chapter 1. **OVERVIEW OF IMPACT INVESTING**

chapter 2. **BUILDING THE CASE FOR IMPACT INVESTING**

PART I

understanding what it is

an introduction to impact investing

Understanding impact investing can seem a more difficult task than it really is. Someone new to the topic may be overwhelmed by overlapping concepts, from sustainable and responsible investing (SRI) and the triple bottom line, to venture philanthropy, and corporate social responsibility (CSR). This first Part of the Guide consists of two chapters and aims to provide a brief, but comprehensive, overview of impact investing, demystifying this approach. Chapter 1 will clarify terminology and explain impact investing based on its key elements and scope. Chapter 2 will discuss why addressing societal challenges through business and investment can work.

chapter 1. OVERVIEW OF IMPACT INVESTING

1.1 DEFINITION AND KEY CRITERIA

What Is Impact Investing?

Definitions of impact investing are numerous and evolving, which does not help someone new to the field to get a clear understanding of it. The following is one of the most commonly used definitions[1]: *Impact investments are investments made in companies, organizations, and funds, with the intention of generating social and environmental impact, alongside a financial return.*

Whatever the exact definition, it is generally accepted that impact investment can produce two types of return simultaneously — social and financial (here and later in the Guide, the term 'social' will mean social and/or environmental). How is it possible to achieve two sets of returns? Impact investors provide capital to companies that use entrepreneurial mechanisms to address various global challenges. They may provide affordable educational loans for low-income students, irrigation systems that double the yields of smallholder farmers, or healthy, affordable school lunches that help fight obesity among children. These enterprises develop innovative business models around particular social or environmental issues, where business activity itself produces the desired impact. Unlike a traditional business (targeting creation of only commercial value) or a traditional charity (producing only social value), these enterprises are able to combine creation of both types of value, and are, therefore, able to provide their investors with both social and financial returns. In this Guide, such organizations are called *impact-generating or impact-driven enterprises*, but they are also sometimes referred to as *shared-value* businesses or *social enterprises*.

> «Impact investments are investments made in companies, organizations, and funds with the intention of generating social and environmental impact alongside a financial return.»

WHAT DOES IMPACT INVESTING COVER?

Impact investing covers a broad range of sectors, regions, types of company, and financial instruments. It may constitute a simple cash deposit in a community development bank in the US; an equity stake in a social enterprise in the Philippines; or an investment in a fund that develops organic farms in New Zealand. The following sections of Chapter 1 will aim to give the reader an idea of the breadth of impact investing.

WHAT ARE THE KEY CRITERIA?

Given how much seems to be covered by this concept, you may be asking yourself: How can I easily recognize an impact investment opportunity? How different is it from my current investments? Does a private equity fund in an emerging market count, or perhaps a pharma company stock, or a bond issued by a chartered school?

These are all good questions. We've already established that impact investing is an approach that pursues two objectives: social impact and financial return. While the type of impact and extent of return targeted by each individual impact investor varies, three criteria need to be in place for the term *impact investment* to apply: *intentionality, measurable impact*, and *positive financial return.*

A. INTENTIONALITY

Investor intention to address a specific social challenge through investment is a defining characteristic of impact investing. This means that impact investors base their decision to invest in a company on its ability to deliver specific *outcomes* (see the box at the top of the next page for definition). These outcomes are diverse — to increase access to education or affordable healthcare, to mitigate the effects of climate change, to reduce homelessness, or to provide quality employment for people with disabilities, for example. Whatever the impact objectives in a particular instance may be, the target company's perceived ability to achieve those objectives is a core criterion in the selection of impact investments. **The investee intention is an important, but not a necessary, condition.** If an impact-neutral company has developed an effective solution to a particular social or environmental challenge that the investor wishes to address (for example, an innovative education software start-up), investment in this company may be considered an impact investment, if it is driven by the investor's desire to support such a solution.

What is excluded?

Investments or investors supporting impactful businesses without specifically targeting impact are disqualified from being called impact investors/investments. For instance, if an investor allocates capital to the same educational start-up solely on the basis of its commercial potential, this does not constitute an impact investment. Why? Because the investment was not motivated by the desire to generate impact. Similarly, even if it provides employment opportunities, a commercial investment made in an emerging market fund does not qualify as an impact investment, unless the investor is actively aiming for job creation and selects this fund for its ability to deliver on this outcome. While not labeled as *impact investments*, the above two cases may, of course, generate significant impact.

Figure 1.1: Core Criteria of Impact Investing

INTENTIONALITY
Investments are motivated by the intention to create a social or environmental good

IMPACT MEASUREMENT
Social/environmental performance is measurable and measured

FINANCIAL RETURN
Return ranges from return of capital up to market returns

OUTPUTS, OUTCOMES, AND IMPACTS

The ability of an investee company to produce impact is at the core of impact investing. The impact value chain is discussed on p.31, but it is useful to distinguish here between the three defining terms:

Outputs: The products and services delivered by the company (for example, number of solar lamps sold).

Outcomes: Changes/effects on individuals/environment resulting from outputs (for example, additional income/savings and increase in exam pass rate resulting from the use of solar lamps).

Impact: The longer-term, deeper change resulting from outcomes (for example, improvement in the quality of life of target populations as a result of additional savings or better education).

B. IMPACT MEASUREMENT

Impact investments are characterized not only by the intention to generate positive impact, but also by the **commitment to measure, evaluate, and manage the investment's impact performance.** Impact assessment helps ensure transparency and provides assurance that the intended impact is indeed taking place. More importantly, it can facilitate the achievement of that impact by focusing the company on outcome targets and holding it accountable for reaching them. Impact measurement can easily become complex and expensive, requiring investors to balance the depth of assessment against its cost and burden on the investee companies.

What is excluded?

Investments that produce positive, but not measurable, impact do not make the cut. This excludes most screened SRI investments (see the box at the bottom of the page). Let's take, for example, purchase of shares of a public company that, alongside traditional products, has developed a fortified baby milk powder, sales of which are likely to have a significant social impact. While investors can 'feel' that the impact is there, **they won't be able to quantify it and trace it to their investment,** which is likely to go into a general pool of corporate capital. If, however, an investor buys a corporate green bond, this will qualify. Why? Because the public company will use bond proceeds solely to fund measures that reduce its carbon footprint and will commit to measuring the environmental impact achieved.

C. FINANCIAL RETURN

Impact investment is a financial instrument, not a grant — investors expect to get their initial investment (*principal*) back. In addition to this *return of* capital, impact investors also target some *return on* capital, or profit, which may range from zero (in the case of an interest-free loan) to a market return.

What is excluded?

Grants are not considered impact investments, nor are examples of venture philanthropy that do not target at least a recovery of the invested capital.

Sustainable and Responsible Investing (SRI) is the practice of incorporating environmental, social, and governance (ESG) factors when making investment decisions. Approaches include negative screening (excluding harmful sectors, such as tobacco or arms manufacturing), shareholder activism, positive screening (investing in sustainability leaders), and thematic investing (investing in such sectors as water, renewables, and energy efficiency).

Venture philanthropy applies venture-capital tools to support social-sector organizations through grants and investments.

1.5 INVESTMENT INSTRUMENTS

Is Impact Investing an Approach or an Asset Class?

While, originally, some investors argued that impact investing should be regarded as an emerging asset class, there is a growing consensus in the market that it is better described as **an investment approach that spans various asset classes.** Indeed, impact investors have at their disposal a broad range of investment instruments, each of which has different implications for the investee company, different return expectations, and a different level of risk.

CASH

Investors often do not associate the cash held in bank accounts with impact investing. But, whether you have a two-year certificate of deposit, or a current account, the bank is investing your money. The simplest form of impact investment is moving part of your cash to a community bank, credit union, or 'sustainable' bank. In these institutions, your money will be used to provide funding for social enterprises, responsible consumer lending, affordable housing, or sustainable agriculture.

FIXED INCOME

There are many opportunities in this space. These include green bonds issued by governments, corporations, or multilateral banks; bonds issued by social enterprises or charities; as well as investments in microfinance or social enterprise loan/bond funds. Loans to impact-generating private businesses could also be included in this category.

PUBLIC EQUITY

There are few listed social enterprises, but thematic listed strategies start to track the impact of the portfolio. There is also a handful of listed Microfinance Institutions (MFIs) and community development banks. Further, the Social Stock Exchange in the UK has listed some public companies on its platform that meet its criteria for 'social-impact business.'

HYBRID INVESTMENTS

The hybrid/absolute-return space has received a lot of attention recently, with the emergence of social impact bonds (SIBs) and development impact bonds (DIBs), which span different sectors and geographies. Other examples are vaccination facilities and hybrid debt/equity microfinance, Small and Medium-Sized Enterprises (SMEs), and agriculture funds.

> **WHY CLASSIFICATION MATTERS**
>
> A typical way of managing a financial portfolio is by splitting it into several asset classes (types of investment), in order to diversify risk. This process, called a Strategic Asset Allocation (SAA), is the backbone of modern portfolio management. If you consider impact investing as a specific asset class, you will only be able to allocate a small portion of your portfolio to it, in order to preserve the target diversification. If, however, you can regard impact investment as an approach that can be practiced across asset classes, you can achieve significantly higher overall allocation to impact-generating investments, while still remaining diversified based on your target SAA.

PRIVATE EQUITY

Private equity is the most active asset class, with ample opportunities to invest, both directly and through investment funds, which operate in various regions and target a broad range of impact themes.

REAL ASSETS

A diverse set of opportunities in real estate, including affordable housing, green real estate, and social-purpose real estate, provides impact investors with exposure to this asset class. A growing range of investment opportunities is also available in forestry and land, which includes sustainable management, land remediation, and conservation features.

See pp.88 and 89 for examples of investment opportunities across asset classes, regions and themes, and p.91 for an explanation of SIBs.

Figure 1.5: Impact Opportunities across Asset Classes

CASH	FIXED INCOME	PUBLIC EQUITY	HYBRID	PRIVATE EQUITY	REAL ASSETS
Certificate of deposit in a credit union or a community development bank	Debt microfinance fund; green or charity bond; social enterprise bond or debt fund	Shares of a listed microfinance bank, charter school, or social enterprise; thematic strategies	Renewable energy project; social impact bond; debt/equity agriculture, or microfinance fund	Equity in impact-generating enterprises (direct or via fund)	Affordable housing; social-purpose real estate; land conservation, organic farming (direct or via fund)

1.6 INVESTING DIRECTLY OR VIA INTERMEDIARIES

Do I Need to Manage My Impact Investments Actively?

Impact investors can choose the degree to which they are involved in selecting and managing the investments. **As with traditional investments, impact investors can place the capital either directly or via financial intermediaries** (see Figure 1.6 for description of the mechanics of investment).

WHAT ARE THE OPTIONS?

Direct investing: Allocating capital in the form of debt, equity, loan guarantees, etc., directly to impact-generating enterprises, for example, a company that sells drip irrigation to farmers or manages a chain of affordable hospitals (option 1 on Figure 1.6). There is an abundance of direct investment opportunities available in the market, but they require careful analysis and structuring.

Investing in a fund (option 2 on Figure 1.6) that will make a number of direct investments in impact-generating enterprises, according to its investment strategy (see Appendix 4 (section 4.1) for an explanation of how a typical fund works). A broad range of impact investment funds currently operates in the market across multiple impact themes and geographies (see www.impactbase.org for a listing of over 380 impact funds).

Investing in a fund of funds (FoF), another form of intermediary (option 3 in Figure 1.6). An FoF will invest in a number of funds, which, in turn, will make direct investments, ultimately providing you with indirect exposure to over 100 businesses. There are only a few impact FoFs currently available in the market.

Distinct mandate: Giving a specific mandate to an asset management company, which may invest both directly and through intermediaries on your behalf.

HOW DO INVESTORS CHOOSE?

The investor's choice to invest directly or through an intermediary will depend on a number of factors, including:

Resources and skills: Direct impact investing requires specific experience, proximity to the investees, and, often, a hands-on approach during the holding period, which is time and resource-intensive. Fund investing provides an opportunity for significant impact without the requirement of active investment monitoring.

Target impact: Investing via intermediaries results in limited control over which specific investments are being made. Direct investments allow a more precise match between the impact objectives of investors and the outcomes targeted by the investees, as well as an opportunity to influence/add value to investees.

Diversification and cost structure: A fund or FoF investment increases portfolio diversification, and, therefore, reduces overall risk. However, investors will need to pay fees, which reduces net return. In direct investing, investors will not need to pay fees, but the cost of internal resources will be higher and diversification lower.

See Appendix 2 for a comparison between investing directly and via intermediaries.

Figure 1.6: Investing Directly or via Intermediaries