ESG Report

Beyond microfinance

Nina Röhrbein finds evidence for a sea-change in impact investing with more varied products in developed as well as emerging economies

Although the term impact investing is relatively new, it seems to carry enough weight to send some institutional investors running for the hills.

This is mainly because of two myths associated with the sector – that investing for impact implies a trade-off and that it is a very restricted asset class.

"By coining the term 'impact investing', the Global Impact Investment Network (GIIN) has done an excellent job of raising awareness of the space," says Michele Giddens, a partner and co-founder at London-based sustainable growth investor Bridges Ventures, the majority of whose assets under management now come from institutional investors. "But some investors still feel the phrase always implies a trade-off in financial returns, which is a concern for us and other thematic funds that invest where attractive financial returns and impact are in lockstep."

While Bridges has a 10-year track record, the impact investment sector as a whole is nascent, and many argue that only a longer track record of returns will bring greater clarity to it. But while there is no denying that social and environmental impact is at the heart of this investment strategy, it has undergone a transformation in recent years.

"Today there are plenty of proven examples where impact investing is not only philanthropy but has resulted in good financial returns," says Theo Brouwers, general manager at SNS Impact Investing in the Netherlands.

But while some pension funds, such as TIAA-CREF in the US and Christian Super in Australia, have been early adopters, pension funds have not been as active in the sector as, for example, banks and development finance institutions, foundations, high-net-worth individuals and family offices.

"But impact investing has become more systematised and is slowly moving towards a genuine market place," says Luther Ragin Jr, CEO of GIIN.

Swiss consultancy onValues has identified about 200 active asset managers in private equity impact investing and about 300-400 funds.

However, today impact investing is no longer simply about private equity or microfinance, the latter of which it was associated with for a long time.

"For many investors, microfinance was for many years the area of social impact investment that was available to them but there was very little else," says Martin Rich, sales director at the UK organisation Social Finance. "Nonetheless, over the last couple of years we have seen a flourishing of other funds and areas for people to invest in, including SME finance, sustainable agriculture and bottom of pyramid healthcare, and now we are at a real transitional point in the market."

Not only has the sector moved beyond microfinance, on the back of the recession it has also begun to spread to developed economies.

In the case of the UK, for example, domestic opportunities developed as a result of the launch of Big Society Capital (which invests money from dormant bank accounts among other capital sources) and other initiatives, while in the US, community investing has a relatively extended track record, particularly in inner-city and rural communities that have been underserved by traditional sources of capital.

"The range of return hurdles that are offered is quite diverse, from below market to risk-adjusted market rate, and investors that put financial performance first are finding a relatively deep reservoir of opportunity across the asset class and sector spectrum," says Ragin. "In short, diversity is increasingly apparent in the impact space."

Ivo Knoepfel, founder and managing director at onValues, estimates that there is $70-90bn (€54-70bn) invested via impact strategies globally, of which about $15bn is microfinance and other themes in developing countries. Community and social investments in developed countries, mainly in the US, make up almost half of the total. A further $20-30bn is accounted for by parts of cleantech, infrastructure and other real assets that onValues also classifies as impact investment.

The missing middle, according to Knoepfel and Brouwers, is the SME market in developed, developing and frontier markets, which is an important contributor to economic development and job creation but is typically underserved by the financial sector.

"The next step for us is to launch a fund focusing on SME banks in developing countries which would be eligible to issue larger loans than the microfinance institutions," says Brouwers.

Meanwhile social bonds are one example of impact investment in fixed income.

"But public private partnerships are also increasingly gaining traction," says Jens Peers, CIO of sustainable equities at Mirova, the responsible investment division of Natixis Asset Management. "We are also exploring impact investing on the listed equity side. Investors can have an impact approach in all asset classes apart from cash."

Giddens notes with interest the layered products being developed, where the fundamental risk taken by private sector investors is reduced with the backing of public or government capital. "This allows institutional investors to enter this market before there is a more developed track record," she says.

The key to minimising risk in impact investing is identifying the right managers. Fundamentally, due diligence for an impact investment is not that different from that in a traditional investment, according to Ragin.

For Giddens, asset managers in impact investment should be mission-driven firms. They can be full profit or not for profit, but must have a sense of purpose, she says.

"One of the challenges of microfinance was that it became a victim of its own success, as it had so much capital coming in from mainstream investors and it had pure, full-profit microfinance institutions," she says. "That is why specialist mission-orientated managers who are focused on the dual lanes of impact investing and have a governance structure with a strong set of independent specialists are crucial."

But the reality is that very little institutional capital has flowed into broader impact investment so far, says Rich. "A number of institutional investors, primarily in Scandinavia and the US, have to some degree invested in microfinance but the number of them who have put capital to work outside of that space to date is minute."

Rich attributes this to the types of products available and issues with scale, a lack of track record to benchmark performance and illiquidity.

"One of the challenges that we have with impact investing, specifically through private equity, is size," says Peers. "The opportunities as a whole may be very large but because the tickets are small on their own it is very time and labour-intensive to manage them. Most firms start to explore the market with a €10-20m fund. We are targeting between €50-100m and from there we want to see what we can do on a bigger scale."

But the argument of size very much depends on the sector of impact investment.

"In sustainable forestry, for example, there is no shortage in finding product to invest in so in this area the argument does not hold up," says Giddens. "In social entrepreneurship, however, there are questions about whether the supply of capital is getting ahead or is behind."

Rich thinks the problem is that the wrong type of capital is looking at the wrong types of projects. "There can be sufficient quantitative deals and sufficient quantitative capital, it is just a question of how do we line them up and bring the two sides together."

Education and awareness-raising is therefore still crucial, in particular as the industry still lacks transparency.

Most investors today use their own particular metrics for assessing the social and environmental benefits they seek but increasingly there is movement towards a common language or standardisation of metrics used to measure the social and environmental benefits of these investments. GIIN's impact reporting and investment standards (IRIS) is a catalogue of over 400 social and environmental metrics that can be selected by investors to identify what social or environmental benefits they seek to measure.

"A number of investors and organisations now use IRIS-compliant metrics, which means the investors still determine what they want to achieve but measure them in ways that are consistent with other investors, creating consistency, transparency and accountability around the social and environmental dimension," says Ragin.

But for every type of impact investment investors need to identify what impact they seek from the outset.

"Investors require a certain level of assurance on what has been achieved in terms of impact but at the same time they are realistic in not demanding scientific proof as it can be almost impossible to quantify impact in the real world," says Knoepfel. "It is often enough for investors to have simple indicators that show them that the impact is going in the right direction."