

Impact Investing in Brief

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Mobilizing Commercial Financing for the SDGs

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On September 30, 2019 the Impact Investing Roundtable convened at the Institute for Corporate Governance (ICR) at the George Washington University. The topic discussed was “Increasing Impact Investing in Middle-Income Countries.” Attendees participated in an informal discussion around the challenges and potential actions to be taken related to the topic (See Appendix A for list of attendees). The discussion was rich with comments and ideas, deep-rooted in the vast experience represented at the event. This document presents an assembly of the discussion, observations and insights offered during these discussions for the benefit of scholars and practitioners, without attribution or a claim of consensus.

Introduction

Three indisputable conditions exist in the world today:

1. Demand for Sustainable Development Goal (SDG) Services in underserved communities worldwide is extensive. Middle-income countries offer investors with different levels of governance, infrastructure, commerce and public services that could support impact investing, but major portions of the population live without access to basic public goods and services or economic opportunities.
2. International donors, national, regional and local governments, and philanthropic actors do not have the funds available to make all the necessary investments. The needs are scored in the trillions of dollars, whereas global philanthropy and development aid budgets are in the billions of dollars

The world is awash with commercial money that could be invested to bring about real improvements in people’s lives. Investment funds, banks, pension funds and wealthy individuals have the necessary funds to finance innovative projects, social enterprises, and business that can bring about real social change and meet investors’ expectations for financial ROI

These conditions have fueled growing enthusiasm for what is broadly called “impact investing” — which includes a range of financial instruments, project structures, investment platforms and targeted outcomes directed at having a positive social impact, plus a financial return for investors. More specifically, according to the Global Impact Invest Network (GIIN):

“Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending on investors' strategic goals. The growing impact investment market provides capital to address the world’s most pressing challenges in sectors such as sustainable

agriculture, renewable energy, conservation, microfinance, and affordable and accessible basic services including housing, healthcare, and education.”¹

Disagreements remain over which investments would qualify as “impact investing,” but popular investment platforms used by impact investors include:

- **Direct Investments** in businesses with a social impact or investing in a fund which in turn invests in businesses with a social impact.
- **Microloans** to communities with limited access to capital to start or support a business enterprise.
- **Green Bond** investment in renewable energy and other activities that protect and improve the environment.
- **Social/Development Impact Bonds** to support social innovations that deliver expected social outcomes where the private sector or philanthropic partners provide working capital upfront and accept the social performance risk rather than governments [in the end governments or third parties fund projects].

All these different approaches are opportunities or destinations for commercial investment capital. Impact investors are very diverse in their expectations for social outcomes, risk/reward profiles, required proposal documentation, levels of detail provided in support of the business case, and tolerance for untested innovations. A common way to differentiate impact investors is with the labels “finance-first” or “impact-first,” yet all impact investments share an intentional effort to generate social returns that is incorporated into the business case. And they all share the dual goal of achieving acceptable financial returns and generating significant social returns: social ROI and financial ROI from one conjoined investment.

The diversity of approaches used by impact investors makes estimates of the current size of global impact investing difficult. According to the Global Impact Investing Network, the size of the global impact investing market (i.e. assets under management) in 2018 was estimated at \$502 billion. This is based on data from more than 1,300 impact investors around the world.² Since the impact investors self-identify, the collection of investments included in the survey are no doubt eclectic. And for context, the total value of global equity trading worldwide was \$25.3 trillion in the fourth quarter of 2018,³ while the total amount of debt owed through bonds is more than \$40 trillion⁴.

Although impact investing is growing, even allowing for a broad and inclusive definition, it remains a very small component of total global commercial financing. Yet it is a growing presence in investment discussions, and with the expanding attention given to ESG (environment, society, and governance) expectations for all investment classes, interest in and capital commitments to, impact investing will continue to expand.

Challenges for Impact Investing

¹ <https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing>

² <https://thegiin.org/research/publication/impinv-market-size>, accessed February 19, 2020.

³ <https://www.statista.com/statistics/242745/volume-of-global-equity-trading/> accessed February 19, 2020.

⁴ <https://finance.zacks.com/bond-market-size-vs-stock-market-size-5863.html> accessed February 19, 2020.

Despite enthusiasm for the potential of impact investing to mobilize commercial financing in support of helping solve community's problems, and especially bolstering prospects for achieving the United Nation's Sustainable Development Goals (SDG), important questions persist about the effectiveness and scalability of current approaches to impact investing. The challenges are extensive and imposing:

1. Limited prospects

- a. It is still a niche industry; there is a demand for good investments, but there is a very small supply of high-quality investments.
- b. Impact investments are concentrated in middle- or upper-middle-income countries with minimal interest in low-income countries due to the relatively low adjusted rate-of-return for the risk in those countries.
- c. The vast majority of impact investments, and blended finance investments, go to microfinance and renewable energy, and to a lesser extent, to agriculture.

Few projects achieve the aim of simultaneously generating high financial returns and high social returns.

2. Deal flow is not flowing

- a. How to get high performing SDG programs investment-ready and scalable remains an unresolved problem.
- b. Project appraisal costs remain a barrier to entry, specifically legal costs.
- c. High project-level risks exist in low-income countries
- d. High project-level transaction costs exist, including costs of measuring impact
- e. Detailed knowledge of local markets and investment opportunities is limited and expensive to acquire.

3. Local capacity has gaps

- a. Entrepreneurial and project management capacities are limited.
- b. Limited experiences utilizing innovative financing tools.
- c. A major barrier is market risk arising from poor market governance and a weak enabling environment; this is the main barrier addressed by blended finance.

4. Metrics on social impacts are tough

- a. Data collection can be expensive and unreliable
- b. Multiple social outcome metrics are available, making comparisons across different investments difficult.
- c. Little is known about actual social returns on investment; typically, projects do not measure the social rate-of-return.

5. Aligning goals across the impact investing ecosystem

- a. It is difficult to match impact investors with the right combination of investment platforms, projects structures, and financial instruments through which impact investments are made
- b. Donor preferences may not align with local priorities, and assumptions about the SDG services people need and how to address them cannot always anticipate local conditions and preferences.
- c. Not-for-profit organizations are not always receptive to an entrepreneurial approach and innovative financing techniques that seeks funding for SDG services by mobilizing commercial financing.

These issues are persistent and continue to be a serious barrier to middle- (and low-) income countries securing investments from investors who are willing to sacrifice some financial ROI if it might support enterprises that produce a social ROI. The enthusiasm for impact investing notwithstanding, the current state-of-play is an approach to investing that is both relatively new and certainly confusing to many people. While impact investors are skilled and knowledgeable, serious capacity and capability issues exist in the impact investing ecosystem.

Overcoming Obstacles and Optimizing Opportunities

The good news is — after a decade of experiences with impact investing — there is a growing knowledge on strategies and operations that promote and facilitate impact investing. The overarching focus is to identify concrete actions that expand mobilized commercial finance in support of the SDGs. And making progress will require the impact investment community to create the right incentives and infrastructure to support private provision of public goods as framed by the SDGs.

- Support joint investments by international and local investors and searching for and disseminating data, e.g. from donors, on local projects and capacities.
- Recruit experienced mediators and fund managers who can work with and bring together local and international investors, and local and international donors, DFIs, philanthropists and non-profits
- Build-out local sector-level market infrastructure facilitating project pipeline development and project management capacities
- Establish local platforms for coordinating co-investors, among impact investors and between impact investors and donors and development finance institutions DFIs and philanthropists
- Establish local platforms for coordinated action at sector and market levels by impact investors and donors and DFIs to reduce market risks and project transaction costs, including by increasing deal sizes and supporting standardized and transparent impact

monitoring and measurement, and offering credit lines and working capital, especially in local currency

- Structure funds and investment instruments to support patient venture capital, including finding ways to enable impact investors to exit more easily by selling stakes to other investors
- Create agencies to support, at sector and project level, training and capacity-building and technical assistance and working capital for social entrepreneurship
- Dialogs with multiple stakeholders for shared goals and interests and expectations

Building on Success

Better efforts are needed in identifying and documenting attributes of successful impact investments. This information will be the building blocks of modelling successful approaches and practices. And it is this modelling that will support the more rapid increase in impact investment opportunities. Best practices in particular country contexts will be invaluable and research on key issues, including:

- Comparative research on the set-up and operating costs of high impact, scaled funds;
- What orientations toward poverty, risk and complexity are possible when the private sector is involved in development financing;
- Comparative experience in the use of different financial products across diverse geographies and sectors;
- Needs assessments of the professional skills fund managers require to manage impact and return;
- Criteria applied by different investor types to make front-end and exit phase decisions;
- field-based research examining the links between impact investments and development outcomes within the framework of the SDGs;

- Nurture national impact investing eco-systems, supporting asset owners, asset managers, investees and service providers, and requiring capacity building through multi-year grant-funding and long-term accompaniment (Jackson and Koenig 2016:65);
- Field guide from government perspective;
- Case studies that highlight how to align financial instruments with project structure; and
- Entry options for institutions and individuals.

Conclusion

Impact investing remains an appealing approach to mobilizing commercial financing of start-ups, firms, and partnerships who are providing SDG Services. And while this enthusiasm is justified, many factors are inhibiting the establishment of a robust pipeline of fundable projects. Greater understanding is needed of the challenges faced by impactors and impact investees specific to local communities. Greater efforts are needed to learn the lessons of previous impact investment successes and failures. And greater attention is needed to remove the barriers that impede impact investments and strengthen local capacities to encourage greater impact investing in the future.

About the Authors

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Bahman Kashi is the founder and president of Limestone Analytics and an adjunct faculty at Queen's University. Dr. Kashi has served as an economic and finance expert on numerous projects for the World Bank, USAID, Millennium Challenge Corporation, and the Inter-American Development Bank for the past 12 years.

Rodney Schmidt advises governments, international organizations, and non-profits on economic growth, impact investing and blended finance, and results-based finance. With expertise in strategy, project design, quantitative analysis, and knowledge management, he analyzes policy, informs programs, leads international teams, and provides technical assistance and training.