Impact Investing: Unleashing Institutional Capital

By Ian Potter , Distinguished Fellow, INSEAD Global Private Equity Initiative

The interest surrounding impact investing has not yet translated into a substantial increase in the amount of capital deployed. But that may be changing.

The ability of impact investing to earn both a financial and social return is appealing, all the more so in light of the excesses of finance over the last decade. But taking the sector from concept to reality requires pragmatic approaches to addressing the needs of capital providers as well as investees. Global organisations are starting to take note of these needs, with the recent publication of the World Economic Forum's excellent report 'From the Margins to the Mainstream' which focused on the needs of institutional investors. Similarly, the Fall edition of the **Stanford Social Innovation Review** also looks at how impact investing can create real impact.

While many will argue over definitional nuances of what impact investing is, it is fair to say that its transformational potential rests on the focused and deliberate granting of access to capital to neglected segments of the economy or population in order to generate both a measurable social impact and a financial return.

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It is therefore a natural assumption that if opportunities exist to invest capital at an attractive rate of return, capital should flow to them. But in the impact investing space, this appears to have not yet happened on a material scale. It is similarly clear that the largest pools of capital are held by institutional fund managers. Yet they are largely not participating in the space. Why not? There is increasing evidence of the ability to earn a market rate of return on some impact investments and ample evidence of opportunities to invest capital for significant social returns. What is constraining the growth of the sector?

The missing link

Currently, the missing link is the key initial enabler of the ecosystem: the credible and viable fund manager. Before my mailbox is filled with angry protests, let me first say that there are able, dedicated and skilled fund managers in the space.

However, what is not yet clear is whether their business models, particularly those developed along traditional private equity (PE) lines of a general partner (GP) advising a group of limited partners (LPs), is viable. Small (often first) fund sizes, small investment cheque sizes, onerous diligence and monitoring costs in frontier geographies all combine to paint a picture of modest management fee income covering a high cost base and potentially diluted net returns at the LP level. This is a dangerous combination – particularly as these are the firms and individuals best equipped to translate and bridge the differences between the needs of the providers and users of capital.

The importance of this link in the flow of capital cannot be underestimated at this early stage of the sector’s development. Impact fund managers bridge the gaps in knowledge (both financial and social), create investment scale and amplify reach that are necessary to allow institutional investors to participate in the sector with confidence. And yet at this stage, they are struggling with their economics and need to scale their assets under management.

Emerging successes

All is not lost, however. Some of the more established and credible niche fund managers are beginning to raise funds for their second private equity-style investment funds and there is increasing and genuine interest in the

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sector from mainstream investors.

At least three impact fund managers are in the market for second funds at present: Bamboo Finance, Developing World Markets and Leapfrog Investments.

While the investment approaches may differ, the managers have developed credible products, metrics and expertise and can now claim exits at reasonable rates of return. So the ingredients for successful fundraising are in place.

If they can successfully raise second funds, some of the pressure on their operating economics will ease (but will not be eliminated) and the likelihood of a viable core group of impact fund managers emerging will increase. In and of itself, this ought to be a potent accelerant for unlocking institutional capital. Without this, institutional capital is unlikely to enter the sector at scale.

Mainstream interest

Are these pioneers the only hopes for the sector to grow its capacity to fund interesting impact investments? No. There is an increasing level of awareness, interest and enquiry from an unexpected quarter: mainstream private equity fund managers. Recent returns to PE firms, and particularly the shareholders of PE firms have been underwhelming. The main listed U.S. PE firms appear to be moving along a path to being asset gatherers in order to reduce their dependence on the performance of a single fund vehicle. The economics of adding uncorrelated portfolios and teams of fund managers are generally attractive as they typically enjoy positive operating leverage at a firm level and can benefit from offering a wider array of products to their clients. In addition, in some of the more mature corners of the PE world, a trend towards direct investing by limited partners is disintermediating traditional PE managers.

For today's niche impact managers, there may be cultural issues (to say the least) but a combination with mainstream PE could have material platform benefits. The operating leverage works both ways and in reality, the core strategic objective of both impact and mainstream managers is quite similar: To facilitate the efficient investment of risk capital. Further, the association with a known PE brand would give cachet to open institutional doors. Some may see this as an uncomfortable alliance, but it is not one to

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be ruled out.

So where does that mean the impact investing world is headed? Near term, we are entering a period that may well mark the end of the beginning. The industry is moving to focus on practical scale and execution issues. Second funds, established track records, exits with market returns, dialogue with institutional investors to understand their constraints, and the evolution of social metrics all give comfort that the sector is growing up. Looking ahead, an awkward adolescence can be expected: a period characterised by growth spurts, sensitivity and setbacks before moving into a more mature, settled state. On the other hand, it is not yet too late to dismiss the possibility that we will still be debating definitions in five years while stuck in a modest niche. The opportunity cost of doing so would be incalculable and the result, disappointing.

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