Getting the Big Money into Social Impact

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

Institutional investors are increasingly interested in putting their money into social impact, but a gap remains between them and the people on the ground.

Scale has always been a challenge for impact investors. Both users and providers of capital suffer from size issues: The kinds of problems being solved on the ground, while noble and lucrative, don’t always have the absorptive capacity to allow investors to deploy meaningful amounts of capital; and similarly, the capital is not always available in appropriate amounts. This isn’t entirely because institutional capital owners aren’t interested. It’s often the case that the plumbing or delivery mechanisms for capital for flow between sources and needs is immature. As a result, many gatekeepers in the financial architecture remain sceptical, including family office managers and private bankers.

Scale is also an issue for investors who don’t yet have sufficient expertise or the resources to achieve sustainable growth in the impact space. Many impact funds have bubbled up in the last five years, but the economics are challenging for them. Diligence costs can be much higher as a percentage of the initial investment than a LBO-type firm pays when putting money into a distressed company. While socially beneficial investments can achieve high or market rates of return, in many cases, the investments are found in parts of the world that are volatile and foundational elements like property rights or accounting standards are uncertain at best.

But optimism is growing that the pipes are lining up, for two reasons. First, serious institutional capital is starting to steer away from investments that have high environmental, social or governance risks. At the recent **Triple Bottom Line Investing** (TBLI) Conference at INSEAD's Asia campus in Singapore, Michael Salvatico, Vice President of MSCI Inc. cited a recent **2 billion euro investment** by two European pension funds into low carbon investments under the MSCI Global Low Carbon Leaders Index.

"There are large amounts of money that are shifting away from climate risk investments and it's happening very quickly, we're just at the beginning," Salvatico told a panel discussion.

Secondly, major private banks and wealth managers are waking up to clients who are increasingly demanding impact investment options. "When we get to the next generation, they want to recycle, they want to divest out of fossil fuels. We're talking about a next gen that is going to drive this for all of us. It won't just be a philanthropic endeavor," said Bonny Landers an advisor and independent consultant to family offices in Hong Kong.

Bridging the gap

But amid the optimism, there is a palpable sense of frustration from those engaged in social projects about this unfinished plumbing and how they can unlock the capital that's supposedly "shifting" into responsible places. Bernard Fung, head of family office services at Credit Suisse summed this up well: "Looking at capital flows and the amount of money around this, I think we are in early days in terms of significant capital to an area that is loosely defined as impact investing."

The dominant sources of capital going into impact investing are currently motivated investors, family offices, endowments and development finance institutions. This makes it easy for projects to get quick backing and decisions on financing but this is not where the scale is.

To get the money across the gulf from major institutions, two things need to happen. First, institutions and fund managers must be reassured and convinced that impact is an investable sector or style and not a charity exercise. This was reflected in the sentiment at the TBLI conference, with more than one call to do away with the name "impact investing" as all too often, private sector institutions think it is either an expensive low-return exercise or a CSR one. Impact promoters should understand that fiduciary fund managers have to earn a return on the risk they're taking and any pitch for investment should include this conversation. While family offices can be convinced on the basis of philanthropic impact, institutional investors must be convinced of the financial returns in addition to the social impact.

Secondly, consolidation may be a logical step for independent private equity general partners (GPs). While some impact funds are raising second funds after successfully exits in their first with good returns, a logical next step for the industry could be to consolidate impact funds into other platforms, becoming part of an asset management platform like Carlyle or KKR. This could serve to bring costs down and drive scale and reputation.

The chicken and egg situation

While the big money is waiting for scalable opportunities to appear, the big opportunities are waiting for the big money to arrive. Encouraging stories are starting to emerge which could tip the scales. While Salvatico's example may be of money shifting into listed equities, it could be considered a logical first step for major institutional money to start looking at investments through an environmental, social and governance (ESG) lens.

Some social enterprises are receiving big investments on their own merit. En Lee, head of Asia Pacific at global impact investor, LGT Venture Philanthropy (LGT VP), cited an investment LGT VP made in M-KOPA Solar, an innovative asset financing company that provides solar home systems to off-grid households in Kenya and other countries in Africa using an affordable mobile money payment plan. Since its commercial launch in October 2012, M-KOPA has connected more than 200,000 households, and is now adding over 500 new homes each day. LGT VP just made its biggest investment yet in the company's fourth round of investment, leading a US$12.5 million debt and equity deal. This follows M-KOPA's last round where it raised US$20 million from Commercial Bank of Africa, Bill & Melinda Gates Foundation, LGT VP, Imprint Capital and Netri Foundation. "There are large players validating this and there will be more to come” En Lee said.

M-KOPA serves as a good example of an organisation able to demonstrate an ability to effectively tackle social and environmental problems, while providing its investors with a viable financial opportunity.

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