



## LAUNCH Food Investment Options

### Key Findings

1. When grants are used strategically they can help leverage additional sources of financing from both other public sector agencies as well as private investors.
2. More and more public sector agencies are starting to collaborate with the private sector in creating blended finance mechanisms to support innovation
3. Co-investing with government allows private investors to get involved in much earlier stages of innovation than investing on its own
4. Ecosystem development is needed, regardless of what stage of development a country is in, in order to help innovators achieve scale and impact

### Introduction

The increasing interconnectedness of our modern world has exposed us to more instances of inequality and suffering than at any other time in our history. However bleak, this unprecedented level of exposure brings with it an opportunity to begin to address the deep-rooted structural defects present in our society, and create the new approaches to problem solving that will be required to address them. Recognizing that the current way of operating isn't working, DFAT is approaching development with a different lens, one that focuses on working with the private sector to help increase "sustainable economic growth and reduce poverty"<sup>1</sup>. This lens acknowledges "that commercially sustainable solutions to poverty are an essential component of the transition away from aid and toward sustainable development"<sup>1</sup>. This includes a focus on working with the private sector to help increase "sustainable economic growth and reduce poverty; and that commercially

sustainable solutions to poverty are an essential component of the transition away from aid and toward sustainable development"<sup>1</sup>.

To achieve sustainable development the *how* of development needs to be changed. How different actors interact with one another, how capital flows are being allocated, how businesses operate in existing markets, how new markets are created and how people think and operate in ways that benefit not just a few but the masses. This requires system change – a fundamental shift in our current way of operating.

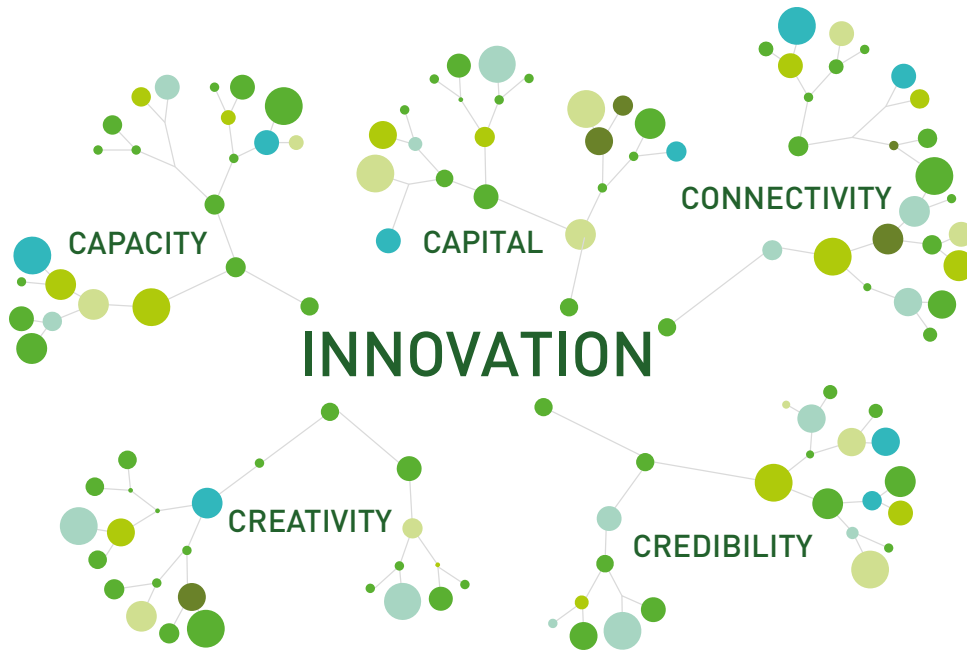
In its latest effort to demonstrate a new way of doing development, DFAT is partnering with the LAUNCH program to accelerate innovations in the food sector.

LAUNCH is a global network-centered innovation platform harnessing innovators as catalysts for collective action against some of humanity's toughest sustainability and global development challenges. LAUNCH believes these global problems are, by definition, too big and complex to be addressed by any one organisation or nation. Rather than focusing on just a small part of a larger problem, LAUNCH looks to systemic solutions: ways to fix not only one minor obstacle, but to shift the global infrastructure. To achieve its goals, the LAUNCH program develops a network of individuals and organisations tailored to the systemic problems that we are trying to solve.

<sup>1</sup> DFAT, Strategy for Australia's aid investments in private sector development. October 2015.

<sup>2</sup> Relevant Sustainable Development Goals: No Poverty, Zero Hunger, Good Health and Well-being, Quality Education, Responsible Consumption and Production, Life below Water, Life on Land. United Nations Sustainable Development goals: <https://sustainabledevelopment.un.org/?menu=1300>.

<sup>3</sup> The Power of Nutrition. (2015). The Power of Nutrition Annual Report and Financial Statements. Retrieved from: [http://www.powerofnutrition.org/wp-content/uploads/Annual-Report-Financial-Statements\\_2015.pdf](http://www.powerofnutrition.org/wp-content/uploads/Annual-Report-Financial-Statements_2015.pdf)



This network offers five critical elements to the innovators which are central to scaling their idea – **capacity**, **credibility**, **connectivity**, **creativity**, and **capital**. Moreover, by bringing this network together, **LAUNCH** enables network effects: the “ripple” effects that happen when network members from different silos interact, compressing expensive cross-sector transactions that would take months into minutes.

This report focuses on **Capital**, and the roles DFAT can play in supporting innovations to scale and supporting innovation ecosystems to thrive. Specifically, the report provides DFAT with insights into how it can use grants more strategically to catalyze additional financing support for innovators from both other public actors and the private sector. This will help create space for the implementation of a suite of alternative financial mechanisms such as credit enhancement tools and debt instruments as well as blended finance models such as capital stacks and pooled funds that will increase the flow of dollars going towards innovation. These types of customized financing instruments allow for better long-term alignment between innovators and their financing partners – leading to more sustainable business growth.

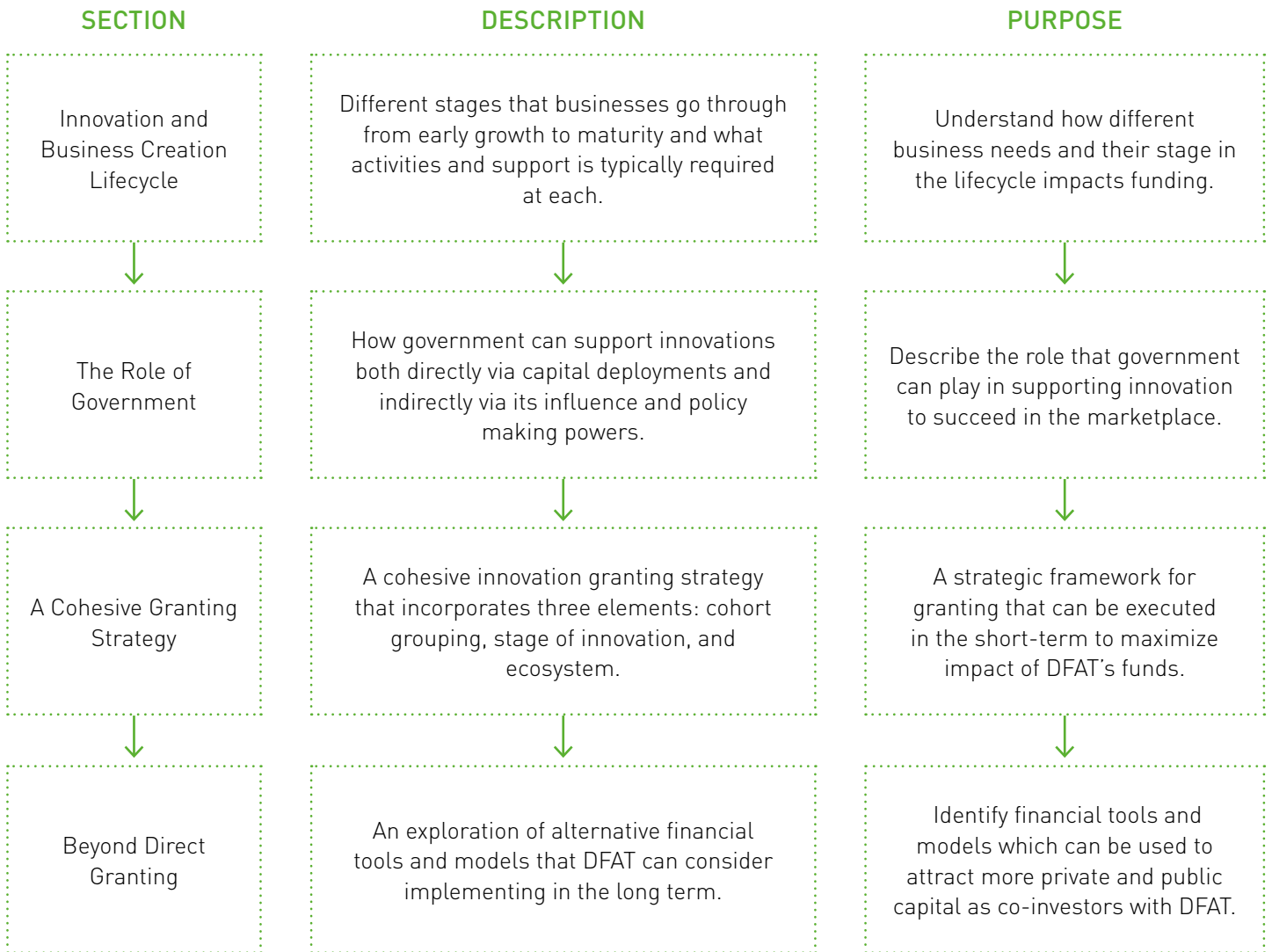
Looking ahead, DFAT is in a unique position to strengthen its catalytic deployment of capital and prove that there is a more effective way of resourcing development. By taking

this framework-level, systems-based evaluation approach to grants, DFAT can more effectively finance development and thereby build a model for other development agencies to adopt and further refine. Investing in innovations and ecosystem building activities helps in the creation of new markets and aids nascent ones to flourish. This approach to development is a different aid model, one that is based on market transactions to transform systems into ones that are self-reliant and positive for people, economies, and the planet. As such DFAT’s role and funding strategy should mirror market creation strategies, recognizing that as an institution DFAT may be limited in their ability to drive improvement across all aspects of a business and requires support of other actors.

### Methodology

Our team’s experience in granting and financing early to late stage innovations was used to create the basis of this paper. Further research was conducted based on the latest publications from the World Bank, International Finance Corporation, World Economic Forum, and OECD to name a few. To better understand the motivations and perceptions of the private sector, we conducted interviews with over 10 investors in various sectors, ranging from individual investors to venture capital firms. Interviews were also conducted with innovators to better understand their business and financing needs.

## How to navigate this paper

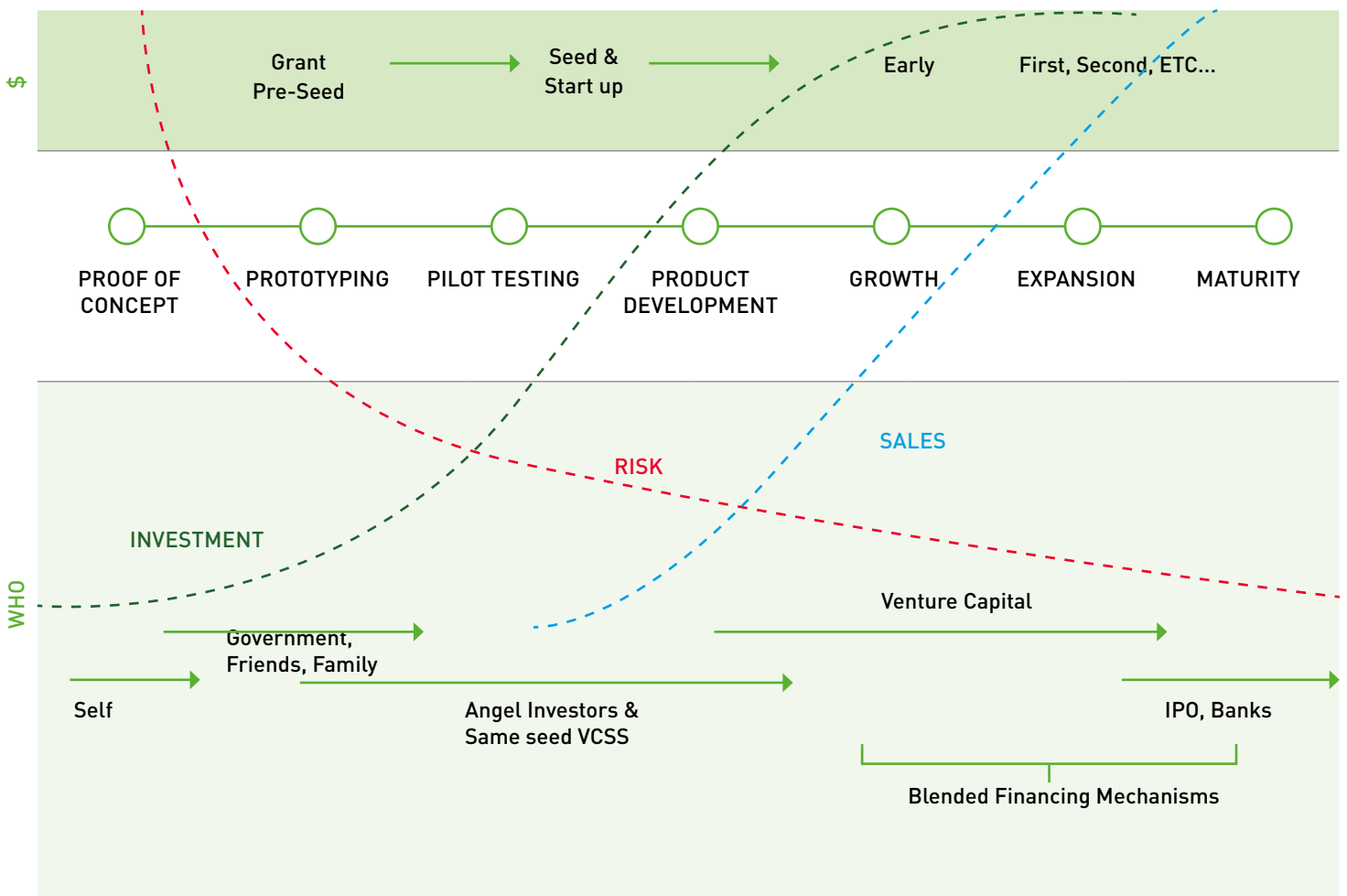


## Innovation & Business Creation Lifecycle

All companies go through stages of development, starting in a raw form and progressing through stages including proof of concept, prototyping and pilot testing, product development, growth, expansion, and maturity. This is known as the company S-Curve. Social innovations may not always follow the same growth pattern as typically laid out in traditional S-Curves, but the steps that they go through

are very similar. Business needs, both financial and non-financial, evolve throughout this lifecycle. Sources of capital tend to come from different places and types of funding vary reflecting the risk and return appetite of funders. The Capital Lifecycle represents the utilization of capital along the S-Curve. Below is a diagram that depicts how the different stages of the S-Curve and the Capital Lifecycle align.

Figure 1: Innovation and Capital Lifecycle



Stages of the S-Curve	Typical business activities	Capital Lifecycle	Timeline
Early Design Stage / Proof of Concept	<ul style="list-style-type: none"> <li>• Highlight the problem being solved</li> <li>• Market research and design research articulating competitive advantages and business model</li> <li>• Product / service profile</li> </ul>	Friends & Family / Sweat Equity	pre-launch
Prototyping & Pilot Testing	<ul style="list-style-type: none"> <li>• Testing your idea in the market</li> <li>• Defining Key Performance Indicators (KPIs)</li> <li>• Building your Key Opinion Leader (KOL) network</li> <li>• Pre-sales lead generation</li> </ul>	Grants / Angel-Seed Investors	approx. 1-2 years (sector dependent)
Product Development	<ul style="list-style-type: none"> <li>• Market testing</li> <li>• Garner required certifications</li> <li>• Internal capacity &amp; team building, including maintenance &amp; customer support</li> <li>• Prepare production / manufacturing capacity</li> <li>• Continue KOL network development</li> <li>• Product refinement based on pilot test results</li> <li>• Sales lead generation / sales team</li> </ul>	Pre-Series A	3-5 years (sector dependent)
Growth	<ul style="list-style-type: none"> <li>• Focus on sales lead generation &amp; execution</li> <li>• Production efficiencies</li> <li>• Build R&amp;D capacity</li> <li>• Second generation / market-ready product</li> <li>• Advisory Board</li> <li>• Internal team capacity &amp; team building</li> </ul>	Venture Capital / Institutional Capital	5-7 years (sector dependent)
Expansion	<ul style="list-style-type: none"> <li>• Expand / scale geographic markets</li> <li>• Diversify and efficiency in production</li> <li>• Government relations &amp; networking</li> <li>• Product pipeline</li> <li>• Internal team capacity &amp; team building</li> <li>• Strategic partnerships across vertical and/or horizontal integration / coalition building</li> </ul>	Institutional Capital / Assess IPO & Strategic Investment	8-9 years (sector dependent)
Maturity	<ul style="list-style-type: none"> <li>• Expand / scale markets</li> <li>• Prioritize profitable and strategic discreet product and services (SKUs)</li> <li>• Strategic partnerships across vertical and/or horizontal integration / coalition building</li> <li>• Government relations &amp; networking</li> <li>• Internal team capacity &amp; team building</li> <li>• Expand product pipeline</li> </ul>	IPO & Strategic Investment / M&A	10-12 years (sector dependent)

Beyond capital, innovators also require: **capacity**, **creativity**, **credibility**, and **connections** to grow their business – part of the 5Cs mentioned earlier. **Capacity** refers to specific skills or capabilities that are needed to develop or deploy solutions. **Creativity** is central to conceiving new products and services and is often needed for business planning and strategy development. **Credibility** within the market can help advance the adoption of a product or a service. **Connections** can be to customers, communities, and other partners that can provide support for the innovation. At each stage of development, companies may require a different combination of these Cs. Although this paper's focus is on **Capital**, it is important to recognise that these are very important for business success.

In addition to directly helping businesses grow, from our experience supporting over 125 innovators throughout various stages of this lifecycle, we understand the importance of the surrounding ecosystem in helping innovations to successfully achieve scale and impact. Ecosystem development requires looking beyond just the innovator itself as a change agent. It focuses on the enabling environment which is composed of multiple actors ranging from academia to the private sector who all need to work together to create the change in the market. Ecosystem development includes interventions such as creation of new policies, bringing together the right market players, movement creation, building market awareness and acceleration services for entrepreneurs, to name a few.

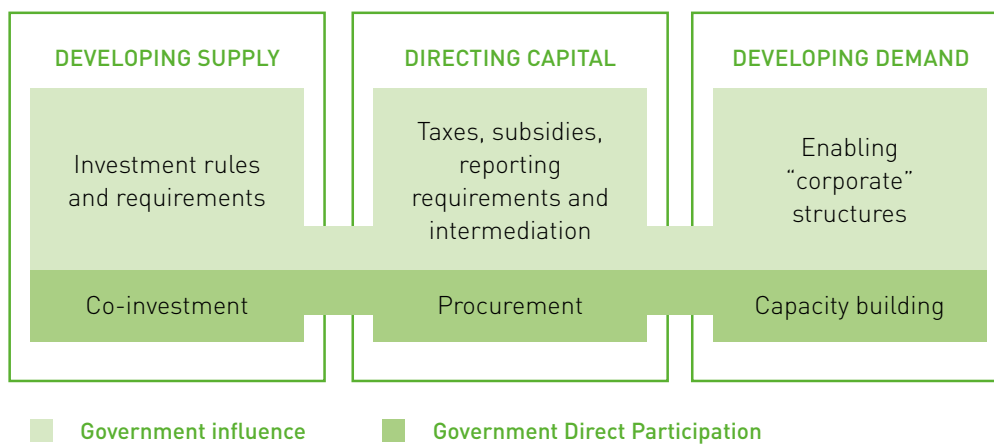
Ecosystem development is needed regardless of what stage of development a company is in; especially in developing countries where the market for entrepreneurs and innovation is less advanced.

## The Role of Government

Having an understanding of the different stages of innovation and their capital needs, we now turn to the various roles that government can play in supporting innovation. Specifically, as it relates to finance government can play a role in developing the **supply of capital**, **directing existing capital**, and **developing demand**.<sup>5</sup> This includes directly using capital to support the growth of businesses and indirectly influencing the ecosystems in which they operate and providing non-monetary support.

Throughout the innovation lifecycle, the engagement of government can play an important role for the growth of a business. At later stages in the lifecycle, the likely role of government transitions from co-investing in the form of grants and building capacity for start-ups to directing capital in the form of procurement and co-investing through blended financing mechanisms. However, as described in detail later, granting can play a catalytic role through all stages of innovation.

**Figure 2: Roles of Government in Supporting Innovations**



<sup>5</sup> See figure 2. Adapted from: IIPC (Impact Investing Policy Collaborative). 2014. Global Policy Report 2014. Retrieved from: [http://globalpolicy.iipcollaborative.org/wp-content/uploads/sites/5/2014/12/2014-IIPC\\_Full-v61.pdf](http://globalpolicy.iipcollaborative.org/wp-content/uploads/sites/5/2014/12/2014-IIPC_Full-v61.pdf).

In **developing supply** DFAT can use its capital to act as a co-investor in innovation with other government agencies as well as the private sector. Blended finance mechanisms provide a model where government can act in this capacity. Strategies to **direct capital** are intended to change the way existing investments are made in the capital markets, shifting more toward development opportunities. Mechanisms such as guarantees and first loss participation in investment funds can be used to change the perceived risk and return characteristics of investment and improve transaction efficiency to attract greater private sector capital participation in the intended markets. Government may also use its own procurement capacity to stimulate market activity in desired domains. **Developing demand** includes strategies such as those currently being implemented by DFAT to build the capacity of innovators by granting directly to them to strengthen their organisations and achieve scale. It could also include creating more targeted capacity building funds for investment readiness.

Government can also support innovators and influence the flows of capital by creating investment rules and requirements, providing tax incentives and subsidies, and enabling corporate structures such as Benefit Corporations. Another way in which government can support innovators is by providing them with **connectivity** and **credibility** - both of which also play a role in de-risking capital. **Connectivity** is needed across all stages of the S-Curve from early proof of concept to maturity. Simply knowing the right people in the right places can have a significant impact on the success of a business. In fact, **connectivity** is one of the main reasons that innovators apply for **LAUNCH** and other similar innovation programs ran by SecondMuse.

To highlight one case, during the Blue Economy Challenge (BEC) Kickoff Summit, BEC Fellow, Wilco Drew from AgriProtein, met with Council Member, Sunil Kadri of Ridley, to identify opportunities to improve AgriProtein's development and composition of black soldier fly based fish feed. Throughout the Accelerator, Wilco and Sunil worked out a partnership through the University of Sterling, where Sunil is an alumni and Ridley is a partner, to perfect the composition of AgriProtein's fish feed and understand how to standardize quality across feedstock, which were major focus areas of DFAT's funding through the Blue Economy Challenge.

Having the recognition of a large government agency can also give **credibility** to an innovation and business team. This recognition acts as a market signal, attracting the interest of industry and investors. Across multiple innovation programs, SecondMuse has witnessed the impacts of this first hand. Below are some additional early success stories from DFAT's Blue Economy Challenge and Aquacelerator.

- **Indian Ocean Trepang** After reviewing Indian Ocean Trepang on the Blue Economy Challenge panel, one of the world's largest aquaculture investors, Aqua-Spark invested \$2.75M to support Indian Ocean Trepang's global growth.
- **MicroSynbiotix** MicroSynbiotix are currently raising a 850,000Euro Seed Round. Their lead investor, Alimentos Ventures began speaking with MicroSynbiotix while he was a judge for the Blue Economy Challenge. As a result of MicroSybiotix being selected and receiving a grant from DFAT, Alimentos offered a term sheet with a valuation higher than their original value.

Interviews with venture capital firms and private investors reinforced the above. Interviewees all agree that government has a role to play in supporting entrepreneurs and innovation. In markets such as food where there has not been a significant amount of foreign investment in new innovative products, having the government involved in regulatory actions and direct investments provides a level of assurance and confidence to investors when investing in foreign markets. Investors also agreed that government has a significant role to play in creating regulatory conditions that support entrepreneurs and creating market incentives to attract investors. By focusing on supporting developing countries to create their regulatory environment, governments would be able to use their influence to attract not only more funding but also the creation of more enterprises which would in turn stimulate more investment.

Government granting was viewed most favorably in very early stages of a business where funding is intended to help mitigate technical or new market risk associated with a new idea. As the business progresses, however, government grants are viewed less favorably as this is seen as a sign that the business is not a commercially viable enterprise or that the management team is not fiscally responsible. The negative stigma associated with receiving government financing can be avoided by staging grants that are based on performance and having management teams operate as closely as possible within budgets. Government grants can also be blended with private capital and private investors and industry can be involved early in the process to further mitigate this negative stigma. Interviewees also emphasized that governments should not play an active role in managing operations or sitting as boards of directors. This is both because it is not an area of expertise for government and it can lead to conflicts of interest.

The proceeding section will focus specifically on DFAT's granting, which is directed to support innovators and their growth. We explore different forms of capital engagement that DFAT can consider to leverage private capital under the Beyond Direct Granting section.

## A Cohesive Granting Strategy

Grants can be a highly effective tool for helping innovations grow and scale. Both early stage and mature stage companies can benefit from grants as they provide a form of non-dilutive capital. This allows innovators to grow their business without having to sell shares or give up ownership of their company. In this section we explore how granting can be distributed for the support of innovation in a more strategic and holistic way. The strategy presented is something that can be executed immediately as certain elements DFAT has already been implementing and others do not require a heavy shift in existing funding structures.

A cohesive innovation granting strategy should look at the following three elements: **cohort grouping**, **stage of innovation**, and **ecosystem**. A cohort-based approach looks to group innovators according to certain key characteristics such as geographic proximity and business model (i.e. product / service / enabler). Thinking about funding a cohort of innovators instead of one off ideas can help maximize the impact of DFAT's funds. In addition to thinking about innovators as part of a cohort, it is important to understand what stage of development they are in (i.e. where they sit on the innovation S-Curve). How the funds will be used and the leverage that they will have will vary depending on the stage of the company. Finally, DFAT should also consider the innovation ecosystem in which the innovation will operate. The ecosystem surrounding an innovation plays a significant role in its success however it is often one of the least funded areas.

Below is more detail about each of the three components that together create a cohesive innovation granting strategy.



## COHORT GROUPING

A cohort-based approach to granting and acceleration provides a strategic mechanism to assist decision making by supporting the development and management of a diverse, robust and synergic portfolio of innovations. This helps distribute and mitigate risks while maximising returns (i.e. innovators achieving sustainability and scale, and delivering impact). In short, a cohort-based strategy helps to answer the questions of why and how to support a group of innovators instead of one off ideas. This approach stems from the recognition that by grouping innovators according to key characteristics resources can be directed in more strategic ways. This amplifies investments and increases their capacity to reshape demand, transform supply chains, and catalyze new markets.

Below are some examples of different types of cohorts with the rationales for their grouping. This is by no means an exhaustive list, but rather a demonstration of cohort-based approach.

- **Business Model** Product or service models will have similar challenges across production efficiency, customer acquisition and talent attraction / retention. Grouping innovators through these similarities can help generate shared learning, collaborative development, and collective resource use.
- **Geography** Simply being located in the same region can allow easier sharing of resources, foster more collaborative development, and enable the establishment of shared infrastructure which can also benefit the broader ecosystem.
- **Dependency** Connecting innovative products and services that form part of the same system or supply chain can enable transformative, systemic change. Grouping innovators with these dependencies can support the creation of new infrastructure while also demonstrating to the market that there are viable alternatives.
- **Transferability/Scaling (i.e. leaders and followers in the same field)** Innovations that can be transferred, scaled, and/or licensed into other markets with the support of local market enablers that can expand the overall impact

of solutions. Supporting a number of like innovators (i.e. similar technologies, processes, objectives) can help to develop mentoring relationships, enable learning to be cumulative and shared. Through this innovators can leverage one another's successes to open up new markets or transform supply chains.

- **Synergies** The potential for generating transformative change is amplified by acting on multiple parts of a system simultaneously (e.g. supply and demand), and by creating collaborative opportunities (e.g. new products and services, business or operating models, and even supply chains), but the ability of innovators to complement one another's efforts is dependent on their capacity to identify and leverage any synergies. In light of this, a skilled intermediary or facilitator is generally required to realise the value of these cohorts.
- **Market Insight** Deep understanding of a sector and/or systems thinking can help identify systemic needs and leverage points. These areas of criticality can guide decision making around cohorts and innovators, and can be particularly helpful when considering exceptions and prioritisation.

The facilitated matching of innovators to address capability gaps or weaknesses can also be hugely valuable, but this process should be considered separately to a cohort-based approach as these relationships are generally more transactional and short-term. It's important to note that cohort membership needn't be mutually exclusive. It can be valuable to consider some innovators as belonging to multiple cohorts.

A cohort-based approach to granting should be grounded in a portfolio-based approach to investment management, and clearly aligned with strategic objectives. Funding can be deployed either directly to individual innovators, to service providers who will support innovators, or to the cohort as a whole for a specific project. Funding deployment will need to be assessed on a case by case basis to determine where funding can be most catalytic.

Furthermore, thinking about innovators as part of a cohort has implications in challenge creation for open innovation programs as well as informing selection criteria. The more synergies between the cohort the more grants can be pooled for several innovators under one pilot project allowing for scaling of capital. Further a cohort aligned by business model, stage of development and geography tied to a clear challenge statement will allow council members to be more targeted in their support and allow for more creative connectivity within the network.

### STAGE OF INNOVATION

Grants can play a catalyzing role throughout a company's growth cycle. For instance for companies that are in the very early **proof of concept** phase, grants can be used towards market research and basic problem definition. For those that are in the **prototyping** phase, grants can be used to run pilots to test their idea and to help land industry partnerships. Businesses in the **product development** phase can use grants to help hire staff to relieve the founder from day to day administrative tasks in order to focus on strategy development. During a **growth** phase, grants can be beneficial for R&D type activities. At **expansion** phase, grants can be used to help reach into new markets. And at **maturity** stages grants can help in the creation of coalitions and strategic cross-sector collaborations. At each of these stages, grants help de-risk the business and can help attract additional capital.

Although we have talked about the six stages of the S-Curve, for the purposes of granting we have distinguished this into two categories: early-stage and later-stage grants. The details below are meant to be guiding parameters based on typical needs of a business. The parameters, including tranching recommendations, of each grant will still need to be assessed on a case by case basis to ensure that the funding is tailored to meet the needs of the innovator and help create the desired impact. As DFAT has requirements for targeted outcomes, in addition to geographical (i.e. country) focus areas, we recommend that grants have activity stipulations for each innovator. While flexible grants (i.e. those that do not have spending requirements) are often given to grantees to use as they deem fit, because DFAT must fund to specific outcomes, we recommend grants with stipulations.

Early-Stage Grants:	
<b>Innovation characteristics</b>	From Proof of Concept to Product Development
<b>Base grant contribution:</b>	\$50,000 unrestricted
<b>Additional Tranches</b>	\$100,000-250,000 restricted for pre-established activities
<b>Typical activities funded</b>	<ul style="list-style-type: none"> <li>• <b>Competitive positioning &amp; value proposition:</b> For innovators and their advisors to engage in market research around how competitive their innovation is and clearly identify what problems they are solving and why. Grants given to the innovator team or outside consultants expert in branding and communications</li> <li>• <b>Key Hires:</b> Allows the innovators to attract the top talent and support their long-term business strategies.</li> <li>• <b>Pilot testing/ market validation with target customers / sales channel development:</b> For innovators to engage directly with market participants for better understanding of their innovation's viability and market opportunity. This allows for innovators to develop leads with important sales channels. Grants can go to innovators, outside consultants and a group of innovators within a cohort.</li> <li>• <b>Pricing analysis:</b> An exercise in calibrating the sales potential of innovations and where they are positioned in the market, for instance high margin-low volume or high volume-low margin. This type of grant is given to experts in market analysis and sales channel development who can aggregate hard to unearth data.</li> <li>• <b>Production capacity:</b> For innovators looking to streamline their production processes, lower pricing of their innovation and prepare for scaling. Requires expertise in supply chain management and can be given internal to the innovator team if the capabilities are present, otherwise outside experts.</li> <li>• <b>Product design/refinement:</b> Grants given to product design experts who will continue to iterate on the product look and feel and integrate customer feedback</li> <li>• <b>Communications and marketing:</b> Grants given to internal or external branding teams that will position the innovation in the market and build on storytelling capacity.</li> </ul>
<b>Value/leverage that grant provides</b>	<ul style="list-style-type: none"> <li>• De-risks technology viability of innovation by providing proof-of-concept</li> <li>• De-risks competitive positioning of innovation by testing the market</li> </ul>
<b>Terms of grant</b>	<ul style="list-style-type: none"> <li>• Generally over 2 years</li> <li>• Grant is distributed according to meeting pre-established milestones i.e. 50% provided up front, 40% provided after meeting pre-established milestones, and 10% after final report.</li> <li>• Requires matching funds (at least 50%).</li> <li>• Non-renewable.</li> </ul>
<b>Evaluation</b>	Suggest to include \$20,000 earmarked for evaluation if granting is more than the base amount.

Later Stage Grants:	
<b>Innovation characteristics</b>	Growth to Maturity
<b>Base grant contribution</b>	\$50,000 unrestricted
<b>Additional Tranches</b>	\$250,000 - 550,000 (up to \$1,000,000) restricted for pre-established activities
<b>Typical activities funded:</b>	<ul style="list-style-type: none"> <li>• <b>Scaling into new markets through pilots:</b> Grants for innovation to be tested outside its local market. Opens the path for product iteration and larger market engagement. Grants can go to international partners and innovator team to identify key new markets.</li> <li>• <b>Product refinement and R&amp;D:</b> Grants for additional product iteration and wider market engagement, including second generation suite of products and vertical or horizontal product integration through R&amp;D. Grants go to internal innovator team along with R&amp;D partners.</li> <li>• <b>Consolidating supply and expanding manufacturing capacity, including localization of production if needed:</b> Building production footprint to achieve scale and international clients. Includes expert supply chain management. Grants go to innovator team and consultants with relevant expertise.</li> <li>• <b>Access institutional series A capital:</b> Grants to support the development of an investment memorandum and transaction structure, including tax and legal advice. Requires hiring outside experts to support with investor outreach and negotiation.</li> <li>• <b>Communications / re-branding / government relations:</b> Building on existing best practice storytelling capacity and reaching broader audience including key government contacts around production and supply chain, R&amp;D and go-to-market strategies. Grants go to internal team or outside to expert consultants.</li> <li>• <b>Strategic partners for product and/or market expansion:</b> Grants to support companies go from growth to maturity in terms of market penetration, product offering and project management protocols.</li> <li>• <b>Increasing HR capacity:</b> Grants to support talent acquisition through working with headhunters and executive search firms.</li> </ul>
<b>Value/leverage that grant provides</b>	<ul style="list-style-type: none"> <li>• De-risks "key man" concerns where innovation is controlled by one star founder</li> <li>• De-risks revenue scaling obstacles</li> <li>• De-risks concerns in production capability to scale and match big orders</li> <li>• De-risks near-term operational capital requirements</li> </ul>
<b>Terms of grant:</b>	<ul style="list-style-type: none"> <li>• Generally over 2 years</li> <li>• Grant is distributed according to meeting pre-established milestones i.e. 40% provided up front, 30% provided after meeting pre-established milestones in year 2, 20% after meeting pre-established milestones in year 3 and 10% after final report.</li> <li>• Requires matching funds (at least 50%).</li> <li>• Non-renewable.</li> </ul>
<b>Evaluation</b>	Suggest to add \$50,000 earmarked for evaluation if granting is more than the base.

## ECOSYSTEM

In many cases, the support innovators need goes beyond strengthening their own operations and is more related to connecting to other parts of the ecosystem. This is particularly relevant for innovators in new markets (geographical or sectoral). Examples of connecting to other parts of the ecosystem includes industry partnerships, value chain integration, and cross-sector collaboration to name a few. Connecting to the larger ecosystem requires coordinated and facilitated conversations between the innovators and other system actors.

System actors include all actors relevant to a particular innovator's ecosystem. They may include financial institutions, investors (asset managers, individuals, institutional investors, etc.), policy makers, corporations, SMEs, Non-profits, consultants, public institutions, government agencies, consumers and community beneficiaries.

DFAT can leverage its convening power and neutral position to create a safe space for constructive interactions to take place, even among stakeholders that might otherwise compete in open markets; e.g. financial institutions.

Convenings can take multiple forms, from gatherings to simply connecting stakeholders to identify solutions to unlocking barriers to scale systems change like the Social Innovation Labs.<sup>6</sup>

### The intended outcomes of ecosystem investments may include (depending on the issues):

- Stronger or more integrated value chains
- More fluid investment flows and larger investment sums
- More enabling public policy
- Better mentoring networks for innovators
- New forms of collaborations among stakeholders
- Greater representation of ecosystem actors
- Better strategies for all given input from better representation of the ecosystem players
- Market awareness creation (i.e. creating market information and signals to private investors)
- Movement building that engages the system actors of consumers and beneficiaries

Ultimately, ecosystem investments can be considered System's level R&D

<sup>6</sup> MaRS: <https://www.marsdd.com/news-and-insights/social-innovation-labs-top-tips-common-pitfalls/> and Rockefeller's Guide to Social Innovation Labs: [https://assets.rockefellerfoundation.org/app/uploads/20150610111553/10\\_SILabGuide-FINAL-1.pdf](https://assets.rockefellerfoundation.org/app/uploads/20150610111553/10_SILabGuide-FINAL-1.pdf)

### Importance of grants for this:

- The market does not currently value the benefits that arise from ecosystem investments, so there is little or no capital dedicated to it. Entrepreneurs do not have the money nor the resources to invest in this.
- Investors do not pay for intangibles as much and results are softer and less tangible than e.g. quantity of products sold or number of beneficiaries reached.
- Governments and foundations are uniquely positioned to provide resources to create enabling environments.
- Some philanthropic funders around the world are starting to put resources into ecosystem development. In Canada the McConnell Foundation, the largest national funder, invests as much in ecosystems through programs like Innoveave or convenings of system stakeholders as they do in innovating organizations themselves. They are doing this work increasingly in collaboration with the government.

Grants allocated for ecosystem efforts can be used to support the costs associated with this integration such as travel, facilitation, meeting/convening coordination and logistics, communication and storytelling campaigns and policy research .

In addition to simply connecting to other parts of the ecosystem, grants can be used for ecosystem development in situations where DFAT is interested in driving larger system interventions than individual granting supports. Developing the ecosystem will likely be a very important component of supporting innovations in the developing world grow and scale since these markets traditionally have fewer mechanisms in place that support the growth of early stage innovations. In these instances, grants would be directed towards policy advocacy, designing centers for innovation, supporting development of market intermediaries and enabling services that support entrepreneurs.

These interventions can be lead by DFAT itself, depending on internal capacity, or by third party service providers where efficiency is a priority and external parties have the expertise to do the work more effectively. Service providers can include strategy and management consultants, accelerator programs, design and innovation agencies. Where possible, local actors should be given priority in receiving these funds as it can help increase local capacity to build resilient innovation ecosystems.

## Beyond Direct Granting

To date, the majority of Australia's development financing has been via grants. The use of non-grant instruments as well as alternative grant-based financing mechanisms has been minimally used.<sup>7</sup> As noted above, grants have an important role to play in helping innovations succeed. Non-grant financial instruments can also be used to support innovators such as credit enhancement tools like guarantee investments and debt instruments. Typically non-grant financial instruments are used in innovations that are at the product development stage or beyond. These mechanisms are traditionally used by private investors but are more and more being explored by development agencies and other public funders as alternatives or complementary to grantmaking.

In addition to adopting new financial tools, the use of alternative financial models such as blended finance and capital stacks has also been increasingly used by development agencies. Blended finance includes a range of models that can be effective tools toward attracting more private institutional investors and sales channel partners. In effect, blended finance is about combining different types of financial instruments and pooling capital from investors with different types of risk-return appetites. This supports resourcing projects more efficiently and effectively at a larger scale, and with the intent of achieving greater sustainability. According to the IFC, it has been "a highly effective catalyst to jump-start high-risk, nascent markets in developing countries".<sup>8</sup> In a survey of 74 blended finance funds by the World Economic Forum and OECD in 2016, they found that every dollar of public money invested helped attract between \$1-20 in private capital, and that blended funds were a requirement to attract private investors.<sup>9</sup> In addition to bringing in more capital, blended finance mechanisms stimulate a series of follow-on investments as they help prove to private investors that their investments can in fact be profitable in these nascent sectors and foreign markets.<sup>10</sup>

DFAT's evaluation of blended finance will require deeper analysis and engagement with the private sector, which needs to show a willingness to co-invest with government. In considering these instruments and models, it is important

to highlight that expected rates of financial return are not defined for any and that DFAT may choose to define its own expected rate, if any.

The list below of financial tools and models is not exhaustive and any application of such instruments must be viewed through the lense of the stage of development of the innovator, if cohort-grouping and ecosystem development is relevant, and the enthusiasm of the private sector.

### FINANCIAL INSTRUMENTS

Below is a range of financial instruments and tools; that is, the forms by which DFAT may deploy its financial capital to support innovators and their scaling efforts.

#### Credit Enhancement Tools:

- **Guarantees:** guarantees act as an insurance mechanism and may be offered in a range of ways.
  - Loan guarantees can be offered to enhance credit worthiness of enterprises and to lower risk for lending parties; either to enable access to financing that would otherwise not be available or to reduce the cost of financing. Guarantees can help enterprises build financial track record at early stages.
  - In other cases guarantees can be provided to intermediaries, such as funds, to help them leverage investment capital from more risk averse investors (example MCE in the US).
  - Guaranteeing parties may also establish agreements with financial institutions to guarantee entire portfolio of projects; enabling the financial institution to expand its financing service offering.

<sup>7</sup> Australian Government Department of Foreign Affairs and Trade. (2016). Future Financing Approaches.

<sup>8</sup> International Finance Corporation. (2016). Blending Public and Private Finance. Retrieved from: <http://www.ifc.org/wps/wcm/connect/242afe004c60ea82b81bbcccf53f33d/EMCompass+++Blending+Public+and+Private+Finance.pdf?MOD=AJPERES>

<sup>9</sup> World Economic Forum & OECD. (2016). Insights from Blended Finance Investment Vehicles & Facilities. Retrieved from: [http://www3.weforum.org/docs/WEF\\_Blended\\_Finance\\_Insights\\_Investments\\_Vehicles\\_Facilities\\_report\\_2016.pdf](http://www3.weforum.org/docs/WEF_Blended_Finance_Insights_Investments_Vehicles_Facilities_report_2016.pdf)

<sup>10</sup> Aus Sierra-Escalante, K. (2016, May 5). IFC: How Blended Finance Helped Turn \$385 Million Into More Than \$4 Billion [Blog post]. Retrieved from: <http://impactalpha.com/ifc-how-blended-finance-helped-turn-385-million-into-more-than-4-billion-3-of-3/>

- Guarantees do not have a fixed pricing mechanism. It is often up to guarantor to decide whether they want to charge for the guarantees and how much. In some instances guarantors charge a nominal price, e.g. 0.5% of guaranteed amount, to align interests and cover part of the transaction cost. In other cases guarantees may cost up to 4-5% of guaranteed amount and in yet other cases no charge at all is imposed.
- Benefits include:
  - Reduces the risk for lenders/investors
  - Allows early stage innovators access financing to build their credit track record
  - For guarantor, there is no money outflow unless in the case of defaults
  - Dedicated funds can be recycled into new projects as exit from guarantees take place

### Debt Instruments:

#### Patient quasi-equity debt

- Usually structured as mezzanine or junior debt that is unsecured and structured around repayment from future cash flows. Quasi-equity investments can be based on the company's future cash flow growth. Patient quasi-equity debt may also take the form of longer-term loans with principal repayment delayed for over 5 years.

#### Low-cost debt

- Debt that carries no coupon or is structured as PIK (payment-in-kind). Some impact funds offer low debt loans but require physical assets as collateral; others provide unsecured loans, i.e. with no collateral, but with an interest rate.

#### Convertible debt

- Debt and/or preferred equity that under certain conditions converts into common equity. Usually convertibility is tied to market performance or corporate activity. The convertible note may pay interest in cash or in-kind.

#### Convertible grant to loans

- Grants that are typically issued at early stages when uncertainty or risk is high and are converted to loans if projects are successful. They effectively serve the same

purpose as equity investments would in terms of sharing risk and success between innovator and investor; and are useful in the case of a) supporting non-profits who cannot receive equity investment, or b) when the funder is restricted in the types of investments it can issue and e.g. cannot make equity investments.

### Other Alternative Tools:

#### Royalty financing

- This is a repayment tool. Loans and/or credit lines that are secured by sales revenues; the loaning agency structures its return by taking a percentage of the sales.

#### 'Green' Bonds

- These are bonds that can be issued to raise capital in the markets to finance very specific development projects. Green bonds' proceeds tend to be dedicated to environmental projects but other forms of dedicated bonds are conceivable. Around the world, governments at all levels and international development agencies are increasingly using this instrument such as the World Bank for climate change projects.

### FINANCIAL MODELS

Independent of the instruments that DFAT chooses to utilize, financial models are the structures through which these instruments are deployed. These alternative financial models allow DFAT to explore new sets of partnerships with philanthropic investors as well as commercial investors.

### Alternative/Blended Finance Models:

#### Pooled funds

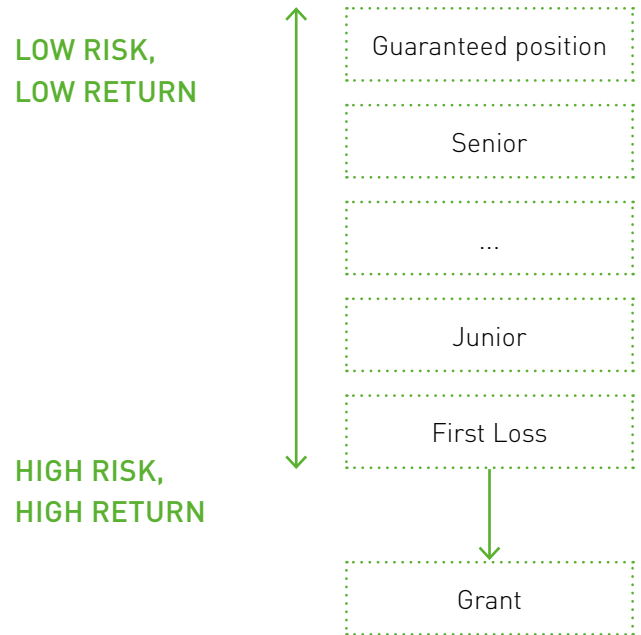
- Allow to pool resources from multiple investors including both public and private sector. In many cases they allow to syndicate loans where several parties each take a tranche of a loan to diversify.
- Investors are typically pari-passu; i.e. they all have equal positions in the fund with all receiving the same treatment in terms of risk and return.
- While the financial terms of investment might be the same for all investors, the participation of public sector and other philanthropic investors in these pooled funds can influence the attention to impact beyond financial returns.



**Capital Stacking**

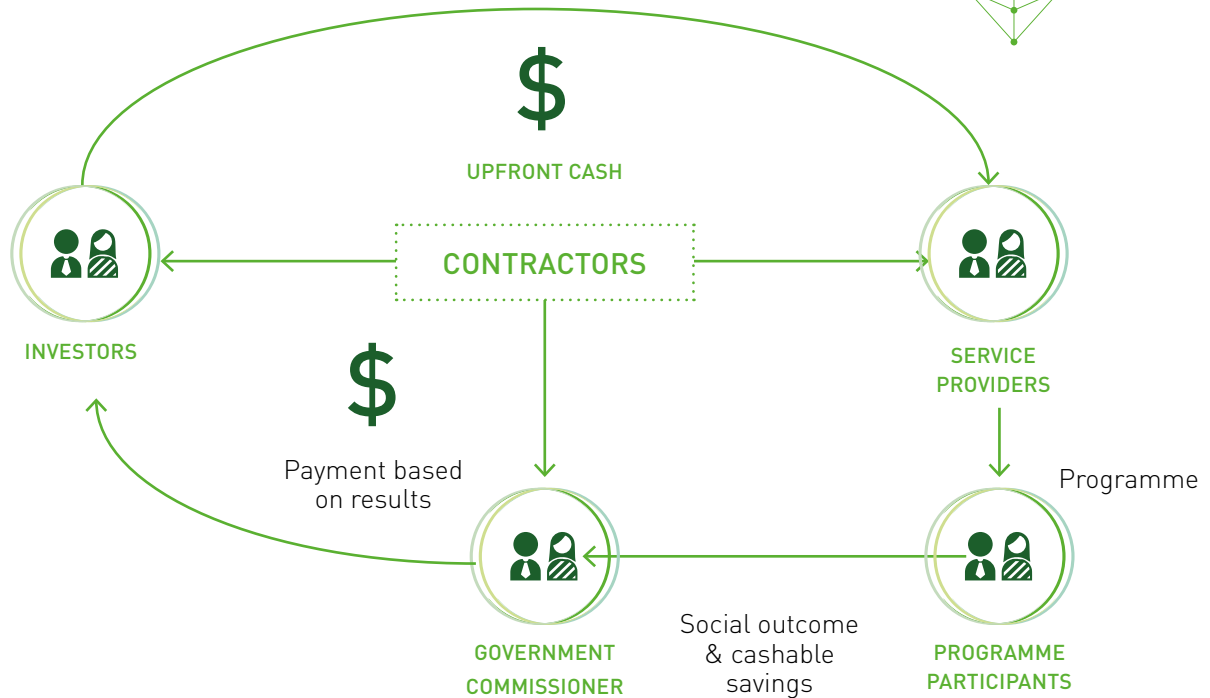
- Funds from multiple investors aggregated for investment purposes that can lead to greater impact. Using a combination of different types of capital ranging from grants to loan guarantees to equity to help de-risk an investment opportunity and attract more capital. Capital stacking allows for co-investment from investors with different kinds of risk-return appetite.
- A first loss position investor is committing to be the first one to have its capital commitment foregone to cover for any losses; up to a pre-established amount. Like with guarantees, taking first loss positions in funds reduces the risk to other investors and may be an important instrument to leverage commercial and other private investor participation.
- Benefits include:
  - Transforms risk from on the ground to the investment level.
  - Leverages capital, pools resources from multiple investors with different types of risk-return expectations.
  - Offers different investment propositions to different investors.

Mission driven social innovators often attempt to capital stack investments on their own, ultimately in an ad hoc manner. The majority of LAUNCH innovators fit this categorization. Ad hoc capital stacking is risky and often extremely inefficient for innovators as they attempt to piece together various form of investment.



**Performance/Results-based financing**

- Used to help incentivize performance by paying for desired pre-defined outcomes or outputs.
- Social Impact Bonds are one example of a type of Pay-for-Success or Outcomes-based financing. It is a contract with the public sector in which a commitment is made to pay for improved social outcomes that result in public sector savings. It helps raise up-front capital that is otherwise scarce and that enables a shift towards up-stream interventions. Requires proven intervention and clean and measurable outcomes that can be economically quantified. They are not good to test new interventions. They are costly and make sense for large-scale interventions.



### Risk Considerations

Proper risk allocation begins with understanding to what extent an investor is comfortable with risk, what their investment time horizons are and what levels of return they expect. The benefit of blending public and private money is that public investors generally have higher risk appetites, lower expected returns, and longer time horizons for their investments than private investors. This is particularly beneficial when investing in innovations that are not yet adapted in the market or in proof of concept and prototyping stage companies. Guarantees, capital stacks, and blended finance structures can combine public grants with private capital to help bring down the risk to private investors. These do not decrease the risk inherent in investing, it simply helps share or re-allocates the risk across public and private investor who have different risk and return appetites. Having private investors involved early on, exposes them to new levels of risk that they have not previously been exposed to. According to research by the IFC, this can help private investors “calibrate their risk perceptions—as their perception of risk comes down, the share of risk or the incentive support which public finance needs to take or provide can also decline”<sup>11</sup>. In the long term this can lead to more private investment being involved in earlier stages helping to build market economies.

### Governance, operations, and legal considerations

In a survey of fund managers, development finance institutions, and donor agencies the following were identified as considerations when structuring blended finance transactions:

- Legal structure should accommodate relevant stakeholders
- Balance priorities of development funders, private sector and end beneficiaries
- Understand the needs of the demand and be clear about ultimate purpose of the engagement
- The blended finance mechanism should fit the purpose
- Be strategic about long-term, shared-value partnerships
- Select strong partners
- Stakeholder coordination and education are necessary

<sup>11</sup> International Finance Corporation. [2016]. Blending Public and Private Finance. Retrieved from: <http://www.ifc.org/wps/wcm/connect/242afe004c60ea82b81bbcaccf53f33d/EMCompass+++Blending+Public+and+Private+Finance.pdf?MOD=AJPERES>

- Test and pilot mechanisms before scaling them
- Funds need to be patient and, where possible and needed, flexible
- Enable qualified local fund managers
- Use intermediaries when necessary<sup>12</sup>

Governance and operations have important implications for these considerations. The use of intermediaries can be helpful across several of them. First and foremost is the role that a neutral intermediary can play in stakeholder coordination and alignment. One fund manager stated that a neutral facilitator could have significantly expedited the negotiation process to create a blended finance fund.<sup>13</sup> In many cases, for blended finance and co-investment opportunities to be successful, investors both private and public, must feel that they are able to engage in new areas and/or at a larger scale as a result of their partnership.

Intermediaries can also facilitate the selection of strong partners and help cultivate the foundations that are necessary for long-term relationships to be developed. It begins with creating a shared vision and having mutual respect and trust. This is done by working with public and private funders to balance their priorities in a way that all parties involved feel that they are able to achieve more together than alone.

Ultimately, whether through an intermediary or directly, it is important to follow a set of principles when designing the governance in order to ensure that all relevant stakeholders feel that their voices and interests are incorporated in the design.

## Recommendations & Conclusion

Disruptive innovation is occurring throughout all sectors of the economy, and finance is not excluded from the paradigm-shifting forces of technology and globalization. The Finance industry is a critical enabler to most other sectors of the global economy and, in being so, can have a tangible influence in the values embedded within capitalism. One of the areas where this missions-based influence can be most powerful is in development finance, and this is why DFAT's role in evolving its financing to become a bridge between the public and private financing sectors is highly relevant.

DFAT will be joining a global conversation joining groups like Ford, Rockefeller, USAID, Open Society and many others toward establishing more sustainable financing platforms. In this vein, we propose that DFAT continues to be involved at both the direct and indirect levels to support the growth of businesses. At the direct level, having a more strategic approach to grant making can help DFAT achieve its development goals at the same time as attracting private capital into this space. In the long term, DFAT can also explore the use of other financial tools that go beyond granting in its efforts to deploy capital for innovation. At the indirect level, DFAT should continue to use and leverage its non-financial capacity as a convener, policy influencer, and active partner of innovators and the ecosystem. These non-financial interventions can actually attract other sources of funding as they help create the foundation that is necessary for innovations to succeed in the marketplace.

We suggest that DFAT begin to implement steps towards strategic grant making while at the same time engaging in conversations with the private sector to form a joint vision for more progressive funding mechanisms including blended finance.

<sup>11</sup> International Finance Corporation. (2016). Blending Public and Private Finance. Retrieved from: <http://www.ifc.org/wps/wcm/connect/242afe004c60ea82b81bbcaccf53f33d/EMCompass+-+Blending+Public+and+Private+Finance.pdf?MOD=AJPERES>

### Specific Recommendations;

- Engage in 1-2 case studies in cohort-based grants, pilot studies, and ecosystem development
  - Cohort-based funding could include funding a program where several innovators can take benefit, such as a curated match-making day with leading venture capital investors or sales channel leads, or a high-impact, high-focus strategy session with key opinion leaders and experts around a common intractable problem across the cohort.
  - Pilot studies can include providing early-stage grants for de-risking proof-of-concept technologies so that an innovator can win a procurement order or later-stage grants allowing an innovator to test a product in a new market thereby catalyzing new sales leads in that market. Funding recommendations for several of the LAUNCH Food innovators would result in such pilot studies.
  - Ecosystem development could include funding expert advisors and partners to provide critical knowledge and targeted networks to innovators, such as licensing and IP expertise, raising capital or building supply chains, design thinking and design research. For example, by requiring that all DFAT LAUNCH Food funded pilot, market and product assessments be made public, DFAT would be leading the generation of market insights which are critical to de-mystifying and de-risking the regional market.
- Convene key private sector partnerships to begin discussions on the structure and framework of blended finance instruments
  - Assuming that DFAT is committed to continued investment in the food innovation ecosystem for the next several years, particularly in the Pacific, it is recommended that DFAT further define which of the blended financing mechanisms it is interested in and capable of executing. With that knowledge and position solidified, DFAT should begin exploratory conversations with potential private and public co-investment partners.
  - It is recommended that monthly dialogues are convened over the course of six months with key partners that build on each other to drive alignment on the investment mandate and investment structure of a blended finance cooperation.
  - Several private investors and financing institutions have expressed interest in exploring co-investing with DFAT on food investments broadly, while outreach has begun to select investors for specific LAUNCH Food innovators. There is a strong base of investors to begin conversations with.

Increasingly, the trend in the market is towards more nutritious and sustainable food options. This, in turn, is increasing the appetite of investors to support the development of such options. In our conversations, none of the venture capital firms had prior experience co-investing with governments, but they expressed an interest in doing so if the proper mechanisms were in place and the goals were aligned. As the strategic alignment between LAUNCH, DFAT, and the food industry (especially investors) increases, the possibilities become more promising.