CrossBoundary Group

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Every Deal is a **Blended Finance Deal**

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Written by Jake Cusack

One of the many nice surprises of returning to in-person conferences post COVID was finding that "blended finance" has entered the common vernacular. In 2019, it still felt like a new term that warranted a quick explanation with each use; now, it seems like even the most staid of financial institutions are bandying it about with casual abandon.

That said, it is worth quickly revisiting the definition. Our friends at Convergence provide the following:

> Blended finance is the use of catalytic capital from public or philanthropic sources to increase private sector investment in sustainable development[1]

We might propose an even simpler, yet more comprehensive framework: every deal is a blended finance deal.

[1] The full Convergence definition goes onto to say: "The actors in a deal come together to achieve social impact and financial return (the relative importance of each to the actors may vary). Blended finance frameworks typically focus on a subset of deals that have a very clear social impact and have public or philanthropic money in the core capital stack that finances the investment."

Every deal has externalities

Every deal has positive or negative externalities that are not fully captured in its financial returns.[2] Business and investing invariably affect the climate, or biodiversity, or public health, or a society's civic cohesiveness, and/or many other attributes of the world we live in.

A blended finance process acknowledges these externalities and asks whether any actors have decided those externalities warrant either additional compensation (such as revenue subsidies or a lower cost of capital) or penalty (e.g., taxes, fines, et cetera).[3]

Even if seemingly not financial relevant today, there is always a question of whether new mechanisms (such as a carbon tax) may reward or punish these externalities in the future, and/or whether the business may face competition from a substitution good that better addresses these externalities.

From this, we can imagine at least three relevant archetypes of deals:

1. **Deals where the desired public or social goods are already internalized and amplified by the core business model.** This is the sweet spot where purpose and profit overlap; where we can achieve our sustainable development goals by simply pushing investment professionals and C-suites to better realize the intrinsic relevance of these factors to their pursuit of shareholder returns. Examples could include companies that lower their costs by investing in renewable energy, or goods that have measurable marketing benefits from social factors such as net-zero commitments or certified fair supply chains.[4]

2. **Deals where public or philanthropic actors are already acting to appropriately incentivize business and investment.** The Inflation Reduction Act (IRA) in the US is an example of almost $1 trillion in various subsidies and industrial policies that will incentivize massive investment into climate-relevant technology. Another example would be rural electrification in developing countries, where the World Bank or country governments have appropriately decided that expanding access to electricity generates

[2] Note that to be a "deal", there must be external revenue. Public goods that should be provided at no-cost (e.g. police/public safety or emergency humanitarian assistance) are not suitable for blended finance.

[3] While beyond the scope of this essay, it is important to note that there are additional justifications for public/philanthropic capital to subsidize activities that interconnect to externalities. For instance, affordability and equity/inclusivity.

[4] The paper "Are Business Ethics Effective? A Market Failures Approach to Impact Investing" provides some thinking on which sectors and countries are likely to have more opportunities with this natural social/financial returns overlap, noting that addressing renewable energy, infrastructure, financial services, and agriculture may be initially more attractive to private investors than water and sanitation, biodiversity and natural resources, housing for the poor, malnutrition, literacy, etc. Further research on sector selection comes from Matthieu Pegon's "A Strategic Approach to Blended Finance", which among other points argues that "leverage" (private dollars mobilized divided by public dollars used) isn't always the best metric for choosing impactful transactions, but rather it should be total social benefits vs. the public cost/blended finance required to make the deal possible. Also see CrossBoundary's paper with Tony Blair Institute on sector selection and facilitation for blended finance deals.

benefits beyond the private consumers' initial ability to pay, and therefore provide new connection "top-ups" or energy charge subsidies. (Similar incentives often exist for rural agriculture/farmers.)

3. **Deals that have material externalities but no incentives yet.** These situations warrant policy/regulatory change and/or philanthropic intervention to address appropriately. Many natural capital factors fall into this area as, for example, the potential depletion of ecosystem health is often not adequately noted and discouraged. Our imaginations here must be broad, as it is easier to think first of mitigating existing negative externalities (e.g. incenting lower energy consumption for operating facilities) than to conceive of the possible positive externalities of production that has not yet been established. For example, having local value-added agri-processing in developing countries improves price stability and self-sufficiency; having a local pharmaceutical industry improves domestic supply and resilience to pandemics; having relevant vocational schools improves equality, human capital, and labor market flexibility; and so on. Yet, there are only occasional public/philanthropic incentives for these "greenfield" projects to be undertaken. Of course, appropriate allocation of new incentives between different sub-sectors or deal opportunities must be considered thoughtfully as both public and philanthropic resources are scarce.

Opportunities through a broadened blended finance lens:

Deal archetype	*Description*	*Financial incentive*
1 Public good externalities already linked to core business		
Core business Internalized externalities	Majority of public goods are fully internalized and amplified by core business model – sweet spot of overlap of purpose and profit	Amplify awareness of relevance of internalized externalities in the pursuit of shareholder returns – e.g. climate resilience
2 Public or philanthropic incentivization of externalities		
Core business Philanthropic or public subsidy	Public or philanthropic actors are already actively incentivizing business – e.g. U.S. Inflation Reduction Act, connection subsidies for rural electrification	Compensate business for positive externalities for which there is no current market mechanism
3 Non-incentivized externalities		
Unpriced positive externalities	Positive externalities are not yet incentivized, and so are under-produced, resulting in sub-optimal social outcome	Need for new financial incentives or public policy changes (regulation)

Most deals already use blended finance tools

The majority of deals—even those considered “purely commercial”—use the instruments of blended finance. Coldly numerate financiers who might dismiss discussions about social outcomes should realize that they use these tools too, just usually in a different legal and rhetorical frame.

For instance, a venture investor who takes a 2x liquidation preference (meaning they receive twice their money back before sharing pro-rata with other investors) is using the tools of blended finance. So, too, is a lender who takes warrants (embedded equity instruments) to capture upside in addition to their strongly covenanted senior debt positions.

Optically, such tools might seem different from those used in social-impact deals, but they exist on the same plane: subordinated “first loss” from a philanthropic player to encourage new private capital is just a rhetorical difference away from management’s common equity being subordinated to a new investor’s liquidation preference. Or, put another way, instruments of blended finance are no different than structured finance, a long practiced methodology for having a "wedding cake" of different tranches of risk & return.

Moreover beyond a deal by deal approach, there are cross-cutting types of blended finance. Targeted tax breaks are essentially a blended tool for crowding commercial investors into markets. Consider the revitalization of American neighborhoods through opportunity zones, or the moves of carbon capture companies to the United States on the heels of the IRA.

So, it’s erroneous to think terms like “first loss” mean a non-commercial transaction. Structures that have a different balance of risk/return for different capital providers are logical in every deal. And notably, structures themselves can have externality implications — an overly levered debt deal can create adverse incentives, or conversely, bringing along new participants into a transaction could enhance demonstration or ecosystem activation

effects.[5]

Our hope is that—by demonstrating that every deal is a blended finance deal—we will widen the external audience for these conversations while helping investment teams be appropriately thorough in their investment processes and policy discussions, rather than treating only a narrow set of deals or products as "blended finance."[6]

A blended finance framework creates opportunities for savvy and responsible investors

Investors should **always** think about the positive and negative externalities of their investments, and how those externalities surface potential subsidies/taxes and catalytic/concessional structuring opportunities.

By using this frame, we can imagine discovering that a philanthropic capital partnership would enable a healthcare business to reach not-yet economic customers, growing the customer base and providing access to care sooner than otherwise possible. Or, an investor might realize that she should be advocating strongly in the policy arena, because her investment is delivering substantial public goods (such as carbon removals) that are not rewarded in the current government framework.

Even the "ruthlessly commercial" investor must acknowledge that public externalities could have future economic consequences for them. Such investors can choose to believe a looming subsidy or penalty will be immaterial to their business—but choosing to ignore something is itself a due diligence and investment decision, possibly one with unforeseen consequences.

This dynamic is even more true with the rise of modern "industrial policy," which has blended finance tools at its core. In fact, a recent study found that 96% of climate tech venture capitalists are two degrees or less away a government grant, and that the US government is the most central co-investor in American climate-relevant companies.

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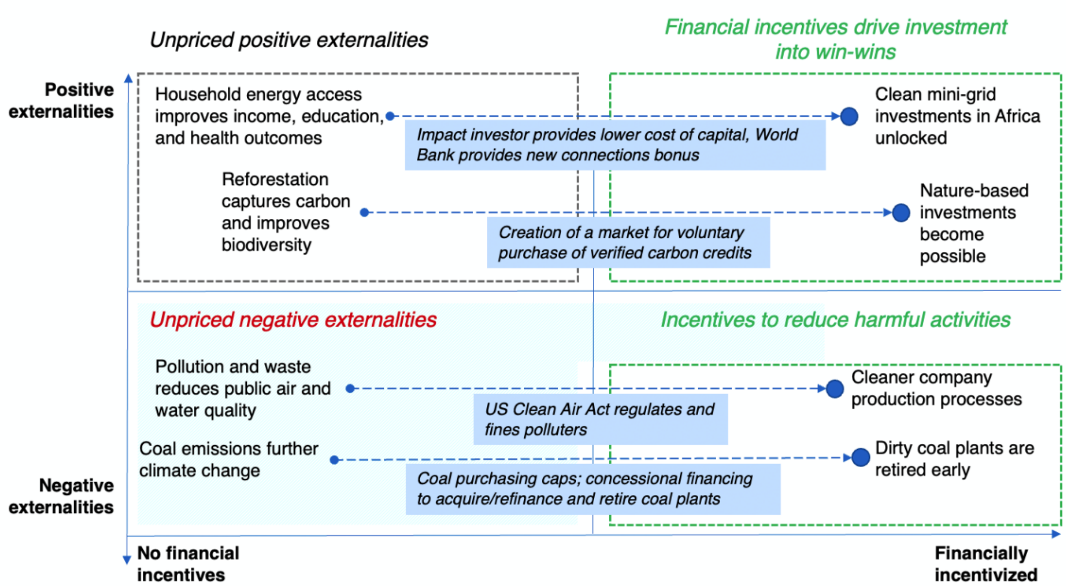
[5] Delilah Rothenberg and others at the [Predistribution Initiative]() have done excellent work on system level risks/externalities that can emerge from asset allocation strategies and deal structures. For example, see their paper "[ESG 2.0: Measuring & Managing Investor Risks Beyond the Enterprise Level]()".

[6] For a similar argument that ESG should be treated as a process rather than a 'product', see George Serafeim, "[ESG: From Process to Product]()", Working Paper 23-069, Harvard Business School, 2023. I would note that I am not attempting to argue that every deal will in fact have blended finance directly within it or immediately adjacent to it, but that virtually every deal has externalities that could directly or indirectly interact with public / philanthropic financial incentives or disincentives at some point, and responsible investment and policy processes should think through this lens.

Economic growth is private sector led, but it is becoming ever more government enabled.[7] Ideally, [new industrial policy approaches]() are based on bottom-up iterative public-private cooperation and coordinated tools specific to the prioritized sectors and locations. This is far preferable than the unrealistic extremes of top-down five-year plans or completely hands off "let the market decide" approaches.[8]

Moreover, if an investor determines externalities are material but "someone else's problem," this logically must correlate to what they personally advocate for the public and philanthropic sectors to do. For example, while it is possible for someone to believe that climate change is a problem but not an inherent corporate responsibility, surely this same person must then argue for public or philanthropic intervention.

The graphic below provides a way to consider this framework: opportunities are mapped in four quadrants, based on whether they have positive or negative externalities, and the degree to which the externalities are financially incentivized. Changes in public policy and the resulting incentives can move whole subsectors between quadrants. If policy can not or will not move fast enough, blended finance structures on a deal-by-deal basis can move specific needs and opportunities between quadrants.



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7 This is the phrasing often employed by the Biden Administration, such as by Jigar Shah, director of the Loan Programs Office at Department of Energy.

8 These new approaches are detailed well in "The New Economics of Industrial Policy" from Dani Rodrik and others. Additionally, a recent essay in Time by Rohan Sandhu emphasizes the importance of supporting local intermediaries to address the coordination failures that can often limit logical investments. Finally, our own work on investment facilitation argues that supporting locally based advisory intermediaries can help lower transaction costs and information asymmetries, unlocking the private investment desired by a government or philanthropic third party in a relatively light-touch and cost-effective way.

Importantly, this landscape is not static. Pioneering transactions that leverage subsidized capital to create new market opportunities can illuminate a path for follow-on investments, foster the development of an ecosystem of participants in the pioneering firm's value chain, and encourage innovations that increase consumer surpluses. Blended finance, in short, can inject dynamism and create virtuous circles of change which eventually reduce or eliminate the need for direct or indirect "subsidy".

A few further examples might help reinforce the point. For starters, while increased scrutiny of the voluntary carbon credit market is appropriately elevating the importance of high-integrity projects, its existence has enabled the growth of rural companies in Africa that previously struggled due to low consumer ability to pay. For instance, Koko Networks, which switches customers from coal to clean cooking ethanol fuel, now receives the majority of its revenue from the monetization of carbon credit streams, while also passing on a reduction in price to consumers.

Or, take organic farming: since US government standards were first implemented in 2002—creating clear certification pathways and customer awareness—organic acres under cultivation (and sales), have gone up by 5x. Consumers benefit from greater choice and healthier foods, while farmers can generate greater margins.[9]

Companies and investors should be forward looking as well. Some packaging companies, for example, are prudently investing in biodegradable options in anticipation of potential bans/taxes on petrochemical-derived plastics. Whether waiting for policy action or not, capital providers of all types can incent appropriate action through their choices of whom they provide capital to and on what terms—and this, in fact, is the most common application of blended finance principles.

[9] See, for example, Conventional and Organic Enterprise Net Returns - Center for Commercial Agriculture.

Notably, to the extent stakeholders differ on whether and how an externality should be addressed, it is often a question of time horizon. A CEO feeling the pressure of quarterly earnings may be tempted to defer responsibility, particular for social costs that might not materialize for years.[10] But in the long run, everyone's preferences will tend converge on the public good—we think about our children, about the fundamental instability of massively unequal societies, of the risk of future unlivable worlds.

The Way Ahead

So, where does this bring us?

Recognizing that every deal is a blended finance deal normalizes discussion of policy incentives and a differentiated cost of capital, rather than artificially shunting deals into "commercial" and "non-commercial." It provides a more useful, nuanced taxonomy for asset allocation and investment theses. And, it forces regular consideration of externalities impacting the public good and their current and possible future financial consequences.

But while it's natural to focus on the "blending" of instruments in the capital stack of a deal, in our experience it is often the transaction costs before and during a deal's execution that are an even bigger barrier than structuring an adequate return. At CrossBoundary, we routinely see opportunities with commercial risk/return economics that could deliver strong returns and public goods, but the costs of finding, diligencing, structuring, and executing the investment are not easily absorbed—particularly for pioneer transactions.[11]

This is even more true for blended finance deals, which often involve a fragmented universe of capital providers with distinct impact/return preferences and mechanisms for deploying their capital, thus raising the initial structuring burden.[12]

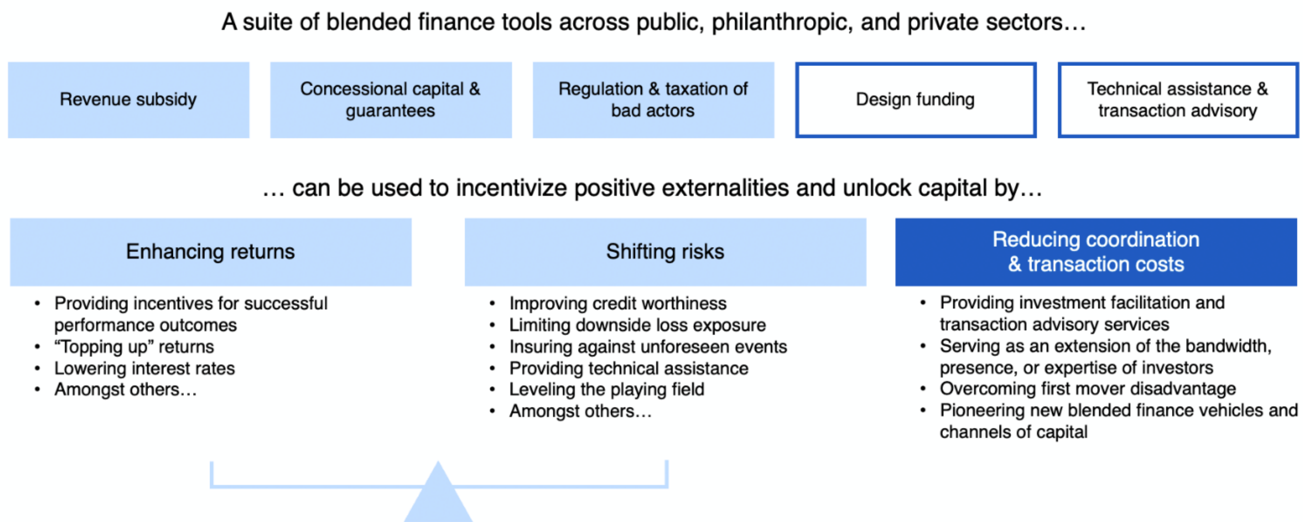
For philanthropic or public actors that would like to take a light touch with the private sector, providing initial facilitation for investments can be less interventionist than taking long-term ownership position in the company or project. Therefore, relevant assistance can include not just providing low-cost investment capital, but also funding to lower transaction costs and reduce information asymmetries, and to construct the opportunity so that it is bankable. The funding of investment facilitation platforms that help construct and package opportunities, or institutions

[10] Put another way, the difference in time horizon or in who is seen as responsible/benefiting from a return/cost can create a mispricing in scarce assets such as biodiversity.

[11] Impactful pioneer transactions, even small ones, are particularly important to support as they create demonstration effects, knowledge spillovers, and value chain complementarity (as argued by Paul Collier, Dani Rodrik, Matthieu Peon, and Paddy Carter in various papers, among others).

[12] We should be careful to keep the transaction cost implications of seemingly innovative multi-layered blended structures in mind, we have seen small investments derailed by overly complicated structuring disproportionate to the size of deal. The simplest viable structures should be pursued.

providing funding to cost-share the burden of early-stage origination and diligence, can play a critical role in fostering the growth and development of sustainable businesses.



Note: Portions adopted from Convergence materials

More fundamentally, beyond the tactical mechanics of unlocking these deals, there are important personal and industry-wide implications of this essay's thesis. Lengthening our time horizons and widening what we perceive as our relevant spheres of responsibility will create greater convergence in cost/benefit decision-making, for all stakeholders.

And for each of us as individual allocators of our capital and time, heightened sensitivity to externalities reminds us that our business, philanthropic, and policy beliefs must work in combination rather than as distinct domains.

Trade-offs of course sometimes remain. But when every deal is a blended finance deal, investors can see better risk-adjusted returns, governments can link policy to tangible outcomes, and all of us can enjoy greater access to public goods while experiencing fewer negative externalities.

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