

# Alternative Financing Structures for Social Investment

## Review Findings

SEPTEMBER 2015



# Introduction

## Background

- Big Society Capital was set up in 2012 to build the social investment market in the UK
- During 2015, Oliver Wyman carried out a review for Big Society Capital into types of financing instruments used by development finance institutions and the lessons for social investment. The review covered:
  - Available financing structures, their mechanisms, objectives and purposes
  - Level of usage by development finance institutions
  - Opportunities for deployment of these schemes to grow social investment (with a focus on the UK)
- The Oliver Wyman team conducted desk-based research and interviewed a range of development finance institutions to understand their approaches and experience with different financing instruments
- The project was conducted within Oliver Wyman's Social Impact programme
- This document provides a summary of the research and frameworks developed during the work

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# Executive summary

- Most development finance institutions use a wide variety of financial instruments
  - Debt and equity remain the key instruments for most organizations
  - Most development finance institutions also use guarantees – though not all, with caution needed around alternative financing due to adverse selection issues and the balance sheet impact
- Instruments are typically deployed within broader financing schemes
  - Schemes are designed to serve specific market needs
  - Support can be at different parts of the finance value chain – whether providing capital directly or supporting intermediaries
  - Most institutions provide active support within schemes, often providing technical assistance for intermediaries
- Approaches to returns vary depending on mandates or state-aid restrictions – most development finance institutions have a tolerance for below market returns or losses in particular portfolios/schemes
- In the social investment market, alternative financing schemes could be used to directly support front line organizations, support intermediaries (funds or banks) or distribute and mobilize investor funds
  - Key bottleneck appears to be on the demand side (front line organizations) and in identification of investible opportunities
  - Findings from investor impact surveys highlight the demand for risk protection and technical assistance
- Some of the potentially most useful schemes to stimulate social investment would be
  - Guarantees for investment into front-line organizations to improve the perceived risk-return for investors
  - On-lending programmes for liquidity-constrained lenders to finance front line organisations
  - Guarantees for investment into intermediaries, allowing funds to leverage up, potentially where track record is unproven
- Best practices identified suggest development finance institutions should start by identifying the end-user needs it seeks to address, then consider the appropriate financing instrument, distribution partners needed and then design the overall scheme

# Development finance institutions help to deploy funds and develop their underlying markets

## Selected development finance institutions

|  |   | Sector/market focus  | Mission/objectives   | Approach to own returns   |
|--|---|--|--|---|
|    | <b>International Finance Corporation</b>                | <ul style="list-style-type: none"> <li>Private enterprises and infrastructure projects in developing countries</li> </ul>  | <ul style="list-style-type: none"> <li>Aid private sector in developing countries bridge gaps, by mobilising finance and promoting open markets</li> <li>Provide good jobs and essential services to the poor</li> </ul> | <ul style="list-style-type: none"> <li>Market returns</li> <li>Some exceptions (e.g. concessional finance)</li> </ul>                     |
|    | <b>Kreditanstalt für Wiederaufbau Group</b>             | <ul style="list-style-type: none"> <li>Germany: SMEs, housing, education, infrastructure</li> <li>Abroad: trade/project finance, businesses in transition countries</li> </ul> | <ul style="list-style-type: none"> <li>Sustainable improvement of economic, social and environmental conditions globally</li> <li>Emphasis on promotion of the German economy</li> </ul>                                 | <ul style="list-style-type: none"> <li>Below market (but &gt;0)</li> <li>Open to &lt;0 in some programs (e.g. venture capital)</li> </ul> |
|    | <b>European Bank for Reconstruction and Development</b> | <ul style="list-style-type: none"> <li>Private enterprises (corporate, energy, and finance), infrastructure projects in transition economies (e.g. eastern Europe)</li> </ul>  | <ul style="list-style-type: none"> <li>Foster innovation and building sustainable and open-market economies</li> </ul>   | <ul style="list-style-type: none"> <li>Market returns</li> <li>Some exceptions</li> </ul>   |
|    | <b>Green Investment Bank</b>                            | <ul style="list-style-type: none"> <li>Green projects in the UK (energy efficiency, renewables etc.)</li> </ul>  | <ul style="list-style-type: none"> <li>Back green projects on commercial terms</li> <li>Mobilise other private sector capital into the UK's green economy</li> </ul>   | <ul style="list-style-type: none"> <li>Market returns</li> </ul>  |
|    | <b>Small Business Administration</b>                    | <ul style="list-style-type: none"> <li>US SMEs (also some disaster relief projects covering private individuals and large companies)</li> </ul>                                | <ul style="list-style-type: none"> <li>Aid, counsel, assist and protect the interests of small businesses</li> </ul>   | <ul style="list-style-type: none"> <li>Below market (&gt;0)</li> <li>"Zero tax payer cost"</li> </ul>                                     |
|  | <b>British Business Bank</b>                            | <ul style="list-style-type: none"> <li>UK SMEs</li> </ul>  | <ul style="list-style-type: none"> <li>Increase effectiveness and dynamism of financial market for smaller businesses</li> </ul>   | <ul style="list-style-type: none"> <li>Below market (&gt;0)</li> <li>Some programs "base case" is 0 (e.g. help to grow)</li> </ul>        |
|  | <b>European Investment Fund</b>                         | <ul style="list-style-type: none"> <li>European SMEs (including social enterprises)</li> </ul>   | <ul style="list-style-type: none"> <li>Help European SMEs to access finance by designing financial products, working with intermediaries and providing risk capital</li> </ul>   | <ul style="list-style-type: none"> <li>Market returns</li> </ul>  |
|  | <b>Big Society Capital</b>                              | <ul style="list-style-type: none"> <li>UK Social finance</li> </ul>  | <ul style="list-style-type: none"> <li>Develop social investment market in the UK</li> <li>Raise awareness and confidence in social investment</li> </ul>  | <ul style="list-style-type: none"> <li>Below market (single mid digit)</li> </ul>   |

# Most development finance institutions use a wide variety of tools and schemes to stimulate their markets, including guarantees

## Product offerings

|  |                                  | IFC                             | KfW                          | EBRD                         | GIB            | SBA                       | BBB                          | EIF                      | BSC                       |
|--|----------------------------------|---------------------------------|------------------------------|------------------------------|----------------|---------------------------|------------------------------|--------------------------|---------------------------|
|  | Definition used, £ BN            | Assets and off-balance sheet    | Assets and off-balance sheet | Assets and off-balance sheet | Portfolio      | Portfolio                 | Planned allocation           | Total signed outstanding | Signed deals              |
| <b>Own balance sheet</b>                               | Equity                           | 10.2                            | 1.7                          | 5.4                          | 0.8            |                           | 1.3                          | 6.9                      | ~0.1                      |
|  | Debt                             | 19.1                            | 287.7                        | 15.8                         | 0.5            | 2.6                       | 1.3                          | 0.1                      | ~0.1                      |
|  | Guarantees                       | 3.7 <sup>1</sup>                | 2.8                          | 0.2                          |                | 82.2                      | 0.9                          | 4.4 <sup>2</sup>         |                           |
|  | Other                            |                                 |                              | 0.4                          |                | 5.4                       | 0.4                          |                          |                           |
| <b>Mobilisation of 3<sup>rd</sup> party investment</b> | Syndication                      | ~£2.4 BN new commitments (2014) | Yes                          | 65% external capitalisation  |                |                           |                              |                          |                           |
|  | Securitization                   | 0 new commitments in 2014       | ~£1.4 BN portfolio (2014)    |                              |                | Via SBIC Investment Trust | To be launched               | Offered with guarantees  |                           |
|  | Fund structures                  | ~£0.6 BN new commitments (2014) |                              |                              | To be launched |                           |                              |                          | £0.2 BN via co-investment |
| <b>Services and grants</b>                             | Advisory, market standardisation | Yes                             | Yes                          | Yes                          | Yes            | Yes                       | Some work on standardisation | Yes                      |                           |
|  | Grants                           | Yes                             | Yes                          | Yes                          |                | Yes                       |                              |                          |                           |
| <b>FTEs</b>  |                                  | ~3,900                          | ~5,500                       | ~1,800                       | ~100           | ~2,100                    | ~100                         | ~300                     | ~50                       |

1. Includes trade guarantees. In 2014 IFC made commitment of \$0.3 BN Non-trade guarantees, vs. \$7 BN in trade guarantees

2. Guarantees and securitisations

Source: Institution websites and public reporting, Oliver Wyman analysis

|  |
|--|
| <span style="display:inline-block; width:15px; height:10px; background-color:#0070C0; border:1px solid black;"></span> Primary focus     |
| <span style="display:inline-block; width:15px; height:10px; background-color:#ADD8E6; border:1px solid black;"></span> Secondary focus   |
| <span style="display:inline-block; width:15px; height:10px; background-color:#FFFFFF; border:1px solid black;"></span> Limited/not known |

# Development finance institutions create financing schemes based on underlying financial instruments and other features

## “Alternative financing” framework

### Instruments



|  |
|--|
| <b>Senior debt</b><br>Loans, bonds   |
| <b>Mezzanine debt</b><br>Loans, bonds (1 <sup>st</sup> /2 <sup>nd</sup> loss etc.) |
| <b>Equity</b>  |
| <b>Securitization</b>  |
| <b>Guarantees</b><br>of debt repayment, performance                                |
| <b>Insurance</b><br>Credit, policy changes   |

### Financing schemes



#### Support for front line organisations

- 1 Guarantees for investments into front-line organisations
- 2 Providing finance for on-lending

#### Support for intermediaries

- 3 Guarantees for investments into intermediaries
- 4 Differentiated investments in funds

#### Distribution and mobilization of investor inflows

- 5 Syndicating loans to funds/projects
- 6 Securitising portfolios of investments
- 7 Issuing performance-linked bonds

### Design features



#### Feature examples (*not exhaustive*)

- Targeted purpose of investment (e.g. causes)
- Lower target returns
- Separation of risks (e.g. policy vs. credit risk)
- Combination with grant funding
- Combination with technical assistance

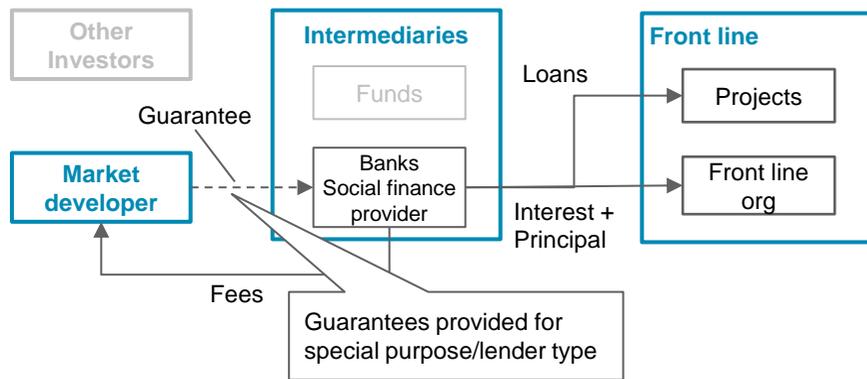
Combinations of schemes possible

# The financing schemes deployed have varying underlying objectives and are suitable in different circumstances

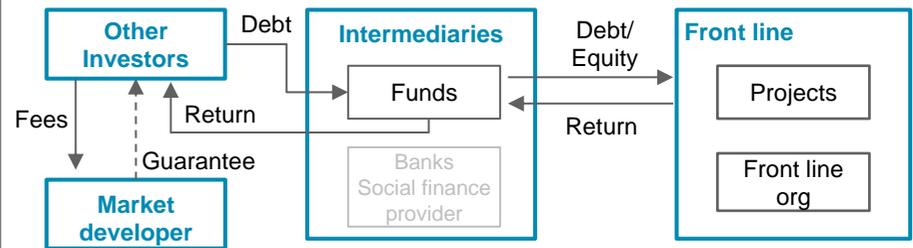
| Objective  | Scheme   | Driver of use   | Examples   |
|--|--|---|--|
| <b>Support for front line organizations</b>              | 1 Guarantees for investments into front-line organisations | <ul style="list-style-type: none"> <li>Improving perceived risk-return for intermediaries in cases of market failure</li> </ul>                     | <ul style="list-style-type: none"> <li>BBB's Enterprise Guarantee</li> <li>IFC's Partial Credit Guarantee</li> </ul> |
|  | 2 Providing finance for on-lending                         | <ul style="list-style-type: none"> <li>Helping liquidity-constrained lenders to finance FLOs; ensuring sufficient margin for lenders</li> </ul>     | <ul style="list-style-type: none"> <li>On-lending programmes for SMEs in developing markets</li> </ul>               |
| <b>Support for intermediaries</b>                        | 3 Guarantees for investments into intermediaries           | <ul style="list-style-type: none"> <li>Allowing funds to leverage up, potentially where track record is unproven</li> </ul>                         | <ul style="list-style-type: none"> <li>SBA's SBIC programme</li> </ul>   |
|  | 4 Differentiated investments in funds                      | <ul style="list-style-type: none"> <li>Helping higher-risk funds to launch; taking riskier positions to attract new/unfamiliar investors</li> </ul> | <ul style="list-style-type: none"> <li>EIF's Private Equity programme</li> </ul>                                     |
| <b>Distribution and mobilization of investor inflows</b> | 5 Syndicating loans to funds/projects                      | <ul style="list-style-type: none"> <li>Raising sufficient funds to enable large projects / investments</li> </ul>                                   | <ul style="list-style-type: none"> <li>IFC project loans</li> </ul>  |
|  | 6 Securitising portfolios of investments                   | <ul style="list-style-type: none"> <li>Freeing up balance sheet of lenders</li> </ul>   | <ul style="list-style-type: none"> <li>IFC securitisations</li> </ul>  |
|  | 7 Issuing performance-linked bonds                         | <ul style="list-style-type: none"> <li>Attracting new types of investors (e.g. retail)</li> </ul>   | <ul style="list-style-type: none"> <li>Calvert Foundation's notes</li> </ul>   |

# In social investment, different financing schemes could provide support across the investment value chain

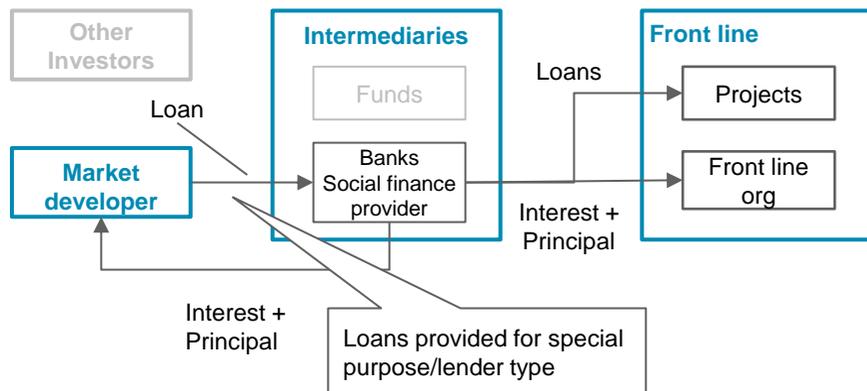
## 1 Guarantees for investment in front line organisations (FLO)



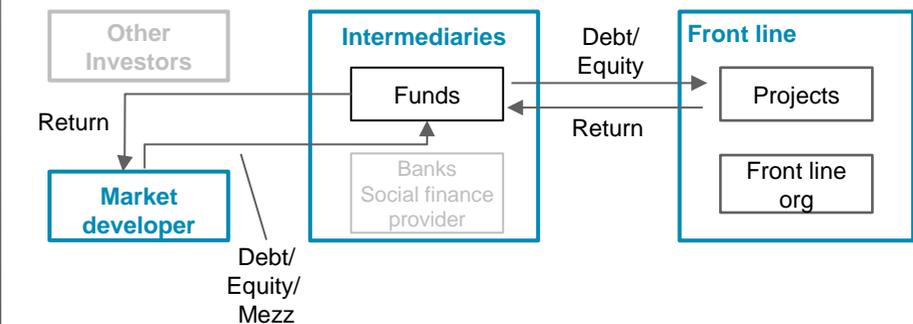
## 3 Guarantees for investment in intermediaries



## 2 On-lending to front line organisations



## 4 Differentiated fund investment



# The Social Investment market sees clear benefits from guarantees and technical assistance

Insights from JP Morgan/GIIN 2015 Impact investor survey

## Views on loss protection

**Lack of appropriate capital across the risk/return spectrum** is seen by respondents as the **#1 obstacle** to growth

**Credit enhancement** is the **most useful** government policy offered according to respondents

**34%** of respondents participated in an investment with a **loss protection feature** in 2014

## Views on technical assistance

Survey respondents identify **Business model execution and management risk** as the **key risk** in impact investment

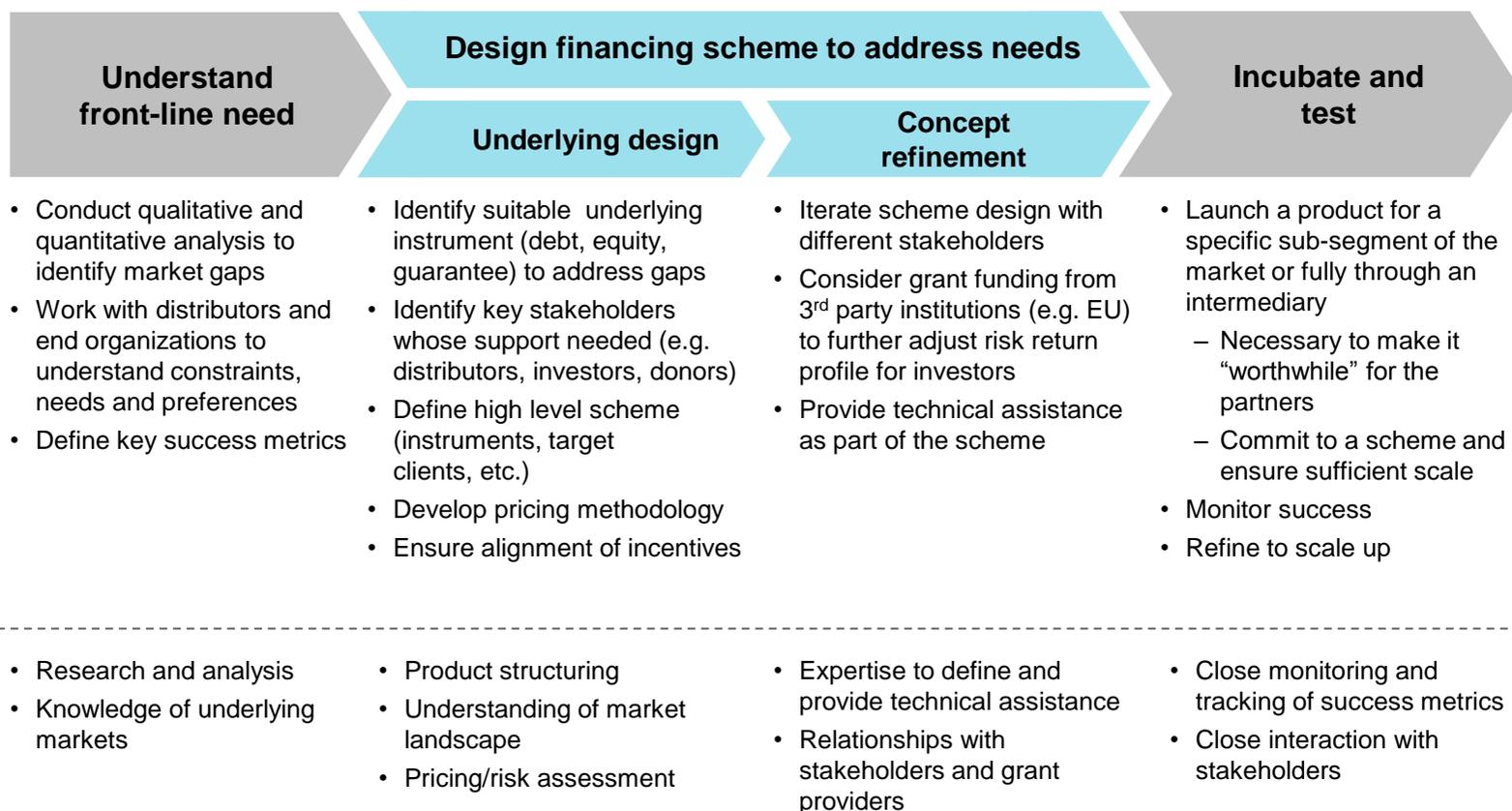
**73%** of impact investors **provide technical assistance** as part of their investments

**76%** of investors providing technical assistance fund it from **own funds**

Source: JP Morgan/GIIN "Eyes on the Horizon: The Impact Investor Survey", May 2015

# Identifying and understanding the end-user need is the critical first step in any financing scheme

## Best practice scheme creation process



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