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Blended Finance

How blended finance can close the prevailing investment gap and allow social enterprises to grow

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15 May 2016

Abstract

In order to meet the Sustainable Development Goals (SDGs) by 2030, $2.5 trillion of additional financing is needed every year. This paper deals with a relatively young, but promising approach at raising those funds. Blended finance is the strategic use of development finance and/or philanthropic funds to mobilize private capital flows to emerging and frontier markets, resulting in positive results for both investors and communities. The goal of this analysis is to give an extensive overview on the topic and to identify how methods of blended finance can close the investment gap. By reviewing the most prominent instruments of blended finance, demonstrating their potential as well as addressing the associated risks, this paper provides a guideline for donors and recipients. It also gives an overview on the critical subjects of impact measurement and the scaling up of social impact business. Both topics are closely related to blended finance, since public and philanthropic donors as well as impact investors often require a thorough impact monitoring in order to make an investment. Furthermore, the upscaling phase in a company's development is where blended finance can make its biggest contribution. By definition, this phase is associated with great investment needs that often hinder the further growth of a social business. Consequently, the company's impact remains at a small scale. This paper will show that blended finance is of particular help for such companies and can thereby make a substantial contribution toward meeting the SDGs by 2030.

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1 Introduction

Investment needs in developing countries are huge. According to the UNCTAD, the annual investment gap in Sustainable Development Goals-relevant sectors is estimated at approximately $2.5 trillion (Zhan, 2015, p. 3). In other words, in order to reach the Sustainable Development Goals (SDGs) by 2030, $2.5 trillion of additional funds are needed every year. Purely in funding terms, closing this gap would be feasible. Global wealth amounts to 250 trillion, so the funds needed make up only 1% of worldwide finances. However, since only a small fraction of the worldwide assets of banks, pension funds, transnational corporations, sovereign wealth funds and foundations are currently invested in SDG sectors, we are far away from closing the funding gap (Zhan, 2015, p. 3). Achieving the SDGs would require a considerable step change in investment by both the public and private sectors (Zhan, 2015, p. 3). The problem is not that there is not enough finance around for the SDGs. Rather, the overarching question is how these existing resources can be mobilized and channeled effectively towards meeting the SDG needs (Zhan, 2015, p. 3).

Blended finance, defined as the deliberate and strategic alignment of public-private capabilities and capital to accelerate social and economic growth in emerging markets, provides a potential way of mobilizing the already existing resources and thereby closing the prevailing investment gap. The goal of this paper is to give an extensive overview on the topic and to identify how new methods of blended finance can close the investment gap and allow social enterprises to grow. It will do so by first explaining and defining the term and demonstrating the need for mobilizing private capital in order to reach the SDGs by 2030. Chapter 3 will then introduce methods and mechanisms of blended finance, while Chapter 4 addresses the critical issue of impact measurement. The literature on impact investing has already revealed the challenge of measuring social impact accurately. In impact investing, investors accept a lower financial return on their investment in order to generate specific beneficial social or environmental effects. Since investors want to know the impact they are generating with their investments, these effects need to be measured. Blended finance is different from impact investing in that it aims at mobilizing private investors that may not have a specific interest in generating a social impact. However, impact measurement is still necessary for blended finance since the public investor does have an interest in social impact and wants to know whether his investment is delivering the expected results. Without impact measurement, blended finance is not very likely to work. Chapter 4 will therefore address this critical subject and show potential ways of measuring the social and environment impact generated by an investment. Chapter 5 deals with the challenge of scaling up social impact businesses. Because of a lack of capital, companies in an early stage of development often face difficulties scaling-up their business. As a result, their

social impact remains at a small scale and cannot reach as many people. Blended finance can be particularly useful to address this challenge by providing capital to such companies and thereby allowing them to grow and increase their impact.

2 The need for a higher engagement of private capital

Analyzing the potential sources of financing, one can see that public money makes up only a fraction of total wealth as compared to private funds. It has therefore not enough capacity to fill the investment gap. In fact, public finances of developing countries are often insufficient to fund necessary infrastructure projects and provide basic services to the population. On the side of developed countries, official development assistance (ODA), even though helpful, is also not very likely to bring about the change. ODA hardly reaches the 1% mark in relation to GNI. By far the best known international target in the aid field is that of raising ODA to 0.7% of donors' national income (OECD, 2016). In 1970, the 0.7% ODA/GNI target was first agreed on by the UN and has been repeatedly re-endorsed by high level decision-makers at international aid and development conferences:

- in 2005, the 15 countries that were members of the European Union by 2004 agreed to reach the target by 2015;
- the 0.7% target served as a reference for 2005 political commitments to increase ODA from the EU, the G8 Gleneagles Summit and the UN World Summit (OECD, 2016).

However, the 0.7% target turned out to be hard to achieve. With the exception of the Scandinavian countries, Luxembourg and the UK, no OECD country was able to achieve this goal in 2014. This holds true not only for this specific year, but for the past 45 years. As a result, it would be too optimistic to expect that this picture will change in the near future and that developed countries will increase their ODA remarkably.

Since public funds are not very likely to close the funding gap, hopes fall on private investors. The issue with private funds is that returns from more sustainable investments are often not high enough to compensate for the prevailing risks. Investments in developing countries are often associated with higher political risks, which makes it hard for social entrepreneurs and companies to attract private funds and raise capital. Because of these financial constraints, companies that find themselves in the growing phase often face difficulties scaling-up their business. Hence, the social impact of such companies remains at a small scale, or the business might even go bankrupt since they are not able to break-even.

How can sustainable investments be rendered more attractive for private capital then? Theoretically, there are two ways. They can become more attractive by either mitigating risks or by increasing the return of such investments. This is where the public sector can make a decisive contribution. If ODA and philanthropic funds are used in a way that they can mitigate the risks of an investment or increase its return, they can make that investment more appealing for private

funds. Consequently, the invested public and philanthropic funds have a multiplier effect by crowding in private capital. This is exactly the idea of blended finance.

The ReDesigning Development Finance Initiative (RDFI) of the OECD and WEF defines the term blended finance as follows: "The strategic use of development finance and [/or] philanthropic funds to mobilize private capital flows to emerging and frontier markets, resulting in positive results for both investors and communities" (WEF & OECD, 2015, p. 4). This definition reveals three constituting characteristics of blended finance:

1. Impact: Investments in emerging and frontier markets that deliver transformative social and economic progress;
2. Returns: Market-based, risk-adjusted returns that meet business goals and fiduciary duties;
3. Leverage: Systematic and strategic use of development and philanthropic funds to mobilize and engage private capital at scale (WEF & OECD, 2015, p. 8).

Although these features seem to be prevalent in traditional forms of investment as well, in the context of blended finance they have different notions. First, concerning the *leverage*, in contrast to traditional forms of investment, resources from public institutions are used to incentivize private investment. For those resources, generating financial return is secondary, as compared to exclusive private financing. With regard to the *impact* of an investment, traditional forms of investment focus on the impact the investment has on future profits, whereas blended finance also focuses on social, environmental and economic impact. Finally, the *return* on investment in traditional financing focuses on pecuniary reimbursement, whereas in blended finance social impact does also form part of the return dimension (WEF & OECD, 2015, p. 8).

The three characteristics help to differentiate blended finance from other, related terms such as impact investing, public-private partnerships (PPPs) and development impact bonds. Social impact investing for example does not require concessional public finance, but can be achieved with private capital exclusively. Since those investors have an explicit interest in generating social impact, there is no need for a systematic and strategic use of ODA and philanthropic funds to mobilize private capital. Criteria number three in the above mentioned definition is therefore not given. PPPs do also not necessarily involve concessional public finance. Public-private partnerships are simply business relationships between a private-sector company and a government agency for the purpose of completing a project that will serve the public (Investopedia, 2016). These partnerships can be used to finance, build and operate projects such as public transportation networks, parks and convention centers (Investopedia, 2016). Hence, they may not always be impact driven but can provide regular public service. In the case of a PPP

with the purpose of running a convention center, criteria number one and three in the above mentioned definition are not given.

As compared to impact investing and public-private partnerships, development impact bonds are much harder to differentiate from blended finance. Development impact bonds, like social impact bonds, are results-based contracts in which private investors provide pre-financing for social programs and public sector agencies pay back investors their principal plus a return if, and only if, these programs succeed in delivering social outcomes (Center for Global Development, 2016). Unlike social impact bonds, development impact bonds involve donor agencies, either as full or joint funders of outcomes (Center for Global Development, 2016). The benefit of development impact bonds is that they shift performance risk to the private sector and increase efficiency in project implementation by means of a result-based program evaluation. In other words, it shifts the focus from inputs to performance and results, since private investors will be concerned about recovering their investment and ensuring it is put to most efficient and productive use (World Bank, 2015). Development impact bonds investors have a strong incentive to ensure that various service providers involved in delivery remain on track, which is a key advantage compared to traditional donor interventions (World Bank, 2015).

By applying the three defining criteria of blended finance, we can see that development impact bonds deliver an impact and financial return. They also involve the systematic and strategic use of development and philanthropic funds to mobilize private capital. Hence, they could be perceived and defined as a blended finance instrument. However, development and philanthropic funds deployed are not really generating a leverage in the sense that they bring in additional money. Since public and philanthropic lenders are the ones who pay back the principal and also provide a financial return to private investors (in the case of a successful project), there is no true financial leverage. In the end it is the public sector and/or philanthropic donors who pay for the program. However, development impact bonds increase implementation efficiency and shift financial risks to private investors. Seen from this angle, there is a leverage effect in terms of a higher effectiveness and efficiency of the development and philanthropic funds deployed. In that respect development impact bonds would very well fall in the definition of blended finance.

As we can see, differentiating blended finance from other terms can be difficult. To further refine the concept, the following chapter takes a closer look at the basic mechanisms as well as different instruments within blended finance.

3 Mechanisms and instruments for blended finance

Since blended finance is a very broad concept used in various types of settings, we should be clear about the scope and the depth of our analysis. The following chapter will focus on blended finance defined as "the strategic use of public and/or philanthropic investment to mobilize private capital" (WEF & OECD, 2015, p. 8). By using this definition, we imply that our basic unit of analysis is the public investor or philanthropic fund. We will therefore focus on the question of what a proper project design of a public institution should look like for blended finance to be successful. Taking the perspective of a public institution and/or philanthropic fund does not mean that private investors and financial institutions do not matter. Quite the contrary is the case. They are primordial to every proper blended finance project design. What we assume by this, is that we look through the lenses of the public institution when assessing private investor's preferences and financial institution's interest's.

On the instrumental level of our analysis of blended finance two limitations need to be mentioned:

- First, we will leave out the specific design of the instruments used for blended finance, since this forms part of the financial institution's perspective and does not directly belong to the public institution's main purpose. Nevertheless, we will give an overview over the most widely used instruments and their specific characteristics.
- Second, we will leave out the topic of social impact bonds. This rather recent field of research follows a different logic, which cannot be explained by the usual mechanics of blended finance outlined in this chapter. It is therefore beyond the scope of this analysis. Readers interested in this kind of investment are referred to the following literature, which serves as a good starting point to become acquainted with the matter: Costa & Shah, 2013, p. 5-10; Social Finance, 2012; Weber & Petrick, 2014; Gustafsson-Wright, Gardiner & Putcha, 2015.

3.1 The mechanisms of blended finance

In order to better understand how public investment can make a difference in creating incentives for private investors let us consider the following simple example: we have a social enterprise operating in the Solar Light sector in Brazil with the need for a 500,000-dollar investment. This investment is expected to generate a return of $25,000, which translates to a 5% Return on Investment (ROI). We know that an expected return of 5% is far too low for a private investor to compensate for the risks it takes by investing in an enterprise operating in a developing country. Usually, in this case no private investment would be made and the

enterprise would try to get the $500,000 from a charitable foundation or a public fund. What if the enterprise used a blended finance approach to borrow money? In this case the enterprise would ask the charitable foundation or public fund to provide only a fraction of the whole investment and try to borrow the rest from the capital market. Let us say, the enterprise would get half of the investment ($250'000) from a public institution. In this case it could double the expected rate of return for private investors. The profit of 25'000$ would be divided among the remaining 250'000$ therefore generating a return on investment of 10%, which is far more attractive to private investors than the previous 5%. This is also favorable from the public institution's perspective, since it had to spend only half of the investment to generate an impact worth of 100% investment. In addition, it can use the remaining $250'000, which it has not spent, for other projects (Bugg-Levine, Kogut & Kulatilaka, 2012, p. 120-121).

3.2 Stages of a project or enterprise

Before turning to the different instruments for blended finance we will give a brief introduction to the different stages of a project/enterprise. This will form the conceptual basis for the subsequent analysis, when answering the question about the instruments' applicability and appropriateness for the different stages.

As indicated in Figure 1, projects or enterprises can be structured into four different stages of growth: explore, build, grow and mature. Each stage of growth is characterized by a variety of challenges and thus requires different capital contributions from investors and financiers to address the balance between risk and return. For example, risks emanating from an unfavorable investment climate (political, regulatory, currency risks, illiquid or poorly-functioning capital markets), or a lack of market efficiency (lack of investment pipeline, lack of standardized products, few intermediaries with proven track record) can undermine a project during the project's entire life cycle. Other investment barriers, such as limited mandates or incentives to invest, or feasibility risk are only relevant during the first half, and first quarter of the life cycle respectively, while liquidity, refinancing, and exit risks may only negatively affect a project in the last half of its life cycle.

However, not only financing barriers can be differentiated according to stages of maturity of a project, but also the benefits that arise from the implementation of blended finance to overcome these barriers: during the explore phase, blended finance brings more bankable projects to market ready for investment, while in the build phase capital is made available in underpenetrated markets and sectors. Investment barriers at the grow stage are alleviated by blended finance by bringing in new investors and skills, while creating efficient markets.

During the mature face blended finance ensures fully commercial solutions, by freeing up public capital for new development projects.

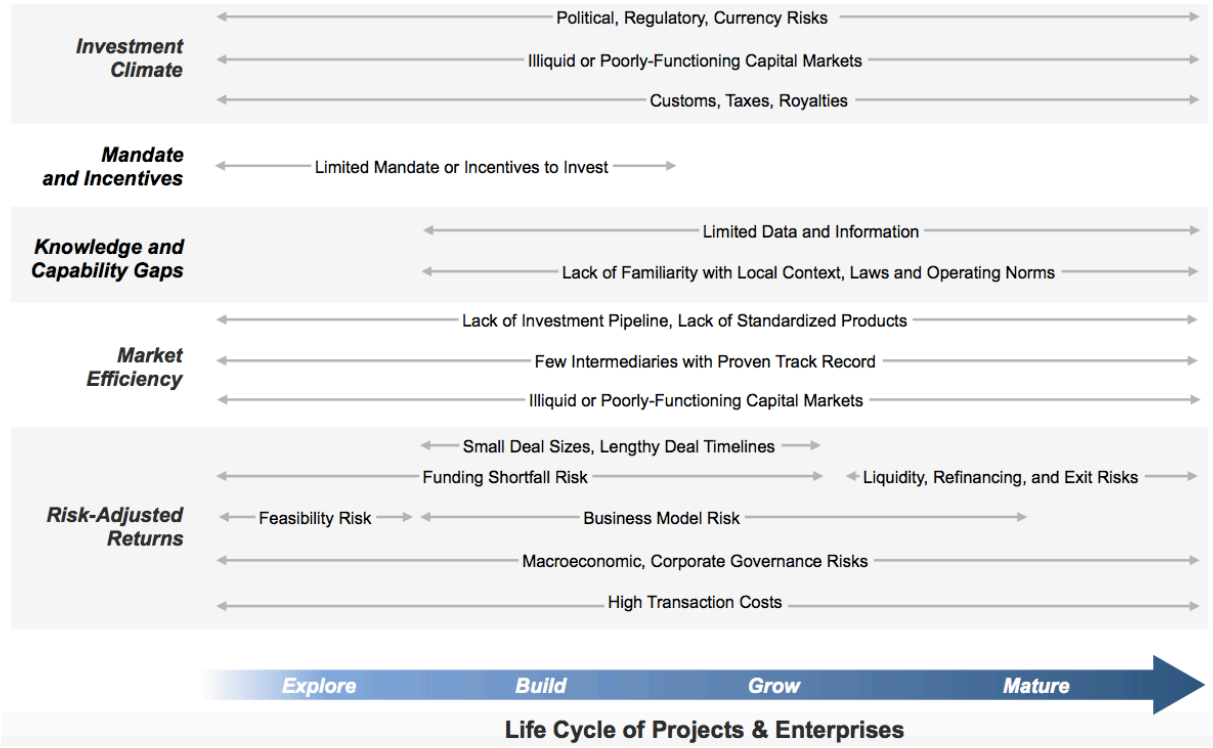


Figure 1: Investor Barriers over the Lifecycle of Investee Projects & Enterprise (WEF & OECD, 2015, p. 12)

Investor barriers can furthermore be classified into five different market segments according to the maturity of the respective company and market within which it is operating. As shown in Figure 2, each of these segments is differentiated according to the type of capital that projects and enterprises require at a specific stage of the investment life cycle, and the task of philanthropic and development actors so as to overcome the investor barriers that exist at each stage.

Preparing	Pioneering	Facilitating	Anchoring	Transitioning
Significant initial costs, coupled with uncertain viability and visibility into whether a project will be approved for construction/ operation or a company will launch, can cause investors to restrict their capital exposure.	In very early stage investments where entrepreneurs are experimenting with new ideas, products and business models, it can be difficult for private investors to justify the time and funds to support innovation.	Projects and enterprises seeking growth require capital to fund expansion and/or ongoing operations. While they may offer strong development returns at this stage, the risk-adjusted returns for private investors may be below commercial thresholds.	As mature or credible enterprises/ projects are seeking capital for scaling or replicating in critical areas of development, capital providers may be hesitant to invest due to real and perceived macro risks, such as political, sectoral and currency risks and uncertainty around exits.	Projects and enterprises at a very mature stage are well suited for commercial viability and access to commercial markets. However, many private investors lack access to a pipeline of deals that are sufficiently sizeable and scalable to fit within investor mandates.

Figure 2: Market Segments (WEF & OECD, 2015, p. 12)

An understanding of these barriers over the investment life cycle and across different segments is essential for enabling development and philanthropic investors to tailor blended finance strategies in a way that allow for overcoming specific barriers to investment at different points in time. Given the diverse nature of projects and enterprises blended finance can thus take on many forms to address investment barriers, either as tools to facilitate capital inflows through supporting mechanisms, such as grants, and guarantees, or as complementary direct funding, such as grants, equity or debt (WEF & OECD, 2015, p. 9-13).

3.3 Blended finance instruments

In the following section an introduction to different blended finance instruments will be made in order to give an overview about various approaches to implement blended finance. Although the list below is not exhaustive, the instruments presented are the most commonly used by leading institutions such as the EU, the IFC or the OECD.

Direct grants (DG's)

Direct grants refer to the direct provision of capital to a specific part of a project that has a substantial social impact, which is however not yet financially viable. It is therefore well suited for projects/enterprises located in the early stages of development, such as the preparing or pioneering-phase. The mechanism example above can be classified under this instrument category. The aim of the grant is to reach financial sustainability in the long-term, thereby rendering further grants obsolete over time. Direct grants can nevertheless lead to conflicting outcomes. As compared to performance-based grants (see section below), direct grants do not

require a specific set of goals to achieve in order to free up capital. If the beneficiary expects further grants in the future, this may weaken his incentive to look for more commercial types of financing (Mustapha, Prizzon & Gavas, 2014, p. 3).

Conditionality/performance-based grants

In contrast to direct grants, conditionality or performance-based grants are only disbursed if certain predefined conditions are met. The idea behind this instrument is to align the interests of the donor with the interest of the beneficiary. Disbursement does not necessarily need to take place before a project starts. There can also be an agreement that the beneficiary borrows money from the capital market in the first place and the loan is only paid back by the donor after completion of the project if the performance targets are met. This is a so called buy-down (Mustapha, Prizzon & Gavas, 2014, p. 4). The disadvantage of this instrument is that it is often difficult to determine the conditions of disbursement. It may for example be that the conditions are far too ambitious and disbursement is never made although the enterprise has a high potential to become economically viable. As with the case for direct grants, this instrument is especially useful for enterprises operating at the early stages of development.

Interest rate subsidy (IRS)

Interest rate subsidies enable the beneficiary to take out a loan below-market interest rates. Instead of a separate loan or grant from a public institution for a specific component of the project, the beneficiary gets a loan from the capital market but under more favorable conditions (Mustapha, Prizzon & Gavas, 2014, p. 4-5). In comparison to grants, where the specific conditions that need to be met are negotiated between the donor and beneficiary, it is the market that incentivizes the beneficiary to deliver results. The disadvantage of this instrument is that it can lead to market distortions. The way the financial institutions set their interest rate is confidential. It is therefore not possible for a donor to reconstruct how prices are set. If a financial institution anticipates an interest rate subsidy being paid by a donor, it could set an interest rate above market rates (Ferrer et al., 2012, p. 45; European Court of Auditors, 2014, p. 16). This instrument is especially useful for mature enterprises/projects. As an enterprise grows, the need for capital grows and refinancing becomes increasingly important. In markets with high uncertainty it is however often very difficult for enterprises to get the capital they need at normal market rates. IRS can thus be very useful at this stage of development.

Guarantee/risk-sharing products

Guarantee or risk-sharing products insure the private investor against potential losses from defaults. If a default occurs, no matter what the cause is, the guarantor pays the loan back to the investor. This instrument is especially useful for projects that involve high uncertainty. As explained above, some projects bear such high risks, that investors refrain from investing even if

expected returns are high. In such circumstances it might be advantageous to make use of a guarantee/risk-sharing product to encourage early movers to invest. This may be particularly helpful for a project that is in the preparing- or pioneering phase, since early movers are most needed on these stages. Finally, this instrument can also be used to insure against specific risks of a project like currency risks, war, terrorism, expropriation etc. (Mustapha, Prizzon & Gavas, 2014, p. 5).

Structured finance – first loss financing

In first loss financing the donor typically invests in the highest risk tranches in order to reduce the risks for the other investors. The donor therefore bears the first losses, protects investors and increases the credit-worthiness of the project (Mustapha, Prizzon & Gavas, 2014, p. 5-6). As it was the case for the previous instrument, first loss financing aims at creating incentives for private investors, especially first-movers, to invest by reducing the risks, therefore rendering this instrument especially useful for projects located at the early stages of development. In contrast to the previous instruments however, first loss financing is not limited to one asset class. It can take the form of equity, grants, guarantees, subordinated debt or a mixture of them according to the investors risk profile and the project's needs (GIIN, 2013, p. 5-6). This instrument proves especially powerful where flexibility is needed. On the other hand there might be a lack of transparency, because different asset classes are intermingled. This can cause problems of accountability and ownership. An equity investor has for example a claim on ownership over the enterprise, which is not the case for guarantees or subordinated debt. This could lead to a conflicting incentive structure that may prove to be detrimental to the business.

Technical assistance (TA)

Technical assistance (TA) is a non-financial approach to blended finance and rather used in combination with other instruments. It is listed separately here, because it satisfies the conditions of the blended finance definition we introduced above. Although the instrument is non-financial in nature, it has the capacity to create incentives for private investment. TA provides support on every stage of a project; from the preparatory phase such as feasibility studies and due-diligence to project supervision and impact measurement (Mustapha, Prizzon & Gavas, 2014, p. 6). By providing guidance throughout the project implementation, TA sends a positive signal to the market. It helps reduce uncertainty and therefore perceived risk, since it is expected to comply with specific rules. Moreover, TA has the capacity to reduce "first mover disadvantage". First mover disadvantage refers to a free rider problem when dealing with highly innovative and risky projects. In such projects early investors often bear the bulk of the risks but other people benefit from the investment, research and work previously done without having to share the costs (DFID, 2012, p. 20). TA reduces this disadvantage by taking over some of the

costs associated with the early stage, such as research and development. Nevertheless, TA is not limited to one stage. It can prove to be useful on every stage of a social business and especially in transition phases, where an enterprise moves from one stage to another. Finally, it should be said that TA should not be overestimated. It needs to be accompanied by other instruments in order to be able to operate efficiently. It is therefore limited in its scope.

Risk capital

Risk capital involves high risk, high return investments. They usually take the form of equity investment. In the context of blended finance risk capital can be a useful tool for public institutions to attract private investment by reducing risk premia, which are usually higher in developing countries. As it was the case for first loss financing, risk capital can be provided for a whole project or certain tranches of it. It can also be used to mitigate specific risks that are attached to a particular project such as currency risks or risks from social unrest. This instrument is especially useful for investments in infrastructure and SME's (Ferrer et al., 2012, p. 46). According to the different stages of an enterprise, risk capital can be used at all stages. In the early stage to reduce risks associated with the experimental nature of the idea or product; in later stages to mitigate macro-risks.

Pay for Success/Social Impact Incentives (SIINC)

Social Impact Incentive (SIINC) is one of the most recent approaches to blended finance. It belongs to the category of so called "pay for success" systems (Price, 2016).

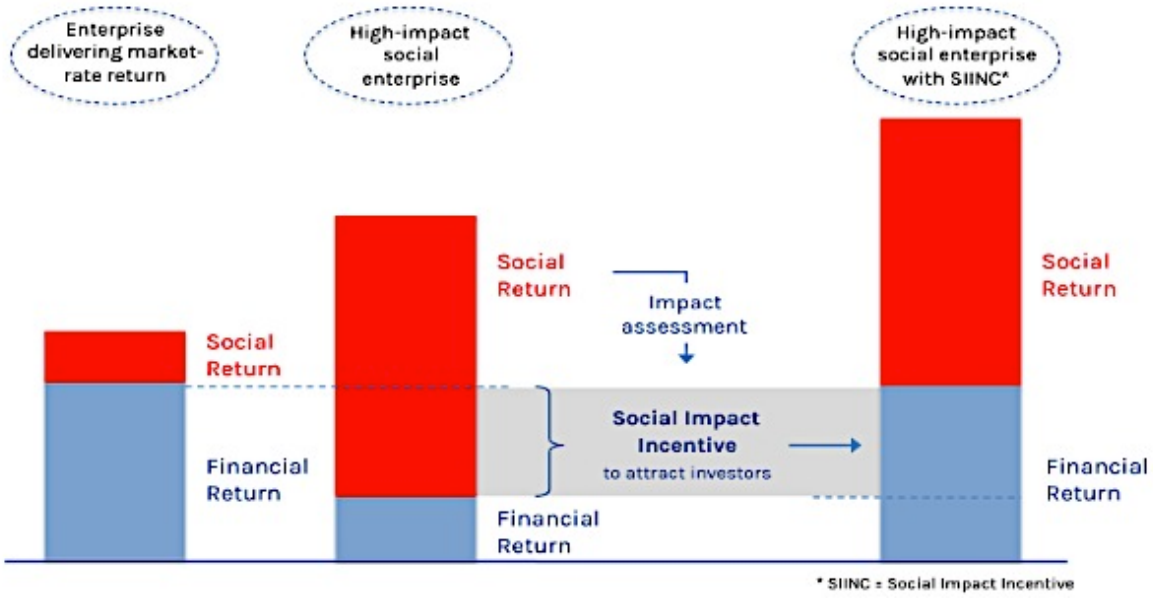


Figure 3: Mechanism of Social Impact Incentives (Roots of Impact)

In contrast to the instruments introduced previously, the contribution made by the donor is tied to the impact of a social enterprise and not the financial outcome. As already mentioned, social enterprises with high social impact often lack capital that would be needed in order to scale up and become more profitable. As figure 3 shows, the SIINC monetizes part of the social impact of a high-impact enterprise with low financial returns to increase its return to market rates in order to attract private investors (Roots of Impact). Since the social impact of an enterprise only unfolds after a certain period of time, this instrument is not applicable to businesses in the early stage of development. It is more useful for enterprises that already have experience with their product and the market they are operating in, which however have not been able to scale-up their business model.

SIINC is especially useful for projects that operate at the Base of the Pyramid. In such market environments a cost leadership strategy often is the only option because purchasing power and margins are typically very low (Price, 2016). In order to be profitable when following a cost leadership strategy, an enterprise needs to generate considerable economies of scale (Porter, 2008, p. 81). SIINC can be a valuable tool to provide those enterprises with the capital they need in order to reach the required scale, become financially sustainable and attract investors on their own (Price, 2016). SIINC is nevertheless not applicable to every kind of project or enterprise. The potential for economies of scale as well as the scalability (see Chapter 5) of a business model are decisive factors that determine whether a project is suitable or not. Typically, the potential for economies of scale is higher, the higher the share of fixed costs to variable costs (Porter, 2008, p.8). A hair dressing company for example has a much higher share of variable costs to total costs than a potato factory. It is not only the haircut but also the whole service you get when going to a hair stylist that cannot be easily replaced by a machine. A potato factory in contrast needs sophisticated machines, big storage places and production facilities, and much less manual labor is needed throughout the production process, since many activities can be executed by machines. The hairdresser will not be able to generate the same amount of economies of scale as the potato factory.

Finally, SIINC also raises an important question about how impact is measured and which opportunity costs come along with it. Sophisticated measurement systems also involve costs which then translate into higher management fees (GIIN, 2011, p.9). Those management fees may discourage potential investors. We will take a closer look to impact measurement in Chapter 4.

3.4 New approaches to blended finance

The instruments outlined above are among the most widely used by institutions such as the EU, the IFC or the OECD. Nevertheless, a new trend has emerged in recent years. This trend is marked by a change in perspective. Conventional blending mechanisms merely looked at the different instruments as being independent from each other. This has changed over the recent years. There is an increasing body of literature focusing on blending different instruments in order to achieve better results. Blending in this sense cannot only be understood as a mixture between private and public capital but also as a blend between different instruments. The principal aim of those products is to further increase the attractiveness for private investors without ignoring a project's specific needs. In this section we will focus on two instruments that reflect this new approach: Quasi-Equity-Debt and Blending Grants and Loans.

Blending Grants and Loans

Blending grants and loans is a well-established practice in international development finance and therefore not a new concept in itself. What is innovative about this concept is that it might also be used as an instrument for blended finance (as defined in the introduction).[1] Up to now this concept only applied to pure public investment and did not include private sector investment. In contrast to traditional forms of blending loans with grants, the new approach has the aim to increase leverage and generate financial return. This has not been the case before. In this respect blending grants and loans embodies a new approach to blended finance. (Núñes Ferrer, Morazán, Schäfer & Behrens, 2012, p. 13)

The grant element of this instrument reduces the overall debt burden of a project or enterprise. This is especially useful for projects that are not able to generate sufficient financial return to cover the interest payments for the loan or for projects that face high market risks, which does not allow them to get the capital needed at normal market rates. The grant component reduces risks if it is employed to finance the high risk tranches of the project. This risk mitigation effect does in turn affect the conditions for borrowing from the capital market and therefore ensures that the project can raise capital at normal market rates, which would otherwise not have been possible. Due to its risk mitigation effects, it is the grant component that produces the financial leverage. (Nuñes Ferrer & Behrens, 2011, p. 5-6)

[1] Note: Blending grants and loans only refers to the combination of loans and grants and not the definition of blended finance as introduced above. Blended finance as introduced above is used to explain the difference between traditional forms of blending grants and loans and the new approach. It may be confusing because in both cases the term "blending" is used, although they mean different concepts. In the context of grants and loans it refers to the combination of both. In the broader context of this thesis it refers to the strategic use of public finance to mobilize private sector investment.

The loan component in turn positively affects the financial discipline as the beneficiary needs to repay the loan. In addition, the loan ensures that the beneficiary's ownership remains intact. On the one hand, the beneficiary gains discretion about the selection of projects allowing him to focus on his own development priorities. (Núñes Ferrer, Morazán, Schäfer & Behrens, 2012, p.15) On the other hand, he is accountable for his actions, which in turn affect his ownership and finally provide a strong incentive for him to perform at his best.

To sum up the loan element provides the incentive structure (return side) whereas the grant element mitigates the risks (risk side). As it was the case for conditionality/performance based grants and technical assistance - here again - we have both dimensions included.

This instrument is especially useful, when dealing with highly indebted countries. The grant element reduces overall indebtedness and the loan element, if designed on a concessional basis, it can reduce the risk of an unsustainable interest burden. (Nuñes Ferrer & Behrens, 2011, p.6)

In contrast to pure grants this instrument has the advantage of providing a positive impetus to become independent and financially sustainable over time. As explained above, grants bear the risk of producing conflicting outcomes by potentially weakening the beneficiary's incentive to look for more commercial types of financing, if further grants are expected in the future. By introducing a loan element, this instrument has a positive effect on financial discipline and provides an incentive to the recipient to improve its financial performance, as he remains the owner of the enterprise and acts with considerable discretion.

On the other hand, this instrument has mainly two disadvantages: first, loans and grants have different durations. Especially loans entail a long-term commitment, which may not follow the path of a particular project. If a project takes longer to take off and becomes financially profitable, the debt burden of the loan may suddenly prove to be unsustainable. Here the grant element should be flexible enough to tamper the effects of such a scenario. It is therefore primordial to clarify beforehand, whether the donor would be prepared to take action if expectations prove to be inaccurate.

Second, it is often very difficult to determine the right mixture between grants and loans, since there is a trade-off between the two. If the grant element is not given enough weight, the project or enterprise will not be able to generate sufficient financial leverage. If it is given too much weight, it may crowd-out private investment and provide a detrimental incentive structure for the project in question. In analyzing the EU's blending facilities Nuñes Ferrer & Behrens (2011) come to the conclusion that the grant element did not have enough weight and thus too little private capital was attracted.

Finally, it needs to be said that this instrument is more useful for mature enterprises/projects. As an enterprise grows, the need for capital grows and refinancing becomes increasingly important. In markets with high uncertainty it is however often very difficult for enterprises to get the capital they need at normal market rates. As it was the case for IRS, blending grants and loans can help generate more favorable conditions for the enterprise to borrow from the capital market.

Quasi-equity-debt

Quasi-Equity-Debt refers to structured financial products that include properties of both; equity and debt. Technically and legally speaking, quasi-equity debt is a form of debt (risk dimension), nevertheless with one particular distinction. The financial return is tied to the company's financial performance. Although the holder has no claim on ownership over the enterprise, the instrument is designed in a way to incentivize the management to run its business efficiently. (Bugg-Levine, Kogut & Kulatilaka, 2012, p. 123) This incentive dimension is similar to the previously introduced instrument, but with one important distinction: In contrast to the loan dimension of the previous instrument, quasi-equity debt has a more direct and stronger incentive effect (return dimension), since the instrument is directly tied to the company's financial performance. Holders can withdraw their support at any point in time. The company must therefore ensure good performance at every point in time. With quasi-equity debt the management will refrain from making long-term investments and rather focus on investments that pay back in the near future, since it must be ensured that the titleholders do not jump off in the meantime. If a business has to go through a longer lean spell, quasi-equity debt is not the right instrument to choose. With a loan there is more room for maneuver since it entails longer durations. The management's incentive is to ensure long term creditworthiness of the company and not short term profits. This also allows adopting unpopular decisions that may be financially unsustainable in the short term but pay back in the future, as long as the creditworthiness is not affected or the grant element is sufficiently flexible to tamper the negative effects thereof. This instrument is therefore not well suited if a long-term perspective is needed and the business is likely to grow slowly. Such an instrument is more likely to be successful for an enterprise or project that is in a growing phase or where management needs to be given stronger incentives to perform at its best.

Finally, it needs to be said that this instrument may prove to be particularly useful for enterprises, which have the legal status of a nonprofit organization. Given that nonprofits in most jurisdictions are not allowed to subscribe for shares, quasi-equity-debt can be a solution to benefit from the advantages of share capital, without having to change their legal structure. (Bugg-Levine, Kogut & Kulatilaka, 2012, p. 123)

Note that the instruments introduced in this chapter are only two examples of the new perspective within blended finance. Blending the different instruments to benefit from the particular advantages of the various products provides us with a near indefinite number of possibilities. This is what makes that approach so valuable. It allows public and financial institutions alike to take care of the specific needs of a project as well as the private investor, by designing the mechanisms to fit the individual requirements. This trend is likely to gain momentum in the future.

3.5 Choosing an instrument

The above described instruments can be divided along two dimensions; risks and returns. Interest rates subsidies and SIINC focus on the return side. The aim is to incentivize private investment by improving a project's profitability and therefore its expected returns. Other instruments, such as direct grants, risk sharing, risk capital and first loss financing focus on the risk dimension. Finally, there are instruments that include both dimensions like conditionality/performance-based grants, technical assistance, quasi-equity debt and blending grants with loans. This distinction is important when it comes to choosing the right instrument for financing a project or project tranche. If a project is for example dealing within an informal market with weak governance structures, intransparent bureaucratic procedures and institutional voids, an instrument focusing on returns may not be appropriate (Godfrey, 2011). Private investors may still refrain from investing although expected rates of returns are perceived to be high, because the environment the project is operating in involves high levels of uncertainty and risks that are difficult to assess. In this case an instrument that mitigates risks is more likely to attract investors than an instrument generating higher returns. It is primordial to be clear about the projects expected risks and returns in order to choose the right instrument.

The table below provides a summary of all the instruments outlined throughout the last two chapters, with their respective advantages/disadvantages and project stages, which they are best suited for.

Blended Finance Instrument	Strengths	Weaknesses	Dimension: Risk vs Return	Stage of the project/enterprise
Direct grants (DG's)	Support to reach financial sustainability	Conflicting Incentive Structure	Risk	Preparing/Pioneering
Conditionality/performance-based grants	Aligning donor interest with beneficiary	Determination of conditions	Both	Preparing/Pioneering
Interest rate subsidy (IRS)	Market incentive/ favorable conditions	Can lead to market distortions	Return	Facilitating/ Anchoring/ Transitioning
Guarantee/risk-sharing products	Encouraging early movers	Limited to one asset class	Risk	Preparing/Pioneering
Structured finance – first loss financing	Credit-worthiness/ Encouraging early movers/ Flexibility	Intransparency/ Conflicting Incentive Structure	Risk	Preparing/Pioneering
Technical assistance (TA)	Positive signal to market/ Reducing first mover disadvantage	Limited in scope	Both	All
Risk capital	High potential return / Lower risk premia/ SME's + Infrastructure	High risk	Risk	All
Pay for Success/Social Impact Incentives	Contribution of donor tied to impact not financial outcome	Depending on scalability of project/enterprise/ Measurement	Return	Facilitating/ Anchoring
Blending Grants and Loans	Financial discipline/ Reducing debt burden	Durations/ Difficult to determine right mixture	Both	Facilitating/ Anchoring/ Transitioning
Quasi-Equity-Debt	Strong incentives/ Nonprofits	Short-term oriented	Both	Facilitating/ Anchoring

Figure 4: Blended Finance Instruments

3.6 Opportunities of blended finance

The Donor

From a public institution's perspective, blended finance helps increase the leverage of ODA and therefore aid effectiveness (European Commission, 2009, p.5). This in turn strengthens the institution's image in public, helps legitimize its operations and finally improves its position when it comes to the allocation of resources between different policy sectors.

Blended finance is also a very flexible instrument as it can be adapted in various ways to fit the specific needs of the donor, the private sector and ultimately the specific characteristics of a project (European Commission, 2009, p. 8). As it was shown in the previous section, the different instruments cover the whole spectrum of investments. What instrument to choose however does not only depend on the needs of the market and the institutions involved, opportunity costs need to be taken into account as well. Theoretically the possibilities to combine those products are unlimited. However, it is a matter of coordination and negotiation. The more complex the

design of these products, the harder it will be to coordinate action between different stakeholders and terminate the negotiation process. This will in turn affect costs and ultimately the project's profitability.

The Recipient

Blended finance helps the recipients to gain access to international capital markets and market knowledge. In addition, they can build up new capacities and get a project off the ground more quickly. Furthermore, technical assistance helps them improve their efficiency and live up to international standards (European Commission, 2009, p. 8 and Mustapha, Prizzon & Gavas, 2014, p. 8).

Moreover, blended finance can be a very valuable tool especially for low-income countries that lack access to capital markets. Those countries face serious challenges to receive enough capital from the donor market. Through a higher leverage from relatively small resources, blended finance can achieve additional financial flows to low income countries that otherwise would not have taken place (European Commission, 2009, p. 7).

3.7 Threats of blended finance

The Donor

As a high leverage is favorable to maximizing the marginal return of social impact, it may also turn into a threat. A higher leverage ratio by definition means that a project attracts a comparatively high amount of private investment. This in turn reduces the relative contribution of the public body and may therefore restrict its influence on a project's design and implementation (Eurodad, 2013, p. 25). If a project develops in an unintended direction that is not in line with the public institution's norms and conditions, taking corrective measures becomes increasingly difficult. In addition, although influence of the public institution may be low, it can still be held accountable for the project's outcomes. This entails a high potential image risk for the institution and may undermine its legitimacy.

In addition, it is often difficult to assess the exact amount of capital needed for a project to become attractive for investors. Measurement errors may lead to an over- or undercapitalization. In the case of undercapitalization, the investment will not be attractive enough for private investors. In the case of an overcapitalization, the public institution may crowd-out private investment, which then leads to a deterioration of the leverage ratio. In addition, this can lead to market distortions and ultimately to market failures. The better financial markets are developed within a country, the higher the risk from such distortions (European Commission, 2009, p. 9).

The Recipient

Blended finance involves a market oriented approach to development finance. By incorporating market mechanisms in the financing of businesses and projects with a social purpose, a conflict may arise between two competing organizational logics and identities. On the one hand, we have an organizational identity, which defines itself by the social impact it generates and is oriented toward the civil society. On the other hand, the organization needs to become more profit oriented in order to generate returns for private investors (Jäger & Schröer, 2014, p. 1291-1293). This may generate two kinds of challenges: firstly, an organization may not be prepared to make such disruptive changes in its strategy. FUNDES, a South-American social business, is a prominent example of a non-profit organization that changed its business model completely in order to become financially sustainable and therefore independent from the donor market. FUNDES has almost entirely replaced its workforce within less than three years. The reason behind this choice was that the people were not prepared or often not willing to change practices. Many had joined the organization for the social purpose and could not identify with a business driven culture. The example shows that such a strategic choice can have major knock on effects, which are often difficult to foresee. Secondly, the organization may drift away from its original mission and purpose. This can be especially harmful when the social purpose forms an essential part of the organization's value proposition. If customers for example choose to purchase in a certain grocery shop because it employs people that otherwise would not have been hired, firing those people could be very harmful to the business, since it may lose its customer base.

To conclude, it needs to be said that the abovementioned examples are certainly extreme cases and the tensions between the two goals are surely overstated. There is in fact a growing body of literature advocating for an integration of both logics. It is argued that a social business may even become more competitive when incorporating both identities in its strategy. For further information, readers are referred to the following literature about "Creating Shared Value" and "Hybrid organizations": Porter & Kramer, 2011 and Jäger & Schröer, 2014, as this chapter only serve as an overview over the basic tensions within blended finance. We will delve into this topic in more detail when considering the particular barriers we may find when operating at the Base of the Pyramid (see Chapter 5).

4 Impact measurement

One of the key challenges that must be overcome so as to enable the full realization of blended finance's potential is the implementation of a rigorous impact evaluation. Impact measurement is central to the practice of blended finance, as it demonstrates the social impact that the investments are having, thereby further legitimizing the practice of blended finance. Given that impact is an increasingly important topic on investors' agendas, measuring and demonstrating the value organizations are delivering becomes a responsibility they can no longer ignore when seeking to access new capital. Impact measurement can furthermore serve as a form of performance monitoring, and sends a signal to investors that the organization cares about improving what it delivers and is willing to assume accountability for its performance. Effective impact measurement will thus not only provide access to finance but also support an organization's key performance indicators and overall effectiveness by increasing the transparency and accountability for the impact delivered (Fedorciow, 2013). Not surprisingly, there has been increased attention to measuring impact in the social sector. According to the second annual EVPA survey of Venture Philanthropy and Social Investment in Europe, the focus on social impact measurement increased, with 90% of respondents measuring social impact on at least an annual basis during the investment period (EVPA, 2013, p. 20).

4.1 Defining social impact

The impact value chain has become a popular starting point for defining and measuring social impact as it clearly fleshes out the differences between inputs, outputs, outcome and social impacts.

Inputs	Activities	Outputs	Outcomes	Impact
Resources (capital, human) invested in the activity	Concrete actions of the SPO	Tangible products from the activity	Changes resulting from the activity	Outcomes adjusted for what would have happened anyway, actions of others & for unintended consequences
$50k invested, 5 people working on project	Land ought, school designed & built	New school built with 32 places	Students with increased access to education: 8	Students with access to education not including those with alternatives: 2

Figure 5: The Impact Value Chain (EVPA, 2013, p. 9)

Although impact evaluations are considered the "gold standard" for monitoring and evaluation, they are challenging and may not be feasible (UN Women, 2012). On the one hand, they require a significant amount of resources and time, which many organizations may not have. On the other hand, impact evaluations require the collection of data following specific statistical methodology, over a period of time, and the forming of a range of control and intervention groups, which may be difficult for some groups (E.g. it would probably not me ethically justifiable to select clients at random for a beneficial social services, then deny the benefits to a control group for the sake of science). Impact measurement furthermore requires the integration of social and environmental considerations into deeply rooted market dynamics and investment management processes (Social Impact Investment Taskforce, 2014, p. 7).

This is why venture philanthropy organizations and social investors tend to focus on outputs rather than outcomes or impact. As the chart below indicates, the objectives of the impact measurement system are in 84% (n=58) of the cases still based on output measures (EVPA, 2013, p. 20).

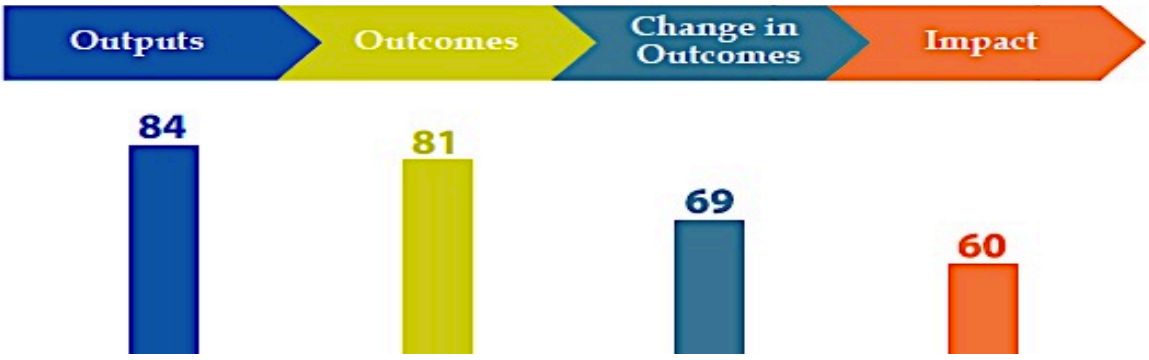


Figure 6: VPO/SI Objectives of Impact Measurement (EVPA, 2013, p. 21)

This is because outputs are directly related to the activities of the organization, and are thus generally easier to measure. Outcomes and impacts, on the other hand, are beyond the scope of the organization's activities (although still within their accountability), because both are also related to the expected and unexpected effects of the organization's activities.

4.2 Measuring social impact

Impact measurement seeks to manage and control the process of creating social impact. In order to maximize social impact relative to costs, impact evaluation occurs continuously, and is facilitated by integrating impact measurement in the investment management process (Social Impact Investment Taskforce, 2014, p. 2).

Most methods and tools[2] implemented by venture philanthropy organizations and social investors follow a general 5-step process when measuring impact. Between 70-90% of venture philanthropy organizations and social investors indicate that they use each of the following 5-steps (EVPA, 2013, p. 53).

Figure 7: Five steps of Social Impact Measurement (EVPA, 2013, p. 23)

Step 1: Setting Objectives

The first step is about defining the scope of venture philanthropy organizations and social investors' (VPO/SI) impact measurement and the setting of objectives. Setting objectives is a vital step in any impact measurement process, and the more specific the objectives are defined, the better the impact measurement that can be prepared. A wide range of methods and tools are available for this step, such as Logic Models, Balanced Scorecards, the Theory of Change, or the SROI.

Step 2: Analyzing Stakeholders

In order to comprehend the expectations of the stakeholders, their contribution to, and the potential impact that the organization's work will have on them, the relevant stakeholders have to be identified (mapping), and tended to (stakeholder dialogue). For this step again, there is a wide range of methods and tools available, such as the Accountability Stakeholder Engagement Manual, The Value Game (a stakeholder led valuation tool), or the SROI Network.

[2] A method is defined as a framework for evaluation that suggests methodological guidelines and process steps. A tool represents a concrete well-developed instrument that assesses performance based on fixed indicators

Step 3: Measuring Results

In order to transform the objectives defined in Step 1 into measureable results, outputs, outcomes and impact need to be defined and indicators have to be chosen. Useful indicators ought to be quantifiable in some way, have the ability to indicate a change, and are appropriate to the outcome in that they really measure the intended change (Social Impact Scotland, 2016). While *hard outcomes* are straight forward enough to measure (e.g. reduction in child mortality), others, such as empowerment, are more difficult to observe.

This is also one of the reasons why different organizations are measuring different things when evaluating impact. For instance, Acumen Fund, a venture philanthropy with a portfolio over 75 investments in social enterprises in Asia and Africa, measures immediate outputs, such as mosquito nets made and distributed. Its primary social metric thus is the number of lives reached in base-of-pyramid markets. The Robin Hood Foundation, which fights poverty through grants to nonprofit organizations, focuses on long-term outcomes in the lives of individuals such as the expected increase in lifetime earnings of its clients. In order to do so, the foundation searches for studies that link immediately observable results of their grants, such as for example school attendance, to expected lifetime earnings or quality of life. The Millennium Challenge Corporation (MCC), which focuses on poverty reduction through economic growth, operates on a 20-year time horizon. Its extensive due diligence process first analyzes the barriers to economic growth in the country, and then identifies the sectors where the grants are most likely to reduce poverty. For instance, the MCC granted $547 million to the Ghanaian Government to build roads and ferries to get agricultural commodities to market. To start, it evaluated the number of farmers likely to benefit, and what those benefits would be: reduced cost and time of getting goods to market, access to new markets, and opportunities for wage employment. These data were used to anticipate an economic rate of return, with the primary outcome metric being increases in farmer incomes, along with impact metrics such as a reduction in regional poverty rates (Ebrahim, 2013).

Given the difficulties associated with the measurement of impact, the EVPA recommends to measure social impact by calculating outcomes while acknowledging (and if possible adjusting for) those factors that contribute to increasing or decreasing the impact of the organization, rather than aiming to calculate very specific impact numbers. In order to accurately calculate social impact, outcomes need to be adjusted for the following factors: (i) what would have happened anyway (“deadweight”); (ii) the action of others (“attribution”); (iii) how far the outcome of the initial intervention is likely to be reduced over time (“drop off”); (iv) the extent to which the original situation was displaced elsewhere or outcomes displaced other potential positive outcomes (“displacement”); and for unintended consequences (which could be negative

or positive). There is furthermore a need to identify output (specific and measureable actions or conditions that assess progress or regression against specific operational activities) and outcome (specific and measureable actions or conditions that demonstrate progress towards or away from specified outcomes) indicators to manage outputs, outcomes and determine impacts.

Step 4: Verifying & Valuing Impact

In order to refine target outcomes and associated indicators, and identify the impacts with the highest social value two aspects are relevant: On the one hand, it has to be verified that the impact happened in the way it was expected. Desk research (analyzing external research reports, databases, government statistics, etc.), competitive analysis (compare the data of the organization with data of other comparable organizations operating in similar geographies on similar issues) or interviews (ask stakeholders about the results of the interventions) represent the three principal approaches to verify results.

On the other hand, it has to be ascertained whether the impact was important and valuable to the stakeholders. This stakeholder valuation can either be assessed qualitatively or quantitatively (monetized). Common qualitative methods are storytelling (describing the outcomes of an intervention from the point of view of a stakeholder), client satisfaction surveys, or participatory impact assessment (stakeholders rank their preferences), while perceived value and cost-savings represent commonly used quantitative measurement techniques.

Step 5: Monitoring & Reporting

The final step in the impact measurement process is monitoring and reporting. While monitoring is all about tracking progress against the objectives defined in step 1, and made concrete through the indicators defined in step 3, reporting concerns the transforming of data into presentable formats that are relevant for key stakeholders. Common tools and methods for this step are for example the German Social Reporting Standard, PULSE, a numeric metric data collection and reporting tool, or GIIRS, which provides both company and fund impact ratings.

4.3 Choosing a method

Another key challenge for organizations seeking to conduct impact measuring is knowing what method is best suited for them (The Guild, 2010, p. 6). This challenge is largely attributable to a lack of standardized procedures and little agreement on a set of hard-and-fast metrics to measure social performance. 73% of the venture philanthropy organizations and social investors consulted in the second annual EVPA survey indicated that they were not using a standardized tool to measure social impact. Among those that did use such a tool, the most frequently mentioned were Social Evaluator and SROI, although a quarter of people did say they were using IRIS indicators or theory of change (EVPA, 2013, p. 20).

As a result, innumerous methods and tools for assessing, measuring, or reporting social impact have been developed[3]. The sheer amount of different tools and methods available is virtually overwhelming, but is necessary given that there is no one size fits all. This is because the way impact is measured depends on the size, capacity, activities and focus of an organization (The Guild, 2010, p. 6).

For example, the Foundation Center, the leading source of information about philanthropy worldwide, provides a database (TRASI) of over 150 tools, methods, and best practices for assessing social impact. If one selects the approach <tools>, and seeks to measure social impact (cultural, economic, environmental, political, social) at the impact stage of the value chain, one ends up with 26 search results. Similarly, if one selects the approach <methods>, while maintaining all other parameters unchanged, one obtains 28 results. The search engine furthermore allows for filtering according to organization type, the respective sector, within which the organization is active, and the purpose of measurement (assessment, management, certification).

Similarly, the MaRS Centre for Impact Investing provides a somewhat less extensive database of seven key tools and methods, which they place along a spectrum from measuring transparency to measuring change, on the one hand, and prescriptiveness (with specific criteria to follow or meet) and adaptiveness (tailored to various situations and organizations as appropriate), on the other.

Figure 8: Seven Key Tools/Methods for measuring Impact (MaRS Centre for Impact Investing)

Likewise, Proveandimprove.org provides charities, voluntary organizations and social enterprise with a list of more than 20 well-known impact measurement approaches to choose

[3] A method is defined as a framework for evaluation that suggests methodological guidelines and process steps. A tool represents a concrete well-developed instrument that assesses performance based on fixed indicators.

from. In order to help organizations identify the tool best suited to their performance management needs, organizations are advised to resort to the webpage's Tool Decider and Comparison Charts.

To conclude this chapter, it can be said that measures can never fully reflect the underlying reality. But still, they can provide value by helping to bring the underlying reality in to better focus than if there were no measure at all. Moreover, without measurement, there is a real risk that money, time and other resources are wasted. To keep investing money without finding out if your efforts are doing any good furthermore jeopardizes an organization's ability to maximize the effects of the funding it is able to direct toward social problems. Lastly, without measurement, the assumption that all positive impact goals are achieved and all negative ones are avoided goes untested (Epstein & Yuthas, 2014, p. 118-120).

5 Scaling up social impact business

"When the poor at the BOP are treated as consumers, they can reap the benefits of respect, choice, and self-esteem and have an opportunity to climb out of the poverty trap."

"I have no doubt that the elimination of poverty and deprivation is possible by 2020."

- C.K. Prahalad, The Fortune at the Bottom of the Pyramid

As already discussed, if we wanted to reach the sustainable development goals only by foreign development aid, a much larger sum would be needed. An amount the developed world does not seem to be willing to spend. Blended finance concepts are one way to overcome the gap. Where foreign development aid isn't enough or isn't effective enough, market based solutions could do the trick. And as a matter of fact they already do. Be it as social impact business or simply by targeting the poor as a yet unsatisfied field of potential customers. The logic is convincing, as Prahalad describes it, there is a fortune to be made at the bottom of the pyramid (Prahalad, 2004). No doubt, access to markets is inherently a good thing. Even for the poorest of the poor it brings choice, opportunity and some sort of benefits and opens up the possibility for market based development solutions: social impact businesses. Yet Prahalad's prediction that the elimination of poverty is possible by 2020 seems overly optimistic. Over ten years have passed since he published his works on *The Fortune at the Bottom of the Pyramid*, and the eradication of poverty seems still far away. This part tries to explain one important reason why this is the case: the problem of scaling up.

5.1 Why scaling up is important

Only by growing can social businesses reach enough of the poor so as to generate a significant impact. To deliver this impact, businesses must reach a certain scale. Or to say it with the words of Koh, Hedge & Karamchandani (2014): *"We believe that scale is important because the problems of global poverty are vast: billions of people around the world live in poverty and suffer its consequences"*. Yet for many businesses scaling up seems to be quite difficult. There are many barriers between a good idea and a large scale social impact business. Barriers that usually are difficult to overcome by the firms. However, overcoming these barriers is necessary to scale up and generate impact. This is where NGOs, foundations, development agencies etc. can generate leverage. They can facilitate funds, know-how, connections etc. to overcome these scaling barriers. Thereby, they take on the role as industry facilitator. Industry facilitators can make substantial contributions toward the scaling up of businesses in the sense that they make them more attractive for private investors.

A study by Koh, Hedge & Karamchandani from 2014 analyzed 439 social businesses in Africa and came to the unfortunate conclusion that only 13% of the firms had reached a significant scale. This raises the question why so many businesses are unable to scale-up.

The difficulty of selling to the poor

It is true, the market serving the poor could be huge*: "Over 2.1 billion people in the developing world lived on less than US $ 3.10 a day in 2012"* (World Bank, 2016). But it is quite a difficult market. Obviously the poor have less money at their disposal than the rich, but that is not the only challenge for selling to the poor. High levels of uncertainty make the poor much more risk averse, limited access to information leaves them unaware of possible solutions, missing education is a general problem, as is the disconnectedness of poor rural areas, and very limited access to financial services makes it difficult for the poor to borrow money to improve their situation. All that makes the market of the poor a difficult market.

Make a product aspirational

Another problem with targeting the poor is often the nature of the social impact products. While a simple ceramic water filter would significantly improve the health of a household, it may not be aspirational enough for the customers. The problem is the difference between push and pull products. Pull products being the ones the customer already desires und push products the unrecognized ones. Push products are often unrecognized because the poor customers do not see the underlying problem, for example the connection between health and clean drinking water. Besides large educational campaigns, one solution is to make push products aspirational. One successful example is the *Super Tunsai* ceramic water filter. Even though much more expensive than the basic model, the stylish designed Super Tunsai led to a sharp rise in the sales of water filters and makes up for almost 100% of water filters sold in Cambodia (Business fights poverty, 2014).

The pioneer gap

"Firms that are pioneering new business models shoulder a heavy burden, particularly in the BoP environment. By definition, these firms are blazing new trails rather than following the well-worn paths established by others" (Koh, Karamchandani & Katz, 2012).

Another big problem is the so called *pioneer gap* described by Koh, Karamchandani & Katz in their 2012 study *From Blueprint to Scale*. It describes the challenge that pioneer businesses often lack the needed funds and support in the early stages. The stages where a business model is tested, organizational capacity is built and supply chains are developed. Pioneering is a rather risky business and social impact firms often cannot guarantee the needed returns to attract risk capital. *"Monitor's Africa research in 2011 found that only six of the 84 fund investing in Africa or*

across regions offer truly early-stage capital. […] *We call this critical gap in support the 'Pioneer Gap', and believe that this is a key factor constraining the availability of investment opportunities for impact investors"* (Koh, Karamchandani & Katz, 2012). This makes starting a social impact business a real challenge. Without addressing the pioneer gap, it is doubtful that social impact capital will reach the businesses in need and will be able to fuel market based solutions. As outlined in Chapter 3.3, technical assistance might be a solution to overcome the pioneer gap. Technical assistance could bear some of the Pioneer's costs and reduce risks by providing knowledge and expertise. This would in turn reduce first mover disadvantage and therefore incentivize investment (see Chapter 3.3).

5.2 Scaling barriers

But the limited access to early stage capital is not the only hindrance to grow for inclusive businesses. Even after the pioneering phase there often are severe obstacles for firms to reach significant scale, so called scaling barriers. We find these barriers on multiple levels. Some can be found within the firm itself or within the industry value chain. Others are related to public goods or the state, governmental laws and procedures.

Barriers at the level of the firm

Probably the most obvious place to look for barriers for scaling is the firm itself. Here the lack of capital can already set a limit to scale. Also the lack of certain operational skills such as leadership and management, or the lack of rather technical/procedural skills can be a hindrance. The business model may work on a small scale but isn't suited to serve thousands or even millions of customers. These and more can be scaling barriers found at the level of the firm.

Barriers at the level of the value chain

As already described in the paragraph the *difficulty of selling to the poor,* the market for the poor is a rather difficult one. Whole distribution channels may have to be built from scratch. Here the difficulty of the last mile delivery is an important topic. How does one reach the poor without making the product overly expensive? As a matter of fact, sometimes for market based solutions to work, a product must sell at a price higher than the minimal possible. Market based solutions are only possible when the last mile distributor can add a margin as well. For example, for water (delivered in jerrycans) this seems to be a problem since the price has to be very low for people to switch from the free dirty water to pricy clean water. But not only is the lack of distribution channels an issue, limited access to finance and credits can further prohibit well needed purchases. As mentioned above, aspirational products are often more expensive than the basic version, coupled with the retailers need for a margin this often makes it impossible for poor customers to purchase a certain product. Limited access to finance can also be a problem for

suppliers and distributors. Without access to it, they may be unable to scale up on their side and therefore impede growth of the social impact business.

Barriers at the level of public goods

On one side this can be closely linked to the problem associated with push products. For a product to be aspirational, there has to be a certain level of customer awareness; an awareness of the availability of the product and of its merits. Often the bad situation, created for example through unclean kerosene cook stoves or lamps, seems to be part of everyday life. Therefore, potential customers are not actively looking for new solutions. The lack of proper education and access to information channels even amplifies this issue. To educate poor customers, extensive public campaigns are often needed to raise awareness of a problem. These campaigns are usually costly and difficult to design. The costs may well be too high for a single firm and it also creates another difficulty: the free-rider problem. After a major initial investment to establish distribution networks and raise awareness, additional investment from new players in the market is comparatively small. Therefore, firms are often reluctant to make the needed first mover investment. Also linked to education is the problem of quality standards. Poor customers are often unable to distinguish the differences in the quality offered, especially in services such as education or healthcare.

A second barrier in public goods is the bad infrastructure such as roads, energy supply and telecommunication. In most developing countries these types of hard infrastructure are not in best shape, which makes distribution of products or the organization of a supply chain difficult. But not only the state infrastructure is in bad shape in many developing countries. Often governance structures are weak and characterized by institutional voids and market activity usually takes place informally. This is another hindrance for scaling up.

Barriers at the level of the government

Government procedures, regulations and laws can impose a severe barrier for a business wanting to scale up. Dealing with the government can be difficult and may need skills and competences firms do not possess. Regulations can be time consuming and hinder fast growth. In addition, taxes and subsidies often make the market an uneven playfield and can further frustrate scaling up social businesses. According to the *Lighting Africa* study (2011) there are still duties on solar products in a number of African countries, whereas kerosene often is exempt from duties and even benefits from government subsidies. This of course makes it very difficult for solar based solutions to replace established kerosene lamps.

Why are firms unable to overcome these barriers?

There are two possible answers to this question: They either cannot or they do not want to. Maybe the free-rider problem is too big and firms are therefore unwilling to invest their time and money to build up distribution channels and raising awareness. This is a classic collective action problem. Since competition is the backbone of the market, firms are rather competitive in nature. For market based solutions to work, social impact businesses have to adopt that competitive nature at least to a certain degree (see chapter 3.5). But this also makes it difficult for firms to work together in raising awareness and creating new markets.

The other explanation for a firm's inability to overcome scaling barriers is that they simply do not have the required capacity: lack of funds, lack of capability or lack of expertise for example when dealing with the government. Yet for market based solutions to work scaling up is essential. For this reason, social impact businesses need help to overcome these scaling barriers. There are many NGO's, foundations and development agencies which can help in that case, be it with providing the needed funds, connections, security or expertise.

Since competition is probably the most important element of a market, it is absolutely needed for market based solutions to work. But competition is not generated by supporting single social impact businesses. Rather the industry as a whole needs support. This is where all the NGO's, foundations and agencies really come into play: to facilitate the growth of an inclusive industry - in the role of the industry facilitator.

5.3 The role of the industry facilitator

"Industry facilitators act to resolve scaling barriers, at the levels of both the enterprise and its wider business ecosystem. […] *They may provide financial resources, build capacity, seed new entities, generate knowledge, train producers, educate consumers, broker partnerships, advocate with public policymakers, or even create new institutions.* […] *Different types of organizations can step into such roles, including foundations, official aid donors, mission-driven intermediaries, multilateral development agencies, investors, industry associations, state agencies and parastatals"* (Koh, Hedge & Karmchandani, 2014).

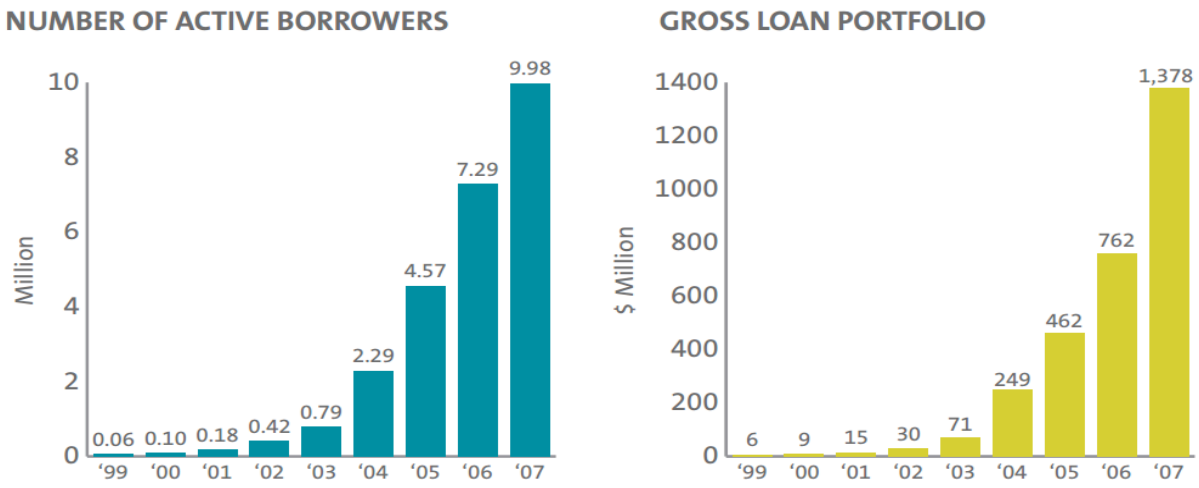
For a social business to grow and even for the whole industry to perform well, industry facilitators are quite important. Without them it is highly doubtful whether market-based solutions and therefore blended finance would work to an extent where they could unfold their potential and generate the desired impact. Industry facilitating has been a success story in many cases. But there are still a lot of unresolved problems which would need facilitating. To see how industry facilitating may work and to better understand industry facilitation we should look at

the different actors involved, the barriers they overcame and how they managed to overcome them. We want to do this by looking at a successful example of industry facilitation.

5.4 Industry facilitation: The rise of microfinance in India

"*Approximately 75 million households* [in India] *need microfinance. Of these, nearly 60 million households are in rural India and the remaining 15 million are urban slum dwellers. The current annual credit usage by these households is estimated to be* [...] *US$ 12 billion"* (Mahajan, Ramola & Titus, 2000).

To a very large extent the rise of microfinance in India was a success story. Inspired by Mohamed Yunus *Garameen Bank* in Bangladesh, established 1983 with the purpose of providing small loans to poor people, Friends of Women's World Banking (FWWB) started in 1992 to experiment with their own microfinance model. In India private moneylenders were already well established but rather famous for usury. Therefore, the demand for cheap microfinance



(Beyond the Pioneer, 2014)

loans was considerable. Starting from Zero in 1992, today there are close to 50 million microfinance borrowers, borrowing a total sum of 10.2 billion USD (miX Market, 2016). This seems to be a huge success, but one should not forget that it took time to build up the Indian microfinance market. At first, in the nineties progress was slow. It was not until around 2004 when the growth of Indian microfinance really accelerated.

Especially important was the period from 1998 to 2005 when the Indian microfinance industry sector built up. In the early nineties the Small Industries Development Bank of India (SIDBI) was supporting over 80 NGO based microfinance institutions. However, growth was small due to limitations in the NGO's legal and organizational structures, which impeded scaling-up. In 1998 the United Kingdoms' development agency DFID partnered with the SIDBI and together they launched a seven years program to promote and scale microfinance institutions in India. With

funding coming from DFID (26.5 million USD), SIDB (23.5 million USD) and the International Fund for Agricultural Development (22 million USD), the partnership aimed at supporting a large number of microfinance institutions and help them to significant scale. Another goal was to increase the involvement of the financial sector in providing financial services (Koh, Hedge & Karmchandani, 2014). To facilitate these goals a new institution was founded – the SIDBI Foundation for Micro Credit (SFMC).

On the other side, the FWWB was still building up microfinance by helping the firms acquire the needed technical and managerial skills and by helping them to develop their business plans. A series of workshops were organized and a policy paper – *Dhakka: Starting Microfinance in India* – was released, putting the issue on the political agenda.

But the banks were still reluctant to lend the needed funds to the newly established microfinance institutions. Therefore, growth was still very modest. It was not until some industry leaders saw the opportunity for the banks to use the support of the Indian Reserve Bank by using the existing Priority Sector Lending (PSL) mandate when growth really started to accelerate. The use of PSL encouraged banks to give greater access to funds at lower interest rates.

The final barrier for the microfinance institutions to overcome was their legal construction as nonprofit organizations. Because of that they were unable to receive equity investment, which would allow them to borrow from the capital market and therefore give out more loans. The solution to that problem was simple: The microfinance institutions were allowed to transform themselves into for-profit non-banking financial companies.

Today Indian microfinance is a vibrant industry and with a customer base of 50 million it is not too far away from the 75 million in need of microfinance. The rise of microfinance was only possible because various facilitators helped to overcome the barriers.

5.5 Lessons to be learned

There are a few lessons to be learned from the case of Indian microfinance:

1. The Product: The product was right. Microfinance loans in India had strong characteristics of pull products. There was a strong demand for microfinance loans at a relatively cheap interest rate.
2. Time: Even if there was a strong demand for the product, the development of the market took a long time. Multiple barriers to scale had to be overcome at different stages in the market's developing phase. This would not have been possible without the crucial help of industry facilitators.

3. Overcoming barriers: Various industry facilitators such as the SFMC, the FWWB or the UK development agency played important roles in developing the Indian microfinance market. The endeavor was successful because each facilitator took on a very specific role. If one tried to do it all alone, he would probably have failed. Moreover, the Indian microfinance case shows the importance of developing the industry as a whole, rather than single companies.

6 Results and conclusion

This study has shown that in order to reach the SDGs by 2030 and fill the prevailing investment gap, much more involvement from the private sector is needed. It has introduced blended finance as a potential solution that can help fill this gap. If the right conditions and partnerships are put in place, there is room to tap into the global financial resources and direct them towards SDG-related sectors (Zhan, 2015, p. 3). By using public funds in a way that make investments in social impact businesses more attractive, blended finance can crowd in private capital and tap into new sources of financing. This so-called leverage effect can be achieved by either reducing risks or raising returns of an investment.

Chapter 3 has given an extensive overview on the specific mechanisms and instruments of blended finance as well as its potential to attract additional private funds for impact investments. A social impact business should be careful when choosing an investment vehicle, since each of the ten instruments presented in this study has its own advantages and risks. We have also shown that not every instrument is appropriate for every stage of a project. Choosing the right instrument requires a detailed assessment of the company's situation and the market environment. As a rule of thumb, informal markets with weak governance structures, intransparent bureaucratic procedures and institutional voids require an instrument that focuses on risks. However, if the company operates in a relatively stable, well-governed market environment, instruments focusing on higher returns may be more successful in attracting private capital.

The further course of this study has shown the importance of impact measurement. What sounds well in theory, may fail in practice if there are no appropriate methods of measuring the impact generated by a social business. In other words, the leverage can often only be created if companies are able to deliver results in terms of outcome and impact. Most methods and tools implemented by venture philanthropy organizations and social investors follow a general 5-step process when measuring impact. Yet finding the right tool to measure social performance can be hard because of a lack of standardized procedures and little agreement on a set of hard-and-fast metrics. In fact, most venture philanthropy organizations and social investors are not using a standardized tool to measure social impact. Still, in order to direct the available funds to the most delivering social investments, concrete measures are needed. The topic of impact measurement is therefore likely to gain increasing attention from scientists and practitioners alike.

Chapter 5 focused on the scaling up of social impact businesses. The upscaling phase in a company's life cycle is where blended finance can make its biggest contribution. A small scale

company has to overcome many barriers on its way to a large scale business. The lack of financing is only one of the many challenges a company has to face. Many barriers cannot be overcome by innovative investment vehicles and technical assistance. Hence, blended finance needs to be complemented by other supporting mechanisms. This support can be provided by an industry facilitator in the form of networks, consulting and expertise. Development agencies, NGO's and foundations should therefore take a close look at companies in need of financing and carefully assess their need as well as the way they intend to help. Finding the right set of financial and non-financial support is crucial in order to support social impact businesses in an efficient, expedient manner.

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