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Impact Investing: Will Hype Stall its Emergence as an Asset Class?

Philo Alto

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Philo Alto is the founder of Asia Value Advisors (www.value.asia), a Hong Kong-based philanthropic advisory and research firm that provides bespoke philanthropy advisory and research to family offices, foundations, and social purpose organisations in Asia. He is concurrently a co-convenor of EngageHK, Senior Advisor to SOW Asia Foundation and advisor to an educational foundation in Malaysia.

From when it was first coined five years ago, "impact investing" has now become more mainstream for traditional investors. However, **Philo Alto** argues that its development is lagging behind the promise of what it can do, and this, in turn, is hampering its emergence as an asset class in its own right.

Impact investing has captured the interest of mainstream investors, philanthropic funders, social entrepreneurs, and social businesses[1] alike. To its supporters, it is a US$400 billion to US$1 trillion "headline" opportunity. However, for mainstream investors and philanthropic funders who are encouraged to shift at least 1% of their portfolio into this emerging asset class,[2] the number of impact investment opportunities,[3] while growing, does not seem to be anywhere near the hoped for billions.

What is amiss?

Promises Lag Behind the Hype

JP Morgan's 2010 research report defines impact investments as "investments intended to create positive impact beyond financial return;"[4] in other words, the ability to produce financial returns on a risk-adjusted basis while also creating positive (social and/or environmental) impact.

As the term gains popularity, the statistics used to demonstrate its growth vary widely. This has resulted in confusion about what impact investing is and what its potential is for the social space. As a result, some seed- and early- stage social businesses which would have typically sought grant funding may have re-positioned their businesses to be "impact investing" ready, thereby risking a mission drift[5] in foregoing social issues or beneficiaries deemed too unprofitable to serve. At the same time, these same social businesses then wonder why there don't seem to be enough impact investors who are willing to "invest."

Mainstream institutional investors have fiduciary responsibilities to their own investors (such as pension funds), and while they may appreciate the desire of social businesses to create positive social impact, they currently don't perceive that there are enough organisations that also deliver financial returns. As a result, these investors tend to be far more cautious in investing in social businesses.

In contrast, social businesses tend to receive a more favourable response from family offices and individual philanthropists who believe in a "blended value" approach to asset allocation and philanthropic funding. Beholden only to their own philanthropic goals and family legacy aspirations, they are more flexible in funding social businesses and tend to treat grants and impact investments as a continuum of funding choices. These funders are currently in the minority.

To illustrate, it is commonly estimated that the projected growth of the impact investment market ranges from US$400 billion to US$1 trillion over ten years (JP Morgan 2010 report). This estimate represents the funding needs within the social sector over ten years, and is sometimes called "potential market opportunity."

In contrast, Acumen Fund, as one of the more experienced and earliest impact investors, has put in US$70 million worth of impact investments over its ten year history, the figure representing just 62 out of over 5,000 (around 1%) social ventures it had reviewed.[6] Even within this subset, only a small proportion have been operating at scale.

LGT Venture Philanthropy, another impact investment firm, has, to date, sourced over 4,000 deals globally and invested in 25 deals (well under 1%).[7] Of the deals invested, around 95% have been well on track in their respective business plans.[8] LGT VP also has a policy of not investing at all if they do not find a suitable social venture that meets their investing criteria.

Both Acumen and LGT Venture Philanthropy are among the older and more established impact investors, and their investments in 1 out of every 100 social ventures clearly suggest that the "impact investment ready" segment is significantly smaller than the broader funding needs in the social space.

If we use this 1% success rate as a benchmark, it translates to at least US$4-$10 billion worth of impact investment opportunity globally in social businesses over the next ten years.[9]

Impact Investing in Asia—Constrained by Supply or Demand of Capital?

To get a regional perspective, let us assume a similar 1% success rate in the Asian impact investing market.

In my previous research published in 2011, I explained[10] how the definitional confusion about what impact investing is has created vastly different expectations of its market potential.

One report has estimated that the total potential demand for impact investing in Asia is between US$44 billion and $74 billion for the decade to 2020.[11] If we apply the 1% historical success rate for impact investing, this translates to US$440 million to US$740 million over the next ten years. While this is not an amount to scoff at, it still pales in comparison to the social funding needs in the region, especially those at the "bottom of the pyramid.[12]"

As a result of this mismatch, the vast majority of funding opportunities lies in helping seed- and early-stage social businesses to grow in size and capability, and eventually hiving them off to impact investors or impact funds after they have received the necessary philanthropic support such as managerial talent, access to networking with other social entrepreneurs through philanthropic intermediaries and funders.

> Social businesses tend to receive a more favourable response from family offices and individual philanthropists who believe in a "blended value" approach to asset allocation and philanthropic funding.

The issue, therefore, is not a dearth of impact investors, but a lack of risk-appropriate philanthropic funding for the vast majority of social businesses in Asia that are either too young or too small in scale to be considered "impact investment ready." In fact, the social entrepreneurship activity in the region has picked up significantly in recent years as evidenced by the increasing popularity of social venture competitions such as Global Social Venture Competition, Sankalp Awards, as well as events such as the annual Social Enterprise Summits in Hong Kong and the recent Impact Forum in Singapore. Clearly, more support by philanthropic funders and venture philanthropy intermediaries is needed to help scale social businesses across their organisational life stages.

Given the significant growth of impact investing in recent years as evidenced by the number of new intermediaries and impact funds, it is anticipated that the quality, number, and scale of social businesses over the next ten years will grow more quickly than it has in the past ten years. This means that the 1% historical success rate is expected to rise.[13]

This raises the question of how we should fund the vast majority of social businesses? Should philanthropic funders just focus on, and wait for, the 1% of impact investment ready social businesses to come through their doors? Or should they proactively help accelerate the growth of social businesses that are considered to be "pre-impact investment" ready?[14]

The Philanthropic Capital Map

The philanthropic capital map shows where social businesses can and should tap into appropriate funding sources as they grow in scale and impact.[15] To do this, they need to understand the motivations of current and prospective funders, and ensure there is an alignment of incentives and expectations between their funding needs and the motivations (whether as philanthropy or as impact investment) of the funders.

Table 1: Philanthropic Motivations, Organisations, and Funding Sources

Social Focus → **Financial/Commercial Focus**

Funder Motivation/ Elements	Doing Good	Doing Good and then Doing Well	Blended Approach	Doing Well and then Doing Good	Doing Well
Organisational structure / Type	Charity/Non-profit organisation	Social benefit enterprise or charity with some earned revenues	Impact-first social business	Finance-first social business	Pure commercial business
Funding Type	Grants and donations	Grants or its equivalent/ Impact giving	Impact giving/ Pre-impact investing funding	Impact Investing	Commercial Investing
Funder Type	Donors	Impact angels/ Donors	Impact angels	Impact investors	Traditional investors
Risk Levels	Pure impact expected	Depends on donor motivations	Heightened expectation of financial return in addition to impact	High-financial risk due to dual impact and financial return goals	Pure commercial risk
Return Expectations	Pure giving/ 100% "loss"	Leverage of impact expected	Leverage of impact expected with upside of financial return	At a minimum return of capital on risk-adjusted basis	Market returns
Liquidity	Deep and well-established	Emerging, and usually via CSR budget	Illiquid, small and very fragmented	Deepening via sustainable investing	Deep and well-established
Size	Large and stable	Small but growing	Even smaller but growing	Large and increasing	Very large (traditional investing)
Awareness of Funding	Decades long and rooted in tradition	Recent years and increasingly accepted	Very recent and gaining strong PR	Recent decades- "Do no evil"	Deeply rooted in capitalistic environment
Growth Prospects	Stable	Growing but lacking definitional boundaries	Growing and with growth risks	Growing steadily	Stable

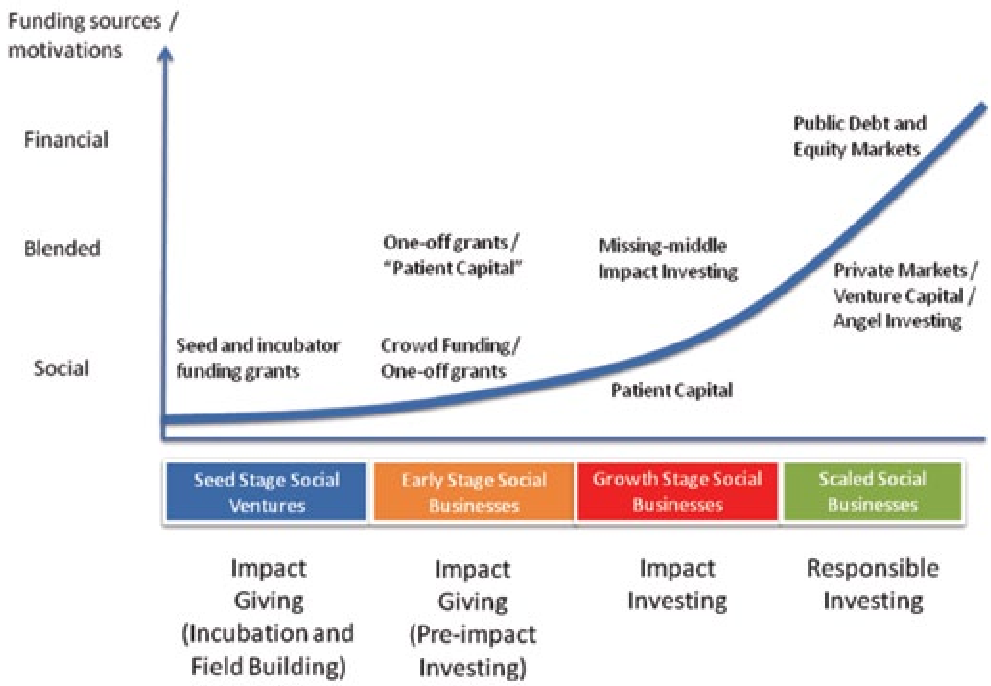
In Table 1, individuals typically start either as philanthropically motivated from the Doing Good side or as an investor from the Doing Well side, with both eventually moving towards the blended value middle. Coming from the left hand side, the motivations are to do good and the enterprises are typically operational charities. For some non-profits that decide to wean their dependence off from grants and government funding, they move towards the blended middle by actively seeking to increase the share of their earned revenue streams. Coming from the right hand side, the motivations are pure commercial goals, moving towards responsible/ sustainable investing ("do no harm") and towards impact investing. Note that for funders coming from the right, especially institutional investors with fiduciary duties, doing well is a minimum threshold (flat to positive financial returns, never negative) with the "doing good" component being an added benefit.

In contrast, the blended approach in the middle column mainly encompasses the seed- and early-stage social businesses where financial returns are unlikely, but social returns are expected. Seed- and early-stage social businesses are typically funded by individuals and family offices who do not have fiduciary obligations, as well as by corporates' CSR or community engagement arms. These latter groups traditionally support non-profits through grants and donations, but are increasingly more in favour of impact giving where financial returns are not expected. Like impact investing, impact giving prioritises social returns but unlike impact investing, it does not expect a financial return at the outset.

Chart 1 illustrates the idealised growth path of a social business as it scales and the sources of funding it seeks:

- Seed Stage Social Venture: The enterprise starts off either as a social enterprise arm of a non-profit organisation with some earned revenue stream, or as a social entrepreneur with a social business idea. Here, grants and incubator funding support are the predominant sources.
- Early-Stage Social Business: The vast majority of social businesses remain "early stage" with revenue streams or concepts that are too premature for impact investors to consider. Since risk adjusted financial returns are still expected to be negative, this is not traditionally considered an investment by institutional investors. Philanthropic funders and intermediaries are more willing to fund from an impact giving perspective as part of their field and capacity building efforts.
- Growth-Stage Social Businesses: A small number of fast growing social businesses that have achieved sufficient scale and impact begin to attract impact investors. Most social businesses struggle to get to this stage.

Chart 1: The Path to Scaling Social Businesses



Source: Asia Value Advisors

- Scaled Social Businesses: Having received impact investment funding and demonstrated financial sustainability, these social businesses eventually become attractive to commercially-focused investors. The Body Shop and Ben & Jerry's both used to be social businesses and they seek to compete on equal footing with their commercially-driven businesses without government subsidy and/or philanthropic funding support.

Early Days for Impact Investing as an Asset Class—More Impact Angels Needed

Given the very small percentage of impact investments completed thus far relative to the number of social businesses needing funding, impact investing as an emerging asset class is clearly in its early days though it continues to exhibit a strong growth potential. Chart 2 below shows that the majority of early-stage social businesses continue to rely on one-off grants and patient capital that can tolerate sub-optimal, possibly negative, financial returns.

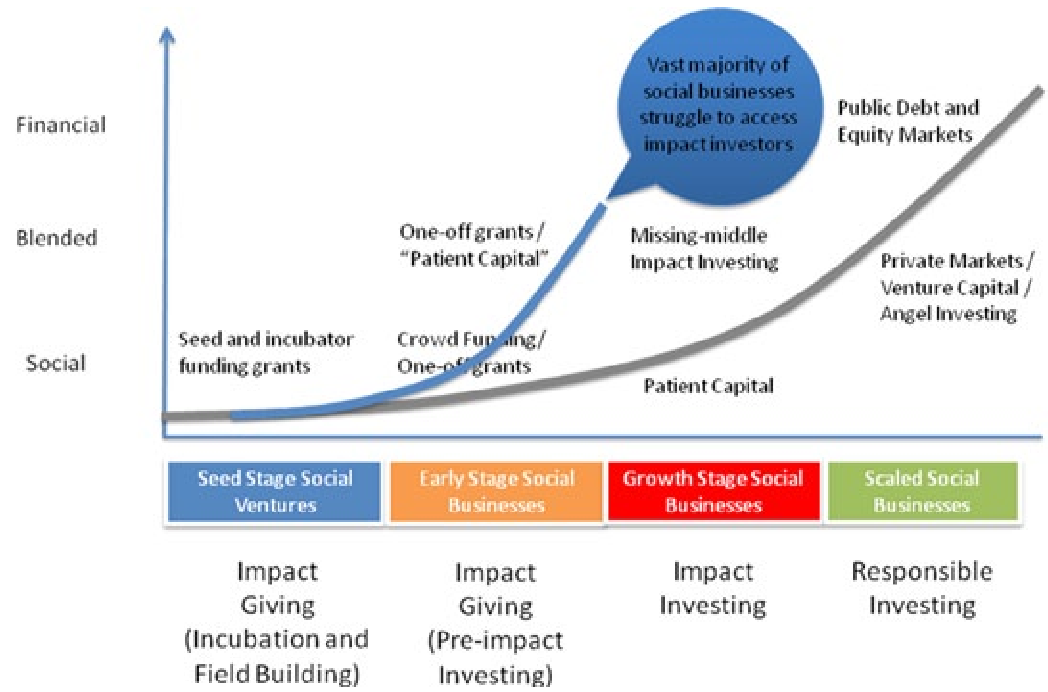
I like to refer to philanthropic funders willing to support early-stage and untested social businesses as "Impact Angels" to reflect the "giving" nature of this type of funding support—giving, as opposed to investing, because of its higher risk and therefore the possibility of up to 100% write-off (which is financially no different from a grant or donation) but with a potential financial return if the social business proves to be successful. However, what it is called is less important than recognising the dangers of calling this type of funding "investing" for its potential to undermine its credibility as an emerging asset class.

As they scale and transform from initial start-up/seed-stage, to early/growth stage, most social businesses face two critical funding and organisational hurdles:

- Initial Funding: It can be very difficult for a budding social entrepreneur to demonstrate the validity and sustainability of her concept. This is why competitions for social entrepreneurs (e.g. Echoing Green, Global Social Venture Competition or Sankalp Awards) are important to help screen and support the best business plans and entrepreneurs.

- The Leap from Pre-Impact Investing to the Impact Investing-Ready Stage: The second hurdle tends to be bigger as funding needs are generally larger, and organisational and cultural changes need to be made to meet the exacting requirements of impact investors (e.g. introducing good corporate governance structures). The challenge for fast-growing social businesses is to get themselves ready for impact investors even as they continue to seek one-off funding in the interim. For a vast majority, this interim period may last for a long time.

Chart 2: Funding Chasm Faced by Social Businesses



Source: Asia Value Advisors

> The hype around attracting impact investments as a success measure can be counterproductive as it risks encouraging a mission drift among seed- and early-stage social businesses to attract this type of funding rather than staying focused on their intended mission.

Moving Beyond the Hype for Impact Investing

For impact investing to emerge as an asset class in its own right, we need to overcome the various issues that hinder its development:

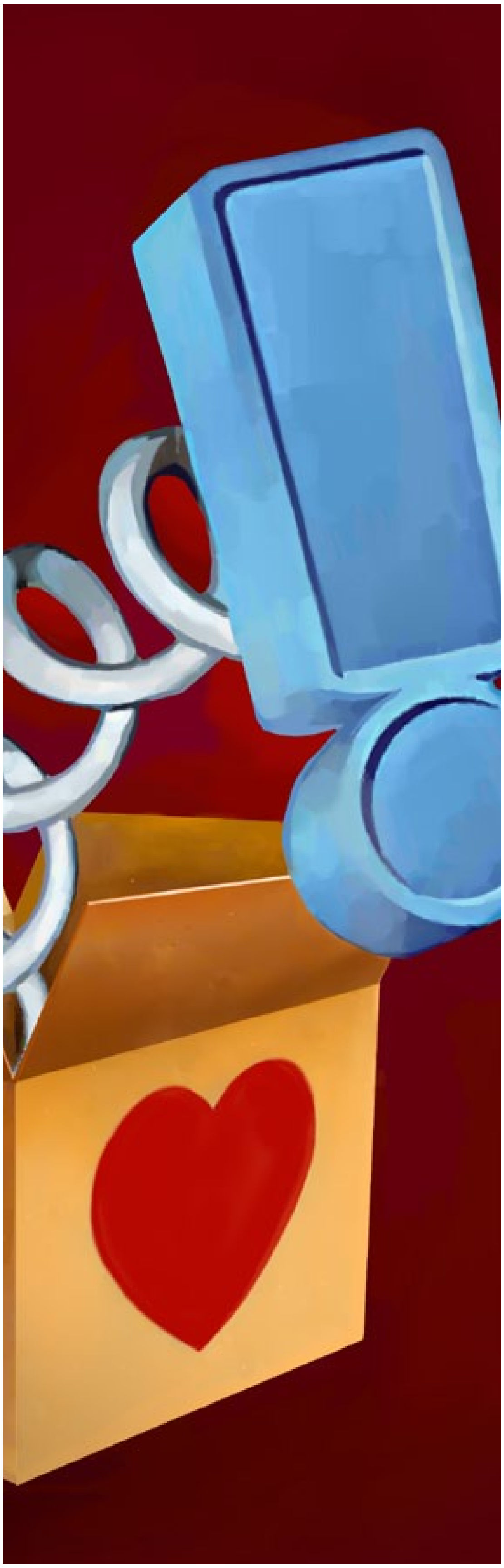
- Loose Terminology Usage to Capture its Buzz Value: The continued confusion around its terminology is creating a pressure on philanthropic funders to call themselves impact investors (sounds cooler at cocktail parties) and to provide funding only through impact investing when the vast majority of social businesses currently need grant-like impact giving which may be more appropriate for those in seed- and early-stages.

- Buzz Around the Topic in Schools: As the impact investing space becomes even more popular (as evidenced by the number of MBA and MPA courses, and student social entrepreneurship clubs catering to this demand), there is a risk of a glut of new impact investment funds that will attract self-declared impact investors who lack the experience in the sector and who may pressure the impact fund portfolio managers to "close deals" to justify their existence. This potentially could create a pressure to lower the selection standards especially when "investment" results may not be evident for another three to seven years. If the promised financial returns do not occur within the anticipated time, the investment will euphemistically turn into "patient" capital.

- Impact Investing is Not for All Social Businesses: For the small handful of social businesses which have won multiple social venture competitions and awards, they will expectedly find impact investment money chasing after them, thus reinforcing the cool factor around the term. However, this leaves the vast majority of seed- and early-stage social businesses spending a disproportionate amount of time seeking impact investment funding when they should instead be seeking grant or impact giving funds that is more appropriate for their organisational life stage. This hype around attracting impact investments as a success measure can be counterproductive as it risks encouraging a mission drift among seed- and early-stage social businesses to attract this type of funding rather than staying focused on their intended mission.

A Call to Action: Need for More Impact Giving Support

Many supporters of impact investing, including this author, would like to see impact investing eventually emerge as an asset class in its own right and thereby unlock the hoped-for billions of dollars in the global capital markets to fund social businesses that address pressing social needs whilst generating financial returns.



However, to get there, philanthropic funders and social businesses alike need to be aware that impact investments are appropriate only to the small handful of fast growing social businesses with demonstrated impact and sustainable business models. It is not an appropriate funding type for the vast majority of social businesses that are more appropriately funded by impact giving and other grant-like philanthropic funding, where financial returns are not imperative.

Having this broader understanding of impact investing as a complement to other philanthropic funding tools/approaches such as impact giving for seed and early stage social businesses will hopefully provide them with a clearer path to funding goals that are in line with their intended social missions rather than forcing them to alter their business models to cater to impact investors. This would be a clear recipe for disaster and disappointment.

Five years after the coining of the term "impact investing," it is imperative that all the stakeholders—funders, intermediaries, and social entrepreneurs alike—should move beyond the hype and have a clearer understanding of the broader philanthropic funding landscape and tools that are appropriate to social businesses as they scale. Impact giving as an alternative approach, while still uncoordinated, is a more appropriate philanthropic financing tool for seed- and early-stage social businesses to receive funding.[16]

[1] In this article, social businesses are used interchangeably with social enterprises. The common theme is the intention to achieve social impact while generating earned revenue sources and wean off the dependence on donor funds.

[2] It is beyond the scope of this article to debate whether this is an asset class or a series of asset classes as segmented by the type of financing (ie. debt, equity or hybrid instruments).

[3] In this article, the perspective taken is mainly from the funders' side unless stated otherwise. Impact investing, in this context, is an investing approach where investors seek to achieve social and environmental impact whilst expecting a positive financial return on a risk-adjusted basis.

[4] JP Morgan 2010 report entitled "Impact Investments: An Emerging Asset Class" (www.jpmorgan.com/pages/jpmorgan/investbk/research/impactinvestments)

[5] Mission drift typically pertains to a situation where an organisation's mission begins to stray from the original intent in favor of achieving more earned revenues.

[6] Two reports: 1) Acumen Fund article (February 2012) entitled "Creating a capital curve for social enterprise" www.acumenfund.org/knowledge-center.html?document=321 and 2) Monitor and Acumen Fund report (April 2012) entitled "From Blueprint to Scale" www.mim.monitor.com/blueprinttoscale.html

[7] As of April 2012.

[8] Acknowledgements to LGT Venture Philanthropy team for the statistics provided.

[9] This 1% success rate is used purely for illustration purposes and it refers to success in terms of raising impact investing funding rather than to being successful social businesses. It is based on two global and more established impact investors and the author does not simplistically extrapolate this as reflective of the broader social business landscape. However, a point still needs to be made that the challenges that Asian funds face is no different from the global trends, which shows that investment firms are struggling to find investment-worthy social businesses.

[10] Asia Value Advisors research brief (October 2011) entitled "Impact Investing in Asia: From Definition to Pathways to Scale via Impact Giving" http://value.asia/our-competencies/research

[11] Avantage Ventures report (August 2011) entitled "Beyond the Margin" www.avantageventures.com/sitedocs/av_report_final_full_screen_version.pdf

[12] Base of the Pyramid is defined as the largest and poorest segments of population living under US$2/day. In Asia alone, 2.9 billion (out of 4 billion globally) live at the bottom of the pyramid (75%) even as the region has been growing the fastest compared to the US and Europe.

[13] To be clear, while the number of social businesses will rise (denominator), the number of impact investment ready social businesses is expected to grow faster (numerator) thereby increasing the % share of "impact investments" in the coming years

[14] I do not feel strongly about coining a new term—impact giving—as admittedly it too has its imperfections in capturing the nature of this funding type. However, to call it "impact investing" when it is clearly not an "investment" in the traditional sense understood by mainstream investors risks undermining its ability to emerge as an asset class.

[15] To be clear, this article does not imply that to grow in scale, a non-profit should transform itself into a social business, nor should a social business alter its business model just to tap into impact investors' funding. Some social business, by virtue of its social mission, may choose to continue to seek grant funding even as it scales by virtue of market or government failure to address a target need/beneficiary.

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