IMPACT INVESTING
An emerging asset class

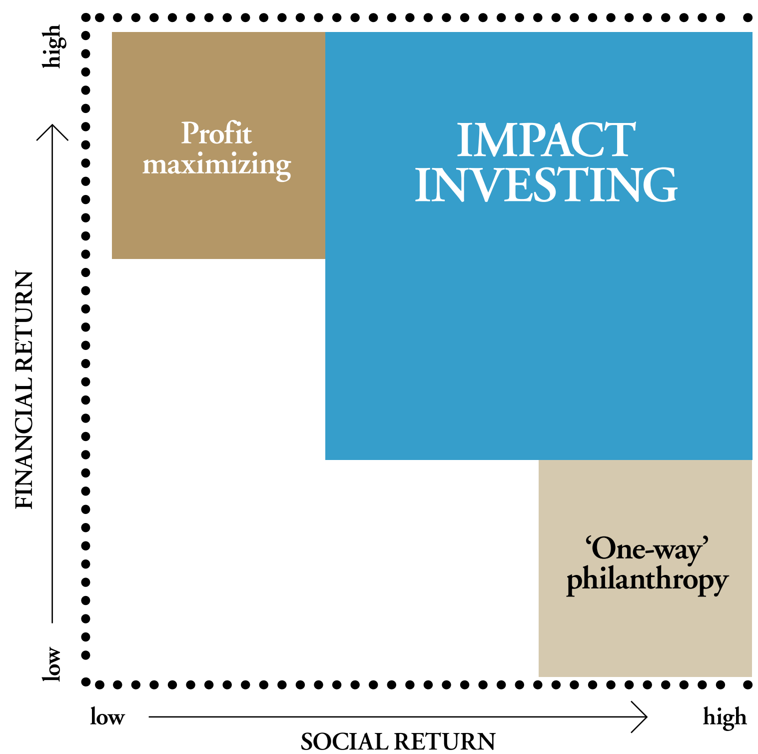
IN A WORLD WHERE GOVERNMENT RESOURCES AND PHILANTHROPISTS ARE INSUFFICIENT TO ADDRESS GLOBAL SOCIAL PROBLEMS, IMPACT INVESTING IS THE BEST NEW ALTERNATIVE FOR CHANNELING LARGE-SCALE PRIVATE CAPITAL FOR SOCIAL AND ENVIRONMENTAL BENEFIT. THE IMPACT INVESTING MARKET IS NOW ENTERING THE MAINSTREAM AND IS EMERGING AS AN ALTERNATIVE ASSET CLASS, FORCING INVESTORS TO RE-CONSIDER THE NATURE OF THEIR PORTFOLIOS AND START LOOKING AFRESH AT THE IDEA OF INTERSECTING 'MONEY AND MEANING'.

By Irene Demetriou

Impact investments can be broadly defined as investments made into companies, organisations and funds with the intention to generate measurable social and environmental impact alongside a financial return.

While certain types of impact investments can be categorized within traditional investment classes (such as debt, equity, venture capital), impact investments are generally defined by a double bottom line of giving profit and impact equal standing or at least paying considerable attention both to financial return and social and/or environmental impact. Impact investing should not be confused with socially responsible investing (SRI) or social entrepreneurship. Impact investing, unlike SRI or social entrepreneurial schemes, does not concern negative screening, which is used to avoid investing in projects which may likely cause a social or environmental harm. The underlying rationale of impact investing is to actively capitalise market-based products and services to tackle global pressing problems in relation to social and environmental issues.

The concept of impact investing has gained loyal supporters across a wide range of sectors and regions. Private equity funds which aim to provide growth capital profitably to businesses that provide social services are growing



and providing access to education and health care as well as housing for underprivileged social groups. Also, clients of leading private banks and pension funds are calling on their investment managers to offer impact investment options. Prominent family offices are actively seeking impact investment opportunities that can help them execute impact investment deals in sectors such as sustainable agriculture to urban infrastructure. Private foundations are also seeking to partner with investment banks and development finance institutions to make impact investments in sectors and regions related to their social missions. JP Morgan predicts that by 2020 there could be between $400 billion and $1 trillion invested this way, generating cumulative profits over ten years of between $183 billion and $667 billion. Impact investing has also attracted philanthropists such as George Soros, a hedge-fund manager, and Pierre Omidyar, the founder of eBay, as well as banks and pension funds. Currently, micro-lending in developing countries dominates the impact-investing arena, but non-debt initiatives in sectors like agriculture, education, technology and energy are gaining ground. As impact investing is mainly accessed through private equity, institutions and wealthy people are the biggest impact investors.

A two-dimensional framework

Impact investment portfolios are unique in their ability to operate in a certain business sector while being designed to address one or more impact objectives related to that chosen business sector. The success of the investment lies to a great extent in the cohesion of this two-fold framework. For example, an impact investment providing access to health operates within the wider business sector of healthcare and at the same time concentrates on its impact objective of improving basic welfare for people in need.

Portfolio risk

Impact investments carry the same risks that would arise from a traditional investment in the same sector or region. Investors must, therefore, assess the risk profile that results from their particular impact thesis and innovation. Impact investment portfolios tend to be more diversified than public equity portfolios, as a broader focus on sector geography or impact pursuit is maintained. Furthermore, portfolio managers and asset managers should bear in mind that impact investing comes with an inherent friction between impact and financial return as well as a stronger need to commit the investee to maintaining a mission focus.

FEATURES OF AN IMPACT INVESTMENT:

- Profit orientation
- Impact and financial return correlation
- Intentional and measurable impact

Impact or return?

In general, impact investments must accommodate a wide range of impact goals and return targets. The option to choose one or the other should not really exist. When impact investing first appeared, the nature of most portfolios treated financial performance and impact as dependent variables in inverse proportion, where increasing one variable should decrease the other. The impact versus profit debate differentiated between 'impact first' or 'financial' first', placing investors in a dilemma of choice; in reality, the distinction only creates barriers for impact investing to scale as an accepted asset class.

A study by J.P Morgan and the Global Impact Investment Network (GIIN), using a sample of 52 impact investment portfolios, demonstrated that 46% of them balance impact and financial return while 60% think that there is no tradeoff between impact and return. Interestingly, the research also showed that 62% of impact investors would sacrifice financial returns for greater impact. The recent financial crisis has reduced the polarisation of the profit vs. impact debate since those investors focusing on a 'financial first' were forced to reconsider the sustainability of their business and the power of value creation while, at the same time, investors with a social and/or environmental focus have realised that placing capital efficiency on equal terms with the investment's impact agenda is a fundamental component for success.

George Soros, Impact Investor

Regional distribution of impact investments

The regional distribution of transactions plays a part in the assessment of investment opportunities. A strict geographic focus or country-specific focus usually entails high investment risks hence most impact investors choose to diversify geographically. In attracting impact investments, emerging markets are way ahead of regions such as Latin America, Sub-Saharan Africa, South & Southeast Asia and Eastern Europe, with Russia & Central Asia gaining the majority of investors. The US & Canada rank first in impact investing from developed markets, with Western Europe lagging way behind.

Sector distribution of impact investments

As in the case of geographic focus, the sector in which the investor operates carries risk which must be addressed. Some impact investors choose to specialise in a particular sector to leverage a competitive advantage while others prefer to spread their activities across several sectors. Microfinance is the sector which is most popular among impact investors with food & agriculture and clean energy & tech also gaining ground.

Impact invest with success

Impact investment opportunities are aimed at providing important services to the 4 billion people at the base of the social hierarchy in developing countries. The Base-of-Pyramid approach (BoP) offers an available profit opportunity and the recognition of this opportunity covers up for market failures or information asymmetries whereby a lack of information prevents efficient market-based allocation of resources to take place. Concentrating on social and/or

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IMPACT INVESTMENT AS AN ASSET CLASS IS RELEVANT TO ALL ECONOMIES, REGARDLESS OF THEIR MARKET SIZE OR MACROECONOMIC ENVIRONMENT

environmental deficiencies naturally covers up for this ‘market failure’ while providing a return on investment.

Private investments in SMEs are the best way to achieve large impact at the local socio-economic level. SMEs are innovative and fresh business entities and contribute a major portion to national income as well as significantly contribute to employment. Furthermore, investing in SMEs creates a subsidiary business increase for suppliers, likely to benefit underprivileged social groups.

Impact investments in a private equity fund or a private equity fund of funds are usually the most stress-free routes for investment.

Impact investing should have a sector rather than individual business focus. The investment will have a more concrete impact if it is made at an early stage, when companies are innovating and open to suggestions.

Impact investment in policy-making

The importance attached to impact when discussing business activities has not only entered mainstream asset classes but has also occupied policy-makers, governments and international institutions across the globe. The issue of social and environmental sustainability as directly linked to growth and competitiveness has been particularly analysed by the World Economic Forum in its Global Competitiveness Report, 2012-2013. As the Report comments, social sustainability enables all members of society to experience the best possible participation and security thus maximising their potential to contribute to and benefit from the economic prosperity of the country they live in while environmental sustainability ensures an efficient management of resources to enable prosperity. The findings of the Report demonstrate that there is not necessarily a trade-off between being competitive and being sustainable. In fact, countries which are the top of competitiveness such as

Pierre Omidyar, Impact Investor

Switzerland are also the best performers in many areas of sustainability. The European Commission has also integrated sustainability objectives into its Europe 2020 growth strategy while the Organisation for Economic Co-operation and Development (OECD) is undertaking the Better Life Initiative which includes social and environmental metrics. Finally, the United Nations Development Programme (UNDP) has included concepts of social and environmental sustainability and equity in its human development assessment.

Impact investment and Cyprus: the way forward

According to The Global Competitiveness Report 2012-2013, the most problematic factors for doing business in Cyprus are access to financing, excessive government bureaucracy and insufficient capacity to innovate. Impact investment can, in fact, prove to be a customised alternative to stagnated investments in a country which clearly lacks the capacity for large-scale local production but with a sound entrepreneurial culture in place. As both investors and asset managers have started reconsidering their approach in relation to portfolios, it is evident that the financial crisis has forced a re-positioning towards asset classes, whereby an asset class is no longer defined simply by the nature of its underlying assets, but rather by how investment institutions organise themselves around it. Impact investment as an asset class is therefore relevant to all economies, regardless of their market size or macroeconomic environment. The complexity of today’s global economic environment has made it more important than ever to recognize and integrate concepts as social and environmental sustainability in investment and growth. Impact investing can pave the way towards fundamental development and progress and it clearly teaches one basic lesson, explaining the success of such investments abroad: only when we start considering impact at large, can we then make an impact at home. G

IMPACT INVESTING: BEST PRACTICES

BRIDGE INTERNATIONAL ACADEMIES is a company which pioneered a model of private education for the poor. The company’s school-in-a-box training program provides a standardized curriculum for students in the slums of Kenya for a cost of about $4 per month. Early investors got involved because of philanthropic intent but since then Bridge has expanded to 82 other schools. The business is now thinking about expanding to other countries.

ALLLIFE DESIGNS, distributes and administers life insurance products. It provides affordable life cover for individuals living with HIV or Type 1 or Type 2 diabetes who commit to follow an appropriate health monitoring and treatment program.

STOREBRAND is a financial institution in Norway offering pension, insurance, asset management and banking services. The institution invests in microfinance and social investments to contribute to economic development in emerging economies and at the same time generate a positive financial return. As of Dec 30, 2011, Storebrand has committed $50 million to microfinance and social investments. The nature of the Storebrand portfolio was a function of the market at the time (2005), when debt funds focused on microfinance. Through the years, their equity allocation has evolved and today this is roughly split between debt and equity.

ALPHAMUNDI, a commercial entity in Switzerland, is exclusively dedicated to impact investing by providing debt and equity financing to profitable and scalable ventures. SAIF-Prometheus is a new sub-fund that will be launched by AlphaMundi in 2013, in partnership with GVEP International, a British NGO with a decade-long track record of renewable energy SME capacity-building in Latin America and Sub-Saharan Africa. Prometheus will provide debt and equity financing to SMEs and small infrastructure projects in the solar, hydro, wind, biomass and biogas sectors, to facilitate access to renewable energy in Sub-Saharan Africa, with an emphasis on East Africa.

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