# THE CASE FOR CAPITAL ALIGNMENT TO DRIVE DEVELOPMENT OUTCOMES

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**EXECUTIVE SUMMARY:**

The emerging markets have largely emerged. According to the International Monetary Fund, the combined GDP of the emerging markets will overtake that of developed economies within the next two years. Foreign direct investment into emerging economies now outpaces investment into developed countries and, between now and 2030, some two billion people, largely in emerging markets, will join the global middle class. Today, private capital investment is the major driver of growth and quality of life improvements around the world. In the past few years, private investors have begun to express a new and growing interest in investments in sustainable economic development that contribute to addressing global development challenges. But to date, hundreds of billions in potential private investment remains on the sidelines because it requires other, complementary capital to accompany it. At the same time, both philanthropic capital and the new breed of double-bottom-line impact investors are increasingly focused on how to connect with and leverage more commercially focused private capital. There is a unique opportunity to align the tools, resources and energies of philanthropic and private capital in pursuit of targeted development challenges in such a way that crowds in private investment capital—both from impact investors and more commercial investors. Development finance institutions (DFIs) are uniquely positioned to be the connector that helps align these groups. The products already exist to deliver on this potential: What is now needed is a process innovation.

**WHAT'S THE ISSUE?**

Today, there is widespread recognition that large amounts of capital that could have tremendous development impact is sitting on the sidelines because it requires risk mitigation, facilitation or partnerships with other capital providers along the risk-capital spectrum. Just like businesses, development projects need different types of capital from different providers at different stages of their evolution. Few actors possess all the necessary types of capital instruments to address the range of investment opportunities. In other words, the proverbial "layers of the capital cake" are rarely coming together at the right time in the investment life cycle. This is despite a rising chorus of voices urging more active alignment of tools and capital.

There is growing interest and activity among private investors to invest in ways that are aligned with their values and that solve development challenges. Recent surveys suggest that, in the United States alone, financial advisors are recommending that up to 2.5 percent of total client assets under management (or $650 billion) be allocated to so-called "sustainable investments." At the same time, investors are increasingly turning to emerging markets. In 2012, for the first time ever, foreign direct investment (FDI) flows to developing countries exceeded those to developed countries. However, the vast majority of financial advisors report that they do not have a sufficient command of emerging markets, nor origination capabilities, to recommend these investments to their clients.

**Distinct Capital Groups**

*Philanthropic Capital*: Funds traditionally spent as grants with no or limited expectation of financial returns.

*Private Capital*

> *Impact Capital*: Funds seeking to generate both a financial return and to proactively create environmental and social benefits.
>
> *Commercial Capital*: Funds traditionally seeking to maximize financial return exclusively.

*Development Finance Institution (DFI) Capital*: Capital from public sector bilateral and multilateral agencies geared toward catalyzing private sector investment for development.

The impact investing sector—characterized by investments that proactively seek to generate financial and social/environmental returns—is coalescing. Estimates from the Monitor Group indicate that the sector will grow tenfold over the coming decade, reaching more than $500 billion in assets. Other estimates place the actual figure several times larger. There is an active debate in the field about whether impact investors are, or should be, willing to accept sub-commercial returns. This paper makes the case that, in certain circumstances, this debate could be put aside.

Private philanthropies working in developing countries have grown rapidly, led by the Bill & Melinda Gates Foundation's pioneering work on global health and development. In recent years, the top 10 private foundations alone have spent upwards of $3.5 billion annually in global causes. However, the operative word here is *spent*. What if a portion of that $3.5 billion could be repurposed as *investment* and deployed explicitly and specifically with an eye to mobilizing some portion of the hundreds of billions in private capital identified above?

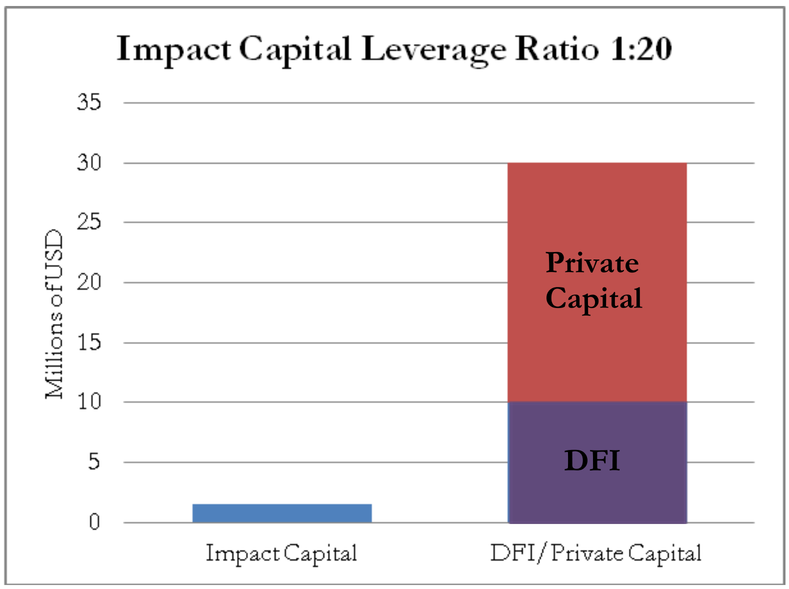
Finally, public sector bilateral and multilateral development finance institutions (DFIs) that work exclusively to catalyze private capital flows into developing countries have become a rapidly growing, powerful part of the global development architecture. These DFIs—which include the World Bank's International Finance Corporation (IFC), the Dutch FMO, and the U.S. government's Overseas Private Investment Corporation (OPIC), as well as roughly 20 other agencies established over the past several decades in most developed countries—operate with the private sector on a commercial basis and are financially self-sufficient. The Center for Strategic and International Studies (CSIS) reports that the combined annual investments of these DFIs have grown fourfold in the past 10 years alone, from $10 billion to $40 billion.

*Consequences of Failed Alignment: Off-Grid Power in Afghanistan* ***(small scale)***

A successful private developer seeks to build and install biomass-powered generation systems in rural Afghanistan. A small-scale project, serving twenty villages, can break even in a relatively short period of time. A DFI is prepared to provide $10 million in loans, alongside an additional $20 million in private commercial equity, to build several systems that will serve another 200 villages, but only once the small-scale business model is proven ( i.e., the project has reached breakeven and the fees are being properly collected to generate cash to pay back the loans). The private developer is willing to put in $1 million of his own money, but needs another $1.5 million to build the first small-scale system and prove out the model. The successful model will trigger the $10 million in DFI financing and $20 million in additional private financing. Without that $1.5 million in early-stage and higher-risk capital, no generators will be built.

Meanwhile, in a neighboring province, a donor agency spends $1.5 million to construct a system that will serve 20 villages. They are completed and operational, but no additional funding was foreseen or available to build more. By not connecting the grant money to the larger sums of DFI money with a shared purpose of providing power to the villages, the additional $31 million in investment does not happen, and small-scale systems serving 220 villages go unbuilt.

*The chart to the right shows the leverage impact of alignment: $1.5 gets you $31.*




Today, the examples of alignment between private and philanthropic capital are too few and too far between, with a handful of well-known and frequently cited successes.[1] Furthermore, those successful examples that exist are often one-off, deal-by-deal solutions as opposed to more efficient, intentional and strategic partnerships that enable greater scale and impact. The reasons, well known to those active in emerging markets, are myriad and include: (a) the difficulty of aligning different organizational processes and incentive systems; (b) information asymmetry; (c) the high cost of deal origination; (d) small deal sizes and/or lack of effective aggregation mechanisms; and (e) overly conservative perceptions of market risk, to name but a few. A further key constraint is that the

[1] For example, the GAVI Alliance, focused on childhood immunization, transformed its financial landscape by leveraging donor support for its programs in the capital markets. Husk Power Systems uses rice husks to fuel village-scale distributed generation systems. It used seed capital, grants, early stage risk capital and equity to grow its business to a stage of sustainable cash flows to support OPIC debt financing.

relevant cast of characters is not used to partnering together in this way. Investors looking for a market return may not be used to partnering with philanthropies. DFIs may focus on the underlying project and related diligence and not other sources of capital that could leverage the impact of DFI support. Philanthropists can be wary of providing grant money that will create profits for others even though "sustainability" (i.e., profitability) is a goal shared by most philanthropists.

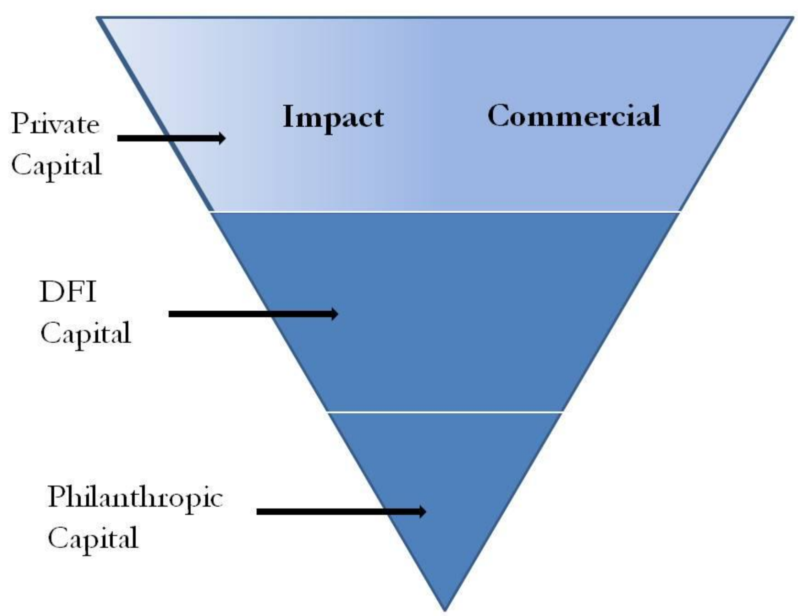
The good news is that DFIs are ideally positioned, both in mission and in expertise, to help bring these distinct pools of capital together and reduce the asymmetries between them. They have deep experience in emerging markets and a healthy risk appetite while, at the same time, they are commercially oriented and focus nearly exclusively on working with the private sector. More importantly, every dollar invested by a DFI tends to catalyze multiples more in private investment.

## WHAT NEEDS TO HAPPEN AND WHY?

Fortunately, a solution is within our sights. Together, philanthropists, impact investors, DFIs and even commercially oriented investors can achieve far more than any one of these could achieve on its own. By combining resources and expertise, significant amounts of capital can be driven into the development arena. This requires a process innovation.

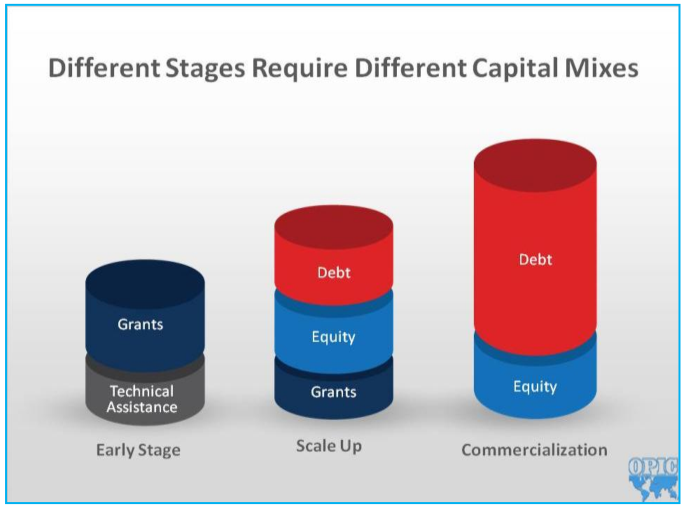
Philanthropists and donors have expertise in seeding and supporting early stage projects as well as the risk appetite to invest at the pilot stage. DFIs have a long and successful track record of investing to scale up projects that are commercially viable in frontier markets, but they often do not have all the expertise or instruments needed for a given project. Private investors can potentially take projects to the next level. **What is needed is a means of aligning philanthropic, private and DFI resources in a way that enables capital to be deployed effectively towards agreed priorities.**

When philanthropic capital is invested in a way that catalyzes development finance institutions, which in turn catalyze commercial capital, it means that capital flows will increase toward targeted sectors, regions and development priorities. More intentional alignment with philanthropic and impact capital can "crowd in" both DFI money and other private capital by bringing together complementary skills, risk appetite and investment instruments.




Alignment can be as broad or as tailored as desired by the partners. Imagine an aligned investment vehicle targeting agricultural projects in sub-Saharan Africa, or renewable energy projects in Latin

America, or infrastructure projects in Southeast Asia. One could just as easily construct a global facility that seeks to support the provision of liquidity to small and medium enterprises. The key is finding the proper partners whose geographic, sectoral and risk appetites are most closely aligned.



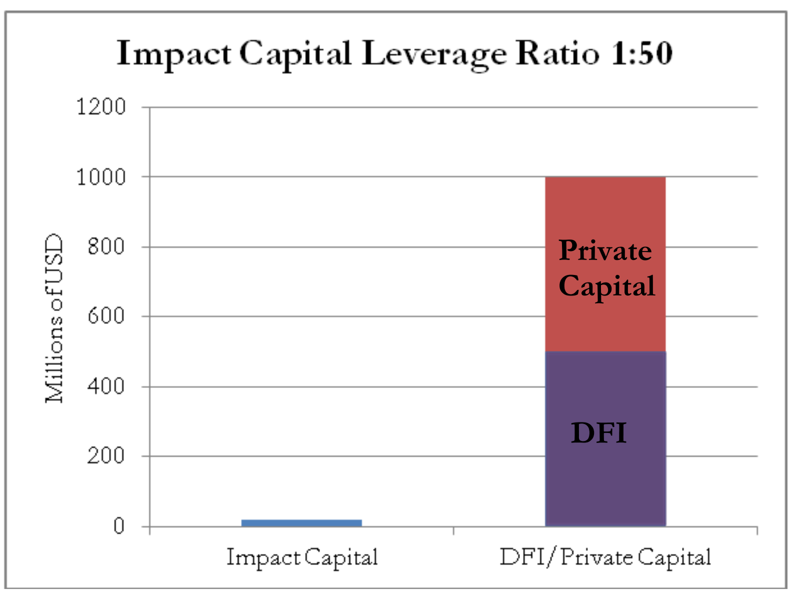

Different sectors need different approaches to achieve alignment. New technologies and business models that have a higher probability of failure will need significant equity capital to maintain growth and achieve market penetration. Infrastructure requires blended financing with significant concessionary components, with grant support for project preparation and transaction costs. And in other sectors, financing is dominated by corporate investors who are unwilling to take on risky projects with long pay-back periods without guarantees or first-loss capital cushions.

*Results of Strategic (Ex-Ante) Alignment: Clean Energy in sub-Saharan Africa* ***(medium scale)***

Despite abundant sources of clean energy, over two-thirds of sub-Saharan Africans lack access to electricity. More than 85 percent of those living in rural areas lack access. Despite the presence of a number of programs to support clean energy development in Africa, OPIC found that many transactions were not moving forward because of the lack of small amounts of project preparation funds for outlays, such as environmental impact assessments, land surveys or legal consultation.

The African Clean Energy Finance (ACEF) initiative is an innovative partnership, which aligns, in a pro-active and targeted manner, $20 million in early-stage project preparation support alongside up to $500 million in long-term project finance from OPIC. Conservative estimates are that this alignment of technical assistance and DFI finance will catalyze at least that much again in private investment into deals in the solar, wind, geothermal and biomass sectors.

*The chart to the right shows the leverage impact of alignment: $20 million gets you $1billion.*



This type of tiered alignment of capital offers discrete advantages to each layer.

**Advantages for the Philanthropist or Donor/Grant Capital**

- Achieves greater development impact for every dollar spent
- Satisfies program-related investments (PRIs) criteria for tax-exempt organizations
- Staff selects sectors and causes capital to flow to it; decision is in the hands of the philanthropist/impact investor
- Assures sustainability and scale-up of projects
- Benefits from the expertise of financier

**Advantages for Development Finance Institutions Debt or Guarantee Providers**

- Has lower risks
- Transactions come together when otherwise might not
- Benefits from expertise of early-stage investor
- Maximizes development impact
- Is able to work with non-traditional actors or operators with fewer resources

**Advantages for the Impact/Private Investor**

- Origination of high-impact emerging market investments is expensive and is effectively outsourced to DFI
- Benefits from legal, business and character- risk due diligence policies of DFI
- Can benefit from "halo" and advocacy work or a government co-investor
- Ongoing reporting, monitoring and impact reporting augmented by DFI

*Indicative Pipeline*: An indicative list of the types of deals currently seeking impact capital within the pipeline of the U.S. government's development finance institution, OPIC, is attached as Appendix A.

## RECOMMENDATIONS, NEXT STEPS & DISCUSSION TOPICS

In this paper, we make the case that there is a big and ever-growing opportunity to more intentionally align capital to profitably and sustainably affect positive development outcomes in emerging markets around the world. Over the last two decades, emerging markets have evolved largely from aid to investment destinations. Yet our thinking on how to realize development goals through private investment has been slower to evolve. Development finance institutions represent the connective tissue linking philanthropic and private impact capital. It is well past time to more strategically align the interests, expertise, capital and risk profiles of key partners to achieve greater financial and development impact. A sample term sheet for one such envisaged aligned capital facility is attached as Appendix B.

## QUESTIONS FOR DISCUSSION

- How do we build trust between the providers of philanthropic and commercial capital?
- What are the sectors and regions that lend themselves most notably to this type of aligned facility?
- What type of facility or vehicle is best situated to blend the various layers of capital?

- How do we distinguish between grant and early stage/risk capital?
- How do we distinguish between 'impact investors' and mainstream investors who seek to invest in profitable businesses with a social purpose?
- How do we overcome the barriers to aligning staff incentives and organizational systems across diverse capital providers?
- How can we move quickly and diligently to operationalize several large-scale demonstration efforts?

## APPENDIX A
## ILLUSTRATIVE DFI DEALS THAT NEED EQUITY

| Country | Sector | Description | Estimated Investment Gap | Total Project Costs |
|---|---|---|---|---|
| Afghanistan | Health | Expand local manufacturing of simple pharmaceuticals | TBD | TBD |
| South Asia | Education | Establish educational initiative to promote critical thinking, creative problem solving and conflict resolution in Pakistan, India, Afghanistan, Bangladesh and Sri Lanka | TBD | TBD |
| Haiti | Manufacturing | Expand existing plastics recycling plant | $750,000 | $3,500,000 |
| Egypt | Health | Expand existing ophthalmology clinic in Fayoum | $300,000 | $1,000,000 |
| Haiti | Manufacturing | Expand existing processing company | $300,000 | $1,000,000 |
| Costa Rica | Agriculture | Establish a banana starch manufacturing plant | $5,000,000 | TBD |
| Egypt | Recycling | Establish a waste motor oil recycling plant to produce base lube oil in an environmentally friendly manner | $1,000,000 - $2,000000 | $6,500,000 |
| Dominican Republic | Energy Efficiency | Establish a compressed natural gas distribution company that utilizes an energy-saving U.S. technology | $1,500,000 | $4,800,000 |
| Zambia | Consumer Goods | Expand an existing fast-moving consumer goods distribution company to enable it to improve its distribution | $200,000 | $800,000 |
| Pakistan, Tanzania | Health | Expand a mobile technology company with a presence in Nigeria and Kenya that utilizes proprietary "brand protection" technology to combat counterfeit goods, primarily in the pharmaceuticals industry | $200,000 - $500,000 | $1,750,000 |
| East Africa | Renewable Energy | Manufacture clean cook stoves in East Africa | $1,000,000 | $3,500,000 |

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| Ghana | Health | Build and expand x-ray imaging centers in the underserved cities of Accra and Kumasi | $350,000 | $1,200,000 |
| Nigeria | Health | Expand a pharmaceutical distribution company so that it can hire more pharmacists as well as develop and market new products | $1,000,000 | $3,500,000 |
| South Africa | Renewable Energy | Expand a solar institute that will educate engineers, investors, product developers, marketing managers and policymakers on clean energy practices through various workshops and classes | $5,000,000 | $12,500,000 |
| Multiple | Renewable Energy | Aggregate and sell carbon credits by partnering with microfinance institutions (MFIs) | $1,400,000 | $3,000,000 |
| Africa | Renewable Energy | Establish loan facility for on-lending to network of African MFIs; loans will be used to fund an expansion of microloans for water and renewable energy | $2,000,000 | $12,000,000 |
| Haiti | Water | Start up for network of for-profit water kiosks in Haiti | $2,000,000 | $6,000,000 |
| Multiple | Impact Investing | Establish fund to invest in first loss tranches of impact investment funds or as first loss directly into impact investment companies | $5,000,000 | $50,000,000 |
| Global | Agriculture | Establish a global fund for microfinance and agricultural co-ops | $5,000,000 - $7,000,000 | $35,000,000 |
| Global | Small and Medium Enterprises | Invest in a range of financial intermediaries that target SMEs through a global fund | $4,500,000 - 9,000,000 | $45,000,000 |
| Cape Verde | Renewable Energy | Develop, construct and operate $7.4 million wind-powered water desalination project, plus another four projects totaling approximately $28 million (same technology, different municipalities) | TBD | $28,000,000 |
| Tanzania | Renewable Energy | Develop, construct and operate two mini-grid biomass power plants, combined capacity 6.3 MW | Up to $3,000,000 | $18,000,000 |

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| Kenya | Education | Expand a for-profit primary school project expected to reach over 100,000 children | TBD | TBD |
| Mozambique | Agriculture | Establish a greenfield nut-processing facility | $350,000 - $500,000 | $2,500,000 |

## APPENDIX B
### SAMPLE TERM SHEET[2]

### ALIGNED CAPITAL FACILITY FOR IMPACT TRANSACTIONS

### SUMMARY OF PRINCIPAL TERMS AND STRUCTURE

| TERM | DESCRIPTION OF TERM |
|---|---|
| | **GENERAL AND PARTIES** |
| **Facility** | The Aligned Capital Facility ("ACF" or the "Facility") will bring together capital sources from a range of investment stakeholders (referred to as "Aligned Capital"): (i) to bring together market transactions that are not otherwise getting done because of a lack of early stage/seed capital and/or first loss capital; and (ii) to attract new, and likely first-time, investors to participate in impact investing transactions by bridging the funding gap under (i) and by providing co-investment opportunities to the pipeline of development finance institutions (the "DFI Pipeline").<br><br>The Facility will be a structured financial vehicle created as a permanent investment company that will be able to make equity, debt and guarantee investments. Sector and region agnostic, the Facility's pipeline of evaluated transactions come from the DFI Pipeline and will focus on deals that demonstrate use of Aligned Capital to reach closure and to deliver appropriate financial and robust non-financial returns.<br><br>ACF will play the role of companion investor alongside one or more DFIs who have prepared a transaction and seek Aligned Capital to complete the deal. A transaction that qualifies for ACF will be referred to as "Qualifying Investment." On the basis of ACF's investment capital, it will have two "wallets" from which to invest in a Qualifying Investment: (i) ACF Capital; and (ii) ACF Co-Investment Capital, both of which are described below.<br><br>The Facility will be funded by equity and debt. Legal form and jurisdiction of the Company are to be finalized, with likely selection of a Delaware LLC.<br><br>The Facility will be externally managed by an experienced third-party manager with impact investment credentials. |

[2] This term sheet was prepared by, and benefited from the seasoned expertise of, Laurie Spengler and a team at Shorebank International Ltd. (SBI), a provider of capacity plus capital solutions that contribute to a more inclusive and sustainable global economy. The capital advisory services team at SBI specializes in designing and structuring layered vehicles of aligned capital to fuel impact transactions around the world. The authors are grateful to Laurie and her colleagues for their time and efforts.

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| **Facility Funding** | The ACF will be funded with various layers of capital:<br>• Equity<br>o Grants.<br>o Catalytic Share Class—this layer will be subscribed by philanthropic investors seeking to catalyze transactions to successful closure that may not otherwise be funded because they are perceived as too early or too risky.<br>1. PRI/venture equity/first loss/early stage capital<br>2. Mainstream equity<br>• Debt<br>o Development Loan Tranche—this will be a mezzanine layer of 10-year duration and carrying a development coupon in the range of [3-5] percent; this tranche will be subscribed on deal by deal basis by Development Finance Institutions seeking ACF Capital to support investment deals in the DFI Pipeline.<br>o Commercial Co-Investment Loan Tranche—this will be a pool of investment capital that can be tapped for investment in Qualifying Investments that will carry the same (or better) return profile as that of the DFI investor in the Qualifying Investment (explained below); this tranche will be subscribed by investors that may be new to impact investing.<br><br>Investors in the Catalytic Share Class may also participate in the Development Loan Tranche and/or the Commercial Co-Investment Loan Tranche. |
| **Objectives and Advantages** | The expected results of ACF include: (i) expanding the range of high-impact transactions that are funded; and (ii) using philanthropic capital to demonstrate the power of courageous capital to catalyze transaction flow and to crowd-in new investors to the industry. |
| **Sponsor/Anchor Investor** | ACF will be anchored by [Foundation/Philanthropy] as the lead Catalytic Shareholder and by Development Finance Institution as lead Development Loan investor. |
| **Investees** | ACF will invest directly into "last mile" transactions and will not be a source of funding for impact investment funds. |

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| **Management** | ACF will be managed by experienced third party with demonstrated capabilities: (i) to vest potential Qualifying Investments; (ii) to determine the amount of funding to come from ACF's two wallets- ACF Capital and ACF Co-Investment Capital; (iii) to negotiate the terms of investment; and (iv) to monitor and report on the performance of the Qualifying Investment.<br><br>In selecting the appropriate manager, the following considerations will be made:<br>• Specialist transaction capabilities;<br>• Development market experience;<br>• Credentials in the impact investing and triple/double bottom line space; and<br>• Experience working with DFI Pipelines. |
| **Pipeline of Qualifying Investment Opportunities and Relationship with Development Finance Institutions** | DFIs will be the source of ACF deal flow.<br><br>The Facility can be increased in size and scale on the basis of pilot. |
| **Initial Target Amounts** | • Equity: $ [TBD] million<br>• Development Investment Loan: $ [TBD] million<br>• Co-Investment Loan: $ [TBD based on size of DFI pipeline]<br><br>**Note:** Grant funding, if secured, would be used to accelerate operational ramp-up. |
| **Tenors** | • Development Investment Loan: [10 years]<br>• Co-Investment Loan: [Commitment is 10 years with tenor for each investment determined by the Qualifying Investment]<br>• Equity: N/A |
| **DEVELOPMENT INVESTMENT LOAN TERMS** | |
| **Maturity** | [x] years from Closing |
| **Availability Period** | [y] years from Closing |
| **Repayment** | TBD |
| **Interest Period** | [Semi-annual] |
| **Interest Rate** | [TBD- anticipated range of 3-5 percent] |
| **Currency** | [USD] |
| **Security** | [TBD] |

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| **Conditions Precedent** | Customary provisions |
| **OTHER** | |
| **Transaction Criteria** | ACF will invest only in direct transactions (not funds) where it considers that (a) the transaction would otherwise not be funded due to a lack of Aligned Capital and (b) there is a reasonable prospect of completion because:<br>• The investee is investment-ready;<br>• A DFI investor has undertake due diligence;<br>• In addition to ACF Capital there is room for ACF Co-Investment Capital; and<br>• The timeframe for completion is approximately 6 months.<br><br>Investment sizes will depend on the underlying DFI pipeline but would be expected to be within a wide range. |
| **Transaction Mechanics** | • ACF will be contacted by a DFI for consideration of an investment within the DFI Pipeline;<br>• The ACF application will include the DFI underwriting package (e.g. due diligence, investment memorandum, etc.);<br>• The ACF Manager will determine whether the transaction is a Qualifying Investment;<br>• The ACF Manager will negotiate the terms of the deal for both the ACF Capital and the ACF Co-Investment Capital;<br>• Upon successful closing of the deal; the ACF Manager will monitor performance of the Qualifying Investment and report to the ACF investors. |
| **Return Expectations** | ACF's return expectations are appropriate financial returns accruing to the ACF Capital and the ACF Co-investment Capital with robust impact returns. A detailed financial model will be prepared to demonstrate these returns on a portfolio basis. |
| **Documentation** | Documentation required will include (but not be limited to) the following:<br>• Constitutional documents;<br>• Shareholder agreement;<br>• Facility agreement between the Borrower and each lender to set out the terms of the Loans. |
| **Fiscal Year** | The fiscal year end of the Company shall be [31 December] of each year. |

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| **Industry Contributions** | The activities of ACF are expected to contribute to the development of the impact investment industry through:<br>• Demonstrating the power of Aligned Capital;<br>• Bringing to market deals that are otherwise not getting funded;<br>• Leveraging the pipeline of Development Finance Institutions;<br>• Crowding in new investors to invest alongside Development Finance Institutions;<br>• Sharing lessons learned on the effective use of Aligned Capital;<br>• Dissemination of quantifiable results:<br>o Number and type of transaction benefitting from Aligned Capital<br>o Transaction preparation periods<br>o Size of transactions successfully closed<br>o Number and composition of investors |