

Impact Investing: Harnessing Capital Markets to Drive Development at Scale

Impact investing is emerging at a time when financial markets worldwide are in turmoil.

While industry participants can do little in the short term to address the wealth destruction that is reducing available capital, they can work strategically to position the industry to absorb a greater share of investment capital when markets inevitably thaw.

By Antony Bugg-Levine



In Hyderabad, India, a private school is expanding after receiving a loan from the India School Finance Company. The Company, capitalized by Gray Ghost, a US\$200 million investment fund in the United States, is demonstrating that educational opportunity can be expanded through for-profit investment in schools that charge as little as US\$4 per month.

Around Virunga National Park in the Eastern Congo, farmers are receiving premium prices selling vanilla and coffee to Gourmet Gardens, a Ugandan exporter. Despite the political instability that keeps mainstream lenders away, Gourmet Gardens secured a working capital loan for these purchases from Root Capital, a US-based non-profit that lends to farmers cooperatives and agriculture aggregators around the world.

In Chicago, USA a business is providing new jobs with good benefits to low-skilled workers after receiving a loan from ShoreBank, a pioneering community bank. ShoreBank could give the loan because major insurance companies and pension funds -including Prudential and TIAA-CREF, two of America's largest financial institutions - made equity investments and targeted cash deposits to expand its lending capacity.

Although they may not know it yet, the students in Hyderabad, the Congolese farmers and the business owner in Chicago are all participants in the rapidly emerging industry of impact investing. Like the individual and institutions who invested in the **India School Finance Company, Root Capital** and **Shorebank**, impact investors seek to make for-profit investments that can also provide solutions to social and environmental challenges.

These impact investors offer a bridge between traditional philanthropy - that can incubate innovation and mobilize attention on exciting solutions - and the private sector capital markets that ultimately hold the wealth required to take these solutions to a satisfactory scale.

When we consider the scope of the world's social and environmental challenges we see there is not enough charitable capital to meet them. We must ask, "Where will we find the money to complement charity and government to bring solutions to scale?" The Rockefeller Foundation launched our Harnessing the Power of Impact Investing, initiative in November 2008 because we believe that impact investing has the potential to be part of the answer.

However, as the recently published report Investing for Social & Environmental Impact by the **Monitor Institute** highlights, the ability of this new industry to deliver on its potential is not inevitable. Industry leaders will need to work together to measure and ar-

ticulate the industry's successes, build infrastructure to increase its efficiency and create products that respond to investors' demand for transparency and liquidity.

Why is impact investing emerging now?

The seeds for the impact investing industry were sewn in the 1980s and 1990s with the socially responsible investment and corporate responsibility movements. They challenged the prevailing attitude that companies' and investors' only responsibility is to maximize financial returns. At the same time, as microfinance gained international renown, and advocates of a commercial approach gained visibility, the idea that investment, rather than pure



philanthropy, could generate development outcomes became increasingly widespread.

Inspired by these examples, entrepreneurs and managers in multi-national corporations pioneered business models beyond microfinance to provide basic social services to poor people and address environmental problems. Impact investing is emerging as the investment counter-party to these businesses.

It would be naïve to believe that the wealth destruction and credit market contractions of the past 18 months have not shaken this new industry. Structural changes that spurred its emergence, however, remain in place to drive its growth when the credit markets revive:

- *Growing importance of private capital* - Sources of capital for development have shifted during the past decade for many (but not all) poor countries. Private sector capital flows, primarily in the forms of foreign direct investment, mobilized domestic savings and remittances, have replaced foreign aid and private philanthropy as the primary sources of capital for investment.

- *Wealth concentration among the “investment-oriented”* - Many individuals and families acquired significant discretionary capital in the past decade. This capital has been concentrated among precisely those people – entrepreneurs and financiers – whose personal life experiences primed them to see investment as a potent tool. They reject the canard that presence of profit is evi-

dence of exploitation.

- *Impatience with traditional approaches*: After half a century of experiencing remarkable success as well as failure, traditional philanthropic options are uninspiring to some. This frustration can be counter-productive when it dismisses the experience and insights of development professionals and the complexity of the challenges they face. It, however, creates an opening for social entrepreneurs who offer a compelling alternative to philanthropy.

These structural trends create fertile soil wherein the impact investing industry is germinating.

Harvesting the fruits of impact investing

Despite, and sometimes because of, a proliferation of activity, the impact investing industry is poised at a delicate moment. Impact investors have already made their mark in a few sub-sectors, most notably US-low income housing, and, more recently, micro-finance and green energy. Yet, impact investing capital is not being brought to bear at the requisite scale of hundreds of billions of dollars.

The industry remains beset by inefficiencies and distortions that currently limit its impact even in areas where impact investing should be viable (such as healthcare delivery, slum upgrading, agriculture development and education). Our language, analytical tools, capital markets and legal system – that

are still structured to support activity on the binary of philanthropy or profit maximization – do not fully support impact investing.

In this context, impact investing can be frustrating. But these frustrations are not unique. They are the archetypal challenges that confront pioneers in new industries. Fortunately, investors’ frustrations are also entrepreneurs’ opportunities. Global innovations and collaborations are now pointing to potential solutions to these barriers to the industry’s maturation:

Building platforms for collective action - While various efforts, outlined below, address specific barriers to efficient investing, impact investors need a broader understanding of the contours and structures of this new industry to enable them to work together. We need to know how big this industry is, who its participants are, who has capital, who has deals and how to connect them more efficiently.

In response to this need, the concept for a Global Impact Investing Network is gaining momentum around the world, with hubs of activity coming together in various countries (including a planned launch in India in late April 2009). The 2008 launch of the Aspen Network of Development Entrepreneurs also provides a promising platform for the substrata of investors interested in supporting small and growing businesses in emerging markets.

Creating credible standards for measuring social impact - Commonly-understood terms reduce transaction costs for mainstream investors. Our research with wealth advisors and private client bankers also indicates that the development of a credible, independent rating agency to measure the social impact of investment will be crucial to unlock this source of impact investing capital.

In light of this research, the recent launch of a process to develop a Global Impact Investment Ratings System and Impact Ratings and Investment Standards is particularly exciting. By mobilizing investors as well as activists, academics and entrepreneurs, this initiative has the potential to break through the historic logjam that has kept similar efforts fragmented.

Developing capital markets - Intermediation, or the placement of money between investors and the businesses and projects that can use it productively, is generally sub-scale and inefficient. Impact investors face high transaction costs in sourcing deals, conducting due diligence, closing and syndicating investments. Investment funds, investment bankers and market platforms have not yet achieved the scale and visibility to provide viable conduits for billions of dollars of latent impact investment capital. The intermediation challenge is, however, being met by innovators working across a spectrum of segments and business models:

- **Impact investment banking** - In London, Social Finance was launched in 2007 as an integrated investment bank serving social sector clients in structuring and placing impact investment capital. In San Francisco, Imprint Capital, a buy-side impact investing advisory boutique, was launched in 2007 and is now serving a range of family offices and private foundations to make impact investments. A new division of the South African Social Investment Exchange, SASIX Financial, is providing similar services to corporate and institutional investors and government. Intellectap in India is expanding its advisory services bouquet to include a range of impact investment services. They are working, in different ways, to provide investors with more efficient deal sharing capability, more attractive investment structures and the liquidity that many require.

- **Wealth advising** - Money managers are tapping client interest in impact investment to grow their customer base and deepen client loyalties. In London, Investing for Good assists wealth advisors to identify and scrutinize impact investments. Veris, a wealth advisor in the US, is building a product suite to offer clients impact investments and screened fund options. ResponsAbility, an independent money manager launched in Zurich, Switzerland in 2003, manages more than US\$650 million in impact investments. Developed with the support of Credit Suisse, this Geneva-based company offers a rare,

Microfinance: Pole Position or Sitting Duck?

As the impact investing industry emerges, microfinance institutions sit in a fascinating position.

They are well-placed to use the skills, networks and business models they developed serving microfinance clients and investors to expand into the broader impact investing market. Some established microfinance players are launching new impact investing products such as Swiss-based Blue Orchard, whose founder created Bamboo Finance in 2007 to invest in medium-scale enterprises in poor countries. Others are diversifying the offerings within existing microfinance vehicles, such as ResponsAbility, which offers investors exposure to investments in socially-oriented alternative media and Unitus, whose second equity fund includes an allocation to investments beyond microfinance. Grey Ghost Capital has also broadened its US\$200 million investment funds beyond microfinance.

Concurrently, the emergence of the impact investing industry will break the near monopoly that microfinance has until recently enjoyed over investors interested in generating positive financial returns while promoting economic development in emerging markets. As an indicator of this trend, when JP Morgan Chase launched an impact investing unit in 2007, it did not launch a “Microfinance” unit (as Citibank had done two years earlier) but rather a “Social Sector Finance” unit whose ultimate ambitions span a broader range of impact investments. Against this backdrop, microfinance fund managers and advisors will face unprecedented pressure to prove why microfinance provides a more effective blend of financial return and social impact than, for example, investing in private schools, health clinics or medium-scale enterprises.



but exciting example of a mainstream distribution channel being utilized for impact investment.

- **Fund management** - Both, Root Capital, the US-non profit funds investing in the Ugandan vanilla exporter, and E+Co. another non-profit investment fund that invests in energy services companies in poor countries, have recently launched ambitious scale-up plans. So have Bridges Ventures in London, the Acumen Fund that invests in social enterprise in India, Kenya and Pakistan, GroFin in Africa and Agora Partners in Central America. Innovators in established fund management companies, such as the managers of impact investing units in TIAA-CREF and Prudential, are growing impact investing portfolios that total hundreds of millions of dollars across asset classes.

- **Retail client mobilization** - Innovators have developed mechanisms to make impact investing accessible to retail investors. The Calvert Community Investment Note can be bought in the US for US\$1,000 minimum from brokers (\$20 minimum when purchased online) and offers up to a 3% coupon which is relatively attractive in the current environment. They are currently considering expanding this offering outside the US.

Securing supportive policy reform - Currently, for-profit businesses and investors who seek to create social value are left to force-fit their aspirations,

often uncomfortably, into existing non-profit or for-profit legal structures. Legal innovation, however, is also gathering steam. The 1995 Dutch reform that provides personal capital gain tax breaks to environmentally-beneficial investments is serving as a model for similar regulatory reform efforts. The UK government created a new corporate form of for-benefit “Community Investment Corporations” in 2005. In France and South Africa, recent legislation will compel investors to place some of their capital in impact investments. The grassroots efforts to create a B Corporation¹ (a new classification of company that uses the power of business to solve social and environmental problems) and L3C² legal form in the United States are similarly starting to build momentum for a new regulatory regime to meet the interest of impact investors.

What is the economic downturn doing to the industry?

Like a butterfly emerging from its cocoon into a hurricane, the impact in-

vesting industry is coalescing just as international credit markets face great turmoil. If I could predict with certainty what effect market conditions will have on this industry, I would be making venture capital investments rather than writing articles in social enterprise magazines.

However, it does seem that, at least for now, both triumphalism and despair are overstated. The financial crisis seems to have created a boon in terms of making human resources available to the impact investment industry. Around the world, experienced finance professionals, recent business school graduates and talented expatriates bear much lower opportunity costs to enter this industry. In some cases, they are returning to work in emerging markets of increasing interest to impact investors.

While impact investors are not immune to the challenges facing investors raising capital and syndicating deals in this credit market, anecdotal evidence shows that they remain committed to this new

¹ www.Bcorporation.net
² <http://americansforcommunitydevelopment.org/>



industry. Many of the impact investment asset management, advisory and banking organizations have remained solvent, and in many cases, grown during a period that has seen mainstream financial services firms brought to their knees.

In the end, the interplay of income and substitution effects will determine the medium-term trajectory of the impact investing industry. Industry participants can do little in the short term to address the wealth destruction that is reducing available capital. We can, however, work strategically to position the industry to absorb a greater share of investment capital when markets inevitably thaw.

What will it take?

The success of this new industry is not certain. The danger remains that “impact investing” will become a mere marketing tool that investment promoters use to raise funds without generating substantial social and environmental benefit. If leaders in the sub-sectors—

of microfinance, education finance, healthcare finance etc. — do not realize the value of coming together to build a single industry infrastructure, they will suffer from duplication and fragmentation.

Building a mature impact investing industry will also require brave self-examination by impact investors and the businesses and funds into which they invest. The impact investment industry needs to be realistic about the kind of returns it will offer and investment products it will need to develop to become a viable proposition for the institutional investors, who control most of the world’s investable assets, but are bound by rules that limit their freedom to invest in unproven and sub-market products. The industry also needs to become more confident and honest about explaining the need for subsidy in many areas, through lower return and higher risk tolerance.

The recently-released report of the Monitor Inclusive Markets research project in India provides a benchmark for thorough analysis. The report is built on the willingness of organizations and companies such as Byrraju Foundation, SKS and VisionSpring to expose their business practices to public review. It shows that impact investors will have to accept that subsidies will be temporarily necessary in some sub-sectors as social enterprises test and refine applicable business models, and permanently appropriate in other sub-sectors where in-

vestment generates substantial positive externalities that cannot be internalized into a company’s profit.

Where does impact investing go from here?

We know from the success of other innovations—such as the development of the private equity industry in the last 50 years—that a small group of leaders must work effectively to accelerate the pace and manner in which an industry matures. The impact investing industry will reach its potential in the beginning of this century if the innovation and stamina of entrepreneurial risk-takers can be coupled with industry-building leadership.

The economic crisis has shaken confidence in established investment ideologies and their mainstream proponents. The emergence of the impact investing industry provides a potentially compelling alternative, by offering to imbue investment with social purpose and, ultimately, to increase the scope of solutions to social problems that continue to proliferate even as philanthropy resources dwindle.

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