CHAPTER 3. Do leverage ratios indicate additionality?

Every dollar of concessional finance can mobilize four dollars of commercial finance. However, whether those four dollars deliver a sustainable development impact will determine if blended finance can bring both financial and development additionality.

Key recommendation: Donors and the wider blended finance community can expand the pool of blended finance by:

i. reducing transaction costs related to the exploration, negotiation and conclusion of blended finance transactions;
ii. exploring how donors can provide not only first-loss financing but also lending at commercial rates, whereby returns on these investments can be put aside for reinvestment into the same or other blended transactions;
iii. continuing to provide grants for technical assistance for SMEs and domestic lenders, as they bring high financial and development additionality;
iv. sharing data, reducing transaction costs and collaborating on cofinancing through the creation of a multi-donor working group, supported by a sustainable finance knowledge hub.

The findings and recommendations on blended finance challenge donors to continue experimenting with blended financing, despite difficulties in determining if their investments are bringing both financial and development additionality. The discussion that follows also makes the case for a multi-donor working group supported by a sustainable finance knowledge hub that will help donors share data and due diligence and therefore reduce the transaction costs of blended financing. Such a working group will also provide the much-needed space for donors to share their experience, concerns and priorities, and collaborate on cofinancing to scale up blended transactions in the years ahead.

Donors are experimenting with blended finance

The appetite among donors and DFIs to experiment with blended finance is growing (see Box 5). The rise in climate finance, as witnessed at COP28 in the United Arab Emirates, and the increasing interest in nature and biodiversity finance, as a follow-up to the Kunming–Montreal Global Biodiversity Framework, promises to provide even more impetus for blending in the years to come.

Box 5 **- How donors are participating in blended finance: tranches and types of funding with examples**

First-loss	**Inter-American Development Bank Invest, the Global Environment Facility (GEF) and the Government of Luxembourg are amongst the first-loss financiers to the Land Degradation Neutrality (LDN) Fund, launched in 2017. The LDN Fund has a target of US$300 million, of which roughly 20–30 per cent is reserved for first-loss capital (Principles for Responsible Investment, 2019).** **The Ministry of Foreign Affairs of the Netherlands provided AGRI3 with a US$35 million non-interest-bearing grant repayable after 20 years as first-loss junior equity (Green Finance Institute, n.d.).**
Equity	Proparco provided an equity investment of EUR 5 million to the Moringa Investment Fund, which focuses on sustainable agroforestry. Proparco also provided the fund with technical assistance to the value of EUR 200,000 (Proparco, 2013). In 2021, the African Development Bank (AfDB) and the European Investment Bank approved equity investments of US$10 million and US$18 million, respectively, in the ARCH Cold Chain Solutions East Africa Fund. The funds support the development, construction and operation of greenfield cold storage, temperature-controlled solutions and distribution facilities in East Africa (AfDB, 2021).
Senior debt	In 2010, KfW Development Bank and the German Federal Ministry for Economic Cooperation and Development committed US$88 million to establish the Africa Agriculture Trade and Investment Fund. KfW Development Bank holds both equity and senior debt. Deutsche Bank provided US$26 million to the fund, and private investors committed a further US$25 million (Burwood-Taylor, 2014).
Guarantees and risk mitigation instruments	USAID, through its former Development Credit Authority, provided credit guarantees of up to US$250 million to the Sustainable Trade Initiative (IDH) Farmfit Fund, launched in 2018, and credit guarantees of US$37.5 million to the Food Securities Fund, launched in 2022 (Chemonics and Kois, 2021).
Technical assistance	The Norwegian International Climate and Forest Initiative is the anchor investor in the &Green Fund, launched in 2021, committing US$100 million in grants. Of this, US$1 million was ring-fenced for a dedicated technical assistance budget. The first-loss and senior debt providers included the United Kingdom Department for Business, Energy & Industrial Strategy, GEF, the Dutch Entrepreneurial Development Bank (FMO), the Ford Foundation and Unilever (&Green, 2023). The United Kingdom Department for International Development and the Bill & Melinda Gates Foundation provided grant funding to the IDH Farmfit Fund's data and technical assistance activities. The IDH Farmfit Fund includes first loss from USAID and senior debt from FMO, Rabobank and the companies Jacobs DE, Mondelez and Unilever (IDH, 2023).

Project development grants:	The German Federal Ministry for the Environment, Nature Conservation, Nuclear Safety and Consumer Protection and the Luxembourg Ministry of the Environment, Climate and Sustainable Development are funding the Restoration Seed Capital Facility, providing grants of up to US$750,000 to help launch blended funds for sustainable agriculture (Restoration Seed Capital Facility, 2023). GEF supported the LDN Fund with a grant of US$2 million in 2019 to kickstart the fund (GEF, 2020b).
Results-based financing grants	The SDC funded the Root Capital and Inter-American Development Bank lab to develop and implement the results-based financing project Social Impact Incentives (SIINC). Using these incentives and a US$1 million initial outcome payment, Roots of Impact disbursed US$12 million in loans to 32 high-impact, early-stage agrifood SMEs. These enterprises generated US$48 million in revenue and US$41 million in income for 9,300 smallholder farmers. Over half of SIINC clients (18 of 32) grew their annual revenue, with 41 per cent average growth compared with pre-SIINC levels (Naeve, 2022).

The leverage ratio

The rate at which concessional finance mobilizes commercial finance is known as the **leverage ratio.** While concessional financing is provided by donors and philanthropic foundations, commercial financing is provided at market rates by DFIs and private investors including commercial banks, institutional investors and, to a lesser extent, donors.

The average leverage ratio across sectors has remained consistent over the last five years, with every dollar of concessional financing mobilizing four dollars of commercial financing (see Figure 9) (Apampa, 2023). However, of the US$4.10 of commercial financing mobilized, US$1.80 comes from private investors and the remaining US$2.30 comes mostly from DFIs (see Figure 10).

In the agriculture subsectors, on average, every dollar of concessional financing going to agroforestry mobilizes US$3.80 of commercial financing, of which US$1.60 comes from private investors while US$2.20 comes from DFIs and philanthropic finance. In the agroprocessing subsector, every dollar of concessional financing mobilizes US$3.50 of commercial financing, of which US$1.40 comes from private investors, and the remaining US$2.10 from DFIs (see Figure 9 and 10).

This shows that the blended finance market is dominated by DFIs that often deploy concessional financing to leverage their own commercial financing rather than mobilizing financing from private investors (Convergence, 2023).

Figure 9 - On average, every US$1.00 of concessional financing mobilizes US$4.10 of commercial financing

Leverage ratio across sectors

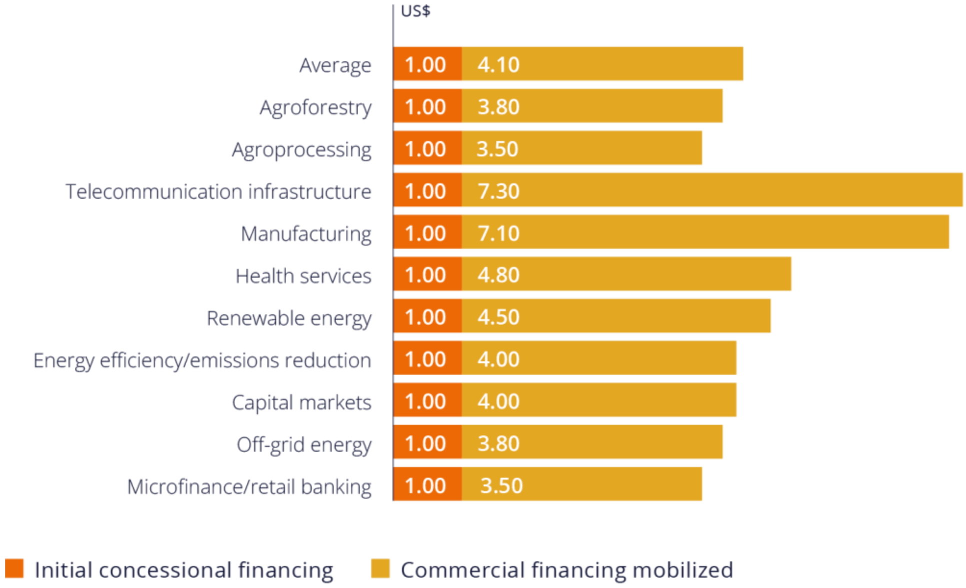


Chart: Lysiane Lefebvre. *Source:* Convergence, 2023

Figure 10 - Less than half of the commercial finance mobilized is sourced from private investors

Breakdown of commercial financing in the leverage ratio, across sectors, in United States dollars

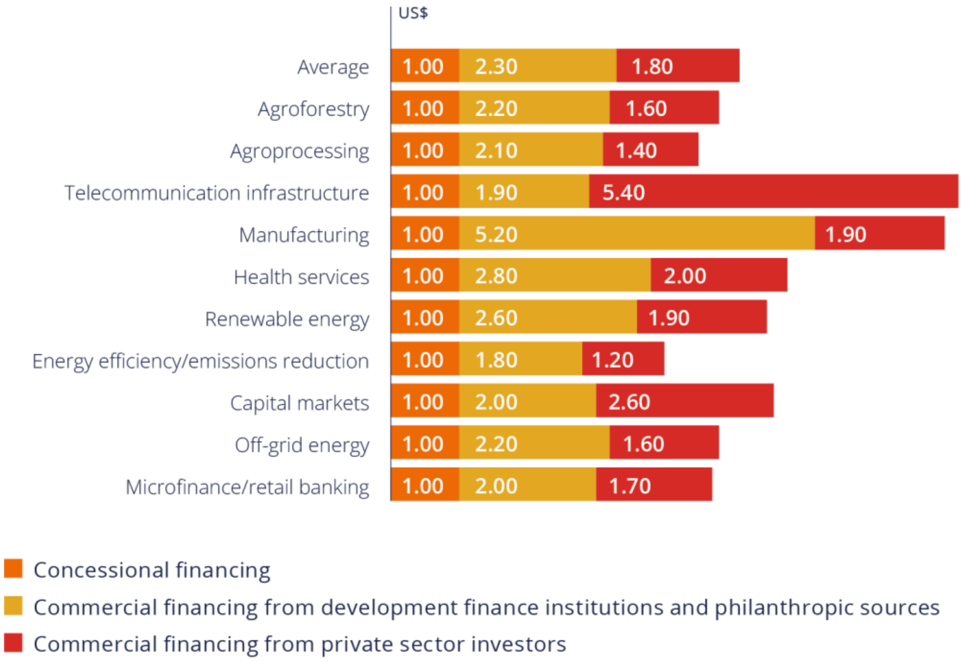


Chart: Kamal El Harty. *Source:* Convergence, 2023

Leverage ratios increase when financing is challenged through intermediaries and local lenders. DFIs and blended funds provide guarantees to local lenders to share loan default risks and encourage local lenders to do businesses with SMEs that they would otherwise consider too risky. Moreover, DFIs and blended funds capitalize on the local lenders' extensive networks to reach a high number of beneficiaries and projects that may be too small for direct financing.

Unlike direct financing allocated to one particular fund or project, this approach typically results in a higher leverage ratio. This is because the leverage ratio also accounts for the total loans disbursed by local lenders. Given their widespread networks, local lenders tend to disburse a larger volume of loans, contributing to an increased leverage ratio for DFIs and blended funds. The examples of AGRI3 and the Financing Agricultural Small-and-Medium Enterprises in Africa (FASA) Fund illustrate this point (see Box 6 and Box 7).

Leverage ratios also increase as blended funds reach maturity over time. As funds mature and demonstrate success in achieving their goals and impact, they gain credibility in the investment community and attract more private sector investment. The share of commercial financing in the fund grows in comparison with the initial share of concessional financing, leading to an increase in the leverage ratio. Furthermore, as the fund achieves positive returns on investments over time, these returns can be reinvested in the fund, thus increasing its financial resources and, ultimately, its leverage ratio.

Box 6 - Leverage ratio of AGRI3

The AGRI3 Fund, launched in 2020 by the United Nations Environment Programme and Rabobank, together with IDH and FMO, aims to unlock at least US$1 billion for DFIs, commercial banks and private investors to finance deforestation-free, sustainable agriculture and land use. The fund will accomplish this mission by offering partial loan guarantees to commercial banks, referred to as partner banks. These guarantees cover 30 to 50 per cent of the exposure on loans ranging from US$5 million to US$10 million for sustainable agriculture projects in developing countries, which the partner banks would typically consider too risky. The fund also provides technical assistance to commercial banks.

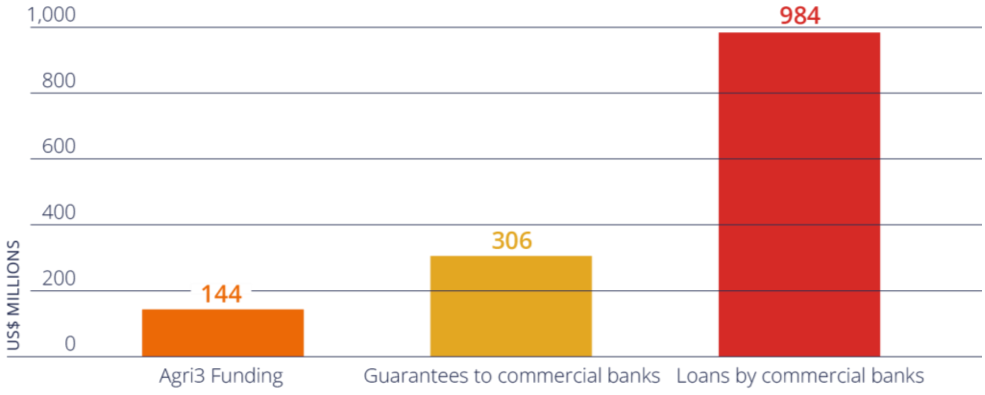
The AGRI3 model is based on extending guarantees to Rabobank, a commercial bank with extensive expertise in agriculture credit risk assessment, and other commercial banks. This enables commercial banks to provide senior debt with extended repayment periods to projects that would have been deemed too risky for financing without these credit enhancements. Additionally, AGRI3 will offer pre- and post-investment technical assistance to the projects being financed. Consequently, AGRI3 can tap into Rabobank's existing client network and leverage its private capital in Brazil, India, Indonesia and Mexico.

The fund aims to achieve a target size of US$144 million to be used to offer guarantees of up to US$306 million to commercial banks, enabling them to unlock US$1 billion in commercial lending to sustainable agriculture projects in developing countries. This will allow AGRI3 to achieve a leverage of seven times the internal funding (see Figure 11).

Figure 11 - AGRI3 Fund expects to achieve a leverage ratio of seven times its financial resources

Expected commercial lending to be mobilized by the AGRI3 Fund

(in millions of United States dollars)



Source: SEO Amsterdam Economics, 2019

Box 7 - The Financing Agricultural Small-and-Medium Enterprises in Africa (FASA) Fund

In September 2023, USAID and the Norwegian Agency for Development Cooperation, each with a preliminary contribution of US$35 million, launched the FASA Fund to increase financing for smallholder farmers and agriculture SMEs in Africa with financing needs of between US$200,000 and US$5 million. The initial commitments from USAID and the Norwegian Agency for Development Cooperation are expected to attract additional contributions from other donors reaching a total amount of US$200 million. This multi-donor fund will then act as fund of funds, providing first-loss financing to 30 to 40 funds with expertise and a track record on smallholder agriculture. By reducing the investment risk for these funds, the US$200 million donor contribution is expected to unlock US$1 billion in commercial financing.

The FASA Fund focuses not only on the leverage ratio – the amount of commercial financing mobilized for every dollar of concessional financing – but also on development additionality. The US$1 billion of commercial financing mobilized is expected to support 500 agrifood SMEs, create 60,000 private sector jobs, benefit 1.5 million smallholder farmers and positively impact about 7.5 million people.

FASA Fund will provide first-loss financing to funds that invest in climate adaptation, crop diversity, regenerative agriculture and the restoration of soil health. The objectives of the FASA Fund are to:

- improve market access for small-scale producers;
- strengthen local value chains;
- promote climate-resilient and gender-inclusive food production;
- enhance food security with a focus on nutrition and biodiversity.

Sources: USAID, n.d.; Marketlinks, 2024; Norwegian Ministry of Foreign Affairs, n.d.

Do leverage ratios reflect additionality?

The principle of additionality suggests that donor financing should only be allocated to programmes and projects that would not be implemented if donor funding were not available. In other words, donors should select projects that would not be financed through the public budgets of beneficiary governments or through commercial investors.

Financial additionality suggests that donor funds should target projects that:

- would not have taken place without donor funds;
- would not have taken have place at the same pace and scale, or under the same terms, and delivered the same impacts if donor funds were not available;
- mobilize co-funding and in-kind contributions that would not otherwise have been mobilized.

Development additionality, on the other hand, relates to impact. It suggests donors should allocate funding to projects to achieve improvements that would otherwise not have occurred. Development additionality is often measured in terms of effectiveness, efficiency, impact and reach.

Donors use a theory of change and customized measurement frameworks aligned to international guidance to measure impact and additionality. Examples include the Donor Committee on Enterprise Development Standard for Results Measurement, the OECD Development Assistance Committee (DAC) Network on Development Evaluation, the Market Systems Approach and the Building Effective and Accessible Markets Exchange. Philanthropic foundations also use a theory of change and frameworks such as the Operating Principles for Impact Management and the Impact Management Platform, as well as the Impact Measurement and Management System from the Global Impact Investor Network.

"Measuring additionality and opportunity costs are very important. The better all of us can measure and learn why we succeeded, the more we can build the investment case for sustainable agrifood businesses."

(Donor agency, Shamba Centre stakeholder enquiry into sustainable finance, 2023)

"Would the impacts have happened without donor spending? Or will it have happened but at a slower pace, or a smaller scale or over a much longer time horizon? These are difficult elements to measure."

(Donor agency, Shamba Centre stakeholder enquiry into sustainable finance)

The most contested debate that cut across this enquiry was if leverage ratios indicate both financial and development additionality. At first glance, high leverage ratios may appear favourable because they show that a significant amount of commercial financing has been mobilized for each donor dollar. However, high leverage ratios alone do not indicate the extent to which the concessional financing from donors launched the project. Nor do they indicate whether development outcomes have been achieved.
Leverage ratios must therefore be accompanied by a comprehensive approach that considers additionality, that is, alignment with development goals, as well as other factors to ensure that the desired positive outcomes for development are achieved without distorting markets (OECD, 2021; USAID, 2023).

Moreover, leverage ratios can vary significantly across sectors, the SDGs (see Figure 12) and geographies (see Figure 13) because of variations in market size and in the potential for commercial returns. An examination of leverage ratios across the SDGs indicates that blended finance works best for SDGs that can generate commercial profits. SDGs 9, 7, 12 and 8, which focus on infrastructure, clean energy and economic growth, have proven to be clear favourites (Convergence, 2023).

Figure 12 - Leverage ratio of commercial financing mobilized across the SDGs varies from 1.5 in SDG 14 to 4.3 in SDG 9

Breakdown of commercial financing in the leverage ratio across SDGs

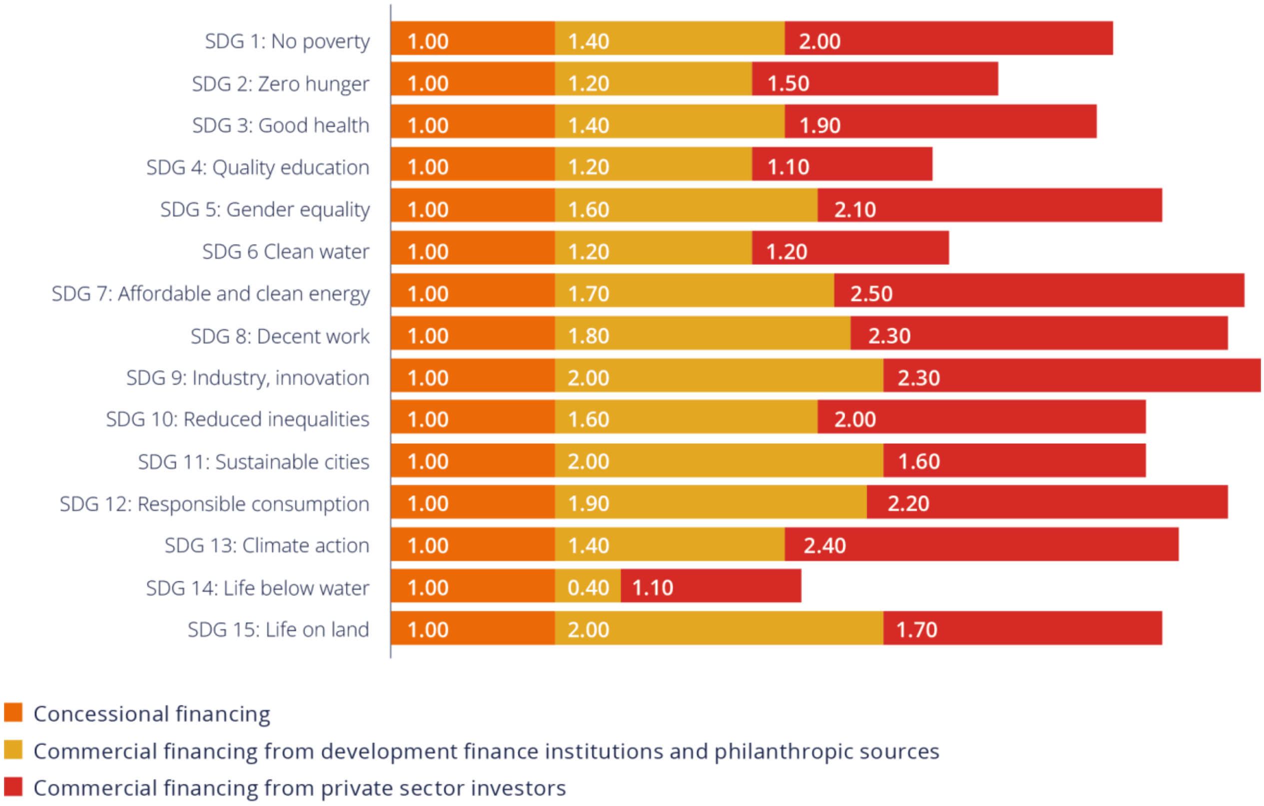


Chart: Kamal El Harty. *Source:* Convergence, 2023

Figure 13 - Leverage ratio of commercial financing mobilized across regions varies from 3.0 in East Asia and the Pacific to 4.7 in Latin America and the Caribbean

Breakdown of commercial financing in the leverage ratio, across regions

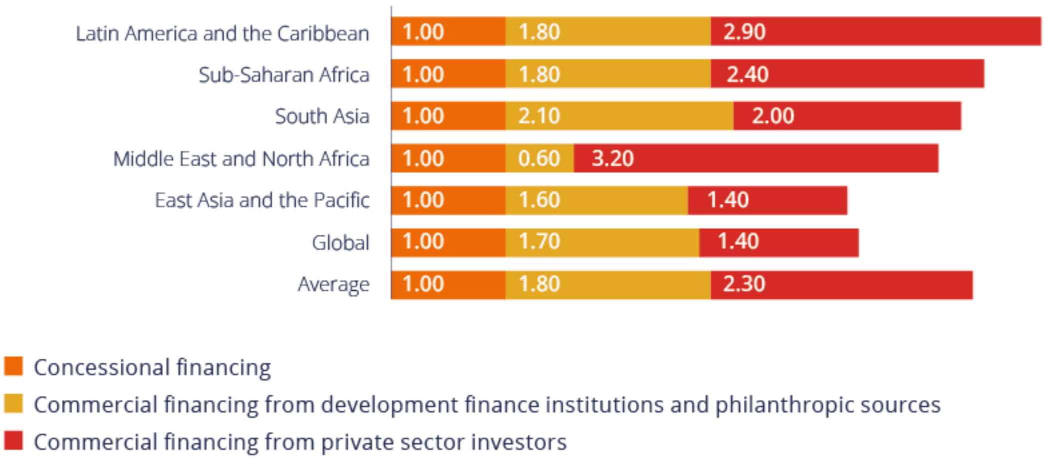


Chart: Kamal El Harty. *Source:* Convergence, 2023

Equally important are the billions of dollars in long-term ODA grants that create the foundation for blended finance. It is these grant investments that help to reduce poverty and support agrifood SMEs as they survive, learn and mature to the level where they may eventually benefit from blended financing. As one blended fund said:

> *"It is public money that is creating the baseline for us to take companies and farmers organizations to the next level of growth, innovation and maturity. Without donors patiently building markets and taking the associated risks of failure, we are nowhere."*
>
> *(Blended fund, Shamba Centre enquiry into sustainable finance, 2023)*

Donors remain cautiously optimistic on blending

As large cross-sections of the agrifood economy remain poor and not sufficiently profitable to meet the expected returns of blended funds, donors remain cautious on overemphasizing the opportunities of blended financing. Some also question if the political mood for collaborating with private sector investors outweighs the opportunity costs and if scarce ODA grants should even be deployed to explore blended transactions, as many of them may not materialize.

> *"There is too much attention on the photo opportunity in the launch of a blended fund. Politicians want to be seen to be working with the private sector, but the reality is that agrarian communities remain too poor for blended financing. Should we not continue traditional long-term grants to build these communities rather than invest in exploring blending, which, at the end of the day, does not help relieve poverty?"*
>
> *(Donor agency, Shamba Centre enquiry into sustainable finance, 2023)*

> *"Completing the due diligence on a blended financing transaction takes a lot of time. We need to make sure that the project financial and development impacts [are] feasible, and that commercial lenders will not make excessive gains. We also need to study how we can increase additionality. All this takes times."*
>
> *(Donor agency, Shamba Centre enquiry into sustainable finance, 2023)*

Despite the above reservations, donors view blended financing as an inevitable and important strategy for closing the SDG 2 financing gap, and an approach that they need to better understand, manage and lead. Donors are building internal expertise on structuring funds and exploring how they can directly finance projects, as opposed to financing an intermediary.

Moreover, donors are studying how they can move from providing first-loss policies to taking equity and mezzanine or senior debt positions. The latter financing tranches bring market rate returns, which donors are seeking to ring-fence and reallocate to results-based financing within the same fund. This is already evident in blending data. Between 2015 and 2020, development agencies and multi-donor funds predominantly offered concessional financing: 87 per cent of their blended finance commitments were provided under concessional terms, with the remaining 13 per cent priced at commercial rates in the form of senior debt, commercial rate equity and mezzanine debt (Convergence, 2021) (see Figure 15).

As one donor said:

> *"We need to make our de-risking financing work even more. Traditionally, we provide first loss. But now, we are looking to change the way we are governed to invest in blended funds directly and to take mezzanine debt. This is new for us – as donors, we receive returns on our investments, so we need to organize how to deal with these returns. We are now studying how these returns can be retained and reused – either in the same blended fund and/or for outcome-based financing (or pay-for-performance financing)."*
>
> (Donor agency, Shamba Centre enquiry into sustainable finance, 2023)

Donors are also encouraged by the ongoing innovation in blended funds: in their success in crowding in domestic investors, making lending conditional on environmental and social performance, targeting investment in women-led and rural businesses, and de-risking by cementing trust between agrifood SMEs and their contracting wholesalers and traders further up the value chain (see Box 8 and Chapter 7).

Box 8 - AgDevCo investment in Jacoma Tropha

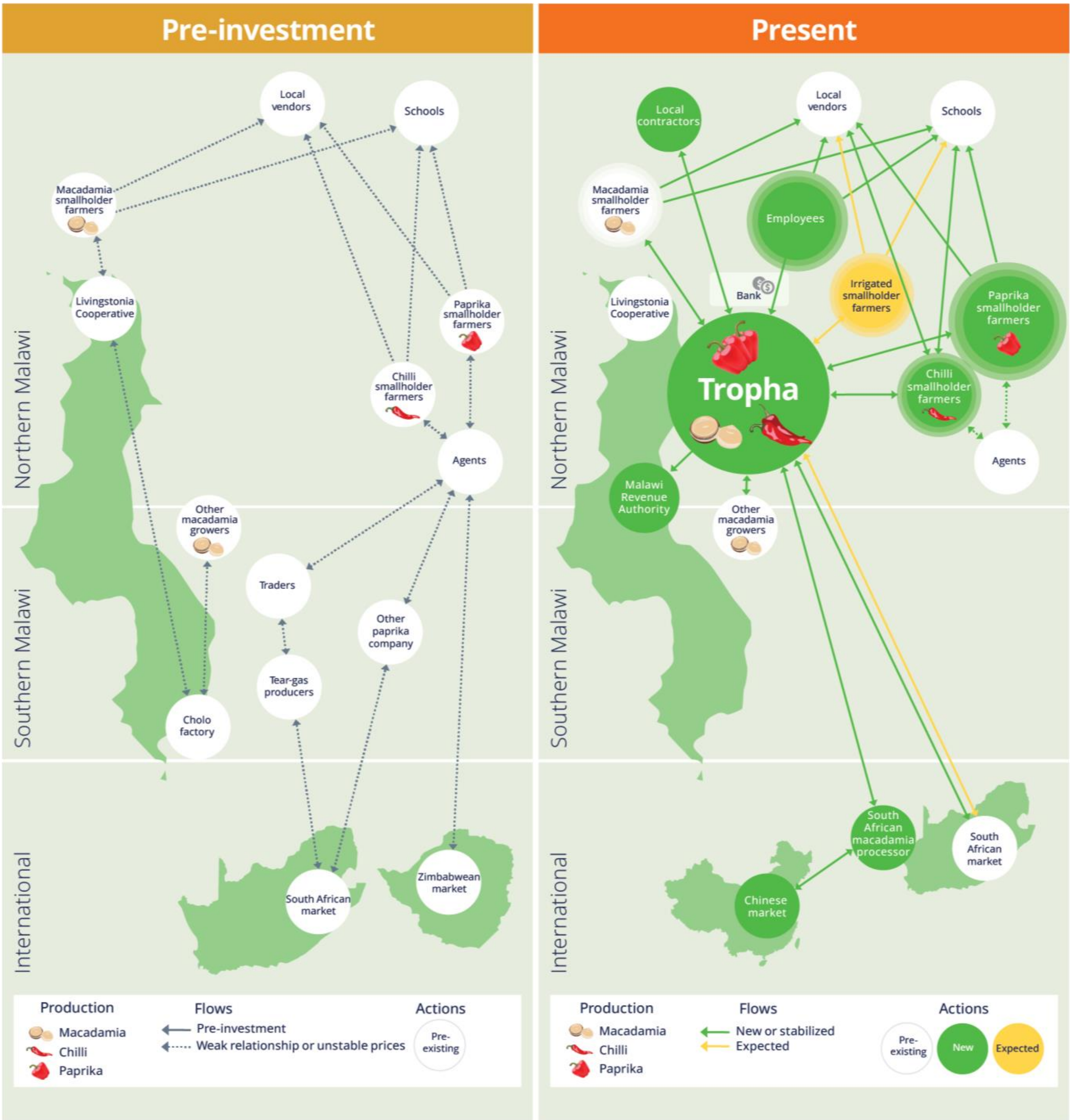
AgDevCo has been an investor in Tropha since 2014, committing US$6.1 million in loans and US$2 million in equity. Tropha, the Malawian subsidiary of the United Kingdom-based farming company Jacoma Estates, owns irrigated farming estates growing macadamia, chili and paprika in northern Malawi. It buys, markets and processes the crops from smallholder farmers who, as a part of the Tropha outgrower scheme, are also provided with credit and technical assistance. The entire Tropha outgrower scheme supports 4,000 smallholder farmers, 47 per cent of whom are women.

As a shareholder in Tropha, AgDevCo contributes to the strategic direction of Tropha's outgrower strategy. It has catalysed an additional US$8 million of equity from British International Investment (previously the CDC group) and grant funding for a 100-hectare community irrigation scheme. Jacoma Tropha has also received investment from British Investment International and Old Mutual, the South African pension fund.

The key development additionality of this project is the expansion of the outgrower scheme and the links that the scheme has developed with the wider market (see Figure 14). Before the AgDevCo Tropha investment, farmers worked with intermediaries who, taking advantage of their incomplete knowledge of markets and prices, bought their crops are very low prices. Farmers experienced great instability in demand and revenues. Crops would sometimes be left to spoil, and farmers had little incentive to continue to invest in their farms.

Since the investment, the smallholder farmers have become more tightly integrated into their respective value chains. Tropha purchases the crops directly from the farmers and provides technical advice and pre-harvest credit. Tropha also handles part of the processing of the macadamia and the full processing of the chili and paprika at its own facilities.

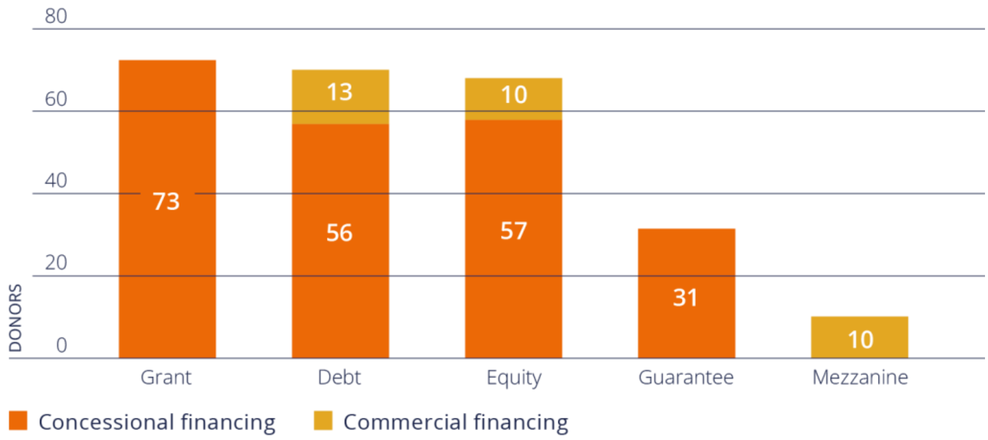
Figure 14 - Food value chain network before and after AgDevCo's investment in Tropha



Source: AgDevCo, 2019

Figure 15 - Donors allocated a portion of their commitments to blended transactions under commercial terms

Donors' commitments to blended transactions in concessional and commercial terms by instrument, 2015–2020



Note: 71 undisclosed donor commitments not included in the total grants.

Chart: Kamal El Harty. *Source:* Convergence, 2021

Using sovereign wealth funds as an anchor

Sovereign wealth fund are state-owned investment funds established using the receipts from the exports of resources, balance-of-payments surpluses, fiscal surpluses, government transfer payments, foreign currency operations and the proceeds of privatisation. A number of developing countries have established sovereign wealth funds, including Angola, Azerbaijan, Bolivia, Botswana, Brazil, Chile, Colombia, Egypt, Equatorial Guinea, Gabon, Ghana, India, Indonesia, Iran, Kazakhstan, Kiribati, Libya, Malaysia, Mauritania, Mexico, Morocco, Nauru, Nigeria, Pakistan, the State of Palestine, Philippines, Rwanda, Senegal, Timor-Leste, Trinidad and Tobago, Türkiye and Viet Nam.

Sovereign wealth funds combine purpose with profit and invest in domestic industries and large infrastructure projects. Because they tend to prioritize long-term returns over short-term liquidity, they are **important stakeholders to partner with donors and DFIs to de-risk projects**. Developing-country governments should facilitate co-investments between donors, DFIs and their sovereign wealth funds or their equivalent national development funds (see Box 9).

Moreover, sovereign wealth funds are increasingly aligning their mandates with the SDGs and the Paris Agreement. The 2022 annual survey by the International Forum of Sovereign Wealth Funds (IFSWF) and the One Planet Sovereign Wealth Fund Network found that over 91 per cent of funds address climate change as a part of their mandates and over 60 per cent of them view climate change as being linked to improving longer-term returns. In addition, over 50 per cent of sovereign wealth funds report that they engage with portfolio companies on environmental issues and require disclosure of how they mitigate and manage climate risks. The same survey also showed that sovereign wealth funds view sustainable agriculture and food security as an attractive investment sector (International Forum of Sovereign Wealth Funds and One Planet Sovereign Wealth Fund Network, 2023, p. 21) (see Figure 16).

Figure 16 - Sustainable agriculture and food security are among the preferred investment sectors
Climate investment preferences of sovereign wealth funds

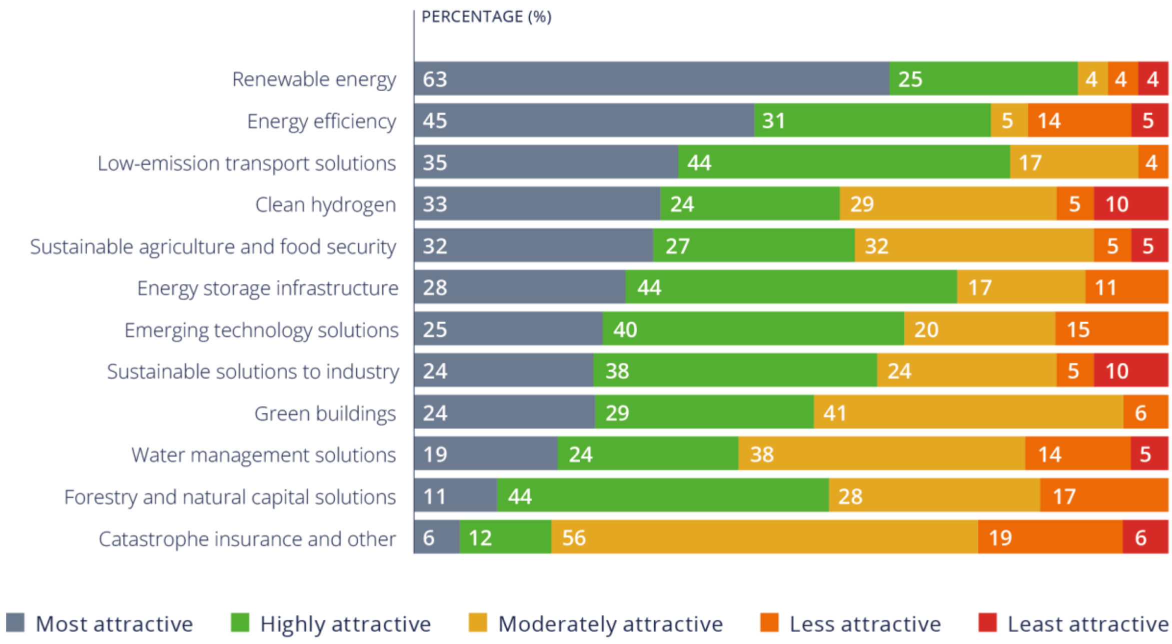


Chart: Kamal El Harty. *Source:* International Forum of Sovereign Wealth Funds and One Planet Sovereign Wealth Fund Network, 2023

Box 9 - Agaciro Development Fund cofinances Africa Improved Foods

Africa Improved Foods is a social enterprise producing affordable fortified foods for pregnant and lactating women as well as infants. It was established in 2015 as a joint venture between Agaciro Development Fund, Royal DSM, FMO, the Dutch entrepreneurial development bank, the United Kingdom Department for International Development Impact Acceleration Facility, managed by British International Investment (formerly the CDC Group) and IFC (FMO, n.d.). This public–private partnership is built upon the innovative collaborative funding model, whereby each stakeholder contributes financing, expertise, technology or sustainable infrastructure to the project. It aims to share risk and returns equitably while harnessing synergies, assets and expertise between the stakeholders and shareholders involved.

The Agaciro Development Fund invested in Africa Improved Foods by providing the company with warehouses and silos. This enabled the Agaciro Development Fund to monetize these former state-owned assets, assigning them a commercial financial value and thus integrating them into the pool of assets that are owned and manged by Africa Improved Foods (Hamirani, n.d.). The Agaciro Development Fund therefore played a key role as an anchor investor and concessional financier in the establishment of Africa Improved Foods.

African Improved Foods sources maize and soya from domestic cooperatives, buying their maize unshelled and on the cob immediately after harvest. The cobs are transported to central silos, where they are processed and dried within 24 hours. This rapid processing prevents the development of aflatoxins in the grains. The reduction in costs from fewer post-harvest losses and the high prices offered by Africa Improved Foods have boosted the income level of approximately 450,000 smallholder maize farmers. Products from Africa Improve Foods are also used by relief programmes of the World Food Programme and the Government of Rwanda (FMO, n.d.).

In 2023, the Agaciro Development Fund also partnered with Hinga Wunguke, the USAID-funded Feed the Future initiative, to cofinance companies that assist farmers in accessing markets, improving post-harvest practices and increasing access to processing infrastructure (The Chronicles, 2023).

The case for a donor working group and sustainable finance knowledge hub

During the enquiry, several donors, DFIs and blended fund managers voiced support for a multi-donor working group and sustainable knowledge hub that would allow for experience sharing. The working group, supported by the hub, would conduct and pool due diligence, data and fund-structuring expertise, and facilitate cofinancing. This can reduce donor transaction costs for blended financing. Stakeholders interviewed said the additional benefits of such a service would be:

- providing a single window gathering project sponsors, fund managers, investment advisers, DFIs and NGOs;
- reducing transaction costs through joint due diligence, stakeholder consultations and expert advice on fund structures;
- collaborating on an aggregated project development seed facility – perhaps along with the United Nations Environment Programme Restoration Seed Capital Facility;
- collaborating on and cofinancing outcome-based schemes (also called pay-for-performance financing and blended financing).

"There is value in 'aggregating' due diligence, cofinancing and experience on blended finance and pay-for-performance financing. This will help us scale blended financing more quickly."

(Donor agency, Shamba Centre stakeholder enquiry into sustainable finance, 2023)