CHAPTER 1

Introduction to Impact Investing

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It is an extremely tempting proposition: Invest money in a business whose product or service offers financial return and at the same time generates positive social impact. All parties seem to win, with an investor making a return and society benefiting. A charity could direct money into an organization that accomplishes the same social mission as one it grants to, but instead is able to receive back and reinvest the granted funds. What could hinder such a paradigm?

This idealistic form of capitalism has surged in the last few years. As of 2014, over USD12.7 billion has been committed to impact investing, representing a growth of 19 percent from the prior year.[1] Numerous investors are active ranging from lone high net worth individuals to a multitude of private equity funds. Even larger-scale financial institutions and investment firms have dedicated funds and resources to impact investing. Ancillary services have emerged to support these investors and further develop the industry including secondary market platforms, capital advisers who specialize in impact investments, and services to validate and rate social performance.

With such fervor, why does it still seem like the impact investing market is constrained? The simple answer is that it is not easy to both create a profitable business that has a significant social impact and also scale that business so that it generates commercial returns for investors and continues to progress its social mission. It comes as no shock, then, that for a number of years in a row, J.P. Morgan's impact investing survey cites "a shortage of high quality investment opportunities with track records" and a "lack of appropriate capital across the risk/return spectrum" as primary hindrances to the growth of impact investing.[2]

[1] Yasemin Saltuk. J.P. Morgan, "Spotlight on the Market: The Impact Investor Survey," *Global Social Finance* (May 2, 2014), 5.
[2] Ibid., 6.

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Part of the issue is that impact investing appeals to our senses and consciences through innovative solutions to pressing social problems. This thought should not be misinterpreted though, as many of the entities and businesses an investor encounters when reviewing social enterprises legitimately intend to or are actively creating significant positive social value. The problem is that a majority of these businesses are not commercially viable and will not generate the return that many investors require. Our morality wants to support these investments, so the industry has grown considerably to encourage social enterprises, but as investors, we must maintain a fiduciary responsibility and invest at the appropriate risk-return level.

However, as we seek to increase the scope of suitable investments, we run the risk of going over an inflexion point, where social impact has been compromised so much that the investment can no longer be considered an impact investment. This can either occur by investing in businesses that actually do not have significant social impact or by investing in a social enterprise that alters itself to become a traditional company. At that point, we have become traditional investors and the paradigm is lost.

We now find ourselves in a delicate situation, balancing financial viability, monetary return expectations, and social impact. How do we achieve the correct balance? As with most industries, the solution is basically hard work and being equipped with the right resources and knowledge. We must know how to look for the right investments and how to screen out ones that are not financially sustainable or demonstrating the right level of social impact. Once found, we must adhere to a rigorous investment process and vet a company to establish its financial and social value. The investment structures created need to properly balance risk and reward. Documentation needs to be done professionally to accurately reflect the structure created and the intentions of all parties. We have to endure far beyond the investment phase, helping businesses scale and exit positions with financial and social success.

It is easy to discuss the beneficial attributes of impact investing and package it in a way that sells a good story. The hard work is in proper investment execution. To get there, this book addresses the following:

- Knowing how to source deals domestically and internationally, while mitigating foreign exchange and business cycle risk
- Properly mapping out the social impact of a company and the metrics that prove it
- Being able to understand, build, and utilize multi-method valuations
- Drafting a term sheet that takes into consideration commercial and social mission risk
- Monitoring and managing an investment to ensure financial and social returns

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- Understanding the economics and realities of leveraging other people's money in impact investment funds

Although a shortage of quality investments vis-à-vis investors exists and will most likely be commonplace with the high degree of interest in impact investing, excellent investments can be found that marry profitability and social impact. This book and the online resources that accompany it will assist investors in choosing the right investments, help align risk and reward, and contribute toward investors building financial and social value.

WHAT IS AN IMPACT INVESTMENT?

An *impact investment* can take many forms, but all share the idea that capital can be deployed into an entity making a good or providing a service that offers positive social impact, while also generating some level of financial return. The Global Impact Investing Network (GIIN), one of the major impact investing industry organizations, defines impact investments as "investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return."[3] Critical to this definition is the intentionality of the investor to deliver on financial and social returns.

The form of investment can be as straightforward as investing money for shares of equity in a company or much more complicated, such as a convertible debt structure. Core investment funds may not even have to be exchanged, as in the case of credit guarantees. The unifying thought, though, is that an investor is committing capital to a commercial business, which aims to compensate the investor for his or her investment.

Geographically, impact investments can be made anywhere. Impact investments exist in emerging or developed markets, as long as the focus remains on coupling social or environmental impacts with financial returns. Although examples in developed markets are less common, programs such as investment funds that target small businesses in East London could be considered impact investments.

With all of these options, the two primary forms of investment into social enterprises are debt and equity, mostly in emerging markets. Much of the recent enthusiasm over impact investing has been targeted at investments in social enterprises. These are companies that are for-profit, but have

[3]The Global Impact Investing Network, "What is Impact Investing?" www.thegiin.org/cgi-bin/iowa/resources/about/index.html#1.

created a good or service that provides significant social impact. Given their early stage and venture nature, the more typical form of investment in these companies is equity. Debt does come into play in impact investing, particularly with new debt funds creating specialized products, but equity is still the predominant force in early stage social enterprises.

Debt is also relevant for impact investing when we consider microfinance, which is a specialized sector of impact investing. Microfinance involves lending small amounts of money to individuals or groups of individuals, who then use that money to fund their own businesses. The borrowers agree to pay back the loan, plus interest. Microfinance institutions, which provide the direct borrower funding and collection services, have grown over the years and are recipients of debt and equity investments themselves. All of these would be considered a type of impact investment.

For the most part, what has been described so far are investments. An investor provides capital and expects return. The key differentiator for impact investing is the impact. We will work to define impact later in this chapter, but an impact investment differs from a traditional investment in that the core business product or service provides a positive social impact. A healthcare company that provides high-quality, affordable tiered services for low- to middle-income patients, for profit, would most likely qualify as an impact investment. A healthcare company that builds clinics for wealthy clients and donates 1 percent of profits to charity would most likely not be considered an impact investment. The social impact has to be engrained in the business operations, product, or service.

A specific feature of impact investing is the investor's engagement to measure and report on social and environmental performance and impact. Impact investments should aim to be evidence-based investments. This means the industry needs to build data on the type of interventions that have a positive development impact. Impact investors need to examine and share learnings on the combination of products and services, the type of designs, the pricing and distribution models, and the accompanying services that will result in positive societal impact on the targeted population. Obvious as it is, it may be worth reiterating: Without evidence, we will not make evidence-based investments. In this book, we go through the challenges of defining adequate impact models, identifying appropriate indicators to track, and monitoring and analyzing output, outcome, and impact indicators.

WHO MAKES IMPACT INVESTMENTS?

As we will come to learn later in this book, no other field within finance has a greater disparity of participants than those found to be impact

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investors. Impact investors differ from traditional investors in a number of ways, but the most important differences relate to return expectations, investment holding periods, and investment motivation. To understand this varied landscape, we should start by looking at some of the oldest impact investors, government institutions.

The International Finance Corporation (IFC), a member of the World Bank Group, is one of the oldest, largest, and best-known impact investors. It invests in a large range of projects, from direct and indirect private equity investments to large-scale infrastructure projects. It would be considered a government institution because it is funded by World Bank member countries. There are a number of other large-scale government funded impact investors, such as IFC, Norway's Norfund, and the UK's CDC Group. The key to these types of investors is that they have a specific mission and seek commercial-style investments, but have a very low cost of capital and longer holding periods than average, which allows them to make investments that strictly traditional investors may not make.

Similar to government-funded investors, in terms of low capital cost and long investment time horizons, are charitable organizations that make impact investments. These organizations can range from nonprofit institutions that use donation money for investment, like Acumen Fund or EnterpriseWorks/VITA, a division of Relief International, to organizations such as Soros Economic Development Fund, which utilize funding from profitable private-sector enterprises to make impact investments.

In the middle of the range of impact investors are high-net-worth individuals who provide their own capital directly into social enterprises. Often they will provide catalytic capital to early-stage ventures or fund business plans that materialize into companies. Similar to the other types of investors already mentioned, these investors have long investment time frames, low costs of capital, and personal motivations for investment that afford them a high degree of flexibility.

Finally, we move up the scale of commerciality to for-profit investors such as GrayGhost Ventures, DBL Investors, and Bamboo Finance. Each of these institutions has a varying commercial approach toward impact investing, where returns and investment horizons are more in line with traditional investors.

HOW THIS BOOK IS DESIGNED

The bulk of this book is designed to guide an investor through every stage of the *investment process*, with a specific look in the last chapter at considerations for an investor who is creating or working for an investment fund.

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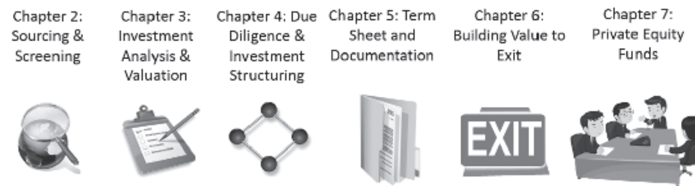

FIGURE 1.1 This book generally follows the investment process that an investor would encounter.

While there are many aspects that work universally for investors, there is a particular focus on equity investments, given that they are the predominant force in impact investing. To help immerse readers in the investment process, a fictitious company is selected amongst three potential investments. This company is then taken through each stage of the investment process. Figure 1.1 provides a graphical overview of the core chapters with a brief discussion of each section following.

Sourcing and Screening

The first phase of the investment process involves identifying potential investments. Most investors have a specific investment thesis that they, or if organized as a fund, their investors believe in. Therefore, it's imperative that the investments the investor sources fit into the investment thesis. For instance, if a healthcare investment fund is funded by high net worth individuals who have an interest in making equity level returns, while trying to address global health problems, the investor must be very careful to find healthcare related investments at good valuations that will lead to strong exits.

While *sourcing* and *screening* investments that fit an investment thesis seems relatively straightforward, time and resources constrain an investor. Time works against an investor since costs constantly accrue. The longer it takes to make investments, the longer it will be before the investment exit returns value. In order to properly place funds, resources are needed, both financially and tangibly. It costs money to undertake onsite due diligences, and to hire consultants, lawyers, or accountants. Often, an investor will hire multiple resources to help with the process. Effective investors place money efficiently and strategically, minimizing costs along the way.

Knowing how to identify regions, economies, and industries that are investable and poised for success is critical to being an effective investor.

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Specific to impact investing, the social mission must be fully understood, mapped out, and tested against the investors' social investment thesis. Weighing both financial and social mission viability early on is critical to selecting the right investments for due diligence.

Investment Analysis and Valuation

Sourcing and screening sets an investor on a path with a limited number of investments. The next stop on this path is vetting the company's operations, financial potential, and social mission scope. Usually, due diligence is split into two phases, with the first being a less-committed "desktop" phase, where business plans and financial statements are analyzed. This allows both an investor and investee to be efficient with their time and resources, since deal-breaking issues can sometimes be garnered from such analyses.

For equity investors, valuation discussions start early to make sure there are no significant gaps in perceived value. In order to have such discussions, an initial *investment analysis* is necessary since it lends to the creation of a valuation range. This range is later refined during the due diligence phase. *Valuation* is one area that impact investors must think carefully about. Impact investing is unique in that it brings together a range of investors with very different costs of capital and required returns. In some cases, these return expectations are not commensurate with the risk being assumed.

Due Diligence and Investment Structuring

Eventually, a company will warrant further analysis and full, onsite due diligence is executed. This entails reviewing all operational aspects, management, competitive analyses, finances, and social mission achievement and plan. Another goal of due diligence is for investors to establish their own opinions on the necessary investments structure. Debt investors will want to review all risks and mitigating factors related to cash flow or collateral value. Equity investors will want to check the assumptions made to create the valuation range and determine what investment structure might be necessary.

When a due diligence is complete and an investor is still interested in a company, negotiations around the investment structure ensue. Some investment structures can be very simple and quick to come to agreement, while others can take a considerable amount of time and develop into very complex arrangements. Debt investors will negotiate covenants to protect their

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priority over cash flow or collateral. Equity investors will agree to a valuation and possibly negotiate preferential rights.

Impact investors have the added requirement of ensuring that the social mission is preserved after investment. This requires properly aligning interests and making sure the structure is able to respond to changes.

Term Sheet and Documentation

Expressing the agreed-on investment structure in documentation is critical to a successful impact investment. The beginning of this phase of the investment process starts with a term sheet that covers the investment structure, preferences, and specific rights. The goal is to have a document that can be converted into a subscription agreement that defines an equity investment or an indenture for a debt investor. Additionally, for equity investors, a shareholder agreement is needed to cover shareholder rights.

Impact investors should also negotiate specialized clauses that protect the social mission and allow the investor flexibility if the social mission is compromised. As an example, a put option, where the equity investor can sell shares back to the company, might be written into the subscription agreement if the social mission deviates too far.

Building Value to Exit

Ultimately, an equity investment realizes value when it is exited. Debt investors technically have their exits through periodic interest and principal amortization. After the investment, but prior to exit, a value-building phase exists. Active investors will take part in board meetings to help shape the company's strategy. Passive investors will be more focused on financial and social metric reporting that is established at the end of the investment and provided periodically. At some point, exits must be completed properly to return funds to the investors at levels that are aligned with their expectations.

Private Equity Funds

Investors frequently establish or work for funds that utilize other entities' money for investment. Leveraging the platform of a fund can greatly increase the amount of money invested, but it brings with it a host of economic, organizational, and impact-related considerations. Most funds operate on management fees that have to be carefully managed vis-à-vis fund expenses. Organizational issues, such as the ratio and size of investments relative to investment managers, need to be carefully thought through. For impact investing private equity funds, a core responsibility is safeguarding the social mission by properly incentivizing investment managers and adhering to strict social criteria for investments.

Impact Investment Evolution

The concluding chapter to this book explores recent developments in the impact investing industry and thoughts on how it may evolve and scale. It's clear that there are problems unique to individual impact investments that stem from investors' disparate sources of capital, sometimes causing irrational risk/return profiles. A brunt of this book seeks to provide solutions to individual impact investment problems through a sound and rigorous investment process. Investment products are also evolving to help mitigate some of these problems and further develop the industry.

However, when looking at a portfolio investment strategy there are contentious issues that divide market participants. Some argue that portfolios can be constructed where there is no trade off between financial and social return. Others believe that for an effective, for-profit commercial strategy to be successful there has to be compromise and capital placed in a gradient of investments, from high impact to traditional. The final chapter in this book explores such topics and takes a position on effective portfolio strategy.

NOTES FROM THE FIELD

Throughout this book, readers will notice excerpts called "Notes from the Field." These are experiences that the authors have had that directly relate to the topic at hand. We hope that these extracts provide context to the topics.

WHAT THIS BOOK IS NOT

There are two important distinctions that should be made from the start regarding the focus of this book: It is not focused on microfinance nor social/green bonds. While we will reference microfinance in a number of sections and provide examples, the focus is not on how to make a loan to an individual nor solely on how to invest funds into a microfinance institution (MFI). There are many good books specifically on this topic. Similarly, social and green bonds have gained popularity, but they are also very specific forms of debt that lend to an entirely different strategy and analytical process.

SETTING FORTH

Impact investing is a unique and demanding field that requires an unusual range of skill sets. This book dives into both social and financial analyses in detail and provides online resources that readers can use professionally.

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Those with limited financial backgrounds will gain valuable insight into the investment process and the underlying components required to invest competently. Those with limited social impact backgrounds will learn the topics and methods necessary to evaluate and measure social impact. Most importantly, readers will learn how both the financial and social impact aspects of impact investing intertwine, creating a challenging, but highly rewarding form of investment.