

FROM WHERE WE WERE TO WHERE WE STAND

ESG SERIES

## Blended Finance

To actually shift capital and enable ambitions to become reality, investment projects need a clear purpose and should find the right mix of public and private investment.

A blend of public/private money has certainly achieved a wealth of success in the past. Consider the steamboat line between New York and New Jersey in 1808, the creation of the Suez Canal in 1869, which connected the Mediterranean and Red Sea; or the construction of the Eiffel Tower in 1889, the world's highest at the time.

Can we draw on past examples to recognise why some were successful and others were not? Perhaps they could allow us to learn from recent mistakes and help us visualise a more verdant road ahead? It might be one where businesses, governments and private investors work together to achieve common goals? As Maya Angelou once said, "You can't really know where you are going until you know where you have been".

Past examples have commonly succeeded when driven by ambition – a dream or passion. Certainly, green projects need to demonstrate positive externalities as well as positive financial returns. Yet that need not make the role of finance overly complicated either. In the end, project finance exists simply to structure funds using the best available approaches. It exists so that the dream becomes a reality.

This series also includes:

**Enabling, not labelling**

Why an obsession with labels will disenfranchise investors from choice

**Meaningful influence**

Why investors must play a more significant role in public policy development

**Enlightened engagement**

Why the concept of active ownership might have lost its way

**True climate impact**

Why managing climate investment risk alone will not fix climate change





This is the first paper in our sustainable investing series – a collection of insights that delve into the detail of what’s really happening in ESG investing today, as well as exploring some of the structural elements that we think are set to evolve in the industry...

## Key findings

- **A golden age:**

From the construction of the Pont Neuf to the financing of the Eiffel Tower, a look back at how modern Paris was created can hold many lessons for those looking to ‘blended finance’ as a step in the right direction towards a more sustainable future.

- **The right blend:**

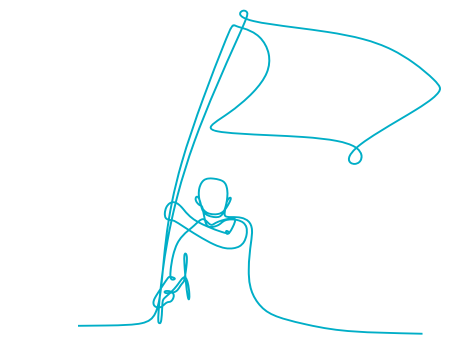
As in the past, modern blended finance uses public interventions to encourage private investment, the result of which can finance projects or businesses that, under normal circumstances, would be considered ‘un-investable’.

- **A meeting of minds:**

Blended finance requires real expertise – first, to find viable projects, then to sell what can be complex deals to private investors. To do this, asset managers have been adding to their skills – employing agronomists or forestry experts, for example, to help them analyse new deals.

- **The longer-term challenge:**

Practitioners must be clear about how they intend to change the market, with the grander aspiration being to create systemic change in the marketplace – the kind that will catalyse further investments while keeping the market inclusive and sustainable.



You can’t really know where you are going until you know where you have been.

**Maya Angelou**

Writer, poet, civil rights activist



## Aiming higher

In the US, the combination of public and private investment enabled many of the early infrastructure projects to be realised. Consider the Philadelphia and Lancaster Turnpike road in Pennsylvania, initiated in 1792, or the steamboat line between New York and New Jersey in 1808. Indeed, many of the railroads, including the nation's first, chartered in New Jersey in 1815, were built by a blend of public and private money – as was most of the modern electric grid.

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### The construction of the Eiffel tower represented an early feat of financing – and one of the first examples of modern project finance

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In Europe too, the construction of the Eiffel tower represented an early feat of financing – and one of the first examples of modern project finance. To celebrate the centenary of the French revolution, the French republic decided to hold a world's fair in 1889 that was intended to showcase French engineering. The proposed project to build the world's highest tower would cost 6.5 million francs (approximately €20 million today), for which the state would provide 1.5 million francs. The balance was to be paid by the monument's operations during the fair and over the subsequent two decades.

At the end of the first decade, the Eiffel tower was to be turned over to the city of Paris. Gustave Eiffel created a limited liability company that issued two kinds of shares (including French ordinary shares, similar to convertible bonds) which began trading soon after the tower opened. Repayment to the LLP was made one year after the tower opened to the public and began collecting tickets. Eiffel, the shareholders and the state profited substantially, and the arrangement lasted for more than a century.

However, the key thing for the project to be successful back then – as is true today – was that it had to be driven by a clear articulated purpose. That's not to say that financiers, too, must always share that purpose: they are fundamentally incentivised by profit. But the point worth remembering is that Gustave Eiffel didn't want to build the most profitable tower, he wanted to build the tallest. If money really was all he was interested in, he'd have probably put a casino on the lower deck.

## A golden age

Paris' past holds many lessons for those looking to blended finance as a more sustainable step into the future. The story of its growth is elegantly told in *'How Paris Became Paris: The Invention of the Modern City'*, by Joan DeJean. In the book, Joan describes how, over the centuries, the French kings have driven many of the developments that have made Paris the city that it is today. Yet many of them were not financed from the king's coffers.

In the 17th century, Henri IV, realised he could never accomplish as much as he wanted, and so quickly, without turning to innovative financing mechanisms, and private investors. His two successors followed in his footsteps. These examples have some striking parallels with today's

discussions about sustainable finance, and some lessons for ESG enthusiasts as well.

Many of Paris' quintessential landmarks – the Place des Vosges, the Île Saint-Louis, the Place Vendôme – began as royal visions and benefited from royal support, but were carried out on a for-profit basis by financiers and real estate developers. Some made fortunes, while others lost everything, illustrating that – like today – few investments are risk free.

For example, consider the Pont Neuf. The bridge that existed before it, the Pont Notre Dame, had been completed in 1510 and, in the manner of medieval bridges, its construction had been paid for by the houses and shops built on top of it. The king, however, wanted the Pont Neuf to be building-free, in order for the walking public to be able to take in the spectacular sights that Paris offered from the bridge. Therefore, he came up with a previously untested funding mechanism: the king levied a tax on every cask of wine brought into Paris.

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### Many aims captured in the SDGs were the subject of cooperation between governments and investors in Paris 400 years ago

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Thus, as was said at the time, “the rich and the drunkards” paid for this urban work. Perhaps, one could argue, that it is with very similar logic today that many economists are calling for a ‘carbon tax’ to finance the energy transition?

In 1604, when the Pont Neuf opened to the public, the king had already begun laying the groundwork for another project. He desperately wanted to jump-start the Parisian economy and decided to launch a silk industry in the French capital. What began as an attempt to revitalise the economy evolved in ways no one could have predicted: the project resulted in the creation of both a groundbreaking model for the city square – the Place de Vosges – and a major new neighbourhood, the Marais.

To realize his design, Henri IV turned to six wealthy tradesmen. The king offered them nobility and tax-free business conditions for the silk manufactory. In return, he asked only that they promise to keep the new silk manufacture operational until 1615.

Today, in sustainability circles, this approach would probably be called ‘impact investment’. After all, many of the aims that are now captured in impact investors’ preferred reference framework, the UN Sustainable Development Goals (SDGs) – Decent Work and Economic Growth (SDG 8), Industry, Innovation and Infrastructure

(SDG 9), Partnerships for the Goals (SDG 17) – were already the subject of cooperation between governments and investors in Paris 400 years ago.

And had the wealthy tradesmen not been incentivised by the tax-free conditions – a mechanism that is very similar to the guarantees and subsidies that are now used in blended finance – the initiative might have never left the drawing board phase.

It’s where governments first realised the important role investors can play in economic development, in technical innovation, and in solving the world’s problems. And it’s where proactive investors came to the table with capital and smart ideas to make the visions of kings and governments a reality.

## The right blend

Fast forward to today and estimates suggest that a whopping \$6 trillion a year is needed to fully meet the UN SDGs. It’s clear more needs to be done to get capital flowing, particularly to developing countries. The burning question for investors, therefore, is how can they contribute more effectively to addressing some of the world’s most significant challenges?

Innovative thinking is certainly required when looking to shift capital into the areas that most need investment. As in the past, modern blended finance uses public funds or government support to encourage private investment, the result of which can finance projects or businesses that, under normal circumstances, would be considered ‘un-investable’.

Governments effectively provide a safety net – their co-investments and guarantees unlock private investment by lowering risk or enhancing returns and, in many ways, transform the ‘un-investable’ into the ‘investable’. But government financing also provides time for investments to build a proper track record – to prove they can deliver not only positive social or environmental impact, but also the profits, cash flow or dividends that investors depend on for returns.

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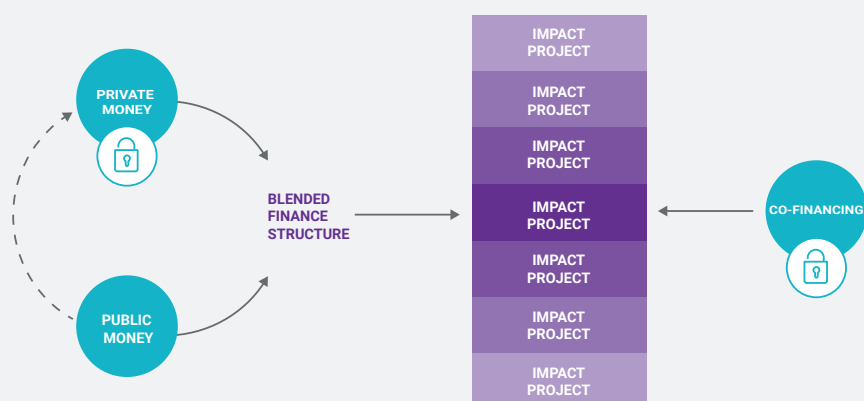
**To investors, blended finance can offer market returns or better. But the advantages go far beyond the financial aspects**

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Blended finance deals usually build in impact measurement from the start. The International Finance Corporation’s (IFC) Operating Principles for Impact Management offer a good framework in this respect. Once a track record is established, the need for public funds diminishes, or disappears altogether. Investors can analyse performance and assess risk, just as they would with more conventional financing.

From an asset manager’s viewpoint, blended finance requires real expertise – first, to find viable projects, then to sell what can be complex deals to asset owners. To do this, asset managers have been adding to their skills – more are employing agronomists or forestry experts, for example, to help them analyse new deals.

### Making blended finance work





To investors, blended finance can offer market returns or better. But the advantages go far beyond the financial aspects. In developing countries, blended finance can reduce reliance on overseas aid or philanthropy. Pooling resources means more investment at scale.

Most importantly, money goes to the areas that need it most: to help in the fight against climate change and biodiversity loss, and to build better, more sustainable livelihoods for local communities.

## Path to progress

As institutional investors get more comfortable with infrastructure and private debt, they are becoming more interested in blended finance deals or funds as a route for them to start investing in emerging markets. These types of solutions can be pivotal in allowing projects to go ahead in situations where extensive risks make financing on commercial terms unachievable.

On the other hand, concessional funds are misspent when they support an investment that would also have proceeded without them. It is therefore essential for blended finance practitioners to be clear about how they intend to change the market, and to think carefully about the role of blended finance in that process. The grander

aspiration should be to create systemic change in the marketplace – the kind that will catalyse further investments while keeping the market inclusive and sustainable.

Several recommendations are succinctly captured in a recent paper, *'The Investor's Guide to Impact'*, by Florian Heeb and Julian Koelbel, researchers at the Center for Sustainable Finance and Private Wealth, University of Zurich. They suggest investing in companies that require concessionary financing to scale positive impacts.

"Concessionary investments are one important way to support the growth of enterprises that have a positive effect on the world," says Julian. "Often these enterprises have growth problems, so concessionary lending or equity financing helps them expand their positive impact. We see blended finance as an instrument to increase the efficiency and amount of funding that does this... with lots of potential for combining different sources of funding."

Florian adds: "The strongest sustainability impact you can have is exactly in the spaces where investments are not yet market rate... blended finance allows the mission-driven part to take over and changes the conditions to the point where commercial investors can say, yes, now it's something I can work with that meets my risk-to-return expectations."

Ultimately, solutions like blended finance, while highly complex, are more likely to achieve meaningful change. Success will depend on both governments and companies spurring on a market for this type of finance, thereby creating momentum.

Ashby Monk, Executive and Research Director of the Stanford Global Projects Centre, says: "Once we get momentum, we get scale – then we get somewhere towards tackling the SDGs. But the impact investing space is too small today. Impact that's concessionary needs to be in the service of moving the trillions, not millions."

"It's not just a capital problem, it's a market problem – markets price things, and people buy and sell those things. You need to create that, which requires really smart people to do the due diligence, originate and manage the deals, discount the cashflows and crunch the numbers. Someone with the skills to assess all the different moving parts and who is able to put it all together."

“Many agree that blended finance can enable solutions to societal problems that are becoming more urgent every day. However, structuring blended finance requires a certain financial ‘wizardry’, and most financial wizards tend to work for large financial firms who may have little interest in what they perceive as insignificant or un-investable deals. At the same time, while many of those firms have been vocal on ESG, their approach has suffered from, in the words of *The Economist*, “woolly thinking, marketing guff and bad data”. I believe financial firms can be the powerful enabler of action that they aspire to be, but this requires proactive action to see how their ‘financial wizards’ can contribute their expertise to the structuring of blended finance investments.



**Harald Walkate**  
Head of ESG  
Natixis Investment Managers



## Key recommendations

For the wider adoption of blended finance, it is necessary that a large number of actors in the finance industry play a role. Here are six considerations that can be implemented today:

- 1. Involve chief investment officers, portfolio managers and analysts:** Issues like ESG, impact, climate and the SDGs tend to be the domain of sustainability departments, but they typically do not allocate money or have the necessary finance expertise to structure blended finance deals. This requires the involvement of 'mainstream' investment teams.
- 2. Encourage these mainstream investment people to interact with those seeking to structure blended finance solutions:** The people who decide on the capital allocation for the large institutional investors are generally not known to, or accessible to, governments, development banks, companies or individuals seeking to finance their projects. An international network of 'investment experts' willing to engage on blended finance is required.
- 3. Give them time to analyse blended finance opportunities:** The complexity and customisation involved in blended finance means the time spent on deals is often disproportionately large compared to the size of the investment. In many cases, involvement of mainstream investment people may not lead to investment but to sharing their expertise, which is still helpful. But they need to know that this is tolerated or even encouraged – as this is unlikely to be mentioned in their job descriptions.
- 4. Be mindful of inherent biases and unhelpful labels:** Owing to subliminal signals in investment literature – pictures of windfarms or impoverished people, or references to 'impact' or SDGs' – coupled with the platforms by which deals reach investors, mainstream investment people may already form prejudices on the 'investability' before analysing the documentation. Projects must therefore be upfront about the risk- return potential and why there is a specific need for public or 'concessionary' capital.
- 5. Include people with 'market maker' expertise:** Structuring blended finance deals is like structuring complex M&A deals, so you need to have those who understand the world of development and SDGs but also the world of Wall Street. This will help bring together the necessary parties and customize the investment so that it fits their risk-return profiles. Investment bankers and M&A lawyers could also play an important role here.
- 6. Bring asset owners on-board:** Our research shows that pension funds and insurance companies would like to allocate more to impact investment but that they are also looking for investments that match the liabilities on their balance sheets. They would be interested in investment opportunities that do both but need to be satisfied that capital will be allocated according to their requirements.



From 'impact' investments....  
to 'blended finance' that meets risk/return  
requirements of large institutional investors.

To actually 'shift' capital and enable ambitions  
to become reality, investment projects  
need to have a clear idea of purpose  
and need to find the right mix  
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## Additional Notes

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