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# Impact Investment

*A Practical Guide to Investment Process and Social Impact Analysis*

+ website

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XIMENA ESCOBAR DE NOGALES

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# Impact Investment

## *A Practical Guide to Investment Process and Social Impact Analysis + Website*

**KEITH ALLMAN**
**XIMENA ESCOBAR DE NOGALES**

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# Preface

Lebanon is a beautiful country, with picture-perfect coastlines, lively cities, and, unfortunately, abject poverty in many regions. It was there, in Beirut, that my venture into impact investing began. I was conducting a pro-bono workshop on credit risk, for local microfinance analysts that were supported by the charity Relief International. On the Israeli border towns I took my first onsite visits to clients who received loans and observed how they utilized the funding to operate and expand their businesses. I was truly impressed with the effect the funding had, as I was able to see real businesses in expansion.

At that time in my career, I had just left banking at Citigroup and was still primarily engaged in private-sector finance. I thought critically about that trip, though, and questioned whether I should make impact investing my full-time effort. I hesitated because of prior experience with nonprofit entities that operated very inefficiently. I also struggled with finding clarity on whether my experience and skill set were best utilized in existing impact investing organizations. For years, I maintained my private-sector focus, but furthered my work with Relief International, consulting on microfinance capital market's issuances, and eventually joining its board of directors.

I persisted with traditional finance and combined my prior securitization experience with early-stage company analysis to work on venture debt transactions. As I learned more about venture company drivers and private equity fund operations, I couldn't get the thought of impact investing out of my head. And as fate would have it, right around that time a former Citigroup colleague informed me about a new private equity fund that had spun off of a large commercial microfinance debt investor. The Oasis Fund, managed by Bamboo Finance, was created to invest for profit, in early-stage, private companies that also had significant social impact. When I researched its investment criteria and the impact it sought, I was enthralled.

I decided then that I would give impact investing my full attention and moved to Switzerland to work for the Oasis Fund, where I became an investment manager tasked with sourcing, structuring, and managing for-profit, impact investments. My first year at the fund was mainly getting oriented with the fund's existing investments and simultaneously building my network for new investment opportunities. I also started learning more on topics foreign to me, such as what defines social impact and how to source investments within a social criteria.

By my second year, I had become heavily integrated into the impact investing industry. I was in the field every few weeks, combining trips to work with the Oasis Fund's portfolio companies, meeting with new companies for potential investment, and conducting due diligences for companies that had progressed through the investment process. I regularly attended and sometimes hosted industry events such as general and sector-specific conferences, dinners, and talks. The second year culminated with successfully sourcing and closing two investments for the Oasis Fund and joining the board of directors for two of its existing portfolio companies.

In what would be my final year with the Oasis Fund, I was promoted to senior investment manager and started working on new fund strategy and fundraising. Those tasks and responsibilities provided a more encompassing perspective on the industry. However, over the course of that last year, I encountered undercurrents of problems that I felt were systemic in nature. Difficulty sourcing investments that met most investors' social criteria was a theme that echoed across my peers. This led to very competitive situations where some nontraditional investors took approaches that lacked rigor and led to inflated valuations. With costs of capital near zero for these entities, the problems could be sustained, but ultimately, it was no longer commercial investing at that point, but a charitable intermediary.

There is efficacy in the models in between commercial investing and pure charity, but the scale is restricted by the sources of capital. Unlocking consistent sources of capital from pension funds, insurance companies, and traditional investors requires a meticulously designed investment thesis that is executed professionally, from sourcing to exit, and provides reliable, measurable financial and social returns. I believe that in order to build the desired volumes for a replicable, scalable investment model, there will have to be different social criteria for varying financial return expectations.

Creating investment portfolios that deliver such financial returns and demonstrate that a specific social impact has been generated is what will define entities in impact investing. This is why the brunt of this book and the electronic files accompanying it focus on the investment process and social impact measurement. There are many publications available that have striking images of rural villagers using innovative technologies and compelling stories of impact-oriented companies, but these are largely motivational and show basic causality. It's the day-to-day tasks of impact investors—which involve accounting, corporate finance, valuation, statistical measurement, and social metric analysis—that are the most difficult, but the most important.

Although I left impact investing as a full-time endeavor because of some of these issues, I remain committed through select investments in solar and energy efficiency that my current position allows for and pro-bono work with impact investing entities. I anticipate a full-time return at some point. In the interim, I can offer this book that tries to address proper investment execution and social impact measurement. As with any of my books, I stand behind the learning process and offer my email directly if you have questions: keith.allman@enstructcorp.com.

Keith A. Allman

New York 2014

I have had the privilege of walking the narrow streets of Mumbai slums and speaking with micro-entrepreneur women whose endurance and creativity merit recognition and respect. I have also heard businesspeople in luxurious offices in Geneva argue that it is not possible to build an ethical gold supply chain. Impact investing builds a bridge between apparently disconnected realities. Impact investing is the promise of channeling private capital to solve intractable social problems while delivering impact, inclusion, and sustainability.

But, is impact investing delivering on its promise? Keith Allman's kind invitation to be a contributing author of this book sparked a desire to share the lessons learned by Bamboo Finance on the importance of adding rigor and accountability in defining, measuring, and assessing impact. Even if we are only at the beginning of the learning journey, we follow from due diligence to exit a responsible investment process aimed at delivering impact.

The impact promise begs for more accountability. Too much money has been deployed with little analysis on effectiveness. Impact investing marries the rigor of the industry of investing with the (nascent) rigor of impact measurement. If impact investing wishes to deserve its name, it needs to be evidence-based investing. Building evidence on what works and what doesn't requires a collective effort. The broader the participation is, the richer the learning will be. The voices of customers at the base of the pyramid, on whose behalf we too often speak, are central to our learning. Also, the entrepreneurs, investors, and academia need to join the conversation. This book seeks to contribute to that learning. I am grateful for the opportunity and excited to read your reactions.
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Ximena Escobar de Nogales

Geneva 2014

## A NOTE ABOUT THE WEBSITE

Readers will find professional-level investment material on this book's website: www.wiley.com/go/impactinvestment. See the appendix for more details.

# Acknowledgments

While impact investing demands a large body of financial knowledge, it would simply be traditional investing without the social impact analysis. I'm thankful that Ximena joined this project to provide her expertise in social impact and be the counterweight that allows this book to cover the full spectrum of challenges and solutions for impact investment.

Also, while I identify the inception of my work in impact investing many years ago through Relief International, it was my work with Bamboo Finance that accelerated my understanding of direct investments and industry-wide issues. I'm thankful for all of the collaboration, discussion, and engagement with Jean-Philippe de Schrevel, Christian Schattenmann, Eric Berkowitz, Keely Stevenson, Natalia Mouhape, Florian Ulmer, Ana Maria Aristizabal, Marlene Mueller, Elvira Espejo, Anu Valli, and Geetali Kumar.

Finally, it's been three years since I've worked with the team at John Wiley and Sons and I still can't thank them enough for the opportunity to publish on their platform and work with their talented staff. In particular, Bill Falloon has worked with me throughout the years and is a great sounding board for ideas and bringing a concept to reality. I'm also very thankful of the work Meg Freeborn, Helen Cho, Maria Sunny, and the rest of the Wiley team completed.

Keith A. Allman

New York 2014

Many people have contributed to the learnings and insights on impact management shared in this book. I am particularly grateful to the individuals whom this industry seeks to serve. In a quest to better understand their needs, we often intrude in their lives. They generously allow us in, even when our “studies” do not always result in gains for them. Thanks also to our investee companies who help us seek evidence of what products and distribution models deliver the expected impact.

Much of my learnings on impact investing come from over four years at Bamboo Finance, and I am most grateful to Jean Philippe de Schrevel, whose tenacious belief in the power of private capital to solve intractable social problems inspires many of us in this industry. I am also thankful to my colleagues at Bamboo Finance and in particular to Sarah Djari, Ana Maria Aristizabal, and Anu Valli for many hours of engaged discussions on identifying, measuring and expanding impact, and to Tracy Barba, for helping us articulate our achievements and challenges.

I have also benefited from the insights of industry-wide social performance and impact management initiatives, specifically the Global Impact Investing Rating System (GIIRs), the Social Performance Task Force (SPTF), and the European Venture Philanthropy Association (EVPA). Many thanks to Neha Kumar, Olivia Muiru, Flory Wilson, Emmanuelle Javoy, Kelly McCarthy, Laura Foose and Lisa Hehenberger. On a more personal note, I would like to thank my daughter Camille for ongoing stimulation.

My greatest gratitude is to Keith Allman for having invited me to contribute to this book.

Ximena Escobar de Nogales

Geneva 2014

# Chapter 1
# Introduction to Impact Investing

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]

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
- 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 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 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. 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.

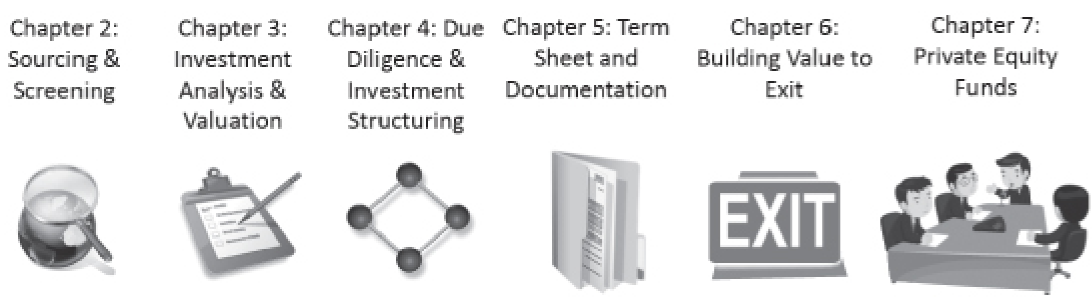


**Figure 1.1** This book generally follows the investment process that an investor would encounter.

## 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. 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 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