PEI Alternative Insight

PRIVATE EQUITY INTERNATIONAL

The 10 Hottest ideas In Impact Investing

Introduction

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You're probably wondering why a private equity magazine is writing about impact investing. Well, three reasons, really.

The obvious answer is that some of the world's leading impact investors don't believe they have to sacrifice financial returns to deliver social returns; indeed, in some cases, they think that addressing a social problem can actually deliver outsized financial gains. In other words, these groups differ from regular private equity firms only in the strategy they pursue to achieve their returns (and the dual proposition they can offer investors, of course).

Perhaps more importantly, though, we take the not-very-controversial view that the future significance of impact investing – the scale of its own impact, if you like – depends to a large extent on its success in gaining access to institutional money and the capital markets more broadly. And this is the audience that we speak to every day. We know from talking to big investors that they have a growing interest in this area; we also know that they're still a bit nervous about it. So we're interested in looking at this issue from their perspective, and examining the pros and cons in a way that's useful to them.

There's also a third (slightly selfish) reason: this stuff is just really interesting to write about. The prospect of unlocking private capital to help solve big societal problems – from recidivism in the suburbs to malaria in Africa – is a hugely enticing one. And because there's a lot of smart people expending a lot of intellectual energy on making it work, there's a lot of innovation happening. In this special report, we've picked out ten of the most intriguing ideas in the space at the moment – all of which we think could, in time, transform the way investors think about impact.

Of course, this list is an entirely subjective one (although I was fortunate enough to receive some very useful input from some of the leading operators in the space, for which I'm very grateful). So I hope you enjoy reading it – but if you think there are any particularly egregious omissions, or if you have any other feedback, please do write and let me know. And do watch this space for more impact coverage from us in the coming months...

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WITH SPECIAL THANKS TO D CAPITAL, BRIDGES VENTURES, BCG & LEAPFROG INVESTMENTS

1

The 30% tax relief

A tax incentive from the state for impact investors

Case in point: *UK Chancellor George Osborne confirmed SITR in his March Budget*

On 6 April, the Social Investment Tax Relief (SITR) officially came into force in the UK. This will allow qualifying investors to offset 30 percent of the money they invest in (specific types of) socially-minded businesses against their income tax liability for the year in which the investment was made – with a stated aim to "encourage new investors to put money into social enterprises". Big Society Capital, the UK social investment bank, has suggested that it could unlock almost half a billion pounds in new finance for charities and social enterprises over the next five years.

It's the first social investment tax break of its kind anywhere in the world, and it's no surprise that it's happened in the UK, where the government has been trying to take the lead globally in promoting social impact investing.

Fortunately, it had an obvious paradigm to hand in the form of the Enterprise Investment Scheme, a package of measures designed to encourage investors to buy shares in small unlisted companies, which includes a 30 percent tax relief. So in effect, SITR gives investors the same incentive to invest in social businesses that they have for any other small unlisted businesses.

Unlike EIS, however, SITR will be available on unsecured loans as well as share purchases – an essential in a world where many of the qualifying businesses (like registered charities, for instance) don't actually have shares to sell.

So does this have the potential to change investor behaviour? Only time will tell, of course. But Theresa Burton, CEO of Buzzbnk, a UK crowdfunding platform for social businesses, suggests that the parallel with EIS could be instructive. "EIS has definitely made an impact – it has clearly been a tipping point for equity crowdfunding players, just as gift aid was a tipping point on the donations side. So you'd expect some kind of impact [from SITR]; the question is how much."

There have been complaints from some quarters that SITR is too limited in scope: certain types of social business won't qualify, and even those that do can currently only raise up to £290,000 over a three-year period, at least until the government succeeds in getting an exemption from European Union state aid rules.

Nonetheless, it's an interesting experiment, the success of which will be watched closely around the world. It also speaks to a bigger picture: the importance of governments' role in creating the conditions necessary for a social investment market to flourish. Tax incentives are one way the state can 'catalyse' more involvement by the private sector – but it's by no means the only way, as we'll see in the coming pages. ■

2

The green bond

Unilever's trail-blazing environmental capital-raise

Much of the interest in (and hype about) impact investing lately has been linked specifically to social impact. But it's worth remembering that environmental impact is just as important to many impact investors – and since it's often easier to measure and better understood by investors, this is an area where impact investing can play a hugely significant role in the coming years.

That's why a recent 'green bond' issue by consumer goods giant Unilever has been attracting a lot of attention.

The idea of a green bond (in the sense of raising capital to fund a particular environmental goal) is not new in itself; international financial institutions like the World Bank and the European Investment Bank have been issuing them for some time, usually as a way to finance development projects. And towards the end of last year, French electricity company EDF became the first corporate issuer, with a €1.4 billion bond designed to fund solar and wind energy projects. So there was already some evidence of investor demand for this sort of product.

Unilever's £250 million offering is the first sterling bond, and the first by a consumer goods business. But there are two novel aspects that really set it apart. The first is that this bond isn't funding some kind of separate environmentally-friendly project; it's helping Unilever fulfil its core strategic aim of halving its environmental footprint (while doubling turnover) by 2020. What's more, the Anglo-Dutch business has been very specific about how it plans to spend the bond's proceeds: it's targeting a reduction of emissions, waste and water usage at a number of particular factories around the world. So its success will be relatively easy to measure.

Unilever's Cornetto and Magnum brands: *one of the company's ice cream factories will be a beneficiary of the bond proceeds*

The second key point is that Nordic environmental consultancy DNV GL helped Unilever develop this plan – and it will provide an independent audit of the company's success in meeting its targets. This kind of third-party validation also gives investors comfort that their money will be well spent.

All of which explains why market watchers were so excited when this bond came to market in March and was heavily oversubscribed. Unilever and its adviser Morgan Stanley have clearly come up with a structure that investors are happy with. Over time, this could persuade many more corporates to tap the bond markets to finance environmental impact activities.

It could also persuade a wider range of capital holders to invest in green bonds. Insurer Zurich is one notable convert already: it said in November that it plans to invest up to $1 billion in green bonds, and has already appointed BlackRock to make this happen. ■

3

Going 'all in'

How the 100% IMPACT Network hopes to win over impact sceptics

One of the biggest challenges in persuading new financial investors to commit to the impact space is the lack of historical performance data. Since this strategy is too new to have built up much of a track record (relatively few organisations have been around long enough to deliver consistent results over a period of time), how can investors be sure that the risk/return profile is right for them? That's particularly true since it's tough to build a portfolio of sufficient scale to be truly diversified.

One group trying to address some of these issues is the 100% IMPACT Network, a group of family offices, foundations and high-net worth individuals led by Charly and Lisa Kleissner. Their aim is an ambitious one: to commit 100 percent of their assets to impact, building a diversified portfolio across multiple asset classes. They intend to demonstrate that this sort of portfolio construction is not only possible but can actually deliver competitive returns. And by doing so, they hope they can persuade other investors to start committing to impact.

> *We have an opportunity to shift tens of thousands of these people into impact investing*

This is very much a personal mission for the Kleissners. In 2000, they established the KL Felicitas Foundation to support social entrepreneurs. Five years later, they took the decision to commit all their assets – a $10 million portfolio – to creating impact, rather than trying to do so purely through their grant-making. Inevitably, given that this was such a nascent area (the term impact investing wasn't even invented in 2005), it has been a slow process. But they're now about 93 percent allocated to impact, and haven't finished yet.

In the meantime, they've also been rallying more like-minded supporters to the cause. In 2010 they founded Toniic, a global platform to help investors co-invest on impact deals, and more recently they've been bringing together a number of groups who share their ambition to go 'all-in'. Today, there are 29 organisations signed up to the 100% Impact Network, with half as many again showing strong interest; most are from the US, although there's already a handful from Europe and Asia, and Kleissner says the idea is gaining traction around the world. Between them, these groups represent over $3 billion in committed impact capital, and have already put about $900 million to work.

The Network does a couple of important things. The first is to help these groups work out exactly what it means to go 'all-in'. How do they move away from traditional portfolio theory to a 'Total Portfolio Theory' that better encompasses externalities, including social and environmental impact? How do they address their particular areas of interest through different asset classes? How do they make public equity investments more impactful? How can they get diversified exposure to impact-oriented real assets? How does their personal real estate and art collection factor in?

The way investors think about outcomes is also crucial, says Kleissner. The social or environmental outcomes must be considered of equal importance to the financial outcomes (so there may be a range of the latter, depending on the former). Then again, investors also need to remain detached from specific outcomes, he adds. That's not easy for those with a philanthropic bent – but unless investors are dispassionate enough to experiment with and ultimately give up on approaches that don't work, performance is ultimately going to suffer.

The other goal of the Network is to help spread the word to the masses – or as Kleissner puts it, to "democratise impact investing" and help it become a "movement".

At the end of last year, the Kleissners took the novel step of releasing a detailed analysis not only of how their impact portfolio has been constructed over time, but also of how the various asset classes have performed.

What's notable is that despite the fact that this portfolio was built specifically to deliver social as well as financial impact, and despite the fact that it was designed to be highly diversified (the target is 30 percent cash and bonds, 57 percent growth assets and 13 percent inflation-hedging real assets), financial performance across asset classes was generally close to, and sometimes even ahead of, the most relevant benchmark.

The Kleissners: going 'all in' has long been a personal mission for them

Kleissner's theory is that if he can show similar results across a number of different portfolios, he can build a compelling case to investors waiting in the wings. "In the US, there are six or seven million people with assets in the single-digit millions to invest. But a lot of these are people in their fifties, who aren't ready to move into impact because they worry it will jeopardise their returns. If I can prove that we have half a dozen or so of these portfolios that are doing just fine – maybe even outperforming, in conventional asset classes – then we have an opportunity to shift tens of thousands of these people into impact investing. That's really exciting."

And he has no intention of stopping there. The next step is to prove this approach also works with a triple-digit million portfolio (of which he has 10 in the Network). "If over the next three years we could show that what we're doing with a $50 million portfolio also works for a $500 million portfolio, that would prove the concept to the institutional capital holders that have more than $1 billion. We wouldn't expect to move trillions overnight – but we could expect them to work with us and carve out a few hundred million, if only because it's good policy to try it." ■

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4

SIBs go global

Innovating and saving with social impact bonds

The first ever social impact bond (SIB), launched in the UK in 2010, was designed to address a very local issue: recidivism among released prisoners in Peterborough. Today, less than four years later, this concept is already going global. SIBs are being used to tackle everything from early years education in the US, to youth employment in the Netherlands, to out-of-home care in Australia, to diabetes in Israel.

And now there are also development impact bonds (DIBs), a slightly modified version of SIBs targeted at aid issues in developing countries. DIBs are being developed to combat HIV in Swaziland, malaria in Mozambique, sleeping sickness in Uganda and the education gender gap in India.

So what's causing all this excitement about SIBs? Four things, according to Toby Eccles, the founder of Social Finance, the UK group that first came up with the idea.

The first is that they address a chronic problem for governments (and aid agencies): the lack of innovation in the delivery of services, and the risks involved with trying new approaches, explains Eccles. "Government really liked the idea that by spending money on preventative services in the short term, you could save money on acute services in the long term. But in practice, they found it difficult to take the risk because they were stuck in a Catch 22 situation on evidence – and they knew they'd face public opprobrium if it didn't work. So instead, they did nothing."

Social impact bonds look to solve the problem by raising money from outside investors to fund new ways to tackle particular social issues – on the proviso that the government pays these investors a portion of the money it saves should the intervention turn out to be successful (DIBs differ only in who pays, and the kind of issues that are typically involved).

Another benefit, says Eccles, is that it creates a form of social investment where the investors are perfectly aligned with the social outcome. The more successful the outcome, the more the investor gets paid – so there's never any question of a trade-off between the financial and the social.

Then there's the flexibility of delivery. Unlike most government work, the organisation delivering the outcomes is free to do so however they like. "A lot of government contracts are about making sure you spend [the money] how you said you would. But every VC knows that version one of the business plan is never the one that flies. So what you have is a culture of holding people to account on a plan that may not be working."

That's particularly relevant with DIBs, he adds. "Everyone realises that a programme designed in Washington or London might not necessarily be the most effective on the ground three years later, when it's fully implemented. But people have really struggled to change the model."

Which brings us to Eccles' fourth benefit of SIBs: they're rigorously monitored, so there are clear feedback loops to show what's working and what's not. "This is what creates the incremental improvement and the real focus on service quality."

That kind of monitoring and adaptation is far more common in the private sector than it is in the social sector – and particularly with DIBs, people are very excited by the potential of helping the aid community tap into this, he adds.

Peterborough: *former Justice Secretary Kenneth Clarke talks to a prisoner ahead of the first-ever social impact bond trial in the UK*

> ***Everyone realises that a programme designed in Washington or London might not necessarily be the most effective on the ground three years later, when it's fully implemented. But people have really struggled to change the model***

This concept is still very new, and lots of issues are still to be resolved. Since some of these social problems have such wide-ranging consequences, it's not always clear which government department should foot the bill (in the UK, a special fund has been set up to facilitate this process). It can be very difficult to ascribe a value to some of the social outcomes being considered. The social businesses involved don't always find it easy to work this way. There's disagreement over whether some kind of philanthropic 'first-loss capital' is a distortion of the market, or sensible downside protection as the market builds a track record.

Equally, it's too early to tell whether they actually work or not. The early indications in Peterborough are positive – but realistically, it's likely that some will fare better than others, as the sector experiments with different approaches and works out where this concept is best applied.

But the potential is clear. Sir Ronald Cohen, one of the most eloquent champions of SIBs (especially in his current role as head of the G8 taskforce on social impact investment), has talked in terms of potential returns of 8 percent or even higher. This would make these social finance products attractive to a whole new audience. And while Eccles is wary of talking specific numbers, he acknowledges that his firm "has tried to design [SIBs] to produce the sort of returns that would look attractive, if you built a track record". And he points to the work of Social Finance US with Bank of America Merrill Lynch, which distributed a New York City social impact bond across its retail platform with great success, as a sign of what's possible.

So all told, there's plenty of reason to be optimistic. "Despite the fact that [SIBs] are tricky, there's no question that they continue to generate really significant excitement in lots of different areas," says Eccles. "So I'm really positive about the momentum behind this way of working. I think we'll see plenty more of it in the coming years."

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5

Open-source impact

Bridges looks to standardise the impact lexicon

In March, impact-driven investment group Bridges Ventures did something that you don't see happen much in the private sector: it took the in-house methodology that it had carefully developed and honed over a decade as a way to deliver best-in-class performance, and made it publicly available to anyone who wanted to read it.

"One of the things that's holding the industry back is that while are getting better at using a common language for impact metrics, we still don't have a common understanding of what constitutes an impact strategy," explains Clara Barby, Bridges' head of impact. "People have done a lot on work on creating taxonomies that can be shared but there's a bigger picture issue. To decide which impact assessment metrics to use in the first place, we need to agree on consistent principles by which we're analysing impact. If you look at a deal, what are the things that make it an impact investment? What features should we care about?"

Bridges has been grappling with these questions since its foundation in 2002, and the result is IMPACT, the 'scoring' methodology it uses to integrate impact considerations into its investment decisions. Not surprisingly, it found that newer, less-experienced firms (or indeed older firms looking to raise their game) were keen to see how exactly how it worked. "We'd been sharing [IMPACT] on a case-by-case, informal basis. So we thought it made sense to put it all together in one document, with some case studies, that could be shared more widely and systematically."

The idea is that this will help Bridges as well as the broader market, she says. "It helps us because it gives us feedback and helps us ensure a best-in-class approach.

Barby: *teaching and learning*

> ***People have done a lot on work on creating taxonomies that can be shared but there's a bigger picture issue***

Our hope is that it can also help others to learn from what we've been doing."

However, Barby insists that it's only intended as a tool, not a solution. "This can be very complex analysis, and while you can use scientific research, you also have to make judgement calls. The point of the IMPACT Radar is not to say that anything with a low risk and above a 2.5 return is in; it's to enable the investment committee to have a structured conversation about the risks and returns of a given deal."

Another group has gone even further to incorporate impact considerations into its investment process. LeapFrog Investments, which invests in high-growth consumer financial services companies in emerging markets, has developed a new set of metrics that integrate its financial and impact reporting.

Some argue that this approach is unrealistic, because of the way it effectively forces the investor to ascribe financial value to complex social outcomes. But it's easy to see LeapFrog CEO Andy Kuper's argument that it's the best possible way to "end the dichotomy" between financial and social performance – and that it "enables execution" by making it very clear where the focus of any impact-oriented business should be. ■

6

Retail therapy

New platforms looking to take impact to the masses

While institutional and philanthropic asset holders have largely been the focus of attempts to broaden the appeal of impact investing, there's no question that retail investors also represent a potentially bountiful source of additional capital.

"Research has shown that retail investors prefer to hold assets that don't impose any negative externalities on society or on the environment," says Thomas Carruthers, CEO of the Social Stock Exchange – an initiative that looks to connect investors with businesses that are having a demonstrable social or environmental impact. "Investors believe companies that pay attention to their [wider impact] are better-run businesses, and that leads to more shareholder value."

Part of the problem for retail investors, Carruthers believes, is a lack of available information. That's why the SSE has just also launched a specific online platform (impactinvestor.co.uk) to collate any relevant resources.

"If you're a retail investor, it's actually terribly difficult to know what's going on in impact investing. There's a huge amount of information and research available to people in the sector that's not available to people outside it. So part of our intention is simply to organise and share that, so it makes sense to someone coming to this fresh."

> ***The concept still needs explanation ... But there's clearly a great deal of latent demand and capacity***

SCOPE: *used a social bond to fund the opening of new charity shops; it's now listed on the SSE*

In addition to initiatives like the SSE, crowdfunding may also prove to be an increasingly viable way for social businesses to access retail money. In the UK, this area has had a double regulatory boost in the last few months: the 30 percent tax relief (which applies to debt as well as equity; see p. 58) and the new Financial Conduct Authority rules on peer-to-peer lending, which kicked in on 1 April and should standardise practices.

"Sometimes trustees can be sceptical [about peer-to-peer lending], so being FCA-authorised should actually help us," says Theresa Burton, chief executive of crowdfunding platform Buzzbnk.

Carruthers is convinced that retail interest is out there. "The concept still needs explanation [to retail investors]. But once it has been explained, there's clearly a great deal of latent demand and capacity for this."

This is apparent, he says, from the success of offerings like that of disability charity SCOPE – which raised a £2 million 'social bond' in 2012 to fund donor acquisition and new store openings. "Bonds of this kind are typically now able to place 30 percent to 50 percent of their offering with retail investors."

Threadneedle, the UK's fourth largest UK retail fund manager, also seems convinced of the potential: it recently partnered with Big Issue Invest, the social investment arm of the Big Issue, to launch a £15 million fixed income fund, which will invest in debt instruments across eight target sectors. ■

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The insurance premium

A new way to de-risk impact investing

Until recently, the only downside protection most impact investors could hope for was some kind of loan guarantee – like the one New York mayor Michael Bloomberg provided to persuade Goldman Sachs to back the city's first social impact bond.

But there's a new concept in town. At the Clinton Global Initiative last September, it was announced that D Capital, the impact investment arm of development consultancy Dalberg, had teamed up with South African insurer Hollard to create a new joint venture called HUGinsure, which claims to be the world's first social impact insurance entity. Global insurer Aon's reinsurance arm Benfield and the Lloyd's market have also thrown their considerable weight behind the idea. At press time, HUGinsure was just about to announce its first transactions.

The gap in the market is clear. Investors often find it difficult to commit to impact because they don't feel sufficiently confident about the risks involved; they'll often find it difficult to assess the creditworthiness of the businesses they want to back, particularly in developing markets. This, in turn, creates problems for the organisations involved, because it's harder for them to get access to the funds they need in a timely manner.

To compound matters, a lot of banks won't lend to such organisations, on the grounds that they don't have much of a balance sheet to offer as collateral. "Banks might refuse to lend, even if the organisation has firm commitments for the capital and a strong track record," says Liesbet Peeters, a founding partner at D Capital. "But that transaction is easy to underwrite as an insurer."

We can do a better job of understanding the underlying risk, using all the latest statistical tools

Which is where HUGinsure comes in. The new venture has been developing a risk assessment framework that will better identify and manage some of the risks involved in investing in these social impact businesses. The idea is that by providing insurance products that de-risk these transactions, HUGinsure can expedite the flow of capital to the places where it is really needed and thus will have the most impact.

Say you have an NGO that provides emergency relief services. It needs capital immediately to address the problem – but even if it has a solid donor base, it takes too long to get hold of the money. What it really needs is a bridge loan from a bank – but the banks don't want to lend to this sort of asset-light organisation.

However, if the NGO has taken out some kind of financial guarantee insurance policy, the bank can make the bridge safe in the knowledge that if the borrower defaults, it will still get its money back. Equally, the NGO is willing to take on the loan, safe in the knowledge that it's covered should its donors default on their pledges. The end result? The money gets to the front line much more quickly and efficiently.

Another application that's high on the priority list for HUGinsure is trade credit insurance – where the insurance policy effectively underpins a transfer of goods from a vendor to a purchaser on credit. The vendor can then use this as collateral to unlock a commercial loan at a more affordable rate, while having the security of knowing that they're insured if the purchaser defaults on their credit line.

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HUGinsure: D Capital's Liesbet Peeters, Hollard's Ian Ross and Aon's Terry Masters launch their new venture with Chelsea Clinton at the Clinton Global Initiative

In fact, according to Peeters, there are a number of different products that could be distributed through the platform, and a number of different ways the transaction could be structured in each case.

One thing they all have in common, though, is that they represent a much more scalable way of managing risk than loan guarantees. Typically, guarantees will only exist between a relatively small number of (large) counterparties. What's more, they're not very capital-efficient. "If you provide a $100 million guarantee to an investor, you have to show that $100 million on your balance sheet," explains Peeters. "But because we can do a better job of understanding the underlying risk, using all the latest statistical tools, we don't need to set aside as much capital against it. So it's a much more efficient mechanism for identifying and spreading risk."

One intriguing prospect is whether the same sort of de-risking or downside protection might eventually be available to an investor's entire impact portfolio, rather than just individual impact deals and businesses. Clearly this would be a complex problem; insurance relies ultimately on scale to make it affordable, so some sort of aggregation would probably be required.

But as impact investing (along with some of the organisations operating in this space) develops more of a track record, and as groups like HUGinsure become more experienced and more sophisticated in the way they assess and manage the risks involved in these transactions, it's easy to see how it might be possible to develop some kind of portfolio-level insurance product that – for example – allowed investors to insure against the possibility of individual defaults.

Either way, what seems clear is that the work of HUGinsure (and other intermediaries such as DeRisk, the first insurance marketing agent to be authorised by the Multilateral Investment Guarantee Agency, a division of the World Bank that provides political risk insurance to private investors in frontier markets) should help the market to better understand the risks involved in impact investing.

And if a fully-fledged social impact insurance market of scale can develop, providing affordable products that de-risk these transactions, there's no question that it should unlock new sources of capital. ■

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The royalty route

Quasi-equity investing in frontier markets

Ever since John Kohler announced last year that he and his team at Santa Clara University had devised a new type of impact financing that could offer investors a clear exit path, he has been racking up airline miles.

The first deal Kohler negotiated with the new product – a hybrid debt-equity arrangement called the 'demand dividend investment' (DDI) – committed growth capital to a young organic cacao production company in Belize. Others are now in the works for social enterprises in India, Nicaragua, and even Mali.

"Traditional equity is an extremely effective vehicle for start-up and early stage investing, but it has been a tough sell to impact investors because there have not been enough successful exits," explains Kohler, who directs the SCU Impact Capital group and was a founder of Redleaf Group, a tech venture capital firm. So social enterprises find it hard to raise equity – and because they don't tend to fit the criteria of conservative, asset-based bank lenders either, borrowing is usually difficult too.

Maya Mountain Cacao: *first beneficiary of DDI*

SCU's demand dividend investment – a.k.a. the 'variable payment obligation' – is focused on accounting for the realities of social enterprises operating in agrarian emerging market economies, like seasonal revenue streams. It's structured as a debt instrument that is repaid (following a honeymoon period) based on a company's free cashflow.

This allows the capital to be put to work immediately, and gives the business a cushion during difficult financial periods. Investors, meanwhile, get the security of a defined exit – but the potential to capitalise on growth.

In the first of these deals, the US-based Eleos Foundation extended a $200,000 loan to Maya Mountain Cacao, a sustainable cacao production company that sources its product from over 200 organic farmers, supporting income generation, jobs and eco-friendly farming in a highly impoverished region of Belize. When Kohler's team introduced Eleos and MMC, the three year old company was looking for capital to expand its demonstration farms (which it uses for training), and to launch operations in Guatemala. Under the DDI terms, MMC agreed to make loan payments every six months starting in 2015 based on 50 percent of its free cashflow. By the loan's maturity date, Eleos is expected to have made double its original investment.

However, the structure and return projections of other DDIs could vary significantly, Kohler explains. As a baseline, he expects most to average in the $20,000 to $50,000 range for three- to five-year investment periods, with interest rates anywhere between 2 and 8 percent, and 20 to 30 percent shares of free cashflow.

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But the DDI is designed to be flexible and easily adjusted to meet different return targets, free cashflow forecasts and interest rates. For instance, a loan to PBK Waste Management Solutions in India was structured with an 'equity wrapper', because of restrictions on local currency repatriation.

"We are not making a declaration about whether it should be 'finance first' or 'impact first'. Each situation is different," Kohler says.

Other quasi-equity vehicles supporting emerging market enterprises are trying to avoid the 'impact' distinction altogether.

The Fund for Agricultural Finance in Nigeria (FAFIN) – a $100 million vehicle managed by Sahel Capital that invests in small and medium-sized agricultural enterprises across Nigeria – has chosen not to market itself as an impact fund even though it is largely a development initiative, sponsored by the Nigerian government. FAFIN, which the Nigerian sovereign wealth fund and German development bank KfW have co-sponsored alongside the Nigerian Agricultural Ministry, is part of a government push to encourage private investment in agriculture, which accounts for 60 percent of Nigerian jobs and 40 percent of GDP.

"By definition, FAFIN will have an impact, but the feeling was that advertising it as an impact fund would lead to misaligned expectations about returns and investment criteria," explains Joe Dougherty, the partner at Dalberg Global Development Advisors who helped structure the fund. As such, FAFIN is being marketed as a "regular" private equity fund, targeting 15 to 20 percent gross returns.

For FAFIN, investing via equity seemed problematic. Dougherty noted that Nigerian entrepreneurs generally lacked sophisticated understanding of equity and were hesitant to give up shares in their businesses – while there was also the danger that the fund wouldn't be able to exit its positions. Debt, on the other hand, would be too expensive and burdensome for many of the companies concerned.

FAFIN settled on pursuing royalty-based quasi-equity investments that would be structured as debt (a strategy also used by outwardly impact-focused agricultural funds like GroFin and Root Capital). The fund will look to make investments of $500,000 to $5 million over a five- to seven-year term, generating returns from loan interest payments and revenue-based royalties.

"[This structure] felt most appropriate for a high-risk environment to set a guaranteed floor but also allow investors to share in the upside," Dougherty said. As an added measure of support to portfolio companies, the fund has a $1 million grant-based technical assistance facility to provide business development support, supply chain management and other services.

Again, it's early days (FAFIN hasn't even made its first investment yet). But the balance of risk mitigation and return potential embedded in quasi-equity vehicles like DDIs and FAFIN's royalty scheme has already succeeded in attracting new capital into frontier market SMEs: FAFIN is KfW's first investment in Nigeria after pulling out of the market several years ago, for example.

Now it's all about whether this approach succeeds in delivering the promised results. As Kohler puts it: "To make this work, we need the money to come in and returns to come back." ■

> **"*Traditional equity ... has been a tough sell to impact investors because there have not been enough successful exits***

9

Readying for impact

The government-backed fund trying to boost dealflow

Jenkins: investors had to play central role

Stimulating the supply of capital to impact investing is clearly an important goal. But there's also a deficiency on the demand side at the moment: many social businesses don't have the resources or wherewithal to attract or manage this sort of funding, or to deliver against the agreed metrics if they get it. So as governments and philanthropic organisations think about how to catalyse the impact market, the idea of stimulating demand also needs to be high on the agenda.

That's certainly the thinking behind an innovative pilot scheme set up by the UK government. The Investment & Contract Readiness Fund, a £10 million pot funded by the Cabinet Office and managed by Social Investment Business, has a very specific function: to help social businesses prepare themselves to raise finance or bid for public sector contracts.

> **There was a need for a fund that could basically underwrite the cost of corporate finance work for these social ventures**

"The feedback from investors was that there was a need for a fund that could basically underwrite the cost of corporate finance work for these social ventures," explains SIB's CEO Jonathan Jenkins. "So you'd be de-risking that transaction, with the intention to create more transactions."

Since May 2012, it has awarded grants totalling just under £9 million to 94 social ventures, allowing them to tap into the expertise of a group of pre-screened third-party providers. Already, eight of these 94 have gone on to win deals worth almost £35 million.

Jenkins stresses that this is not intended to be a permanent subsidy; instead, the hope is that the scheme can demonstrate the benefits of this approach to such an extent that either the social business or the ultimate investor eventually becomes willing to foot the bill.

Critically, investors have played a central part: a panel comprising most of the UK's leading impact investors got to approve all the providers and intermediaries, and assessed all the applications. "We had to make them a core part of the decision-making, because ultimately, we'll be judged by whether they do or don't invest," says Jenkins.

It's early days, and there's still room for improvement: a recent report by the Boston Consulting Group, while praising the fund's work, suggested SIB should have been given more resource; it also recommended more transparency on provider performance. But the idea seems to be working: in fact, Jenkins suggests that at the current rate, the activity of the current fund could bring somewhere between £75 million and £100 million of extra capital into the sector.

Conversations are apparently underway about an extension to the fund: expect that to happen before too long. And, probably, for others to follow suit. ■

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The intentionality question

Impact investing that's not impact investing

What is impact investing, exactly? Maybe there isn't a universally-accepted answer to that question yet. But the Global Impact Investing Network's definition provides a pretty good reflection of current thinking: "Impact investments are investments made into companies, organisations, and funds with the intention to generate measurable social and environmental impact alongside a financial return".

One of the interesting aspects of this definition is the phrase 'with the intention to'. In other words, impact investing can't be impact investing unless it's deliberately intended to be.

Or can it?

There's a debate going on in the impact space at the moment about the importance of intentionality. After all, impact and intention aren't intrinsically linked; it's perfectly possible to have a positive social and environmental impact without deliberately intending to, just as it's perfectly possible to have a negative social or environmental impact without deliberately intending to.

Farming in Malawi: *Agri-businesses in Africa usually have positive social impact even if run on a purely commercial basis*

This question is particularly salient in emerging markets, when even businesses that operate on a wholly commercial basis will often also have a positive social impact (on employment, for instance).

As a recent report on impact investing in Africa by Bridges Ventures and the African Private Equity and Venture Capital Association puts it: "An impact investment mechanism can occur even when the intention to create impact (and measurement of it) is not shared by all members of the value chain . . . In fact, there are many impact investment mechanisms at work in Africa where it is not."

In other words, there are times when the investor and the target enterprise both have the intention to generate a positive impact. But there are other times when a commercial lender or investor might back an impact-first enterprise solely because it's attracted to the commercial potential. And there are other times when an impact investor might back a purely commercial enterprise because it generates a positive impact as a corollary of its growth.

Equally, Bridges notes, even when the investor and the enterprise share the same impact motivation, they might not share the same financial motivation: for instance, grant-type funding might be used to support the initial growth stage of a business that hopes to be commercially viable in the medium-term (an approach sometimes called 'enterprise philanthropy').

Why does this matter? Because if policymakers want to maximise the potential of impact investing, they need to be aware of all the various mechanisms available for generating impact. That way, they can look to stimulate as many of them as possible. ■

PEI Alternative Insight

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