Pacific RISE

Pacific Readiness for Investment in Social Enterprise

Australian Aid

Overview of Global Impact Investing

Lessons for designing effective impact investment support in the Pacific

January 2021

Contents

Introduction

Pacific RISE commenced in 2016 as a pilot initiative to pioneer and facilitate a social impact investment market in the Pacific. It works with investors, funds and intermediaries to develop an understanding of the potential for impact investment in the region and deepen the knowledge about the investment process and the Pacific investment ecosystem. Funding is provided to intermediaries to seek and assess investment opportunities and to provide investment readiness support to Pacific social enterprises[1] to raise capital.

Pacific RISE's progress has been slower than expected due to a number of assumptions made about how impact investment could occur in the Pacific, including:

- the type of appropriate finance – most intermediaries assumed private equity would be the ideal source of finance for social enterprises in the Pacific or, in some cases, venture capital however there was a mismatch in the return expectations and size of investment required by Pacific businesses
- timeframes proved longer than expected
- the level of understanding of the Pacific among impact investment intermediaries was low and a limited understanding of the legal and regulatory environment among some intermediaries delayed investments, with intermediaries underestimating the cost and time to obtain investor licences, and/or finding that their existing investment platforms were not set up to send funds to the Pacific, combined with a range of governance issues
- the level of pre-existing knowledge and perceptions impact investment intermediaries and impact investors hold on the Pacific – many investors have a high-risk perception of the Pacific, which can influence whether they invest and how they price their capital.

We concluded it would be useful to supplement our learning with what others have learned about impact investing in other regions. Therefore, we reviewed existing reports and other literature on impact investing to pull out the key challenges and opportunities identified by global impact investment stakeholders.

This paper highlights the key challenges and opportunities in global impact investing. It is intended to provide a summary of the global market to the Australian Department of Foreign Affairs and Trade (DFAT) for reference when designing new activities to support the ongoing development of the impact investment market.

Scope of this research

This report covers the following areas:

- The size and key characteristics of the global impact investment market, based on an annual summary produced by the Global Impact Investing Network (GIIN).[2]
- Key challenges and opportunities highlighted by impact investing practitioners.

This report does not seek to evaluate the effectiveness of impact investing, nor does it seek to provide a comprehensive review of all the existing literature on the impact investment market. Pacific RISE relates these challenges to its own work in the Pacific in its completion report.

[1] Pacific RISE defines a social enterprise as an enterprise of any size, stage of growth, or sector, which intentionally creates social, economic or environmental impact. The impact it intends to create must be part of its business mission and its business model. Many social enterprises in the Pacific qualify as MSMEs; and due to the limited research available globally on social enterprises in particular, some data and information is presented on MSMEs or SMEs as a proxy.

[2] The Global Impact Investing Network is the global champion of impact investing. It is dedicated to increasing the scale and effectiveness of impact investing around the world, and completes regular reviews and surveys of the sector.

1. Background on impact investing

Impact investing is defined as actively placing capital in businesses and funds that generate social and/or environmental good and at least return the nominal principal to the investor (Freireich & Fulton, 2009). Impact investing differs from other investment strategies, such as ethical investing, socially responsible investing or sustainable investing, through its intentional pursuit of positive and measurable impact, as opposed to just mitigating negative externalities (Castellas, Ormiston & Findlay, 2018). Definitions of impact investing – as an umbrella term for investments that seek positive returns and social or environmental impact – are constantly shifting.

As of the end of 2019, the Global Impact Investing Network (GIIN) estimates the size of the global impact investment market to be US$715 billion worth of assets under management (AUM),[3] with over 1,720 impact investment organisations (Hand et al., 2020).[4] A majority of impact investors (79%) are based in the United States and Canada, and Western, Northern and Southern Europe (Hand et al., 2020) (Figure 1).

1.1 Impact investment stakeholders

The literature indicates that the development, growth and success of an impact investment market requires the engagement of multiple stakeholders. Table 1 shows the key stakeholders engaged in impact investing.

Table 1: Impact investment stakeholders

Stakeholder	Role
Social entrepreneurs and/or enterprises	Social entrepreneurs and enterprises, whether micro, small, medium or large are the direct recipients of impact investment. Social enterprises design and deliver innovative products, services and activity that solve social, environmental and cultural challenges (Hill & Addis, 2017). As a definition, social enterprises have both business and social goals and are intentional about both. Social enterprises can be structured as either for-profit or nonprofit and can take on any form of legal entity.
Investors	Investors are those directly investing funds for purpose and profit. Impact investors can include institutional and corporate investors, philanthropists, retail investors or consumers, public investors and development finance institutions. They provide the funds to finance the activities of social entrepreneurs and enterprises (Hill & Addis, 2017).
Government	Governments can become involved in impact investing both directly and indirectly. Governments can directly fund activity to encourage the flow of capital and enterprise development, such as encouraging the development of innovative solutions, enterprises and intermediaries (Addis, Bowden & Simpson, 2014). Indirectly, governments can procure services from the nonprofit sector – stimulating demand for innovative solutions and encouraging additional private capital into the nonprofit sector (Addis, Bowden & Simpson, 2014). Governments also set up the regulatory and policy environment, including national legal frameworks for social enterprises and sector- or industry-specific regulation (Hill & Addis, 2017; Carpenter & Keller Lauritzen, 2016). According to Carpenter and Keller Lauritzen (2016), governments also support the social enterprise ecosystem through: » networks and mutual support mechanisms » business development services and support schemes specifically designed for social enterprises » marks, labels and certification schemes » impact measurement and reporting systems

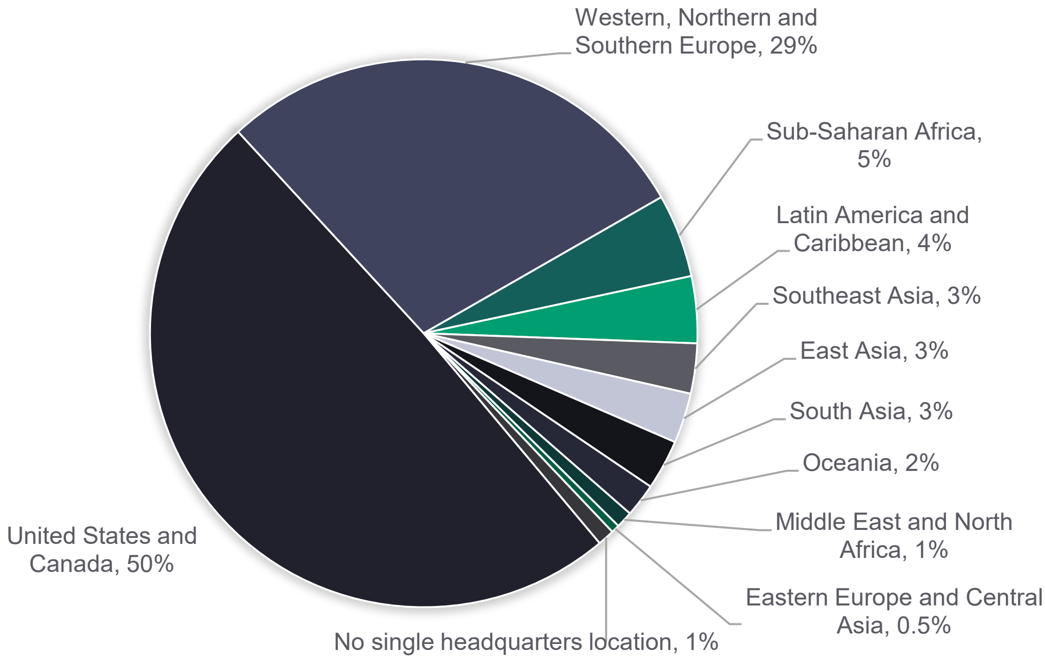
[3] Assets under management is used to estimate the size of the market and refers to the total market value of investments that are managed by investors.
[4] By comparison, estimates as of the end of 2018 were US$502 billion of AUM, with 1,340 impact investment organisations (Mudaliar & Dithrich, 2019).

Stakeholder	Role
	» social (impact) investment markets. Governments engage in impact investing because they recognise the benefits from activity in the impact investment market, which can include offering opportunities for more efficient delivery of public services (Addis, Bowden & Simpson, 2014), and addressing national problems like poverty and inequality through private sector rather than public sector resources (Koh, Karamchandani & Katz, 2012).
Financial and other intermediaries	Financial and other types of intermediaries link different stakeholders in the system (Hill & Addis, 2017). Intermediaries help those 'looking for investment and those with resources to find one another and transact on appropriate terms' (Addis, Bowden & Simpson, 2014: 31), therefore acting as aggregators for investors in finding and assessing investment opportunities, which can make sourcing investments more efficient (Freireich & Fulton, 2009). The roles of intermediaries can include: » working with companies to identify financing needs, and assessing the appropriate amount and type of capital, given a social enterprise's track record and potential for scale » advising in the capital raise and negotiation process by helping to streamline due diligence and structure impact investment deals and products (Addis, Bowden & Simpson, 2014) » supporting social enterprises to more effectively leverage the capital they have (CFF, n.d.). The role of intermediaries is important in impact investing as '[m]any investors do not have local presences in every country in which they invest, thus depending heavily on intermediaries to source deals and get enterprises "investment-ready"' (GIIN, 2018: 15).
Other market enablers or builders	Other market enablers or builders include those that support the infrastructure for impact investment, such as lawyers, accountants and other consultants (Hill & Addis, 2017). This group consists of actors outside of the direct intermediation of deals.
Donors (official development assistance)	Official development assistance, or international aid, from bilateral and multilateral agencies has played a role in the impact investment market – through supporting investor expansion and capacity building; social enterprise capacity building; intermediary capacity building; ecosystem development; de-risking investments through blended finance or other mechanisms; or making direct investments into funds or impact enterprises.

1.2 Current state of the global impact investment market

The following information summarises the impact investment market and is based primarily on the GIIN's 2020 survey of approximately 300 impact investment organisations, which were responsible for a total of US$404 billion of AUM in 2019 (Hand et al., 2020)[5]. While the sample of respondents may not be representative of the entire industry, the GIIN survey is the most comprehensive annual survey of the impact investment market.

Figure 1: Where impact investors are based



Note: Number of impact investors = 1,419. Oceania includes Australia, New Zealand and Pacific island countries.

Source: GIIN Annual Impact Investor Survey 2020 (Hand et al. 2020: 41).

1.2.1 Who are impact investors?

- **Type of organisations:** Impact investors are organisations or high-net-worth individuals that intentionally and actively place capital in businesses, nonprofits or funds that generate social and/or environmental impact, with the expectation that at least the nominal principal will be returned to the investor. Of the estimated 1,720 impact investment organisations at the end of 2019, the highest number of impact investors were identified as asset managers, foundations, diversified financial institutions, development finance institutions, family offices, pension funds and insurance companies. According to market share, asset managers and development finance institutions invest the largest share of global AUM (54% and 36% respectively) (Hand et al., 2020).

About Asset Managers:

Asset managers make investments on behalf of a broad range of investors, from which they source capital. In the GIIN's annual survey, 65% of respondents were themselves asset managers, accounting for 31% of total AUM, with a further 37% of respondents investing through asset managers. The majority of asset managers are for-profit entities (Hand et al., 2020).

According to existing data, the most common sources of capital for asset managers are development finance institutions and foundations. Approximately half also raised some capital from family offices and high-net-worth individuals, and just under half raised capital from banks, diversified financial institutions and retail investors (Bass, 2019). By volume of capital, the highest portion of AUM managed by asset managers in 2019 was from pensions funds. Despite their size and prominence in the market, raising investment by asset managers is relatively new and uncertain: 'Social investment is a developing market; who investors are and precisely what they are willing to fund is evolving over time, which creates a level of uncertainty' (Ronicle & Fox, 2015: 12).

[5] Survey respondents were primarily asset managers (primarily for-profit asset managers). Others included foundations, development finance institutions, family offices and diversified financial institutions.

- **Geographic focus:** 55% of respondents to the survey are focused on making investments in developed markets, while 40% are focused on investments in emerging markets.[6] Developed markets include East Asia, Oceania,[7] United States and Canada, and Western, Northern and Southern Europe. Emerging markets include Eastern Europe and Central Asia, Latin America and Caribbean, Middle East and North Africa, Southeast Asia, South Asia and Sub-Saharan Africa. Annex A provides snapshots of the supply side of the impact investment markets in Southeast Asia and Australia, and observations on the development of the impact investment market in Australia.
- **Investments:** While direct versus indirect investing varies by organisation type, 76% of all surveyed investors invest directly into companies, projects or real estate assets, while just under a quarter invest indirectly through intermediaries, including fund managers.
- **Organisation size:** About half of the survey respondents are small investors with total AUM of US$100 million or less, while the other half are medium and large investors (total AUM over US$100 million).
- **Target financial returns:** The majority of respondents (67%) target risk-adjusted, market-rate returns, while 18% target below-market-rate returns closer to market rate, and 16% target below-market-rate returns closer to capital preservation. Typically, private equity-focused investors seek market-rate returns, while private debt-focused investors seek capital preservation strategies.
- **Impact focus:** The majority of investors target both social and environmental impact. The top three impact areas are decent work and economic growth, no poverty, and good health and wellbeing.
- **Source of capital:** Asset managers collectively raised nearly US$18 billion in 2019. The largest volume of capital came from pension funds, retail investors and diversified financial institutions. However, there has been notable growth in investment into impact funds by high-net-worth individuals and family offices and foundations (and more than half of asset managers received some amount of funds from each of these three).

1.2.2 Where are investments made?

- **Location of investments:** The majority of investments (59% of AUM) are directed to developed markets, while 41% are allocated to emerging markets. Within the emerging markets group, the top region receiving investment is Sub-Saharan Africa. The United States and Canada are also a common region for investment. Western, Northern and Southern Europe, and East and Southeast Asia are the fastest growing regions. In the coming years, investors plan to increase their allocations to many emerging markets, with over half planning to increase allocations to Southeast Asia and Sub-Saharan Africa.
- **Snapshot of Oceania:** In the 2020 survey, the percentage of assets under management invested in Oceania was 5% of the total reported by survey respondents[8] – with investments primarily by private debt-focused and market rate-focused investors. That is an increase of 1% as reported in the GIIN's 2019 survey (Mudaliar et al., 2019). Among repeat survey respondents, geographic allocations to Oceania have increased 16% between 2015 and 2019.

[6] Excludes outliers.
[7] Oceania includes Australia and New Zealand, as well as the Pacific island countries within Melanesia, Micronesia and Polynesia. It is classified by the GIIN as a 'developed market' region because of the inclusion of the larger developed economies of Australia and New Zealand.
[8] That is, 5% of total AUM reported by respondents (n = 289, total AUM = US$221 billion).

1.2.3 What type of investments are being made?

- **Volume of deals:** During 2019, the full sample of respondents executed 9,807 transactions, amounting to US$47 billion in capital. In the last five years, the volume of capital invested grew by 12% per annum, the number of investments by 9% per annum, and the average deal size by 2% per annum.
- **Asset class:** Private debt, public equity and private equity have attracted the most capital. Private debt had the largest share of AUM in 2019; however, private equity was the most popular, with 70% of investors making these investments. Emerging market-focused investors allocated more capital to private debt, as did below-market-rate investors. The highest growing asset class since 2015 has occurred in public equity, followed by real assets.
- **Deal size:** The average deal size in 2019 was US$5 million across all asset classes, whereas investors that exclusively make impact investments (versus those that also make non-impact investments) had an average private equity deal size of US$2.8 million. However, for frontier finance transactions, the average deal size was US$1.1 million, with the smallest deal reported as US$49,000 (Bass, 2019).

Within emerging markets, frontier finance is a growing subset of impact investments. It specifically 'seek[s] to improve the lives of low- to lower-middle-income people in emerging and frontier markets' (Bass, 2019: 2). Such investments share certain characteristics, including:

- investing in small and growing businesses with relatively small ticket sizes, usually between US$20,000 and US$2 million with a median of US$385,000
- using seed-stage or early-stage risk capital and/or patient risk capital
- investing in businesses with models that serve customers (B2C) or businesses (B2B)
- providing capacity-building support alongside investment capital
- primarily targeting market-rate return
- primarily focused on social impact objectives (Bass, 2019).

1.2.4 In what type of businesses are investments made?

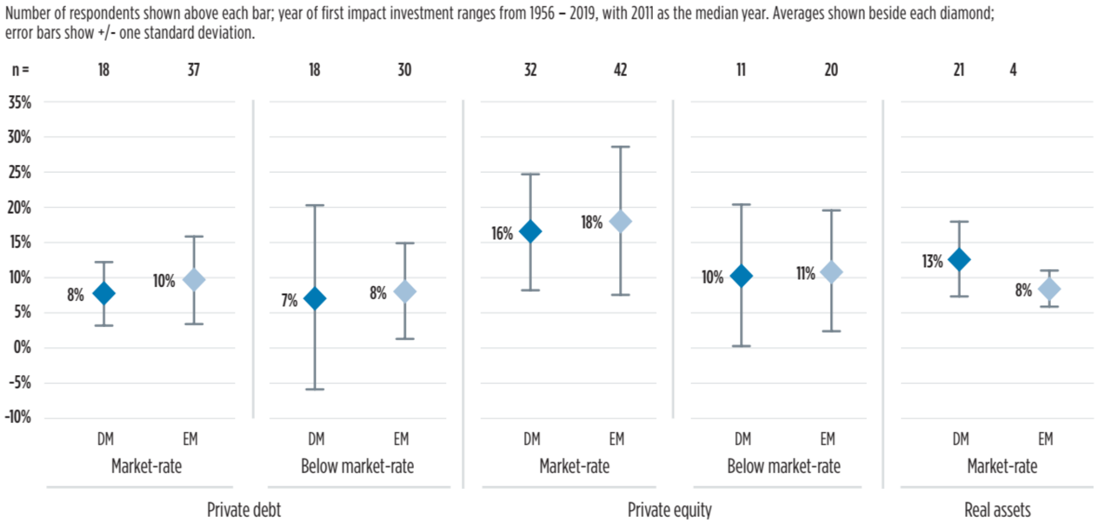
- **Stage of business:** The largest percentage of investment dollars were made in mature private companies (34% of AUM) and mature publicly traded companies (31% of AUM). While 36% of investors invested in seed- and startup-stage businesses in 2019, those investments made up only 1% of AUM. Investors focused on emerging markets (also called frontier markets) focus more on growth-stage companies than those investors investing in developed markets (Mudaliar et al., 2019). Since 2015, investments in mature, publicly traded companies have grown the most (by over one-third), while investments in seed- and start-up-stage companies have decreased (Hand et al., 2020). Overall, less capital is invested into early-stage enterprises (startups or venture-stage companies), which generally require smaller amounts of capital. According to research from Asia, investors may be less likely to invest in early-stage enterprises because these enterprises are less likely to seek external finance; or the size of the investments and expected returns are not proportional to the costs associated with the investment sourcing and process. Investments into these types of enterprises is relatively new, particularly in emerging markets. Those investors that do focus on early-stage finance are diverse – there is no 'one size fits all' as they differ in terms of investment strategy, offering, funding sources, business model and track record. However, they are focused on providing risk finance, as early-stage enterprises are riskier due to their lack of historical financial records, cash flow and collateral (Roberts et al., 2019).
- **Sector:** The sector receiving the largest share of AUM was energy, followed by financial services (excluding microfinance). Food and agriculture (which was only 9% of AUM) and healthcare received investment from the largest number of investors, with about half of investors investing in those sectors, and investments in those sectors are expected to increase over the next five years.

1.2.5 How have investments performed?

» **Investor expectations:** Almost all investors have met their impact performance expectations, while 88% have also met their financial return expectations. However, financial performance expectations varied by type of investor – with more below-market-rate investors and emerging market-focused investors reporting underperformance in financial expectations (compared to market-rate investors and developed market investors).

» **Realised private investment returns[9]:** On average, equity investments generated higher returns than investments through debt or real assets; however, this varied by focus of the investor. According to GIIN data, return on investments in emerging markets exceeded that of investments in developed markets across private debt and private equity for both market-rate and below-market-rate investors. The highest returns were achieved in private equity investments by market-rate investors, and the lowest returns were achieved in private debt by below-market-rate investors. Overall, impact investors report performance of their investments as being in line with or exceeding both impact and financial expectations. By a few different estimates, upwards of 90% of impact investor respondents have met or exceeded financial return expectations (Mudaliar et al., 2019; Hand et al., 2020). A survey of frontier finance investors shows that 20% of investors exceeded expectations, with another 68% performing in line with expectations (Bass, 2019). The average realised gross returns since inception for private debt, private equity and real asset investments are shown in Figure 2.

Figure 2: Average realised gross returns since inception for private market investments



Source: GIIN Annual Impact Investor Survey 2020 (Hand et al., 2020: 60).

» Research conducted by Symbiotics (2019) and supported by the GIIN looked at the financial performance of different asset classes and found that private debt impact funds generated a net annual return of 1.9% over the period 2013–2017, with USD-denominated funds performing at an annual return of 2.7% (Table 2).

[9] Analysing impact performance of the whole market (i.e. not on a fund, investor or investment basis) has historically been a challenge because of the lack of standardised methods or indicators used across impact investments with which to compare, aggregate or benchmark impact performance. However, more recently, the GIIN has begun publishing rigorous comparisons of impact results (typically sector based). Based on feedback from investors themselves, 99% of investors surveyed by the GIIN have met their impact performance expectations (Hand et al., 2020). A more extensive review of existing information on the relationship between business growth, financial performance and impact performance would be valuable, but was beyond the scope of this review.

Table 2: Net annual returns, by asset class, over 5-year period (2013–2017)

Asset class	Net annual return (%)
Private debt impact funds (overall)	1.90
Private debt impact funds (USD-denominated)	2.70
Emerging market bonds	6.08
World stocks	12.33
Cash	0.55

Source: Symbiotics (2019).

1.2.6 How is catalytic capital used?

- **Catalytic capital defined:** Catalytic capital is defined as 'investments that accept disproportionate risk and/or concessionary returns relative to conventional investment in order to generate positive impact and enable third-party investment that otherwise would not be possible' (MacArthur Foundation, 2019).
- **Who provides it:** About half of the GIIN survey respondents reported providing catalytic capital directly, with a greater proportion of below-market-rate investors and private debt investors providing catalytic capital. These investors deployed a total of US$3.5 billion in catalytic capital in 2019.
- **How they provide it:** Those engaging in a catalytic role – whether by providing, participating in, or raising catalytic capital – do so most frequently through debt with flexible terms, grants and equity in an 'all catalytic capital' structure (an investment that qualifies as entirely catalytic, such as one that invests in fragile states or untested business models).
- **Why they provide it:** Investors use catalytic capital for diverse reasons related to supporting innovation, early-stage investments, particular populations, specific business models, and underserved places.
- **Why others don't use it:** Those who do not provide catalytic capital state that it is because catalytic capital does not fit within their investment model, or because deals would not yield the desired financial return.

2 Social enterprises and the demand for capital

This section examines the characteristics of social enterprises and the challenges they face in sourcing capital. Non-financial challenges can also present a significant barrier to development and growth.

2.1 Characteristics of social enterprises

There are a variety of definitions of social enterprises, but one thing they all have in common is that they operate to fulfill a social, cultural or environmental purpose that benefits a community or the wider public. Regardless of the size, age or business model, or whether the business is for-profit or nonprofit, a social enterprise holds its **social mission as the key purpose of its business.** Intentionality is a key part of being a social enterprise – businesses that do not have a clearly stated social mission or purpose are generally not considered to be true social enterprises, even if they create unintended positive externalities.

Most of the data on social enterprises is country specific, as the characteristics of social enterprises and the contexts within which they operate can differ greatly across countries and regions.

Generally, social enterprises have the following characteristics, particularly in emerging markets – which are of most relevance to the Pacific:

» **Social enterprises tend to be small and growing businesses** – they are critical actors for driving inclusive growth in emerging markets. Not only are these businesses found in all sectors of the economy, but they also employ and target many underserved markets that larger businesses either cannot serve or overlook (Dalberg, 2020).

» **Social enterprises tend to prioritise impact over fast and large-scale growth** – they differ from traditional enterprises as they can view financial returns as a means to sustainability rather than continually seeking growth and scale. They are content to grow their businesses gradually rather than prioritising rapid growth (Armeni & Ferreyra de Bone, 2017).

» **Social enterprises have a growing demand for finance** – intermediaries brokering deals and offering finance all report increased volume of demand for finance among social enterprises (Addis, Bowden & Simpson, 2014). Though social enterprises have a diverse range of business models and unmet financing needs (Dalberg, 2020), they place a strong emphasis on preserving their mission despite taking on investment, which makes equity investments and traditional return, timeline and exit expectations less attractive (Armeni & Ferreyra de Bone, 2017).

2.2 Financial challenges faced by social enterprises

Social enterprises have a wide range of finance needs, and there is a mismatch between their financing needs and the financing available to them. This creates a 'misalignment between the products, strategies, and expectations of different SGB [small and growing business] finance providers and their investors and the impact and financial return that different types of SGBs can provide' (Dalberg, 2020: 2).

2.2.1 The finance gap?

Very little information exists on the size of the finance gap for social enterprises specifically. Research into small and medium-sized enterprises (SMEs) uses different definitions to estimate the finance gap for SMEs generally.[10] The United Nations Development Programme estimates a US$2.5 trillion funding gap for social enterprises in Asia (Angelou, 2018).

While estimates of the finance gap vary, almost all commentary recognises that the gap is largest for enterprises in the startup or seed stage of business.

Reports identify a number of reasons for the existence of this finance gap for SMEs and social enterprises:

» The types of businesses typically suffering from a finance gap are usually early-stage ventures or businesses with moderate growth prospects, which lack the size, assets, growth prospects and return potential expected by investors (Hornberger & Chau, 2018).

» Smaller enterprises often lack track records, collateral, and information about their operations and management, and have inconsistent or weak financial performance, which makes it difficult for finance providers to assess the risk and return potential (Hornberger & Chau, 2018; Lyon & Owen, 2014).

» In other cases, where the risk and return can be assessed, the high transaction costs, or 'cost relative to investment return (i.e. high transaction costs and small ticket sizes) may prevent traditional financial service providers from seeing a strong business case for serving these segments of the market' (Hornberger & Chau, 2018: 5) (see also Armeni & Ferreyra de Bone, 2017).

» The longer time horizons required for investments in social enterprises or growing enterprises (Armeni & Ferreyra de Bone, 2017) affects not just the decisions of finance providers, but affects the entrepreneurs as well. Luscher and Lower (2017) note that 'raising investment capital takes big chunks of an entrepreneur's time and they are often left with the feeling that it is unwelcome distraction which takes them away from building their business. … [a]n investor that drags out a decision for months before saying "no" doesn't lose any cash'.

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[10] Hornberger et al. (2020) estimate that micro-, small and medium-sized enterprises (MSMEs) with high-growth potential face a US$930 billion finance gap annually. Bruhn et al. (2017) estimate that the MSME finance gap in developing countries is US$5 trillion, which is 1.3 times the current level of MSME lending. Further, 31 million or 41% of formal MSMEs in developing countries have unmet financing needs. Women-owned businesses comprise 23% of MSMEs and account for 32% of the MSME finance gap.

- Because social enterprises tend to be smaller than traditional enterprises, some of the market failures that exist in all finance markets are exacerbated. For example, asymmetric information[11] is a more serious problem for smaller firms than larger firms because fewer SMEs maintain audited financial statements, 'the line of demarcation between the finances of the owner(s) and those of the business is usually blurred', and there is large heterogeneity in the SME sector in terms of profitability, growth and volatility (OECD, 2015: 15). This compounds the principal–agent problem,[12] as the 'entrepreneur may use funds in ways other than those for which it was intended' (OECD, 2015: 16). Because of this, the terms and conditions for finance often look different for smaller firms – for example, bank loans require higher equity contributions, collateral, credit guarantees or loan covenants (OECD, 2015).

It is generally agreed that the financing gap for social enterprises is particularly acute for seed and early-stage funding (McCutchan, Addis & Curatolo, 2019), and is likely linked with the high cost of making these types of investments (Armeni & Ferreyra de Bone, 2017).

Some reports highlight the lack of information and market segmentation on social enterprises and their demand for finance contribute to the ongoing finance gap (Hornberger & Chau, 2018; Hornberger et al., 2020; IFC, 2011). Some argue that this has historically resulted in attention on 'investment readiness' to generate more demand for the available supply of capital (Lyon & Owen, 2014). The lack of segmentation 'contributes to confusion in the market and misaligned expectations around risk, financial returns, exit prospects, and impact potential for SGBs [small and growing businesses]' (Hornberger & Chau, 2018: 5). This, in turn, contributes to inefficiency in matching enterprises with the right sources of funding and financial instruments (on appropriate terms and at the right time according to their business development stage).

An alternative approach focuses instead on the need to better segment the heterogenous social enterprise market, to understand the differing characteristics and financing needs that exist, and to adapt the supply of finance to match the demand.

2.2.2 The gendered finance gap

The finance gap is amplified for women-owned businesses. Reporting indicates that women are denied bank loans in high numbers, which further discourages them from applying (IFC, 2011). In addition, anecdotal evidence shows that financial institutions systematically underserve women, due to 'a perception of higher risk and cultural bias amongst loan officers' reported by local banks (IFC, 2011: 40).

Some of the other factors identified that contribute to the gendered finance gap include the characteristics of women-owned businesses, such as the size of firms (women are skewed towards smaller firms); the sectors in which women entrepreneurs operate (women are typically concentrated in less profitable industries such as customer-oriented services); the greater likelihood that women-owned businesses are in the informal sector (with women more likely to be operating their business from the home and starting a business out of necessity to supplement income); and the fact that women are less likely to be employers than men (IFC, 2011).

Non-financial barriers that affect women's access to finance can include the following:

- **Legal environment** – this is typically related to asset ownership, as women are more likely to experience a lack of immovable assets and collateral, which disadvantages them in credit markets.
- **Cultural environment** – culture can constrain what types of opportunities women can pursue; it can reinforce the gendered division of labour, which influences how women's time is spent; and culture can limit women's control over resources and their own mobility.
- **Human capital** – in some places, a gender gap in schooling and prior work experience can limit women's ability to obtain finance.
- **Regulatory environment** – regulatory requirements discourage formalisation, limiting access to formal finance.
- **Infrastructure** – poor infrastructure restricts women's physical access to finance.

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[11] Unequal knowledge between each party to a transaction, so that one party has better information than the other party. This creates an imbalance in a transaction, which affects decisions, deal terms and the cost of doing business.
[12] Where agents are motivated to act in their own best interests, which may be contrary to those of their principals, and which may be caused by asymmetries of information.

- **Governance** – weak governance tends to hurt smaller firms more (IFC, 2011).

The International Finance Corporation (IFC, 2011) also makes the point that successfully serving women-owned enterprises may require financial service providers to further tailor their financial products to the specific needs of this market segment.

2.2.3 What are the funding needs of SMEs and social enterprises?

The global literature agrees that for SMEs and social enterprises, the main driver behind the finance gap is the lack of forms of capital that meet their specific needs.

SMEs and social enterprises have a diverse range of finance needs, including finance for early-stage growth, expansion, working capital and new assets (Hornberger & Chau, 2018). The amounts of finance needed can vary – with estimates ranging from US$10,000 up to US$2 million (Hornberger & Chau, 2018; Roberts et al., 2019).

Social enterprises often need a combination of types of finance to grow, including working capital, debt and equity. However, historically, social enterprises tend to rely on bank loans or grant capital (grants, donations, project funding) (Carpenter & Keller Lauritzen, 2016; OECD, 2015).

However, bank loans do not fulfill all the needs of social enterprises, especially newer or faster growing businesses, so many consider that the banking system does not effectively serve SMEs, where many impact investing innovations are taking place (Freireich & Fulton, 2009). Smaller businesses often need non-asset-based financing, which is based on future cash flow projections rather than on collateral, since most small or early-stage businesses have little if any collateral to offer (Roberts et al., 2019). But for newer businesses, profits are difficult to forecast (OECD, 2015; Armeni & Ferreyra de Bone, 2017). The terms and conditions that come with bank loans can also discourage smaller, more innovative enterprises from applying. The most discouraging terms include 'complex application procedures, unfavorable interest rates, high collateral requirements, and insufficient loan size and maturity' (Bruhn et al., 2017: 18). This is more pronounced for women-owned SMEs, which are less likely to obtain formal financing, often pay higher interest rates, and – in some regions – receive smaller loans than SMEs owned by men (IFC, 2011).

For example, in Latin America, many impact enterprises lack the collateral and established relationships that are needed to ease concerns about risk to secure bank loans. In addition, banks are unfamiliar with the business models and markets of impact enterprises. These two issues combined limit the availability of loans by banks (Armeni & Ferreyra de Bone, 2017). In another example from the United Kingdom, a more mature impact investment market, only 15% of social enterprises were seeking debt finance, most of whom were borrowing from commercial banks through loans or overdrafts, and of which only 3.6% approached social investors. The majority of social enterprises continued to rely on public sector grants and were cautious about taking on debt (Lyon & Owens, 2014). For more information on social enterprise finance in the United Kingdom, see Annex A.

2.3 Non-financial challenges faced by social enterprises

Beyond finance, social enterprises face many barriers to their development and growth, particularly in emerging markets. These include:

- **Complex operating environments:** Social enterprises operate in complex environments that affect their business, customer base and supply chains (Koh, Karamchandani & Katz, 2012). Social enterprises often serve traditionally overlooked market segments (whether low-income, rural, or base of the pyramid), which can push impact enterprises to be more innovative in terms of product design, distribution channels, or even segmentation strategies to service hard-to-reach customers with limited resources. This approach can increase risk without a corresponding increase in potential returns for the business (Armeni & Ferreyra de Bone, 2017). In addition, social enterprises often engage suppliers with limited capabilities, high production volatility and low loyalty due to cash flow needs (Koh, Karamchandani & Katz, 2012).

- **Higher cost of doing business:** Many social enterprises must not only cover ordinary business expenses (wages, marketing, rent, etc.), but they also face 'social impact costs', which include 'costs associated with lower productivity rates, demonstrating both social and financial impact, liaising with public employment services, conversations and care with disadvantaged employees, and building social capacity' (Carpenter & Keller Lauritzen, 2016: 3). They may also face higher costs associated with educating and awareness building for customers, poor infrastructure and inefficient regulation (Koh, Karamchandani & Katz, 2012). This all creates lower and volatile operating margins, which makes it difficult for social enterprises to meet interest rates or other financial requirements under the same conditions as ordinary SMEs. For example, 'as an impact-focused investor, Acumen Fund reports that its portfolio companies have an average profit after tax of minus 20 percent. Its eight most profitable investees record an average profit after tax of just six percent' (Koh, Karamchandani & Katz, 2012: 6).
- **Inconsistent legal structures and government regulation:** Social enterprises can be required to meet high standards of corporate governance, reporting and accountability (McCutchan, Addis & Curatolo, 2019), and regulation/red tape can act as an obstacle (UK DCMS & UK BEIS, 2017).
- **Skills and capacity building:** Social enterprises often encounter a lack of appropriate skills in the market and a lack of support services to get the technical support and mentorship they may need (McCutchan, Addis & Curatolo, 2019), particularly early-stage business support (GIIN, 2018). The most demanded services from social enterprises participating in accelerators and support programs were centred around network building, direct funding, and mentorship (GALI, 2019). Both investors and social enterprises alike broadly recognise that business support beyond finance is needed (Ronicle & Fox, 2015).

3 Challenges within impact investing

This section examines the demand-side challenges, that is the challenges faced by social enterprises; and the supply-side challenges, or those faced by investors; as well as challenges in the broader ecosystem.

3.1 Challenges on the demand side: the limited pipeline of investible social enterprises

There is general consensus globally among impact investors that a large challenge is the limited pipeline of investable social enterprises, particularly in emerging markets and developing countries. In other words, there are not enough social enterprises seeking capital that are considered ready to take investment from investors at the required rates of return.[13] This has been a challenge since the early days of impact investing:

> *[A]lthough sufficient absorptive capacity for capital is not the initial barrier in most places, it will soon become one; it is already a challenge in such markets as India, where lots of capital is seeking deals. Some investors are finding that there are few businesses with proven investable business models and that they are stopping at the same 50 doors as other investors. (Freireich & Fulton, 2009: 22)*

This challenge has also been demonstrated by Acumen Fund's experience – over a 10-year period, more than 5,000 companies were considered for investment, but investments were made in only 65 (Koh, Karamchandani & Katz, 2012).

Investors have identified various reasons behind the lack of investable social enterprises, including lack of business maturity, concerns about the quality of enterprises, and social entrepreneurs' limited awareness of capital.

[13] Freireich and Fulton (2009: 15) describe the challenge as an 'imminent lack of impact investing opportunities into which large amounts of capital can be placed at investors' required rates of return'.

3.1.1 Social enterprises are considered too early-stage for investment capital on offer

Many impact investing innovations are taking place within small and medium-sized enterprises. In most emerging markets, for-profit social entrepreneurship itself is a relatively new concept, so many social enterprises are at the seed and early stages of the business life cycle and lack a track record (Freireich & Fulton, 2009; GIIN, 2018; Bass, 2019). The development of these business opportunities into effective and scalable business models is slow – the timeline to achieve profitability, as well as impact, is often longer than for traditional enterprises (Freireich & Fulton, 2009; Armeni & Ferreyra de Bone, 2017). Freireich and Fulton (2009: 23) note that '[s]ome businesses will take several years before they can be investable, and about 10 to 15 years before they are able to operate at broad scale'.

Acumen Fund, which emphasises its role as an 'impact-first' investor, demonstrates this reality. In a study of 439 promising inclusive businesses in Sub-Saharan Africa, only one-third were commercially viable and only 13% were operating at scale (Koh, Karamchandani & Katz, 2012). Many impact investors are focused on mature, investment-ready enterprises, and very few impact investors are investing in what is considered 'priming the pump' (Bannick & Goldman, 2012).

3.1.2 Investors cite concerns about the quality of enterprises

Many investors cite the ability to source investment-ready deals as the main challenge to impact investing (Bass, 2019). For investors with a specific geographic or sectoral focus, or specific impact requirements, this problem is exacerbated (Bass, 2019). Investors often feel that the quality of social enterprises' business plans is low and the capacity to implement them is lacking, so many small businesses are unable to meet investor due diligence requirements (OECD, 2015). Investors state that social enterprises have limited experience with financial modelling and financial management, growth projections, and impact reporting. Investors are also often concerned by talent gaps, particularly at the senior and middle management levels (Bass, 2019).

In some places, quality issues are being addressed through training and mentoring to improve entrepreneurial skills and strategic vision and planning (OECD, 2015). However, most enterprises have a limited ability to pay for such support services (GIIN, 2018), or such services are not readily available – so investment readiness work falls to investors or other third parties such as governments or official development assistance programs. Building the quality of social enterprises is tricky – investors may invest in pre-investment support; however, it is not guaranteed that the investee will reach the desired level for investment to occur (Bass, 2019).[14]

3.1.3 Social enterprises have a limited awareness of capital and are focused on other ways to improve growth and sustainability

Many social enterprises are not focused on attracting capital and instead focus on other ways to improve growth and sustainability (Carpenter & Keller Lauritzen, 2016). As a result, many social enterprises have a limited understanding of sources of financing beyond traditional bank lending, such as private equity (OECD, 2015; Bass, 2019). This lack of familiarity extends to impact investors (GIIN, 2018). In some places, such as Southeast Asia, social enterprises rely heavily on grant capital, which reduces the incentive to seek other forms of private finance (GIIN, 2018).

Influencing unprepared or unaware enterprises to take on capital, or certain types of capital, can be detrimental to the business. For example, in an equity investment that has few exit opportunities, a push towards a buyer that is not aligned with the enterprise's mission can compromise the enterprise's impact goals (Armeni & Ferreyra de Bone, 2017). Or, for more easily obtained debt, increasing an enterprise's debt can overleverage the business, threatening longer term sustainability of the business (OECD, 2015). So that social enterprises can effectively engage in the investment-raising process to their advantage:

> *[t]here is a need to understand how different instruments can serve different financing needs at specific stages of the life cycle, the advantages and risks implied, [and] the complementarities and opportunities for leveraging between some of these sources. (OECD, 2015: 9)*

[14] This perception around the quality of enterprises is often viewed through the lens of private equity and what would be expected from a fast-growing business as opposed to the low- or normal-growth businesses more common in the market.

3.2 Challenges on the supply side: lack of available appropriate financial products

On the supply side, growing social enterprises face a gap in the availability of appropriate financial products. This problem has been identified by impact investors themselves (Hand et al., 2020). They 'consistently cite a lack of flexible capital appropriate for frontier and emerging market investments and for innovative business models, such as early-stage and high-risk capital, patient capital, and capital that addresses underserved geographies and sectors' (Bass, 2019: 2).

Overall, the needs of smaller businesses can be challenging for impact investors to meet because of the higher cost of capital, longer time horizons, differing risk and return profiles, misalignment of expectations, and the lack of a sophisticated local financial ecosystem (Dalberg, 2020). These challenges are covered in more detail in the sections that follow.

The gap in appropriate financial products – Latin America and the United Kingdom

In Latin America, the 'lack of appropriate capital across the risk/return spectrum' is considered the key constraint to the growth of the impact investment market:

> *Despite solid financial statements and demonstrable contributions to the economy and to society, many impact enterprises find it challenging to obtain capital that aligns with their needs and characteristics and enables their development and growth. This is particularly the case for impact enterprises in the early and growth stages (Armeni & Ferreyra de Bone, 2017: 1).*

In the United Kingdom, feedback from social enterprises showed that:

> *[t]he social investment that is taking place is ill-fitted to the needs of the vast majority of charities and social enterprises; designed instead around large deals, assets, and government contracts. It does not reflect the realities of their various enterprising activities and, instead, feels like it is driven by the demands of investors: seeking market returns, transferring risk, and emphasising competition rather than collaboration between organisations. (Access, n.d.)*

Feedback from UK social enterprises also showed that:

> *social investment is not felt to be of the sector – charities and social enterprises perceive it to be disempowering, something imposed by government and financial services. Its role is not embedded in existing networks and relationships and there is suspicion around the messengers (government and financial services) and their tone ("be more business-like, be more efficient"). … The voluntary sector often feels that it has to "shape up" and get "investment ready" in order to meet what capital supply there is; but few are the right shape. (Access, n.d.)*

A report commissioned by the United Kingdom's National Lottery Community Fund in 2012 highlighted this mismatch, concluding:

Organisations that are looking to raise finance are primarily interested in longer term finance of less than £100,000 to help them scale up their existing activities. This does not match the dominant type of capital on offer to this sector. (Gregory et al., 2012: v)

3.2.1 Impact investment is time-intensive and expensive

Impact investing, particularly transactions in emerging markets, is generally recognised by investors to be both time-intensive and expensive (Bass, 2019).

Investments into impact enterprise often require a longer timeframe for the transaction to develop, and a longer timeframe to create meaningful returns (hence the term 'patient capital'). Due diligence periods reported by investors can range from 6 months to 2 years (Bass, 2019). Impact investments made in emerging or frontier markets through cross-border transactions are often subject to complex legal processes, which increases the time required to execute a deal (Bass, 2019). In addition, impact enterprises often address complex problems in complicated markets, which slows the pace at which the business develops (Armeni & Ferreyra de Bone, 2017). Typically, investors expect returns in 5 to 7 years; however, impact investments do not always meet this expectation (Armeni & Ferreyra de Bone, 2017) as they usually require 'ten years or longer to realize their impact and financial potential' (Bass, 2019: 17).

Impact investment deals also incur higher transaction and other costs compared to traditional investments (Armeni & Ferreyra de Bone, 2017; Bass, 2019). This could be for various reasons, including:

- the typically smaller size of deals for social enterprises (Armeni & Ferreyra de Bone, 2017)
- the lack of investment-ready deals and resulting expense to strengthen potential investees with pre-investment support – the extra cost may be a sunk cost if the investment isn't eventually made (Bass, 2019)
- complex bureaucratic regulations to set up and run a fund (Bass, 2019)
- the location of many impact investors outside the region of investment, resulting in additional costs from fly-in/fly-out models to maintain effective investment management (Bass, 2019)
- high monitoring costs relative to the level of investment (OECD, 2015).

3.2.2 Investors perceive the risk in impact investing to be high

Investors perceive the risk in impact investing to be high, particularly for investments in frontier finance or emerging markets. The main risks cited by impact investors include:

- **Business model execution and management risk:** risk that the enterprise will perform less well than expected (Bass, 2019; Hand et al., 2020).
- **Country, currency and macroeconomic risks:** including political risk, such as unpredictability of government policy, as well as regulatory, economic or currency-based risks, including depreciation (Bass, 2019; Hand et al., 2020; Berard, 2016).
- **Market demand and competition risk:** risk that there will be low demand for the investee's products/services or declining market share and revenue due to competition (Bass, 2019)
- **Liquidity and exit risk:** one of the most common challenges for the impact investment industry as a whole, as identified by investors in the GIIN's annual survey, is the lack of suitable exit options. In most emerging markets, there are even fewer suitable exit options (such as initial public offering, merger or acquisition) and lower levels of liquidity, which can be a deterrent to investors (Hand et al., 2020; Armeni & Ferreyra de Bone, 2017; OECD, 2015; Roberts et al., 2019).

Many impact investors seek deals with risk-adjusted commercial rates of return. Some feel that investors often lack alignment between their investment strategies, their aims and expectations for risk, return and impact, and the realities of the markets in which they invest:

> *Pursuing new business models to tackle the toughest social problems affecting the poorest communities will not generate high risk-adjusted returns, and in fact may not even generate 1x return. (Koh, Karamchandani & Katz, 2012: 48)*
>
> *Applying financial products (e.g. pure equity or straight debt) in their "pure" form from developed markets to a diversity of emerging markets is not yielding the expected results, but risk, return and impact performance expectations need to be adjusted to the realities of the local operating ecosystems, including adopting a more patient approach (including "patient capital") to enable returns to realize and base expectations on actually realized performance in target markets instead of using other markets' reference points. (Roberts et al., 2019: 55)*

3.2.3 Influence of traditional finance contributes to a disconnect between drivers of impact investing and the needs of social enterprises

Impact investing is based on traditional systems of finance, including its processes and products. However, the differences between impact enterprises and traditional enterprises often creates challenges because of the mismatch between investor business models and expectations and the realities of social enterprises. One study in Australia looked at this issue specifically and reviewed impact investors' institutional logic, which is made up of their practices, rationales and priorities. The study determined the dominance of an investment-centric logic in the industry, which mirrors mainstream investment, and affects both how and what investments are made. This logic also affects performance measurement, which is focused on financial performance outcomes (Castellas, Ormiston & Findlay, 2018). The study highlighted that:

> *There was clear evidence that impact investors in Australia are prioritizing the investment logic, upholding logics from mainstream investment both pre- and post-investment. These logics are potentially at odds with the focus on achieving blended value, as investment activity appears somewhat biased toward achieving financial returns. (Castellas, Ormiston & Findlay, 2018: 149)*

The study also found that expertise in mainstream investment dominates most asset management teams, and:

> *many practitioners appear to be making decisions in their traditional way, based on the familiar metrics from their backgrounds in finance, banking and venture capital. This approach to decision-making is potentially at odds with the experience of many social enterprises, which are often less embedded within the market-based investment logic. (Castellas, Ormiston & Findlay, 2018: 149–150)*

The reliance on an investment-centric logic contributes to a disconnect between the direction of impact investment and the needs of the social enterprise sector in various ways (Castellas, Ormiston & Findlay, 2018):

- Impact investors seek larger scale and more mature investments than the majority of social enterprises.
- There is incompatibility between the financial instruments, investment time horizon, and stage of investment between investors and social enterprises.
- Impact investors following mainstream investment logics (and a focus on financial performance), which draws investment away from social enterprise development and can influence which types of social enterprises are successful (i.e. those that meet the needs of mainstream investment).

Other literature has focused on how the influence of traditional investment models exacerbates the mismatch between return expectations and the size and stage of impact investments, as detailed below.

Return expectations between investors and social enterprises does not match

In some studies, impact investment does not actually offer a trade-off between financial returns and social impacts, and continues to target market rates of return over the long term (Castellas, Ormiston & Findlay, 2018). More than two-thirds (67%) of investors surveyed by the GIIN are seeking risk-adjusted, market-rate returns (Hand et al., 2020). As mentioned previously, many are also seeking returns within 5 to 7 years, which does not account for the growth rate and trajectory of social enterprises.

This mismatch is more acute in equity investment. Traditional venture capital investment has strongly influenced equity investments, so much so that equity-focused investors tend to look for large and fast-growing investments (Ben-Ami, 2018), and can find the financial returns of impact enterprises to be 'unappealing' (Armeni & Ferreyra de Bone, 2017: 4).

Impact enterprises that seek equity investments 'often face a trade-off between impact and profitability' (Armeni & Ferreyra de Bone, 2017: 4). Impact enterprises are slower-growing enterprises that may reach limited financial scale, because they are often addressing market failures, working in areas where profit-seeking entrepreneurs have not engaged for a reason (Armeni & Ferreyra de Bone, 2017).

Size of deal expectations between investors and social enterprises does not match

Another mismatch that exists between investors and social enterprises is the size of deals. The majority of impact investments are relatively small deals, which are less attractive to investors because of the additional effort or finance required to source these deals, or because smaller deals do not meet investors' return expectations (Freireich & Fulton, 2009; Roberts et al., 2019). However, the average deal size made by impact investors in 2019 across asset classes was US$5 million, and the average deal size is growing by 2% per annum (Hand et al., 2020).

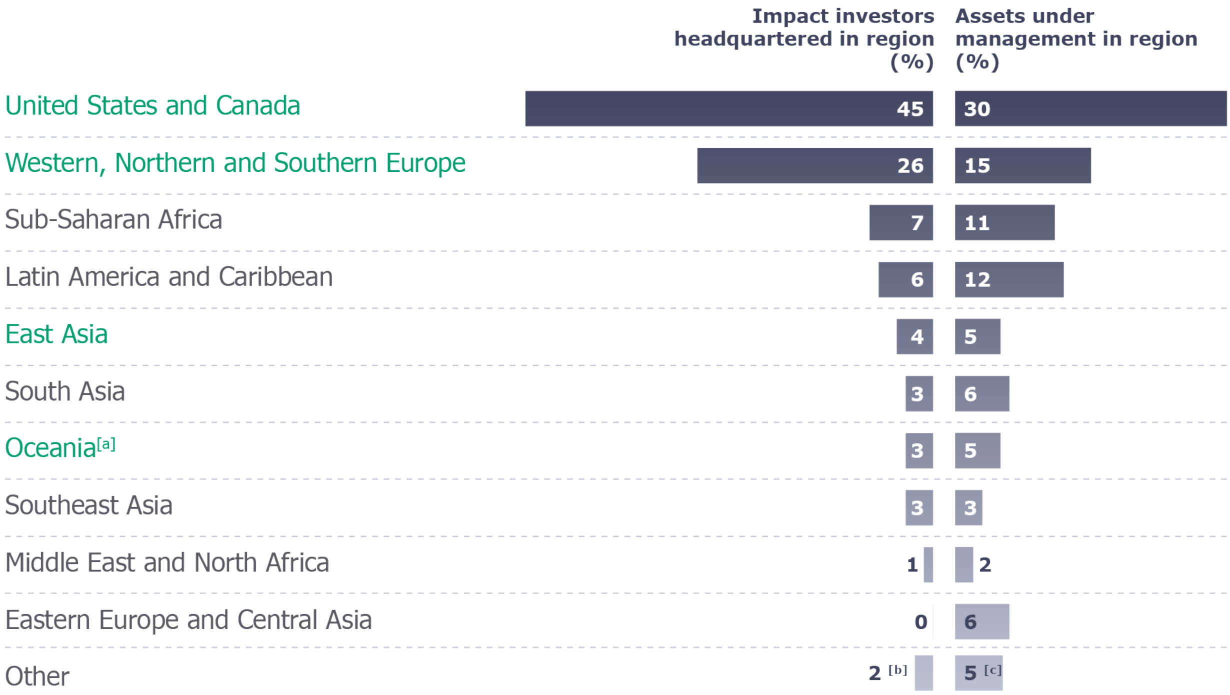
As more asset managers or fund managers come on the scene, limited partners seeking to make impact investments find 'few accessible impact investing fund products' that have strong financial and impact track records and the ability to take on smaller investments (Hand et al., 2020: 23). On the other side, limited partners do not always understand the trade-off between risks, impact and returns, which makes it challenging for asset managers or fund managers to raise investment for impact funds that would make smaller investments (Roberts et al., 2019).

The mismatch that exists between investors and social enterprises demonstrates the need for more education on the part of investors, and more examples of the realities of impact and financial performance of impact investment (Bass, 2019).

3.2.4 Foreign and home bias means investors typically invest locally and a majority of impact investment is in developed countries

Looking at the flow of capital between countries sheds some light on the potential challenges posed by foreign and home bias. The majority of impact investors are based in developed markets – 46% of impact investors in the GIIN database are headquartered in the United States and Canada, and 34% are headquartered in Western, Northern and Southern Europe. By country, the majority of surveyed impact investors were based in the United States, followed by the United Kingdom, Canada and the Netherlands (Hand et al., 2020).

Figure 3: Location of impact investors and destination of investments (as of end 2019)



a Includes Australia, New Zealand and Pacific island countries.

b No single headquarters location.

c Includes investments allocated globally.

Notes: a) Number of investors = 289; total AUM = US$221 billion. Percentage of AUM excludes outliers.

b) Green are developed markets by GIIN definition and grey are emerging [markets]

Source: GIIN Annual Impact Investor Survey 2020 (Hand et al., 2020: 2, 30).

The two geographies that received the highest percentage of AUM in 2019 were the United States and Canada (30% of sample AUM) and Western, Northern and Southern Europe (15%) (Figure 3). However, almost half of investors are focused on investing in emerging markets,[15] and 40% of AUM in 2019 went collectively to emerging markets (Hand et al., 2020).[16]

The impact investment market is likely not completely immune to these biases. While impact investors can invest in a widely diverse set of countries (even within the same region), the socioeconomic and cultural barriers can make cross-border transactions and capacity-building support more challenging – and so it requires the commitment of time, skills and resources. If investors do not understand the nuances of each country in which they operate, risk may be mispriced (McCutchan, Addis & Curatolo, 2019).

In relation to Latin America, Hume, Davidson and Guttentag (2020: 15) note that:

> *[m]ost of the investment activity in 2018–2019 came from outside the region, with only 26% of capital and 33% of deals coming from impact investors headquartered in Latin America (despite representing a greater proportion of the sample). The average deal size for impact investors based in Latin America was half that of foreign investors. While this shows that foreign investors continue to dominate larger ticket sizes, it is encouraging that local capital is stepping in and filling the gap in smaller investments for local entrepreneurs.*

For example, impact investment fund managers in Southeast Asia have identified reliance on foreign pools of capital to be an important supply-side challenge (GIIN, 2018). The limited local presence of investors limits their operations through:

- increasing the time required to source deals
- increasing the time required for decision-making and due diligence
- increasing the perceived risks associated with investing in the region
- limiting investors' ability to provide high-touch support to their investees (GIIN, 2018).

These all increase the costs, and thus the pressure, on impact investment to perform financially.

In East Africa between 2015 and 2016, 80% of disclosed investors were foreign investors and 90% of the capital invested went to a very small group of expatriate-founded businesses (startups with one or more European or North American founders) (Peacock & Mungai, 2019). Analysis showed 'gaps in understanding between foreign impact investors and local entrepreneurs that needs to be bridged if capital is to be allocated to locally-founded businesses with long-term growth potential' (Peacock & Mungai, 2019). Annex A contains further analysis of foreign bias in the East African impact investment market.

The flow of capital between countries is likely to create challenges. These challenges are well documented in traditional finance markets (Ke, Ng & Wang, 2010). The phenomenon of home bias 'is well known in financial analysis: investors strongly tilt their portfolios toward domestic assets and away from foreign instruments' (Perricone, 2009). This is likely due to:

- information asymmetries or domestic information being easier and less expensive to obtain than information on foreign enterprises and economies (Dziuda & Mondria, 2012; Ke, Ng & Wang, 2010).
- cross-border boundaries, including variation in regulation, culture, taxation, accounting standards, corporate governance, language, legal environments, and economic and market development (Ke, Ng & Wang, 2010).
- familiarity or investor recognition (Ke, Ng & Wang, 2010; Beugelsdijk & Frijns, 2010).

[15] According to the Global Impact Investing Network 2020 survey, 77% of sampled investors are headquartered in developed markets, and 21% in emerging markets. Developed market–focused investors make up 48% of the sample and emerging market–focused investors make up 43% (Hand et al., 2020).
[16] Excludes outliers.

- geographic proximity – home bias can be present as long as geographic distance separates investors from potential investments (Ke, Ng & Wang, 2010).
- cultural characteristics, including uncertainty avoidance – a greater cultural distance creates unfamiliarity and reduces risk tolerance (Beugelsdijk & Frijns, 2010).

3.2.5 Impact measurement is not standard and can result in 'impact washing'

Despite the prioritisation of 'impact' in impact investing, one of the ongoing challenges within the industry is impact measurement. The 'sophistication of impact measurement' is one of the main challenges cited by impact investors (Hand et al., 2020).

Unlike financial performance, there are no standardised ways to measure the many different types of impact that social enterprises create that would allow investors to compare with benchmarks or other investments. As a result, when investors are looking to make an investment, or when they measure the impact of their investment, they can only judge success based on whether the investment meets internal expectations or projections rather than measuring it against a benchmark (Addis, Bowden & Simpson, 2014). The lack of consistent, good-quality and widely used social metrics makes assessing the trade-off between financial and social benefits difficult for investors (Freireich & Fulton, 2009).

Further, impact measurement costs money, requires specialised skills and takes time, and so investors would rather assume impact is created or rely on anecdotal stories, with few investors measuring impact rigorously over the duration of an investment (Starr, 2012; Freireich & Fulton, 2009; Hand et al., 2020). This further exacerbates the risk of 'impact washing', when investments claim to be impact investments but, in reality, do not address social or environmental problems to create meaningful impact. This 'mission drift' is a risk to the industry and has already created controversy within environmental, social and governance investing (Wallace, 2019).

While significant improvements in this area have been made over the years, when identifying challenges for the next 5 years, investors cite 'impact washing' and 'impact performance' as high on the list (Hand et al., 2020).

3.3 Challenges in the ecosystem

Challenges not only exist on the demand and supply side of impact investing, but also within the broader ecosystem. The most cited challenges within the ecosystem are the lack of sustainable high-quality intermediaries, the need for greater capacity development within the industry, and government policy.

3.3.1 Lack of high-quality intermediation

Intermediaries, including incubators and accelerators, transaction advisers, and consultants, play a key role in the impact investment industry by matching social enterprises with investors. Many investors see a need for increased engagement from intermediaries, which act as 'a "gateway" between capital and impact investment opportunities' (Hand et al., 2020: 11) and which reduce the costs of sourcing for investors by serving as a mechanism for aggregation (Freireich & Fulton, 2009).

Intermediaries have their challenges. Many investors feel that intermediaries currently lack scale, depth, diversity and reach (Addis, Bowden & Simpson, 2014). Key issues include:

- **a lack of specialist advice and mentors**. A relatively small number of intermediaries have the right knowledge and skills and a focus on impact or impact investing (GIIN, 2018; Hill & Addis, 2017; Addis, Bowden & Simpson, 2014). The demand for support from these intermediaries outweighs availability – and the availability and quality of services varies between and within countries (McCutchan, Addis & Curatolo, 2019).

- **a risk that intermediaries are financially unsustainable**. Many social enterprises are unable to pay for the services of intermediaries, which do not have enough customers to sustain revenue, and which face high search and transaction costs caused by fragmented supply and demand (GIIN, 2018; Freireich & Fulton, 2009). Often social enterprises are 'cash constrained, need investment sizes that are disproportionately small relative to the cost of helping them raise funding, and often do not view capital advisory services are valuable to their growth trajectory' (CFF, n.d.). As a result, many intermediaries struggle to grow and attract quality talent, operate with volatile revenue streams (such as philanthropic capital and/or fees linked to successful capital raises), and end up working on smaller deals for less lucrative fees (CFF, n.d.; Freireich & Fulton, 2009).
- **the concentration of intermediaries in urban areas,** which limits their reach (GIIN, 2018).

3.3.2 Industry capacity development is needed

It is generally recognised that awareness building is needed to further educate all stakeholders on the potential for, and realities of, impact investing. Challenges in building industry capacity take many forms, including:

- lack of success stories that could educate investors and reduce perceived risk in the market (GIIN, 2018)
- limited availability of capacity-building support for fund managers (GIIN, 2018)
- underdeveloped networks (Freireich & Fulton, 2009)
- lack of strong leadership, skill enhancement and career paths needed to develop critical mass in the industry (Addis, Bowden & Simpson, 2014).

3.3.3 Government policy is still emerging but is an opportunity

The literature contains few specifics on the challenges of government policy, other than that country-level infrastructure and policy can create roadblocks for impact investment (GIIN, 2018), and that coherent policies are needed to accelerate development, remove barriers and encourage participation in the industry (Addis, Bowden & Simpson, 2014).

4 Opportunities for impact investing

Despite the many challenges, practitioners have identified numerous opportunities to continue to employ and grow impact investment effectively in the global market.

4.1 Understanding business differences to provide appropriate finance

Social enterprises require different types of finance at different stages in their life cycle, in different amounts, which may be provided by different types of investors (Dalberg, 2020; Roberts et al., 2019). An important driver of the finance gap for social enterprises, and a challenge in the supply of impact capital, is the misalignment of expectations around impact and financial returns (Dalberg, 2020). Much of the feedback from practitioners suggests one solution is for investors to better understand different segments of social enterprises to understand their different characteristics and financing needs and then to build appropriate structures of finance to meet those needs.[17]

[17] This is supported by Hill and Addis's (2017: 6–7) observations:

> *In many of the conversations that we held there was a sense that, so far, momentum has been finance-led (as opposed to being activity-led), which is a pattern that is common across a number of impact investing markets globally. Investors and financial intermediaries are seen as playing a key role in "pulling" activity into and through the impact investment system.*
>
> *.....*
>
> *The views from people across the impact investing ecosystem provided a clear sense that there is a need to balance up the dynamics in the current system and get both "push" and "pull" factors working in sync to drive impact at scale. Indeed, some people indicated the system should be activity or service innovation-led rather than finance-led to ensure that effort and activity is focused on the right sorts of issues and responses.*

Carpenter and Keller Lauritzen (2016: 5) conclude that:

> *multiple studies have showed that there is no right mix of financing suitable for all social enterprise. What is required instead is a broad range of financing products across the full spectrum, allowing the individual enterprise to pursue the combination of instruments best suitable for their particular business – model, type of enterprise and development stage.*

There is a large opportunity to develop a broader mix of finance options and structures, rather than being limited by traditional debt and equity structures, and to build the capacity of both investors and social enterprises to use a wider variety of financial options (Addis, Bowden & Simpson, 2014). A wide range of alternative types of finance or investment structures are being experimented with around the world, which are flexible and provide more options for investors and social enterprises.

There is also an opportunity to involve different types of financiers – including local finance – in the mix:

> *While deploying local capital is not necessarily a prerequisite to successfully generating impact, research shows that local investment networks are well-positioned to identify the highest-impact opportunities and "direct capital flows to where they are most needed." (Hume, Davidson & Guttentag, 2019: 14)*

4.2 Blended finance creates an opportunity to involve official development assistance (ODA) in impact investing

Blended finance is defined as 'the use of catalytic capital from public and philanthropic sources to mobilize additional private sector investment in developing countries' (Convergence, 2019: 3). To date, blended finance has mobilised approximately US$139 billion in capital through 3,700 transactions towards sustainable development in developing countries.

Convergence (2019: 7), a global network for blended finance, describes the rationale for, and barriers to, blended finance as follows:

> *Blended finance is a structuring approach that allows organizations with different objectives to invest alongside each other while achieving their own objectives (whether financial return, social impact, or a blend of both). The main investment barriers for private investors addressed by blended finance are (i) high perceived and real risk and (ii) poor returns for the risk relative to comparable investments. Blended finance creates investable opportunities in developing countries which leads to more development impact.*

Blended finance creates an opportunity to involve official development assistance in impact investing – using public funds to catalyse private sector investment to realise the Sustainable Development Goals (Hall, 2019). A research report commissioned by the UK Department for International Development discusses the role of blended finance and provides recommendations on how to mobilise private investment at scale in blended finance (Convergence, 2020).

Convergence (2019) summarises the state of blended finance as follows:

- There is approximately US$15 billion in annual blended finance, with deal sizes ranging from US$110,000 up to US$8 billion.
- Over 1,100 unique organisations across the public, private and philanthropic sectors have made one or more financial commitments to blended finance transactions, with approximately 20% of these organisations active blended finance investors.
- Blended finance has achieved the greatest traction with financial institutions (e.g. commercial banks) and corporates (e.g. multinational companies), while participation from institutional investors, as well as local investors, has been limited to date. Impact investors represent a declining share of financial commitments to blended finance transactions, but continue to represent an active subset of investors.
- Development agencies, multi-donor funds, multilateral development banks and development finance institutions have all increased their blended finance activities over time. The most active public investors with a development mandate in blended finance are the United States Agency for International Development (USAID), Germany's Federal Ministry for Economic Cooperation and Development (BMZ), and IDB Lab (the innovation laboratory of the Inter-American Development Bank).
- Sub-Saharan African was the region most frequently targeted by blended finance transactions; however, they have also been growing in Asia.
- Concessional debt (67% of transactions) or equity have been the most commonly deployed financial instrument in blended finance structures, including first-loss debt or equity, investment-stage grants, and debt or equity that bears risk at below-market financial returns to mobilise private sector investment; followed by technical assistance funds, often in conjunction with debt or equity.
- Energy and financial services are the two most common focus sectors of blended finance transactions.
- Blended finance can come in different forms, such as concessional capital, guarantees/risk insurance, technical assistance funds, or design-stage grants.
- The current practice is still at relatively low leverage ratios, with much room for improvement in structuring transactions that effectively and efficiently draw in private sector capital.
- Foundations and NGOs can play an important role in blended finance, given their aptitude for flexible financing and long-term vision for achieving development impact.

4.3 Partnering philanthropic capital and impact investment can support early stage entrepreneurs and broader ecosystem stakeholders

Outside of blended finance structures, there is also an opportunity for philanthropic or public sources of capital within impact investment. Philanthropic capital can be deployed in many forms, including grants, equity, debt and technical assistance, and can be used for many purposes – not only supporting earlier-stage enterprises but also the development of broader ecosystem stakeholders, such as governments and intermediaries. For example, philanthropic capital can be used to:

» lower the overall cost of capital with below-market returns, or to directly de-risk opportunities for investors by acting as first-loss capital, or guarantees or insurance, on below-market terms (Bass, 2019; Convergence, 2019)

» support early-stage incubators and accelerators to build and strengthen the pipeline of potential investment opportunities (Bass, 2019)

» support technical assistance or other forms of capacity-building support to strengthen potential investees' pre-investment business models, financial management and planning (Bass, 2019), or to strengthen post-investment commercial viability and developmental impact (Convergence, 2019)

» create and support specialist intermediaries (Koh, Karamchandani & Katz, 2012).

One type of philanthropic capital often highlighted is grants:

> *Grants represent the ultimate 'risk capital' for these businesses because they are not predicated on the likelihood of financial return, and so can tolerate uncertainty around commercial viability. They also lend themselves well to the creation of a public good where heavy investment is required to prepare market conditions, such as building supply chains or stimulating customer awareness. Moreover, the time horizons of private philanthropists in particular can be much longer than that of investors or governments, and so can support the long gestation periods associated with new inclusive business models. (Koh, Karamchandani & Katz, 2012: 15)*

Experiments show that grants to microenterprises can deliver higher returns than even loans, which 'lead to less risky, lower-return investments that have little effect on profitability' (ANDE, 2018: 4).

It is important, however, when using grant capital to avoid distorting the market or undermining sustainability by ensuring that the grant capital fills gaps that are not being addressed by others in the market (Bass, 2019).

4.4 Support is needed beyond finance to technical and business advisory

Many social enterprises, particularly smaller businesses and those in emerging markets, also require technical and business advisory support, to help the enterprises grow and increase the social impact they create in their communities, and to help build the pool of demand (the pipeline) that impact investors are seeking (Hill & Addis, 2017).

Many reports looking at the role of capacity building in the industry concur with Hill and Addis's dual purpose and refer to capacity-building support for social enterprises as taking two forms: impact or market ready – which refers to the ability of enterprises to grow, become sustainable and create social impact; and investment ready – which refers to the ability of enterprises to take on the investment they seek (Mettgenberg-Lemiere, 2016; Gregory et al., 2012).

Impact Investors often take on the role of providing capacity-building support, by either offering services themselves or partnering with other organisations. Impact investors investing in frontier finance in particular make this type of support a key part of their offering, because it helps shape and strengthen market infrastructure, access and stability (Bass, 2019). However, philanthropic capital, government support and official development assistance continue to play a key role in funding this type of support; and others such as incubators, accelerators and business consultants are involved in its delivery (Bouri et al., 2018).

From the investor perspective, '[t]he field must enhance capacity building for entrepreneurs and project developers in order to build a robust pipeline of impact investing opportunities' (Bouri et al., 2018: 60). Just over half of all respondents to the GIIN's 2020 survey anticipate supporting the development of businesses focused on impact.

There are countless case studies on how investors and others are providing capacity building alongside finance[18]. Some general lessons on capacity building include:

- Capacity building is a versatile, widely applicable tool that offers direct benefits to both investors and investees (Pineiro & Bass, 2017).
- There is no single way to structure and deliver capacity-building support (Pineiro & Bass, 2017); it can come in the form of structured support, customised consulting, coaching and mentoring (Mettgenberg-Lemiere, 2016). While many acknowledge more research is needed to understand the effectiveness of capacity building, existing evidence shows that:
  - Standardised information delivery without additional personalised support is less effective in transferring knowledge to entrepreneurs and changing behaviour (Hume, Davidson & Guttentag, 2019; ANDE, 2018).
  - Individualised consulting is expensive but effective for firms of various sizes (ANDE, 2018).
  - Mentorship has shown to be highly effective in helping small businesses achieve growth. Guidance from mentors with successful entrepreneurship experience tends to be more seriously considered and valued by entrepreneurs, regardless of whether the engagement is formal or informal (Hume, Davidson & Guttentag, 2019). However, the nature of results will vary based on the structure of the mentorship program (ANDE, 2018).
  - Peer learning improves firm performance, and firms learn best from those who are similar yet slightly more advanced (ANDE, 2018). It is also cost-effective and can be particularly useful when culture plays a role (Gregory et al., 2012).
- Organisational needs vary with the stage of business of the company, the timing of support, the investment instrument, and the business model (Pineiro & Bass, 2017; Mettgenberg-Lemiere, 2016). So support should include a combination of bespoke and generic information (Gregory et al., 2012).
- There is benefit and opportunity in openly sharing lessons learned with others (Pineiro & Bass, 2017; Gregory et al., 2012).
- Support could be funded through a range of methods: grant funds, co-funding, contribution from enterprises themselves, and a payment-by-results model (Gregory et al., 2012).

Hume, Davidson and Guttentag (2019: 10) make the following observation:

> *A key value that capacity development organizations offer to SGBs [small and growing businesses] is access [access to new markets/customers, meeting product standards, access to materials, and access to investment services (investors, pitch readiness, information/research)]. …*
>
> *However, new research on investment facilitation suggests that support organizations should be providing connection points that go beyond pitch competitions and instead include more time to build stronger relationships with investors. This may be particularly important for supporters focused on earlier-stage SGBs, the so-called "striver" category, who may need initial tranches of smaller amounts of capital before being ready to pitch for larger funding rounds.*

There is an opportunity to continue to provide support to social enterprises, through investors or others, and to advance the industry's understanding of what services most effectively accelerate the development of new businesses and address gaps preventing access to finance (Bouri et al., 2018).

4.5 There is an important role for government and policy directives to play

While impact investing has developed and survived in many places without strong government involvement, many acknowledge the important role of government and policy.

Bannick and Goldman (2012) argue that impact investment cannot operate outside of political considerations, and that the role of government is necessary to ensure robust competition for the benefit of

[18] See Pineiro and Bass (2017), Hume, Davidson and Guttentag (2019) for example

consumers; establish appropriate regulation that is not overly onerous but encourages innovation while protecting consumers; and promote entrepreneurship.

The Organisation for Economic Co-operation and Development (OECD, 2015) highlights that government policies should focus on addressing market failures, such as improving information asymmetries and increasing transparency in order to support the development of alternative financing instruments for SMEs. But there is no one-size-fits-all solution for government policy or involvement. The OECD (2015: 10) concedes that:

> *in some cases, however, public facilitation efforts have not produced the desired results, due to the lack of maturity of local markets, i.e. little scale or lack of investor-ready companies. This further highlights the need for a policy mix that takes into account existing limitations on both the supply and the demand side.*

In order to identify the right policy mix, governments need a solid understanding of what impact investing is, and how it can contribute to government objectives. They can then determine what is required to leverage the potential of impact investing based on the state of the local market (Hill & Addis, 2017).

For governments investing official development assistance into impact investing, there are opportunities to provide seed money to protect, encourage or de-risk investments, which could potentially bring investors into riskier developing markets (Niculescu, 2017).

4.6 A shift is needed to focus on sectors and ecosystems, not individual firms

One analysis argues that investments need to shift from focusing on individual firms to entire industry sectors:

> *… the impact investing sector should focus more on what is required to spark, nurture, and scale entire sectors for social change. Though investing in firms is an essential component to driving sector-level change, it is ultimately sector development that matters the most. As Alvaro Rodriguez of the impact investing fund Ignia has written, "Single firms are born, they mature, they get lazy and they die. But industries prosper over time and reach scale as competition fosters the delivery of better products at lower cost." (Bannick & Goldman, 2012: 7)*

To do so, investments are needed in three types of firms or organisations simultaneously: market innovators, market scalers and market infrastructure (Bannick & Goldman, 2012):

» **Market innovators** are trailblazing entrepreneurs that spark new business models. However, these innovative enterprises take a long-term approach to development, are riskier and offer uncertain returns (examples in India took 15 years to scale).

» **Market scalers** are businesses that enter the market after the model has been de-risked and help accelerate growth and scale in the industry, which means they offer stronger financial and social returns.

» **Market infrastructure** organisations or firms address common needs of market innovators and scalers in the industry. They are often not highly profitable, if at all, but are equally important in contributing to the growth, success and impact of market innovators and scalers.

Most of the impact capital currently goes to individual market-scaling businesses, which means only so many investment opportunities will be available unless investors are willing to invest in early-stage innovators and supportive infrastructure. This will likely require a mixed approach, with capital coming from commercial (finance-first) impact investors, foundations, development institutions and high-net-worth individuals. In addition, the role of grant capital and subsidies may be necessary, but how and where they are used should be adapted to local market conditions (Bannick & Goldman, 2012).

Catalytic capital often supports ecosystem development, as many organisations providing this type of capital:

> *aim to build the necessary infrastructure and markets that create conditions for return-seeking investments to more easily address the "missing middle" funding gap that small and growing businesses in emerging markets face – helping take the "strivers" at the smallest end of the SGB [small and growing business] spectrum and provide a capital pathway for growth. (Hume, Davidson & Guttentag, 2019: 13)*

In a similar vein, a report by Enclude (2019: 10) identifies that impact investors are increasingly engaging in 'systems practice to better understand the underlying causes to social and environmental problems and to identify high leverage solutions to advance positive systems change'. Systems practice is defined as a practice that:

> *seek[s] to understand the whole system in which the social and environmental issues are occurring, identify causes and effects within the system, find high leverage points to catalyse significant, long-lasting, positive change, and invest capital to yield positive results within the mapped system. (Enclude, 2019: 11)*

Investors engaging in systems practice have often found ways to redirect their investments within a market system or a sector to create the highest potential impact and avoid negative unintended consequences. The Enclude report further outlines a framework for impact investing that adopts a systems practice:

- When an opportunity is identified, investors first consider what type of resources are best suited to make the specific intervention a success and how best to structure the investment so that it works for all stakeholders – often introducing innovative features in the deal so it is fit for purpose.
- Investors typically seek variable returns at a portfolio level rather than a specific target range, and reject the term 'market-rate return', which does not consider the impact the investment may have on the targeted system.
- Investors accept a longer time horizon, as systems change takes a long time and requires ongoing engagement; however, investment timeframes made within the system may vary.
- Investors acknowledge that investment capital (or investment capital alone) is not always the best instrument to achieve the desired results, so are open to flexible structures with multiple types of capital when evaluating opportunities. This could include other sources of direct funding (grants) or indirect funding (policy change support or technical assistance support).

4.7 Gender lens investing can create financial returns for investors and significant impact on gender equality and women's economic empowerment

Gender lens investing, a term first coined in 2009, refers to deliberately incorporating a gender analysis into a financial analysis in order to get better outcomes (Anderson & Miles, 2015; Ruiz Carlile & Pyott, 2018). According to Kaplan and Vanderbrug (2014: 36), '[l]ooking through a "gender lens" helps investors gain new perspectives, highlight poorly understood inequalities, uncover new opportunities, identify blockages in the system, and find value where none was found before'.

The GIIN (n.d.) defines gender lens investing within two broad categories:

Investing with the intent to address gender issues or promote gender equity, including by:

- Investing in women-owned or -led enterprises
- Investing in enterprises that promote workplace equity (in staffing, management, boardroom representation, and along their supply chains); or
- Investing in enterprises that offer products or services that substantially improve the lives of women and girls.

And/or investing with the following approaches to inform investment decisions:

- a process that focuses on gender, from pre-investment activities (e.g. sourcing and due diligence) to post-deal monitoring (e.g. strategic advisory and exiting); or
- a strategy that examines, with respect to the investee enterprises:
  - Their vision or mission to address gender issues;
  - Their organisational structure, culture, internal policies, and workplace environment;

– Their use of data and metrics for the gender-equitable management of performance and to incentivise behavioural change and accountability; and

– How their financial and human resources signify overall commitment to gender equality.

While there is a plethora of research and data on gender lens investing – including its history and development, and case studies – this section focuses on the broad opportunities that it creates within impact investing.

According to Ruiz Carlile and Pyott (2018:2), gender lens investments into public market strategies reached $2.4 billion in 2018 and '[a] boom in innovative new investing vehicles is taking place across all asset classes, and in both public and private markets'. Investors that are structuring portfolios and leadership teams to include a gender lens are 'discovering that their actions are generating results beyond the bottom line' (Cortes, 2019). But it is not just investors who are engaging in gender lens investing – support has also grown among foundations, pensions funds, academics, governments, NGOs and research organisations (Ruiz Carlile & Pyott, 2018).

While there is no universal approach to gender lens investing, three common strategies are used – investing in women-owned or -led enterprises; investing in enterprises that promote workplace equity; and investing in products and services that improve the lives of women and girls. Gender lens investing can not only support women and girls (Anderson & Miles, 2014), but also can improve the financial and social returns of investments (Kaplan & Vanderbrug, 2014). From an investment perspective, the broad opportunities of gender lens investing are:

» **Gaining access to capital:** A gender lens can expand, rather than limit, the range of financial products and services and the types of clients served. In addition, new opportunities 'present themselves when investors expand the definition of what type of business constitutes a good investment' (Kaplan & Vanderbrug, 2014: 39).

» **Promoting workplace equity:** Evidence shows that gender-diverse teams and inclusive environments are associated with better decision-making and organisational outcomes. Seeking out investments that demonstrate workplace equity can help investors identify high-quality companies. On the side of the investee, investment vehicles with a gender lens can 'use the power of these investments to help push companies [and their value chains] toward gender equity' (Kaplan & Vanderbrug, 2014: 39).

» **Creating products and services:** Products, services and their respective value chains that are designed to empower women and girls and improve their lives can decrease risks, open up new market opportunities, and increase sales and adoption of those products and services.

All of these strategies can create not just economic and financial gain for investors and investees, but can create significant impact on gender equality and women's economic empowerment in the companies, their value chains and communities (Ruiz Carlile & Pyott, 2018; Anderson & Miles, 2014).

Ruiz Carlile and Pyott (2018) observe that the opportunity for gender lens investing in impact investment continues to grow:

» The capital dedicated to gender-focused products has been accelerating.

» Investors are becoming more dedicated to gender lens investing on a portfolio level (rather than through single products) and are changing their corporate priorities.

» The gender lens investing ecosystem is expanding, spurring growth and innovation as new entrants contribute capital, purpose, philanthropy, thought leadership and analytical resources.

» Demographic changes have created a transfer of wealth to women and millennials, and there is increasing interest in impact investments that yield both financial and social returns.

Supporting gender lens investing and encouraging its expansion and development provide key opportunities for increasing both the social impact and economic benefits of impact investment.

4.8 Exchanging ideas, share lessons learned and encourage partnerships will help build the market

Many investors highlight that promoting success stories and sharing lessons learned will help build the market. The market is still growing and requires more examples of successful investments (and unsuccessful ones) to learn from. The GIIN's roadmap for the future of impact investing identifies six categories of action to help build impact investing over the next five years: identity, behaviour and expectations, products, tools and services, education and training, and policy and regulation (Bouri et al., 2018).

Information on financial and impact performance within frontier markets is particularly limited. Bass (2019: 19) argues that:

> *[a]sset managers and asset owners both can address these knowledge gaps by sharing their own success stories through news and social media, case studies, and participation in the various forums described above. These stories can and should be widely celebrated and leveraged to offer greater insight into various pathways to success available to frontier finance investors while also clarifying the range of opportunities across the risk/return/impact spectrum.*

Partnerships are regarded as successful for strengthening the impact and financial performance of investors and provide an opportunity for further growth in impact investing. Types of successful partnerships cited by investors include:

- partnerships with local investors that have a local presence and therefore better networks with prospective investees
- partnerships with co-investors, either through conventional co-investment models or blended finance models with philanthropists, that accommodate different risk and return requirements
- partnerships with incubators, accelerators and business plan competitions that have networks across the enabling ecosystem
- partnerships through pooled facilities, which can help investors to 'collectively navigate regulatory requirements and risk events' (Bass, 2019: 18).

5 Conclusions

The literature summarised in this review shows that while the capital allocated to impact investing has been growing, and impact and profitability can be achieved together, it is not a panacea for SME financing or social impact. Instead, it requires intentional actions of all stakeholders to overcome the challenges and take advantage of the opportunities. With many donors increasing their support of impact investment, to understandably leverage private sector capital for social and developmental outcomes, there are key considerations to make when designing an impact investment support program.

Some of the key assumptions that affected Pacific RISE's implementation, namely about the type of finance offered to social enterprises; the timeframes; the readiness of social enterprises; and the risk return profile of investors; are all challenges faced by practitioners in the global impact investment market.

Based on Pacific RISE's experience, three key conclusions can be drawn from this global literature review which apply to impact investment support programs:

» **Impact investment should be more demand driven:** that is driven by the financing needs of social enterprises, not just by the capital available. This would require understanding the context and needs of social enterprises to develop a broader mix of finance options and structures and to build the capacity of both investors and social enterprises to use a wider variety of financial options.

» **Impact investment support programs should seek to engage all stakeholders:** For impact investment to be most effective and to effect long term impact and sustainability, the impact investment market or ecosystem requires effective functioning of intermediaries, local governments, and business support services, and not just investors and social enterprises.

» **Impact investment should review expectations:** expectations about what impact investment and impact investment support programs can achieve – related to the timeframe, return, investment size, support required and social impact should be considered in the context of a demand driven and market based approach covered in the first two points. Impact investment support programs may need to reset expectations in order to build an effective and efficient market around the needs of social enterprises – this may require different approaches (use of grants and blended finance in addition to different forms of investment); require support of different actors (beyond just investors and social enterprises); and require a different set of targets (beyond investment dollars or size to measure things such as market growth and the effect of gender lens investing).

"International experience shows that impact investment does not need to be a trade-off between social and financial return. Employed effectively, impact investment opens up to approaching investment and tackling societal issues, with the potential to unite a field of practice and create new value (Addis, Bowden, Simpson, 2014)."

Annex A: Snapshots of other impact investment markets

This annex provides snapshots of the supply-side impact investment markets in Southeast Asia and Australia; the development of impact investing in Australia; financing of UK social enterprises; and foreign bias in the East African impact investment market.

Southeast Asian impact investment market – supply side

- East and Southeast Asia were among the fastest growing regions for impact investment between 2015 and 2019, growing at 23% (Hand et al., 2020). In Southeast Asia:

  'PII [private impact investment] activity began slowly in the early 2000s and plateaued during the 2008 global financial crisis. Since 2013, investment activity has increased. This has been driven, in part, by the region's increased focus on entrepreneurship and the presence of a young, well-networked generation that seeks to leverage technology to create positive socio-economic or environmental impact.' (GIIN, 2018: 13)

- Over the 10-year period between 2007 and 2017, at least 60 different private impact investors have invested US$904 million in 225 deals; and almost a dozen development finance institutions (DFIs) have invested US$11.3 billion in 289 deals in Southeast Asia (GIIN, 2018). Debt in the region is estimated to total US$495 million, and equity is estimated to be US$408 million in total. The average overall deal size across investors for debt is US$5.8 million, with the average deal size for equity at US$3 million (GIIN, 2018).
- In Southeast Asia, DFIs have invested the most impact capital to date, accounting for over 90% of all impact capital invested. On average, DFIs make significantly larger investments than private impact investors (GIIN, 2018). DFIs have traditionally invested in the financial services sector, specifically microfinance, to target outcomes in financial inclusion for marginalised communities and women; but have also targeted investments that expand access to basic services and create livelihoods. DFIs have typically invested through debt (85% of investments), but are increasingly making smaller equity investments (GIIN, 2018).
- Private impact investors have been increasing their activity and interest in Southeast Asia since 2013, and continue to be optimistic about impact investment opportunities in the region. Among all investors, the energy sector, microfinance and other financial services, and food and agriculture are the most common sectors for investments (Mudaliar et al., 2019). The highest value of capital deployed by private impact investors has been in the financial services sector (roughly 60%), and investment from private impact investors has been the highest in Cambodia, while the largest number of deals is in Indonesia (GIIN, 2018).
- Private impact investment in Southeast Asia, particularly in larger deals, has commonly focused on debt, with only 10% of deals below US$100,000 (GIIN, 2018), which 'reflects limited exit opportunities for larger equity deals; limits on regulatory protection for equity holders; and the more predictable cashflows of debt repayments' (McCutchan, Addis & Curatolo, 2019: 20). However, the number of equity deals by private impact investors has been increasing:

  Driving this shift, in part, has been increased awareness among enterprises of equity as an instrument, increased appreciation among enterprises of the benefits that accompany equity investors (such as high-touch support, sector expertise, and access to global markets and networks), and an increased number of investors with a local presence, which allows them to better assess seed- and growth-stage enterprises suitable for equity investment. (GIIN, 2018: 20)

- There remain gaps in seed-stage impact capital (the US$100,000 to US$500,000 range). Most investors invest in deals of US$1 million or more. This is likely because the investment process is expensive for investors, which have minimal local presence in the region, so target larger and later-stage investments to cover the cost of sourcing investments. Instead, most seed-stage businesses in Southeast Asia will seek capital from their own resources, family and friends, accelerators and incubators, and grants (GIIN, 2018).
- The GIIN (2018: 12–13) describes the impact investment market in Southeast Asia as 'highly fragmented':

  Countries in the region are at vastly different stages of economic development and have entrepreneurial ecosystems with varying maturity levels facing context-specific challenges.

  …

  Challenges remain, such as limited focus on innovation and low financial literacy among entrepreneurs, a limited investee pipeline, concentration of seed-stage enterprises, and only a few records of exits.

Australian impact investment market – supply side

The Australian impact investment market has grown rapidly over the past decade, with private equity and debt the most common products, and environmental impact attracting the largest share of investment.

Size of the market

- ‘The Australian impact investment market has grown rapidly, beginning with an aggregate product value of $30m (across two transactions) in 2010 and growing at an annual growth rate of over 100 per cent between 2010 and June 30, 2015’ (Castellas, Ormiston & Findlay, 2018: 139).
- There are approximately ‘5,000 foundations that give between A$500 million – A$1 billion each year, over 1,000 of which are estimated to be private ancillary funds with combined assets of around A$3 billion’ (Addis, Bowden & Simpson, 2014: 10).

Focus of investment

- The largest concentration of impact investment products in the Australian market is in private equity and debt, with the highest volume by dollar value in fixed income products, predominantly comprised of green bonds (roughly A$900 million) (Castellas, Findlay & Addis, 2016). Otherwise, the current Australian impact investment market is largely characterised by relatively small private debt transactions (Castellas, Ormiston & Findlay, 2018).
- The largest impact area has been environmental outcomes. By number of transactions, more deals are done in the areas of income and financial inclusion. Qualitative data suggest that investors are more focused on the target beneficiary group of disadvantaged populations rather than on a specific outcome area (Castellas, Ormiston & Findlay, 2018).
- The majority of impact investment targets mature-stage investments, with little evidence of investment support at the startup or seed stage, paralleling trends in mainstream finance and investment (Castellas, Ormiston & Findlay, 2018).

Risk and return profile

- The literature has a lot to say about the risk profile of Australia-based impact investors. Overall, it appears that Australian impact investors are more risk averse and more frequently seek market-rate returns compared to impact investors based in other markets, and do not expect a trade-off between returns and impact (Castellas, Findlay & Addis, 2016; Hill & Addis, 2017; Addis, Bowden & Simpson, 2014).
- In an analysis of a set of impact investments, actual financial returns realised were 5.4–17% for debt; 3.25–12% for fixed income; and 0–12.6% for real assets – which was reported by investors to be tracking within expected ranges (Castellas, Findlay & Addis, 2016).

Development of the impact investment market in Australia

The Australian Advisory Board on Impact Investing has made interesting observations about the development of the impact investment market in Australia. Two excerpts from the report (Hill & Addis, 2017) capture the main observations:

> *There is a sense that we are starting to build a track record of investments and, for most people, that we are moving from early stage exploration, where activity was happening in a more ad hoc or uncoordinated way, into the early stages of market building. [p. 4]*
>
> *Reaching scale was seen as being important to be able to realise the full potential of the Australian market, but scale meant different things to different people.*
>
> *On the financing side people talked about needing to build a stronger pipeline of investments and to increase the size and change the structure of investments so they would be more attractive to large*

scale investors. There was a clear view that if the impact investing field was to grow in terms of the level of investment, activity and impact then more work needed to be done to ensure that there was a steady stream of investable opportunities. There was also a view that the key to achieving a step change in activity and investment was getting institutional investors, particularly superannuation funds, to engage and that that would require larger sized investments that met those investors' minimum liquidity, risk and return requirements.

People in government and service delivery usually talked about scale in terms of increasing the reach and impact of activity. For these groups the size of the investment was less important than its impact.

In many of the conversations that we held there was a sense that, so far, momentum has been finance-led (as opposed to being activity-led), which is a pattern that is common across a number of impact investing markets globally. Investors and financial intermediaries are seen as playing a key role in "pulling" activity into and through the impact investment system. …

Some social entrepreneurs and larger scale service providers have been part of that, leveraging early enterprise and investment development funds and participating in SIBs [social impact bonds]. But for many service providers, whether for profit or not for profit, impact investing is still a grey area. Some do not yet understand impact investing or see it as being relevant to them, others find it difficult to work out how to link into investors to harness more and different resources to support their work, and some find it too costly and time consuming to get involved.

Most investment activity to date has tended to take place on a transaction by transaction basis and generally involved relatively small-scale investments. In many cases neither funded innovations nor transactions have been designed to scale. As a result of that, transaction costs and lead times have stayed relatively high. This has discouraged some players on both the activity and financing side from entering the impact investing system.

We heard that a number of people see innovation happening on the ground and can see opportunities for investment, but much of that activity is happening outside the current impact investing ecosystem. The activity does not seem to be "pushing" into the ecosystem in the way that it could, certainly not at scale. We heard that market dynamics have not yet shifted and power still seems to rest with the funding side.

The views from people across the impact investing ecosystem provided a clear sense that there is a need to balance up the dynamics in the current system and get both "push" and "pull" factors working in sync to drive impact at scale. Indeed, some people indicated the system should be activity or service innovation-led rather than finance-led to ensure that effort and activity is focused on the right sorts of issues and responses. [pp. 6–7]

United Kingdom - social enterprise finance

A 2013 survey in the United Kingdom shows that 40% of social enterprises regard lack of access to finance as a significant barrier to starting up, and 39% regard it as a significant barrier to sustainability and growth (Carpenter & Keller Lauritzen, 2016).

The UK Government completed a review of its social enterprise programs in 2017 (UK DCMS & UK BEIS, 2017). The review includes a useful analysis on what types of finance social enterprises are looking for and why, and their ability to obtain the finance:

» Social enterprises looking to grow are more likely to apply for external finance, and so a higher proportion of social enterprises, compared to traditional SMEs, sought finance over the last year.

» The four main reasons for applying for external finance are the same for social enterprises and regular SMEs: to acquire working capital or for cash flow reasons; to acquire capital equipment or vehicles; to buy land or buildings; and to improve processes and products.

» The three main types of finance sought are similar for social enterprises and regular SMEs: bank overdraft, including credit cards; loans from a bank, building society or other financial institution; and leasing or hire purchase. Social enterprises were most likely to seek leasing or hire purchase than regular SMEs.

» Social enterprises seek finance through government grants and schemes more often than regular SMEs.

» Social enterprises applied more often than regular SMEs for smaller amounts of finance. In particular, they were more likely to apply for between £25,000 and £49,999, and none applied for £250,000 and up.

» The average investment size from Access – The Foundation for Social Investment was only £63,000, with one-third of social enterprises seeking below £30,000 (Access, n.d.).

» 53% of social enterprises had sought external information or advice in the preceding 12 months. Social enterprises were significantly more likely to access information on both day-to-day operations and strategic advice to help grow the business.

Foreign bias in the East African impact investment market

Peacock and Mungai (2019) examined foreign bias in the East African impact investment market, reporting on Village Capital's review of the capital invested in East Africa between 2015 and 2016. The review found that 80% of disclosed investors were foreign investors and 90% of the capital invested went to a very small group of expatriate-founded businesses (startups with one or more European or North American founders).

The review found that this has created a bias in how impact investors invest, which is affecting the market. As most of the funds and therefore investment decisions are made outside of Africa, the lack of local market knowledge and the bias of foreign impact investors does not lead them to promising local entrepreneurs with the 'best chance of long-term financial success and social impact'; rather, investment is consolidated into just a handful of expatriate-founded businesses. This has resulted in a lack of transparency and created growing 'backlash against impact investors among local entrepreneurs in Africa who are increasingly frustrated at the bias investors have shown in favour of expatriate-founded business.'

Peacock and Mungai identify additional challenges that affect the efficient and effective allocation of capital in the region and which have affected the reputation of impact investment among local entrepreneurs:

> **Impact investors often do not have any funds to invest but do not tell entrepreneurs they don't have any money**
>
> Investors are frequently fundraising, but most do not tell the entrepreneur that they do not have funds available and will have to raise capital before they can actually invest. Many of these investors are seeking a pipeline of projects to aide their fundraising and use business ideas from contacts with entrepreneurs, often without their permission.
>
> Entrepreneurs can waste a lot of time engaging with investors, believing that they are able to invest, when they do not have any funds. The time entrepreneurs waste on what may turn out to be a wild goose chase, can damage the business itself and leave entrepreneurs exhausted and frustrated.'

Most impact investors seek commercial returns and few, if any, make an explicit trade-off between commercial and social returns

Impact investors may accept greater risk than more conventional investors by offering unsecured loans and early stage equity investments, often without a clear exit. However, most still seek commercial returns on the capital they invest. …

Innovation attracts funds regardless of local relevance

To attract early stage investment, the local entrepreneur's business must now be perceived to be highly innovative, typically involving the use of ICT, often combined with a northern business model. Conventional 'bricks and mortar' businesses are looked down on and are hard to sell.

Most investors do not have a clear investment process

The process of moving from first engagement to disbursement of funds can be lengthy and time-consuming for busy entrepreneurs struggling to manage a young, growing, business. Entrepreneurs have to spend time informing the foreign investor about the market and their business which can significantly distract from running the business itself. …

Investors lack staff who have hands-on business experience

Entrepreneurs frequently complain that they have been asked to change their business model (route to market, product range etc) against their own business judgement, or invest in new staff as a condition of investment, but with no guarantee of securing the investment. …

Most influential actors tend to be expatriates who have no prior experience in entrepreneurship leading to market distortion and poor decision-making

The most influential actors in the Nairobi entrepreneurial ecosystem are incubators, accelerators and impact funds

…

Additionally, these organizations are funded primarily by grants from donors, governments and corporations. This has been cited as a major influencing factor as to why businesses struggle to scale, as these groups are sending the wrong signals to the entrepreneurs they support and can create grant dependency.

…

Local entrepreneurs are often poorly-equipped to engage with foreign investors on their terms. 'The majority are raising investment for the first time and are inexperienced, naïve and unprepared, resulting in a mismatch between northern impact investor expectations and the local entrepreneur's hopes and capabilities.

Foreign investors typically expect sophisticated financial models and detailed business plans which, in their eyes, reflect the calibre of the entrepreneur and by proxy the business itself.

Local entrepreneurs will have different, frequently qualitative, skills, market insights and valuable social capital and political networks, crucial to business growth and long-term sustainability. However, this unique local knowledge and social capital are valued less highly than quantitative skills in the due diligence process.'

Peacock and Mungai suggest how the local ecosystem can be strengthened and better integrated into the impact investment market:

» Linking foreign investors with local angel investors whose insights and capital could be leveraged to find and support local entrepreneurs.
» Donors and investor consortiums investing in locally managed entrepreneur support networks to help find and support new businesses.
» Linking local businesspeople to support young entrepreneurs through mentorship or becoming involved as non-executive directors.
» Creating and promoting standards of good practice for engagement of impact investors with entrepreneurs and vice versa. This should include, at a minimum, honesty in communication and setting out a clear investment process and decision-making points.

Many will recognise that these challenges are not unique to East Africa but are common to impact investing across developing countries, and therefore the solutions are widely applicable.

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