Public Private Equity Partnerships:
Accelerating the Growth of Climate Related Private Equity Investment

ISSUE BRIEF

In partnership with GLOBAL ENVIRONMENT FACILITY INVESTING IN OUR PLANET
Mitigating climate change requires vast investment. The World Bank estimates “the volume of financing needed to meet the additional costs by the international community for climate change-related development at between $180 billion and $250 billion per year. However, this sum represents only the additional or incremental costs: it would need to leverage nearly 20 times that amount—or up to as much as $4.6 trillion—from underlying investment finance from other public or private sources.”

These investment needs are diverse, and catalyzing the necessary finance to address the challenge of climate change will require interventions across all asset classes. Among the various types of capital, Private Equity/Venture Capital (PE/VC) is uniquely suited to financing climate friendly investments that are risky, innovative, and relatively small. PE/VC funds will certainly not provide more than a fraction of the $4.6 trillion investment needed—but they fill a key niche. In particular PE funds can:

- **Make risky investments**: PE/VC funds provide firms and projects with a form of financing that is more patient and flexible than debt. PE/VC funds are among the only investors willing to provide cash to medium sized companies to burn while they develop into profitability
- **Provide cornerstone finance**: PE/VC funds are able to provide equity finance to earlier stage companies that cannot access debt financing (cash flows too risky and too few tangible assets) and are too small to access securities markets, but too large to rely on friends and family. The equity financing provided by PE/VC funds allows the companies to invest and access other forms of financing such as debt
- **Help companies do business better**: PE/VC funds help the companies in which they invest to build up their governance, managerial and technical capacity. This provides much needed support, especially in developing countries where such capacity is often lacking
- **Identify and develop business opportunities**: PE/VC funds take an active role in developing the pipeline of projects and companies in which they can invest. This often means helping companies in which they wish to invest to build up the systems (such as governance, accounting and personnel) needed to absorb outside financing, systems which are often lacking in companies in developing countries.

Over the last decade there has been a significant growth in climate friendly investment by PE and VC firms. From very few deals in 2000 the market has grown to US$ 20 billion per year in 2010.
**Fund manager formation:** New investment areas need new fund managers. However, putting together a new fund is risky, costly, and time-consuming. Few professionals with the right skills have the appetite to do it. Unfortunately, a shortage of good fund managers slows the rate at which the entire market can develop.

**Raising capital:** Mitigating climate change requires investments in new sectors, using novel business models and technologies. These investment types often have no track record of historic returns. The fund management teams who have the skills to tackle these areas are often new too, with no track record. Yet typical investors in PE/VC funds rely on track records of teams and sectors in deciding where to place their capital. This leads to a chicken and egg problem. A fund or sector needs a track record of returns to attract capital, but without a track record of returns it is unable to raise financing and so cannot invest and build a track record.

**Deploying capital:** Small, innovative climate friendly projects may impose high management expenses on PE/VC funds, which are uneconomic within the industry-standard two percent management fees. Such pioneering investing can benefit the development of a whole industry, since it produces models for others to follow, but it is often hard for the pioneers to capture this aspect of the benefits they produce. Further, PE/VC funds—like any other investor in climate friendly projects—suffer from difficulties in capturing the positive externalities from carbon emissions reductions in a form that can attract finance.

**PUBLIC CAPITAL CAN BE DEPLOYED TO ACCELERATE PRIVATE SECTOR INVESTMENT**

The public sector—particularly the International Financial Institutions (IFIs) and bilateral donors—can help to overcome the barriers holding back the PE/VC market. To assist with the formation of funds and raising capital, public sector financial institutions can:

**Anchor new funds:** IFIs can identify promising new fund management teams and commit capital to them. Anchoring includes letting teams with potential know where they need to strengthen their offering (for example, by bringing additional skills), helping the fund with structuring and documentation, and introducing the fund to other potential investors. The advice and introductions are made credible by the IFI committing capital to the fund. Anchoring has successfully kick-started PE/VC investing in areas as diverse as early stage climate friendly infrastructure in Asia, plantation forestry in Africa, and clean technology in China. To help develop emerging fund managers, IFC invests a substantial proportion of its funds with new fund managers. During the early 2000s, IFC supported many first time PE/VC funds in nascent markets with little previous PE/VC fund activity. As shown in Figure 3 IFC’s investments in these first time funds were relatively successful. IFC’s investments in first time funds outperformed global benchmarks, and also outperformed IFC’s investments in follow on funds in more established markets. IFC believes the differentiating factor in fund returns is the manager’s skill set, not whether this is a first time fund.

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**Figure 2: Development dynamics of the PE/VC market**

**Figure 3: IFC’s Returns from Investing in First Time PE/VC Funds Outperform Follow on Funds and Industry Benchmarks (2000-2010)**

Source: IFC and Cambridge Associates emerging markets benchmarks.

**Finance new fund development:** Public institutions can provide capital to new management teams to help them finance the costs of setting up a new fund and getting commitments to the fund from investors. The capital provided could be a quasi-equity investment in the fund manager, which would return capital to donors from returns on the fund if it is successful. IFC does not do this now, but its experience with first time funds suggests that this approach could be commercially successful, as well as developmentally positive.
• Invest in a new fund on a concessional basis through a waterfall structure: In a classic fund structure, all investors, including any public institutions, participate pari passu—that is, they share equally in profits and losses. Public institutions have an opportunity to offer a ‘waterfall structure’, which subordinates their returns to the returns of private investors in certain circumstances. The waterfall can be designed to attract private investors by dampening their losses if the fund does badly or leveraging upside if the fund succeeds. This approach contributed to the development of the Venture Capital (VC) sector in Israel. In Israel, the Yozma fund deployed US$100 million of government capital in 1993 into select VC funds using a waterfall structure. This helped catalyze the development of an industry which had US$9.6 billion under management by 2001. In other words, as shown in Figure 4 for every dollar invested by the Israeli government in 1993 by 2001 US$96 had been invested by the private sector.

To help overcome the barriers to deploying capital profitably, public sector institutions can:

• Support pioneer investments: Grants can be provided for pioneering activities such as feasibility studies and regulatory approvals for new types of investment. Given the scale of the pioneering needed, there is potential for governments to increase the level of support provided and to proactively route it through the PE/VC funds. In order to mitigate potential moral hazards and to increase the alignment of interest between public and private capital support could be provided through a loan facility that is repaid out of the fund manager’s future earnings. This facility could help cover the upfront costs enabling PE funds to provide business and market development services as part of their investment strategy.

• Improved carbon payment mechanism: Bilateral donors have an opportunity to create a carbon payment mechanism which could offer guaranteed minimum prices for future carbon sales. This would greatly help with project financing, while the cost could be quite low. Channeling the carbon payment mechanism through suitable PE/VC funds would help ensure that the funds reached their targets, and also aid with financing, given the cornerstone role that PE/VC funds play in many financial structures.

Removing these barriers to the development of the PE/VC market could create a virtuous cycle. Easier fund raising would encourage more fund managers to form. More funds would mean more investment, building up track records, and investment history. The benefits of early pioneering would come through in lower costs going forward. Perceptions of risk would fall. Improved carbon payment mechanisms would make more climate friendly projects profitable, further improving investor perceptions of the sector, and increasing capital flows. As this process unfolds, more and more climate friendly investments in emerging markets would be able to access PE/VC funding. This would be a significant boost for the myriad of companies with climate-friendly projects that need equity to finance start-up costs or to accept the risk of volatile and risky cash flows, but are too large to rely on finance from family and friends. Clean technology development, energy efficiency investments, renewable generation projects, efficient transport infrastructure and land use and forestry projects all can benefit from the specific characteristics of PE/VC financing.

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