Elizabeth Littlefield

Impact Investing: Roots & Branches

Foreign aid has grown to become a $200 billion global enterprise,[1] and aid funding from traditional donor nations alone has increased more than 63 percent in the past decade.[2] In many sectors, the investment has paid off. At a time when the world population is climbing inexorably beyond 7 billion, we are now on track to actually reduce the number of people living in extreme poverty by more than half, from 1.3 billion to fewer than 600 million, in the decade from 2005 to 2015.[3] Meanwhile, long-sought progress is being made on basic needs such as access to safe water, sanitation, and nutrition, as well as on issues such as maternal mortality reduction, primary school completion, and gender parity in education.[4] The magnitude of this generation's advances against some of humanity's most pervasive and debilitating problems is unprecedented.

That said, new and stubbornly persistent social and environmental problems continue to require investments that far exceed the coffers of governments and other donors. Just one of the challenges facing the developing world—adapting to climate change—is estimated to require an additional $70 billion to $100 billion per year.[5] Fortunately, however, such problems are not beyond the scale of global financial market resources. Commercial businesses and investors have the capacity to help address the needs of developing nations, and ever more private investors and entrepreneurs are seeing opportunities in doing so.

ENTER IMPACT INVESTING

There is growing optimism about business as a force for good in the developing world. A new momentum is building along with this around a breed of private investor that aims to solve social and environmental problems while making a financial return—impact investors. These investors have abandoned the long-held

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belief that their philanthropy draws from one of their pockets while their financial revenue lines another. These objectives can be blended rather than separated, and both values and commercial discipline can apply across the whole of their investments. To their minds, this is where the borderless world of capital meets the borderless world of conscience.

For decades, both public and private investors have sought in different ways to harness the power of private enterprise for the greater good, or at least to steer it away from making matters worse. Take the socially responsible investor movement. The market capitalization of corporations targeted each year by socially minded investors who engage with those companies as shareholder activists and advocates measures in the trillions. Other socially responsible investors, who only invest in funds that screen out undesirable industries such as tobacco, gambling, or liquor, are now estimated to account for as much as $3 trillion.[6] Best-in-class investors set an even higher bar for social performance, but command fewer assets.

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Today's impact investors are fundamentally different. Instead of a policy of excluding undesirable investments or an engagement as shareholders to improve investee companies, impact investors seek those rare investments whose very business model is geared toward having a positive impact on a social or environmental need. They aim from the outset—frequently before an enterprise is created—to hardwire positive social and environmental returns along with sufficient financial returns into their investments. They hope to draw on the efficiency, versatility, market discipline, and powerful incentives of the private sector in order to address public needs.

PUBLIC AND PRIVATE PIONEERS OF IMPACT INVESTING

Impact investors have development goals in their DNA, just like mission-driven public-sector organizations. So, loosely defined, this "impact first" model is not a new phenomenon. Community development finance institutions were created in the United States early in the 1900s. Credit unions and housing investment trusts soon followed. And public-sector institutions that finance the private sector have

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been an established tool of the foreign aid community for decades. These development finance institutions such as the CDC Group of the United Kingdom, International Finance Corporation of the World Bank, DEG of Germany, FMO of the Dutch government, and the Overseas Private Investment Corporation of the U.S. were created, in effect, to serve as impact investors for underdeveloped nations.

In their early years, DFIs were regarded as peripheral players, smaller in staff and lending capacity than their kin who financed governments. As emerging markets have grown and attracted more private capital, however, DFIs have grown with them. Using a combination of loans, equity, and risk-management instruments, DFIs have played an outsized role in helping create private-sector jobs and mobilizing finance for high-risk, low-income markets.[7] OPIC, for instance, has supported nearly $200 billion worth of investments in developing countries, generating an estimated 830,000 jobs in those countries. The IFC's outstanding portfolio has grown to roughly $50 billion.

The DFI model is largely what impact investors now seek to emulate: co-financing and risk management for profitable emerging market investments; sophisticated management of corporate, country, and currency risks; job creation and tax revenue for less-developed host nations; spillovers such as technology transfer, improved corporate governance, and market diversification; and measurable contributions to vital sectors such as energy, water, health care, agriculture, and housing. Moreover, DFIs have been financially self-reliant. Over its 40-year history, OPIC has generated enough income to return profits to the U.S. Treasury every year.

The ways in which impact investments contribute to development are virtually limitless. Consider the diversity of just a handful of OPIC investment projects in recent years:

- Buchanan Renewables Fuel Inc. is a Liberian company that converts old rubber trees into biomass that will help replace coal as a fuel source in European energy plants.
- Habitat for Humanity's subsidiary, MicroBuild I, provides microfinance loans to help thousands of low-income families throughout the developing nations build or improve their homes.
- Afghan Growth Finance makes loans and equipment leases to SMEs focusing on agribusiness, light manufacturing, energy, information technology, construction, and consumer goods and services.
- Husk Power Systems of India builds facilities to convert rice husk waste into electricity.

The other development finance institutions, like the IFC and those in European countries, have similar stories to tell.

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PUBLIC AND PRIVATE CAPITAL INVESTING TOGETHER FOR IMPACT

Today, these DFIs are engaging with the new breed of private capital-based impact investors who have the potential to extend the reach of financing far beyond what governments alone could hope to supply.

Among these funders are foundations such as the Calvert Foundation, Rockefeller Foundation, and The Omidyar Network; retirement funds such as TIAA-CREF; "layered" entities that blend philanthropic funds and investment financing, such as Acumen Fund; sector-specific funds such as the clean energy investor E+Co. There are also angel investors, ultra-high net worth individuals, and families.

The thousands of social enterprises that have already benefited from other investment and returned profits to their investors include microfinance providers like Equity Bank, Water Health International, and Grameen Phone, which cover virtually every market sector and developmental issue.

There are business school programs and affinity networks dedicated to building infrastructure for the asset class, such as the Aspen Network of Development Entrepreneurs and the Global Impact Investing Network.

The result has been an outpouring of innovation and groundbreaking initiatives ranging from mobile phone banking to advance market commitments for vaccines to projects that monetize the benefits of biodiversity.

But impact investing is still small in comparison to other forms of social activist investing and foreign aid. Figures are notoriously difficult to obtain, but some researchers such as the Monitor Institute place impact investing assets in the range of $50 billion.[8] J. P. Morgan recently argued that impact investing already qualifies as a distinct asset class and estimated that the scale of impact investing capital among poor populations in five sectors—housing, rural water delivery, maternal health, primary education, and financial services—will range from $400 billion to $1 trillion over the next 10 years. Of equal importance: the profits generated by these sectors could range from $183 billion to $667 billion.[9]

One aspect of this activity has been lacking, however: scale. With a handful of exceptions, enterprises in the impact investing sector have often been too small and location dependent to draw capital from large investors and provide suitable exits for investors. One recent study estimated that there were only about 200 impact investments that were viable vehicles for the developing world as a whole.[10] "Scaling-up" has become the mantra of the day.

WHO'S IN? WHO'S OUT? MEASURING PERFORMANCE

As the new wave of impact investors attempts to create a distinctive asset class, one question continues to crop up: who qualifies? One finds a number of competing definitions of an impact investment. Financial performance benchmarks vary. Some definitions call for positive environmental or social impact accompanied by

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a very small financial rate of return or simply a return of capital. Others call for environmental or social impact plus a competitive rate of return.

Developmental standards also vary and are far more complex—as complex as poverty itself. While there seems to be unanimity that a firm's intent must be "impact first" rather than profit maximization, guidelines for operations and methods of measuring impact still vary considerably. With numerous segments of the investment and development communities engaged in the debate, there is unlikely to be consensus soon.

One can fairly ask whether consensus is necessary. To date, there is little evidence that a lack of universal guidelines has been a deal-killer for impact investors. Witness the microfinance sector, where a consensus on best practices and measurement of both financial and developmental performance has emerged over time and is still evolving. Inclusivity, rather than exclusivity, served the movement well in its early phases.

In a complex global economy, private firms have innumerable valid ways to make positive economic, environmental, or social contributions.

In a complex global economy, private firms have innumerable valid ways to make positive economic, environmental, or social contributions. A firm can do so through its production factors (organic farming, off-grid renewable energy), products (e.g., antimalarial bed nets, low-income housing), or its target market (e.g., post conflict populations, disenfranchised women).

The signal question is whether impact investors can craft consistent, quantifiable, and comparable measures of developmental outcomes per dollar invested across projects—a "price-to-impact" ratio, similar to a price-to-earnings ratio—and ensure that those outcomes are transparent and subject to verification. Should this prove possible, mainstream investors now on the sidelines will have a critical missing element in their decision-making equation: the means to analyze the trade-offs between development outcomes and financial rates of return that CEOs and boards of social enterprises inevitably make. Big capital will trust hard evidence more than pre-approval punch lists and post disbursement anecdotal reports.

For example, suppose an investment's intent, standards, products, target population, and financial sustainability match all checklists but still fall short of hoped-for returns? The Abdul Latif Jameel Poverty Action Lab of MIT recently conducted a randomized trial (increasingly regarded as the gold standard in impact analysis) to examine the effect of charging small fees for preventive health care products—for example, insecticidal bed nets, water disinfectants—across ten projects in four developing countries. The researchers found that even very small prices for such products led to huge drops in consumer uptake and that charging

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a fee for the products had no bearing on whether consumers actually used them.[11] This type of price-to-impact finding need not doom every private enterprise that seeks to deliver health-care products. Still, such findings should inform the decisions of future investors and investees alike.

The impact investing community has a plethora of new entrants and experiments. Its next phase requires rigorous evaluation, transparency, and platforms for sharing comparable information. As the managerial capacity and adroitness of impact investors and their investee companies improves, brighter lines to determine "who's in and who's out" will emerge.

INGREDIENTS OF GROWTH

Impact investing holds enormous promise for addressing the problems of the developing world. However, a sturdy, large asset class of such investments will need more than a steady tide of creative entrants, a few hundred small, break-even incumbents, and a handful of larger "lighthouse" ventures that best market performance. It will need a generation of managers with enough sophistication to negotiate both local development issues and investment climate risks, such as political instability, corruption, and red tape. It will need margins to cover management fees, overhead for impact monitoring, reinvestment for growth, and then some. It will need enterprises with enough scaleability to warrant attention from institutional investors. It will need liquidity beyond mere industry sales and management buyouts. It will need broad-based indices that enable market analysts to make reliable estimates of long-term rates of returns, assess volatility, and find correlations with market and economic variables.

The history of the global financial markets has proven that none of these hurdles is insurmountable. In the decades since their founding, DFIs in the emerging markets learned their lessons the hard way and devised solutions for investors when none were at hand. Through trial and error they succeeded, and helped others succeed, sometimes spectacularly so. From a vast desert of equity opportunities a generation ago, the stock market capitalization of emerging markets has grown to $14 trillion, and it may be as much as $80 trillion by 2030.[12] Impact investment in the developing world, where both needs and market opportunities will be greatest, can and should be a vital part of that trend. It is no longer a hypothetical asset class; it is well on its way. Ultimately, that will mean millions of lives bettered and potentially millions of lives saved.

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