

DEMYSTIFYING IMPACT INVESTING

APRIL 2014

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Acknowledgements

The authors would like to acknowledge a number of people who contributed to this study. The following people were consulted for their opinions and experiences in impact investing:

Joann Chen, Senior Investment Associate, Impact Assets

Maya Chorengel, Co-founder, Elevar Equity

Peter Forton, Managing Director, CAPE Fund

Charles Holt, Vice President, Investeco

John Kohler, Director Impact Capital, Santa Clara University Center for Science, Technology, and Society

Stephen Nairne, Managing Director, Lundin Foundation

Gerhard Pries, Managing Partner and CEO, Saron Asset Management

Beau Seil, Managing Partner, Unitus Impact

Kate Storey, Senior Associate, Renewal Funds

This report is made possible thanks to the ongoing support of the Lalji Family and the Swift Family Foundation.

Demystifying Impact Investing

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April 2014

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CONTENTS

01	INTRODUCTION
02	WHAT IS IMPACT INVESTING?
03	THE GLOBAL IMPACT INVESTING INDUSTRY
04	A TRILLION DOLLAR MARKET?
05	WHO ARE THE IMPACT INVESTORS?
07	GEOGRAPHY OF IMPACT INVESTING CAPITAL FLOWS
08	FUND AND INVESTMENT SIZE
09	BUSINESS STAGE
10	FINANCIAL RETURNS
12	Case Study: Microfinance and the Limitations of Impact Investing
14	IMPACT INVESTMENT SECTORS
14	IDENTIFIED SUCCESS FACTORS
15	CANADIAN IMPACT INVESTING INDUSTRY
15	MARKET SIZE
15	FUND AGE
16	Returns
16	INVESTED SECTORS
17	DEAL FLOW
17	GOVERNMENT SUPPORT
18	CONCLUSIONS

LIST OF FIGURES

FIGURE 1: Impact Investing Across Asset Classes Pg 03 | **FIGURE 2:** Impact Investing Market Breakdown Pg 04 | **FIGURE 3:** Types of Impact Investors Pg 05 | **FIGURE 4:** Spectrum Of Impact Investors Pg 06 | **FIGURE 5:** Impact Investors And Approaches Pg 06 | **FIGURE 6:** Impact Investing Fund Domiciles Pg 07 | **FIGURE 7:** Geography Of Impact Investing Capital Flows Pg 07 | **FIGURE 8:** Stages Of Company Development At Which Impact Investors Prefer To Invest Pg 09 | **FIGURE 9:** Baseline Expected Returns And Benchmarks Pg 10 | **FIGURE 10:** Benchmarks Across Asset Classes Pg 11 | **FIGURE 11:** Success Factors Pg 14 | **FIGURE 12:** Example of Canadian Impact Investing Market Estimate Pg 15 | **FIGURE 13:** Canadian Venture Capital Performance Pg 16 |

INTRODUCTION

Impact investing has emerged over the last decade as one of the most talked about new strategies for tackling social and environmental problems. The emergence of the concept has been accompanied by a great deal of hype and a confusing array of competing definitions of impact investing.

There have also been many claims about what kind of financial return can be achieved while also solving social and environmental problems. Some analyses of the impact investing sector suggest that it accounts for \$9bn of investment capital flowing through channels that are distinct from the mainstream capital markets from a range of investors including philanthropic foundations, high net worth individuals and traditional investors seeking to create impact alongside financial return.¹ Others have questioned whether the approach is indeed new, whether projected financial returns will really meet the expectations of investors and whether impact investing truly refers to new sources of capital or is only a new term for traditional investments that happen to have positive social or environmental impact as a by-product.

The purpose of this report is to evaluate the size, scope and scale of the impact investment sector. We sought to answer several core questions. Firstly, rather than seek to develop a single comprehensive definition of impact investing, we have differentiated between investments on the basis of whether they seek to generate financial returns comparable to traditional investments with the same risk profile or whether

they also accept lower financial returns to achieve higher social returns. To add a further layer of differentiation, we also distinguish between investments that focus on creating impact in developed and developing country markets. This approach allowed us to categorize the forms of capital and the geographic focus. Next, we sought to develop a clearer picture of what constitutes a market rate of return in impact investing and how this compares to traditional investments. We also examined the difference between targeted and realized rates of returns in impact investing to assess the performance of this investment category.

Our methodology involved a detailed review of a number of reports that are cited throughout this publication. We examined the impact investment funds database of the Global Impact Investment Network (GIIN) and organized the data according to our typology to develop a picture of how and where capital is flowing into impact investments. Finally, we have benefitted from numerous interviews with leading practitioners in the impact investment sector. They are identified in the appendices, but we don't attribute specific findings to them, in order to protect confidentiality.

¹ J.P. Morgan (2013). Perspectives on Progress: the Impact Investor Survey. Accessed from http://www.thegiin.org/cgi-bin/iowa/download?row=489&field=gated_download_1 on 14 January 2013.

WHAT IS IMPACT INVESTING?

There is a significant difference between impact investing in cash/cash equivalents and fixed income (which include deposits into community banks and credit unions, green and social impact bonds) and private equity and venture capital investments both in their risk/reward profiles and in the type of impact that can be created.

The concepts of impact investing and social enterprise emerged out of a recognition that the private sector could also contribute to the development and social agendas, while the social sector could engage with the market and business sector while pursuing social and development goals. Unlike Socially Responsible Investing (SRI), which seeks to avoid investments in “harmful” companies or uses shareholder power to push for improved corporate practices related to the environment, social performance, or governance; impact investing seeks to find investments that generate positive social and environmental value. In the last few years impact investing has been gaining a great deal of attention in the UK and North America and has garnered interest from investors and philanthropists, researchers in top business schools such as Harvard, UCLA, and Wharton and finance professionals in established firms, such as JP Morgan and Deutsche Bank, leading to the establishment of social finance units in top banks.

The term impact investment itself was coined in 2007 at the Rockefeller Foundation and “Harnessing the Power of Impact Investing” has been one of the Foundation’s primary initiatives in recent years. Although the popularity of impact investment has significantly increased as a result of the Rockefeller Foundation’s efforts to promote it, the concept of investing for impact is not new. In a 2012 survey of impact investors, 17 of 99 respondents stated that they had been engaging in impact investment since at least 1995.² The drive behind the Rockefeller Foundation’s initiatives in this sector is the belief that it will take far more money than all the philanthropists and governments have available to make a significant impact in improving the lives of the poor and vulnerable people in the world and that impact investing, by also generating profit while addressing social/environmental problems, could unlock substantial new capital to complement philanthropy in addressing these challenges.³ One of the most contentious issues related to the definition of impact investing is the question of what type of impact is sufficient to differentiate an impact investment from a traditional investment. Many investments can be considered to have a component of common but positive impact such as job creation. Currently the most common definition of impact investing is the definition adopted by the GIIN, which states that “impact investments are investments made into companies, organisations, and funds with the intention to generate measurable social and environmental impact alongside a financial return.”⁴ This definition leaves both the level of financial return and impact generated very broad, and we can find examples of impact investing strategies that prioritize financial return and impact return very differently.

Impact investing approaches can range from seeking to recoup invested capital to seeking to maximize financial returns. It is difficult to assess these approaches under one definition so in this paper, impact investing approaches are being segmented to reflect these differences. Although some refer to impact investing as a new asset class⁵ we can see development of impact investments across all asset classes, from cash and fixed income through private equity to alternative instruments such as real estate and hedge funds⁶ (see Figure 1). There is a significant difference between impact investing in cash/cash equivalents and fixed income (which include deposits into community banks and credit unions, green and social impact bonds) and private equity and venture capital investments both in their risk/reward profiles and in the type of impact that can be created. It is necessary to break down each asset class and impact sector in order to truly gauge the amount of impact created and the amount of financial return that is feasible while also intentionally creating social or environmental impact.

² J.P. Morgan (2013). Perspectives on Progress: the Impact Investor Survey. Accessed from http://www.thegiin.org/cgi-bin/iowa/download?row=489&field=gated_download_1. on 14 January 2013.

³ Rockefeller Foundation website. <http://www.rockefellerfoundation.org/our-work/current-work/impact-investing>. Accessed Oct 19th, 2013

⁴ GIIN website. <http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html>

⁵ J.P. Morgan. Impact Investing: An Emerging Asset Class. 29 November, 2012. Retrieved from http://www.thegiin.org/cgi-bin/iowa/download?row=151&field=gated_download_1

⁶ The Parthenon Group, Bridges Ventures, and the Global Impact Investing Network (GIIN). Investing for Impact: Case Studies Across Asset Classes. March, 2012.

<https://www.missioninvestors.org/system/files/tools/investing-for-impact-case-studies-across-asset-classes-the-parthenon-group-bridges-ventures-and-the-global-impact-investing-network-giin.pdf>

ASSET ALLOCATION FRAMEWORK

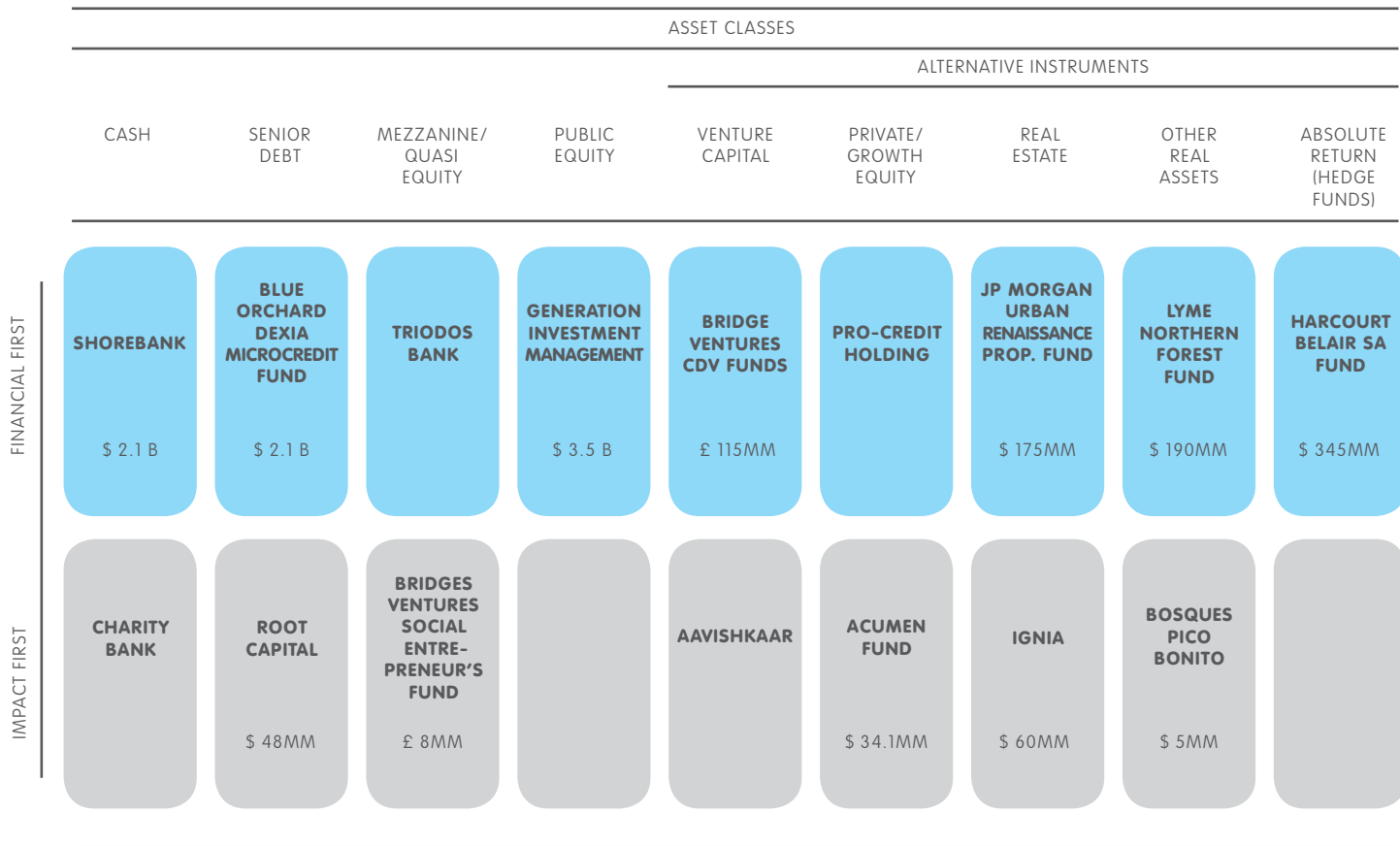


Figure 1: Impact Investing Across Asset Classes⁷

The focus of this study is limited to the private equity (including venture capital and buy-out) asset class, specifically, those funds listed in the GIIN ImpactBase (the largest and most comprehensive fund list for impact investments). This is the asset class that can most readily be differentiated as impact investment as investors have more ability to determine and influence their preferred balance of impact and financial returns. Private equity and debt are the most common instruments used by impact investors⁸ since they allow the flexibility to support impact investment strategies and the early stage nature of investment opportunities. The sources of capital that flow into this asset class include both philanthropic and commercial capital. Philanthropic capital invested for impact is defined as funds that are donated to a registered non-profit organization in exchange for a tax benefit and are reinvested by the organization on an ongoing basis with no financial return to the funder. On the other hand, commercial capital describes funds that are invested in traditional capital markets with the expectation of attaining a market rate financial return.

⁷ The Parthenon Group, Bridges Ventures, and the Global Impact Investing Network (GIIN). Investing for Impact: Case Studies Across Asset Classes. March, 2012. <https://www.missioninvestors.org/system/files/tools/investing-for-impact-case-studies-across-asset-classes-the-parthenon-group-bridges-ventures-and-the-global-impact-investing-network-giin.pdf>
⁸ Source: J.P. Morgan. Perspectives on Progress: The Impact Investor Survey. Available from: http://www.thegiin.org/cgi-bin/iowa/download?row=489&field=gated_download_1;

THE GLOBAL IMPACT INVESTING INDUSTRY

A TRILLION DOLLAR MARKET?

The current and potential size of the market is one of the biggest questions in the impact investing sector. Using a broad definition of the model, JP Morgan currently estimates the industry to be a \$9B market in its report, Perspectives on Progress the Impact Investor Survey. By 2020, this number is expected to climb to as much as \$400B – \$1trillion.⁹ Our analysis of funds in the GIIN database shows that the estimated current market size is fairly accurate but that there is still a significant gap between targeted and committed funds. Our research shows that the sum of committed capital for all funds in the database amount to \$5.7B, while the targeted capital is \$12.8B.

This estimate of market size is based on the definition of impact investing used by the GIIN, which requires an “intention to generate measurable social or environmental impact alongside a financial return.”¹⁰ It does not require impact creation to be a primary purpose of the investment and it does not differentiate between level of returns in the traditional or “non impact investing” market.

This has implications for the original question of the size of the impact investing industry and does not answer the question of how much of the activity currently labelled impact investing is new, as opposed to investment activity that was already happening without the specific label of ‘impact investing.’ Some funds listed in the GIIN ImpactBase existed before impact investing emerged as a concept and some of the largest funds in the database are hard to differentiate from traditional private equity and venture capital (PE/VC) funds; their impact component appears to be a by-product of investing in a sector with potentially high financial returns, such as clean technology.

To analyze the impact investing market more closely we subcategorized it using two criteria that we identified as common distinguishing features of impact investment strategies: whether impact or financial returns are the primary goal and whether investments are being made in developed or developing markets. Based on these factors we created four categories: finance first funds investing in developing countries; finance first funds investing in developed countries; impact first funds investing in developing countries; and impact first

funds investing in developed countries. Based on this breakdown, we were able to conclude that most of the capital in impact investing appears to be in the finance-first sphere, accounting for 96% of the total value of all listed funds in the ImpactBase. A bulk of these investments (74%) can be categorized further as finance first funds investing in developing countries. The dollar value of all impact first funds is currently \$212M, which represents only 4% of total committed capital in this subcategory of impact investing. The dollar breakdown can be seen in Figure 2.¹¹

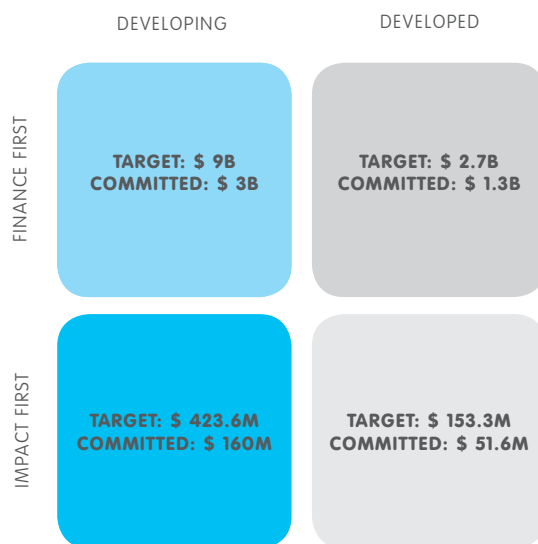


Figure 2: Impact Investing Market Breakdown¹¹

Breaking down the impact investing market in this way shows that the size of the market depends on the definition of impact investing that is used. Using a broad definition that includes traditional investments such as clean technology that can also be considered “impact investments”, the sector size is large, with an estimate current targeted capital of \$9 billion. However, if impact investing was to refer to funds that are not part of the traditional market but only to investments that would not be made if the risk/reward profile required was the same as in the traditional investment market, then impact investing is a small sector, with only approximately \$212 million of committed capital based on the most current information in the GIIN Impactbase.¹²

⁹ Saltuk, Y., Bouri, A., Abhilash, M., & Pease, M. (2013). Perspectives on progress the impact investor survey.

¹⁰ GIIN website. <http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html>. Accessed Nov 2nd, 2013.

¹¹ Source: GIIN Impactbase

¹² Ibid.

WHO ARE THE IMPACT INVESTORS?

In addition to examining different types of impact investments, it is important to note that there are different types of impact investors with different motivations that determine the type of impact investing undertaken. Although impact investors could be differentiated by several factors and in reality impact investors and their corresponding investment strategies represent a spectrum (see Figure 4), most current literature divides impact investors into two main groups, financial first and impact first investors (see Figure 1). Financial first investors are defined as investors who aim to maximize financial returns while creating real and measurable impact. On the other hand, impact first investors are defined as investors who seek to maximize social impact while still making some financial return, be those above-or below-risk adjusted market rate returns.¹³ For the purpose of this study we define “financial first” impact investors as those who seek a market rate of return and “impact first” impact investors as those who are willing to accept a below market rate financial return in exchange for impact.

SEGMENTS OF IMPACT INVESTORS

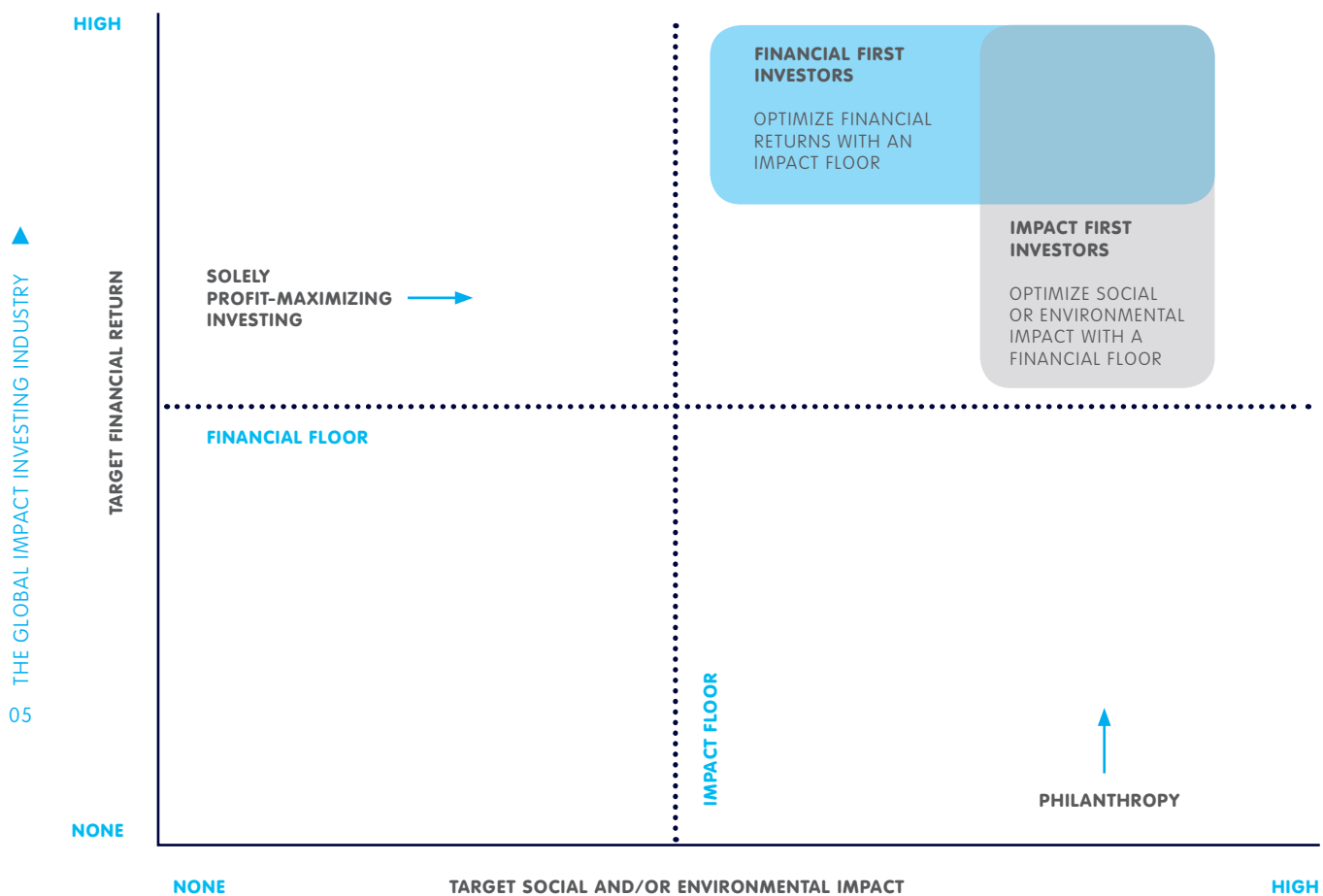


Figure 3: Types of Impact Investors¹⁴

It is also important to note that capital invested in impact investing can be financial or philanthropic. The source of funds invested has implications for the type of impact investment that is selected. For example, a high net worth individual (HNWI) may invest from their investment portfolio into a fund that has a track record of delivering market returns. This individual may also donate from their

¹³ Monitor Institute (2009). Investing for Social and Environmental Impact: A Design for Catalyzing an Emerging Industry. Accessed from <http://www.rockefellerfoundation.org/uploads/files/3d58520b-a89d-42ff-8ed1-9f5efa7c8aa0.pdf>

¹⁴ Ibid.

philanthropic portfolio to a non-profit impact investment fund investing in solutions to some of the most pressing social problems in developing countries, such as lack of sanitation. The type of capital invested, whether philanthropic or investment capital, has significant implications on the financial and impact return expectations.

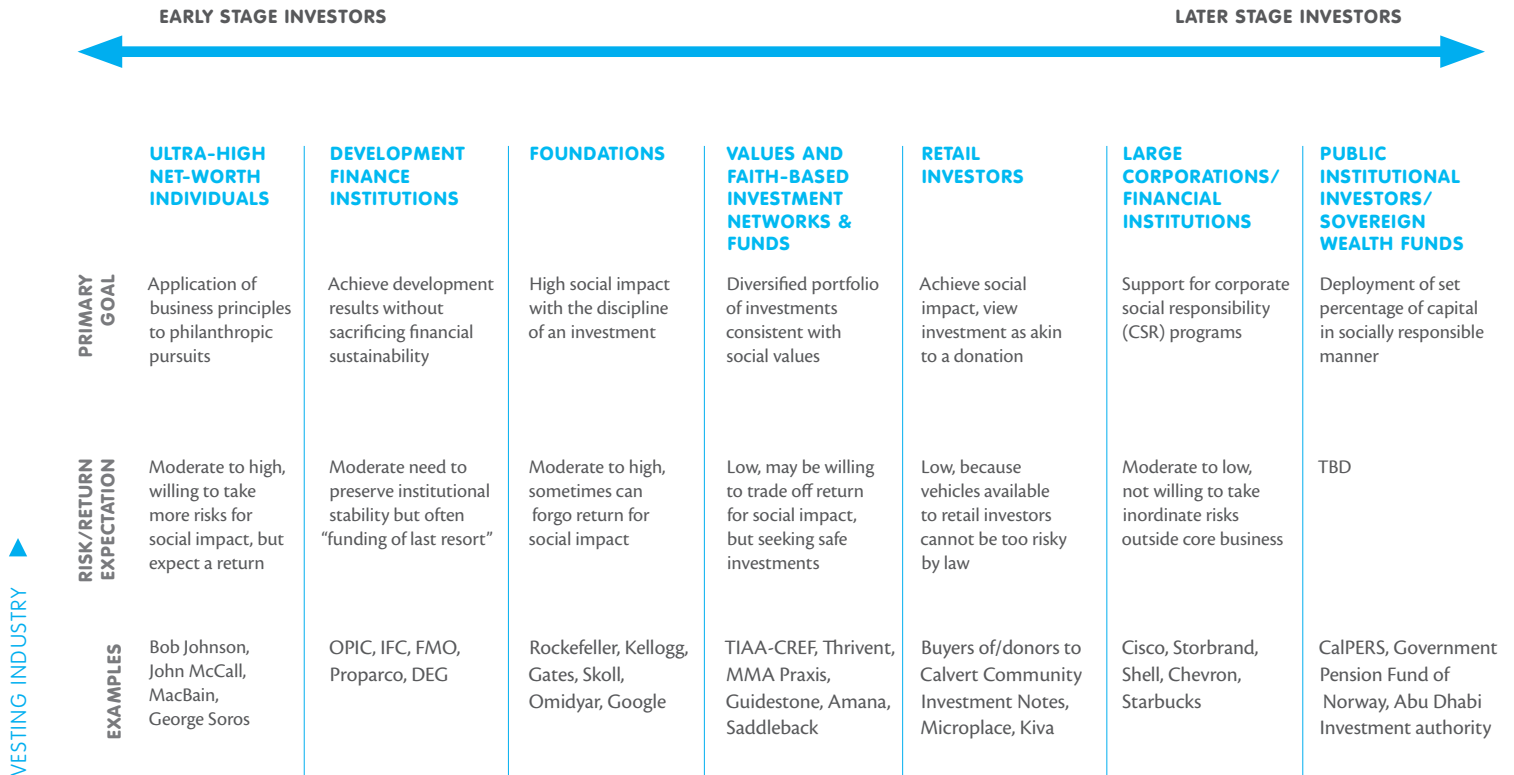


Figure 4: Spectrum Of Impact Investors ¹⁵

It is also worth noting that retail investors are not included in the profile of impact investors. This is largely due to the lack of financial products in the market for retail investors. The vast majority of investment opportunities in impact investing are PE/VC funds or individual company private offerings, which are available only to accredited investors.¹⁶ The absence of finance professionals versed in the realm of impact investing also serves as an impediment to retail investors participating in the impact investing space.¹⁷ Retail investors are for the most part limited to more traditional "Socially Responsible Funds."

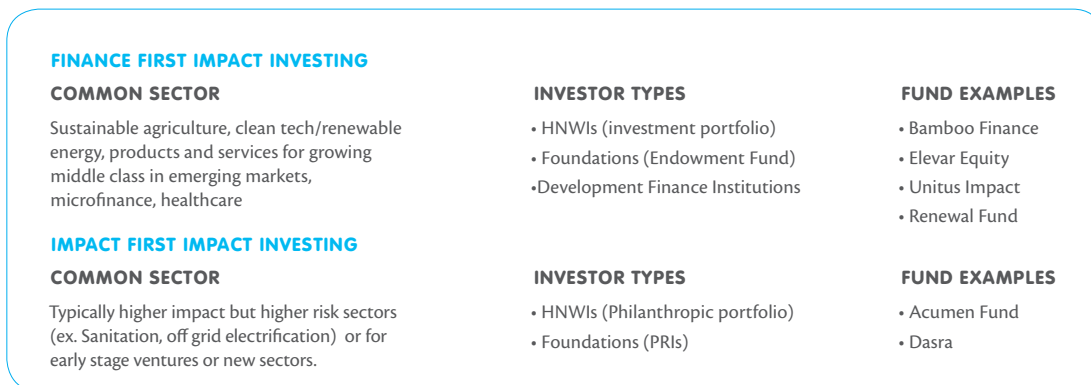


Figure 5: Impact Investors And Approaches

¹⁵ Barmeier, Julia and Simon, John. 2010. More than Money: Impact Investing for Development. Center for Global Development. <http://www.cgdev.org/publication/more-money-impact-investing-development>
¹⁶ An accredited investor is an individual that meets a particular threshold for income or net worth which differs by jurisdiction. Accredited investors are considered sophisticated investors and are permitted to invest in certain higher risk investments than retail investors.
¹⁷ Harji, K., Kjarven, A., Geobey, S., & Weisz, A. (2012). Redefining returns: Social finance awareness and opportunities in the Canadian financial sector.

GEOGRAPHY OF IMPACT INVESTING CAPITAL FLOWS

There are 167 private equity funds currently registered in the ImpactBase of the GIIN. Of these funds nearly 70% have headquarters located in developed markets; North America (defined in this research as only Canada and the US) alone is home to 40% of these funds. These statistics likely reflect the relative high GDP per capita and amount of investable dollars within these countries.

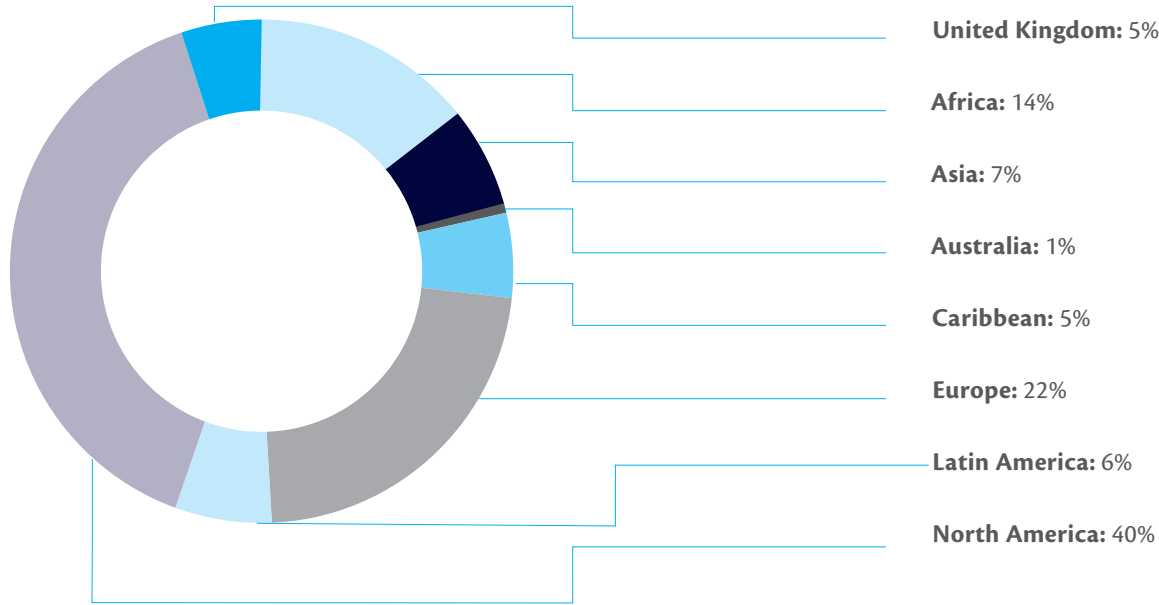


Figure 6: Impact Investing Fund Domiciles

Most of the funds in the ImpactBase are currently also investing in developed countries. This trend is very prominent for funds based in the United States, with 60% of all funds investing within the home country or in another developed country. However, the opposite is true when we look at the dollar value being invested rather than the number of funds. Currently, 73% of targeted capital raised globally is intended for developing countries. However, when we break this down on a continental basis, different profiles emerge. Funds that are domiciled in the US do not follow the same pattern: 59% of committed dollars are being invested within the US (see Figure 7). In the case of Europe, both the number of funds and dollar value predominantly target developing countries (see Figure 7).

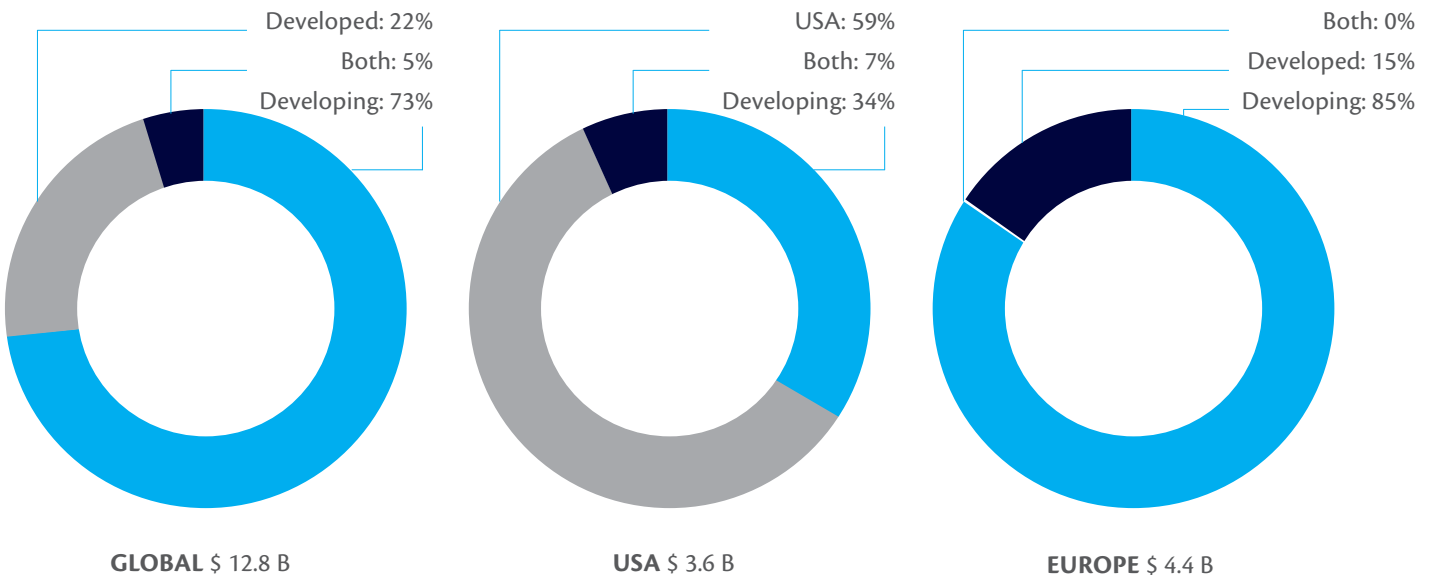


Figure 7: Geography Of Impact Investing Capital Flows

The discrepancy between where most funds invest and where most dollars are invested is largely due to the fact that the biggest funds invest in developing markets. The 10 biggest funds in the ImpactBase are predominantly investing in developing markets and represent 33% of targeted investment dollars of all funds in the database. It is also important to note that 9 of the 10 funds are located outside the United States, which further highlights the finding that while US funds predominantly invest in the US, other funds globally invest in emerging markets.

The discrepancy between where funds invest and where the dollars are going also points to another important finding: deal flow in developing markets involves larger dollar amounts. This would have to be the case given that almost all capital in a traditional private equity fund must be deployed. With such a large amount of capital to be invested, it must be the case that the ventures that are receiving investment are larger in scale. This could reflect risk-hedging strategies taken by fund managers and investors seeking more established ventures that have more stable and larger cash flows. The industries that are targeted for investment may also

play a role in the size of the investments.

Other conclusions that can be drawn from our examination of the geographic flow of funds include:

- ▲ Most funds will either invest in developed or developing markets, but not both.
- ▲ The majority of impact investment opportunities are in emerging and developing markets (Latin America, Africa, South Asia, Eastern Europe, SE Asia).
- ▲ US funds are most active in domestic investment, likely due to a higher acceptance of market based solutions for social issues, than in the UK and Canada.
- ▲ Fund managers must have extensive networks and strong knowledge of the local context if they are to invest in a certain market. Having the presence of in-country staff is also essential as this reduces the risks involved in a fly-in, fly-out¹⁸ strategy.¹⁹

FUND AND INVESTMENT SIZE

There is a wide range in the size of impact investing funds. Target fund size for private equity funds in the ImpactBase ranges from \$10M-\$500M, however committed capital is typically in the \$10M - \$50M range. With committed capital representing only 44% of targeted capital there seems to be a lot of potential for primary and secondary investors to still enter the market. This difference between targeted and committed funds could also mean that the size of the impact investing market is inflated, as the target fund size is much larger than committed funds.

Interviews with investment funds based in Toronto, Vancouver, and San Francisco and an assessment of funds in the GIIN ImpactBase show \$50M to be a common target size for an impact investment private equity fund. This appears to be a factor of fund economics and available deal flow. Larger deals sizes mean lower transaction costs (such as deal sourcing and legal costs) but deal sizes are also limited by the nature of existing deal flow. Maintaining a fund that is over \$60M, for example, would either require investment in more ventures

or in more established businesses. This increases the risk that the quality of investments is lower, i.e. are less profitable, have less social impact, or a combination of both. This also increases the pressure to deploy a lot of capital in a relatively short period of time which is another factor that could lead to poor investments and/or an inefficient deployment of capital.

In terms of North American investments, the mean and median of committed capital are even lower at \$29M and \$22M respectively. This supports the notion that deal sizes in North America are smaller than those in developing countries. It's probably safe to hypothesize that funds investing in developed countries are investing in earlier stage ventures, which may be possible due to lower levels of political and destabilization risk.

Lastly, our research shows that an ideal fund size will largely depend on the fund's mission (financial or impact first), the sector it seeks to invest in, as well as the geographic location. The nature of deal flow and target business stage are also factors determining a target fund size.

¹⁸ Fly-in, fly-out strategies involve investing in a market and managing such an investment overseas. This is a perilous strategy for managing hands-on investments (such as PE and VC investments) as it involves distancing the investor from the investment.

¹⁹ This finding emerged from interviews with various fund managers.

With impact investing still in its infancy, it is not surprising that most impact funds are less than 5 years old. Of the 167 funds that are registered in the ImpactBase, 140 (or 84%) are 5 years old or younger. The average age of all funds is 4 years. With the lifespan of typical private equity funds at 10 years, it is difficult for investors to really know whether these funds will actually attain the returns they aspire for. It is highly probable that most of these funds will not deploy all of their

capital given that traditional PE and VC funds deploy capital during the first 5 years of a fund’s life. The next 5 years will be an exciting time for these impact investment funds, and for the impact investing sector as a whole, as the funds come to a close. The big question is whether or not the majority of these funds will reach their target IRR and continue to propel the impact investing movement into the minds of more traditional investors.

BUSINESS STAGE

50% of funds in the ImpactBase claim to invest in several different business stages. However, further examination of these funds’ prospectuses shows that most are primarily investing in growth stage ventures. Funds that state that they only invest in one business stage mostly prefer ventures in the growth stage. Interviews with a number of these fund managers suggested that the stability and venture traction at this stage is attractive, while still maintaining large potential for profit and growth. It appears that this stage has the best risk-reward trade-off, especially in frontier market investments that may be exposed to high political and destabilization risk. Our findings are similar to those of a 2012 survey of impact investors by J.P. Morgan (see Figure 8).

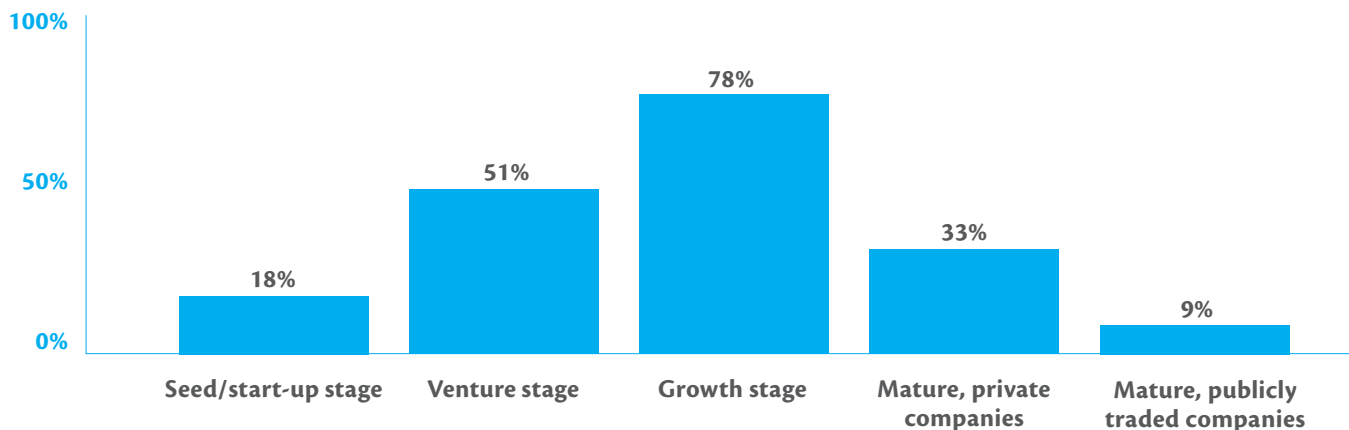


Figure 8: Stages Of Company Development At Which Impact Investors Prefer To Invest ²⁰

The strong preference for investment in growth stage ventures likely causes an excessive demand for deal flow in this stage, creating a competitive market for deals. This could potentially create a scarcity in quality deals as well as the overvaluation of such deals. This hypothesis was validated by a conversations with several impact investment funds in the US. It was suggested during the interviews that successful funds should search for ventures or sectors where no other fund is present as this will allow them to price and acquire ventures at lower valuations. Having competition for the same deals would logically increase the valuation and make equity acquisitions much more expensive, reducing financial returns. As was stated earlier in this paper, the majority of impact investing funds are less than 5 years old and have not yet raised or committed half of their target capital. This factor, combined with evidence of increasing competition for deal flow at the growth stage, leads us to conclude that competition for deal flow will continue to increase and that deploying capital efficiently will become even more difficult for funds.

It is also important to note that growth stage ventures could be less capital constrained compared to seed stage or early stage ventures if most funds are geared to investing in the growth stage. As such, true impact first investors should consider investing in seed or early stage ventures due to the financial constraints such ventures face. This approach is exemplified by the likes of Acumen Fund and Insitor, funds that are widely considered to be at the forefront of impact first funds.

²⁰ The source used the following definitions for the investment stages: Seed/Start-up: Business idea exists, but little has been established operationally (pre-revenues); Venture: Operations are established, company may or may not be generating revenues, but not yet positive EBITDA; Growth: Company has positive EBITDA and is scaling output; Mature: Company has stabilized at scale and is operating profitably. Source: J.P. Morgan. Perspectives on Progress: The Impact Investor Survey. Available from: http://www.thegiin.org/cgi-bin/iowa/download?row=489&field=gated_download_1;

FINANCIAL RETURNS

It is understandable that investors who are new to impact investing would think of it as a less profitable investment compared to its traditional capital market counterparts. This may be due to the current norms in the sector where philanthropy and market returns are located on opposite ends of a continuum (see Figure 3). As such, it is hard to believe that impact funds could achieve the above-market returns they aspire to. According to the information submitted to the GIIN Impactbase, the most common rate of return targeted by funds is 20% IRR. The median return that funds based in North America are targeting is very close to the 17% mean of global PE/VC funds in the ImpactBase. The IRR represents the targeted goal of fund managers rather than their actual performance. Interviews with Canadian based

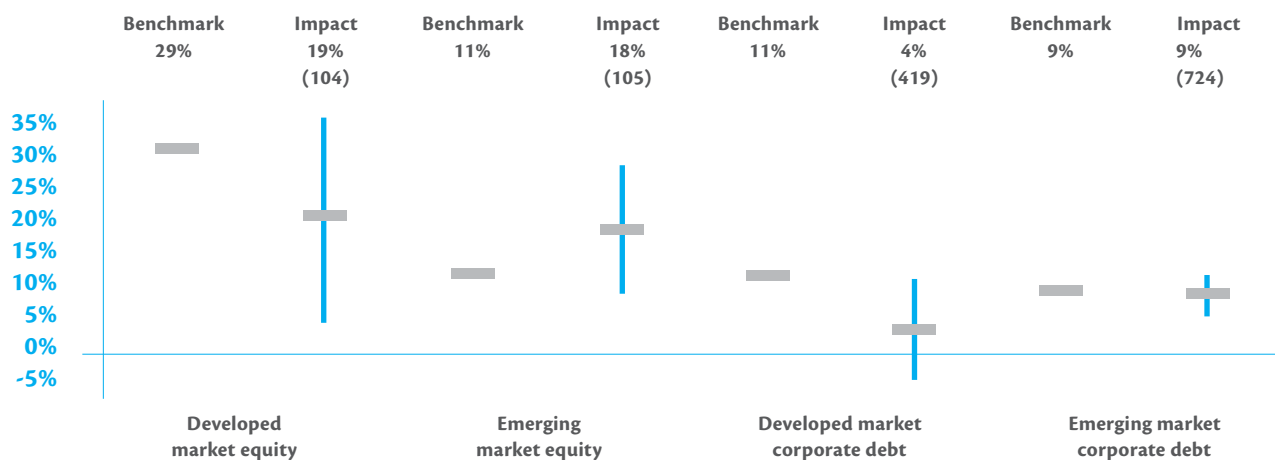
funds suggest they also have a 20% net IRR target. Figure 9 shows the comparison between industry benchmarks and impact investors' expected returns.

The majority of impact investing funds are relatively new and only a small minority have a track record of achieving this level of financial returns. The JP Morgan report, Perspectives on Progress, The Impact Investor Survey states that impact investment funds surveyed said that they were on track to achieve their target financial returns. However, these funds are only in the range of 3-5 years into a 10 year or more investment strategy and their current response that they are on track to achieve targeted financial returns is not a guarantee that they will achieve these returns.

y-axis: Annual internal rate of return (*IRR*) or yield (gross, in USD)

The horizontal bars show the average baseline expected return for impact investments reported or average realized return for benchmarks (listed at the top of the chart), the vertical bars show the standard deviation of survey responses, and the number of observations informing each average is shown in parentheses.

▲ THE GLOBAL IMPACT INVESTING INDUSTRY 10



Source: GIIN, J.P. Morgan. Note that the lower standard deviation for Develop Market Debt is below zero: -3%. Benchmark returns are average annual returns for: Cambridge Associates US Venture Capital Index and Emerging Markets Venture Capital and Private Equity Index, for vintage years over the period 1989-2008 (the longest data history available for both, and excluding the more recent vintages as Cambridge Associates recommends for data quality); and J.P Morgan's Developed Markets High Yield index and Corporate Emerging Market Bond ("CEMBI") Index, over the period 2002-2011 (the longest data history available for both). The emerging market debt impact investment expected return is 8.7% relative to the benchmark average return of 9.4%. The number of investors who responded for each instrument, and the number of investments in the sample (respectively) are: DM Equity = 14, 104; EM Equity = 18, 105; DM Debt = 12, 419; EM Debt = 18, 724. Vintage years for reported impact investments are 1990-2011, with one transaction each in 1970, 1972, and 1988.

Figure 9: Baseline Expected Returns And Benchmarks ²¹

²¹ J.P. Morgan. 14 December, 2012. Insights Into the Impact Investment Market. Available from: http://www.jpmorganchase.com/corporate/socialfinance/document/Insight_into_the_Impact_Investment_Market.pdf

Studies of private equity returns also point to skewed nature of the return distribution of traditional commercial PE funds. As of 2011, Cambridge Associates state that funds in the upper quartile (in terms of returns) are averaging 7.04%, while those in the lower quartile average -14.28%. The large standard deviation of 29.33% is further proof of the large gap between top performers and the rest of the industry. Traditional venture capital returns are even worse. Funds in the upper quartile average a 2.25% return, while those in the lower quartile average -21.66%. The standard distribution of the returns is 21.51%.

Exit risk is another issue that may impede the ability of impact funds to achieve above market returns. Based on our research of PE funds in the GIIN database, common benchmarks used to determine market rate include LIBOR, Cambridge Associates Indices, and country CPI. However, despite the variety of different market rate sources, a market rate has not yet been

established for impact investing. Financial first investors point to a range of 15% – 20%, while impact first investors are looking more at the 0% (return of capital) – 5% range.

It is important for potential impact investment investors to be wary of the kind of returns they can realistically gain from their investments. These returns are largely determined by the impact sector that is chosen and the venture stage of companies in a fund's portfolio. Returns of 15% – 20% should be seen as an exception to the rule and not the basis for future returns. Many funds may aspire to compete with the funds in the top quartile in terms of returns, however historical performance of past traditional PE and VC funds shows that most funds are likely to fail in achieving such goals.²² Furthermore, returns in the PE/VC space have significantly declined in recent years, and 20% is no longer the market rate even in the traditional investment space.

		CASH	QUASI EQUITY	PUBLIC EQUITY	BUYOUT	VC	REAL ESTATE	COMMODITIES
1981-1990	Average Lower Bound	6%	7%	10%	16%	8%	5%	N/A
	Average Upper Bound	10%	13%	16%	22%	18%	15%	N/A
1991-2000	Average Lower Bound	3%	4%	5%	8%	25%	8%	3%
	Average Upper Bound	6%	8%	10%	14%	45%	15%	12%
2001-2005	Average Lower Bound	1%	5%	4%	-10%	-12%	12%	5%
	Average Upper Bound	4%	10%	10%	2%	2%	20%	15%

Range Considered Was 2001-2008 For Quasi Equity, Buyout And VC

Figure 10: Benchmarks Across Asset Classes²³

On a positive note, there is evidence of funds that have been successful in North America. Sarena Asset Management, Elevar Equity, and Unitus Capital have established fund models that have yielded realized returns for their investments. However, these funds invested mostly in growth stage ventures in the microfinance industry, which has become controversial in some cases. Other funds that have realized success include Renewal,

which has invested mostly in clean tech and sustainable agriculture, industries which are very trendy and are growing in North America. As such, the question remains whether impact investment funds can truly achieve above market returns while investing in industries that do not fall under the financial services and clean tech realm. Whether or not these models can be replicated in the same industry is also another point worth pondering.

²² By definition, 75% of funds will not be in top quartile.

²³ The Parthenon Group, Bridges Ventures, and the Global Impact Investing Network (GIIN). Investing for Impact: Case Studies Across Asset Classes. March, 2012. <https://www.missioninvestors.org/system/files/tools/investing-for-impact-case-studies-across-asset-classes-the-parthenon-group-bridges-ventures-and-the-global-impact-investing-network-giin.pdf>

Case Study: Microfinance and the Limitations of Impact Investing

The microfinance sector is one of the biggest sectors for impact investment inflow²⁴ and is often used as an example of how social goals can be achieved while generating market rate returns for investors. At the same time, recent insights into the microfinance industry have resulted in evidence to the contrary, and microfinance has also become the example used by those who believe it is not possible to achieve impact simultaneously with market rate financial returns.

The pioneer of microfinance was Grameen Bank, founded in Bangladesh in 1976 by Prof. Muhammad Yunus. Yunus learned that basket weavers in his community were selling their products to middle men at an extremely low price because they had no way to purchase their raw materials other than from the eventual buyer of their product, who also required that the baskets be sold to him at a pre-agreed price. This market was very disadvantageous for the weavers. He tested a model of lending these weavers small amounts of money so they could purchase their raw materials and then sell their products at a market price.²⁵ The success of this experiment led to the establishment of the microfinance model, where access to credit is made available for people at the bottom of the economic pyramid who are excluded from formal credit systems.

When Prof. Yunus developed the microfinance concept he was addressing a specific problem faced by micro business people at the bottom of the economic pyramid who needed to access credit for their businesses. Access to credit for the poor in itself is not a solution to poverty, rather it can be the cause of a cycle of indebtedness for an individual resulting in further problems. This is true in any context and the implications of too much access to consumer credit were demonstrated by the recent consumer credit crisis in the USA. In developing countries, consumers are even more likely to seek to access available credit as they are often in truly dire situations. Even when funds are used for essentials such as food and housing, access to credit does not benefit the poor overall if they are not able to repay it. The resulting over-indebtedness without a means of repayment compounds the borrowers' problems when they have to face aggressive collection practices or resort to loan sharks to borrow funds for repayment.

It took the Grameen Bank's model 17 years to break-even²⁶ and it is still not a commercial business model, nor does it intend to become one. The organizations' model has, however, developed and proven the microfinance model that is now used by many other organizations to provide people at the bottom of the economic pyramid with access to appropriate credit that has helped many people significantly improve the economic situation and quality of life for their families. Microfinance is now a commonly used tool for addressing poverty that is effective when applied appropriately. Funders who helped to prove and develop this model have made a significant contribution to poverty alleviation globally.

²⁴ J.P. Morgan. 14 December, 2012. Insights Into the Impact Investment Market. Available from:

http://www.jpmorganchase.com/corporate/socialfinance/document/Insight_into_the_Impact_Investment_Market.pdf. Accessed 1st August, 2012.

²⁵ Grameen bank website. http://www.grameen-info.org/index.php?option=com_content&task=view&id=19&Itemid=114. Accessed 4 November, 2012

²⁶ Koh, Karamchandi and Katz. From Blueprint to Scale: The Case for Philanthropy in Impact Investing. April 2012. Accessed from: www.mim.monitor.com/blueprinttoscale.html

The success of Grameen Bank's model also attracted attention from investors who saw a potential new market opportunity in providing credit services to the world's poor. Viewed at this basic level, the market of poor people who would take loans is very large. However, when taking into consideration whether credit is appropriate for an individual and whether they have sources of repayment, this potential market shrinks considerably. With this consideration, it becomes limited to micro business owners who can demonstrate that they can use credit to grow their business and generate sufficient income to repay the loan and have a surplus. Furthermore, small loans have a very high transaction cost as even loans of \$25 should be assessed by a loan officer.

The drive to commercialize microfinance has driven efforts to make this model more profitable. As a result, lending criteria have become very loose, loan sizes have increased to decrease average transaction costs, and collection practices have become more aggressive. The average microfinance loan size in Cambodia is currently \$559 USD; this is not a loan size targeted to the poorest populations.²⁷ In 2010 the microfinance industry in India came under scrutiny after reports that as many as 200 microfinance borrowers in the state of Andhra Pradesh had committed suicide after being unable to repay their loans. Microfinance lenders were accused of coercive collection practices that had led these borrowers to take their lives.²⁸

One of the largest microfinance organizations active in Andhra Pradesh was SKS Microfinance, a for-profit commercial model of microfinance lending. SKS, among other lenders, was accused of providing borrowers potentially un-repayable debt and using coercive collection practices.²⁹ At a recent conference on the topic of social enterprise at the Harvard School of Business, Vikram Akula, the founder of SKS Microfinance, said that Grameen Bank's founder, Prof. Yunus, a critic of for-profit microfinance models such as SKS, was right. "Bringing private capital into social enterprise was much harder than I anticipated," Akula said, acknowledging the limitations of commercial funding models in achieving development goals.³⁰

The experience of the microfinance sector demonstrates that commercial investment cannot always, and likely not even often, be effective for addressing a social challenge. Although the contribution of private sector finance to development has strong potential, caution is necessary about the expectations of financial return that can be generated alongside impact. Impact investment is not the same as commercial investment.

²⁷ Cambodia Microfinance Association website. <http://cma-network.org/drupal/MicrofinanceEnvironment> Accessed on 28 November, 2012

²⁸ The New York Times. India Blog. 27 February, 2012. "Yunus was Right" SKS Microfinance Founder Says.

Accessed from: <http://india.blogs.nytimes.com/2012/02/27/yunus-was-right-sks-microfinance-founder-says/>. Accessed on 28 November, 2012

²⁹ Social Enterprise Conference at the Harvard School of Business website. 26 February 2012.

Accessed from: <http://socialenterpriseconference.org/former-chairman-of-sks-microfinance-vikram-akula-shares-lessons-learned-2/>. Accessed 8 November, 2012.

³⁰ The New York Times. India Blog. 27 February, 2012. "Yunus was Right" SKS Microfinance Founder Says.

Accessed from: <http://india.blogs.nytimes.com/2012/02/27/yunus-was-right-sks-microfinance-founder-says/>. Accessed 8 November, 2012

IMPACT INVESTMENT SECTORS

Impact investors have been active in numerous sectors including healthcare, housing, ecotourism, transportation and education. However, the sectors that have garnered the most attention are the microfinance, agriculture (includes sustainable and organic food) and clean technology sectors. This is largely due to the fact that these sectors are more mature, have attained enough scale and are considered to be de-risked. The presence of historical data and key comparables plays a key role in reducing risk.

Based on our analysis of the GIIIN database and other research papers, trends can be identified among successful investments in developing and developed markets. For example, funds that have invested within North America focus largely on clean technology and sustainable agriculture. On the other hand, funds that invest in frontier and developing markets have invested largely in microfinance and other financial services. There are also a number of investments in clean tech, although this is not as prevalent as investments in microfinance.

It can be argued that investments in certain geographies equate to investments in certain sectors. This is largely due to

the difference in scale and the sophistication of economic and governmental infrastructures in various geographies. For example, the water sector in Canada is not a likely candidate for attracting impact investing capital. In Africa, the reverse would be the case, since there are millions of people unable to access clean drinking water and basic infrastructure.

Despite this hypothesis, it is currently very difficult to break down impact investments in terms of sector. The difference in impact per venture further exacerbates the issue. For example, many funds may target ventures in the finance sector, yet the ventures' mission and the consequent target market can be very different. With almost all funds investing in more than one sector it has also become extremely difficult to assert what sectors financial first and impact first investments look at and invest in. It becomes more advantageous to look at the target customers of the ventures to evaluate the impact the investment makes and ascertain whether these funds are in fact impact or financial first and can attain the returns they promise.

IDENTIFIED SUCCESS FACTORS

The most common success factor among all the different PE funds in the ImpactBase is the need for strong experience in investment banking, consulting, or private equity. The need for strong sector know-how is also essential, as are strong connections in the industry and public domain. Our evaluation of the management teams, fund operational structures and investment strategies of successful funds resulted in the identification of the following success factors for the various types of funds in the impact investing space (see Figure 11).

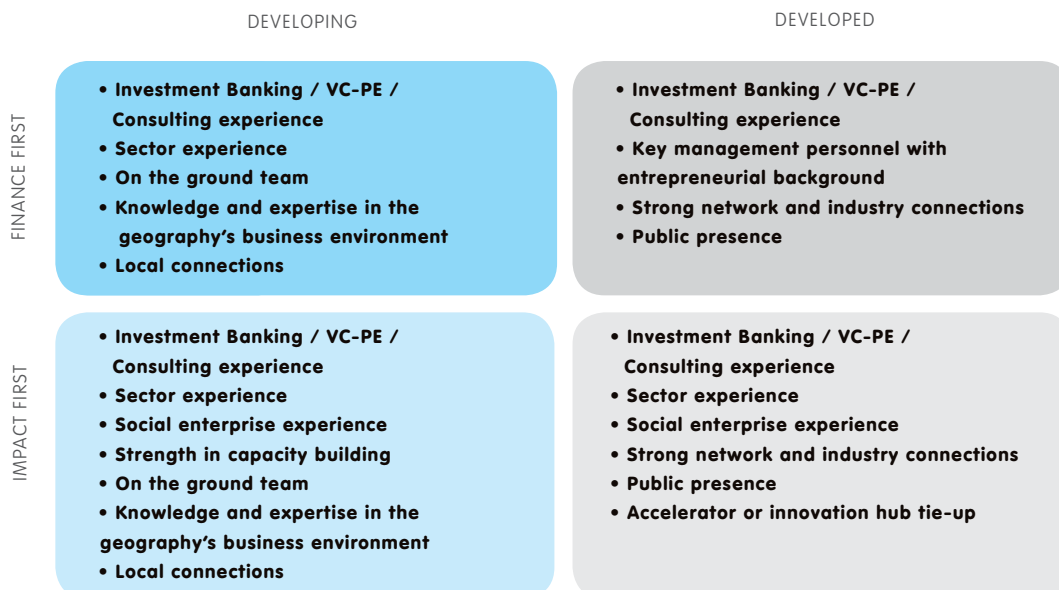


Figure 11: Success Factors

CANADIAN IMPACT INVESTING INDUSTRY

MARKET SIZE

A 2010 report, entitled *Impact Investing in Canada: A Survey of Assets*,³¹ stated that the Canadian Social Investment Organization (SIO) has estimated the Canadian impact investment market at \$4.45B (see Figure 12). This number is very large in proportion to the global assets targeted for impact investing based on the GIIN database (\$9B). A closer look at how this estimate was derived shows that funds included in the estimate were not only private equity investments but also government and credit union assets. This is an example of how grossly the size of the “impact investing” sector can be overstated when there is no clarity around the boundaries of what qualifies as an impact investment.

IMPACT INVESTMENTS ASSET BY CATEGORY	ASSETS (\$ MILLIONS)
Aboriginal Funds	285.7
Community Futures Development Corporations	910.6
Community Loan Funds and Social Venture Capital	348.8
Credit Unions	951.5
Foundations	32.0

IMPACT INVESTMENTS ASSET BY CATEGORY	ASSETS (\$ MILLIONS)
International Impact Investments	5.6
Quebec- Development Capital	1,049.1
Quebec- Solidarity Finance	850.5
TOTAL	4,447.8

Figure 12: Example of Canadian Impact Investing Market Estimate ³²

Canadian funds currently registered in the ImpactBase all identify as finance first funds. This tends to give the impression that the impact investing space for impact first funds in Canada is very small. However, our research has shown that there is also a significant presence (relative to the size of the Canadian market) of impact first funds not in the ImpactBase. Some of the most prominent impact first funds in Canada include Cape Fund (\$50M), Vancity’s Resilient Capital (\$13.5M), and the recently launched RBC Generator (\$20M).

FUND AGE

Numerous participants in the Canadian impact investing space described the nascent stage of impact investing in the country. The United Kingdom is the current global leader, as evidenced by their use and creation of more innovative products, such as impact bonds, and the support the sector receives from the current coalition government. The US seems to be in second position and the approach is starting to gain more ground through the support of President Barack Obama, who recently highlighted the US’ impact investing efforts at the G8 Social Impact Investing Forum.³³ Canada, on the other hand seems to be a decade behind, with most investors still unaware of the concept.

³¹ Bragg, I. (2010). *Impact investing in Canada: A survey of assets*.

³² Ibid.

³³ <http://blogs.cabinetoffice.gov.uk/socialimpactbonds/2013/06/social-investment-comes-to-the-g8/>

Looking at Canadian PE/VC funds in the GIIN ImpactBase, it was not surprising to see coherence in the age of the funds given the relatively new status of the concept in this country. The average age of these funds is 2.6 years with only one fund, Sarona Risk Capital Fund, past the 5-year mark. The number of registered funds in the database is also a testament to how young the sector is in Canada. To date only 7 funds that are domiciled and headquartered in Canada, have registered in the ImpactBase. The lack of legal infrastructure and government support are further evidence that Canada’s impact investing scene still has a long way to go.

RETURNS

The average target IRR for Canadian funds registered in the ImpactBase is 16%, which is very similar to the (optimistic) global average of 17%. Looking at the returns from the traditional VC industry for the last decade reinforces the view that targeted returns are very optimistic (see Figure 10). Even VCs that are in the IT space are making much lower returns with the sector averaging 6%.³⁴ The inconsistency between the current difference between actual market returns and the targeted returns of impact investment funds should caution any impact investor to be skeptical of the high returns promised by fund managers.

3-year venture capital annualized returns for Canada and United States 1980-2010

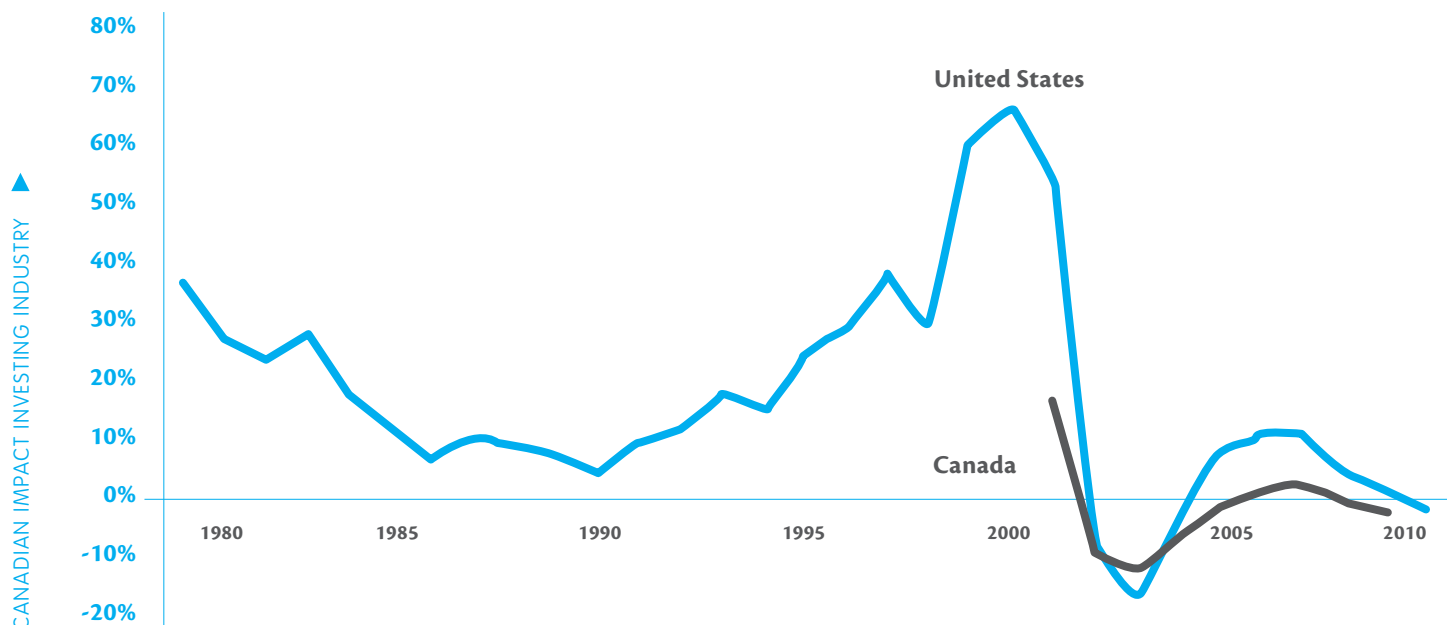


Figure 13: Canadian Venture Capital Performance ³⁵

INVESTED SECTORS

Almost all Canadian funds invest in Canada and the US, with Sarona as the only large fund investing in developing markets through its successful ‘fund of funds’ approach. This strategy allows them to avoid the additional expense of having a team on the ground and has also allowed Sarona to invest in sectors such as microfinance, agriculture, and other basic services such as water, healthcare and education.

Other than Sarona, all other impact funds domiciled in Canada have chosen to invest in North America. The sectors that are most commonly entered are clean tech, sustainable agriculture (organic food) and sustainability (waste management and clean energy). These are sectors that are currently very attractive with growing demand for products that offshoot from these sectors.

The invested sectors in Canada are typical of the sectors that are invested in by funds in other countries. What makes the Canadian profile unique, however, is that all Canadian funds target market returns. Commonly, funds that target basic Bottom of the Pyramid

³⁴ Venture capital returns. (2013, May 22). Canadian Business. Retrieved from <http://www.canadianbusiness.com/sponsored-information-feature/exchange-insights-from-tsx-tsxv/venture-capital-returns/>

³⁵ Institute for Competitiveness & Prosperity analysis based on data from Canada’s Venture Capital and Private Equity Association (CVCA); National Venture Capital Association (NVCA); Thomson Reuters, and Cambridge Associates LLC

(BOP) services aim for below-market returns, which is not the case in the Canadian fund Sarona. This is a key reason why the business model Sarona currently employs is very unique as it seems to avoid a trade-off between impact and financial success.

DEAL FLOW

Contrary to the findings of numerous reports, Canadian fund managers state that there is a lot of deal flow coming available. Every year fund managers are able to screen hundreds of potential deal opportunities and select a handful of the very best. This success is largely attributed to the ever-growing presence of start-ups that belong in the invested sectors. Using traditional PE and VC strategies, fund managers search for deal flow in a variety of places. Leveraging existing angel networks and reviewing the portfolios of incubation and accelerator hubs are some of the most common techniques to generate deal flow.

GOVERNMENT SUPPORT

Phillips, Hager & North succinctly described the government support provided to impact investing, "Structures have been legislated into existence in the U.S. and the U.K., as noted above, but Canadian entities still face challenges."³⁶ This sentiment is largely shared by other Canadian fund and endowment managers. For example, there are still a lot of restrictions on how foundation capital can be used and in what it can be invested. A draft paper by the Carleton Centre for Community Innovation titled Social Finance in Canada ³⁷ may have identified the reason why most investors either look for pure financial returns or donate grant money: "The charity route is simpler and provides a tax deduction not currently available for a below-market investment."

It is imperative that the Canadian government work on ways to help impact investing in the country. In Ontario, a lot of progress is being made by working within the structure of current regulations rather than with the support of government. It appears that the Harper government is now more aware of the importance of government support with reference to the option of releasing social impact bonds into the market. More of this is needed, as the "...[social impact bonds] announcement is [merely] a [small] positive development in Canada, which has fallen behind the rest of the world in the creative use of capital for social purposes."³⁸

³⁶ Phillips, Hager & North. (2010). An overview of impact investing.

³⁷ Hebb, Tessa. The Utilization of Social Finance Instruments by the Not-For-Profit Sector. Working Paper #12-02. Carleton Centre for Community Innovation. <http://carleton.ca/3ci/wp-content/uploads/3ci-Utilizing-Social-Finance-Report-August-16-Final.pdf>

³⁸ Sherri, T. (2013, May 8). Private money, public programs? There will always be strings. The Globe and Mail.

Retrieved from <http://www.theglobeandmail.com/commentary/private-money-public-programs-there-will-always-be-strings/article11765335>

CONCLUSIONS

The impact investment sector is currently in the range of \$9 billion USD, and growing. However, this includes investments that are also considered traditional investments and were in existence prior to the coining of the term impact investment. Impact investments focused on impact over financial returns are a small minority.

The size of the impact investing industry depends on the definition of impact investing used. If it includes traditional investments that create positive impact “by-default” while pursuing financial returns then the industry is approximately \$9bn as estimated by J.P. Morgan. If impact investing refers to investments that seek to intentionally create impact in areas where there are market failures resulting in potential solutions not being funded because of a higher risk profile than what is predominant in the market, then the size of the industry is significantly smaller.

Impact investors are varied and range from HNWIs to governments. There is a spectrum of impact investors and corresponding impact investment strategies and both financial and philanthropic capital are used to make impact investments. There is a range of risk/reward profiles in this spectrum of impact investors and investors must find the subset of impact investments that correspond to their goals and risk/reward profile.

Within the impact investing space investors have been categorized into “impact first” investors and “financial first” investors by the primary focus of their investment strategy. “Impact first” investors tend to be defined as those that are

willing to accept a lower financial return, or higher risk, for a higher impact return. “Financial first” impact investors require a risk/financial reward profile that is at the current market rate but select investments that also create positive impact, often as a result of the nature of the sector, for example clean technology, microfinance, or investment in emerging markets. It is important to note, however, that an “impact first” investment can generate a market or above market rate return and that “financial first” investments often fail to realize target returns.

Capital flowing into impact investing comes from diverse sources, including philanthropic funds of HNWIs and family offices, foundations, investment funds of HNWIs, corporations, endowment funds, development finance institutions and others. The source of the capital has implications for the type of impact investing strategy it can pursue and whether impact or financial returns can be prioritized.

Investors interested in pursuing impact investment strategies should first decide what types of capital they are allocating to impact investing, the risk profile for that capital and the impact they seek to create with their investment.

³⁶ Phillips, Hager & North. (2010). An overview of impact investing.

³⁷ Hebb, Tessa. The Utilization of Social Finance Instruments by the Not-For-Profit Sector. Working Paper #12-02. Carleton Centre for Community Innovation. <http://carleton.ca/3ci/wp-content/uploads/3ci-Utilizing-Social-Finance-Report-August-16-Final.pdf>

³⁸ Sherri, T. (2013, May 8). Private money, public programs? There will always be strings. The Globe and Mail.

Retrieved from <http://www.theglobeandmail.com/commentary/private-money-public-programs-there-will-always-be-strings/article11765335>

Impact investing encompasses investments across asset classes and risk profiles. As such there is no single target rate of return in impact investing. Our research did find that within the VC/PE asset class within impact investing “impact first” funds generally target an IRR of 20% and “impact first” funds seek financial returns in the range of 5% at the fund level.

Based on those factors an investor can determine which subcategory of impact investing is appropriate. Investors often invest across the subcategories as a total portfolio strategy for impact investing, for example investing from their philanthropic portfolio into a non-profit “impact first” fund investing in solutions to some of the most challenging problems in developing countries and from their financial portfolio into a “financial first” fund investing in clean technology or job creation in a developed market.

Impact investing encompasses investments across asset classes and risk profiles. As such there is no single target rate of return in impact investing. Our research did find that within the VC/PE asset class within impact investing “impact first” funds generally target an IRR of 20% and “impact first” funds seek financial returns in the range of 5% at the fund level. We also found that there are only a handful of funds that have achieved their target returns and the vast majority of funds that self identify as impact investing funds are less than 5 years old and most have not exited any investments. It is highly likely that the impact investing funds will follow the same pattern of traditional VC/PE funds where only around 10% of funds will achieve their target returns. We can conclude that it is possible to achieve market rate returns in impact investing, but only a small number of funds will do this.

The majority of investors and funds are currently seeking the “low hanging fruit” in the impact investing industry, those opportunities that have high financial return and impact return potential. These opportunities are widely sought after. Based on the geographies and sectors that funds are seeking to invest in we can conclude that such opportunities are in developed markets in sectors such as clean technology and job creation and in emerging markets in various sectors including microfinance, green and sustainable consumer products and services for the growing middle class and the bottom of the economic pyramid.

Globally the majority of impact investment is flowing into developing and emerging markets, with the exception of the US, where the majority of domestic impact investing funds are also invested domestically.

- ▲ The majority of impact investment funds from the US are flowing into domestic markets, primarily clean technology and small business development.
- ▲ The majority of impact investing funds globally are flowing into emerging and developing markets.

A potential reason for this difference is that the US has historically been more open to market based solutions to social problems than Canada or Europe.

There is no common standard for impact measurement or reporting, and the impact of “impact investments” varies greatly in breadth and depth. It is up to the individual investor to determine how they value impact.

The Canadian impact investing industry is very small in comparison to the global industry. One reason for this is the smaller size of the market in Canada, but a more important factor may be that in Canada foundations are not allowed to engage in impact investing through their granted funds. By comparison, this activity is allowed in the US. In addition, the government does not support the sector financially as it does in countries like the UK, where government funds seed many impact investing initiatives. In other words, regulatory changes could have a significant impact on the sector in Canada.

