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Impact Investing, Soros-Style

The Soros Economic Development Fund is quasi-philanthropic and invests in high-risk projects in parts of the world most people couldn't find on a map. But the Fund is self-sufficient and boasts a "blended" portfolio return of 8 percent a year. How do they do it?

"What I really deal with is venture capital without the returns," Stewart Paperin tells the audience at INSEAD's Entrepreneurial Forum in Fontainebleau recently. Paperin is administrative vice-president of the worldwide Open Society Foundations and (since 1997) president of the Soros Economic Development Fund (SEDF) which currently manages US$200 million of investment capital covering some 28-projects in seven regions of the world.

OK. That works as a definition. But not really as an explanation of what might attract people to invest. And in what, exactly?

"People invest in this 'high impact capital'," he explains, "with two objectives: one is the financial return of course, but the second is the social return." And the challenge. "You're dealing with early-stage companies, with management that's not as up to scratch as we would normally find in the more developed worlds; you're investing in environments where the laws and regulations are not necessarily those you wish you had. The risk is high, return is moderate."

"Moderate" is of course subject to market fluctuations. Paperin aims at what he calls a "blended return of 8 percent" on his portfolio. In today's investment climate, with interest rates still at historic lows, 8 percent (even "blended") sounds pretty good. "We underwrite our investments for a much higher return but as one knows, things don't always turn out as you plan, so a "blended return" of 8 percent allows us to replenish our capital, pay our expenses, and go on and continue to invest; and this has been going on for thirteen years, so it has actually worked quite well for us."

At the beginning, SEDF received small grants for operating expenses from the Open Society Foundations. Discussions are also being held with the Open Society Foundation to re-capitalise SEDF in order to finance future expansion.

Underwriting Economic Recovery

SEDF followed on the heels of George Soros' ground-breaking Open Society projects aimed at making sure that the Eastern European shift towards democracy remained permanent. Hence, the first countries targeted for impact capital investment were so-called "transitional democracies" such as Bulgaria, Romania, Hungary, Croatia, Serbia. But Soros needed help in structuring these investments.

"He called me one day," Paperin recalls, "and when somebody asks you if you want to talk to George Soros, it's very hard as a finance person to say no.

So I went and I met George and he laid out this ideas. He had this very large foundation that he didn't really have the infrastructure to manage and he asked me to become its chief financial officer." Subsequently, Soros proposed the creation of SEDF, which Paperin describes as "a natural evolution" of the philanthropic funding work that the foundations were doing.

Paperin's entire career has been a bit like that – unplanned but targeted. He spent many years working at Pepsi Cola and "a number of years working with a group of people who could best be described as 'hostile takeover fellows' working first in technology." He then served as Western Union's CFO during its restructuring and then went to Russia as a merchant banker in time to ride the privatisation wave. The man knows a deal when he sees one and has the background and backbone to get what he wants.

The first investments made by SEDF to try to make a positive influence on the economic recoveries of Eastern Europe after the collapse of Communism were small and medium-sized enterprises using existing as well as "greenfield" (start-up) banks. "It was profitable," Paperin says, "and it created long-standing banks that continue to function today – that continue to be SME banks today and have created thousands of jobs. If you go back and look at the history of the economic recovery of Central and Eastern Europe, you see that it was driven principally by small and medium-sized enterprise."

Emphasis on Africa

Today the Fund's focus has shifted to Africa and to some extent to South Asia – primarily on agriculture, logistics and financial services because they seemed to have the greatest developmental impact. But these investments were not everything Paperin had in mind. "We've made many good investments, but they tend to be isolated," he says. "They tend to be little islands of positive investment that don't touch each other. So we took a strategic decision about a year and a half ago to refocus on things that are either scalable or disruptive or both… and those are really hard to find, and that's where I spend a lot of my time: trying to ferret out things that are either scalable or disruptive or both."

A recent example of an investment in a company in Mozambique falls into the "scalable" category. The company involves primarily cassava farming but secondarily food crops for crop rotation. It's an elegant business model with far-reaching social impact: the cassava is refined into ethanol, the ethanol is sold (together with a high-efficiency stove) to replace charcoal stoves now widely used in cooking. Why is this an investment that Paperin thinks will be a success?

"Cooking in a poor home in Mozambique is typically done by young girls standing for hours over a charcoal stove. That's the equivalent of smoking two packs of cigarettes a days, so obviously replacing that stove is a public health issue." Charcoal is also a major source of deforestation which in turn adversely affects the local climate and contributes to soil erosion. But wait, there's more.

"If this business works in Mozambique we can import it into 45 more African cities, each of which has the same problem," Paperin points out. "At this point this becomes a US$2 billion business and saves the equivalent of two million tonnes of carbon annually." That's "scale".

On the disruptive front, Paperin is looking to invest the Fund in a company that has created a biological growth stimulant for plants, which increases plant yield and resilience to drought and temperature change. "When it was used in Indonesia on rice," Paperin says, "it took yields from five tonnes per hectare to 12 tonnes per hectare. In a world that's faced with food security issues, as is Africa, and as is the world in general, that is disruptive."

Paperin has co-investors for the Mozambique project: a "major enzymes company" and a small Danish DFI (Development Finance Institution). He's speaking to the Family Office Circle Foundation - a collection of some 40 of the largest family offices in the world – for the agriculture venture. "It's amazingly hard to find co-investors in this area," Paperin muses, "but we welcome them. We don't charge fees, we don't financially participate, we share our due diligence. We think it's worth growing this segment of the market and anything we can do as a quasi-philanthropic organisation to help grow that segment of the market is a real contribution."

And a Failure ...

There have been some failures: one notable one in Haiti, following the devastating earthquake some four years ago. "We wanted to do something in the agricultural sector, so we put money into a company that would process mangoes that were bruised or damaged and couldn't be sold as whole fruit. They would process them and turn them into quick-frozen mango sherbet used by institutions. Total wipe-out. We could never get the equipment to work, the management was not up to snuff. It was a great piece of learning about how we really failed to do proper due diligence. We were in too much of a rush to make an investment. We still own part of the company and we keep debating if it would be worth it to sue in the Haitian courts to recoup even part of our investment, but our view is the cost of doing so would probably outweigh the yield."

In addition to being the VP for administration of the Open Society Foundations worldwide, Paperin's role today as president of the Soros Economic Development Fund is three-fold. "One is to constantly refresh the strategy; the second is to try to bring hard core investing and restructuring skills, and the third is to try to think about what the future of this business is."

"I think impact investing will grow," Paperin continues. But it's not for the faint-hearted opportunist. "It requires the same basic financial preparation you need in the business world. An analytical bent, someone who's interested in working in different markets, even frontier markets. You have to be a disciplined investor with hard core financial skills who enjoys working in extraordinary markets. But if you're not an investor, you will fail."

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