THE BOTTOM LINE
INVESTING FOR IMPACT ON ECONOMIC MOBILITY IN THE U.S.

THE ASPEN INSTITUTE

CONTENTS

INSIGHTS FROM ABROAD: IMPACT INVESTING IN EMERGING MARKETS

Randall Kempner, Executive Director, and Alexander Pan, Program Coordinator, Aspen Network of Development Entrepreneurs

The Aspen Network of Development Entrepreneurs (ANDE), a policy program of the Aspen Institute, is a global network of organizations that propel entrepreneurship in emerging markets. ANDE members provide critical financial, educational, and business support services to small and growing businesses (SGBs) based on the conviction that SGBs will create jobs, stimulate long-term economic growth, and produce environmental and social benefits. Ultimately, we believe that SGBs can help lift countries out of poverty.

Members of ANDE include both for-profit and nonprofit investment funds, capacity development providers, research and academic institutions, development finance institutions, and corporations from around the world. Launched with 34 members in 2009, ANDE now comprises over 200 members who collectively operate in more than 150 countries.

From our perspective at ANDE, we have seen impact investing become an increasingly important tool used to support small and growing businesses in the developing world that are capable of creating jobs, stimulating long-term economic growth, and generating social impact. However, impact investing is still very much an emerging tool. If it is to scale and become a viable solution to social issues in the United States, there are several key lessons from the international context that the industry should consider.

To start, it is important to note that impact investing actually makes up a very small portion of the approximately $80 trillion dollars in assets under management globally. At $46 billion, impact investing comes to about 0.06 percent of total assets under management.[1] And the total in deals completed is only $9 billion, or roughly 1/100th of 1 percent of the total.

So impact investing still clearly has a lot of room to grow, but let us not be overly negative: $9 billion in investments dedicated to social impact is still a considerable sum of capital and indicates the burgeoning interest in this sector. Moreover, with at least $35 billion in impact capital waiting to be invested, the sector is poised for launch.[2]

But for the moment, there are not enough good deals, at least in emerging markets. While there are many investors in this space, the first thing they generally complain about is the lack of investment-ready opportunities. Conversely, entrepreneurs complain that they have trouble connecting with impact investors and that these investors are not willing to take enough risks. This results in a large number of stagnating social businesses. Bridging this gap between investors and entrepreneurs is absolutely essential if impact investing is going to succeed in any part of the world. So, it is worth exploring why this gap exists in the first place.

[1] *J.P. Morgan & Global Impact Investing Network. (2014). Spotlight on the Market: The Impact Investor Survey. New York: J.P. Morgan.This figure likely represents a vast majority of impact capital; it is not intended to be a comprehensive figure and likely undercounts the true amount of impact capital.*

[2] *Ibid.*

POINT OF VIEW

The Two Talent Gaps

The first issue is human capital. As almost any venture investment professional will tell you, the most important thing they look for in an opportunity is the quality of the entrepreneur and his or her management team. However, in the emerging market context, investors often find that management teams lack the necessary business skills and training.

To address this issue, a range of capacity development providers have emerged, including numerous incubators and accelerators, that aim to augment the business skills and general capacity of an enterprise. While ANDE believes in the potential of these organizations, most are start-ups themselves with little track record. There is a clear lack of understanding of best practices in business incubation, even in the developed world. ANDE is working to better understand the impact of acceleration and establish an understanding of what works and what does not through its research initiative.[3]

While there is still much more research to be done, there are two salient findings from our initial research. The first is that an incubator's selectivity matters: Incubators with lower acceptance rates have a higher proportion of successful graduates. In addition to the obvious logic that better firms in lead to better firms out, there seems to be added value in having interaction and "cross-fertilization" of ideas and contacts with higher quality participants. The second is that an incubator's ability to develop partnerships with locally based commercial investors is a key determinant of success. For many accelerator graduates, the next step in financing may not come from impact investors, but rather from local commercial investors who have a strategic interest in the impact objective of the incubator's graduates. By engaging these potential investors, incubators can greatly increase their likelihood of obtaining funding for their graduates.[4]

In addition to the lack of talent on the venture side of the equation, there is a talent shortage on the investment side as well. Many limited partners complain that they cannot recruit or retain skilled fund management teams. This is not entirely surprising, as the impact investment industry is still rather new, and investment managers with extensive impact investing experience are nearly nonexistent. The talent shortage is further exacerbated in emerging markets, where the indigenous talent pool of well-trained investment managers tends to migrate to global financial capitals such as London or New York. This indigenous talent, however, is critically important to facilitating deals, as natives tend to have a much more nuanced understanding of the local context, have more extensive networks in the local impact investing ecosystem, and can more easily develop a good rapport with the investees. Without this indigenous investment management skill, the cost of conducting due diligence can skyrocket and the ability to understand a potential investment's position in the local context is impaired. While this problem is particularly acute in emerging markets, the importance of locally rooted investment teams should not be overlooked in the Global North.

---

[3] *In addition to publishing the report Bridging the Pioneer Gap, ANDE is currently collaborating with Emory University and Village Capital to build a robust and holistic database of incubators and their clients to assess performance.*

[4] *Lall, S., Baird, R., & Bowles, L. (2013). Bridging the "Pioneer Gap": The Role of Accelerators in Launching High-Impcat Enterprises. Washington, DC: the Aspen Network of Development Entrepreneurs.*

Managing Investor Expectations on Both Ends of the Impact Spectrum

Despite impact investing's promise of social impact without a reduction in financial returns, for the vast majority of impact investing deals, there is still a trade-off between social and financial impact. This reflects both the higher cost structure associated with managing impact investing funds and the fact that the industry is still nascent. But expectations need to be realistic to avoid disappointment and bubbles.

Managing expectations should not be hard for the large number of impact investors driven by philanthropic goals. For grant-making institutions, the potential to create modest financial returns while seeding organizations with sustainable, scalable impact should be attractive. On the other side of the spectrum, for those with a financial-first perspective who have expectations for fully risk-adjusted returns, this reality is harder to swallow.

However, in the context of developed financial markets like the U.S. and Western Europe, there may be increasing opportunities to hit financial return goals. New tools like social impact bonds (SIBs) offer returns that are competitive with traditional investment returns. In New York's 2012 prisoner rehabilitation SIB, Goldman Sachs was the major buyer, demonstrating that large finance-first commercial investors can play a major role.

Investment Structure

To date, a majority of impact investors have utilized traditional venture capital fund structures, with 2 percent management fees and a 20 percent carried interest. However, this fund structure may not be a viable option for supporting social businesses.

As detailed in Monitor Group's *From Blueprint to Scale*, enterprises pioneering new business models for social change shoulder tremendous upfront burdens, as they are often forced to refine business models through trial and error, build management teams, find customer bases, and assemble complex supply chains.[1] This often adds to the capital required, the time horizon to profitability, and the management support needed from investors. Furthermore, as these enterprises pioneer new business models and operate in new or hard-to-reach markets, the cost of conducting due diligence on these investment opportunities rises. These factors reduce the likelihood of quick and lucrative deals.

There is also a growing realization that the traditional straight equity deals may not be a viable impact investment mechanism, especially in emerging markets. First, many founders who are committed to ensuring social impact are hesitant to give up their controlling equity stake in their businesses. Further, most emerging markets lack established stock exchanges, which precludes the possibility of an exit via IPO and lengthens the investment's time horizon, making it difficult to use traditional time-bound equity funds.

To overcome the limitations of straight equity, impact investors in emerging markets have developed a variety of innovative "quasi-equity" investment tools, many of which may prove to be important mechanisms for the domestic impact investing sector. For example, convertible debt instruments allow lenders to make a loan with a built-in conversion option that allows the lender to convert the

---

[1] *Koh, H.K., Karamchandani, A., & Katz, R. (2012). From Blueprint to Scale. Monitor Group.*

outstanding principal into an equity stake. Royalty-based vehicles are also being successfully utilized as a debt investment, but they exchange more favorable repayment terms for a predetermined share of revenue. These are only a few of the innovative financial tools that are helping to overcome the limitations of pure equity. As impact investing takes off in the United States, it will be important to consider similarly innovative financial instruments.

Knowledge Sharing as the Way Forward

In a sense, impact investing as a mechanism faces the same type of pioneer gap as the ventures it is trying to support. There is a great deal of experimentation, trial and error, and management development required before the industry can begin to function more effectively. While some of the lessons from the emerging market context may transfer to the developed world, the most salient takeaway is the importance of knowledge sharing to overcome gaps.

Other resources

- Cambridge Associates. (2014, May 29). Venture Capital Fund Performance Continues to Strengthen Amid Improving Exit Market. Retrieved from Market Wired: http://www.marketwired.com/press-release/venture-capital-fund-performance-continues-to-strengthen-amid-improving-exit-market-1915336.htm
- Fisher, D. (2012, June 6). Venture Capital Is Glamourous, But Stocks Have Higher Returns. Retrieved July 10, 2014, from Forbes.com: http://www.forbes.com/sites/danielfisher/2012/06/06/venture-capital-is-glamourous-but-stocks-have-higher-returns/

About the Authors

Randall Kempner is executive director of the Aspen Network of Development Entrepreneurs (ANDE). As executive director of ANDE, Kempner oversees the implementation of ANDE's extensive program and advocacy agenda, including training programs for investing in emerging-market entrepreneurs; promoting investment opportunities in emerging market small and growing businesses; and developing standardized financial, social, and environmental metrics for impact investment.

Alex Pan is a program coordinator at ANDE. In this position, Pan helps manage ANDE's global network of regional chapters and facilitates collaboration and knowledge sharing among ANDE's 200-plus members. He also manages ANDE's initiatives to systemically address the talent gap for small and growing businesses and leads ANDE's efforts to create a more supportive ecosystem for science-, technology-, and invention-based entrepreneurship in the developing world.