

Blended Finance: An Uneasy Balance Between Bankability and Viability

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In our article “Blended Finance: The Case for Realism and Reform,” forthcoming in Development Finance Agenda (#DEFA, Chartered Institute of Development Finance), Amil Aneja and I examine briefly several hurdles that prevent Blended Finance from achieving adequate scale.

Two principal beliefs attempt to explain the supposedly disappointing performance of Blended Finance: for no good reason, vehicles have complex and diverse structures; and, for mysterious reasons, insufficient concessional resources are being committed. We do not agree entirely with either of these beliefs.

We explore how concessionality affects the financial sustainability of vehicles. **Interested in the difference between vehicle bankability (meaning that a vehicle can attract private-sector financing) and vehicle viability (meaning that a vehicle has a positive NPV), we touch upon the common misconception that sovereign/philanthropic equity can decrease a vehicle's overall cost of capital.** For example, *Scaling Blended Finance: Practical tools for Blended Finance Fund design* contains the following statement:

“The first-loss protection provided by junior equity enables the senior debt tranche to be priced at more favourable rates, which in turn lowers the fund's weighted average cost of capital (WACC) and facilitates the fund's investment strategy.”

In the case of a fund—with private-sector debtholders and sovereign/philanthropic shareholders—that has the investment strategy of lending on sub-market terms to private-sector borrowers, our article can be interpreted as connecting several ideas:

1. The cost of capital associated with an investment depends mainly on the riskiness of the investment: it is the use of the money, not its sources, that matters. In *Fundamentals of Corporate Finance*, the authors—Stephen Ross, Randolph Westerfield, and Bradford Jordan—describe this fact as “one of the most important lessons in corporate finance” and caution the student:

“It is a common error to forget this crucial point and fall into the trap of thinking that the cost of capital for an investment depends primarily on how and where the capital is raised.”

Blended Finance funds may be assumed to pay no taxes (funds are pass-through vehicles) and face immaterial costs of financial distress (sovereigns/philanthropies and DFIs/MDBs are exceptionally concerned about reputational risk).

2. **The WACC can be interpreted as the required return on the fund's assets.** This required return, which can also be called the appropriate discount rate, depends on the riskiness of the assets, and it does not change due to changes in the fund's capital structure; rather, as the Nobel Laureates Modigliani and Miller (M&M) have shown, the fund's cost of equity depends on the required rate of return on the fund's assets, the fund's cost of debt, and the fund's debt-to-equity ratio.

3. **M&M have also shown that the value of the fund does not depend on its capital structure.** If the fund lends on sub-market terms, say, 15% instead of at the required return of, say, 20%, then the value of the fund will go down. Extending loans at a rate lower than the required return is similar to paying 100% for bonds with coupon rates of 15% and appropriate discount rates of 20%: each such transaction is a negative NPV investment. To represent risks that should be paying 15%, the private-sector borrowers who are priced at 20% by the market would have to purchase suitable guarantees.

4. As the motivation behind Blended Finance is the creation of sub-market financing vehicles through the utilization of concessional resources, **Blended Finance seems to be predominantly about value redistribution, with risk-return profiles changing as a result.** In general, investors do not care about returns: investors care about value. A rational investor would prefer an investment that makes \$100 and offers a return of 5% to an investment that makes \$50 and offers a return of 10%.

5. **A Blended Finance fund can be bankable (i.e., attract private-sector investors) even when it is not viable (i.e., has a negative NPV).** This outcome occurs because value is redistributed from the sovereign/philanthropic shareholders to the private-sector debtholders and the private-sector borrowers.

6. **When a fund with shareholders has a negative NPV by design, questions about fiduciary duties arise.** Hence, it is vital to employ legal forms that are conducive to joint ventures among sovereigns/philanthropies, DFIs/MDBs, and private-sector investors.

7. **When a sovereign provides a fund with concessional resources, with value transferred to private-sector borrowers and private-sector investors, questions about the proper use of public funds arise.** Thus, it is imperative to deploy public funds in line with social norms in order to avoid even the appearance of partiality.

Our article demonstrates the relevance of a global Blended Finance platform that operates in accordance with consistent methodologies and uniform standards. Jonathan Stilwell and I advanced the concept of such a platform in the 2024 Development Finance Agenda article "A Global Blended Concessional Finance Hub."