

Impact Investing in Brief

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Impact Investing Meet Public Partnerships (I2 Meets P3)

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The needs of underserved communities around the world are painfully evident, especially in the current economic situation. It has been proven that conventional funding methods for development in these communities just does not achieve the results needed to lift these populations out of poverty. Impact investing is an underused strategy for mobilizing commercial capital to support businesses and enterprise that advance Sustainable Development Goals (SDGs) with real impact.

Impact investing, or the act of financing projects that have both a social impact and a financial return, accomplishes both missions, all be it much more slowly than hoped by the global development community. This frustration is highlighted in examples like the Global Impact Investing Network (GIIN), which estimated that impact investing reached \$511 billion in 2018. While this sounds like a big number, it is dwarfed by scale of global capital markets¹, it also includes a wide range of different types of investments with varying qualifications as “impact Investments,” so the actual level of funds reaching communities most-in-need of access to financing is a small portion of impact investing, writ large.

So, what are the challenges to growth?

The impact investment pipeline is full of innovative ideas to help promote development and advance SDGs. Many of these ideas are backed by variations of business plans, log frames and project proposals. However, despite their honorable goals, these projects lack the sufficient documentation to give investors the confidence required to believe that investments will produce the projected social ROI as well as the necessary financial ROI at an acceptable level of risk to warrant investment. The impact investment market is stuck at a junction: there are so many good ideas that would bring about serious social change, and there is so much investment capital looking for good opportunities, but still progress is prevented due to lack of information. Impact focused deals are not closing near the level desired by any interested party and the frustration with the market grows.

Government funded activities follow a mandate, authorizing legislation, budgets and other legislative and executive restrictions on how funding must be spent. Within these bureaucratic constraints the best options, and best prospects are selected among the possible development plans. The difference is impact investors are under no obligation to choose any investment that does not meet their private standards of combined social impact, financial return and risk. Many impact investment opportunities embrace innovative ideas that have considerable risks, while other opportunities have limited capacity to scale. So, what is holding impact investment back from becoming the “new” government source of project financing?

One of the major obstacles is the difficulty and expense of providing evidence-based documentation supporting the project social impact linked to the investment. This lack of verifiable documentation is but one of the reasons that impact investment levels are not nearing government backed spending, even in a time of retreating governmental support. Many impact opportunities do not have the documentation that provides clear evidence of the social benefit produced from the investment. While

¹ The total value of global equity trading worldwide was 25.3 trillion U.S. dollars in the fourth quarter of 2018 (<https://www.statista.com/statistics/242745/volume-of-global-equity-trading/0> and as of 2017, the size of the worldwide bond market (total debt outstanding) is estimated at \$100.13 trillion (SIFMA)

others might require some need funding in order to further demonstrate their social impact and financial performance.

So, what needs to change?

Impact investing is not only about making a sound and prudent financial investment that provides economic return while attending social benefits. It is about engaging the investment community in a partnership to support new ideas that solve problems, both big and small, in new ways. Those in the impact investment community have searched for ways to close the gap between investment needs and investor requirements. Evidence-based results can use techniques such as randomized-control trials (RCTs) to establish greater assurance of future outcomes, but they can be prohibitively expensive and oftentimes are undermined by weak data. The importance of quality measurement of social outcomes has sparked extensive efforts to develop proper and standardized metrics for impact investors. However, the true social impact can be qualitative and manifested in subtle (yet profound) ways not easily measured by standardized, one-size-fits-all metrics.

Fortunately, the tools, techniques and processes to overcome these barriers to impact investing have been developed and refined through a quarter-century of investing in public-private partnership (P3s).² P3 procurements solicit bids for the delivery of public goods and services financed by private investors, a combination of debt and equity. If delivered in the more traditional of P3 models these public goods are designed, built, financed, operated and maintained by a partnership of multisector firms all working under one long-term contract. The selection of the winning bid is based on the best value-for-money (VfM) that is assured by the bidding partnership. VfM is achieved through a combination of savings from long-term maintenance responsibilities, more cost-effective management, re-aligning risks between the government and P3 partners, and innovative approaches to meeting government specified contract deliverables. P3s are pay-for-performance contracts that incentivize bidders to project long-term cost saving and enhanced performance as their competitive advantage in winning the solicitation. The debt-to-equity capital stack described above is very similar to the more familiar blended finance model in the impact investment space. Under both financing structures there is clear that different financial partners will have different goals for rate of return or type of return.

So, how can P3s increase I2?

Many aspects of the P3 approach could be adopted into the I2 market and accelerate the number of impact investments made. One of the benefits of a public-private partnerships is the extra due diligence that must be undertaken to determine the full life-cycle costs of the project. This full life cost analysis is also critical to a successful impact investment strategy. Will the project meet all the environmental, social and financial goals over the long term? Will both investors and the populations targeted for help benefit for the full term of the project? Accounting for full life costs is not as common in the public space as it should be. Too much focus is placed on the “sticker-price” or the up-front capital costs and never enough on the review of the cost of ownership. Applying this model of long-term planning to the impact investment space will result in better, more sustainable outcomes.

The involvement of equity partners, or direct investors with funds at risk in the project and dependent on the success of the project for financial gains, is one of the unique aspects of the public-private

² P3 is the shorthand for attracting private investment in public infrastructure through public procurement.

partnership model that provides benefits not found in other financing models. Equity investors will become more involved and motivated to see the project succeed, as it is equity that is first lost and last paid in the model. In the impact investment field, the impact investor's capital is at risk and it should be upon these investors to take an active role in the success of the project. Like a private equity investor in a P3, the social impact investor should set goals (both financial and non-financially) and hold the project managers accountable to address those issues that could limit and prevent success.

Both the involvement of a private equity mind-set and the long-term planning to account for full life costs will result in the hallmark of any good public-private partnership, better value-for-money. Improved VfM is always the goal of a P3 meaning that the public user received the same level of positive outcomes at a lower costs, or more outcomes for the same costs, or greatly improved outcomes for minimum additional costs than would be possible if a more traditional procurement method had been utilized. For the impact investor this would force the question: is this project resulting in "more good," "more positive outcomes," "more benefit" than would have been achieved if the project had been delivered as it would have been in the past? The goal of the impact investor model, like a public-private partnerships model, should be to see a multiplier effect for the funds invested versus past attempts.

An additional benefit brought to a project through the P3 model is the focus on proper allocation of risks among all parties. Under a P3 model both the public owner and the private partner should work together to identify all project risks and assign each of those risks into one of three categories within the contract — retained by the public owner, risks shared by the parties and risks transferred to the private partners. This risk allocation model must also be deployed in the impact investment space with a full accounting of all project risks, otherwise called the risk registry, to create an honest conversation between the parties as to who is best able to mitigate each risk.

Finally, the concept of "pay-for-performance" has a mixed history, and even a more mixed perception in the impact investment community but, it is critical that a few key lessons from this model be applied to the P3 for I2 model. First, the payer (generally the public owner) must budget for the true cost of the project. The idea that a P3 or impact investment agreement is free money must be removed right from the start. Second, all parties must agree on a reasonable definition and measurement for "performance." While these sort of social impact public-private partnerships can deliver better results for the same investment, all parties must be realistic on the outcomes. Third, all parties, including the impact investor, must provide for some alliance to fix problems, otherwise know as the cure period, to allow the private sector partner to correct underperforming project aspects before financial penalties are imposed. These cure periods should be the time that both the project operator and the project investor work together to address issues before they result in major project costs.

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