Improving Reporting on the Multiplier Effect: A Call for Increased Precision in Terminology

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Abstract 2

Why is it important to understand the multiplier effect? 2

Part 1: More Precise Terminology Around the Multiplier Effect is Critical

What is the multiplier effect? What is catalytic capital? 2

Is the terminology used to describe the multiplier effect imprecise? 3

Why is it important to increase precision in the use of terms related to the multiplier effect? 5

Part 2: Understanding the Determinants of the Multiplier Effect

Usually, how large is the multiplier effect? 6

Under what conditions is the multiplier effect large or small? 7

How does the type of organization providing concessional capital affect the multiplier effect? 9

Abstract

The multiplier effect commonly refers to the amount of private capital that is able to flow into an investment due to concessional capital. Through our survey of the literature, we find an overarching lack of discipline in the use of terms related to the multiplier effect such as "unlock" and "catalyze" in various organizations' reporting on their use of concessional capital. Precise definitions of the multiplier effect and standardization of calculation methods are critical to maintain comparability across investments. With greater comparability, impact investors can better understand when concessionary capital is most effective and to more efficiently allocate capital. We hope to highlight this imprecision in reporting the multiplier effect to enhance the ability of impact investors to make progress on the world's largest social and environmental issues.

Why is it important to understand the multiplier effect?

There is a widely-recognized need to mobilize capital to achieve the United Nations' Sustainable Development Goals by 2030. The UN estimated that achieving the goals will require between $5 and $7 trillion annually in global SDG-oriented investment and that annual private capital flows to impact enterprises and SDG-oriented projects would need to be around $1.8 trillion more than they are today.[1] With a better understanding of when the multiplier effect is most effective, concessionary capital can be allocated more efficiently and greater progress can be made in addressing the world's social and environmental issues. With such large amounts of capital necessary to make progress on some of the most pressing issues in the world, effectively mobilizing capital is of life-saving importance.

This paper hopes to bring attention to lack of consistency in reporting on the multiplier effect. We begin by explaining foundational concepts about the multiplier effect and catalytic capital. Next, we discuss how current language used by impact investors and philanthropies about the multiplier lacks specificity, decreasing comparability across investments. Finally, we discuss the necessity of increasing discipline in the use of these terms to more efficiently allocate capital that creates impact.

Part 1: More Precise Terminology Around the Multiplier Effect is Critical

What is the multiplier effect? What is catalytic capital?

The multiplier effect occurs when investment from concessional capital, or capital expecting below market rate returns, results in increased commercial investment. Making use of the multiplier effect is crucial to finance and catalyze capital for development projects aimed to generate positive social or environmental impact, as initial investments to such projects may be slow due to the lack of investors willing to accept high risk or concessionary returns.

1 Roadmap for Financing the 2030 Agenda for Sustainable Development

The multiplier effect occurs when investment from concessional capital reduces barriers to investment from traditional capital such as lower or unstable returns. Primarily, by mitigating the significant risk factor of many socially and environmentally oriented development projects through tools such as guarantees, reluctant investors that have specific risk/return targets can be incentivized to allocate more capital to community investments. Depending on the size of the multiplier effect, the amount of capital required to catalyze a certain amount of traditional capital can differ. Factors that may influence the size of the multiplier effect range from sector or type of organization providing the capital.

Catalytic capital or concessionary capital refers to capital that is willing to receive below-market-rate returns in order to attract traditional capital which would receive closer to market rate returns. Catalytic capital in blended finance focuses on public or philanthropic sources for private-sector investment. In the 2019 Tideline Report, catalytic capital is defined as "debt, equity, guarantees, and other investments that accept a disproportionate risk and/or concessionary returns relative to a conventional investment in order to generate a positive impact and enable third-party investment that otherwise would not be possible".[2] For future investors wary of financial losses through potential low-return, high-risk investments, catalytic capital by an investor or donor that bear first losses are able to catalyze further participation of co-inventors that *otherwise would not have entered the dea*l by improving risk-return profiles and incentivizing investment. By merging capital from investors with varying risk-return target profiles, catalytic capital leverages more capital from conventional investors.

Depending on the growth stage and need of the investee requiring the catalytic capital, the flexibility of the investor and conditions of additional participating investors differ — thus also the traditional financial instrument into which it is integrated. Catalytic capital from grants can fund early-stage projects to test and adjust their business. Concessionary debt, equity, cand hybrid can help growing projects *multiply their impact*: expand into new areas and populations or reach economies of scale. Concessionary debt or long-term guarantees can sustain vulnerable business models.[3]

Is the terminology used to describe the multiplier effect imprecise?

While analyzing the multiplier effect and exploring how it varies across multiple factors, our team noticed a lack of specificity in the use of terms such as "unlock," "leverage," and "catalyze" when referring to how much commercial capital flows into a space due to concessional capital. This inconsistency in the

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2 Catalytic Capital

3 Ibid.

use of these terms made it difficult to compare the multiplier effect across scenarios and identify when concessionary capital is most effective. When launching the Sustainable Jobs Fund in 1999, the MacArthur foundation provided a $1 million program related investment, or concessionary capital, to "serve as risk-taking capital to help *unlock* $17 million for SJF's first fund" with other first-fund investors including Bank of America, the Treasury Department, Citibank, and Deutsche Bank[4]. This investment from the MacArthur foundation would have an implied multiplier effect of 17.0x, which is more than three times the average estimates of the multiplier effect from Convergence and the World Economic Forum's analysis of blended finance funds. When our team was trying to analyze the multiplier effect of the MacArthur foundation's program-related investment, we wanted to understand what amount of the $17 million "unlocked" was commercial and not concessionary, the corresponding time period, and what amount of commercial capital would have been invested without the program-related investment to more accurately gauge the multiplier effect.

We encountered multiple instances of imprecise and varying uses of catalytic terms. Convergence's *Leverage of Concessional Capital* data brief and the World Economic Forum's study of blended finance fund represents the multiplier effect with the term leverage ratio which means the proportion of commercial capital over concessional capital in a blended finance fund.[5] Using terms related to the multiplier effect in a different way, Tideline's report Catalytic Capital detailed financing for the Window of Opportunity Initiative in which the MacArthur Foundation's investments of "more than $150 million over a period of about 15 years enabled dozens of nonprofit affordable housing organizations and supporting blended funds to *attract* more than $9 billion of additional permanent capital form conventional lenders."[6] This statement would imply an enormous multiplier effect of 60x. Readers are left with questions about the meaning of phrases such as "attract" additional capital from conventional lenders: Is this capital that would not have been invested without the presence of concessional capital? What is the relevant time period for attracting additional capital? Is this additional capital expecting market returns?. Without greater precision and consistency in the use of "unlock" and "attract", comparing the effectiveness of concessional capital in allowing investment from private capital is difficult and cumbersome, as a researcher would have to reach out for more information on each case of the multiplier effect. Greater standardization and consistency would allow for easy identification of effective and ineffective uses of catalytic capital in blended finance funds, philanthropic donations, and other instances of impact investing. These instances are representative of several imprecise and varying uses of

[4] Catalytic Capital at Work
5 LEVERAGE OF CONCESSIONAL CAPITAL
6 Catalytic Capital

catalytic terms which made it difficult to compare and understand the multiplier effect when compiling this report. In the future, we hope that reporting of the multiplier effect will be standardized to include concessional capital amounts, commercial capital amounts, time periods, and counterfactual analysis to clearly identify the effectiveness of concessional capital.

Why is it important to increase precision in the use of terms related to the multiplier effect?

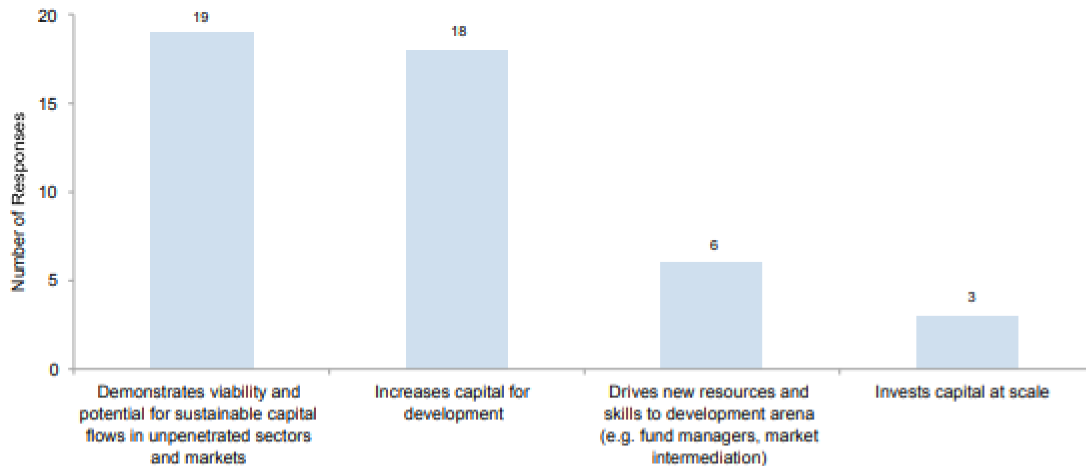
Investors trying to do good cite crowding in as a central goal of their investments. USAID INVEST has structured several blended fiance funds and financial instruments with the central goal of "unlocking the power of private capital to drive inclusive growth."[7] One example includes USAID INVEST's blended finance deal to provide assistance to the Women's World Banking Asset Management fund which had the goal of "crowding in commercial investment to improve financial inclusion for low-income women" by providing downside protection to investors [8] With the amount of private capital catalyzed as an explicit goal and metric for effective use of concessional funds, standardized definitions and calculations of the multiplier effect are crucial to identify which opportunities are actually the most effective use of concessional capital.

Looking further into what motivates concessional capital providers to make investments, the World Economic Forum's Survey of Blended Finance Vehicles finds that the top two investment motivations for development and philanthropic funders were demonstrating viability for sustainable capital flows in unpenetrated sectors and increasing capital for development. Since the multiplier effect is a central goal of concessional investors, we would expect an emphasis on accurate and standardized calculation of how much private capital some amount of concessional capital flows in. However, as detailed in the section above, we find that a lack of specificity in terminology and methodology surrounding the multiplier effect, making it difficult to understand and compare the actual effect of various concessional capital investments.

Figure 1: Development and Philanthropic Funders Investment Motivation

7 INVEST | Build A Partnership With Us

8 Member spotlight Lala Faiz Cameron Khosrowshahi USAID - Blog - Convergence News | Convergence



Part 2: Understanding Determinants of the Multiplier Effect

While the lack of specificity made it difficult to compare the multiplier effect, we attempted to use data available to understand how effective concessional capital has been in catalyzing traditional capital and when this multiplier effect is large or small.

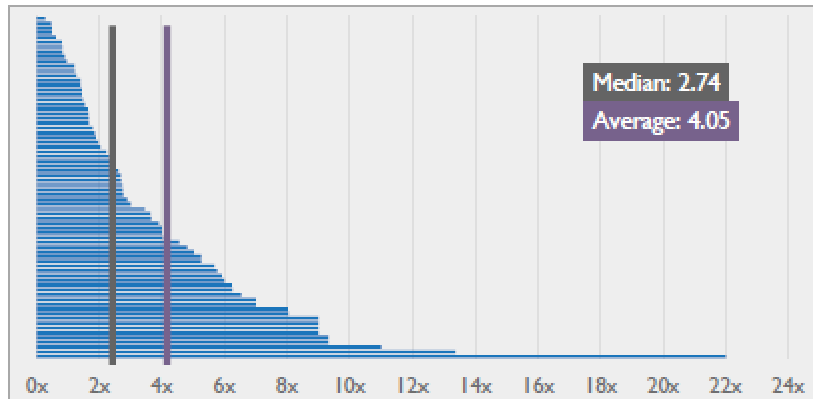
Usually, how large is the multiplier effect?

In practice, various studies found blended finance funds to have a leverage ratio of around 4.0, meaning that for every $1 of concessional capital, $4 of commercial capital has been mobilized. Data from the Convergence database of 72 blended finance funds, found an average leverage ratio for blended finance funds with concessional capital has been 4.0 with a minimum of 0.3 to a maximum of 22.0 and a median of 2.7.[9] Similarly, the majority of deals studied in the World Economic Survey on Blended Finance Insights were found to have had a leverage ratio of about 5.0. As seen in the figure below, blended finance structures experience a variety of leverage ratios influenced by factors such as sector, geography, and size of fund. Though it is important to note that the impact investing community does not have rigidly defined criteria for calculating the multiplier effect resulting in discrepancies and a lack of comparability across organizations and scenarios (discussed further in conclusion).

Figure 3: Leverage ratios of 72 blended finance structures with concessional capital[10]

9 LEVERAGE OF CONCESSIONAL CAPITAL

10 LEVERAGE OF CONCESSIONAL CAPITAL



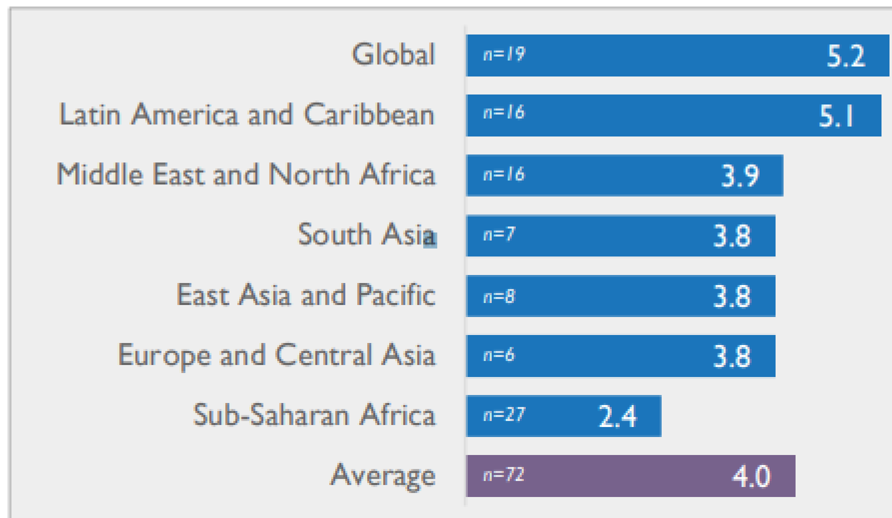
An important consideration when calculating the size of the multiplier effect is to what extent concessional capital may be crowding out investment from private capital. Such crowding out could occur when development funders invest in a project that would have attracted commercial financing without concessional support. Concessional capital's lack of additionality is not only harmful because scarce donor funding is misspent, but also because it may hinder the development of a healthy private sector, counteracting a goal of blended finance. However, the World Economic Forum survey of blended finance funds found that all respondents indicated that blended finance was required to attract private capital into their investment funds, signifying that private capital would not have invested in these areas without concessional support (though we understand that this survey is not definitive proof)[11]. This also mitigates the concern that leverage ratios may be inflated as private capital would not have flowed into the projects without the concessional support.

Under what conditions is the multiplier effect large or small?

Understanding what allows for larger multiplier effects can help more efficiently allocate concessional capital, maximizing cash flow to high impact investments. The Convergence database found a smaller multiplier effect in areas such as Sub-Saharan Africa which was attributed to the higher perceived and real risks for commercial investors in these regions. Due to greater risk, commercial investors required more concessional capital dollar-for-dollar. As seen in the figure below, the leverage ratios do not perfectly match expected match risk in a region; this may be explained by varying availability of private capital or differences in expected returns.

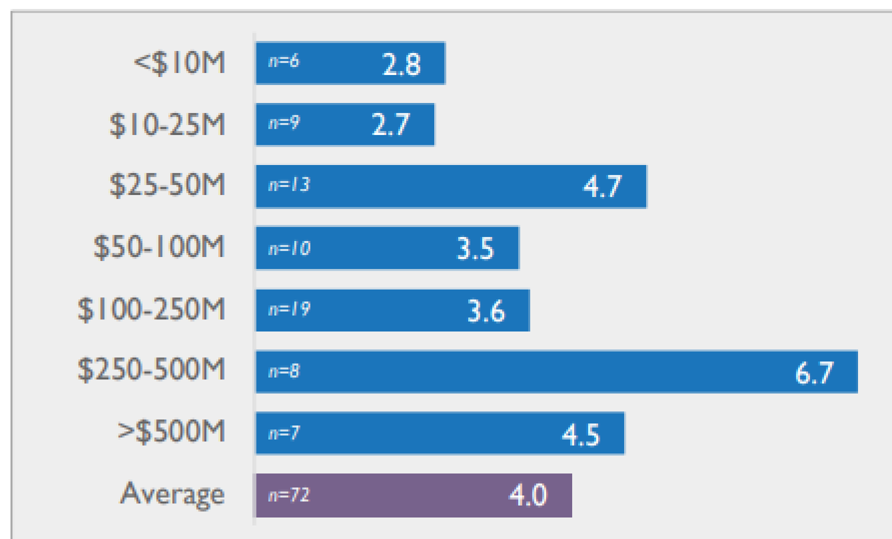
11 Insights from Blended Finance Investment Vehicles & Facilities

Figure 4: Average leverage ratio by target region[12]



In terms of sector, higher leverage ratios were achieved in funds targeting microfinance and capital markets and lower ratios were found for funds in agricultural and SME finance. As expected, larger blended finance funds generally attract more private capital per dollar of concessional capital, as seen below. This trend may be due to commercial investors requiring larger ticket sizes given transaction costs, portfolio size, and investment mandates.

Figure 5: Average leverage ratio by deal size[13]



[12] LEVERAGE OF CONCESSIONAL CAPITAL
[13] LEVERAGE OF CONCESSIONAL CAPITAL

How does the type of organization providing concessional capital affect the multiplier effect?
Specifically, the type of organization providing concessional capital is also critical to the magnitude of the multiplier effect observed. Up to 49% of concessional capital providers are development agencies, while philanthropic providers and DFIs/MDBs account for 28% and 17%, respectively. Yet, despite the fact that development agencies account for almost half of the concessional capital provider population, funds originated or led by development agencies have had lower leverage ratios than commercially-oriented deal sponsors like DFIs and MDBs. One of the key reasons is that these commercially-oriented fund managers have "specialized skill sets" in areas such as asset management and emerging markets. Additionally, their experience working with private investors is valuable. On the contrary, development agencies place their focus on the poorest regions in the world and may also have less experience working with private investors, leading to lower leverage ratios relative to those of DFIs and MDBs[2]. However, the claim regarding development agencies having less experience working with private investors needs to be investigated further.

In addition to examining the relationship between the size of the multiplier effect and the type of concessional capital provider, the relationship between concessional instrument shares in each sector and the corresponding sector specific leverage ratio also reveals information about effectiveness of the sector specific instruments. For example, in the Infrastructure sector where climate projects are prevalent, the most widely used instrument in 2017 was senior debt. The Infrastructure multiplier effect was about 3.89x. In the Finance/Banking sector where projects generally support SMEs, the use of equity, risk-sharing facilities, and guarantees was more prevalent - the corresponding multiplier effect was around 6.58x in 2017. In other sectors including agribusiness, equity was also the predominant instrument used, and the corresponding multiplier effect for those sectors was around 5.41x. Compared to the average leverage ratio of 1:4 observed in blended finance funds, the leverage ratio from the Infrastructure sector in 2017 is marginally below that average while the leverage ratios from the Finance/Banking and Other sectors are above the average. Although more information is needed, this could suggest that the prevalence of different instruments used for each industry has a relationship with that industry's leverage ratio[3].

Conclusion
The impact investing sector has doubled in size over the last two years, as investors realize the necessity of mobilizing capital to address our world's social and environmental issues. Catalytic capital is a critical

tool for enabling impact investing to mobilize the trillions of additional private sector investment needed to achieve sustainability and development goals. Without greater precision in the terminology surrounding the multiplier effect, comparing the effectiveness of concessional capital will remain cumbersome, leaving the possibility of great opportunities to catalyze large amounts of private capital unidentified and drains of concessional capital overfinanced. While catalyzing capital is not the only goal of concessional investors, it is a central one, and if we hope to catalyze the capital necessary to tackle our world's largest social and environmental issues, we need to maximize the power of the multiplier effect.