TECHNICAL NOTE

Unleashing the catalytic power of donor financing TO ACHIEVE SUSTAINABLE DEVELOPMENT GOAL 2

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Unleashing the Catalytic Power of Donor Financing to Achieve Sustainable Development Goal 2: Technical note

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This technical note presents the detailed research, findings and recommendations from the enquiry into sustainable finance in agrifood systems conducted in 2023 by the Shamba Centre for Food & Climate in collaboration with members of the Global Donor Platform for Rural Development (GDPRD). The report was produced in accordance with IFAD's Guidelines for Publishing.

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Executive summary

The enquiry into sustainable finance in agrifood systems occurred against the backdrop of increasing official development assistance (ODA) for agriculture, food security and nutrition in response to rising food prices and the Russian invasion of Ukraine in 2022. In 2022, the G7 committed an additional US$4.5 billion of such ODA, taking its total annual food security contribution to over US$14 billion (G7, 2022). However, donor governments warned that fiscal stress, regional wars and inflation in their own countries were likely to result in a decline in ODA from 2023 onwards.

The discussions at COP28 in December 2023 indicated that the political mood for innovative finance has never been stronger. As reported by the Organisation for Economic Co-operation and Development (OECD), the climate finance target of US$100 billion per year has been attained. In addition, donors and development finance institutions (DFIs) now include climate-resilient debt clauses in their sovereign lending and are beginning to channel unused special drawing rights from the International Monetary Fund through multilateral development banks (MDBs), which may enable them to more easily issue bonds and draw in private capital for sustainable development.

Discussions at the World Economic Forum's annual meeting in January 2024 affirmed the relevance and timeliness of the recommendations on the "missing middle". Economists Esther Duflo, Thomas Piketty and Ann Pettifor argued that global challenges from wars, poverty and climate change cannot be solved without reducing economic inequality. Addressing the missing middle remains at the core of this debate since it can greatly increase the distribution of income across societies.

The enquiry shows that donors are ready to explore how they can complement their traditional concessional financing with commercial lending, albeit at lower market rates. In tandem, DFIs appear ready to explore how they can provide longer-term and higher-risk financing, perhaps beginning with dedicated pools of money allocated from their shareholder governments and that are expressly designed for this purpose. The enquiry also shows that blended finance is nascent but thriving, with noteworthy innovations taking place across blended funds and instruments.

Implementing the recommendations of the enquiry will require widespread changes to the mandate and mindsets of donors, beneficiary governments, DFIs and the development finance community at large. But the effort will be worthwhile as it promises to make agrifood development finance truly transformative. As global food crises are likely to persist in the medium term, it is imperative that aid is used not only to address market failures, but also to lend comfort and reduce risks for other concessional and commercial financiers to support sustainable food and agriculture value chains. Domestic lenders in developing countries, which remain on the sidelines, merit particular attention.

Blended finance, the mixing of public and private sources of finance, represents an untapped opportunity for donors, DFIs and private investors to pool their experience, expertise and risks with the goal of increasing finance to sustainable agriculture, food security and nutrition in low- and middle-income countries.

This technical note provides detailed answers from stakeholders on the three central questions of the enquiry:

(i) How are donors making their financing more catalytic?
(ii) How can donors ensure that their financing is additional?
(iii) How are donors using their concessional financing to crowd in commercial financing from DFIs and the private investors? (see Box 1)

A summary of the key findings and recommendations is available in the main report (see *Unleashing the Catalytic Power of Donor Financing to Achieve Sustainable Development Goal 2*, pp. 8–36). Over 80 stakeholders from donor agencies, philanthropic foundations, DFIs, public and blended funds, fund managers, investment advisors, international organizations, non-governmental organizations (NGOs), investor networks and sustainable finance networks, academic institutions and consulting firms participated in the enquiry. Virtual and in-person interviews took place under Chatham House rules (see the annex of the main report for a full list of institutions).

Chapter 1 presents the state of play in blended finance and points out why the potential for blended finance scaling remains significant. This is particularly true in the agrifood sector, where blended finance transactions increased from 23 per cent in 2019 to 41 per cent in 2022. The potential of scaling is further strengthened given that only 2 per cent of the annual ODA for agriculture is used as concessional financing in blended finance transactions while 5 to 10 per cent of DFI and MDB transactions in agriculture mobilize private finance (Apampa et al., 2021).

Chapter 2 unpacks the findings and recommendations on financing the missing middle: small and medium-sized enterprises (SMEs) seeking financing between US$25,000 and US$2 million. It also discusses why SMEs operating in domestic markets are particularly challenged because they spend and earn in local currencies and stresses the importance of crowding in domestic lenders. The recommendations also address the upskilling of agrifood SMEs in accounting, bookkeeping and financial management.

Chapter 3 discusses the leverage ratio of blended financing and provides the rationale for donors to continue experimenting with blended financing, despite difficulties in determining if their investments are bringing both financial and development additionality. The discussion 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 their transaction costs on blended financing.

Chapter 4 presents the rationale for increasing the risk appetite of DFIs. The discussion explores why and how DFIs should take more risks and, in doing so, mobilize greater amounts of financing from private investors.

Chapter 5 makes the case for more and better research and data on the loans donors provide to agrifood SMEs, in order to scale lending and blending. There is currently no public (or private) data repository where data are recorded, cleaned and prepared for investment decisions. The lack of comparable data impedes transparency and the development of market insight, which is critical for building inclusive markets.

Chapter 6 presents anecdotal evidence of how blended funds are responding with increasing innovation and additionality. The stories of blended funds illustrate how they are integrating environmental and social performance into lending criteria, increasing services to first-time borrowers and sharing risks across tighter supply chains.

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CHAPTER 1. The promise of blended finance

Blended finance is the strategy most talked about but perhaps most underused by donors, development finance institutions (DFIs) and private investors to mobilize the additional finance needed to fill the Sustainable Development Goal 2 (SDG 2) investment gap (see Box 1). This is a missed opportunity because blended finance offers these actors an innovative way to combine their resources, experience, expertise and risk appetite to achieve development impacts that are otherwise not possible. If donors and DFIs are willing to use grants and concessional loans to expand incentives for de-risking, blended finance can be the greatest opportunity to mobilize private investment for SDG 2. Indeed, the United Nations Addis Ababa Action Agenda underscored the significance of blended finance as a key instrument for leveraging public and private sector finance to advance progress towards the 2030 Agenda for Sustainable Development (United Nations, 2015).

Blended finance and its principles

Blended finance is the use of concessional finance from donors and philanthropic foundations to mobilize commercial finance from DFIs and private investors to invest in projects that are too commercially oriented to be eligible for grants and yet still too risky with insufficient returns for most private investors. Blended finance is therefore an important strategy to bridge the gap between these two sources of finance and contribute to fill the investment gap for achieving SDGs.

Box 1 - Defining blended finance, concessional finance and commercial finance

The OECD defines blended finance as "the strategic use of development finance for the mobilization of additional finance towards sustainable development in developing countries, where additional finance refers to commercial finance" (OECD, 2020, p. 5). Convergence describes blended finance as "the use of catalytic capital from public or philanthropic sources to increase private sector investment in sustainable development" (Convergence, n.d).

The DFI Working Group on Blended Concessional Finance for Private Sector Projects defines blended finance as "combining concessional finance from donors or third parties alongside DFIs' normal own-account finance and/or commercial finance from other investors, to develop private sector markets, address the Sustainable Development Goals (SDGs) and mobilize private resources" (DFI Working Group on Blended Concessional Finance for Private Sector Projects, 2023).

What are concessional and commercial finance?

Concessional finance includes grants, equity and loans that are longer-term and offered at below-market interest rates, and loan guarantees that aim to reduce the risk for private investors and DFIs. They are provided by donors and philanthropic foundations.

Commercial finance refers to equity and loans offered at market rates. They are provided by DFIs and private investors.

Blended finance strategies are informed and guided by the OECD blended finance principles and the DFI Working Group on Blended Concessional Finance for Private Sector Projects (see the annex). These principles have shaped the discussion on blended finance, receiving support from various organizations including the United Nations, the European Union, the World Economic Forum, as well as the G20 and the G7.

The OECD blended finance principles establish the rationale for blending as well as the need for regulation, transparency and accountability in the management of blended funds and instruments. According to these principles, blended finance strategies must result in both financial and development additionality.

The DFI Working Group aims to guide the promotion of commercially viable solutions using minimum concessional finance. They specifically call for increased scrutiny to ensure that the concessionality of blended financing does not distort nascent markets in developing countries. They also emphasize adherence to high standards in corporate governance, environmental impact, integrity, transparency and disclosure.

The state of play in blended finance

The share of **official development assistance (ODA) that is directed towards blended finance annually is around 2 to 3 per cent of total ODA** (Convergence, 2021). Over the past 10 years, the blended finance market has seen an annual average of 77 transactions, 41 of which specifically target climate. The median annual financing for the entire market has been approximately US$14 billion, with more than half (US$8 billion) dedicated to climate-focused blended finance deals. Moreover, only 5 to 10 per cent of DFIs' and MDBs' transactions for agriculture mobilize private finance (Apampa et al., 2021).

While the number of annual blended finance deals increased from 79 deals in 2018 to 117 deals in 2022, the total amount of these deals decreased from US$18.5 billion to US$8 billion over the same period (see Figure 1). This indicates that the focus of blended finance is shifting towards smaller transactions (Convergence, 2023).

When considering blended finance deals across geographic regions, **sub-Saharan Africa accounts for the highest share of activities,** with the region's share of blended finance transactions increasing from 41 per cent in 2019 to 68 per cent in 2022 (see Figure 2). Blended finance transactions in sub-Saharan Africa have grown from 27 per cent in 2018 to 40 per cent in 2020, notably favouring agribusinesses. In comparison, blended finance transactions in Latin America and the Caribbean have tended to offer greater support to rural and smallholder farmers and women as end beneficiaries (Convergence, 2021).

Figure 1 - The volume and value of blended finance since 2019 indicate a possible shift towards smaller ticket sizes

Annual volume and value (in billions of United States dollars) of blended finance transactions, 2014–2022

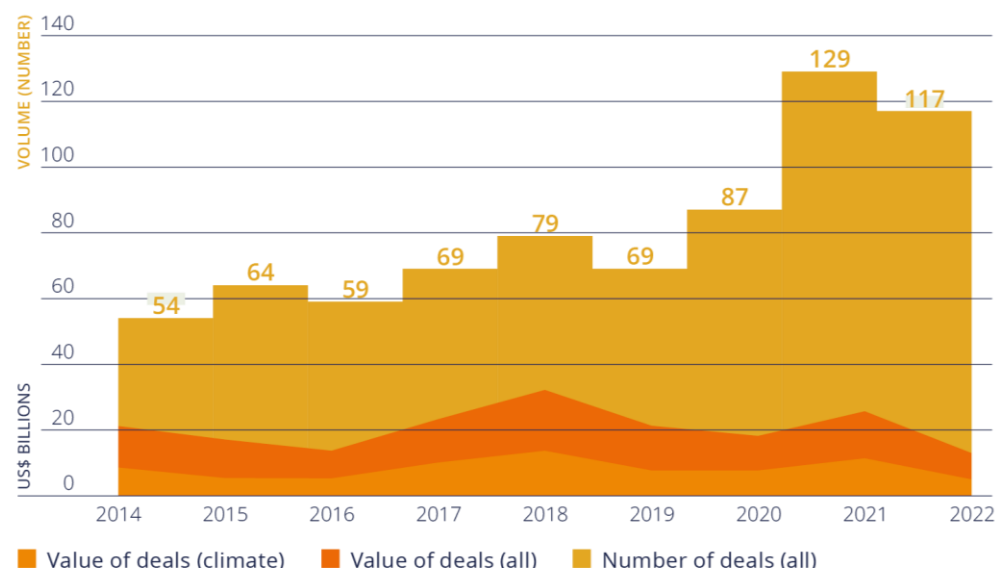
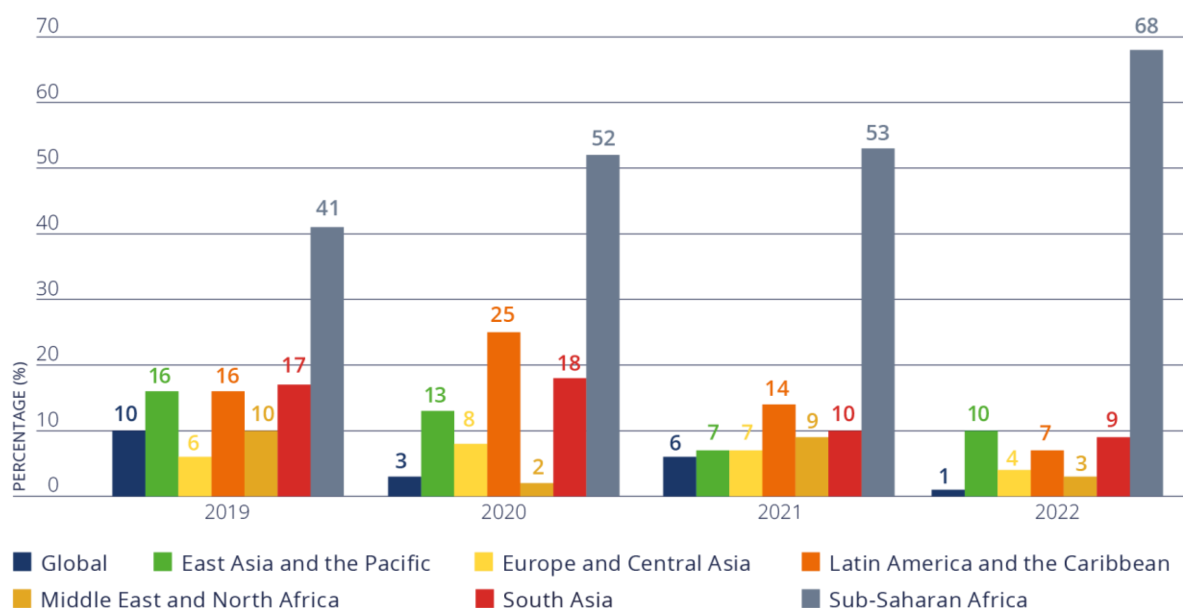


Chart: Lysiane Lefebvre. *Source:* Convergence, 2023

Figure 2 - Most blended finance transactions over the period from 2019 to 2022 have gone to sub-Saharan Africa

Proportion of blended finance transactions by region, 2019–2022

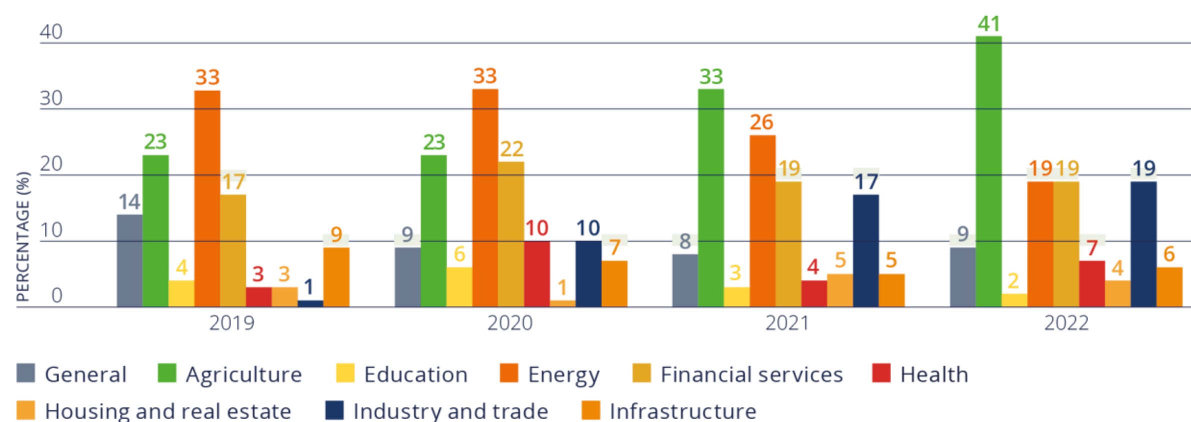


The percentages do not total 100 per cent, as a single transaction may target more than one region.
Chart: Kamal El Harty. *Source:* Convergence, 2021, updated with 2023 data following direct communications

The **proportion of transactions in agriculture has also grown**, from 23 per cent in 2019 to 41 per cent in 2022 (see Figure 3). This increase in the use of blended finance in agriculture has been primarily driven by financing for climate-smart agriculture and agrifood businesses, particularly those involved with agricultural inputs (Convergence, 2021).

Figure 3 - Between 2019 and 2022, the share of blended finance transactions targeting agriculture steadily increased

Proportion of blended finance transactions by sector, 2019–2022



The percentages do not total 100 per cent, as a single transaction may target more than one region.
Chart: Lysiane Lefebvre. *Source:* Convergence, 2021, updated with 2023 data following direct communications

The majority of blended finance transactions, approximately 58 per cent of transactions between 2020 and 2022, targeted lower-middle-income countries, primarily in sub-Saharan Africa, Latin America

and South Asia, with the aim of lowering the risk – both real and perceived – for private investors. Meanwhile, blended finance flowing to low-income and least developed countries represented only 28 per cent and 33 per cent of all transactions, respectively (see Figure 4).

Figure 4 - Blended finance is heavily concentrated in lower-middle-income countries

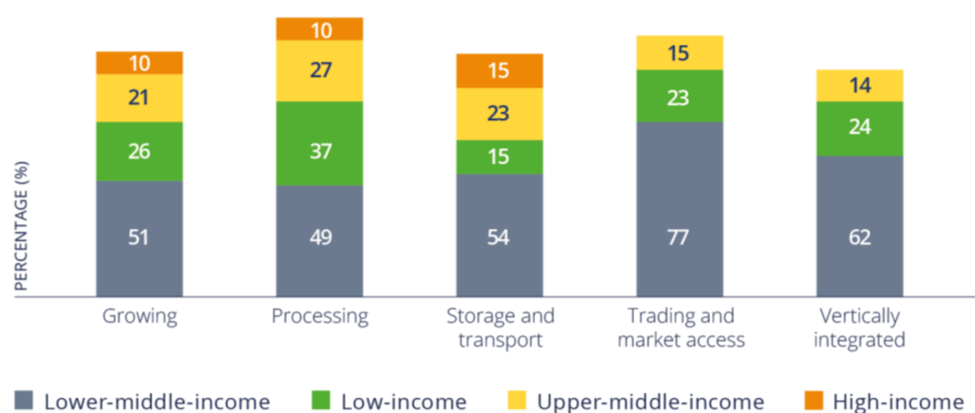
Proportion of blended finance transactions by income level during the periods 2017–2019 and 2020–2022

The percentages do not total 100 per cent, as a single transaction may target more than one region.
Chart: Kamal El Harty. *Source:* Convergence, 2021, updated with 2023 data following direct communications

This trend also persists in agriculture and food value chains. The smaller proportion of blended finance transactions targeting low-income and least developed countries is mainly due to real and perceived risks. These risks include underdeveloped business environments, expensive and time-consuming project pipeline origination, and a shortage of market data (see Figure 5) (Convergence, 2022).

Figure 5- Low- and lower-middle-income countries are the primary beneficiaries of blended finance across the agrifood value chain

Proportion of blended finance transactions by income level across the food value chain



The percentages do not total 100 per cent, as a single transaction may target more than one region.
Chart: Kamal El Harty. *Source:* Convergence, 2022

Blended finance transactions across the food value chain **primarily target agrifood small and medium-sized enterprises (SMEs) as direct beneficiaries, with only a small proportion flowing to financial institutions**. While this recognizes the importance of agrifood SMEs as the backbone of agricultural value chains, it also underscores the need for more concessional financing, guarantees and incentives to support lenders in financing agrifood SMEs (see Figure 6) (Convergence, 2022).

Figure 6 - Agrifood SMEs are the primary beneficiaries of blended finance across the food value chain
Proportion of blended finance transactions by direct beneficiaries across the food value chain

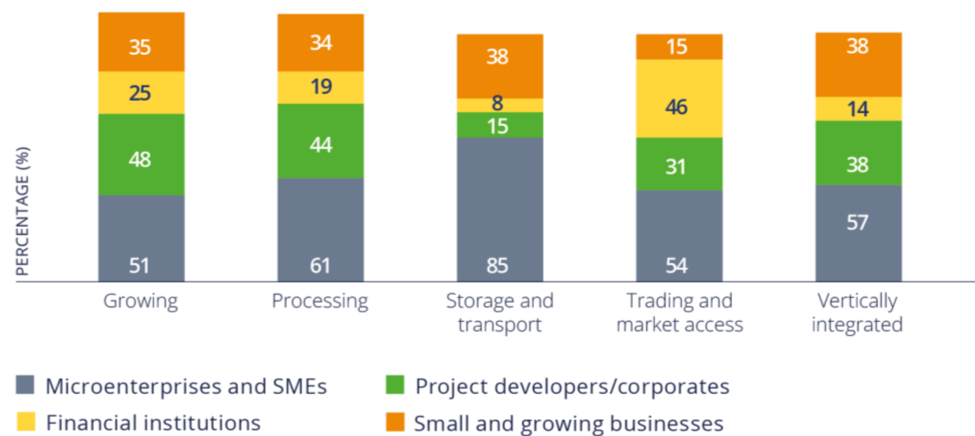


Chart: Kamal El Harty. *Source:* Convergence, 2022

The above trends in blended finance indicate that, while the market is nascent, the potential for its scaling remains significant. This is particularly true in the case of the agrifood sector, where blended finance transactions have increased from 23 per cent in 2019 to 41 per cent in 2022.

Of particular significance is that just 2 per cent of the annual ODA for agriculture is used as concessional financing in blended finance transactions. Furthermore, only 5 to 10 per cent of DFIs' and MDBs' transactions for agriculture mobilize private finance (Apampa et al., 2021). To attain the required scale of development finance for achieving SDG 2, donors need to increase their ODA allocation, and DFIs and MDBs need to mobilize more private financing in their agriculture and food transactions.

How this can be achieved is discussed in the chapters that follow.

CHAPTER 2. Financing the missing middle

Blended finance can make the biggest contribution to SDG 2 by focusing on the missing middle: agrifood SMEs seeking finance between US$50,000 and US$2 million.

Recommendation: Donors and DFIs can increase the flow of finance to agrifood SMEs by:

i. building the agrifood expertise and risk appetite of domestic lenders. This includes the development of an agrifood credit risk assessment scorecard, as proposed by the United Nations Economic Commission for Africa;
ii. scaling up priority lending programmes and results-based lending incentives for domestic banks, encouraging them to use their own balance sheets to lend to agrifood SMEs;
iii. increasing financing for affordable, indemnity-based, weather-indexed and crop-indexed insurance;
iv. Incorporating bookkeeping and accounting skills into SME technical assistance programmes.

The discussion below unpacks the findings and recommendations on the missing middle. It draws from the evidence that agrifood SMEs that are servicing domestic markets are particularly challenged in accessing affordable finance. This brings into play the role of domestic investors and the skills and maturity of agrifood SMEs themselves. This discussion also covers why insurance and financial incentives can be highly affective in improving the credit risk profile of agrifood SMEs.

Understanding the missing middle

The lack of available and accessible finance appropriate to the risk profile of agrifood SMEs in developing countries remains one of the biggest market failures and a major obstacle to achieving SDG 2.

While there is no internationally accepted definition of an agrifood SME, the Smallholder and Agri-SME Finance and Investment Network (SAFIN) of IFAD defines agrifood SMEs as: "profit-oriented enterprises that are involved in the agricultural value chain either directly or by providing enabling services to value chain actors" (SAFIN and ISF Advisors, 2020, p. 2). SMEs are typically able to service an investment of US$50,000 to US$2 million, have more than 5 but fewer than 250 employees, have an annual turnover of US$100,000 to US$5 million and/or have total assets of at least US$20,000. They may include small commercial farms and farmer cooperative-owned enterprises (SAFIN and ISF Advisors, 2020).

Agrifood SMEs are therefore a diverse group of enterprises. The poorest and most marginalized depend upon subsistence farming and require long-term, or patient, donor financing. Moreover, they need several years of continuous donor financing and donor-financed capacity-building before they may be able to reach the appropriate level of maturity, professionalism and profitability to work with impact investors and blended financiers. **These agrifood SMEs seek financing under US$50,000 and are generally best served by ODA and philanthropic grants channelled through not-for-profit financing intermediaries. Microcredit is one of the most successful solutions for this group.**

The next group of agrifood SMEs, often referred to as the "missing middle", seeks financing between US$50,000 and US$2 million (Aceli Africa, 2023). Such amounts are too small to attract commercial loans at market rates from private equity groups, yet too large to qualify for ODA grants or microcredit (Doran et al., 2009).

Lending to the missing middle is particularly challenging because of the high risk of losses and costs of servicing small value loans. Lending institutions that are members of the Council of Small Holder Agriculture Finance (CSAF) reported an average loss of US$18,700 on a loan of US$665,000, excluding the cost of funds. CSAF also found that loans below US$500,000 carried an 80 per cent higher risk of default than larger loans (USAID & CSAF, 2018).

This results in an agrifood SME financing gap estimated at US$106 billion annually across sub-Saharan Africa and South-East Asia (ISF Advisors, 2022). The gap is especially large for agrifood SMEs in sub-Saharan Africa, representing 83 per cent of the total annual financing need and amounting to US$74.5 billion (see Figure 7).

Figure 7 - The agrifood SME financing gap across sub-Saharan Africa and South-east Asia is estimated at US$106 billion (66 per cent of total financing need) annually

Agrifood SME financing gap across sub-Saharan Africa and South-East Asia in billions of United States dollars

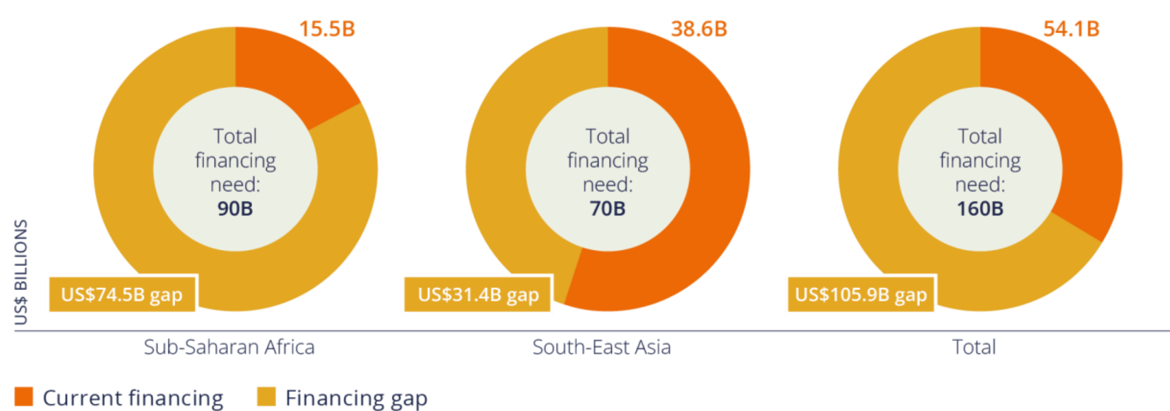


Chart: Lysiane Lefebvre. *Source:* ISF Advisors, 2022

Challenges facing agrifood SMEs supplying domestic markets

Impact investors, commonly referred to as “social lenders” in the finance community, provide affordable financial and technical assistance to domestic lenders and borrowers in developing countries. They accept purchasing contracts and contract farming agreements as guarantees, which allows them to provide loans without requiring collateral.

However, such contracts are in hard currency, since impact investors seek to avoid risks associated with exchange rate fluctuations (as they receive their own financing in hard currencies). A significant proportion of impact financing therefore flows to SMEs producing for export. This results in a situation whereby those agrifood SMEs producing grains, fruits and vegetables for local markets and working in local currency are largely being left out. While impact investors are starting to finance domestic producers in local currencies, the many risks associated with lending to this segment remain a barrier.

In 2022, lenders from CSAF primarily directed their lending to cash crop value chains (CSAF, 2023a). Agrifood SMEs and farmer organizations involved in coffee, cocoa, cashew nuts, soya beans and quinoa received most of the loans, with only 24 per cent going to value chains in crops for domestic consumption in 2022 (see Figure 8) (CSAF, 2023b).

According to one fund manager interviewed:

> *"If you are growing organic coffee designed for foreign markets, you can find lenders. But if you are growing cassava or carrots for local markets and want lending in local currency, there is practically nobody. Local lenders have to fill this gap. They are not doing so because sustainable agrifood businesses are not often profitable in the shorter term, and because local lenders do not understand the agrifood sector."*
>
> *(Fund manager, Shamba Centre enquiry into sustainable finance, 2023)*

Figure 8 - Most financing is going to cash crops destined for export rather than food crops meant for domestic consumption

Volume of lending by value chain in millions of United States dollars, 2013–2022

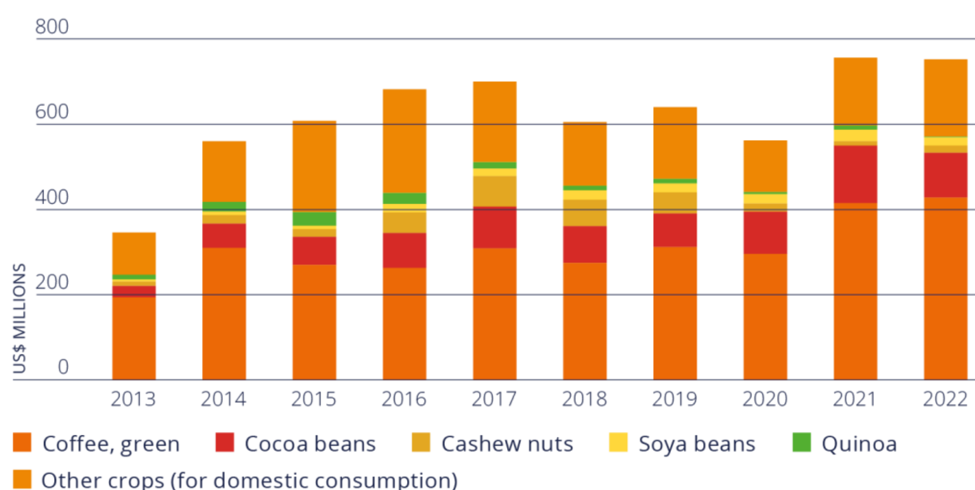


Chart: Lysiane Lefebvre. *Source:* CSAF, 2023a

Domestic lenders remain on the sidelines. As discussed earlier, **the financial demand of agrifood SMEs in sub-Saharan Africa and South-East Asia is estimated at US$160 billion.** However, only US$54 billion of this total demand being financed by and through domestic lenders.

- Domestic and regional commercial banks only meet US$40 billion of this need. Because of prudential banking regulations and low-risk appetite, commercial banks seek to minimize risks and typically only provide short- and medium-term financing to mature agrifood SMEs with strong collateral and stable cash flow, despite often being backed by donors and government guarantees and incentives to encourage lending (ISF Advisors, 2022).

- Domestic and regional non-bank financial institutions such as credit unions and leasing service providers meet US$6 billion of this demand (ISF Advisors, 2022). Because non-bank financial institutions do not have a full banking licence and thus less rigorous and prudential regulations, they can often offer financing with less stringent collateral requirement. Given the additionality of these institutions in serving the underfinanced segment of agrifood SMEs, further engagement with them is critical.

- Domestic development banks meet US$4 billion of this demand. Driven by their economic development agenda, these state-sponsored banks provide a mix of grants, concessional and commercial loans (ISF Advisors, 2022).

- Social lenders and impact funds meet US$4 billion of this demand. These entities can be domestic and foreign funds working through local intermediaries.

The critical role of domestic investors lies in their vast networks, reaching large numbers of borrowers, and their knowledge and specialized expertise in serving a specific segment of agrifood SMEs. However, these domestic investors hesitate to lend to agrifood SMEs because of the high transaction costs of making loans, the small value of the loans required, the perceived risk of lending to agrifood SMEs and the reality that many agrifood SMEs are not investment ready. More concerted action to engage with these stakeholders is therefore a prerequisite for servicing the missing middle.

Domestic lenders also lack data and expertise on the agrifood sector. The accuracy of the credit risk assessments undertaken by financial institutions prior to making lending decisions depends on the availability and quality of data. According to stakeholders interviewed, the gap between the actual and perceived risks in the agrifood sector is driven by lack of data, knowledge and transparency. It prevents domestic lenders from financing agrifood enterprises and optimizing credit lines and guarantees provided by donors and DFIs.

Historically, financing for agriculture from domestic lenders in developing countries has been very low. For example, the proportion of total credit in Africa extended to the agricultural sector increased from 3.9 per cent in 2000 to 4.3 per cent in 2019 (Koloma and Kemeze, 2022).

Domestic lenders also have little incentive to take the time to explore new business opportunities when revenues from government bonds remain far more lucrative. One fund manager interviewed said:

"If lenders are better informed on the agriculture sector, it can also have a big impact on their appetite to lend – even if returns are less lucrative than other sectors."

(Fund manager, Shamba Centre enquiry into sustainable finance, 2023)

"When banks in developing countries do so well by investing in sovereign bonds, they have no motivation to explore new opportunities, especially those that require additional effort to source lenders, assess credit risks and settle loans. This is perhaps the biggest hurdle in agrifood finance."

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

Stakeholders continue to debate if priority lending and results-based financing can be more effective than credit lines and loan guarantees to crowd in domestic lenders. The reality is that credit lines and loan guarantees do little to increase the interest of domestic banks in exploring the agrifood sector, differentiate between the real and perceived risks, and encourage them to use their own money to lend to agrifood SMEs. According to stakeholders interviewed, the suboptimal use of these credit lines and guarantees by domestic banks is due to their lack of expertise and tools to assess credit risks in the agrifood sector. To address this issue, many governments and donors continue to experiment with priority lending and results-based financing targeted at domestic banks (see Box 2).

Box 2 - What is priority lending?

Priority sector lending programmes are designed and led by central banks to increase lending to economically important but less profitable sectors of the economy that would otherwise not receive affordable and timely credit. Sectors usually targeted by priority lending programmes include agriculture, SMEs, health and education. They are part of the regulatory framework for commercial banks and financial institutions in many countries, both developing and developed (Kumar et al., 2016).

Priority lending programmes are implemented by issuing retail banks with sector-specific lending targets that are accompanied by tradable priority sector certificates. Banks exceeding their lending targets can trade their surplus certificates with those that fall short. In the absence of tradable priority certificates, central banks can require banks that do not meet lending targets to lend to public institutions at very low interest rates.

The terms and conditions of priority lending do not include lower interest rates or unsecured lending, which would distort the market. Rather, the objective of this policy is to encourage banks to develop expertise in and comfort with the priority sectors.

What is results-based, or outcome-based, financing?

'Results-based financing' refers to any programme that offers a reward, whether monetary or otherwise, to incentivize the achievement of specific outputs or outcomes. These rewards are contingent upon verification that the agreed-upon results have been successfully delivered. Incentives may be directed towards service providers, beneficiaries or both parties involved. Payments or rewards are withheld until the satisfactory delivery of results or performance (Musgrove, 2011).

Results-based financing is also a strategy to increase the impact of an investment by linking payments for results that would otherwise not have been achieved at the same pace, scale or timeframe. These results are hence additional development impacts. For example, results-based financing can be used to meet the transaction costs of small-value loans. It can also be used as an incentive payment to encourage domestic banks to do business with women and rural entrepreneurs who lack the required credit profiles. Results-based financing can also be designed as payments for ecosystem services to meet the additional costs of restoring soils, lowering nutrient run-off and increasing habitat for pollinators.

According to one impact fund manager:

> *"Traditional loan guarantees provided by donors to local banks don't often result in lending, as they don't increase the risk appetite of the local banks to explore the food and agriculture sector. What we therefore need are incentives that motivate and even prompt local banks to say: 'we are being invited to explore a new market and donors will pay for us to do it.' In good times, these banks will develop expertise and appetite in the sector and donors can hopefully then step aside."*
>
> *(Fund manager, Shamba Centre stakeholder enquiry into sustainable finance, 2023)*

For example, Aceli Africa, an incentive facility funded by the Swiss Agency for Development and Cooperation (SDC), the United Kingdom Foreign, Commonwealth & Development Office (FCDO), the United States Agency for International Development (USAID), the IKEA Foundation and Convergence, is experimenting with results-based incentives for domestic banks (see Box 3).

Box 3 - Aceli Africa

Aceli Africa provides results-based financial incentives to domestic lenders in Kenya, Rwanda, the United Republic of Tanzania and Uganda. In the absence of these incentives, local lenders would not be lending to agrifood SMEs. The incentives are designed based on lending data from 31 financial institutions, including local banks, international social lenders and members of CSAF.

- A partial loan guarantee is given to domestic lenders for loans between US$25,000 and US$1.75 million.
- Origination incentives for domestic lenders cover the costs of providing loans of between US$25,000 and US$500,000 to SMEs in remote areas or for specific value chains, such as local food crops.
- Impact bonuses are given to domestic lenders for loans extended to SMEs that meet higher requirements on environmental and social performance, gender inclusion, food security and nutrition.
- Aceli Africa accompanies these incentives with technical assistance to agrifood SMEs and capacity-building for domestic lenders.

Aceli Africa's budget for 2020–2025 is US$75 million, more than 50 per cent of which is used to provide incentives. As of October 2023, Aceli Africa's incentives have supported 1,404 loans totalling US$142 million (60 per cent of loans to first-time borrowers). The SMEs receiving loans employ 25,000 workers and provide market access to 834,000 smallholder farmers. Enterprises returning for a second loan have increased revenues by 27 per cent.

Sources: SDC, 2022; Milder, B., personal communication, 12 October 2023

Using insurance to improve credit risk profile

Despite the economic importance of the agrifood sector, agricultural insurance in developing countries remains rudimentary, with low coverage rates and a limited range of products. For example, out of the 600 million farmers in Africa, only 600,000 have insurance coverage (Stevens, 2023).

Continued donor financing is needed to increase affordable, indemnity-based, weather-indexed and crop-indexed insurance for the missing middle. Insurance is particularly important as climate change intensifies. It enables SMEs to maintain their income, recover faster and continue to operate despite weather events and failed harvests. Insurance also increases the eligibility of SMEs for pre-harvest financing to cover the costs of seeds, fertilizers, equipment and more (see Box 4).

Box 4 - National Agriculture Insurance Scheme, Rwanda

Despite the participation of local insurers and international underwriters, the launch of an agricultural insurance pilot in Rwanda in 2011 was met by low demand. This was due to the high cost of premiums and low awareness of the benefits of insurance for agrifood SMEs and smallholder farmers.

In 2019, the Ministry of Agriculture and Animal Resources of Rwanda launched a new programme, the National Agriculture Insurance Scheme, in partnership with three insurance companies: SONARWA, PRIME Insurance and Radiant Insurance. The scheme included government subsidies that covered 40 per cent of the premium payments for weather-indexed and yield-indexed insurance. This increased the eligibility of smallholder farmers and SMEs for pre-harvest financing.

The One Acre Fund, supported by donor concessional finance, is also a key participant in developing Rwanda's agricultural insurance market. In 2023, the Once Acre Fund, in partnership with the International Finance Corporation (IFC), the United States International Development Finance Corporation (DFC) and the African Risk Capacity Group, launched the One Acre Fund Re, a reinsurance facility to provide risk transfer projects to smallholders.

Source: Access Finance Rwanda, 2020; One Acre Fund, 2023

The case for a food and agriculture credit risk assessment tool

The representatives from the United Nations Economic Commission for Africa, as well as several impact investors participating in the enquiry, recommended the development of a credit risk assessment scorecard for domestic lenders, including both banks and non-bank institutions.

Armed with such a scorecard, domestic lenders would be better placed to evaluate agrifood enterprises. Based on the internal rating methodologies and loan-specific details such as the value, maturity and borrower's track record, domestic lenders will be able to accurately price the risk of loans and distinguish between real and perceived risks in agrifood lending.

Such a scorecard can also increase the appetite of domestic lenders to make better use of donor-funded guarantees and credit lines. Moreover, they can collaborate with impact investors and DFIs. The scorecard should be designed to address full spectrum financial risks, including the Know Your Customer regulations (to prevent financial institutions from being used for money laundering, terrorist financing, fraud and other illicit activities), agrifood business-specific risk, climate risks, and environmental, social and governance (ESG) aspects.

Developing SMEs' financial skills

Many stakeholders participating in the enquiry expressed concern about the financial literacy of agrifood SMEs and farmer cooperatives and their minimal skills in bookkeeping and accounting. Moreover, even when financial skills exist, many SMEs do not maintain records of their cash flow. Investors are therefore not able to estimate the financial health of SMEs, further exacerbating the lending gap that results in the missing middle.

During the enquiry, several blended funds were categorical on the challenge of assessing market share, which is a key element in investment decisions. Market share is typically assessed by estimating the total addressable market: the revenue opportunity from equity and loans if 100 per cent of the market share were achieved. From then on, investors continue to estimate the total serviceable market: the number of clients the borrowing SME could realistically seek to reach. These estimates are important, since they show investors the growth potential of both the borrowing SMEs and the market in which they operate.

Investors remain cautious regarding estimates of the addressable market, since very few SMEs have the maturity and accounting skills to make such calculations, manage loans and financially administer the growth of their business. In fact, the lack of financial management skills partly explains why most SMEs maintain poor or no records of their financial performance and the fluctuations of their cash flows across months and years (Mang'ana et al., 2023). This skill gap is therefore another contributor to the missing middle.

Impact investors and donors participating in the enquiry also commented that most technical assistance programmes are yet to include financial literacy and baseline skills on financial management. Rectifying this could result in truly transformative improvements in SME financing.

"There are few investable agribusinesses that are ready for blended and commercial capital. This speaks to the inherent risks in agriculture that are made worse by poor infrastructure, complexity around land ownership and market distortions from badly conceived policies."

(Fund manager, Shamba Centre stakeholder enquiry into sustainable finance, 2023)

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

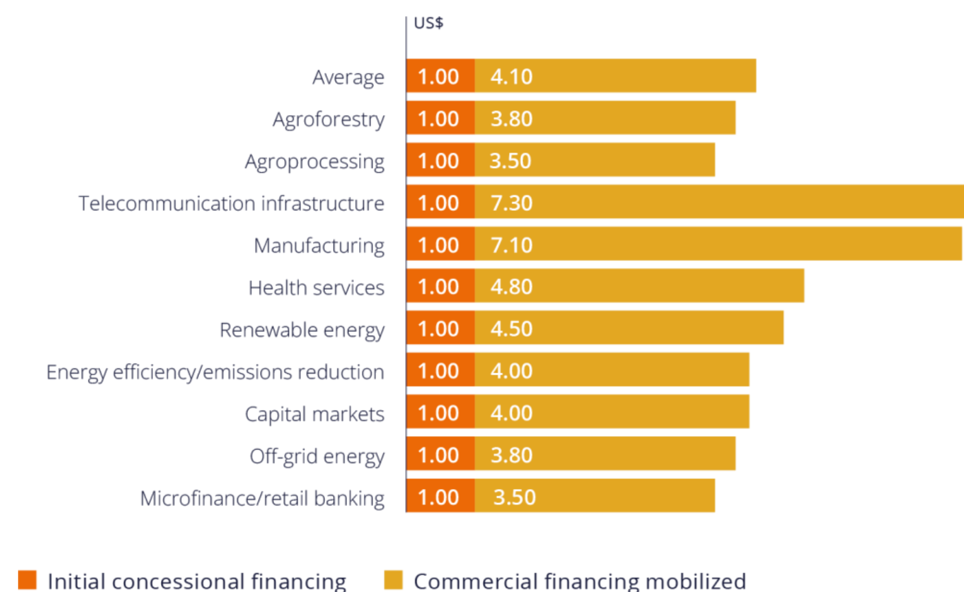


Chart: Lysiane Lefebvre. *Source:* Convergence, 2023

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

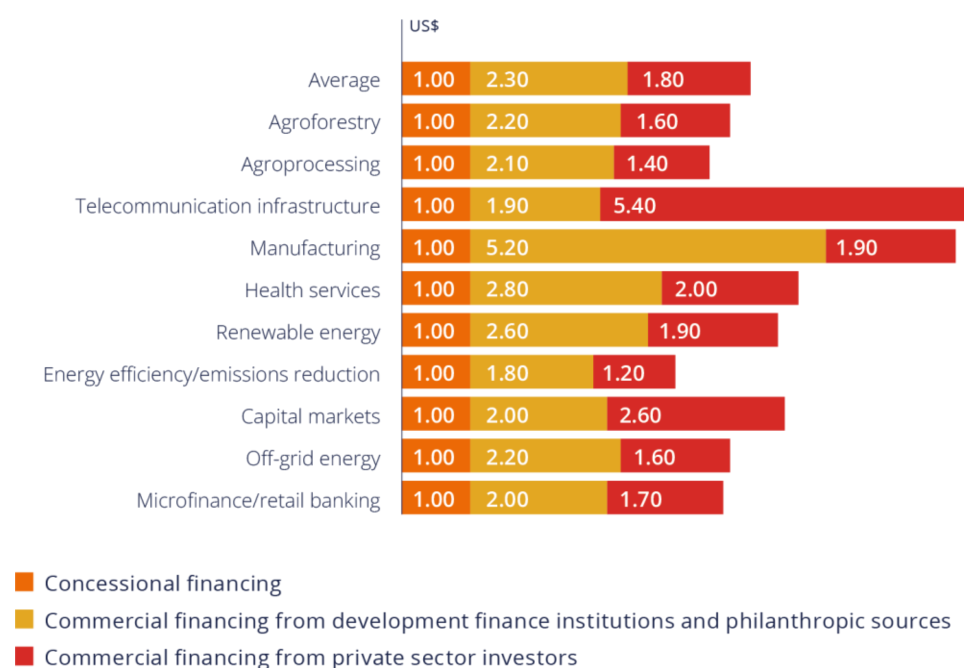


Chart: Kamal El Harty. *Source:* Convergence, 2023

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

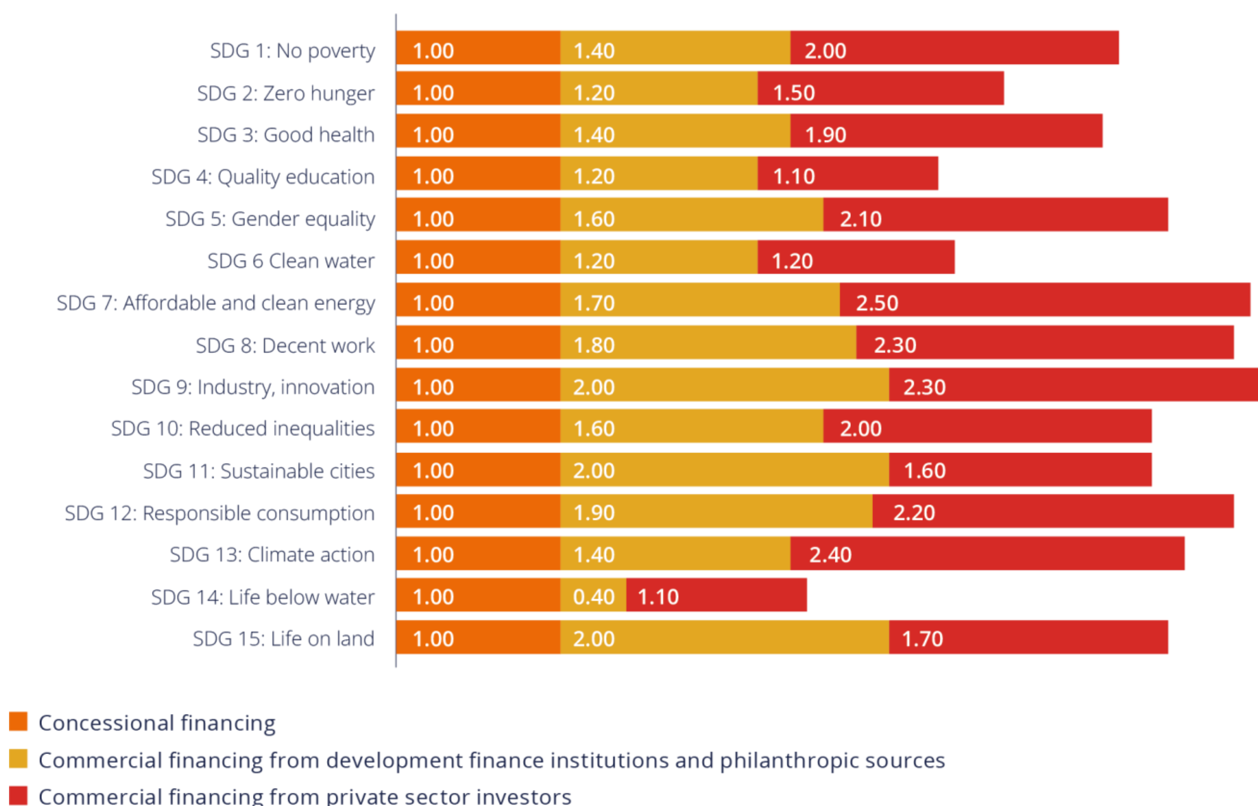


Chart: Kamal El Harty. *Source:* Convergence, 2023

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

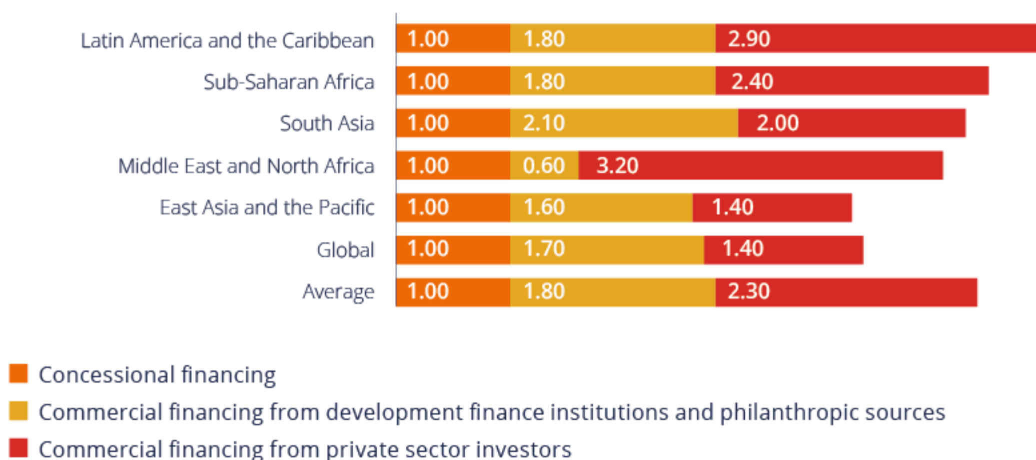


Chart: Kamal El Harty. *Source:* Convergence, 2023

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

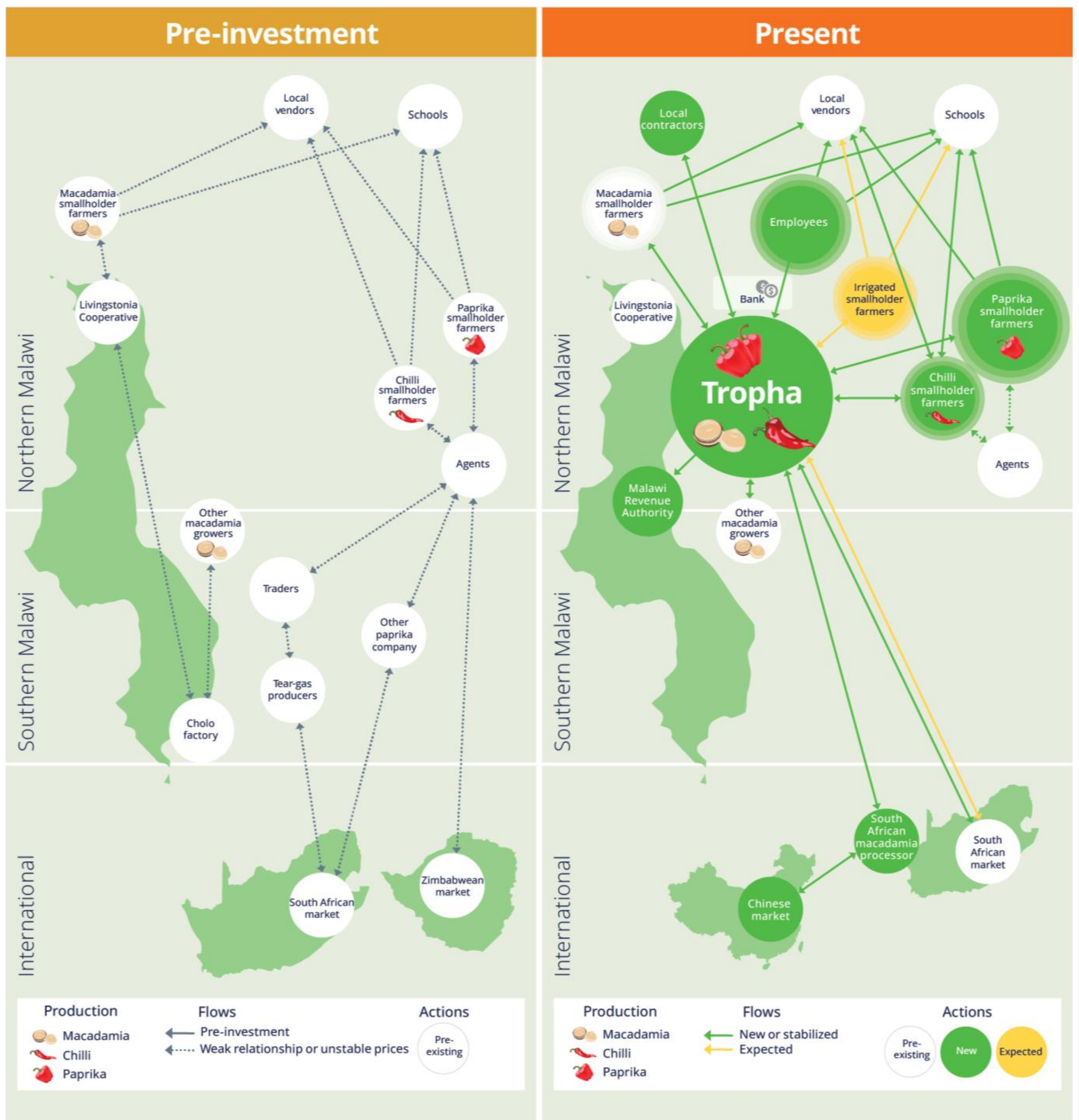
AgDevCo has been an investor in Tropha since 2014, committing US$6.1 million in loans and US$2 million in equity. Tropha, the Malawian subsidiary of the United Kingdom-based farming company Jacoma Estates, owns irrigated farming estates growing macadamia, chili and paprika in northern Malawi. It buys, 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.

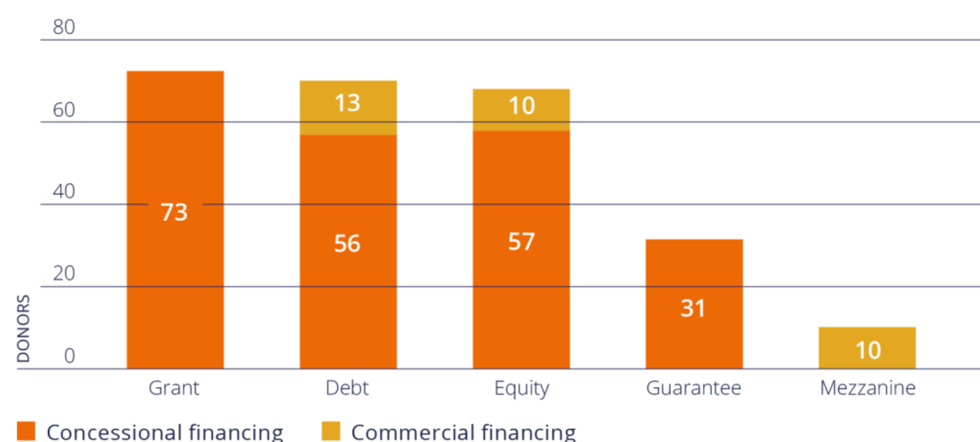
Figure 14 - Food value chain network before and after AgDevCo's investment in Tropha



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

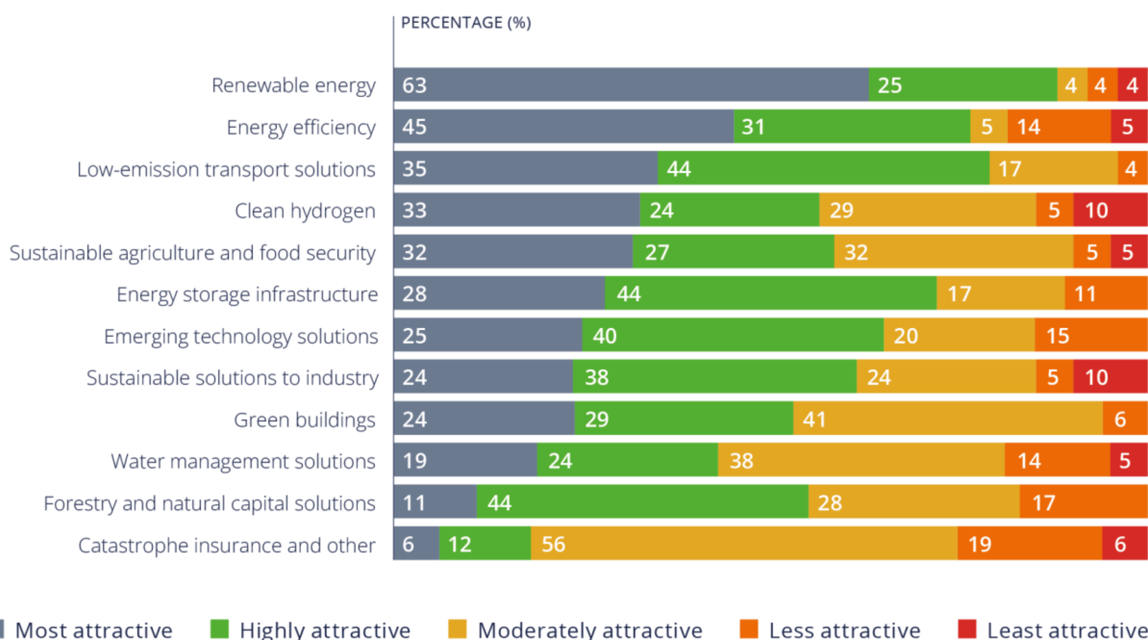


Chart: Kamal El Harty. *Source:* International Forum of Sovereign Wealth Funds and One Planet Sovereign Wealth Fund Network, 2023

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)

CHAPTER 4. The risk appetite of development finance institutions

DFIs are governed by rules that discourage them from taking risks to provide financing that would otherwise not be available from commercial lenders.

Key recommendation: Donor governments must provide DFIs with dedicated funds that allow them to:

i. offer higher-risk loans, such as first loss and mezzanine debt, that have well-defined targets on sustainable food and agriculture;
ii. provide long-term credit lines, guarantees, transaction advice and technical assistance to domestic financial institutions to build institutional knowledge on sustainable agriculture and food systems;
iii. accompany institutions, funds and projects over the long term.

This section presents the rationale for the above recommendations and discusses why and how DFIs should take more risks. In doing so, DFIs have the potential to mobilize greater amounts of financing from private investors.

DFIs are largely funded by either government guarantees or (inter)national development financing. This strong backing ensures their creditworthiness, allowing them to raise money in international markets and provide financing at very competitive rates (OECD, 2023a, no pagination). Developing finance institutions include bilateral and multilateral institutions. The latter are also referred to as MDBs, are established by more than one country and are subject to international law (OECD, 2023a, no pagination).

DFIs hold investment-grade credit ratings and take a portfolio approach to investment. They can therefore distribute project risks across their balance sheet and thus participate in transactions of varying risk and return levels. They also have distinct mandates. For example, DFC is financed almost entirely through budget allocations and therefore may be able to take on more risks than other development banks, which may need to uphold their credit ratings. DFIs that maintain investment-grade credit ratings can raise cheaper capital and lend to projects in higher-risk countries (Horrocks, n.d.).

Do DFIs crowd out private investors?

Additionality is one of the central questions in increasing efficiency and innovation in development finance. In the case of DFIs, additionality refers to the extent to which they offer financing on favourable terms and conditions that commercial investors will not be able to match. It also refers to the extent that the financing terms and comfort provided by the DFIs result in de-risking and mobilizing commercial investors that would otherwise not have participated in development projects.

The challenge for DFIs is that they are governed by prudential rules and statutes that prevent them from lending to high-risk projects. DFIs hold investment-grade credit ratings (rated AA or AAA by Standard & Poor's and Fitch Ratings) and, to maintain these high ratings, their regulations discourage excessive risk-taking. As the food and agriculture sector is higher risk and tends to offer lower financial returns than other sectors, DFIs tend to hesitate to lend to food and agriculture projects (see Figure 17). When they do, they tend to provide senior debt rather than first-loss financing (see Box 10).

Figure 17 - DFIs deployed less financing to food and agriculture projects than other sectors

Total volume of DFI blended finance projects in millions of United States dollars, 2021

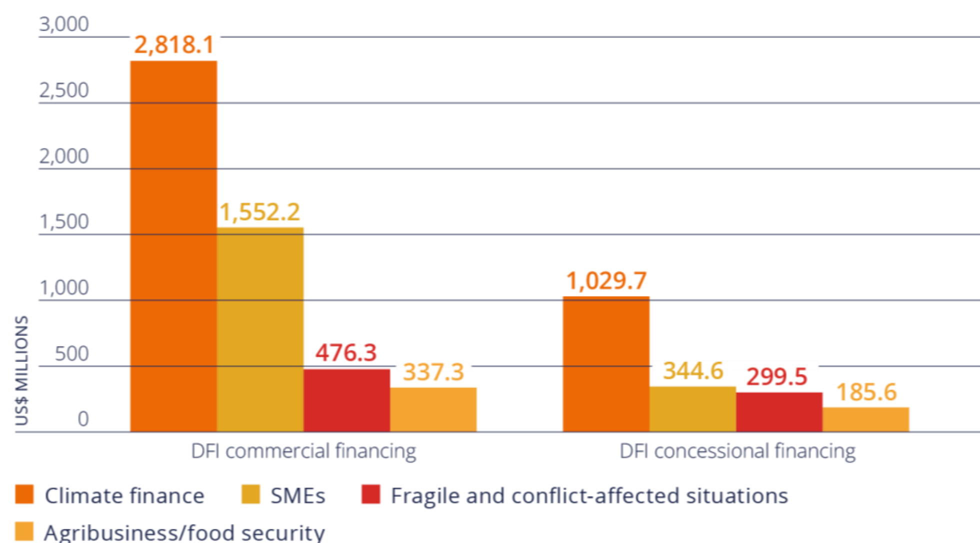


Chart: Kamal El Harty. *Source:* DFI Working Group on Blended Concessional Finance for Private Sector Projects, 2023

Box 10 - What are first loss, senior debt, mezzanine debt and loan guarantees?

First loss is a type of concessional finance where the lender is the first in line to take a loss if the project or fund fails.

Senior debt is a type of loan with commercial interest rates. These loans are the first to be repaid before any other creditors or shareholders if the project or fund fails.

Mezzanine debt can be concessional or commercial finance. It gives the lender the right to convert to an ownership stake (equity) if the borrower does not repay the debt on time and in full.

Loan guarantees are guarantees provided by a third party who agrees to repay the loan if the borrower defaults.

Sources: K4D, 2021; SDC, 2017; USAID, n.d.

As one expert on sustainable finance said:

> *"Development banks are being asked to realize financial returns along with development additionality, and these two objectives are not always compatible. Ministries of economic development and foreign affairs require them to help developing countries, but treasuries and finance ministries, along with credit rating agencies, determine their risk exposure. The incentives they receive therefore promote returns over impacts."*
>
> *(Expert on sustainable finance, Shamba Centre stakeholder enquiry into sustainable finance, 2023)*

This is a lost opportunity for the development finance community. If DFIs take first-loss financing, it will increase the pool of concessional finance that can, in turn, mobilize more commercial finance for development projects. The overall pool of development finance could then be significantly increased.

The debate heightens when considering whether senior debt loans provided by DFIs crowd out commercial lenders. Stakeholders interviewed had different views on this matter.

According to one commercial lender interviewed:

> *"Development banks are almost a competitor to us. They take senior debt, and we ask, 'What is their additionality?'"*
>
> *(Commercial bank investing in agriculture, Shamba Centre enquiry into sustainable finance, 2023)*

Similarly, one fund manager remarked:

> *"Development finance institutions must take on more risk. What is their value when they don't provide first-loss financing?"*
>
> *(Fund manager, Shamba Centre enquiry into sustainable finance, 2023)*

The DFIs that participated in this enquiry were, however, unequivocal in saying that they compete much more among themselves than with private commercial lenders. They also considered their role to be that of an anchor lender, bringing comfort to other commercial lenders so that may then invest alongside them.

According to two DFI representatives:

> *"We do not crowd out private commercial lenders, but we compete between ourselves. When sponsors of projects approach us, there are often several of us [development banks] in the conversation – but no private commercial banks. So, yes, we take senior debt, but we are almost always the only entity willing to lend on the terms we do."*
>
> *(Development finance institution, Shamba Centre stakeholder enquiry into sustainable finance, 2023)*

> *"Our additionality is that we help build institutions and enterprises. The technical assistance, market facilitation and advisory services we provide are also very important – even more important than the money we lend. Businesses and institutions in developing countries do not receive these services from commercial lenders."*
>
> *(Development finance institution, Shamba Centre stakeholder enquiry into sustainable finance, 2023)*

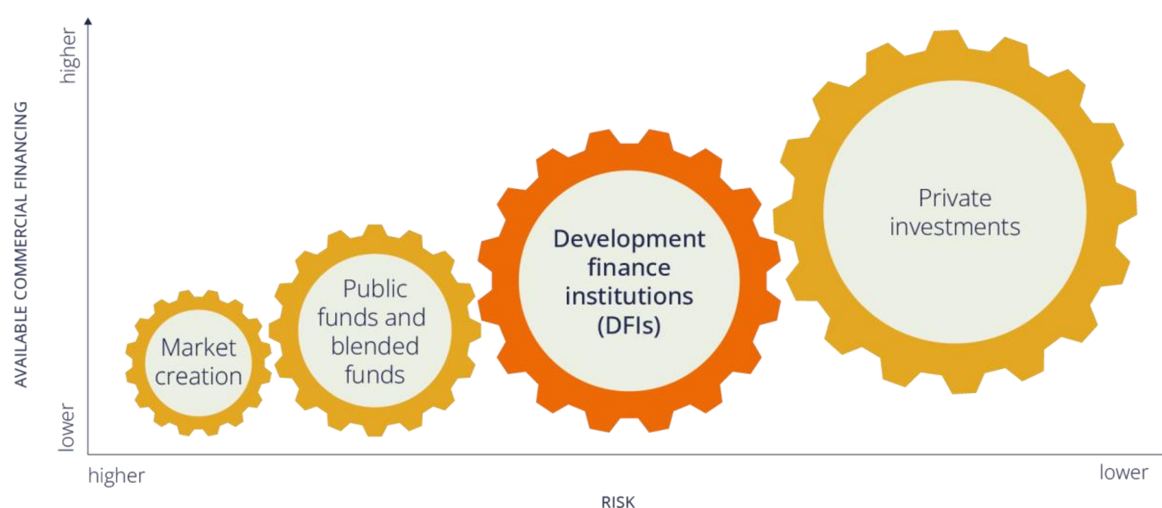
DFIs are driving performance on environmental, social and governance measures

DFIs consider themselves change agents that drive innovation and ESG improvements across value chains. They view their additionality as financiers of early-stage, high-risk ventures such as in agricultural technology and green financial technology in low- and middle-income countries.

When funding such ventures, DFIs predominantly use public funds under their management or finance local financial intermediaries and blended funds. Once these projects reach a certain size and produce a more stable cash flow, DFIs then seek to finance them directly using their own financial resources to the point where commercial investors can take over (FMO, 2022) (see Figure 18).

Figure 18 - How DFIs view their additionality

DFIs view themselves as anchor investors cofinancing along with private investors and supporters of blended funds and public funds in market creation



Source: FMO, 2022

DFIs also work with financial intermediaries and their follow-on beneficiaries to increase their expertise on measuring, managing and reporting on climate risks. The eligibility requirements to borrow from DFIs include the ability to report an organization's exposure to climate risks. Borrowers need to report on their direct emissions for scope 1 (emissions from assets that are owned and controlled by the borrower), scope 2 (indirect emissions from the production of electricity used by the borrower) and scope 3 (indirect emissions that the enterprise triggers across its value chain). Many banks, non-banks and private enterprises in developing countries have not yet developed the skills to manage and report on scope 3 emission and, thus, are finding themselves not eligible to receive loans that originate from DFIs. DFIs are therefore starting to offer loans with tranches that are conditional to improvements in climate risk measurement.

> *"Understanding scope 3 emissions remain[s] particularly problematic in the food and agriculture sectors. It is becoming important for us to have the flexibility to lend to such entities on the conditionality that they will begin scope 3 emission tracking and mitigation during the loan tenure …"*
>
> *(DFI representative, Shamba Centre stakeholder enquiry into sustainable finance, 2023)*

DFIs welcome the opportunity to take more risk and offer more favourable and more longer-term commercial financing

The DFIs that participated in the enquiry unanimously welcomed changes in their mandates that will provide them with the flexibility to:

- consider longer-term loans and provide longer-term technical assistance and transaction advisory services to accompany domestic lenders and businesses through different stages of growth and maturity;
- work with dedicated pools of financing to provide first-loss financing (see Box 16);
- increase the use of guarantees, hedging instruments and liquidity facilities to finance riskier projects and mobilize commercial financing (see Box 11 and Box 12).

Moreover, the MDBs that participated in the enquiry welcomed the option to use their callable capital (i.e. capital that is not yet paid in by shareholders) to take additional risks.

In tandem, the World Bank Evolution Roadmap, published in October 2023, reports on several reforms under way including an equity-to-loan ratio lowered from 20 to 19 per cent and greater use of callable capital and guarantees. This increased lending capacity, together with the reinvigorated priorities on poverty alleviation, shared prosperity on a liveable planet and transnational global challenges, is likely to result in more risk-taking across the World Bank Group and the MDBs systems more widely (Development Committee, 2023).

Box 11 - Proparco and the Food and Agriculture Resilience Mission

The French President, Emmanuel Macron, announced the Food and Agriculture Resilience Mission (FARM) initiative at the EU summit in March 2022. Through FARM's third pillar, which focuses on strengthening local agricultural production in vulnerable countries, the Government of France launched the first pilot phase of the FARM private sector initiative. With an initial budget of EUR 40 million, this initiative will be implemented by Proparco and other French public financing institutions.

Proparco will use this budget to finance African and French agrifood SMEs across the entire food value chain. The starting ticket size will be EUR 100,000 and, working through intermediaries, Proparco aims to reach SMEs with financing needs as low as EUR 1,000. Financing will be designed as loans, guarantees and technical assistance to local and French banks and microfinance institutions that will on-lend to SMEs (Proparco, direct communication). The objective is to provide an incentive for local and French banks to increase lending to SMEs with limited collateral and based in rural environments (Proparco, direct communication, 2023) (see Figure 19).

This pool of off-balance-sheet financing presents new opportunities and challenges for Proparco as it works to put in place due diligence processes to manage smaller, high-risk loans for agriculture and agrifood logistics.
As a representative from Proparco remarked, "The FARM financing is new for us, as we are taking first loss, working with smaller ticket sizes, investing in riskier businesses with the goal of addressing food security and climate change. Our success is critical to the catalytic potential of the FARM initiative" (representative from Proparco, Shamba Centre enquiry into sustainable finance, 2023).

In June 2023, through the FARM initiative, Proparco allocated a grant of EUR 230,000 to Advans Côte d'Ivoire, a microfinance institution, to support a pilot programme of pre-harvest lending and technical assistance to 1,500 corn cooperatives. In the absence of this dedicated financing, Proparco would have not been able to support this high-risk pilot programme (Proparco, 2023).

Figure 19 - Overview of the Food and Agriculture Resilience Mission (FARM) private sector initiative

Beneficiaries	**Start-ups and incubators in Africa**	**SMEs in Africa**	**Agro-industrial enterprises across the food value chain**
Ticket sizes	Between EUR 1,000 and EUR 1 million	Between EUR 1,000 and EUR 5 million	Starting from EUR 5 million
Financing from the AFD Group, including Proparco	Financing for start-ups directly and through investment funds	Financing for SMEs in partnership with domestic banking and microfinance institutions	Financing and technical assistance for agro-industrial enterprises across the food value chain
In partnership with French public financing institutions	Support for the acceleration of start-ups	Financing for SMEs in partnership with French banks	Financing and technical assistance for agro-industrial enterprises seeking to establish themselves in Africa

Source: Proparco, direct communication, 2023

Box 12 - The European Union's InvestEU programme

InvestEU provides an EU budgetary guarantee to the European Bank for Reconstruction and Development (EBRD), enabling it to provide unfunded guarantees to financial intermediaries.

Under the InvestEU guarantee agreement signed between the European Commission and the EBRD in December 2022, the EBRD will extend an EU budgetary guarantee valued at EUR 470 million to eligible partner financial institutions in 12 EU Member States. This guarantee will be partially covered by first-loss cover provided by the European Commission (EBRD, 2023).

With the support of this EU budgetary guarantee, EBRD gains the capacity to take on risk at the first-loss level and have skin in the game in going beyond its typical risk-taking capacity. The budgetary guarantee is significant, as it is a legal confirmation from the EU that it will back EBRD investments under this programme by placing the associated financial obligation on the budget of the EU should a specified event materialize.

It is estimated that EBRD will unlock EUR 2.1 billion of financing by extending these guarantees to financial institutions. This financing will support projects across a wide range of sectors, including sustainable infrastructure, energy, food, the green and blue economies and digitalization (Ahlemeyer, 2022).

Since this guarantee is provided by InvestEU, EBRD does not set aside reserves from its own financial resources to cover potential loan losses in case of default. The freed-up financial resources, traditionally earmarked for guarantees, can be used to increase EBRD's lending capacity to support more beneficiaries.

In addition, under this agreement, financial institutions that benefit from the risk reduction on their portfolios of loans through the EBRD guarantees will be required to improve the conditions of the loan extended to end-borrowers. This improvement may include lower collateral requirements, lower interest rates and long loan terms (Investment Committee of the InvestEU Fund, 2023).

Owing to the additionality of the InvestEU guarantees, EBRD is considering increasing its guarantees to up to EUR 805 million (EBRD, 2023).

CHAPTER 5. The value of data

More research and data on the performance of agrifood SME loans that originate from donors are a prerequisite to make ODA catalytic.

Key recommendation: Donors should create a data repository on the performance of agrifood SME loans, based on the experiences of stakeholders such as the Council on Smallholder Agricultural Finance, IDH Farmfit Fund, AgDevCo, Acumen Capital Partners and MIX Market.

To scale up lending and blending, donors need research and data on the loans they provide to agrifood SMEs. They also need to be able to compare their own portfolios of agrifood SME loans with those of other donors and DFIs. While donors may be collecting this information, there is no public (or private) data repository where data are recorded, cleaned and prepared for investment decisions. The lack of comparable data impedes transparency and the development of market insight that is so critical for building an inclusive market.

The value of collecting and using loan performance data is demonstrated by the work of Acumen Capital Partners and the Council on Smallholder Agricultural Finance (CSAF).

The Acumen Foundation, through grant financing from donors, invests in marginalized SMEs and receives a revenue of US$0.89 cents for each dollar invested. This translates into losses of US$0.11 cents per dollar (Perera, 2023). Acumen continues to support these SMEs, carefully recording their progress on climate resilience, sustainable farming and processing practices, and the management of their assets and cash flow.

Using these data records, the Acumen Foundation, through Acumen Capital Partners, launched the Acumen Resilient Agriculture Fund in 2022. The Acumen Resilient Agriculture Fund takes equity stakes in SMEs to finance, advise and scale up climate resilient farming and processing. Concessional financing for the Acumen Resilient Agriculture Fund was provided by the Acumen Foundation and the Green Climate Fund with commercial financing from FMO, the Soros Economic Development Fund, Proparco, the Children's Investment Fund Foundation, Global Social Impact, the IKEA Foundation and others (ARAF, n.d.).

Similarly, CSAF, a network of impact investors, is a successful example of the value added of sharing and analysing data collectively. CSAF broke new ground in collecting and analysing data on loans that originate from donor funds disbursed by CSAF members to agrifood SMEs in developing countries. Data are collected on loans by region, size, existing versus new borrowers, informal and less developed value chains, and contract duration. CSAF members benefit from comparative analyses and can find solutions to common challenges. Aceli Africa was launched, in part, to address some of these challenges.

Other examples include MIX Market, a data catalogue for financial service providers targeting unbanked communities in developing countries, and SAFIN, which provides resources and designs clinics to help SMEs prepare due diligence for investors.

During the enquiry, several stakeholders voiced support for a wider data repository on agrifood SME loans, based on the experiences of Acumen, IDH, CSAF and MIX Market.

Box 13 - The value of loan-level data: The IDH–Neumann Kaffee Gruppe advance payment programme

The Neumann Kaffee Gruppe (NKG) launched the NKG Bloom advance payment programme with a first-loss guarantee from the IDH Farmfit Fund and a second-loss guarantee from USAID. Implementation began in Uganda in 2017. NKG Bloom operates through farmer services units that are set up within NKG export companies. These units provide coffee farmers with service bundles, including mobile money advances, fertilizer inputs and training, to enable them to run their farms at full potential and maximize their incomes. Farmers are provided with the preferred option to repay the money advances with the harvested coffee.

Assessing the credit risks of smallholder farmers is challenging because of the lack of reliable data on their productivity. NKG Bloom overcame this challenge by assessing the credit risk and the indebtedness level of farmers based on transactional data from the sales of coffee by farmers to NKG export companies. The credit a farmer can obtain is contingent on the volume of coffee they supplied in the prior season (FRP and Rural and Agricultural Finance Learning Lab, n.d.). NKG Bloom aims to expand their risk appetite and additionality by offering longer-term loans to farmers with well-established track records of repaying short-term loans.

CHAPTER 6. Blended finance in action

This enquiry confirms that both donors and DFIs understand their financing can be far more catalytic and impactful when they partner with other concessional and commercial financiers. In 2023, the OECD DAC members formalized the rules for Private Sector Instruments as an eligible tool of ODA. This includes the institutional approach, such as providing more risk capital for development financing institutions, and the instrumental approach, such as providing concessional loans to private financiers. This development can be expected to drive more blending in the medium term (OECD, 2023b).

Blended funds are responding with increasing innovation and additionality. The stories of blended funds that follow illustrate how they are integrating environmental and social performance into lending criteria, increasing services to first-time borrowers and sharing risks across tighter supply chains.

Land Degradation Neutrality Fund

The Land Degradation Neutrality (LDN) Fund officially launched at the United Nations Convention to Combat Desertification (UNCCD) COP13 in Ordos, China, in 2017. Global Mechanism, the operational arm of the UNCCD initiated and designed the LDN Fund.

The LDN Fund is a first-of-its-kind blended fund, leveraging public financing to raise private financing for land degradation neutrality projects. According to the UNCCD, "land degradation neutrality" is defined as a state whereby the amount and quality of land resources necessary to support ecosystem functions and services to enhance food security remain stable, or increase, within specified temporal and spatial scales and ecosystems.

The LDN Fund provides long-term mezzanine debt and equity financing ranging from US$5 million to US$20 million for 10 to 15 years, along with pre- and post-technical assistance to projects that reduce or reverse land degradation. The LDN Fund reached its final closing at US$208 million in March 2021. It is managed by Mirova, an affiliate of Natixis Investment Managers SA.

The Land Degradation Neutrality Fund structure

First-loss	Inter-American Development Bank Invest, the GEF and the Government of Luxembourg are among the first-loss financiers of the LDN Fund. The LDN Fund has a target of US$300 million, of which roughly 20 to 30 per cent is reserved for first-loss capital (Principles for Responsible Investment, 2019).
Commercial financing	The European Investment Bank offered US$45 million in commercial financing, with additional commercial financing contributions from private investors, including Allianz, BNP Paribas Cardiff, BPCE Vie, Fondaction, Fondation de France and Garance (Cheelsy, 2019).
Technical assistance facility (TAF)	The TAF, managed by IDH and financed separately by the French Development Agency and GEF, provides grants and reimbursable grants for pre- and post-investment technical assistance to improve the project quality, enhance its environmental and social impact to meet the investment criteria, reduce transaction costs and risks, and expand the LDN Fund's projects pipeline. It also assists beneficiaries in monitoring their contributions to land degradation neutrality, enabling them to report progress and adapt their business operations to maximize development impact and reduce risks.

The LDN Fund finances projects committed to preventing, mitigating or reversing land degradation while also benefiting local community and ecosystems and adhering to stringent environmental and social standards. It specifically focuses on projects that banks are unable to support and requires a proven and detailed business model that includes revenues and cost projections, strong connection to value chains and capacity for scalability. Notably, the LDN Fund supports projects that demonstrate the ability to generate financial returns within roughly five to seven years, have an appropriate risk profile and have effective management. While interest rates and expected returns of the LDN Fund are market-based, it is set up to provide long-term debt or equity financing ranging from US$5 million to US$20 million for periods of 10 to 15 years. The financing options it offers come with flexible repayment schedules and long grace periods if needed. The earnings generated from the projects are then redistributed to investors and reinvested in further projects by the LDN Fund.

Projects aimed at achieving land degradation neutrality are characterized by volatile cash flow returns due to the inherent risks associated with halting and reversing land degradation. The LDN Fund mitigates this risk by stabilizing financial returns of projects through the diversification of revenue sources, often facilitated by technical assistance. Additional revenue streams can be generated through, for example, earning additional income from cash crops and carbon financing, improving yields and product quality sustainably, and enhancing value through processing.

Achieving land degradation neutrality often requires long time horizons for generating positive financial returns, typically five to seven years, a period during which commercial banks are unable to finance such projects. Businesses thus depend on patient, long-term financing from investors such as the LDN Fund. However, attracting international investors requires structuring projects of sufficient scale, a common challenge in the sector. Nonetheless, many projects in which the LDN Fund invests adopt innovative models to expand their operations and accelerate cash flow. For instance, Miro Forestry and Cacao Oro have expanded their operations through outgrower schemes that aggregate the existing production of many smallholders, while other investees have integrated fast-growing crops into agroforestry systems. These activities help stabilize cash flow and attract private investors to land degradation neutrality projects.

Sources: Mirova, 2019; UNCCD, n.d.

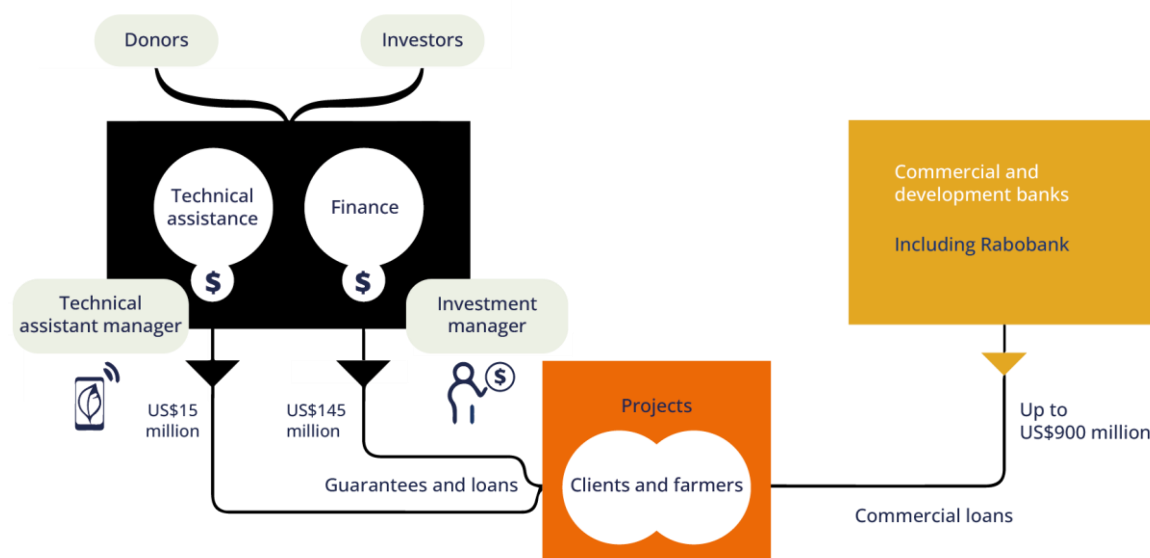
AGRI3

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. AGRI3 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. AGRI3 also provides technical assistance to commercial banks (see Figure 20).

AGRI3 Fund structure

Concessional financing	The Ministry of Foreign Affairs of the Netherlands contributed a US$35 million non-interest-bearing repayable grant as part of AGRI3's first-loss tranche, which will be repaid after 20 years. In addition, the **GEF** provided US$13.5 million mezzanine debt.
Commercial financing	The concessional financing by the Netherlands and GEF enabled Rabobank to extend US$50 million in senior debt and attract other private investors and DFIs to take senior positions in AGRI3.
Technical assistance facility (TAF)	The TAF had a target size of US$15 million, of which the Ministry of Foreign Affairs of the Netherlands granted a US$5 million non-repayable grant. The TAF is managed by IDH.

Figure 20 - AGRI3 Fund structure



Source: GEF, 2020a,

AGRI3's 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. In addition, 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.

AGRI3 aimed to achieve a target size of US$144 million, which would 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 would allow AGRI3 to achieve a leverage of seven times the internal funding (see Figure 11).

The technical assistance facility, overseen by IDH, collaborates closely with the fund manager and investment advisors to accelerate the development pipeline of projects and enhance their impact. This programme includes pre-investment assistance, ensuring that projects become AGRI3 Fund-ready within a 24-month period, thereby strengthening the project pipeline. Post-investment technical assistance focuses on enhancing the project developers' capacity to implement projects during the implementation phase, thus reducing the risk to the AGRI3 Fund and potentially amplifying the social and environmental impacts of these projects. The technical assistance also includes an impact-monitoring component, supporting both projects and the investment advisor in tracking and evaluating progress towards targeted impacts. In addition, the programme promotes learning and sharing of valuable insights from transactions.

As an illustration of additionality, the AGRI3 Fund and Rabobank have launched a 10-year loan product in Brazil, called *Renova Pasto*, to support the restoration of degraded pasturelands and accelerate forest conservation. It provides financing for activities that restore degraded pastureland while improving compliance with the forest code and enhancing the conservation and restoration of forest areas on cattle farms.

The partial guarantees offered by AGRI3 allow Rabobank to increase its risk appetite and extend its loan duration from 7 to 10 years. The technical assistance offered by the AGRI3 Fund to cattle producers in the Cerrado and Amazon regions further reduces the project's risks and enables Rabobank to support non-cash-generating activities such as forest conservation. Farmers are required to adhere to environmental and social action plans, including a commitment to zero deforestation across all their farms. These requirements are integrated into Rabobank's credit approval process.

The initiative has concluded its first pilot transaction and aims to expand rural credit options for Brazilian farmers, promoting sustainable production models in less productive areas.

Sources: Green Finance Institute, n.d.; SEO Amsterdam Economics, 2019

AgDevCo

AgDevCo is a specialized investor that supports agrifood SMEs in sub-Saharan Africa. It provides long-term debt and equity financing ranging from US$2 million to US$10 million, with an average investment horizon spanning 7 to 10 years and technical assistance of up to US$800,000. Currently, AgDevCo manages a portfolio worth US$280 million across 10 countries. It is incorporated as a not-for-profit distribution company in the United Kingdom in 2009 with an endowment from the Government of the United Kingdom.

AgDevCo Fund structure

Concessional financing	AgDevCo was established in 2009 with an endowment provided by the Government of the United Kingdom, which has supported AgDevCo over the past decade. The Government of the United Kingdom has also provided de-risking for other DFIs to contribute commercial financing to the AgDevCo Fund.
Commercial financing	AgDevCo has secured multiple rounds of financing since its inception. The most recent of these, in February 2022, provided AgDevCo with US$90 million from multiple DFIs, including US$50 million of equity from British International Investment, US$20 million of equity from the Norwegian investment fund for developing countries, Norfund, and US$20 million of senior debt from DFC.
Technical assistance facility (TAF)	Alongside its fund, AgDevCo has a TAF that is financed separately, thus recognizing that assistance as well as patient financing is needed to build sustainable commercial agribusinesses. In 2022, British International Investment, Norfund and the FCDO provided supplementary funding of up to US$5.4 million for AgDevCo's integrated TAF.

The AgDevCo investment portfolio consists of 40 per cent of investments in earlier-stage ventures and 60 per cent of investments in later-stage growth. Through this combination, AgDevCo aims to achieve a minimum gross financial return of 5 per cent on its core capital, which includes AgDevCo's equity capital, supported by FCDO, as well as US$20 million in third-party debt and US$70 million in preference share equity capital as of 31 December 2021.

The AgDevCo growth portfolio includes investments that range in size from US$3 million to US$10 million, generate positive financial returns and have gross assets greater than US$10 million. This segment includes companies that typically have significant corporate expertise with a proven business model and are seeking financing to expand their operations or venture into a new geography or value chain segment. These companies are expected to carry a lower level of risk and have the potential to yield consistent cash flows or provide promising financial returns.

The AgDevCo ventures portfolio comprises investments of smaller ticket sizes ranging from US$2 million to US$5 million. It is primarily focused on businesses in earlier developmental stages, which inherently carry higher risk. Investments are categorized as ventures when they are not yet profitable and/or when their total assets are less than US$10 million. AgDevCo allocates a portion of its capital to companies with high-risk profiles, provided that they demonstrate a significant degree of additionality, strong developmental impact, short- to medium-term financial viability with a fully funded business plan, and the potential for self-sustained growth over time without the need for additional investment from AgDevCo.

AgDevCo continues to reach smaller borrowers though investments in financial intermediaries such as Lending for African Farming and Equity for Africa. The former is a non-profit organization that specializes in providing equipment loans of up to US$60,000 without requiring collateral except for the equipment itself.

AgDevCo is currently exploring opportunities to secure resources for a new concessional fund, Venture Plus, which will support smaller investments in the range of US$1 million to US$3 million.

The technical assistance facility, funded by donors, allows AgDevCo to offer tailored, in-house technical assistance support to its investees throughout the entire investment cycle, from the initial investment to exit or reinvestment. It also allows investees to test new concepts or innovative processes and supports the investees on a wide range of issues including risk, ESG and regulatory compliance, climate resilience, gender equality and smallholder development. The objective is to make businesses more resilient, impactful and investment ready. AgDevCo also provides investees with technical and project management expertise to strengthen the relationships between agribusinesses and smallholder farmers to reduce risks and improve operational efficiency in working with smallholders, whether as producers, intermediaries or customers. The support is provided through in-kind contributions such as training and workshops, and cash contributions in the form of grant-based cofinancing. The TAF projects are financed by AgDevCo and the investee on a matching basis where AgDevCo's contribution can range from US$50,000 up to US$800,000. The TAF has been instrumental to AgDevCo's success.

AgDevCo has also developed in-depth industry knowledge in tree crops (fruits and nuts), poultry and maize-milling businesses, and it is steadily building expertise in other sectors such as aquaculture, forestry and floriculture.

Sources: AgDevCo, 2022; World Bank, 2021

IDH Farmfit Fund

Farmfit is a rapidly growing marketplace designed to connect service providers, i.e. businesses and banks, with smallholder farmers, who form their client base. The platform's primary goal is to improve the economic conditions of smallholder farmers. It offers data, insights and financial support to businesses and banks, thus enabling them to design and implement successful and scalable business models that cater to the unique needs of smallholder farmers. This results in inclusive and sustainable value chains that are profitable for both businesses and smallholder farmers. The adoption of a holistic approach is made possible through a combination of public and private sector support, thus making it a powerful initiative in the agricultural and economic development space. Farmfit accomplishes its mission through three key components.

- **Farmfit Intelligence** provides data and insights to businesses, banks and other entities that work with smallholder farmers, helping them understand the financial performance of smallholder business models that cater to smallholder farmers and benchmark them against peers.

- **Farmfit Business Support** assists businesses and banks in using these insights to design scalable models tailored to smallholder farmers' needs. Consequently, this enhances the efficiency and effectiveness of smallholder value chains. This EUR 30 million facility is funded by the United Kingdom Department for International Development and the Bill & Melinda Gates Foundation.

- **Farmfit Fund** offers concessional financing to scale and replicate successful business models that have been designed and informed by Farmfit Intelligence and Business Support. The Farmfit Fund seeks to increase access to affordable finance for smallholder farmers, thus enabling them to enhance their productivity while adhering to climate-smart agricultural best practices and ultimately breaking the cycle of poverty. The Farmfit Fund is the world's largest public–private impact fund dedicated to smallholder farmers.

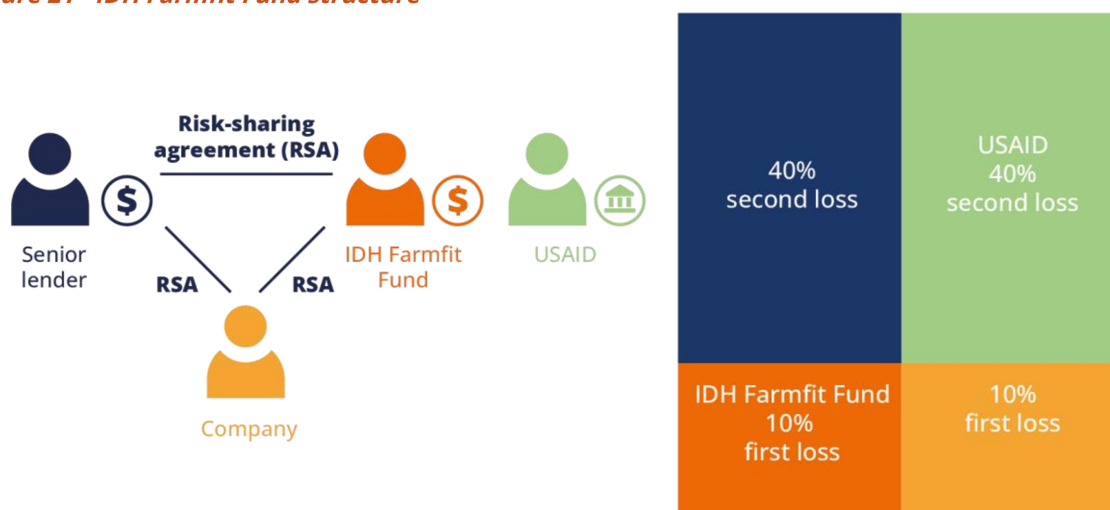
Farmfit Fund structure

Concessional financing	The Farmfit Fund, valued at EUR 100 million, received 50 per cent of its financing from the Ministry of Foreign Affairs of the Netherlands. The fund also benefits from additional de-risking guarantees from **USAID**, with coverage of up to US$250 million.
Commercial financing	The remaining 50 per cent of the Farmfit Fund's value is financed by five additional lenders. Of these five, four are from the private sector (Unilever, Cadbury, JDE Peets and Rabobank) and one is a public entity (FMO through the state funds MASSIF and Building Prospects).
Technical assistance facility (TAF)	The Farmfit Fund is accompanied by Farmfit Business Support, which is a TAF that supports businesses and banks in designing scalable models tailored to smallholder farmers' needs. The facility, valued at EUR 30 million, is funded by the United Kingdom Department for International Development and the Bill & Melinda Gates Foundation.

The Farmfit Fund provides first-loss financing to banks covering 10 per cent of loans and second-loss guarantee facility from USAID covering 40 per cent of the loan (see Figure 21). Leveraging these guarantees, the Farmfit Fund is expecting to build a portfolio in excess of EUR 1 billion.

This concessional financing model, coupled with innovative business models guided by smallholder farmer data, makes investments in smallholder farmers more appealing and also minimizes the risks and costs for both the farmers and investors.

Figure 21 - IDH Farmfit Fund structure



Source: IDH, 2023

As an illustration of both the additionality of the Farmfit Fund and the challenges farmers face in securing financing, IDH Farmfit provided a first-loss guarantee up to year 5, alongside US$9 million in financing from ABN AMRO, to the NKG in 2017. This concessional financing allowed the NKG to introduce its NKG Bloom initiative in Uganda with the aim of boosting the productivity and livelihoods of smallholder farmers and ensuring the long-term sustainability of green coffee supplies.

NKG Bloom offers fertilizer and mobile money advances so that farmers have immediate and regular access to cash for various purposes within predefined limits. This system enables them to avoid exploitative lending practices. The advance is then repaid during the harvest period, with coffee being the preferred means of

repayment. NKG Bloom Uganda also offers soil analysis, education, and training on good agricultural practices and financial literacy for smallholders, thereby reducing the risk of default of smallholder farmers.

NKG Bloom discovered that farmer segmentation is challenging and costly, particularly for small, informal smallholders, and that it is challenging to obtain reliable data. Instead, it bases its loan approvals on transactional data, such as coffee sales, which are a more reliable method for assessing farmers' indebtedness capacity. NKG Bloom is actively working on digitalizing payments in the supply chain's last mile and enhancing transparency and traceability.

NKG Bloom have also introduced a mobile field solution to record transactions digitally. Loan approvals are based on transactional data, typically correlated with a farmer's previous years' sales value with some adjustments. They initially start offering conservative loans to farmers and give them the opportunity to repay and establish a track record. NKG Bloom aims to include nearly all farmers who can sell coffee into the database, starting the process with their first recorded transaction. However, very small farmers with less than a quarter-hectare of coffee present operational challenges for microloans below a certain size. The goal is to expand into riskier segments and provide longer-term loans, such as seven-year renovation loans, as farmers demonstrate their repayment capability over time.

In 2019, IDH expanded its successful pilot project with NKG Bloom in Uganda into 10 new countries with ABN AMRO, BNP Paribas, Rabobank and USAID. NKG launched the Coffee Smallholder Livelihoods Facility, a US$25 million initiative designed to provide smallholder coffee farmers with fertilizers, seedlings and equipment cash advances, training and market access. This support aims to enhance the resilience and livelihoods of smallholder farmers within NKG's supply chains.

The US$25 million revolving credit facility is backed by a first-loss guarantee from IDH and a second-loss guarantee from USAID. IDH and NKG will collectively absorb the initial losses, with each contributing up to US$2.5 million in case of potential farmer defaults. This first- and second-loss guarantee mobilizes additional resources from commercial banks including ABN AMRO, Rabobank and BNP Paribas, allowing them to take senior positions within the facility.

Sources: International Comunicaffe, 2019. ; Messie et al., 2020

Food Securities Fund

Launched in March 2021, the Food Securities Fund is designed as an open-ended (evergreen) impact investment fund centred on sustainable agriculture within emerging markets. The Food Securities Fund was established in collaboration with the investment advisory firm Clarmondial and received support from various organizations including Convergence, the Global Environmental Facility (GEF), Good Energies Foundation, USAID, DFC, World Wildlife Fund USA and others.

Food Securities Fund structure

Concessional financing	The **Food Securities** Fund expects to raise approximately US$53.25 million in concessional financing, including US$37.5 million in credit guarantees from **USAID** and US$15 million in equity from the **GEF**.
Commercial financing	Commercial financing, valued approximately at US$734.25 million, is expected to be raised from institutional investors, impact funds, family offices, private banks and DFIs.
Technical assistance facility (TAF)	The Impact Advisory Board and directors of the Food Securities Fund are committed to exploring possibilities for additional resource mobilization. This may involve providing support for local technical assistance to enhance existing investments. Various groups, including the International Trade Centre, the World Wildlife Fund, the United Nations Environment Programme and the Government of Nigeria, have signalled their interest in such collaborations.

The Food Securities Fund addresses the financing gap for agrifood SMEs by providing them with short-term and renewable loans without requiring collateral. It achieves this by using guarantees from international agriculture companies that have business relationships with agrifood SMEs, in addition to guarantees from USAID Development Credit Authority (DCA). This innovative de-risking strategy balances the risk/return profile of agriculture projects for private investors. By providing loans that span the entire agricultural cycle (see Figure 22), the Food Securities Fund empowers agrifood SMEs to extend increased pre-harvest support to farmers. Furthermore, by making loans conditional on the improvement of ESG performance, the Food Securities Fund actively encourages the adoption of sustainable and climate-smart agricultural practices, thereby contributing to the achievement of the SDGs.

The accessibility of collateral is one of the primary obstacles preventing agrifood SMEs from obtaining financing. The fixed assets of agrifood SMEs (e.g. land and equipment) are often already used as collateral with local banks and other lenders to secure leases and mortgages. Other valuable assets, such as agricultural produce (e.g. grains) and sales agreements (e.g. export contracts), can only be used as collateral after the harvest. The journey from sowing to harvesting, particularly in the support of smallholder farmers and implementation of sustainable agricultural practices, demands a substantial amount of financing (see Figure 23). During this period, most agrifood SMEs lack the necessary collateral to secure financing.

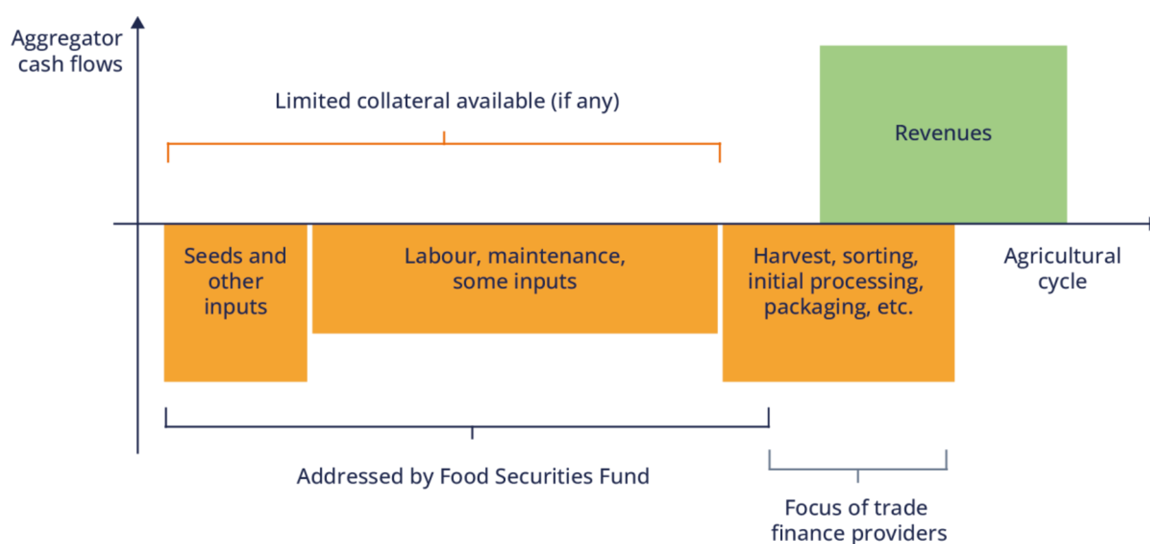
The Food Securities Fund collaborates with international agriculture companies to identify agrifood SMEs (borrowers) with a proven track record in two critical areas: (i) strong commitment to sound social and environmental practices; and (ii) active engagement in transactions with farmers who implement good agricultural practices, including climate-smart agriculture. In addition, an extensive due diligence procedure, which includes both financial and non-financial evaluations, is implemented for prospective investment opportunities.

The Food Securities Fund then provides renewable, short-term loans, typically on a 12-month basis, for agrifood SMEs in developing and emerging countries. These loans, denominated in United States dollars and

incurring a 9 to 15 per cent interest rate, allow the agrifood SMEs to finance their operations throughout the entire agricultural cycle. Thanks to its partnership with international agricultural companies (e.g. traders, input providers, exporters, agents, consumer facing brands) that have an existing business relationship with agrifood SMEs, the Food Securities Fund is able to provide these loans without requiring collateral. Instead of collateral, international agricultural companies provide first-loss guarantees to the Food Securities Fund, which cover 10 to 40 per cent of the loan principal. If an agrifood SME defaults on its loan, the international agriculture company will compensate the Food Securities Fund for part of its losses. The model therefore allows the Food Securities Fund to provide short-term, renewable financing to agrifood SMEs that have a longer-term and mutual commitment with an international agriculture company. Moreover, through DFC, USAID provides an additional guarantee that covers a loan period of up to six years (including renewals) for specific borrowers (see Figure 23).

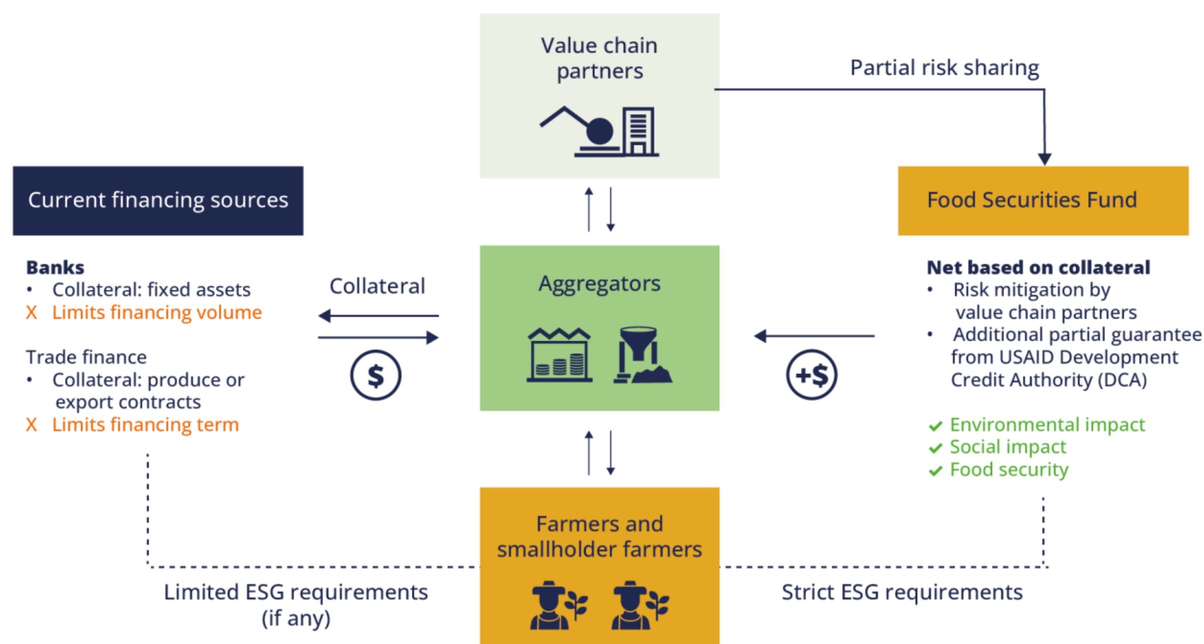
At the outset of any new lending agreement, the Food Securities Fund and the agrifood SME establish a set of key performance indicators that complements mandatory ones regarding compliance with sustainable agriculture, social and environmental practices, and rural livelihood development. These key performance indicators are included in the loan agreement, are subject to quarterly assessments and are considered in the annual decision regarding the loan renewal. This model provides a compelling financial incentive for agrifood SMEs to enhance their ESG and production sustainability performance to qualify for loan renewal.

Figure 22- The additionality of Food Securities Fund in financing aggregators' agriculture cycle



Source: GEF, 2019

Figure 23 - Food Securities Fund provides financing to aggregators using guarantees from value chain partners



Source: GEF, 2019

One Acre Fund and One Acre Re

One Acre Fund: At a glance

One Acre Fund is a non-profit organization that provides smallholder farmers with a comprehensive package of goods and services that enable them to increase their crop yields and income. This all-inclusive "market bundle" includes high-quality agricultural inputs on credit, financing with flexible repayment terms, proximity to convenient distribution points, training in modern agricultural techniques and market support services such as crop storage solutions. In 2022, One Acre Fund reached 1.6 million farm families across Burundi, Kenya, Malawi, Nigeria, Rwanda and Tanzania, enabling these farmers to realize a nearly 150 per cent return on their investment and allowing them to end hunger in their households, in addition to saving and investing in their children's education, medical expenses, improved housing and other productive assets.

One Acre Fund functions as a business and is consistently improving financial sustainability. For every US$1 provided by donors, farmers contribute US$3 towards the (subsidized) services offered by One Acre Fund. In 2022, 96 per cent of the credit extended by One Acre Fund was repaid by farmers, covering 72 per cent of the organization's field operating costs.

One Acre Fund: Smallholder insurance offering

Today, One Acre Fund stands as a major provider of smallholder insurance in East Africa, having paid out and forgiven US$5.1 million in agricultural loans since 2012. One Acre Fund has provided insurance coverage to farmers in its network by purchasing index insurance from private companies and reinsurers. Through this insurance, One Acre Fund has been able to forgive portions of the input loans for its farmers when they faced lower yields due to extreme weather, pests or other destructive events. The insurance thus not only acts as a safety net preventing farmers from skipping meals, selling assets and withdrawing children from school in response to adverse shocks; it also promotes investments in high-quality inputs for additional land.

However, the impact of One Acre Fund's insurance products has been constrained by market gaps and structural challenges in the sub-Saharan insurance market. Climate change is forcing insurers to leave certain markets, including those serving smallholder farmers, as a result of higher risk and lower profitability. When insurance products are available for smallholder farmers, premiums are often inflated by fees and brokers' profits. Farmers are therefore unable to afford insurance products that offer comprehensive resilience cover. Instead, they are constrained to low-protection options, typically covering only inputs or specific assets such as funeral insurance. As a result, the investments made by farmers and One Acre Fund's loan repayment model are jeopardized.

One Acre Re: A new reinsurance fund for climate resilience

To address these challenges, in 2023 One Acre Fund launched a pioneering "reinsurance fund", One Acre Re, to increase the resilience of smallholder farmers in Africa. One Acre Re was developed with the support and partnership of the IFC, DFC and the African Risk Capacity Group, and aims to expand insurance coverage, increase the value of insurance offerings and improve the timeliness of payouts for farm families. In this endeavour, One Acre Fund intends to establish its own reinsurance capital pool, which will operate with reduced risk and profit expectations compared with conventional insurers.

One Acre Re's model eliminates brokers and intermediaries, thereby increasing the potential for profitability. Profits from the insurance programme could be given back to farmers in the form of higher payouts or reduced premiums. One Acre Fund's physical presence in Africa also promises to diversify risk across the various markets and climate zones in which the organization operates. Moreover, its network of 1.6 million smallholder farmers will provide valuable insights for the development of tailored agricultural and microinsurance solutions for African smallholders. The long-term stability of One Acre Re will rely on solid capitalization of the One Acre Fund in the initial and expansion stages, rather than continuous donor funding. Future expansion plans include the introduction of new insurance products and support of microfinance institutions beyond One Acre Fund to extend services to smallholder farmers.

Sources: One Acre Fund, direct communications, 2023

CHAPTER 7. Conclusion

The underlying value proposition of the enquiry was echoed at the World Economic Forum's annual meeting in January 2024. Economists Esther Duflo, Thomas Piketty and Ann Pettifor argued that global challenges from poverty and climate change cannot be addressed without reducing economic inequality (Nuttall, 2024). The missing middle is at the core of this challenge.

Reducing inequality requires that small enterprises receive not only affordable financing but also accompanying services to help them upskill and reskill as innovation and technology advance. In addition, the world is predicted to breach the 1.5° C threshold in 2024, which will push an additional 68 million to 135 million people into poverty and expose 245 million people to new and aggravated water shortages. These numbers will more than double if temperatures reach the 2° C threshold (Milman, 2024). It therefore becomes even more urgent to address the missing middle as they are the first in line to be affected.

The enquiry also finds that the political mood for risk-taking and blended finance is ripe. This was demonstrated at COP28 through the following.

- DFI and donor government commitments to include climate-resilient debt clauses in their sovereign lending to developing countries. Under these clauses, countries have the option to pause debt servicing during times of climate stress and catastrophe (AfDB, 2023).
- Several donor countries agreeing to channel unused special drawing rights through MDBs, which, in turn, would use them to issue bonds and crowd in private financing for sustainable development (IDB, 2023).
- The World Bank committing to use its callable capital to take more risk and expand lending (Christie, 2023). Callable capital is the commitment from the World Bank's shareholders to provide fresh financing under extreme circumstances. The World Bank is working to expand the conditions and clarify the procedures under which it can 'call' on its shareholders and, in doing so, increase additionality in making more high-risk investments.
- The announcement that the 2009 commitment made by developed countries to provide US$100 billion a year in climate finance was reached. As reported by the OECD, approximately US$89.6 billion in climate finance was availed of in 2021 and contributions were expected to have exceeded US$100 billion in 2022 (OECD, 2023c).

These are all significant milestones. The reality is, however, that difficult geopolitics, wars, climate change and supply chain disruptions are likely to maintain high food prices and that global food crises are likely to continue in the medium term.

Therefore, donor dollars will probably become an extremely sought after and rare commodity. Donors must not be shy. As providers of a rare commodity, they must raise the bar and demand more financial and development additionality for each dollar deployed. This includes demands for greater participation from and risk sharing with beneficiary governments and sovereign wealth funds. The recommendations from the enquiry chart the immediate steps in this direction.

The fundamental challenge is, however, that agriculture and food are difficult businesses and agrifood SMEs are often barely profitable. The experience of donors and blended funds that participated in this enquiry show that, when lending to the missing middle, the risks and costs of lending are so high that the "returns" are around US$0.88 to US$0.91 per dollar invested (Acumen, 2022). This indicates losses of US$0.12 to US$0.09 per dollar. Profitability increases when investments are larger and enterprises are more mature.

The objective of the agrifood development finance agenda must hence strike the difficult balance between providing concessional financing for marginalized SMEs and supporting those with better business models to reach a stage of maturity to work with blended and private financiers. In practice, however, a large cross

section of SMEs will fall short of fully embracing commercial financing (ISF Advisors, 2022). The reality is that most SMEs will always remain SMEs. This underscores the continuous need for and the high additionality of concessional financing, guarantees and incentives. Together, they provide the basis for increasing resilience and access and lowering the cost of capital for the missing middle.

The enquiry shows that donors are already rising to the challenge and experimenting by placing concessional financing in mezzanine, junior debt and equity positions and increasing performance-based financing. Donors are also working on incentives such as payments to banks to cover the additional costs and risks of lending to first-time borrowers.

Bold donor decisions are paramount to making agrifood development finance more affordable and accessible. The catalytic power and the demonstrated effect of donor money must not be underestimated.

Annex. Principles of blended finance

The OECD DAC blended finance principles for unlocking commercial finance for the SDGs:

Principle 1: Anchor blended finance use to a development rationale

- Use development finance in blended finance as a driver to maximize development outcomes and impact
- Define development objectives and expected results as the basis for deploying development finance
- Demonstrate a commitment to high quality

Principle 2: Design blended finance to increase the mobilization of commercial finance

- Ensure additionality for crowding in commercial finance
- Seek leverage based on context and conditions
- Deploy blended finance to address market failures, while minimizing the use of concessionality
- Focus on commercial sustainability

Principle 3: Tailor blended finance to the local context

- Support local development priorities
- Ensure the consistency of blended finance with the aim of local financial market development
- Use blended finance alongside efforts to promote a sound enabling environment

Principle 4: Focus on effective partnering for blended finance

- Enable each party to engage on the basis of its mandate and obligation, while respecting the other's mandate
- Allocate risks in a targeted, balanced and sustainable manner
- Aim for scalability

Principle 5: Monitor blended finance for transparency and results

- Agree on performance and result metrics from the start
- Track financial flows, commercial performance and development results
- Dedicate appropriate resources for monitoring and evaluation
- Ensure public transparency and accountability on blended finance operations

Source: OECD, 2020

Enhanced blended concessional finance principles for DFI private sector operations:

- **Rationale for using blended concessional finance:** DFI support for the private sector should make a contribution that is beyond what is available, or that is otherwise absent from the market, and should not crowd out the private sector. Blended concessional finance should address market failures.

- **Crowding-in and minimum concessionality:** DFI support for the private sector should, to the extent possible, contribute to catalysing market development and the mobilization of private sector resources and minimize the use of concessional resources.

- **Commercial sustainability:** DFI support for the private sector and the impact achieved by each operation should aim to be sustainable. DFI support must contribute towards the commercial viability of clients. The level of concessionality in a sector should be revisited over time.

- **Reinforcing markets:** DFI support for the private sector should be structured to effectively and efficiently address market failures and minimize the risk of disrupting or unduly distorting markets or crowding out private finance, including new entrants.

- **Promoting high standards:** DFI private sector operations should seek to promote adherence to high standards of conduct in their clients, including in the areas of corporate governance, environmental impact, social inclusion, transparency, integrity and disclosure.

Source: DFI Working Group on Blended Concessional Finance for Private Sector Projects, 2023

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The Global Donor Platform for Rural Development (GDPRD) and the Shamba Centre for Food & Climate have undertaken an enquiry on how to make donors and public funds more catalytic for food systems through innovative financing approaches. This report is part of the GDPRD workstream on sustainable/ blended financing for SDG2.

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