Making a difference while turning a profit

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OVERVIEW

Impact investing seeks to create both social and environmental change alongside a financial return, but can these two ever go hand in hand or is this just philanthropy by another name?

In today's increasingly interconnected world, people have become painfully aware of social and environmental issues around the globe. But heavily indebted governments are no longer able to tackle the world's needs, particularly in the aftermath of the 2008 financial crisis.

In this context, impact investing – a new form of financing for good works – has emerged, underlying a shift away from traditional political activity in favour of social and environmental change driven by investors and corporations working together, often in partnership with governments.

This investment approach acknowledges that philanthropy alone will never raise enough funding, as once the donor capital is spent, more has to be raised. In contrast, impact investing, a term coined in 2007 by the Rockefeller Foundation, leverages on the power of global financial markets to raise capital for projects, often start-up businesses, having the purpose of generating measureable social or environmental benefits.

Investments in these for-profit firms, which need to be sustainable and scalable, pay financial returns while meeting people's growing desire, particularly strong among younger generations, to create a better world, by generating an ongoing stream of revenue for worthy causes.

"The idea is not to be donor dollar dependant, that is the primary constraint in philanthropy," says Christina Alfonso, founder and CEO of Madeira Global, a specialist New York-based investment and advisory firm. "Impact investing is not seeking to replace traditional philanthropy, it's simply an alternative."

FAVOURED LOCATION

Almost 70 per cent of total impact investment assets are invested in emerging markets, according to GIIN and JP Morgan

While in the past there was a strong dichotomy between traditional investments looking to achieve a financial return and philanthropy, aimed at generating a social return, "impact investing is seeking to bridge that gap," explains Ms Alfonso.

There are different approaches incorporating environmental and social issues. Socially responsible investing (SRI) screens out certain sectors to achieve financial return and avoid social harm, and the environmental, social and governance (ESG) approach includes ESG risks as part of the investment analysis process.

"But impact investing offers a unique lens, as it integrates the intentionality of doing good, which is critical and more forward looking," says Oliver Karius, partner at LGT Venture Philanthropy. When the social mission is at the core of a company's core strategy, there are lower chances of a mission drift.

Impact investing is focused on allocating capital to innovative business models through early stage funding, explains Mr Karius. The large majority of vehicles available to investors in this space are therefore private equity or real asset funds.

GAINING TRACTION

Private banks are increasingly active in this space, launching products often in partnership with third party specialist fund managers, although there a few issues to address.

"Some of the challenges private investors face are illiquidity and perceived high risk, as most of the products invest in developing countries," says Mario Marconi, head of global philanthropy and values-based investing at UBS Wealth Management. Also, investment vehicles in this space have a short track record, and private equity funds are generally small, with most of them having just around $30m (€22.6m) in assets.

Lack of transparency, which determines an inefficient match between capital available and investment opportunities, sub-scale and lack of global initiative are all characteristics of a nascent industry, notes Mr Marconi.

Some social impact funds are so focused on a topic or country that is difficult to reach a significant size. Other funds can be larger, more global but "private money is still very shy to flow into the sector," he says, with the bulk of capital coming from governments, development agencies and foundations.

Two years ago, UBS launched a

TOP CHALLENGES TO THE GROWTH OF THE IMPACT INVESTING INDUSTRY

1	Shortage of high quality investment opportunities with track record
2	Lack of appropriate capital across the risk/return spectrum
3	Difficulty exiting investments
4	Lack of innovative deal/fund structures to accommodate investors' or portfolio companies' needs
5	Lack of common way to talk about impact investing
6	Lack of research and data on products and performance
7	Lack of investment professionals with relevant skill sets
8	Inadequate impact measurement practice

Source: GIIN, JP Morgan

social impact private equity fund of funds dedicated to investing in small and medium-sized enterprises (SMEs) in emerging and frontier markets, with a "strong social focus". The fund, which runs $50m in assets, is managed by Obviam, a Swiss specialist investment adviser, which is responsible for identifying local fund managers/partners.

To address the issue of illiquidity in the sector, Lombard Odier recently launched an open-ended social impact fund of private debt funds, offering monthly liquidity. "Illiquidity is a big stumbling block for many investors in this space," states Bertrand Gacon, head of impact investing and SRI at the Swiss bank.

Despite being lower in number, compared to private equity funds, private debt funds are attracting increasing inflows, explains Mr Gacon. Interesting products are found in microfinance or in the agriculture segment, where farmers' cooperatives in emerging markets for example need debt to achieve their social mission, and investment strategies in this space are fairly liquid. By attracting a large number of clients investing small amounts, the fund raised $100m in the first two weeks.

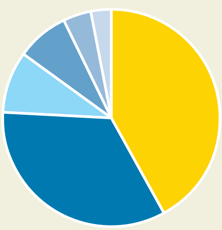
"One of the challenges in the industry is to move impact investing from the margins to the mainstream, and to make funds appealing to the large audience," says Mr Gacon.

Social impact funds are gaining traction in mature markets too. Last year Berenberg UK introduced a growth capital impact fund investing, Impact Ventures (IV) UK, in partnership with LGT VP, which manages it.

The key driver for the launch was "the emergence of social entrepreneurs and innovative business models, which focus on creating positive social impact for disadvantaged people and communities in the UK, and are designed to be very competitive and effective," explains Richard Brass, head of UK clients at Berenberg Private Banking and founder of IV UK.

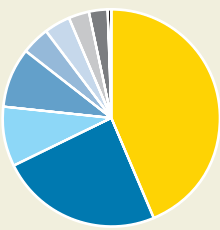
The fund, which has a target net annual return of 7 per cent and a capital lock-up period of up to 12 years, announced its first close last December after raising £20.8m (€26.1m) from investors, including £10m of cornerstone investment from Big Society Capital (BSC). Launched by the UK government in 2012, BSC is described as the world's first social investment bank, and with £600m of equity to be paid-in over five years it seeks to support the growth of a social investment market through supporting emerging funds and intermediaries in the impact investing space.

IMPACT INVESTMENT ASSETS BY INVESTOR TYPE*



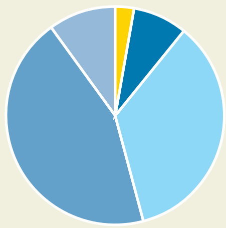
- Development finance institution 42%
- Fund manager 34%
- Foundation 9%
- Diversified financial institution/bank 8%
- Other 4%
- Pension fund or insurance company 3%

IMPACT INVESTMENT ASSETS BY INSTRUMENT



- Private debt 44%
- Private equity 24%
- Public debt 9%
- Equity-like debt 9%
- Real assets 4%
- Other 4%
- Deposits and cash 3%
- Public equity 3%
- Social impact bonds 0.3%

IMPACT INVESTMENT ASSETS BY STAGE OF BUSINESS



- Seed/start upstage 3%
- Venture stage 8%
- Growth stage 35%
- Mature, private 44%
- Mature, publicly traded 10%

** While family offices/HNWIs contribute just 0.2 per cent of total impact investment assets, they represent the second largest investor group for impact investment fund managers (17 per cent), after pension funds and insurance companies (22 per cent)*

Source: GIIN, JP Morgan

BEYOND PHILANTHROPY

"It is important to discuss with clients how they want to see their money being deployed, and not just their long term return and risk appetite," says Mr Brass. "Investors could look at giving money away or find ways to give back without giving away. I don't think you need to be a bona fide philanthropist to be interested in social investments," he believes.

However, impact investments are often believed to be just an extension of philanthropy. "Families and foundations invest in this space out of the money they would otherwise give away, and in line with their philanthropy interests," notes Rebecca Eastmond, head of philanthropic services JP Morgan Private Bank in EMEA. "Impact investment is adding another tool to the box of philanthropists, and often is believed to offer a very good way to achieve the social aim investors want to achieve."

The global bank is currently running a

ONE OF THE CHALLENGES IS TO MOVE IMPACT INVESTING FROM THE MARGINS TO THE MAINSTREAM

Bertrand Gacon, Lombard Odier

series of impact investment breakfasts, so that clients can meet other impact investors and build up their knowledge. "We feel our role is to educate our clients, to give them opportunities to understand what impact investing is, where impact investments might work, the new trends and developments in the market," she says, explaining the bank also facilitates meetings with fund managers in this space.

Illiquidity is not necessarily a deterrent for clients, believes Ms Eastmond. As the market grows and develops, there will be more types of investments, and more exits and success stories will help the market to build as well. Also, people move from giving to investments, but with philanthropy offering zero financial returns, "locking the money up for a long time is not such a big leap," she says.

FINANCIAL RETURNS

While one of the hot debates in the industry is whether impact investing should be considered a separate asset class or a new investment style, the issue is that "returns from social investments are generally significantly lower, because they are prioritising social return, although there are a few standout examples in the other direction," notes Ms Eastmond.

But the concept of an inevitable trade-off between social impact and financial return is not widely accepted in the industry.

The fact that there is no single agreed upon industry definition of impact investing also contributes to the confusion.

There is no major difference between sustainable and impact investing, if capital is put to work in a way that has financial but also social and environmental return considerations, believes Colin le Duc, partner of UK-based sustainable investment firm Generation Investment Management. This is regardless of whether investments are made with an explicit outcome impact in mind.

The firm's impact investing activity is focused on areas that help with reducing social inequality and slowing down environmental destruction. This means, for example, investing in renewable energy companies, or in firms that ensure cheap access to healthcare, providing low-cost drugs or medical devices to poor communities. These companies are able to penetrate markets they would not otherwise be able to get into, and therefore no change in the return profile is expected, says Mr le Duc.

"While there are impact funds out there that are very explicitly compromising financial returns to higher social returns, we are not compromising financial returns," he states.

Over the past couple of years, the low-income consumer story as a multi-trillion market opportunity has drawn considerable interest from asset managers in the industry, according to UBS. In the healthcare sector for instance multi-million dollar scanner machines are being designed with less features at a fraction of the cost of standard machines, and sold into low-income countries. In the education sector, investment opportunities are found in operators of low-cost private schools in poorer communities, in countries such as India. The revenue model of these businesses is based on the fact that low-income families are ready to pay a small fee for their children to gain access to quality education.

YOUTHFUL ZEAL

The desire to strive for social good is particularly strong in the youngest, with 75 per cent of those under 40 citing driving social impact as either extremely important or very important, according to according to this year's World Wealth Report by CapGemini and RBC Wealth. Although no single mechanism for achieving social impact stands out, making investment choices with a clearly defined objective to create positive social impact was rated as the most important, beating out the more commonly accepted mechanisms of charitable donations and volunteering

Investors should not have to give up on financial returns in order to achieve either social or environmental outcomes, maintains Madeira Global's Ms Alfonso. "There must be integrity in the assessment of the expected financial return of any investment before we consider its social impact," she states.

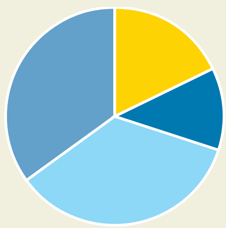
In conjunction with New-York based hedge fund Brevet Capital Management, Madeira recently launched an investment vehicle

FACING THE CHALLENGES

Shortage of high quality investment opportunities with track record and lack of appropriate capital across the risk/return spectrum are the most limiting characteristics of the market today, according to the latest impact survey by JP Morgan and GIIN, the non-profit organisation launched formally in 2009 dedicated to increasing the scale and effectiveness of impact investing (see table p26).

Another major challenge in social impact investing is impact measurement and one of the key initiatives brought forward by GIIN is the development of a standardised framework for assessing social and environmental impact, called Iris (impact reporting and investment standards). Today this is recognised as the leading standard in the impact investing industry.

TARGETED NET INTERNAL RATE OF RETURN OF IMPACT INVESTMENT FUNDS



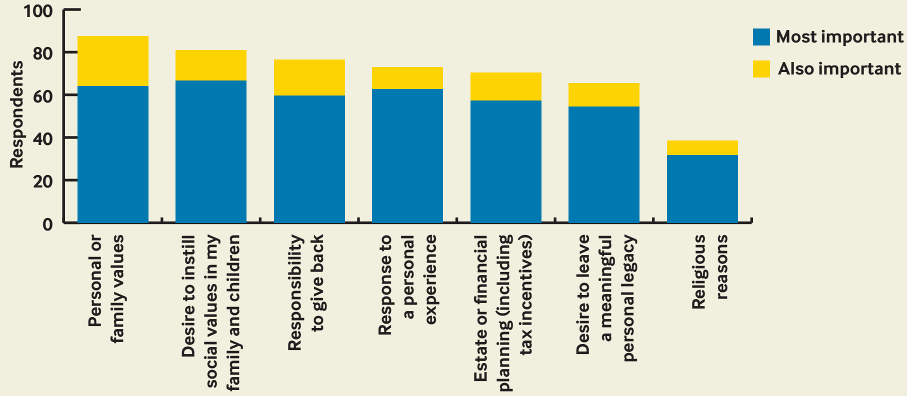
Less than 6% (18%)
6% to 10% (12%)
11% to 20% (35%)
Greater than 20% (35%)

Source: GIIN, Impact Base, Deloitte Analysis

THERE MUST BE INTEGRITY IN THE ASSESSMENT OF THE EXPECTED FINANCIAL RETURN OF ANY INVESTMENT BEFORE WE CONSIDER ITS SOCIAL IMPACT

Christina Alfonso, Madeira Global

IMPORTANCE OF KEY DRIVERS OF SOCIAL IMPACT FOR HNWIS



Source: Capgemini, RBC Wealth Management and Scorpio Partnership Global HNW Insights Survey 2014

consisting of short duration collateralised loans to middle market companies in six social and environmental impact areas.

"A short duration vehicle is probably the easiest way to unlock the larger pool of capital that investors are willing to allocate to this space, by ensuring they have a positive first experience," says Ms Alfonso.

At Rockefeller & Co, the US-based multi-family office, public equities can be an effective means to pursue impact investments for positive social outcomes. The boundaries between philanthropy and investments are clear, says Joyce Haboucha, director of sustainability at the firm. Clients are looking to have a return on their equity investments, but also want to make an impact in the world.

"We believe impact investing can be achieved through select investments in public equities that provide opportunities for purposeful engagement with management on social and environmental concerns relating to a company's business."

These conversations may include discussions about how to become more resource efficient by reducing a company's carbon footprint and greenhouse gases, for example. In other instances, discussions may focus more on human capital and supply chain management issues, including the establishment of appropriate human rights policies and practices, as well as the importance of being responsive to the communities in which a business operates.

While the purists in the industry do not agree on considering big corporations as eligible for high impact strategies, as the social mission is generally not at the core of their business model, lines today are increasingly blurred, with some large firms such as Siemens and Danone even spinning off some high impact social businesses.

In the private banking space, clients are increasingly asking for the environmental, social and governance issues to be taken on board in investments, says Sarbjit Nahal, head of thematic investing and ESG Strategy at Bank of America Merrill Lynch. "You have got the full spectrum of clients, some prioritise social and environmental impact over returns, but the majority are looking to strike a balance between the two," he says.

There is a broad demand for social impact private equity funds but also mutual funds, ETFs, bonds, community investment trusts, popular in the US, alternative investments as well as social impact bonds.

The bank's wealth management business in the US created a 'green shelf' which offers more than 180 ESG-themed investments which cut across that broad spectrum, reports Mr Nahal. "We have tried to create a broad portfolio in this space, as people are approaching impact investing from such a wide variety of angles depending on their personal belief, investment perspectives or time horizons." ●

REACHING ITS POTENTIAL

Since the term was first coined in 2007, many leading proponents of impact investing have estimated the potential size of the sector. In 2009, the Monitor Institute estimated that the impact investment market could potentially reach \$500bn (€376bn) by 2020, or 1 per cent of total managed assets, estimated at \$50tn. In 2010, JP Morgan and Rockefeller Foundation estimated that the impact investment sector could reach \$400bn to \$1tn by 2020.

At a present conservative market size of approximately \$25bn, the impact investment sector will need to grow by approximately 53 per cent annually to reach \$500bn or 69 per cent annually to reach \$1tn by the year 2020. This will be a potentially difficult achievement given that the sustainable investing market in the US grew by 11 per cent per year since 1995, according to a study from the World Economic Forum.

"What we need in the sector are more 'lighthouses', ie shining examples of what impact investing is all about," says Oliver Karius, partner at LGT Venture Philanthropy.

"We need to showcase what is actually possible, because ultimately impact investing has to become more attractive for mainstream investors."