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INCOFIN WATER ACCESS ACCELERATION FUND

Lessons Learned Report

CONTENTS

LIST OF ACRONYMS

DFC	United States Development Finance Corporation
ESG	Environmental, social, and governance
EU	European Union
EUR	Euros
LP	Limited partner
IFU	Investment Fund for Developing Countries
Incofin	Incofin Investment Management
MFI	Microfinance institution
MSME	Micro, small and medium enterprise
SDG	Sustainable Development Goal
SWE	Safe Water Enterprise
TA	Technical Assistance
USAID	United States Agency for International Development
USD	United States Dollars
VC	Venture Capital
W2AF	Water Access Acceleration Fund

INTRODUCTION AND BACKGROUND

THE SAFE WATER ACCESS ISSUE

Access to safe drinking water continues to be a major challenge today. Globally, 2.2 billion people lack access to safe drinking water,[1] and half of the world's population is projected to live in water-stressed areas by 2050.[2] The lack of proper water management infrastructure and appropriate sanitation, storage and delivery methods create poor health and living conditions and cause deaths from preventable diseases due to contaminated water. Additionally, limited water supply continues the cycles of economic inequality as populations in rural areas often suffer disproportionately due to high costs of investing in water sanitation infrastructures as well as significant time spent on daily trips to collect safe water.

Further, access to drinking water is more acute in Southeast Asia and Sub-Saharan Africa with high population growth and growing income disparities.

THE FUNDING ISSUE IN THE WATER SECTOR

Historically, the main sources of funding in the water sector have been through government grants and donations from foundations and multilateral organisations. On the private side, there is a lack of understanding from investors of the needs of the sector and limited familiarity with solutions other than costly infrastructure investments. Solutions have also typically been perceived to be the government's responsibility rather than private funding opportunities. These factors mean the water sector remains underfinanced.

Public utilities are not investing enough time or funds to maintain the depreciation of their existing assets or respond to the rapidly increasing growth of urbanisation. In addition, the majority of utility-supplied water is not sufficiently or adequately treated and stored to be used as safe drinking water.

Funding from the government and foundations does not typically have the purpose of creating long-term, financially sustainable solutions through investments in local business models. Further, they often do not and cannot provide the continuous support and expertise needed to maintain and grow the individual companies.

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[1] World Health Organization, 2019.
[2] Dalberg, "The untapped potential of decentralized safe drinking water enterprises," 2017.

RATIONALE FOR THE WATER ACCESS ACCELERATION FUND

In recent years, a few business models have emerged with an aim to develop scalable and replicable solutions to provide safe drinking water in a financially sustainable, affordable, and safe manner, business models such as safe water enterprises (SWE), regional pipe network, and water technology, are ready for private sector investment. To address the funding needs to scale such opportunities, Danone decided to become the sponsor investor of a new fund focused on accelerating this market.

Building on the decade long experience of Danone Communities, Danone's incubator fund that invests in water access and nutrition, Danone has selected Incofin to manage the Water Access Acceleration Fund (W2AF) with the aim to:

- Scale access to affordable and safe drinking water by investing in innovative, early-to-growth stage business across the water access value chain; and

- Catalyse the growth of the sector by demonstrating the financial viability of water businesses.

STRUCTURE OF THE FUND

The Fund is an impact-first, ten-year closed-ended fund that will focus on private equity and quasi-equity investments in the water sector. The Fund will target EUR 50 million in size with a hard cap at EUR 70 million, investing in 10-12 portfolio companies over 5 years. The investments will range from EUR 3-8 million and will target predominantly Sub-Saharan Africa and South and Southeast Asia, focusing on countries with high incidences of water access inequality and where Incofin already has local presence or long-term investment experience.

The Fund achieved its first close at EUR 36 million in February 2023. Investors include Danone, Aqua for All, the U.S. International Development Finance Corporation (DFC), Norfund, Investment Fund for Developing Countries (IFU), BNP Paribas, and several other private investors. The U.S. Agency for International Development (USAID) provided catalytic funding, as detailed below.

RELATIONSHIP WITH USAID INVEST

In 2021, Incofin Foundation, a non-profit foundation founded by Incofin, entered a contract with DAI Global LLC under the USAID INVEST programme to mobilize capital for the Fund. As part of the engagement contract, USAID INVEST would provide USD 760,000 as concessional and catalytic funding. Incofin Foundation would invest this capital in W2AF in the catalytic first-loss tranche. However, in order to receive the support from USAID INVEST, the Foundation would raise USD 3.04 million (4X USD 760,000) capital for the Fund. These commitments would come from new or existing private sector investors but not from Development Finance Institutions.

In February 2023, the Fund was able to successfully raise the requisite capital, which made it eligible to receive financing from USAID.

LESSONS LEARNED THROUGH THE FUND DEVELOPMENT PROCESS AND IMPACT OF USAID FINANCING

DEMONSTRATING THE IMPORTANCE OF A BLENDED FINANCE STRUCTURE

PHOTO CREDIT: INCOFIN

It is well known that blended finance capital structure plays a crucial role in de-risking investment for private sector players in impact first funds. For background, this innovative financing approach combines traditional development finance with commercial investment, reducing the risk of investment for private sector players. As a result, private sector players are more likely to invest in the fund, and development impact can be increased through greater investment in the water sector. This structure helps to bridge the gap between commercial investment and development goals, making it a valuable tool for development finance institutions.

W2AF used a blended finance capital structure alongside a technical assistance (TA) facility to provide pre and post investment TA to potential investees. The fund aims to have at least 20% of its capital in a catalytic first-loss tranche.

The Incofin team realized the importance of blended finance in de-risking investment not only for private sector players, but also for development finance institutions. This realization led to an increase in the target size of the first close of the fund from EUR 25 million to approximately EUR 36 million. The fund's first close is taking place at this increased amount, which is a testament to the increased demand for blended finance solutions in the water sector.

The infusion of concessional capital from USAID enabled W2AF to achieve a higher first close of the fund than anticipated. USAID's commitment of USD 760,000 allowed Incofin to increase the total first-loss capital in the fund, helping the W2AF de-risk the fund for private sector investors, and unlocking an additional USD 3.04 million in the process in preferential (non-first-loss) capital. Additionally, USAID's commitment also encouraged commitments from other investors in the first-loss tranche, helping to attract more investors and building momentum for the fund's first close.

The success of W2AF shows the potential for blended finance to attract commercial investment to the development sector and contribute to sustainable development goals.

COMBATTING THE HIGH PERCEIVED RISK OF THE WATER SECTOR

The Incofin team learned that the drinking water sector is often perceived as a risky investment opportunity by private investors due to several factors. The sector is heavily regulated and changes in regulations can have a significant impact on the financial performance of water utilities. Another factor contributing to the perception of risk is the belief that providing drinking water is the responsibility of the government or donors, making it difficult for private investors to see drinking water as a viable investment opportunity. Finally, environmental risks, such as contamination of water sources and changing weather patterns, can also impact the financial performance of water players. These factors all contribute to the perception of risk in the drinking water sector and make it challenging for private investors to assess the level of risk associated with investing in this sector.

However, this perception is not entirely true. Incofin have invested time and effort into educating private investors about the investment readiness of the drinking water sector. Our team have identified three business models that are financially sustainable and poised for growth, and where the Fund would invest. These include the SWE model, which delivers safely treated drinking water through storefronts or home delivery and has already reached over 3 million people globally. Another model is the regional level pipe network, which connects households directly to a central treatment unit and offers more cost-efficient solutions compared to conventional infrastructure. The third type of business model is water technology that enables better, more efficient access to safe drinking water through purification technologies or monitoring systems. These technologies, ranging from point-of-use to centralized systems, have a total estimated market of USD 52 billion.

Throughout our discussions with potential investors, the Incofin team emphasised that these business models are not mutually exclusive and can complement each other in serving the needs of communities for safe and sustainable access to drinking water.

ADDRESSING A LACK OF GROWTH CAPITAL IN THE MARKET

As mentioned previously, historically, the main sources of funding in the sector have been through government grants and donations from foundations and multilateral organisations. However, the water sector remains underfinanced due to lack of understanding from private investors of the needs of the sector and limited familiarity with solutions other than costly infrastructure investments. Further, these solutions have typically been perceived to be the government's responsibility rather than private funding opportunities.

W2AF is uniquely positioned as provider of growth capital to businesses in the access to drinking water sector. This is a key differentiating factor that sets W2AF apart from other funds. Other players encounter different issues when executing such a strategy because of the following reasons: (1) limited availability of capital for drinking water sector; (2) use of instruments other than growth equity; (3) a different geographical scope with emphasis on industrialized markets; and (4) focus on earlier stages of investments (Seed, Pre-Series A, or A).

A market mapping of the drinking water segment could translate as follows:

W2AF'S UNIQUE MARKET POSITIONING	
TYPE OF PLAYERS	AN IMPORTANT VALUE PROPOSITION BUT A DIFFERENTIATED WATER RESPONSE
Focused on smaller tickets – earlier stage companies	Most water impact investors have been able to provide small tickets and seed capital. Such funding typically comes from foundations and family offices whose size only allow them to target young companies and place small tickets. W2AF offers growth capital funding to companies with proven business models ready to scale.
Indirect through MFIs	Some water investors have been making indirect debt funding via MFIs, for example having a differentiated value proposition than a growth equity fund.
Project focus	Many donor-led projects aim to structure the water ecosystem to back large infrastructure project and involve national governments. While complementary to W2AF, the Fund does not focus on large-scale projects or those that could be considered as greenfield.
Sector-agnostic impact/PE	A few growth equity impact funds have ventured opportunistically in the sector. However, there is only a limited sample of water companies which have been financed by such funds and this cannot be considered a viable response providing a sustained flow of capital for the sector.
Water tech/VC focus – mostly industrialized markets	Some venture capitalists have emerged more recently with an exclusive focus on seed- and early stage businesses offering an innovative technology angle. W2AF will provide growth equity to efficient water treatment technology providers but won't take a technology risk (i.e. will only invest in proven technologies active on the market for some time).

ENSURING MEASUREMENT AND MANAGEMENT OF IMPACT

The Fund's Impact Theory of Change has been developed by the W2AF investment team, in consultation with the Environmental and Social Governance (ESG) and Impact team of Incofin. It was important to benefit from the expertise of the Incofin level ESG & Impact team to ensure that the highest standards were met in terms of impact measurement and management.

Building on what has been done in the past for Incofin's existing funds, the Sustainable Development Goals (SDGs) targeted by W2AF were translated into concrete and measurable output and outcome indicators, to be tracked on an annual basis, in order to measure the Fund's contribution to the selected SDGs. Throughout the fundraising process, the list of impact indicators has been refined based on discussions with the different limited partners (LPs) and their particular sensibilities, and also based on realities in the field. For instance, complex outcome metrics (such as the number of hours saved by women and girls from not having to fetch water very far away from their home) will be integrated into broader impact studies (end-customers surveys to be conducted by third-party data providers) with the support of the LPs, rather than collected directly by the W2AF team from investee companies.

Positive impact created by the company will also be assessed during the due diligence, thanks to a rating tool built in-house. While the first version of the tool did not allow the team to isolate "impact performance" indicators, the tool was revised with the intention to clearly differentiate the ESG risk assessment from the Impact Performance assessment, which is more in line with LPs' recommendations and compliant with the European Union's Sustainable Finance Disclosure Regulation. As a result, the due diligence tool generates a separate impact rating which allows the W2AF team to assess what a company is doing to contribute to the SDGs through the adoption and implementation of best practices.

Finally, while a climate lens and a gender lens have been envisioned and integrated from the very beginning into the Fund's impact, those strategies have been refined throughout the fundraising process based on LPs' advice and recommendations as well as industry trends and best practices (for example, the Fund's gender strategy has evolved around the innovative 2X Challenge criteria).

ESTABLISHING AN ON-THE-GROUND PRESENCE TO BUILD A CREDIBLE PIPELINE

In order for investors to be convinced that the water access sector is investment ready, the dedicated team did extensive work in building a pipeline across the three sub-sectors of the Fund. This has resulted in a pipeline of over 180 opportunities with three deals at an advanced stage.

The strong on-ground presence of the W2AF team allowed them to establish strong relationships with partners and clients, understand the unique needs and challenges in each market, and ultimately source and vet high-quality investment opportunities. Our Cambodian office enables us to cover South and Southeast Asia and our Kenyan office enables us to cover sub-Saharan Africa.

The on-ground presence of the staff from the Fund gave comfort to investors as it is critical in building its pipeline, especially in the Asian and African markets. This is especially important in the water access sector, where the local context plays a significant role in determining the feasibility and sustainability of companies.

CREDIT: INCOFN

Subsequent to first close, the Fund aims to rapidly deploy approximately EUR 7.5 million in an Indian specialized drinking water quality improvement solutions company which helps addressing various chemical and biological contamination issues. This water operator has been active for over fifteen years and works in an engineering, procurement and construction and operations and maintenance capacity as the implementer of water quality projects where it gets contracted by the government and corporates. Since its founding, the company has installed over 2,500 treatment plants in eleven Indian states.

ANNEX 1: PARTNER ROLES

"We are immensely thankful for our partnership with the USAID. Thanks to their contribution of catalytic concessional capital, we were able to mobilize capital from private players. Now that the first close of the Fund is behind us, we are confident that we would be able to provide 20 billion litres of safe drinking water to 30 million people by 2030."

- Dina Pons, Managing Partner, W2AF Fund Relationship Manager, Incofin

THE FUND MANAGER

Incofin is a leading international impact fund manager focused on investing in emerging countries in a financially sustainable way. Incofin was founded with the purpose to drive impact for people by developing business solutions that promote inclusive progress. Incofin wants to improve the lives of the more vulnerable or less privileged people hence its slogan "committed beyond investment".

Incofin is a licensed alternative investment fund manager and has over 20 years of experience of working with risk capital in the form of private debt and private equity investments with over EUR 1.4 billion in assets under management. Incofin's diverse investor base includes development finance institutions, pension funds, insurance companies, fund of funds, commercial banks, corporates, high net worth and retail individuals. Incofin is an independent investment organization and majority team owned.

Incofin has historically focused on financial inclusion (investing in institutions active in microfinance, micro, small and medium enterprise (MSME) financing, housing finance, educational finance, etc.), further expanded to the agri-food value chain (through producer organisations and agricultural value chain small and medium sized enterprises) and now entering the drinking water sector. In addition, Incofin also offers TA services for strategic and operational projects in many of its portfolio companies. The tailored TA support aims to improve capacities of its investees to maximize financial and social & environmental returns for the benefit of the end client. Incofin has structured seven TA facilities and mobilised over EUR 10 million in committed donor funds.

Incofin has a global team of approximately 90 professionals, including approximately 50 emerging market investment professions specialising in private equity, private debt and TA. The team is organized across its head office in Antwerp (Belgium) and local offices/affiliates in Bogotá (Colombia) and Nairobi (Kenya), Chennai (India), New Delhi (India), Phnom Penh (Cambodia).

THE ANCHOR INVESTOR

Dedicated to bringing health through food to as many people as possible, **Danone** is a leading global food and beverage company building on health-focused and fast-growing categories in three businesses: essential dairy & plant-based products, waters, and specialized nutrition. With more than 100,000 employees, and products sold in over 120 markets, Danone generated EUR 24.7 billion in sales in 2018.[3]

[3] See the 2018 Annual Report: https://iar2018.danone.com/danone-in-2018/100-years-of-pioneering-healthy-innovation/

Danone aims to inspire healthier and more sustainable eating and drinking practices, in line with its "One Planet. One Health" vision, which reflects a strong belief that the health of people and that of the planet are interconnected. To bring this vision to life and create sustainable value for all its stakeholders, Danone has historically implemented various sustainability initiatives, including the Ecosystems Fund and Danone Communities. More recently, Danone has defined its 2030 Goals as a set of nine integrated goals aligned with the United Nations SDGs.

Through these goals, Danone commits to operating in an efficient, responsible and inclusive manner and continues to hold itself to the highest standards in doing business - as reflected by its ambition to become one of the first multinational-certified B Corps. To date, a total of 20 Danone entities have earned the B Corp Certification.