PART IV

taking the plunge

impact investing in practice — the process

Once you have decided on a strategy, built a team, and developed your operating processes, it is time to begin investing. Part IV describes the particularities of the impact investment process. It focuses on private equity and debt investing, given that the majority of impact investments are currently executed in these asset classes. Further, private impact investors tend to have a greater affinity with and higher degree of personal involvement in these investments. Chapter 13 will focus on direct investing and Chapter 14 on investing through intermediaries, such as funds. Chapter 15 will summarize the most common mistakes made by private investors (and how to avoid or mitigate them). And, finally, Chapter 16 examines the specificity of investing for impact in emerging markets, which represent an area of great interest to both local investors and those from developed markets.

Note on how to use this part: It would take a separate book to explain in detail the entire impact investment process. Therefore, this Part focuses on identifying the key particularities of impact investing, as well as practical tips from, and lessons learned by, impact investors. To help those who are new to investing in general to benefit from this rather technical part, the reader will often be referred to the Appendices (end of the book), which contain basic concepts of the traditional investment process. Those who would like to go deeper into the impact investment process and/or are ready to apply it in practice will find additional information and resources in the Tools & Resources section (in the middle of the Guide).

13.2 DUE DILIGENCE

Assessing the Merits and Risks of Investment Opportunities

Sourcing/Screening → **Due Diligence** → Structuring/Terms → Investment Management → Exit

Due diligence is the process of in-depth analysis and investigation of a potential deal, after it has been screened and confirmed to fit the investment criteria. The summary of the traditional process and the key methods are provided in Appendix 3 (section 3.2).

PARTICULARITIES OF IMPACT INVESTMENT

Comprehensive analysis: Impact investment due diligence is broader than that applied to traditional investment, as it **includes a thorough assessment of the ability of the investee to generate target impact.** The financial analysis follows the traditional investment process in its depth and scope, but takes into account the realities of the impact investment market and models. Management and co-investor analysis cover both impact and financial aspects and are of particular importance in impact investing.

Higher complexity/cost: Impact investment due diligence is **an intensive, resource- and time-consuming process**. The addition of impact analysis adds to the scope of the work, and innovative business models often provide only a limited amount of information, which, coupled with the small investment sizes, makes balancing the need for thorough analysis and manageable due diligence costs tricky.

Use of external help: Given the broader scope of the impact investment process and the diversity of impact investors, some investors **outsource significant parts of the due diligence process to external service providers.** In the case of foundations, it is typically the financial due diligence that is outsourced, while FOs may outsource impact assessment. Further, as in traditional venture investing, experts may be engaged to help on specific aspects of due diligence (such as technology, tax or legal).

Partnership approach: Many impact investors think of due diligence as an **opportunity to strengthen the investee enterprise, even if they decide not to invest**. They spend time brainstorming solutions to problems, suggest areas where they would be able to help, and refer entrepreneurs to other investors, viewing this as their contribution to building the ecosystem for impact-driven enterprises.

The summary of the four core areas of impact investment due diligence (*impact, financial, management, and co-investor*) is provided in the following pages.

TIPS

1. **Be rigorous:** Many private impact investors recall not being sufficiently thorough in conducting due diligence, which led to a higher failure rate. Apply the same amount of rigor as you would to a traditional investment (on the financial side) or a traditional grant (on the impact side).

2. **(Get to) know the field:** Understand the cultural, political, and regulatory landscape, especially when investing in emerging markets. While desktop research and analysis are important, time spent on the ground visiting the site and meeting the management team and potential customers is invaluable.

3. **Bring key issues up early:** Identify deal-breakers and confront management with these right away. For example, many impact investors report that some social enterprises are inherently against paying investors an appropriate return, in spite of the profitability of the business, so it is better to address these issues before spending months on due diligence.

4. **Collaborate:** Coordinate due diligence with co-investors, to reduce cost and the burden on investees. Act with integrity throughout the process and look to establish a relationship of trust with the entrepreneurs, making them comfortable in discussing real issues, as opposed to simply pitching to you.

5. **Follow your gut feeling:** If something does not feel right about an investment, make further checks. Many investors report that they had a hunch that an investment was going to fail, which eventually proved correct, despite acceptable results from the due diligence.

6. **Maintain objectivity:** It is easy to 'fall in love' with an impact investment opportunity. Follow a disciplined process and set up an effective governance system (for example, use team members not directly involved in the deal, or an external IC member, to vet the investment).

WILLEMIJN GELDORP, NETHERLANDS

an unlikely angel

«You don't have to be super-rich to invest for impact. You need to stay close to the issues you feel strongly about and then find the opportunities that match your investment capacity and skills.»

Willemijn Geldorp grew up in a village in the Netherlands, where her father owned a nearby industrial business. Being part of the family did not automatically entitle Willemijn to a position within the family business — she and her brother were expected to gain external experience first. After college, Willemijn joined Shell and went to Ecuador. There, she invested in, and became a partner in, a start-up manufacturing hand-made furniture for export, before returning to Europe.

A DREAM CAREER

As time went by, Willemijn was torn about joining the family business. She had always felt that contributing to the machine behind the family wealth was a responsibility that came with the benefits of her inheritance. But running a mature business was not that exciting — her preference was for early-stage, dynamic enterprises, with room for creativity and exploration. She was also unsure if working with her brother, who was managing the business by that time, would be good for family relations. All things considered, Willemijn decided against joining.

During her MBA studies, she was struck by the concept of the social enterprise. Being involved in a business with a social mission seemed like a dream career, but she was still stuck in her 'deferred life plan:' 'I thought I should first make money and then focus on social activities,' she explains. 'I felt the need to earn the right to do what I really wanted, to deserve it.' Planning to switch to social causes later, Willemijn joined the eyewear giant, Luxottica. Three years later, she felt her long-held vocation pulling her away. Furthermore, she realized, there was no real reason to wait. She left the company and started to network in and around the social-enterprise space.

INVESTING AS A MEANS TO AN END

Living in London at that time, Willemijn attended conferences for social entrepreneurs, where she met a nurse who had built up Parents 1st, a program supporting vulnerable expectant couples. The organization needed funding and mentoring, which sparked Willemijn's interest. She joined the company as a non-executive director, and helped the founder refine the business plan, enabling her to raise additional funds: 'I was able to offer my time, because I had the funds to support myself, while reinventing my career,' notes Willemijn.

Willemijn also decided to join Clearly Social Angels, a network of like-minded early-stage impact investors (see p.126 for more info). As well as a degree of guilt about using her inherited wealth, Willemijn doubted her ability to be a good investor and to add value to companies. So, it surprised her to notice that, while she needed time to learn the investment terminology, she often had a firmer grasp of the key business drivers than her more 'financial' colleagues — her business background had prepared her well to add value to young, impact-driven enterprises.

FINDING HER DREAM

One such company was Eyejusters, a business that aims to increase access to affordable eyeglasses in developing countries where trained optometrists are lacking. It developed a special, adjustable-focus lens that can fit into normal spectacle frames. Willemijn made a £20,000 investment and decided to join the company. The fit was serendipitously perfect — not only did Eyejusters have a strong social mission, but it was also in the eyewear industry, which she knew well. Having joined a technology-driven founding team, she used her commercial experience to strengthen the business model, making the company more investable. In the meantime, Willemijn's father learned about Eyejusters, was convinced by the company's commercial potential, and impressed by its mission. Typically reluctant to invest in start-ups, he joined the next investment round and has committed £400,000 in total. This was a positive surprise for both Willemijn and the founding team, who weren't aware of her family-business background.

MANAGING MODEST WEALTH FOR IMPACT

Willemijn continues to invest for impact, having allocated 25% of her annual income to the field — the amount she feels she can risk. Her salary at the social start-up is modest, and so she uses part of an annual dividend from the family business to support herself and her young daughter. She has now invested in five start-ups, putting in £10,000–£25,000 per deal. The rest of her wealth, which is below £750,000 at the time of writing, is managed conservatively in a pool of investment vehicles, which are loosely screened to align them with Willemijn's values. She would like it to yield more impact, but finds it difficult to do, being simply an affluent client of an independent wealth manager.

Although Willemijn's investment capacity is limited, by combining it with her skills and energy, she hopes to make a real difference. Finally, she has challenged the false dichotomy of her early years; she no longer feels the need to choose between social impact and financial success, and feels privileged, rather than being ashamed of her wealth. 'Impact investing has put me at ease with using my inherited wealth and has led me to my dream career. I am so excited to be part of a social venture I truly believe in!'

chapter 13. INVESTING DIRECTLY IN VENTURES

A IMPACT ANALYSIS

A key part of due diligence, impact assessment analyzes the potential impact that the investment can generate and the likelihood of that happening. It is rare that the potential investee company will be able to provide thorough, completely objective impact reporting, so you may need to carry out your own impact assessment or delegate the task to a specialist. Typically, impact analysis during the due diligence phase covers the following key areas:

IMPACT THESIS

What is the intended impact of the investee and how will it be achieved? During analysis, you will first need to understand the mission of the organization, the impact it hopes to achieve, and how it plans to go about achieving it. You will map the impact value chain of the organization, starting with its mission and going on to inputs, activities, outputs, outcomes, and impact.

See p.31 and p.168 on the impact value chain analysis.

IMPACT RISK

Impact risk is the **risk that the intended impact will not be achieved.** This can happen for various reasons — the theory of change may be flawed, management may deviate from the stated mission (mission drift), or simply fail to deliver on its targets. An investor will need to assess what could prevent the company from fulfilling its mission and how likely that is to happen. The key areas of analysis are:

Strength of impact thesis: Once you understand the impact plan, you need to assess whether it is compelling and realistic. You should try to find **evidence that the impact thesis is credible and that it is working**. The challenge is that you may be dealing with a novel approach and/or an organization that does not have a track record in generating the target impact. In this case, you can try to research whether this model has been used in other markets and to what degree it has been successful.

Best alternative: Understand the **competing solutions that have attempted to address the same problem**, and how likely each is to be successful in achieving the target outcomes.

Alignment of the business model: Is the company's business model a realistic mechanism to meet its impact objectives? **How strong is the likely tension between reaching profitability and generating impact?** If these objectives are at odds, it will be difficult for management to resist pressure, from the market and from investors, to perform financially, at the expense of impact. For some impact investors, strong tension may be a deal-breaker, while others will accept it and focus on managing it effectively after investment.

Mission protection: Especially if the potential tension between impact and financial objectives is significant, it is important to investigate ways of **protecting the company's mission**. This could be done by embedding it in the statutes, the governance structure, and/or branding strategy.

Check the subject paper of the Mission Alignment Group of the Social Impact Investment Taskforce called *Profit with Purpose Business* (2014).

Exit-route alignment: Is the target route to repaying investor capital and generating a return likely to endanger the mission of the company? A sale of equity stake to a traditional private equity fund or a trade buyer, not interested in impact generation, may endanger the mission of the company; while a loan repayment or a sale of equity back to management will not generate such a risk.

Alignment of management team/co-investors: Is management committed to generating target impact and are the co-investors aligned? These issues are discussed in sections C and D below (Management Assessment and Co-investor Analysis).

UNINTENDED IMPACT/ESG

In addition to the intended impact, it is important to assess the **impact of investee operations**. Here, the focus is on assessing the environmental, social, and governance (ESG) practices of the company. Essentially, investors want to avoid situations such as, for example, their social enterprise's paying low wages to its staff, being exposed to child labor in the supply chain, or using environmentally unfriendly production methods. In addition to impact of operations, **there is the risk of unintended consequences of the investee business model itself,** such as introduction of the subsidized products or services, which can disrupt local industries or markets. A good example is Toms Shoes, an enterprise operating under a *buy-one, give-one model*, meaning that, for each pair of its shoes sold in developed countries, it donates a pair of shoes to emerging markets. While its intentions were good, and intended impact clearly positive, it has been criticized for the unintended negative impact on the local shoe sellers, whose businesses can be diminished as a result of the influx of free shoes.

IMPACT TARGETS AND MEASUREMENT

Having understood the impact thesis of the company, you should be in a position to **determine the likely *scale* (number of people) and *depth* (degree of life improvement) of the impact it plans to generate**. You can work with your impact value chain table developed in the first step, and input the target numbers on the outputs and outcomes. You can now judge if the type/scale of impact is attractive to you and fits the impact objectives of your investment program, which were explained in Chapter 9 (as of p.162).

If you opted for a hands-off approach to investing, you will likely focus your analysis on the impact of your investee (enterprise impact). Alternatively, active investors who value *additionality*, also evaluate their own impact on the investee and broader industry *(investment and non-financial impact)*. Figure 13.2.2 provides a summary of the questions that can guide this analysis. Having established target enterprise impact, you will also explore whether/how the company is planning to measure its impact and, potentially, agree on the assessment approach at this stage.

Figure 13.2.1: Questions for Impact Assessment of Individual Investment

ENTERPRISE IMPACT	INVESTMENT IMPACT	NON-FINANCIAL IMPACT
Vulnerability of beneficiaries: How vulnerable or excluded are the beneficiaries, and how great is their need?	**Scale of investment:** What is the scale of your investment (relative to the investment round or size of the organization)?	**On investees:** Can you offer valuable expertise on financial and impact issues, and access to relevant networks?
Scale, capital-intensity: How many beneficiaries will be reached and what is the cost per head?	**Capacity building:** Will the investment grow the organization and its impact, and strengthen its financial position?	**On industry:** Will your investment have a broader impact on the sector/ecosystem by signaling demand or building the broader infrastructure of impact investing?
Depth of impact: How significant will be the improvement in their lives?	**Access to other/further capital:** Does the investee have other sources of funding? Is this a new type of investment to it? Is the investment likely to attract further capital from other sources?	
Wider impacts: Does the investee have an additional impact through awareness-building, advocacy, demonstration effect, or contribution to the local and national economy?		
Impact of operations: What are the environmental footprint of operations and employment conditions?		

Source: Adapted from *The Good Investor: A Book of Best Impact Practice* (Investing for Good, 2013).

See section 11.2 (from p.181) on developing an impact assessment methodology, p.118 for the list of outcomes, and pp.122–123 for an example of impact assessment methodology of Bridges Ventures. For further reading suggestions on this topic, see p.131.

TIPS

1. Be realistic about the impact that is achievable. Challenge the theory of change — this will help the entrepreneurs to think through their proposition and will avoid disappointment later on.

2. Strength of evidence: Be aware that there is an inverse relationship between innovation and the amount of evidence you will be able to collect on a potential investee.

3. ESG as a value driver: Investors are often so focused on the social mission of their investees that they tend to forget about the unintended consequences of investee operations. When undertaking the ESG analysis, look for opportunities to add business value. For example, addressing poor workforce employment conditions will likely reduce the turnover and the associated HR costs for the company and improve quality of services to beneficiaries.