

Using Blended Finance to Access Commercial Finance

Session 8



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Accessing Capital

- Learning Objective
- Sources of Capital for Water Utilities
- Accessing Commercial Finance
- Structuring Finance

Learning Objective

Learning Objective

Understand what sources of capital exist, how those sources differ, what is the resulting impact on utilities, and how utilities can access them

Sources of Capital for Water Utilities

Water Utilities Need Access to Capital

Water utilities are capital intensive... they require multi-year capital investments to:

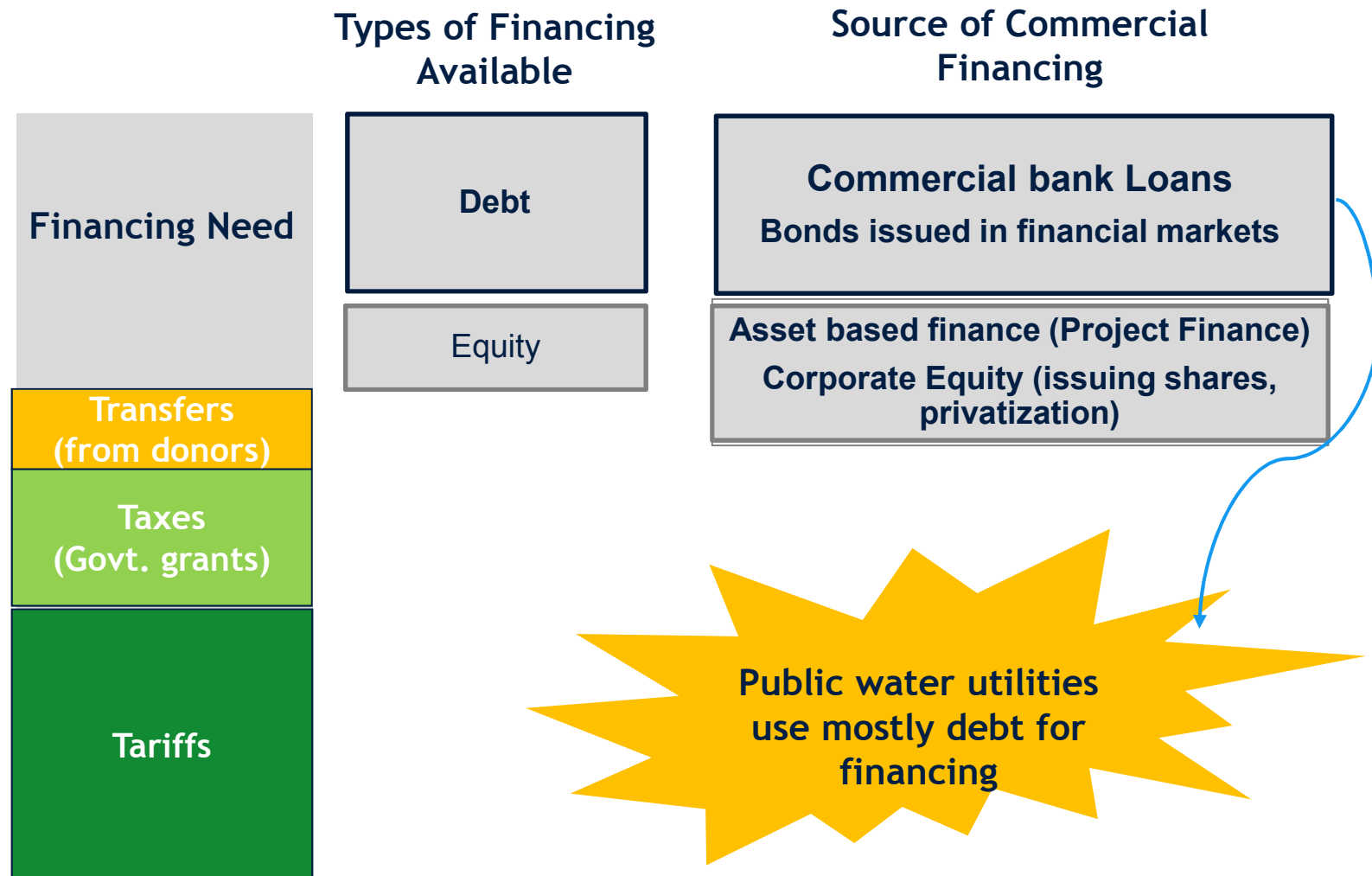
- Achieve universal access to water and sanitation
- Achieve quality of service
- Achieve operating efficiency
- Achieve better financial performance

These capital investments may be covered through cash from operations or financing... utilities without financial capacity depend on Government transfers

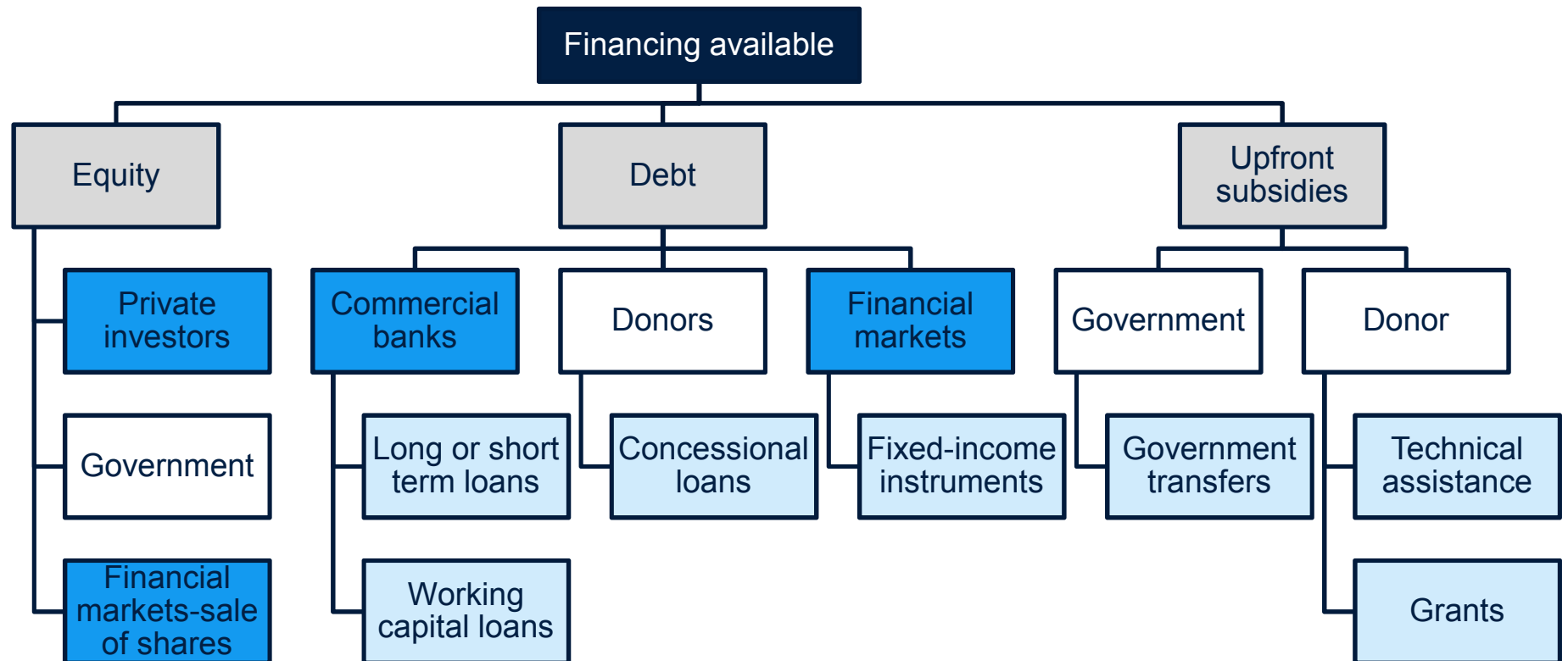
Sources of Financing and Funding

	Instruments offered	Characteristics	
Development Financial Institutions	Concessional loans Technical assistance	Loans in more favorable terms compared to other sources. Important but insufficient	Financing Utility has to repay its obligations
Commercial banks	Working Capital Financing Commercial lending Short or long term	Difficult to access if the utility/project is not creditworthy	
Financial markets	Fixed-income instruments Sales of Shares	Difficult to access if the country does not have developed financial markets	
Other Sources	Customer Advances Credit from supplier	Credit from supplier may only cover financing for specific investments	
Government	Transfers by government.	Important but not sustainable in the long term.	Funding Utility does not have to repay these amounts

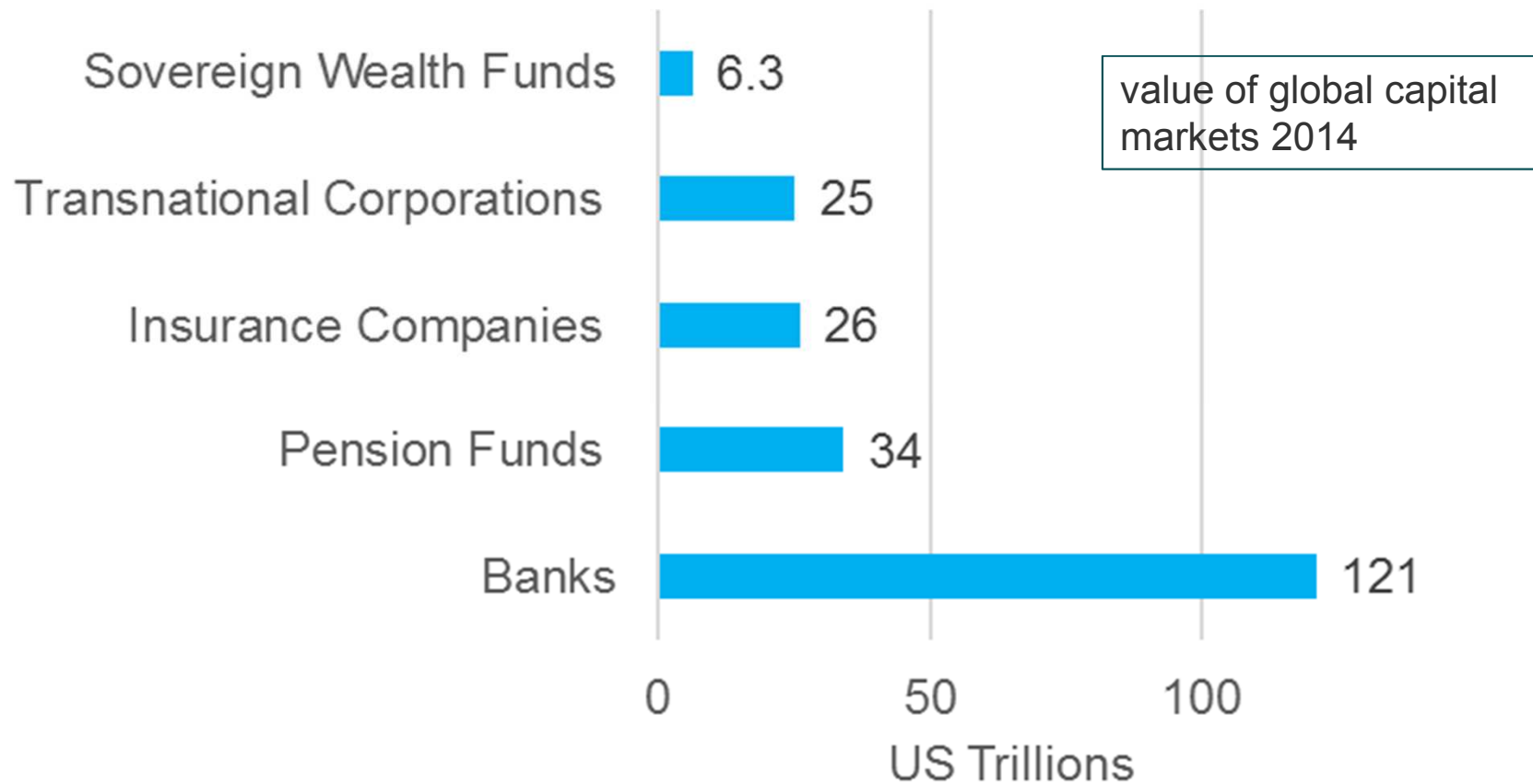
What are the Sources of Commercial Financing



Types of Financing Available



Private Providers of Finance Globally (1/2)



Source: Development Committ, 2015; MSCI indices, OECD 2014

Providers of Commercial Finance

- Microfinance Institutions
 - Community based project lending to the poor
 - User (customer) funded household connections
- Commercial Banks
 - Often used to lending to companies for shorter-term (3-7 years)
 - Suitable for last leg infrastructure projects that have a positive return (due to upstream infrastructure costs being off-balance sheet)
- Capital (bond) Markets
 - Often used for longer-term larger scale infrastructure projects
- Other equity investors
 - Provide equity for projects
 - Pension funds, insurers, corporations, private equity funds, infrastructure investors

Comparing Sources of Finance

	Concessional	Commercial banks	Financial Markets	Private equity investors
Availability	Low	High	High	Medium
Flexibility	Low	High	High	High
Speed	Low	High	Medium	High
Opportunity Cost	High	Low	Low	High
Financial Cost	Low	High	Medium	High

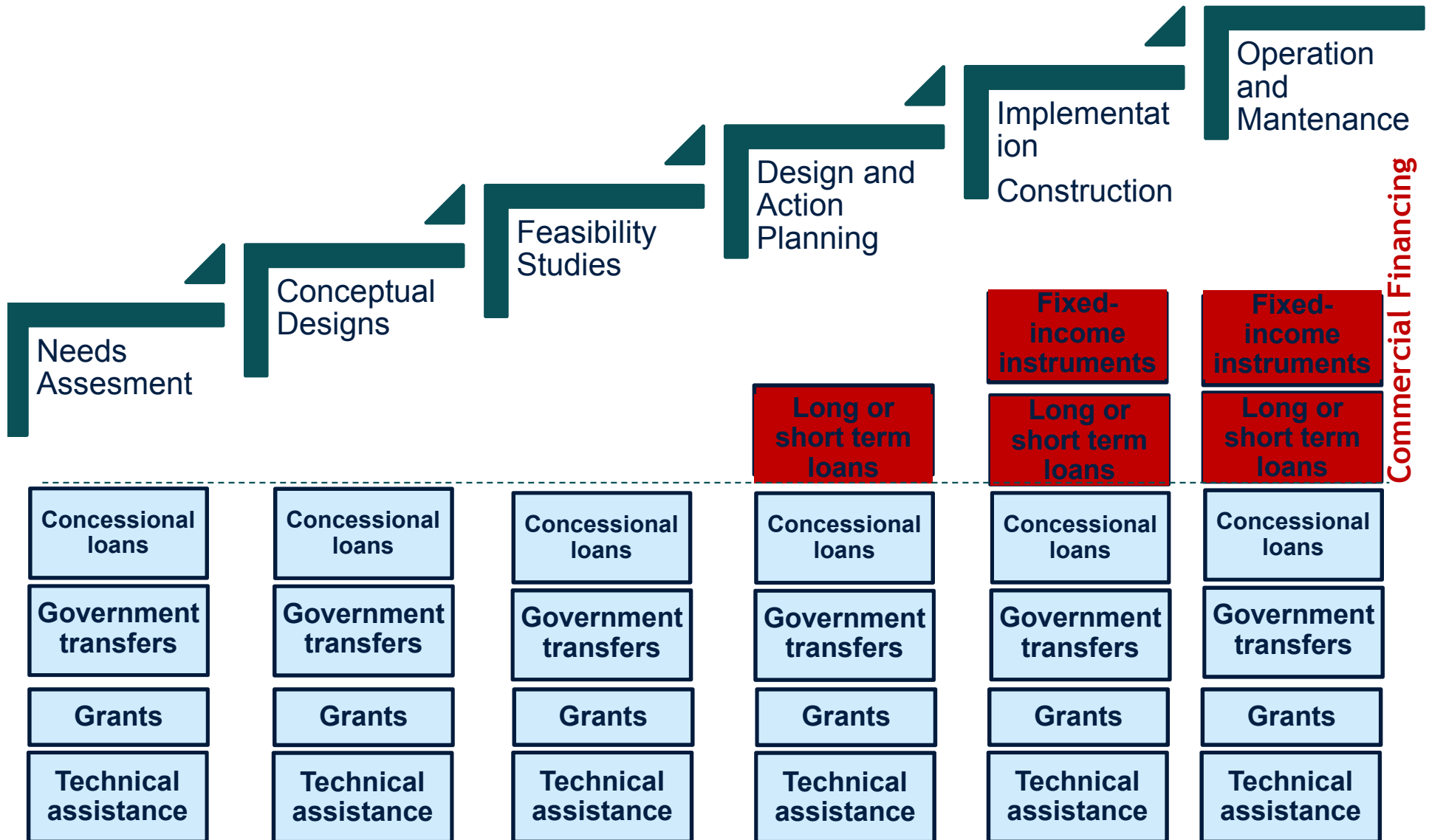
Play an important role, but their resources are insufficient

Have enough resources, but many WSS utilities/projects cannot access them due to low credit ratings

Work for utilities/projects in developed markets, but not so much for utilities in developing markets.

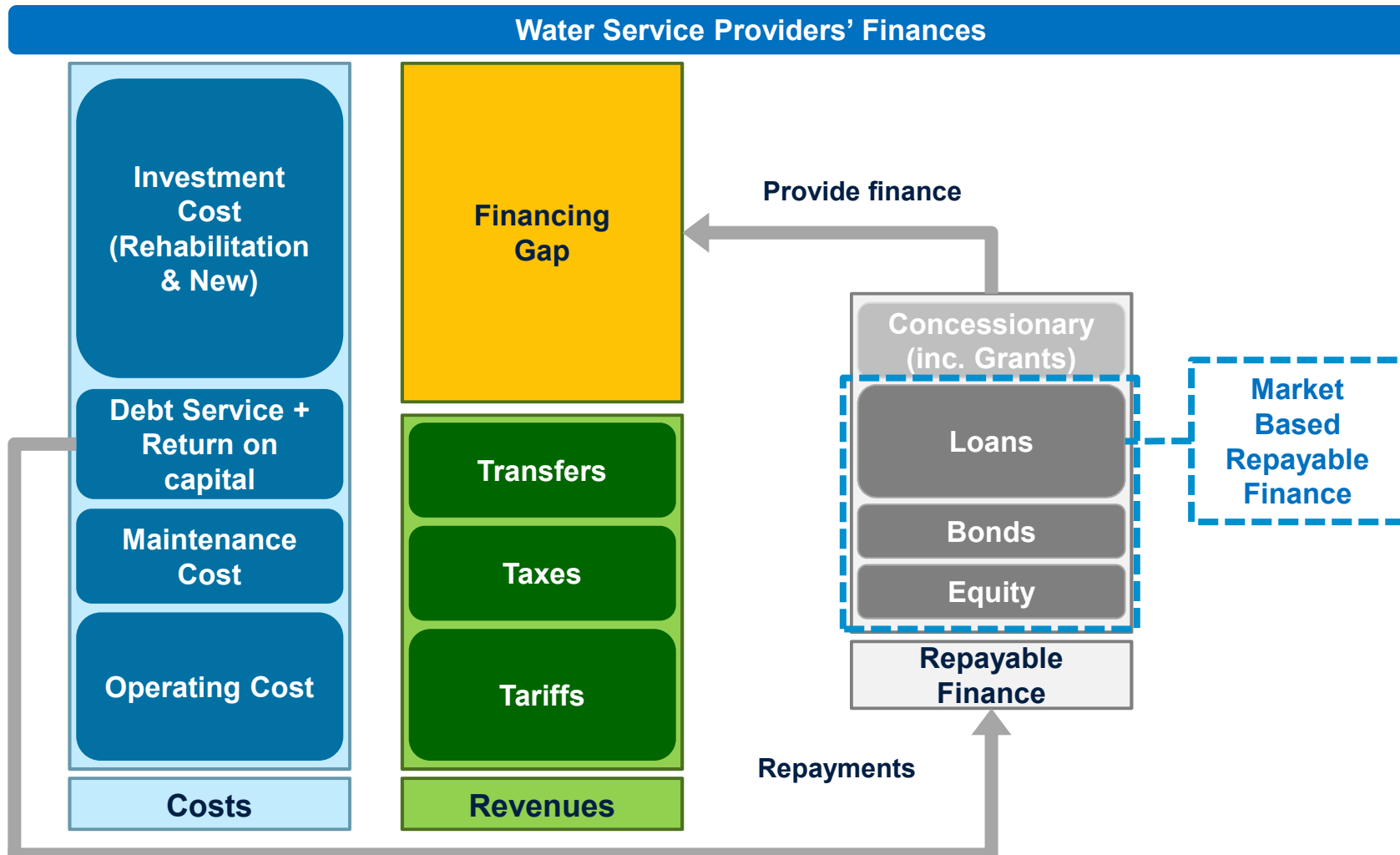
Higher risk and higher cost of capital.

Project Cycle and Sources of Finance Available at Each Stage



Accessing Commercial Finance

Commercial Finance is Required to cover WSS Investment Needs

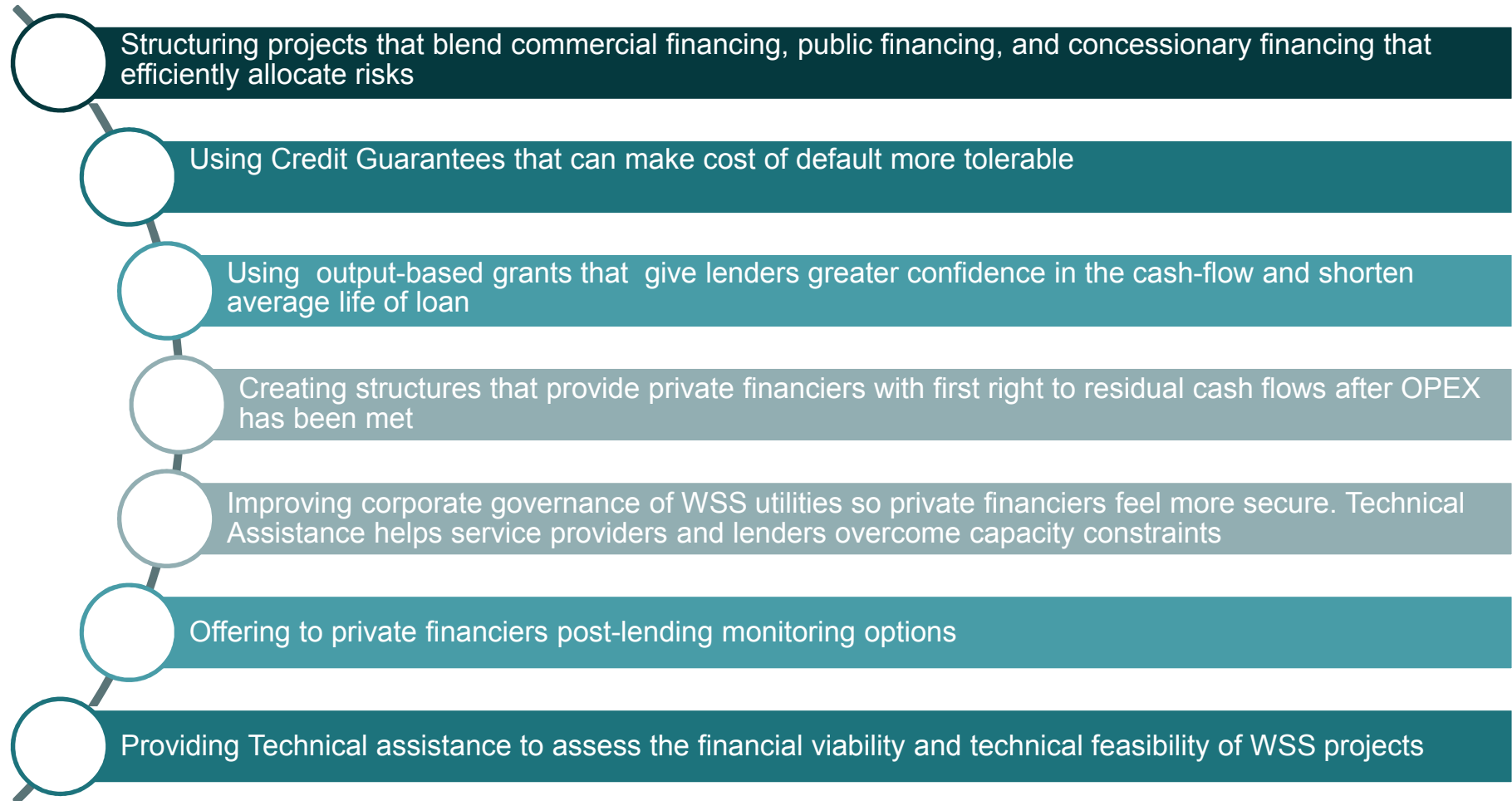


Source: OECD.

Accessing Capital through Financing

- Financing covers the time difference between needing to spend money (CAPEX and working capital) and getting the money back (could be a combination of tariffs, taxes, and/or transfers)

Mechanisms for Improving Access to Private Capital



Accessing Capital through Subsidies

Subsidies are any payment from government for which the government does not receive a commercial return, including:

- Explicit, planned subsidies: OBA payments; Matching grants
- Explicit, unplanned subsidies: Debt-write off for bankrupt utilities, paying electricity bills for water utility
- Implicit subsidies:
 - Concessional loans (loans that bear less than a commercial return)
 - Non-commercial equity contributions (where the equity return is less than commercial)
 - Unremunerated risk bearing – government provides guarantees or otherwise bears risk for a third party, and does not receive a commercial compensation for that risk bearing (note, this is a subsidy even if the risk does not crystallise)

Macro-Benefits of Accessing Commercial Finance

- **Financing**
 - Enough resources to cover investment (CAPEX) and operating (OPEX) financing needs
 - Government and multilateral funds are not enough to cover needed investments, private sector capital is
- **Increased Skills and Capacity**
- **External Oversight and Accountability**
- **Control and timing**
 - Provide large financing up-front, required to pre-finance investments that are repaid later on through cash flows from operation (front-loaded profile)

Understanding Accessing Finance Can Help You

Improve project design

Make policy arguments more persuasive

Impart best practice and options to client

Make reforms sustainable

Structure projects and blend sources of funding so that projects are viable

Understand how a utility works and how to measure its performance

Determine impact of investments and prioritize investments

Considerations for Accessing Private Capital

- What is the objective?
- What is being financed?
- What type of resources are needed? Short? Long? Domestic? Euro/Dollar?
- What is the legislative framework?
- Who are the targeted investors? What do they need? What is their level of sophistication?
- What is the legislative/regulatory framework?
- What changes would be necessary (for example, intercepts)?

Payment Obligations

Access to Commercial Financing Comes with Obligations

- ‘Finance’ has an opportunity cost – the opportunity cost of capital. Example, loans bear interest
- So “payment obligations” mean:
 - “getting back the money” (return off capital) plus
 - an additional amount (return on capital)

Obligations and Impact of Borrowing

The utility/project has to pay interests and repay the principal.

Impacts to →	Balance Sheet	Income Statement	Cash Flow
When receiving the loan	Cash and liabilities increases by the principal value	-	Cash flow from financing increases by the principal value
During the loan	Cash decreases as interest is paid. Liabilities (principal) remain unchanged	Net income decreases due to interest payment	Cash from financing decreases due to interest payments
At the end of the loan	Cash decreases as the last interest is paid and principal is repaid.	Net income decreases due to interest payment	Cash from financing decreases due to interest payments and principal repayment

Private Financers usually Impose Debt Covenants

Financers usually seek to prevent borrowers from taking actions that would damage the value of their loans.

For that they can impose debt covenants, for example:

- Debt Service Coverage Ratio: 1.2x to 2x
- Rate Covenant (Sufficient Tariff)
- Ring fencing
- Waterfall
- Revenue Pledge/Charge over accounts/ Set Off Rights
- Negative Pledge
- Termination Payments
- Step In Rights

Structuring Finance

Structuring Projects

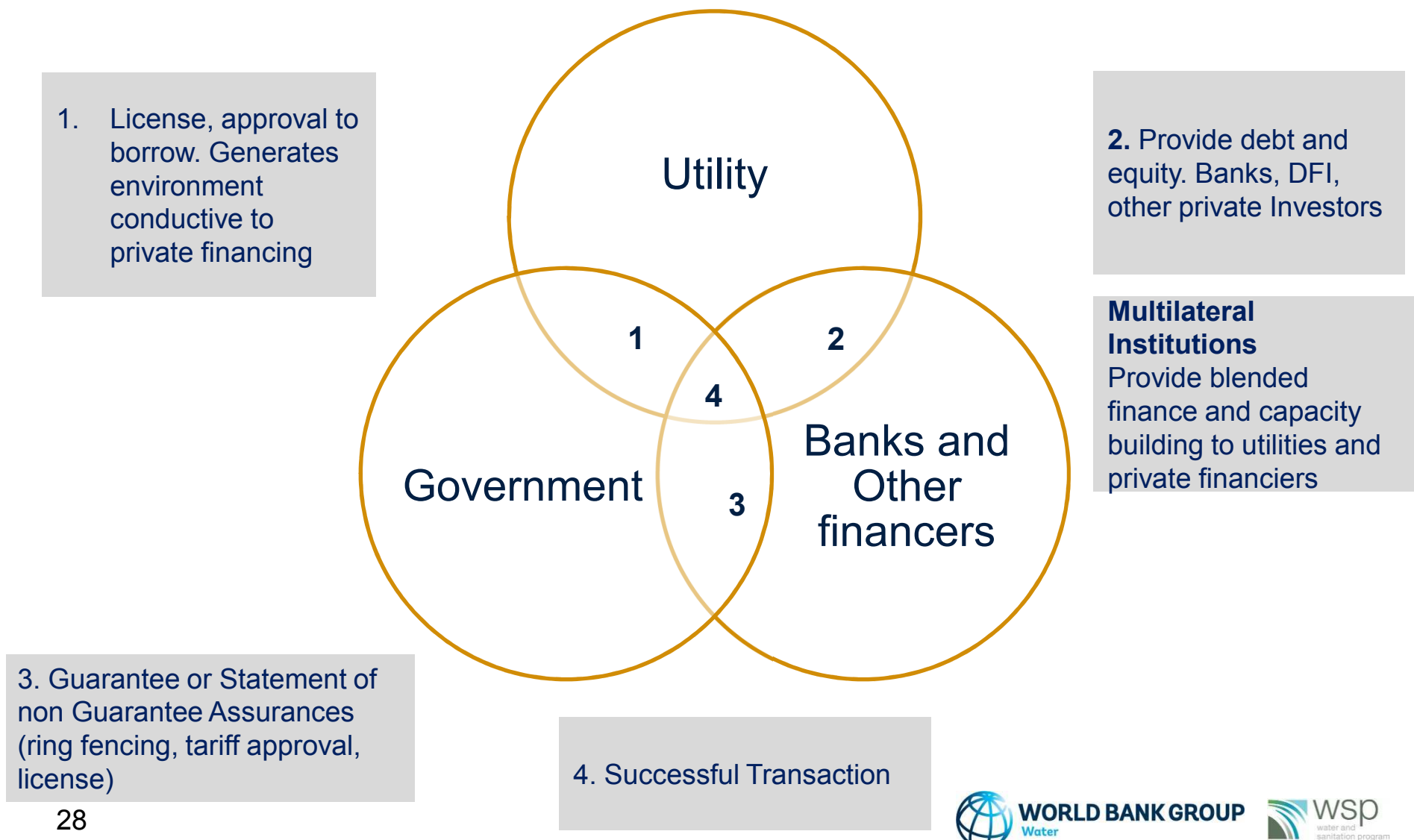
- Structuring projects is about finding the right mix of sources
- It is about making sure that the private sector gets involved in the right way
- Also about minimizing the cost of capital, taking into account:
 - Cost of debt and debt obligations
 - Maximum equity private sector can provide
- This can be done in several ways....
 - Using blended finance

Reasons for Creditworthy Water Utilities' Limited Access to Private Capital

Limited knowledge of the sector	Unfamiliar with water projects and credit analysis of water utilities
Long payback period	Willing to finance projects for 7 to 10 years, but water projects can extend up to 30 years
Sub-sovereign risk	Water utilities owned by subnational governments do not offer enough guarantees for private investors
Foreign exchange risk	Risk of mismatch between revenues denominated in local currency and obligations denominated in foreign currency
Overestimate risks involved in serving the poor	Incorrectly view the poor as having a low willingness and ability to pay for WSS services
Limited collateral	Water assets provide only limited collateral to lenders because they have little liquidation value



Key Stakeholders that Must be Engaged



Using Blended Finance (1/2)

- Blended finance is the strategic use of development finance and grants to mobilize private capital flows to emerging and frontier markets, by mitigating risk and/or ensuring commercial risk adjusted returns.
- It has three characteristics:

Leverage

- Use of development finance to attract private capital into deals

Impact

- Investments that drive social, environmental, and economic progress

Returns

- Financial returns for private investors in line with market expectations, based on real and perceived risks

Source: OCDE, Blended Finance Vol 1, 2015.

Using Blended Finance (2/2)

Blended Finance

**Domestic Commercial
Finance**
US\$ 10m, 15%, 8 Years

World Bank/IBRD Lending
US\$ 40m, 3%, 20 Years

Domestic
commercial finance
can reduce the cost
of mitigating the
foreign exchange
risk

Years 1-8: Weighted-Average Cost of Capital → 5.4%

How Blended Finance Works (1/2)

- Blended finance structures financial instruments to catalyze private capital, either by reducing risks or increasing returns when the risks are high for the private sector.

Debt	Money lent for repayment in later date, usually with an interest - Money market rate debt, when rates and terms are determined on capital market prices and tenors - Flexible (Concessional) Debt with favorable terms or rates for the borrower relative to market pricing
Grants	A financial award with no expected payment or compensation
Guarantees	Protection from Various Sources of Risk intended against capital losses for investors
Equity	

How Blended Finance Works (2/2)

Grants	Junior Equity	Flexible Debt	Market Rate Debt or Equity	Guarantees
Funds costs and activities that lead to investment	Subordinate position absorbs highest risk	Favorable terms shift risk-return profile	Investment on same terms demonstrates viability and provides investor comfort	Risk Reduction tools that protect investors against capital lossess or provide credit enhancement

The diagram illustrates five blended finance structures, each showing how Grants are integrated into the capital structure:

- Grants:** A box labeled 'Grants' with an arrow pointing to a 'Capital Structure' box containing 'Debt' and 'Equity'.
- Junior Equity:** A 'Capital Structure' box with 'Debt' at the top, 'Equity' in the middle, and 'Junior Equity' at the bottom.
- Flexible Debt:** A 'Capital Structure' box with 'Senior Debt' at the top, 'Flexible Debt' in the middle, and 'Equity' at the bottom.
- Market Rate Debt or Equity:** A 'Capital Structure' box with two columns. The left column contains 'Debt' and 'Equity'. The right column contains 'Debt' and 'Equity'.
- Guarantees:** A 'Capital Structure' box with a 'Guarantee' box on the left and a box containing 'Debt' and 'Equity' on the right.

The Financing Universal Access to WSS Initiative will include three components

Component 1: Demand-side: global advocacy and capacity building

- Position paper on financing universal access
- Raising awareness of need for innovative financing inside and outside the World Bank with dialogue and analytical work
- Water Finance Course for WBG staff

Component 2: Supply-side: building creditworthy service providers

- Water Creditworthiness Initiative for Utilities: online self-assessment tool, 5-day Creditworthiness Academy, action plans

Component 3: Transaction Support

- Portfolio review to identify potential countries for leveraging private finance
- Pre-investment support to TTLs in 10-12 pilot countries to identify potential transactions. Includes support for assessments, prefeasibility studies, training

Interested staff should contact Joel Kolker (jkolker@worldbank.org) or John Ikeda (jikeda@worldbank.org)

Thank you



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