

Stanford SOCIAL INNOVATION REVIEW

Q&A

Roundtable on Impact Investing

Moderated by Johanna Mair and Katherine Milligan

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Roundtable on Impact Investing A group of social innovation leaders from around the world have been meeting to discuss the burgeoning field of impact investing and what can be done to make it more effective.

THE FIELD OF IMPACT investing is attracting growing numbers of organizations and increasing amounts of money. By some estimates there are nearly 200 registered impact investment funds, and many foundations (such as Rockefeller), networks (like GIIN and ANDE), and mainstream financial institutions (including JPMorgan Chase) are active in the field. Impact investing even has its own marquee conference—SOCAP—that attracted 1,400 people from 56 countries to San Francisco this fall.

Impact investors, however, are a heterogeneous group with a range of expectations about appropriate financial and social returns. Some investors are drawn by the hope of earning substantial financial returns by investing in businesses that have a social mission. The flurry of investment activity around green tech is perhaps the best example of this. Others are drawn by the desire to achieve more sustainable impact than they could achieve through philanthropy alone. Investments in social businesses striving to improve the health of poor people in the developing world are a good example of this.

Although the growing number and breadth of impact investors represent an important milestone for the sector and an important source of growth capital for social ventures, the excitement—sometimes bordering on hype—that surrounds the field is a growing source of concern. Exaggerated claims raise expectations about the ability of impact investing to provide consistently both outsized financial and social returns, something that is not always possible or in some instances even desirable.

To better understand emerging trends in social innovation, such as the growing

ROUNDTABLE PARTICIPANTS:

(left to right)

JACQUELINE NOVOGRATZ, founder and CEO of Acumen Fund

ÁLVARO RODRÍGUEZ ARREGUI, co-founder and managing partner of Ignia Partners, and chairman of Compartamos Banco

KATHERINE MILLIGAN, head of North America and Middle East at the Schwab Foundation for Social Entrepreneurship

JOHANNA MAIR, chair of the Global Agenda Council on Social Innovation, associate professor of strategic management at IESE Business School, and academic editor of *Stanford Social Innovation Review*

IFTEKHAR ENAYETULLAH, co-founder and director of Waste Concern

ASAD MAHMOOD, managing director of Global Social Investment Funds at Deutsche Bank



importance of the impact investing industry, the Schwab Foundation for Social Entrepreneurship, in collaboration with its sister organization, the World Economic Forum, created the Global Agenda Council on Social Innovation. This group, comprising 17 leading social entrepreneurs, academics, philanthropists, and impact investors, meets periodically to explore important issues facing the sector.

In the council's discussions about impact investing, a number of important themes have emerged: Impact investors need to become comfortable taking greater risks and more flexible in the financing terms and instruments they use; philanthropic and soft capital have an important

role to play, particularly when it comes to making or facilitating small seed investments; and impact investors should have intimate knowledge of the local conditions where their investees are located so that they can act as a true partner.

In the roundtable that follows, four members of the Global Agenda Council on Social Innovation—Álvaro Rodríguez Arregui of Ignia Partners and Compartamos Banco, Iftekhar Enayetullah of Waste Concern, Asad Mahmood of Deutsche Bank, and Jacqueline Novogratz of Acumen Fund—discuss these themes and other important issues in impact investing. The discussion is moderated by council chair Johanna Mair of the *Stanford Social*

Innovation Review and Katherine Milligan of the Schwab Foundation for Social Entrepreneurship.

Johanna Mair: There is a growing amount of interest in impact investing, some of which has been fueled by highly optimistic analyst reports, such as one by JPMorgan Chase, about the size and profitability of

made about the potential of microfinance to eliminate poverty, whereas the reality of microfinance was far different. We created the perception and the reality didn't match that perception, so the risk increased.

And that is what is happening in impact investing. We don't have a common definition of what impact investing is. So, yes, there is a need to show the long-term

debate would be more effective if we framed it around the latter.

Iftekhar Enayetullah: I find that the perspectives funders have on these issues really vary. There is a fundamental difference between dealing with donors and dealing with investors. When we are dealing with UNDP [the United Nations



the market. Is all this attention a good or a bad thing?

Asad Mahmood: It's important for people to be shown that the potential of impact investing is great. But if you talk just about the potentiality and not about the reality, then we damage and confuse the marketplace because the expectations are out of kilter with reality. When I look at impact investing I see a very limited number of social ventures that are capable of attracting money that is not philanthropic.

In some ways it's a good thing that the sector has become popular, but you can see some similarities to what happened in microfinance, where a lot of claims were

potential, but my concern now is how realistic that vision is and whether it helps or hurts the industry.

Jacqueline Novogratz: My biggest concern is that the proposition for impact investing ends up being more about the potential financial returns on capital than about why the capital is being invested in the first place. The risk is that the focus is more on financial return as an end in itself rather than as a tool and a means to solve big intractable social problems. Right now the debate is often framed by the financial return an organization can make rather than by the goals of that organization and the best capital structures to realize those goals. I think the

Development Programme] or UNICEF [the United Nations Children's Fund], they look first at the development impact of the project. When we sit down and negotiate with them, before they look into the financials they first want to look into the development impact, such as whether the project is fulfilling the United Nations' Millennium Development Goals. Once it is clear that the project meets the development goal, then they look into the financing issues. But their entry point is development impact.

When we discuss the same proposal with investors, they will first want to dive into the numbers and the business plan. They want to understand how long the payback

is, whether my assumptions are right, and what risk mitigation plans we have looked into for the project. If the project involves carbon credits, they will want to know what our plans are if the Kyoto Protocol falls apart. It's only after looking at these financial issues that they want to look at the project's social and environmental benefits.

So there is a basic difference in the way each type of funder approaches these investments, and we have to take a different approach when we discuss the same project with different investors.

Álvaro Rodríguez Arregui: One of the issues we have is that many funders put forward their financial solution before they ask the appropriate questions. The first thing they say is “we provide grants,” or “we provide equity,” or “we provide loans.” That's not the right approach. You need to first look at the issue the organization is trying to address, look at what intervention is required to solve that issue, and then look at what type of capital is required. As a funding institution, you need to have a portfolio of different instruments and use them accordingly.

In many ways, we keep failing to learn many of the lessons from the business community. In the business community, you look at the project, you look at how you want to address that project, and then you decide how you want to fund it—equity, debt, quasi-equity, or whatever. But that's the last question you answer. The only funder in the social sector that I've seen use that approach is the Omidyar Network.

Katherine Milligan: Entrepreneurial ventures of all kinds have a life cycle that requires different types of capital at different stages of development. How does this play out in the social finance sector?

Novogratz: Let me use Husk Power Systems [an Indian company that generates affordable and renewable electricity using discarded rice husks] as an example. In the initial prototype development stage, there was so much uncertainty and risk that the only kinds of capital that would work were grants or angel investments.

The next stage is where long-term patient capital, such as equity or loans, plays

an important role. It's still high risk, but by that point you've at least experimented with the product and developed a hypothesis that is rooted in a better understanding of the customer and the marketplace. You're taking a risk on the business and you still have to battle corruption, bad infrastructure, and customers who are risk averse and have ingrained habits [such as using kerosene or cutting down wood to generate power] and who make only a few dollars a day. In the energy sector, that phase might last anywhere from two to seven years.

In the case of Husk Power Systems, the only way to make the business model work was to reduce the price to the end consumer. The Indian Ministry of New and Renewable Energy provided a capital subsidy on each new plant, enabling the business model to cover costs and provide enough profit to begin expanding. Slowly at first, because the profit levels were razor thin, but now they are increasingly looking at more market-oriented capital. Husk has now brought electricity to 150,000 low-income villagers in rural Bihar.

Mair: Most foundations focus on providing grants, but they do have alternative ways of providing financial support to organizations creating social change. What are some of those alternatives?

Rodríguez Arregui: In the social sector one has to understand that some interventions will never be commercially viable, but they are needed, and it's important to continue supporting these initiatives philanthropically through grants and other types of giving. But, focusing for a moment on those models that could become commercially successful, I always say, “Why don't you set up as a for-profit and have a foundation give you a program-related investment instead of a grant?” If a foundation gives you an equity investment of \$1 million instead of a \$1 million grant, that money is going to do the same thing; it's going to let you try to prove that your model is commercially viable. The difference is, if the foundation provided that investment as equity instead of a grant, and if the initiative becomes commercially viable, the foundation has a piece of that equity and will enjoy the upside.

Take the example of Compartamos [the Mexican microfinance bank that Rodríguez Arregui is chairman of]. USAID [the US Agency for International Development] and CGAP [the Consultative Group to Assist the Poor] made grants, so they did not own a piece of the equity and never enjoyed the benefits of the financial upside when the company went public. If we could do it again, I would say, “Let's set it up as a corporation from day one rather than an NGO and have these guys make million-dollar investments, not grants.”

The only difference is risk. They were willing to make this investment because they were willing to bear the risk, a risk that no one else was willing to bear. But we silo our thinking and say, “If it's nonprofit, it needs to be grants, no upside.” To be clear, the objective is not to get the financial upside. The objective is to make an investment in an innovation. But there's a bonus. If it's successful, you as the donor can reinvest that extra capital to make many more of these types of investments.

Milligan: What other types of risk are involved in impact investing, and how do these risks differ from the risks that investors take in traditional capital markets?

Mahmood: What distinguishes social finance from regular finance is two additional risks. One is the risk of failing to innovate—failing to push the envelope to meet the needs of the client and integrating the social impact into the business. It can't be an afterthought—“We'll make money and then contribute some of it to improve people's welfare or set up a foundation”; that is not, in my mind, a social business. By labeling that a social business, we create a risk to the fundamentals of how this industry needs to develop. If our focus becomes making money and giving it away afterward, then we are not achieving the potential. The social and financial aspects have to be intertwined, like DNA.

If we don't focus on the customer and if we don't innovate to meet and service the needs of the customer, then we will create a bigger risk in the sector because the expectations of the sector are far different than a normal business. It's important to distinguish these risks from

normal business risks. They are far more exaggerated for social enterprises because we have positioned this sector as being beneficial to the poor and beneficial to society. To me, one of the greatest risks in the sector is that it pumps up all its potentiality and then fails to focus on the customer, thereby creating no loyalty to the business and none of the social outcomes that were promised. How do we define the social finance industry? How do we avoid making it so commercial that the customer and the social service become secondary? That to me is a primary risk.

Expectations have been raised about the ability of impact investing to provide both outsized financial and social returns, something that is not always possible or desirable.

The second type of risk is political risk. The social sector is a temple of the politicians because poor people represent a large share of the voter base, especially in developing countries. So it is very easy for politicians to attack social businesses, to attack microfinance, which is clearly a risk that happened in India and in numerous other places. When you talk about social business you are talking about changing the ways we look at society and empowering huge numbers of poor people, which can lead to deep political changes from an economic and social perspective.

On the positive side, one can say that social finance will create political change. This is certainly the desire among people who want to see greater transparency and democracy in the world. So we have to be very careful in how we position social finance and how it is perceived by society.

Mair: As a social entrepreneur you have firsthand experience with many of these very issues, Iftekhhar. Could you talk a bit about your experiences raising money for your venture, and what lessons you have learned?

Enayetullah: In 1994, Maqsood Sinha, I, and another businessman established Waste Concern [a Bangladeshi hybrid organization engaged in waste recycling, renewable energy, and poverty reduction]. Our first visitor

was one of Maqsood's professors, who referred our project to USAID. The director of Southeast Asia for USAID came and said: "Many people talk about community-based environmental initiatives, but you're the first one on the ground. I want to fund you, but in order to do so you have to become a not-for-profit. We cannot give funds to a for-profit company."

At that time, we didn't have any legal status. It was just a project initiated by two fresh university graduates. So we registered Waste Concern as a not-for-profit with the government's registration bureau and were

able to get financial support from USAID. In 2000, UNDP and the Bangladesh Ministry of Environment wanted to test the model in five more areas of Dhaka [the capital and largest city in Bangladesh]. So they contributed grant money to undertake additional pilots in 19 neighborhoods.

After the pilots, we wanted to scale up, but we quickly found that donors like UNDP and UNICEF were not interested. They said that their funds were only for pilots, and if the project is successful, you have to look for other funding sources. So we went to commercial banks, but the head of BRAC Bank said: "We cannot finance you. You are registered as an NGO. If you do not make a profit, how on earth will you pay us back?"

Maqsood and I came back to our office and thought: "We are in a fix. We had to convert to a nonprofit to receive initial funding, and now that we want to scale up, they say they cannot finance us because we do not make a profit."

Our long-term solution to this dilemma was to create an organization that has for-profit and nonprofit operations. But none of this was easy, and we had many problems. One of the issues we faced is that the transaction costs become high when you involve conventional banks. When we received investments from FMO, the Dutch development bank, and the Triodos Innovation Fund, they wanted top-notch

lawyers from Clifford Chance [a global law firm based in London] to draft the financing agreement. We had to pay a large amount of money as part of our project cost. They also wanted a 0.5 percent financing fee. We said, "No, you have to reduce it." We agreed on a fixed fee that was lower. These are the kinds of things that social entrepreneurs and investors need to come to a common understanding about, for example, that commercial financing fees cannot apply to social investments.

Milligan: Your experience in Bangladesh brings up an interesting issue—the importance of local knowledge. How important is it for impact investors to have in-depth knowledge of the country where they are investing or to have people living in those countries with local contacts?

Rodriguez Arregui: There is a reason why so many funds are set up in prestigious geographies. You've got to raise the capital, and people are going to feel more comfortable giving you money if you are just a few blocks away from them. But raising money is just a discrete moment in time. Where you are really going to create value is during the many years you make investments and work with entrepreneurs, and for that you need to be local.

The developing world is a difficult environment. At the end of the day, it's much more difficult to work in Bangladesh, India, Mexico, or Bolivia than it is to work in the United States or Europe. There are a lot of friction points and thus greater risk. The mortality rate for projects is much higher. So the question is how you, as the investor, reduce the mortality rate. How do you enable the entrepreneur to operate on a more level playing field? The answer is by helping the entrepreneur get through hurdles, by unlocking bottlenecks and opening doors.

There are hundreds of stories I could tell you about how we have helped the organizations we invest in. Sometimes it is simple things. One entrepreneur obtained a piece of land to set up a health clinic, but there was an electricity pole in the middle of the property that prevented him from starting construction. After six months of trying to get the power company to remove it, I

called the CEO of the company and it was removed the next day. It would probably still be sitting there if our investee didn't have the access that I had. In developed countries, you don't have to worry about things like that.

Having said all this, I realize there is one tension, and that is size. There are only a few markets large enough to give investors the economics to be able to play just locally. In South America it is Brazil and maybe Argentina. We [the impact investing venture capital firm Ignia Partners, based in Monterrey, Mexico, of which Rodríguez Arregui is managing partner] are fortunate that Mexico is a large enough market to let us focus on just one country.

Novogratz: When an investor comes in from afar, it's much easier to make decisions about the entrepreneur based on her charisma and the strength of her idea, but not necessarily on her long-term relationships in the area and on her understanding of the customers that she serves. Having somebody on the ground who can give you a good sense of the entrepreneur's reputation and business operations is very, very important.

Being local is also an advantage because it allows you to build local networks that you can use to help the entrepreneurs. This becomes particularly important as companies attempt to grow in a difficult business environment.

Last, it is important to be based locally when something goes wrong, as inevitably it does. Having teams on the ground enables the relationship managers to work quickly and effectively to resolve those problems. You need to understand exactly what's going on at a company level to make the kind of change that's needed.

Mair: One of the complaints social entrepreneurs make is that it is very difficult to raise small amounts of seed capital to get their organization off the ground. Most impact investors want to invest \$1 million or more in a new venture. Is this true, and if so, why?

Rodríguez Arregui: If I make a \$2 million investment, and the investors are paying me a 2 percent management fee, that's

\$40,000 a year. With that money I can pay an analyst and part of the overhead costs to monitor that investment. But if I invest \$200,000 and I get a 2 percent fee, that's only \$4,000. With \$4,000 I can pay the electricity, but I can't support the overhead to do this activity. Nobody is doing it because it makes no economic sense.

But investments of \$200,000 are still needed in emerging markets where many of these initiatives are very small. That's where philanthropic capital can play a role. Taking the earlier example of the \$4,000 vs. \$40,000, if a foundation came to me and said, "I will give you a \$36,000 grant so you can make this \$200,000 investment and others like it," I could afford to do that, and some of them will create significant transformations that otherwise would not have taken place.

Novogratz: What we're finding is that smaller investments in highly innovative startups are a critical part of the marketplace, but they have a much greater risk of failure. Despite that risk, it's been one of our sweet spots. It's messy and it's long term, but I do believe we need a set of incentives and a set of players that are proudly investing in this area.

If I were king, I would have the aid agencies focus on providing patient, early-stage innovation capital. Aid agencies could play an enormous role by funding intermediaries and other organizations that are willing to take on these smaller-scale, high-risk, early-stage, high-innovation investments. This is probably one of the most fertile areas for aid agencies to get involved in.

Then there's another area of the marketplace, the larger scale growth capital in the \$1 million to \$5 million range. We need both. For the growth stage capital, it seems that the DFIs [development finance institutions] have a stronger role to play there.

Milligan: There seems to be general agreement amongst you that impact investing holds great promise, but that much remains to be done for the industry to live up to its potential. What needs to happen for impact investing to grow in size and influence?

Mahmood: What is most needed is perceptual change. Change in the way investors

are looking at this, in the way politicians are looking at it, and in the way that the ultimate beneficiaries and customers are looking at it. That perceptual change is happening, which is a good thing. There is a new mental model of how we want to address the issue of poverty. It has moved away from the traditional charity-based solutions or government-based solutions to more of the private sector-based solutions.

But in order for this dream to be realized, there clearly has to be public sector engagement. Take housing as an example. You need sewer pipes, water pipes, infrastructure, and land development. And that role is traditionally played by the government. So we need to ensure that the government sector is engaged. The government has a lot of tools to incent businesses. For example, the government could give a tax break, allocate land resources for housing, or let its hospitals be run by the private sector with greater efficiency. It could do that on the educational side as well. I know a lot of dysfunctional government schools that have the infrastructure but not the teachers, and I know a lot of private schools that are well managed but lack infrastructure to grow. Think of the potential if they work together.

We also need to worry about providing the right type of financing and financing structures to ensure that the rudimentary stages of the sector are built up to achieve their potential. Investors can't ask for everything at the very early stages that we are in. They need to get comfortable taking greater risk. We need capital providers motivated not just by the economics of it, but by the social impact of it as well. To further this sector we need to move beyond this idea of venture capitalism, because I am not quite sure it has proven that level of profitability.

To summarize, we need people who are trying to use business methods to achieve social goals, who are willing to take some risks to innovate, and who see the government as a partner rather than an inhibitor. We need to have a concerted effort toward government. We need to have a concerted effort toward the investors. And we need to have greater clarity that the businesses we are supporting have sound business viability. ■