EGEN BY PNO GROUP

CIRCULAR ECONOMY FUNDING EXPLAINED

PART TWO: BLENDED FUNDING STRATEGIES

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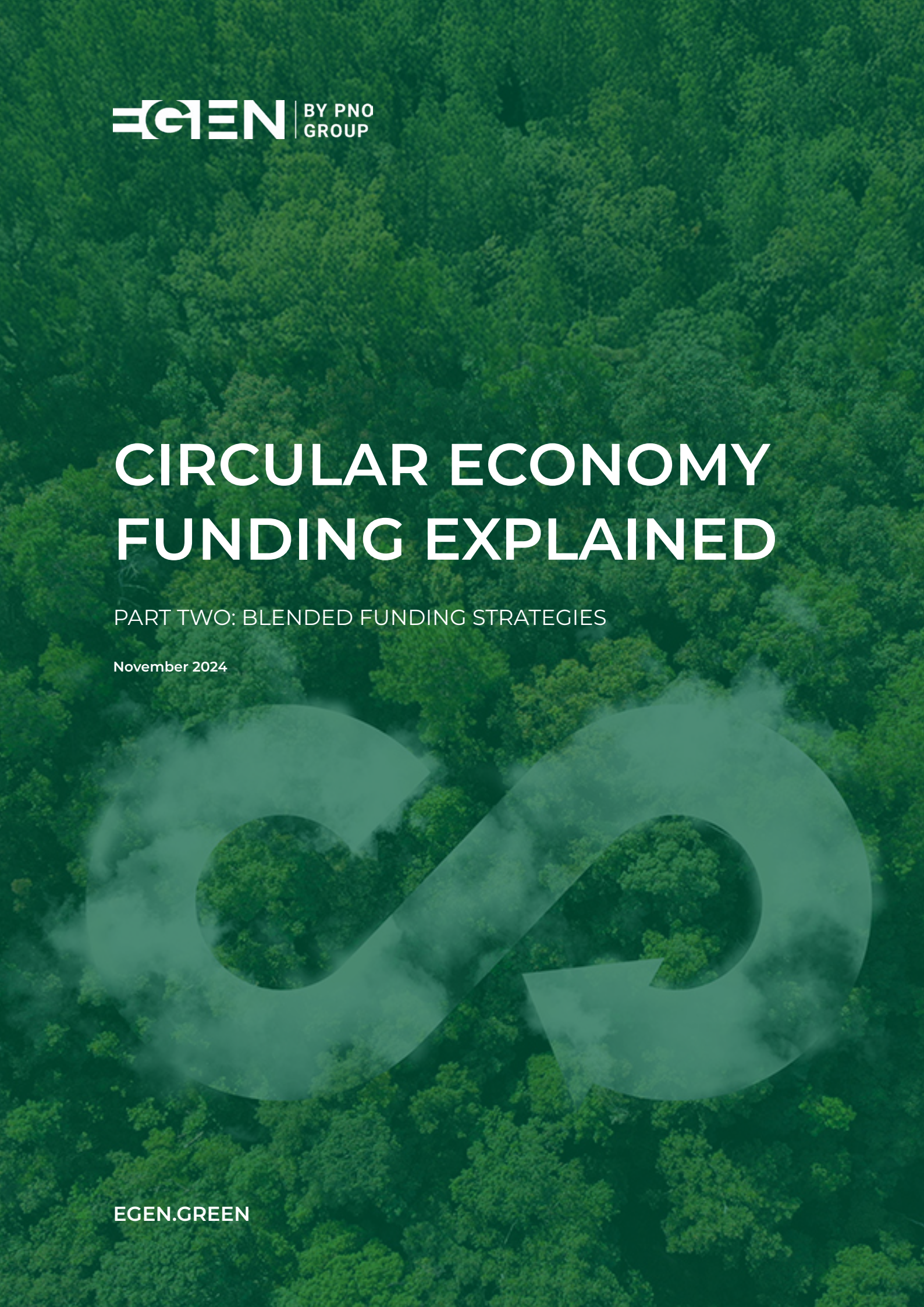

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Introduction into this series on circular economy funding[1]

"Circular economy funding explained" is a series of articles created by EGEN to support you in identifying the best suitable funding strategy for your circular economy projects and initiatives. The articles will provide different funding types, their applicability for circular economy projects, as well as various (blended) funding strategies and successful projects and practices. Whether you are looking for funding opportunities for the public sector or private sector, this series intends to equip you with knowledge that will help you to define relevant funding routes for your project.

[1] 1 While the title includes the term "funding" which suggests that the focus is on grants and subsidies as types of financial support, also other types and sources of financing are covered in this article, i.e. equity, debt, alternative funding.

1. BLENDED FUNDING STRATEGIES

In the first article in this series, we have provided five types of funding instruments, describing each funding instrument as an individual option to finance your innovative circular economy project. However, it can be difficult for project promoters to align investment needs, project development phases, and associated project risks with requirements of individual funding instruments. In this article, we introduce the concept of blended funding. Blended funding refers to combining or mixing different sources of financing to support a project, program, or initiative. The goal of blended funding is not to increase the total amount of funding for a circular economy project, but to create an acceptable risk-return profile for private sector investors.

To understand what an acceptable risk-return profile is, it is important to introduce the concept of the risk-return frontier (or the efficient frontier). The risk-return frontier depicts the maximum possible return that can be achieved for a given level of risk or, vice versa, the minimum possible risk for a given level of return. Investors aim to maximize returns, while controlling and managing their risks. This means that investors will focus on projects or investments that are on or near the risk-return frontier.

Circular economy projects, however, tend to face additional barriers and risks compared to traditional sector projects. These specific barriers push circular economy projects below the risk-return frontier. Examples of these barriers are:

- *Economic viability* – since the circular economy is still in its infancy, for revenue-seeking investors it is difficult to predict consumer demand, market developments and analyze potential competitors for circular economy projects.
- *Long-term perspective* – circular economy projects tend to have relatively large upfront investments while returns are divided over a longer period, for instance in a product-as-a-service or other leasing model. From the investor this requires a more holistic view of value creation.
- *Supply chain collaboration* – the collaboration of multiple actors which is often required for circular economy projects creates an additional complexity for arranging financial agreements with investors. The interdependency between different actors as well as a shared responsibility for the business case creates additional uncertainty for investors.
- *Degree of innovation* - circular economy projects typically require either technological or social innovation, for instance new business models, in order to enable more efficient use of resources. Assessing the viability and upscaling potential of circular economy innovations might be challenging due to technological uncertainties or a lack of proven track record.
- *Regulatory landscape* – the regulatory environment and legislation for circular economy are evolving since governments and regulatory organisations want to promote sustainability. However, this changing regulatory landscape also brings uncertainty for investors as it is unclear how these regulations will impact the profitability and feasibility of projects.

Figure 1 depicts an hypothetical circular economy project that, due to one or more barriers mentioned above, falls below the risk-return frontier. The arrows in the figure depict the two strategies that blended funding can provide to push the project on (or at least near) the frontier, thereby potentially mobilizing more private sector investment for the project:

A. Return enhancement: focus of this strategy is to improve the overall project performance and to increase its potential return for investors, e.g. by reducing project costs.
B. De-risking: this strategy makes the project less vulnerable to potential adverse effects or financial uncertainties, e.g. by providing technical assistance to increase project maturity.

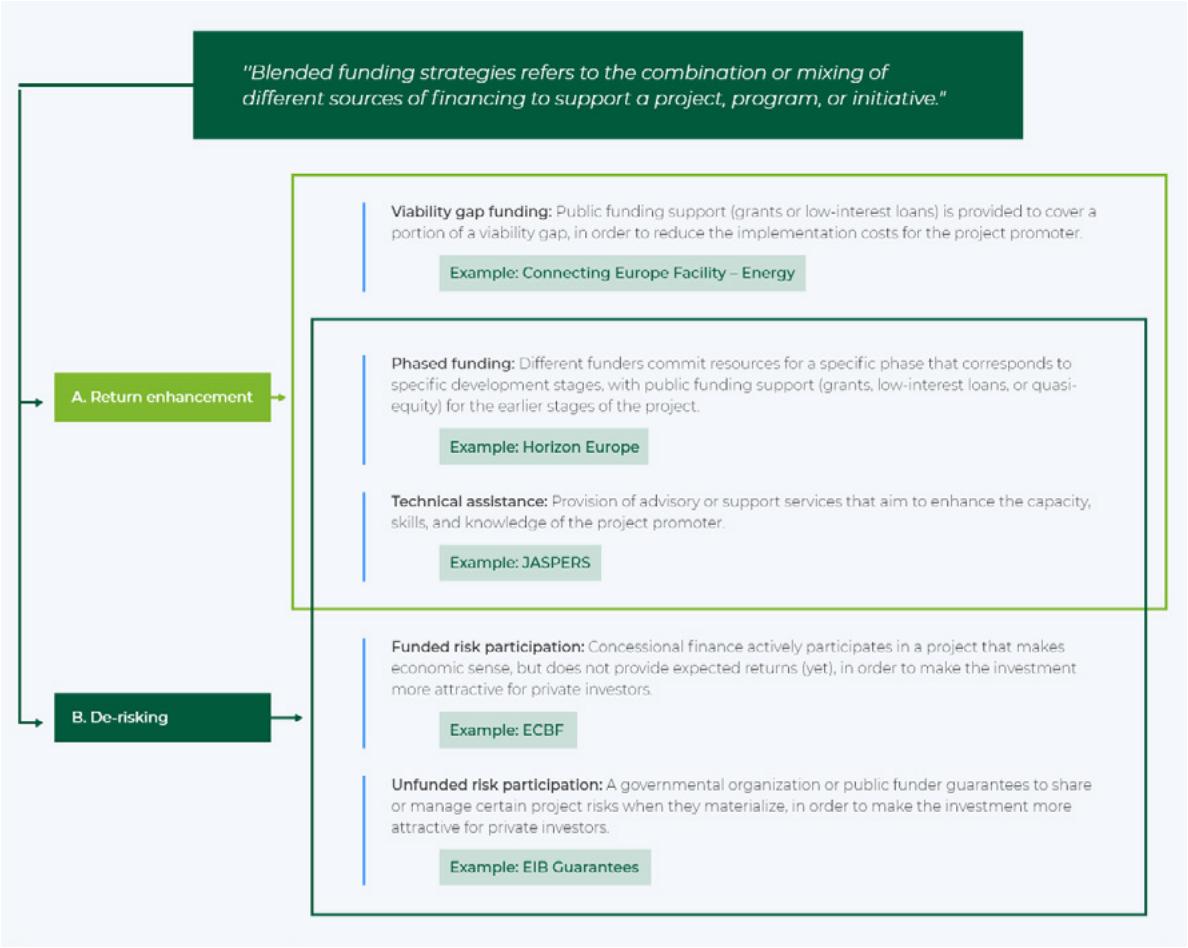
Figure 1 Two strategies to push a circular economy project towards the risk-return frontier, either via (A) return enhancement, or via (B) de-risking.

In the next chapter, we introduce five blended funding archetypes that focus either more strongly on "return enhancement" or on "de-risking" of circular economy projects[2]. We will discuss subsequently: (1) viability gap funding; (2) phased funding; (3) technical assistance, (4) funded risk participation; and (5) unfunded risk participation.

[2] It will become clear, however, that all archetypes combine (in some degree) both "return enhancement" and "de-risking".

2. FIVE ARCHETYPES OF BLENDED FUNDING

The archetypes described beneath are based on earlier research on blended finance as a means to catalyze private capital for the SDGs in frontier and emerging markets. In order to fit them better to the circular economy as well as to the European context, we have slightly modified these archetypes. In addition, we provide per archetype an example of an existing (public) funding instrument that can be used in a blended funding strategy to support circular economy project implementation.



1.1 VIABILITY GAP FUNDING

Viability gap funding is a blended funding instrument that enables return enhancement by reducing the implementation costs for the project promoter. This blended funding instrument is regularly used in infrastructural projects, where the private sector may be hesitant to invest due to a (perceived) lack of economic viability. A crucial step for this instrument is the identification of the viability gap (sometimes called funding gap). By means of an assessment of project costs and determination of revenues streams, the expected amount that needs to be filled to make the project financially feasible is calculated.

Subsequently, public funding support (grants or low-interest loans) is provided to cover a portion of the viability gap. The costs that are actually covered by the instrument depend on the nature of the project, the sector, and specific terms and conditions of the funding scheme. Some typical types of costs that can be included are: construction costs, land acquisition costs, and technological or innovation updates. The governmental organization that provides the funding often specifies conditions to ensure that the project has strong positive societal benefits, e.g. open-access of the infrastructure or low user fees.

EXAMPLE: CEF

The Connecting Europe Facility (CEF) is a EU fund for infrastructure investments across Europe in transport, energy, digital and telecommunication projects, which aims at a greater connectivity between EU Member States. CEF provides a grant of up to 50% of the project costs and in this way enhances return on infrastructure investments for CEF applicants. As the private sector may be hesitant to invest in infrastructure investments, the CEF programme aims to use its public funding as a catalyst to attract private finance from the market. Therefore, a prerequisite for obtaining a grant from the new CEF calls, i.e. CEF Alternative Fuel Infrastructure (AFIF), is to have private funding in place that covers the remaining part of the investment costs.

In order to be eligible for this grant instrument, the applicants need to conduct a Cost-Benefit Analysis not only showing the financial feasibility of their infrastructure investment but also the broader economic impact including external effects such as environmental impact and impact on employment.

1.2 PHASED FUNDING

Phased funding is another blended funding instrument that enables return enhancement by reducing the total costs for the project promoter. Whereas viability gap funding addresses the viability gap of the total investment, phased funding addresses specific stages or phases of the project lifecycle. A crucial step for this instrument is demarcation of investment phases that correspond to specific stages of project development. Different funders can subsequently commit resources for a specific phase, with public funding support (grants, low-interest loans, or quasi-equity) for the earlier phases of the project.

Many project promoters actually apply a phased funding approach, but without formulating an explicit blended funding strategy or leveraging on its benefits. These project promoters identify per project phase a funding source that might cover (some of) their funding needs. For funders (public and private), however, it might actually be beneficial when a project promoter has an explicit phased funding approach.

On the one hand, the public funder will be ensured that after successful implementation of the early phase (covered, for example, by a grant), scale-up funding is available for follow-up steps. The private funder, on the other hand, is ensured early-on that the project progress is critically reviewed and that (high) R&D costs are covered.

EXAMPLE: HORIZON EUROPE

Horizon Europe is the EU's key funding programme for research and innovation, where projects focusing on tackling climate change is one of the major eligible themes. Horizon Europe has different calls for proposals aiming to support various phases of the project lifecycle. The grant instrument defines specific calls for early research & development, for pilot & early deployment, as well as for coordination and support actions focusing on the collaborative aspects of project development. The subsidy percentage can cover up to 100% of the eligible costs, depending on the type of action. As such, this grant instrument can be an interesting instrument to enhance the return of subsequent phases of a project's lifecycle. Moreover, Horizon Europe also requires its applicants to develop a plan to guarantee the sustainability of project results during the next phases of the project lifecycle. Therefore, it can be a suitable instrument to develop a blended funding strategy in order to secure funding for the upcoming project phases and in that way leverage the phased funding approach.

1.3 TECHNICAL ASSISTANCE

Technical assistance is a blended funding strategy that encompasses both return enhancement and de-risking. By providing in-kind or financial support (often in the form of a grant), a governmental organization covers part of the project costs, thereby driving up the expected return of the project promoter. De-risking occurs because technical assistance focuses specifically on the provision of expertise, knowledge, and other advisory services that address the technical or innovation challenges of the project.

EXAMPLE: INNOVATION FUND PDA

Innovation Fund Project Development Assistance (PDA) provides direct support to project promoters. The PDA will offer tailor-made support to selected projects, with the goal to increase project maturity for subsequent Innovation Fund calls (grant instrument for European flagship projects realizing significant GHG savings). The Innovation Fund PDA aims to support project promoters through high-quality technical and financial advisory support tailored to the project needs. This advisory support is typically provided by external consultancy firms under supervision of the European Investment Bank and is offered for free to selected project promoters. This should help project promoters to sufficiently de-risk their project for financial institutions in order to develop their project towards a bankable investment.

Technical assistance is either provided directly or via a financial support instrument. In the first case, experts from a dedicated governmental organization provide support to project promoters. An example is JASPERS (Joint Assistance to Support Projects in European Regions). Experts working for this partnership between the European Commission and the European Investment Bank (EIB) provide: (1) advisory support in project preparation; (2) capacity-building support; (3) independent project-appraisal support. In the case of a financial support instrument, project promoters can obtain a grant to cover costs for advisory support, feasibility studies, technical studies, capacity building, etc.

1.4 FUNDED RISK PARTICIPATION

Funded risk participation is a blended funding strategy that focuses primarily on de-risking the investment for private investors. As opposed to unfunded risk participation (see part 1.5), this strategy emphasizes the direct financial contribution to cover or share specific risks. Funded risk participation is applied to projects or investments that make sense from an economic point of view, but that do not (yet) deliver the returns associated with its risk profile. In this strategy, public investors provide financial support (in the form of active participation) to make the investment more attractive for private investors.

Funded risk participation is provided either via a debt instrument or an equity instrument. In the case of a debt instrument, a public funder provides a loan with favorable terms or rates relative to market pricing. In addition, these loans often have a subordinated character meaning that it protects private investors as it will take the first losses on the investment. This is also the case for funded risk participation with an equity instrument, as public equity is often provided as junior equity. Again this means that the public funder will take the first losses (if any), making it more attractive for private investors to step in.

EXAMPLE: ECBF

The European Circular Bioeconomy Fund (ECBF) is a private venture capital impact fund exclusively dedicated to the (circular-) bioeconomy. ECBF supports businesses with high potential for innovation, favorable returns, and sustainable impact. ECBF offers financial investors from private organisations a strong and risk-adequate financial return by the implemented risk buffer of up to EUR 100m provided by the European Investment Bank (EIB). Therefore, the ECBF provides a good example of funded risk participation where the public funder is taking the risk of participating and thus de-risking the investment for private investors.

1.5 UNFUNDED RISK PARTICIPATION

Unfunded risk participation is another blended funding strategy with a strong focus on de-risking the investment for private investors. As the concept already gives away, this strategy focuses on risk participation without applying (direct) funding. Instead of providing such a financial contribution, a governmental organization or public funder guarantees to share or manage certain project risks when they will materialize. By providing this guarantee, the public funder backs the project promoter and makes the investment more attractive for private investors. This mitigates the perceived risks for the investor.

EXAMPLE: EIB

The EIB guarantees unlock additional financing for small- and medium-sized enterprises or mid-caps by covering a portion of possible losses from a portfolio of loans. Financing for small- or medium sized enterprises is typically more risky for investors because these organisations are still in an early development phase and are thus lacking consistent cash flows that are required to keep their business in operation, particularly in case of unexpected losses. With the provision of this financial instrument the EIB encourages commercial banks or other financial institutions to provide finance to SMEs, by de-risking their SME investment portfolio with a guarantee product.

3. CONCLUSION

An optimized financial strategy, based on a combination of different financial instruments, is often needed to sufficiently derisk and cover the funding gap of Circular Economy initiatives. The blended funding archetypes described in this article provide a structured approach for the development of a solid financial strategy to support the implementation and uptake of a Circular Economy project. Depending on the innovativeness, size and maturity of a CE initiative as well as the implementing organization(s) different funding archetypes can be applicable. In this way, the blended funding framework is believed to be flexible enough to support a wide range of organizations that are active within the Circular Economy.

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Alina Margolina
Alina.Margolina@egen.green
+351 914 240 873

Tjerk Wardenaar
Tjerk.Wardenaar@egen.green
+31 (0)6 52 77 22 04

Thomas van den Nieuwenhuizen
Thomas.Vandennieuwenhuizen@egen.green
+31 (0)6 29 55 88 81

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Authors: Alina Margolina, Thomas van den Nieuwenhuizen, Tjerk Wardenaar

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