal	A Japanese automotive company investing in Cote d'Ivoire
Financial Investors (Debt)	A Vietnamese bank providing loans to Vietnamese SME's	A Singaporean insurance company investing in a bond issued by a Filipino manufacturing company	A Canadian pension fund investing in a covered bond issued by a Cambodian bank
Financial Investors (Equity)	A Thai fund buying common equity in a Thai mid-cap	A Japanese pension fund purchasing 25% of a Filipino mid-cap	A Singaporean private equity firm purchasing control of an Indonesian oil firm



Foreign
Direct
Investment

FINANCIAL INVESTORS CAN BE CATEGORIZED INTO SEVEN SEGMENTS WITH UNIQUE CHARACTERISTICS & PREFERENCES (1/2)

	Segment	Summary	Characteristics & Preferences
Financial Asset Owners	Pension Funds	Investment pension payments from policy holders to pay future retirement benefits	<ul style="list-style-type: none"> • Restrictions in some asset classes and geographies • Risk and liquidity constraints
	Insurance Companies	Investment premium payments from policy holders to provide funding for future claims	<ul style="list-style-type: none"> • Highly regulated with high capital charge for investments with high risk • Large investment teams and expertise to investment in developing countries
	Sovereign Wealth Funds	Invest their country's wealth derived from trade surpluses and commodity revenue	<ul style="list-style-type: none"> • Tend to prefer returns over liquidity • Higher tolerance for risk compared to other investor segments
	Commercial Banks	Lend to small and large businesses	<ul style="list-style-type: none"> • Do not invest; instead provide financing • Required to allocate high levels of capital when lending to high risk borrowers

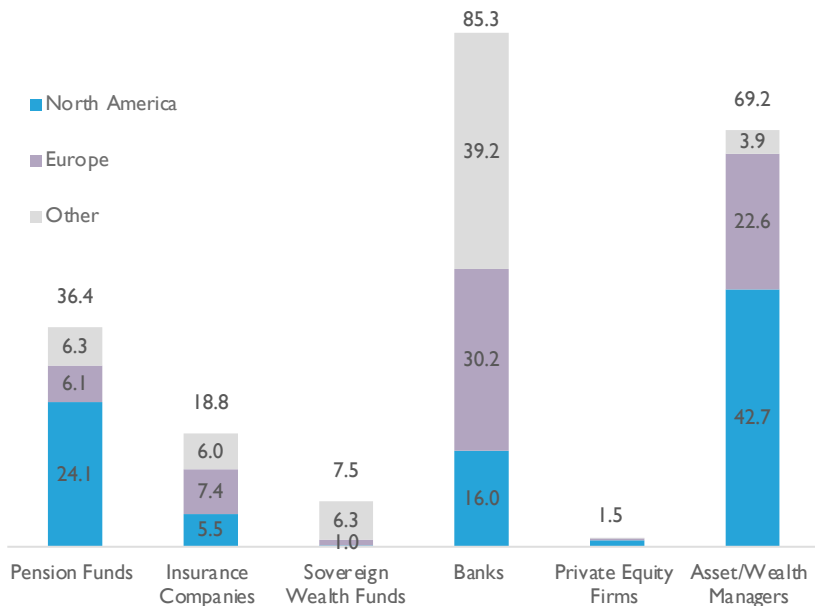
FINANCIAL INVESTORS CAN BE CATEGORIZED INTO SEVEN SEGMENTS WITH UNIQUE CHARACTERISTICS & PREFERENCES (2/2)

	Segment	Summary	Characteristics & Preferences
Financial Asset Owners	Investment Banks	Invest in and/or arrange large transactions for institutional clients	<ul style="list-style-type: none"> • Provide underwriting services, facilitate mergers and act as a broker/advisor to institutional clients • Tenor restrictions driven by capital charges are constraint for on balance sheet investments
	Private Equity Firms	Invest institutional and own capital into private companies and funds	<ul style="list-style-type: none"> • Invest capital over long holding periods • Have relative freedom in their investment activities
Financial Asset Managers	Asset/Wealth Managers	Invest institutional and retail capital across a range of investments	<ul style="list-style-type: none"> • Coordinate and oversee investment portfolios on behalf of clients like pension funds & insurance companies • Preferences and constraints depend on nature of clients

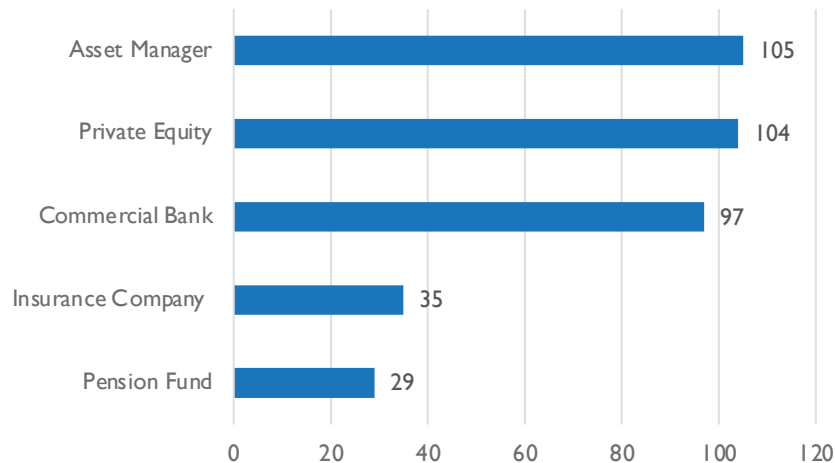
PRIVATE SECTOR INVESTMENT TRENDS (1/2)

- Seven segments described earlier represent around \$200T of financial assets under management
- Fairly active in blended finance deals, however tend to invest no more than 20% of deal size

AUM of Institutional Investors Across Segments (USD Trillion)



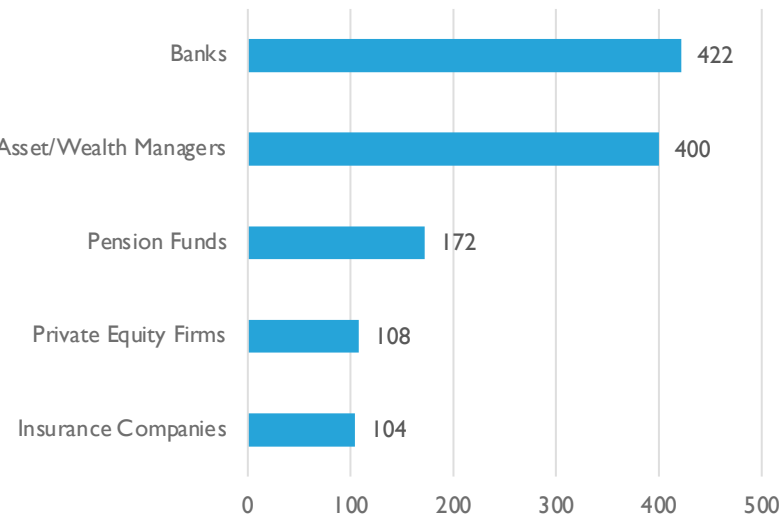
Institutional Investor Activity in Blended Finance in Developing Countries Based on Convergence Database (# of Investments)



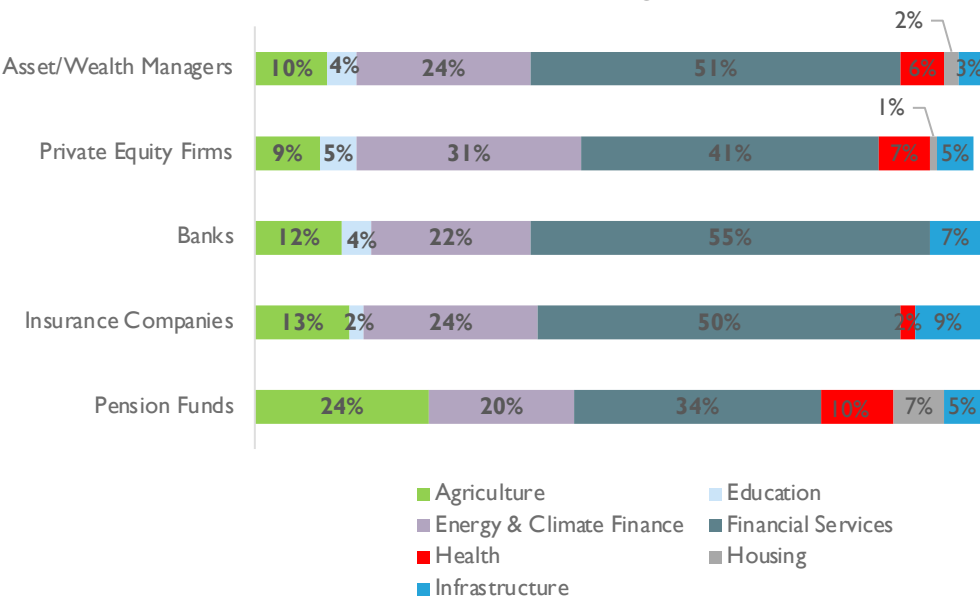
PRIVATE SECTOR INVESTMENT TRENDS (2/2)

- Banks/Asset Managers have appetite for large transaction sizes
- Majority of transactions focused on financial services and energy & climate change

Average Total Deal Size of Institutional Investors Based on Convergence Database (USD Million)



Institutional Investor Activity in Blended Finance in Developing Countries Based on Convergence Database



PRIVATE SECTOR INVESTORS - SEGMENTATION AND POTENTIAL FOR INVESTING IN EMERGING MARKETS

- Table based on Convergence research with Blended Finance Taskforce – research, surveys and interviews to ascertain main interests and challenges to invest in emerging markets

Perspectives	Plans to scale investments in EMs	Understanding of blended finance and development finance	Importance of incorporating SDGS into activities	Plans to scale activities related to the SDGs
Pension Funds	Scaling	Fair	Strong	Reducing
Insurance Companies	Maintain	Poor	Expert	Maintain
Commercial Banks	Scaling	Strong	Strong	Scaling
Investment Banks	Scaling	Fair	Expert	Maintain
PE Firms	Maintain	Fair	Strong	Unsure
Asset / Wealth Managers	Reducing	Poor	Expert	Unsure
Sovereign Wealth Funds	Scaling	Fair	Strong	Maintain
Key	Zero/Poor/Unsure	Low/Fair/Reducing	Strong/Maintain	Strong/Expert/Scaling

A Look at Debt Investors

PRIVATE INVESTORS (DEBT): FUNDAMENTAL ANALYSIS OF COMPANY

Corporate Debt investors analysis similar to Fitch model to assess creditworthiness of borrower Risks to Repayment

- Macro Considerations: Identify macroeconomic drivers which significantly influence cash-flow profile.
- Operating environment: Sovereign risk, systemic risk & sources and sustainability of economic growth
- Sector: Sector structure, competition & effect of industry growth drivers on company performance

2. Management and Shareholders

- Evaluate management's strengths and weaknesses and influence of company ownership.

3. Business Risk

- Strategy: Markets, products, services and competitive position as well as corporate actions underpinning its growth strategy
- Earnings dynamics: Sales and operating profitability, sources of operating cash-flow, trend and peer analysis
- Asset management: Asset conversion cycle to create expectations about balance sheet and asset efficiency
- Forecasting and sensitizing key cash-flow drivers

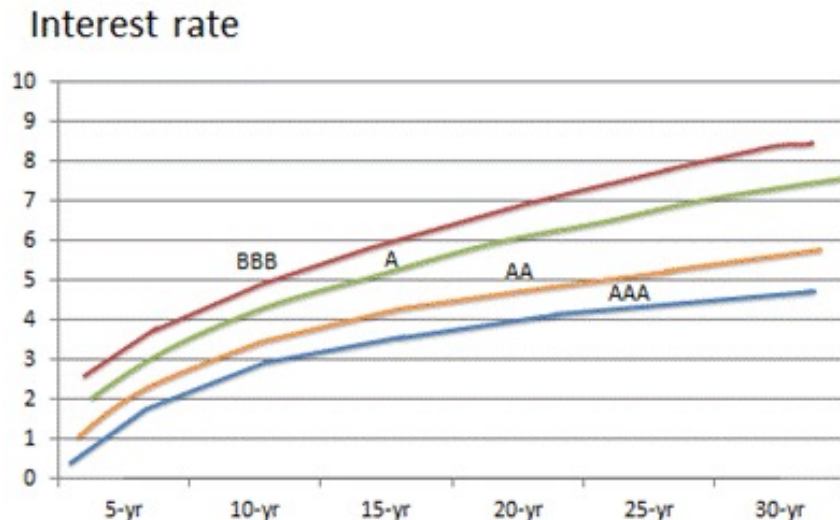
4. Financial Risk

- Financial strategy, Liquidity and Solvency

PRIVATE INVESTORS (DEBT): BLENDED FINANCE INVESTMENTS MUST COMPETE FAVOURABLY WITH CONVENTIONAL ASSETS

- Interest rate required by investors (cost of debt) is driven by international bond market pricing, bank loan market pricing and expected loss calculations
- All bond issues are priced at premium to risk-free “AAA” issuers
- To attract institutional debt investors, blended finance investments must offer comparable/superior returns to conventional assets

Illustrative Yield Curve for Rated Bonds – Secondary Market



PRIVATE INVESTORS (DEBT): HIGH RISK RATINGS OF BORROWERS IN DEVELOPING COUNTRIES

- Majority of private sector borrowers in most ODA eligible countries are deep speculative grade
- Median sovereign rating is “B+”. (Actually, worse since 65 unrated countries would likely be rated lower)
- Most “good” private sector borrowers would be 1-3 notches lower than sovereign; around “B-”.
- “B-” too weak for most private sector investors; Probability of Default and Expected Loss too high

Distribution of Countries on OECD DAC List 2018-2020			
Country Classification	Number	Sovereign Risk Rating	Number
Least Developed Countries	47	A- or better	3
Other Low Income	2	BBB	10
Lower Middle Income	38	BB	16
Upper Middle Income	58	B	45
Total	145	CCC or worse	6
		Unrated	65
		Median rated	B+

HOW CAN BLENDED FINANCE WORK TO CREATE A RISK-RETURN RATIO THAT IS ACCEPTABLE TO PRIVATE (DEBT) INVESTORS?

1. Portfolio approach creates diversification, in effect reducing risk

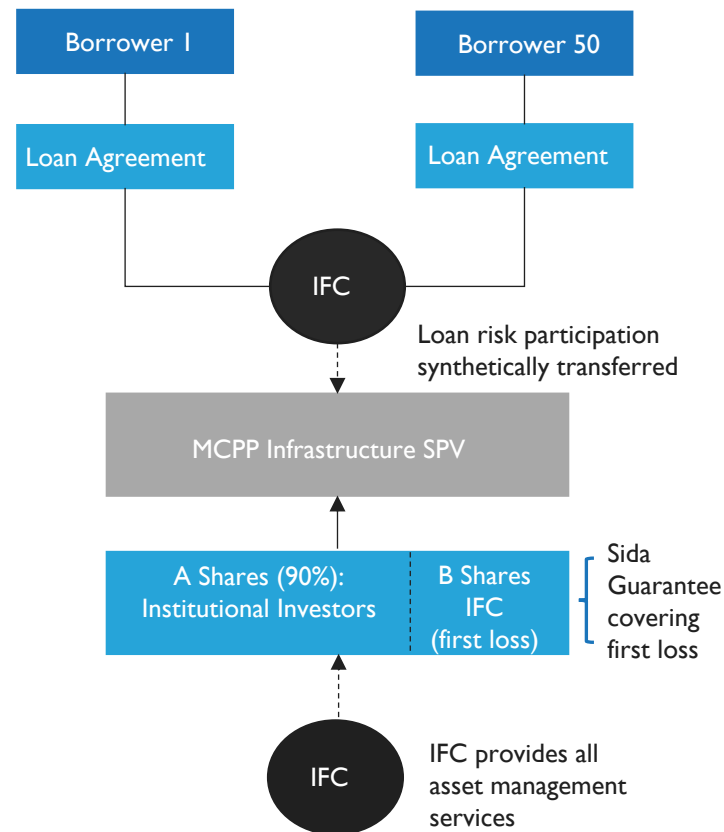
- Aggregating many loans into a portfolio diversifies risk across many borrowers (and countries, sectors and currencies)
- One borrower defaulting on a portfolio of loans has minimal impact on portfolio, but would have material impact on that one loan
- Diversification alone can lead to 1-2 notch up-lift in risk rating

2. Subordination of development funds improves risk for private sector investor

- Assume portfolio is funded by two tiers of capital - junior capital effectively absorbs losses until junior capital depleted (e.g., “first loss”)
- The higher the percentage of junior development capital, higher the cushion to absorb losses
- If defaults and losses do not materialize, then junior development capital is returned (possibly with positive returns)

BLENDED FINANCE VEHICLE FOR DEBT INVESTORS

- Key details of structure:
 1. IFC synthetically sells portion (50%) of its new infra loans to new SPV
 2. SPV funds its purchase of the IFC loans by:
 - Inviting institutional investors into senior “A Shares”, 90% of total
 - Having IFC buy “B Shares” – junior, 10%
 3. Sida provided a guarantee which covers first loss portion of loan portfolio
 4. Leverage ratio achieved: 9:1
- Net Effect: Private investors benefit from **portfolio diversification**, **seniority**, and **credit enhancement**; allows underlying IFC B and BB loans to be enhanced to investment grade



A Look at Equity Investors

PRIVATE INVESTORS (EQUITY): FUNDAMENTAL ANALYSIS OF COMPANY

1. Revenue Growth

- Is the business model viable?
- How long does it take for the business to become profitable?

2. Value added of product or service

- Is it unique and difficult to replicate/replace?
- Are customer acquisition and retention high?

3. Management Team

- Team qualifications and track record.
- Do they work well together?

PRIVATE INVESTORS (PUBLIC EQUITY)

- MSCI Emerging Market Index is the index for EM equity
- The index comprises around 830 constituent companies and covers around 85% of the free float-adjusted market capitalization in each country
- 70% large cap, 15% mid-cap and 14% small cap
- No Low Income Countries represented

OECD Income Classification of 24 countries in the MSCI Emerging Market Equity Index

Lower Middle Income Countries	Upper Middle Income Countries	High Income Countries
Egypt	Brazil	Czech
India	Chile	Greece
Indonesia	Colombia	Hungary
Pakistan	Mexico	Poland
Philippines	Peru	Qata
	South Africa	Russia
	Turkey	UAE
	China	Korea
	Malaysia	Taiwan
	Thailand	

PRIVATE INVESTORS: RETURNS COMPARISONS

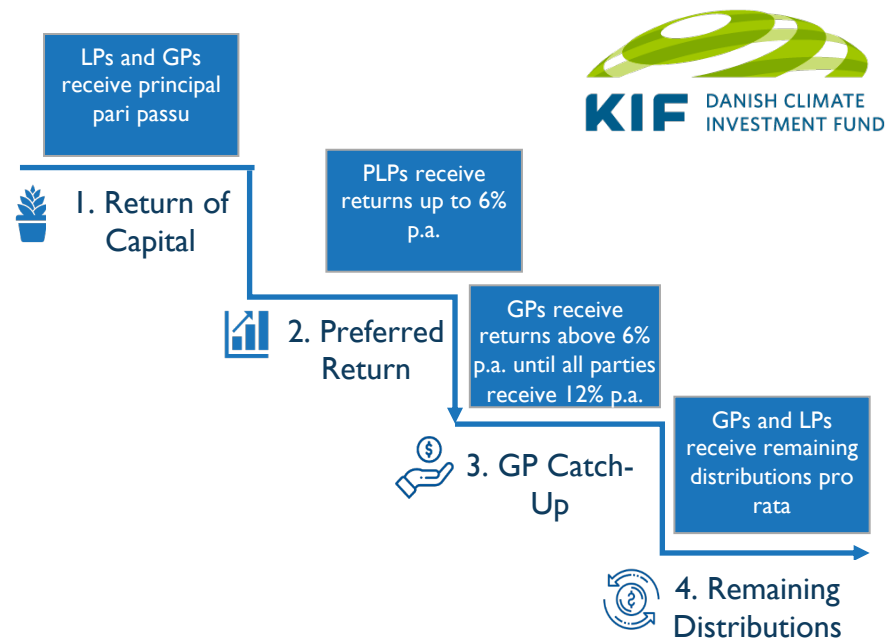
Despite all impressions, Private Equity Investors are not making very much commensurate to the risks they are taking; big opportunity for blended finance to stimulate more activity

Emerging Markets vs. Developed Markets, Public vs. Private (Comparative End-to-end Returns)

	Index	1-Year	3-Year	5-Year	10-Year
EM	Emerging Markets PE & VC	4.6	9.2	10.3	9.9
	MSCI Emerging Markets	11.6	-2.2	1.6	2.2
DM	U.S. PE	12.9	10.0	13.2	10.0
	U.S. VC	0.3	11.8	14.0	9.4
	S&P 500	12.0	8.9	14.7	7.0
	Western Europe PE	12.5	7.1	11.8	7.4
	Western Europe VC	-0.01	7.6	11.8	5.4
	MSCI Europe	-0.4	-3.2	6.3	0.4
	Asia-Pacific Developed PE & VC	11.6	11.8	9.3	9.3
	MSCI Pacific	4.2	1.4	7.2	1.6

BLENDED FINANCE VEHICLE FOR EQUITY INVESTORS

- Danish Climate Investment Fund (KIF) is a private equity fund (USD \$220 million) established by the Danish State and IFU
- Mandate is to invest in projects that reduce greenhouse gases and/or adapting to climate change in developing countries.
- KIF uses a preferred return structure to ensure acceptable risk/return structure for institutional investors:
 - Overall IRR target: 12% per annum (p.a.), with preferred return schedule:
 - All parties receive distributions until invested amounts are returned
 - PLPs receive returns up to 6% p.a.
 - Danish state benefits from a catch-up period after PLPs receive 6% p.a., until all parties have received 12% p.a.
 - Returns above 12% p.a. distributed pro rata, with premium to Danish State



Additionality & Minimum Concessionality

STEP BY STEP BLENDED FINANCE IMPLEMENTATION FRAMEWORK – FOCUS ON ADDITIONALITY & CONCESSIONALITY (OECD)

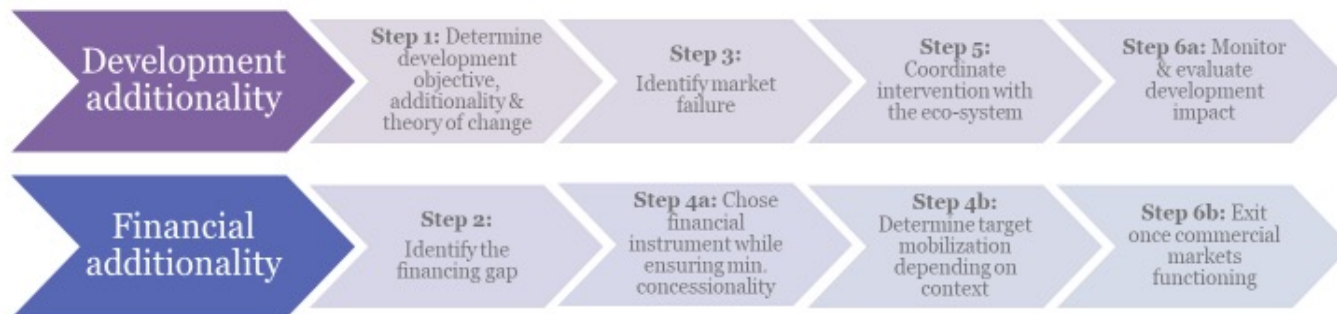
- Step 1: Determine development objective, **additionality (development and financial)** and theory of change
- Step 2: Identify financing gap
- Step 3: Identify market failure
- Step 4a: Choose financial instrument while **minimizing concessionality**
- Step 4b: Determine target mobilization
- Step 5: Co-ordinate intervention with the eco-system
- Step 6a: Monitor and evaluate development impact
- Step 6b: Exit once commercial markets are functioning

HOW ADDITIONALITY FITS INTO BLENDED FINANCE



Step-By-Step Approach to Implementing OECD DAC Blended Finance Principle 2

At the level of the blended finance transaction:



Accompanying interventions at country, sector, market and stakeholder level:



HOW ADDITIONALITY AND CONCESSIONALITY FIT INTO BLENDED FINANCE

Mobilization of Private Investment, subject to sufficient Additionality and minimal Concessionality, is core to Blended Finance

