Impact Investing for Sustainability

By Daniel Robin, Senior Partner, In3 Group
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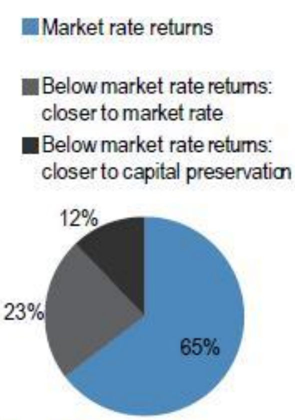
> Large numbers of people around the world have experienced the removal of historic constraints. Attainment of their newfound freedoms coincides with more wealth, longer life spans, better communication, and an array of [social and environmental] problems that necessitate the creation of new solutions.
>
> - From *Social Entrepreneurship … what everyone needs to know,* by David Bornstein

According to the Global Impact Investment Network (theGIIN.org), impact investing is a relatively new industry that is growing in both size and sophistication. The term first emerged around 2007, describing what previously relied on regulation in order to minimize the negative social and environmental consequences of business activities. But there is a history of individual investors using socially responsible investing (SRI) to express their values, usually by avoiding investments in specific companies or activities with negative effects. Gradually, the trend has shifted toward affirming positive effects, or impacts, with ventures and projects addressing global issues of poverty, habitat destruction/deforestation, livable cities and communities, climate change, and access to basic services.

Impact investing brings together the goals achieved by capitalism and philanthropy (charities) by partnering with private, for-profit businesses. Social and cleantech entrepreneurs, in particular, represent a far better mechanism to respond to societal needs and environmental issues than we have ever had before—a decentralized and emergent force that remains our best hope for solutions that can keep pace with our problems and create a more peaceful, verdant, and sustainable world.

A January 2013 study conducted by J.P. Morgan and GIIN poled investors that manage $10 million or more in this nascent and growing space. Results indicate they plan to commit USD $9 billion to impact investing in 2013, up by more than $1 billion over 2012. Additionally, the vast majority of surveyed investors report that their impact investment portfolio performance is meeting or exceeding social, environmental, and financial expectations.

What are impact investor's expectations for financial returns? Diverse. Nearly two-thirds of respondents are principally pursuing market-rate financial returns. The other third expect below-market rate returns, with 12% surveyed nearly philanthropic ("capital preservation" implies a self-sustaining endowment, but not necessarily net profit), and 23% willing to accept slightly below market rates. A few of the 65% are nearly indistinguishable from traditional venture capital.



Source: GIIN, J.P. Morgan.

In between these extremes, the industry is comprised of both public and private, for-profit and not-for-profit entities.

Some 96% of those surveyed measure their social and environmental impacts using established or customized metrics and rating systems (such as the Global Impact Investment Rating System, or GIIRS). This might not be representative of the entire field, as the practices continue to evolve.

Seen another way, there are three "camps" (actually a continuum of diverse interests):
1. Those seeking **financial returns first** (65%)
2. Those seeking **impacts first** (12%), and
3. Those seeking a **blended mix** of the two, and willing to accept slightly below-market returns (23%).

Even the most financially-motivated impact investors, except for the few outliers pretending to be something they are not, do not seek the outrageous "home run" fortunes of traditional VCs. Nonetheless, there is still a lack of appropriate capital across the full risk/return spectrum, and shortage of high quality deal flow.

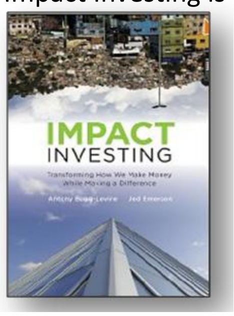
Who is investing in impact projects?

The field is comprised of numerous, smaller "boutique" funds dedicated to a specific purpose (such as alleviating energy poverty in a particular country or region of the world), plus development finance institutions (regional development banks, public/private partnerships, government-sponsored sovereign, bilateral and multilateral funds), diversified financial institutions, and many others. [In3 Group]() maintains a database of more than one hundred impact investors (fund managers and investment officers) organized by target sector or industry preferences, stage, size, geographic focus and expectations for returns.

Formally, impact investing does not include individual angels, angel groups or super-angels, although these wealthy individuals and family trusts often invest in the myriad of dedicated funds. The rest of us invest for impact via our own entrepreneurial activities, and some via peer-to-peer, crowdfunding, or microfinance vehicles.

Why is it gaining importance?

Impact Investing is and can be a positive disruptive force – a "transformational vehicle" for delivering



what author Jed Emerson calls a "blended value" approach. But blending of what with what? According to the authors, impact investing blends the *drivers of philanthropy* – the desire to do good – with the goals and practices usually associated with *for-profit capitalism.* It is precisely this blending of goals and activities, previously siloed in enclaves, that makes impact investing powerful, useful, and likely here to stay.

Emerson's book defines this emerging industry for participants on all sides of the funding equation (investors, funders and social entrepreneurs) and explains how impact investing has yet to develop its own precise language (though the book tries).

The terminology may be new, but the practice is not. Many have been making such investments for decades. Still, impact investing now enjoys a range of popular international events, an industry association (GIIN), blogs (sample), formal metrics (see IRIS online), risk and performance rating systems.

Impact investing's popularity is unmistakable. A Nov 2011 Harvard Business Review article[1] about it begins "Rarely has a field been so energized by a new idea...”). The long-established *SRI in the Rockies* (the longest-running conference on socially responsible investing, now in its 25th year) recently repurposed the "SRI" acronym to now stand for "Sustainable, Responsible & Impact" investing.

But so much of investing is momentum, following the leaders, only leading cautiously if at all, and thus a popularity contest. The true value – the long-term worth of something – is more closely reflected in the rising importance of the entrepreneurs that they fund, uniquely poised to address the most critical social and environmental issues of our day. In other words, it has become important because it's working.

Where is impact investing working?

Certainly the poster children for impact investing are developing and emerging markets worldwide. Are there any US-based impact investors investing in US operations? Yes, certainly some early stage impact investors focused on the US, though most will also want to know how the business model will scale over time, which is often the international component. Some examples of developed market investments, such as community development or help inner city youth, are reported in the media, but the vast majority of funding is going overseas, building stronger trade partners, augmenting or replacing foreign aid, and growing private-sector jobs where they are able to fulfill the specific mandates of the investors.

Specific qualified countries (a subset of the total) are listed at in3finance.com/qualified-countries. Social impact investing usually seeks to address poverty, lack of access to access to basic services like energy, affordable housing, food supply, etc., at risk populations, and related sustainability problems. Those who are disenfranchised or marginalized represent the strongest developmental opportunities and potential for positive impacts.

[1] Download full, 21-page text at evpa.eu.com/wp-content/uploads/2010/11/The_Promise_of_Impact_Investing3.pdf

What do they invest in?

Anything with social and/or environmental benefits that can also generate sufficient financial returns (cash flow) to self-sustain. Some ventures or projects may require formal or informal subsidy or grants in the early stages, but the core idea of impact finance remains the same – leveraging those initial infusions toward a thriving business that also produces social/environmental value.

At current US Treasury lending base rates, loans to qualified companies doing business overseas can be extremely low cost. This is an example of an informal subsidy. As the US government's development finance institution, US Overseas Private Investment Corp (OPIC) has a mandate to support worthwhile small- and medium-size enterprises and their impact projects. World Bank's International Finance Corp and OPIC, among others, preferentially support projects that deliver strong social/environmental impacts.

How do investors screen and evaluate project companies seeking capital?

- **Their main interests** are often the source of a common misunderstanding: even with strong social and developmental benefits, lenders and investors are still exceedingly careful – more measured and rational, not easily seducible by the promise of impacts – so their main concerns are usually (a) management team track record, (b) mitigation of technology or business risks, and (c) business plans with cash flows that make sense so they'll be able to exit successfully, per their mandate.
- **What are their pet peeves**? They expect you to know their style and type of investing, and your adherence to that is critically important, so do your homework or they'll just pass over the opportunity to avoid being accused of "style drift" (investing outside the established mandate – usually an agreement with their backers). Another peeve is sloppy presentation, reflecting a lack of caring. Third: too much of the wrong information. They want a succinct summary that they can quickly scan to determine if there's a fundamental fit with their style and type of investing. If you attempt to tell your entire story (send your full business plan or more than a few pages) without this initial checkpoint, it will be seen as disrespectful. Social skills like effective interpersonal communication and negotiation skills are essential, as investors rarely make investments in deals when they don't feel there can be a compatible working relationship. Find out how they like to do business. Active or passive? Formal or informal? Only with a face-to-face-meeting? Once in conversation, will the investor conduct detailed due diligence or is it more like pitching a Hollywood movie script?
- **What to watch out for when seeking impact funding?** A close alignment in values and strong cultural compatibility. If you accept funds from an investor that has a different set of priorities, it could ruin your business. Ask a lot of questions. Look carefully at their portfolio (what they have already invested in to date). You'll find vast differences and specialization within the investment spectrum. It might appear otherwise at first via initial Google searches, but there are as many niches as there are impact investors. Keep digging and you'll find that substantive differences exist between investors in the exact same industry. Even development finance institutions have quirky sets of rules and unique mandates. Each impact investor occupies a niche or set of niches that tend to overlap but nonetheless remain unique, even more so than in the traditional venture capital industry.
- **Cost of debt capital**? Almost all projects are a combination of debt and equity, the equity used to securitize the debt, and the debt used to leverage the equity and assets. Projects with budgets larger than US $10 million can expect to pay roughly 0.75% - 1.5% of the amount borrowed; less than $10 million typically pay more, but never more than 3% - 4% in total financing costs.

Impact Investment Mechanisms

The impact investment market is primarily an intermediate capital market, where investment capital has overlapping characteristics of equity and debt. Loan capital has a significant role to play alongside equity and quasi-equity, and philanthropic capital that is invested is a valuable enabler in attracting commercial investment capital.

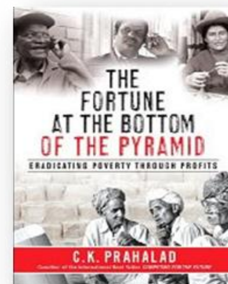
Impact investments occur across asset classes – stocks, bonds, private debt, etc. Among the best-known mechanism is private equity, and second most common is project debt finance. Impact investments are structured similarly to those in the rest of the venture capital community. Investors may take an active role mentoring or leading the growth of the company, similar to the way a VC firm assists in the growth of an early-stage company, but as previously noted, key differences are expected returns and measures.

Impact investing primarily takes place through mechanisms open to institutional, accredited investors. However, there are ways for individuals to participate in providing early stage funding to ventures that blend profit and purpose. A form of so-called "crowdfunding" has been limited mostly to not-for-profit and philanthropic organizations such as Indiegogo (international crowdfunding website site), and US-based, multipurpose Kickstarter, Heifer International, Kiva , and Zidisha (peer-to-peer microlending), MYC4 (microlending to African small businesses). Some might call this micro-impact investing.

Organizations receiving impact investment capital may be set up legally as a for-profit, not-for-profit, "C" Corporation, Benefit or "B" Corporation, Flexible Purpose Corporation, Sustainable Business Corporation (Hawaii), Limited Liability Company (LLC), hybrids of these or other designations that may vary by country.

History and roots of Impact Investing

Impact investment builds on a long history of well-developed, not-for-profit, charitable and voluntary sectors as well as financial services. It comes out of not-for-profit traditions more than for-profit (VC) culture. Much of the history of impact investing can be traced to the pioneering work of C.K. Prahalad and his work with microfinance in developing economies aimed at eradicating poverty. Microlending opened up new possibilities in an asset class everyone (but Prahalad) believes was too risky. But microloans as small as $10 to "Base of the Pyramid" populations demonstrated a higher repayment rate (lower loss rate) than expected.



All the way back in the 1990s, author Jed Emerson advocated the blended value approach described above, for foundations' endowments to be invested in alignment with their mission, rather than to maximize financial return, which had been the prior accepted strategy.

Simultaneously, approaches such as pollution prevention, corporate social responsibility, and triple bottom line sustainability began to measure non-financial effects inside and outside of corporations. Around 2007, the term "impact investment" emerged, an approach that deliberately builds intangible assets alongside tangible, financial ones.

Additional Resources & References

Global Impact Investment Network (GIIN), co-sponsors of ImpactBase, IRIS, GIIRS, and numerous studies on the state of impact investing: Download Jan 2013 study | Jan 2013 study homepage | Nov 2010

Further Research Reports – Another survey shows the perspective of those seeking impact funding for social/environmental ventures. For example, the UK's Keystone Accountability (keystoneaccountability.org) originally surveyed 330 social enterprises anonymously on behalf of 7 impact investors worldwide. The 7 impact investors received their feedback and are making indicated improvements in their work. The feedback data and the investors' experience in using the feedback is featured in March 2013 report, What Investees Think (short answer: there are issues, indicating further maturation is needed, particularly in the area of measuring social/environmental impacts).

In3 Finance – impact fundraising services for US companies focused on emerging markets or working in sustainability-related industries such as biorenewables, waste conversion, renewable energy, and others. OPIC Designated Loan Originators with international impact investor relationships.

Contact In3 to discuss the result of your assessment (tool.in3finance.com), qualification process, or with any questions. +1.831-761-0700, apply@in3finance.com, or visit www.in3finance.com