



COORDINATING IMPACT CAPITAL: A New Approach to Investing in Small and Growing Businesses

An Examination of Impact Investors and
Phased Investing for the Launch and Growth
of Social Enterprises

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Formed in 1997, the Center for Science, Technology, and Society (CSTS) has brought together scholars and practitioners to study and support organizations and innovations benefiting underserved communities worldwide. Partnering with international leaders including the World Bank and The Tech Awards, CSTS serves as a bridge between Silicon Valley and the developing world. Since launching the Global Social Benefit Incubator (GSBI™) in 2003, CSTS has convened scholars and Silicon Valley entrepreneurs to help fledgling social benefit enterprises develop compelling and sustainable business plans.

Through its experience providing direct capacity development assistance to more than 140 early-phase social benefit organizations worldwide, CSTS offers a unique perspective to the global development sector. Additionally, CSTS continues to expand its presence working with the social capital community to enhance investment capital flow to promising enterprises serving the developing world. Addressing critical obstacles to international development, CSTS embraces the philosophy that meaningful social impact requires financially viable enterprises, which serve as nuclei for economic growth and delivery of essential services to impoverished communities.

The Aspen Network of Development Entrepreneurs

The Aspen Network of Development Entrepreneurs (ANDE) is a global network of organizations that invests money and expertise to propel entrepreneurship in emerging markets. Officially launched in 2009, ANDE is a member-driven organization housed within the Aspen Institute, an international nonprofit that promotes enlightened leadership. Its members are the vanguard of a movement focused on small and growing businesses (SGBs) that create economic, environmental, and social benefits for developing countries. Ultimately, ANDE seeks to build sustainable prosperity in the developing world.

ANDE identifies common strategic challenges and opportunities facing SGBs and, based on these findings, provides programs and services for its members and the sector as a whole. ANDE aspires to be the leading convener and conduit for organizations and individuals committed to building SGBs in the developing world. ANDE acts as a trusted advocate for the SGB sector, educating investors and policymakers about the extraordinary opportunity the sector represents.

ANDE works to dramatically increase the amount and effectiveness of capital and capacity development services for entrepreneurs in developing countries. With the right support, ANDE believes SGBs will generate much-needed employment, and in the process, address critical social and environmental problems in the developing world.

The opinions expressed herein are the opinions of the authors.

TABLE OF CONTENTS

Acknowledgements	3
Participating Organizations	4
Project Background	5
Project Objective	5
Executive Summary	5
Research Methodology	7
The Need for Capital Aggregation	9
Venture Capitalists Have it Easy	9
A Note from Jim Koch, Director of the Global Social Benefit Incubator	11
A Note from Thane Kreiner, Executive Director of the Center for Science, Technology, and Society	12
A Note from Mitchell L. Strauss, Special Advisor for Socially Responsible Investment Finance, Overseas Private Investment Corporation (OPIC)	13
Project Findings	15
Sources of Capital	15
Form of Investment	16
SGB Life Cycle	17
Expected Returns	18
Deployment of Capital	20
Capacity Development Organizations	20
Geographic Focus	21
Sector or Mission Focus	22
Segmenting the BoP Market	22
Urban versus Rural Focus	23
For-profit versus Nonprofit SGBs	23
Investment Time Horizon	24
Average Size of Investment	25
Observations on Capital Support for Small and Growing Businesses	27
The Case for Syndication	31
Impact-first versus Financial-first	35

Examples from the Field	39
Investor Syndication Example by Gray Ghost Ventures	39
Investor Syndication Example by D. Capital Partners	39
Capital Aggregator Example by Toniic	40
Appendix	41
Comparison of Terms and Suggestions for Transition Milestones	
Encouraging Syndication	42
Acronyms	43
Glossary	43
References	45

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This report builds on the previous work of many thought leaders in the space, but in particular the leadership of John Kohler, who serves as an Executive Fellow at the Center for Science, Technology, and Society and who spearheaded this initiative from an ANDE Working Group to a full-fledged project. John's expertise as a high-tech venture capitalist brought a private-sector discipline and approach that guided the project from start to its current status. In addition, John's commitment to social entrepreneurs as a mentor in the GSBI program at the Center enabled him to tap direct experience with social entrepreneurs from around the world and ground these Silicon Valley perspectives in relation to the needs of promising ventures in resource constrained environments. Additionally, in 2010, John

co-founded Toniic, an international impact investor network. His experiences with Toniic and CSTS have contributed to his belief that pooling together like-minded sources of capital can create a more efficient social impact market. We expect this report to serve as the beginning of a longer-term project aimed at creating a market for impact investing.

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Participating Organizations

The following organizations were interviewed for this research:

Acción Frontier Investments Group

Acumen Fund

Aga Khan Foundation

Agora Partners — Prometeo Fund

Agora Partners — Agora Venture Fund

Bamboo Finance

Calvert Foundation

CHF International

Citi Foundation

D.Capital Partners

Draper Fisher Jurvetson

E+Co

Elevar Equity

Ennovent

Good Capital

Grassroots Business Fund

Greater Capital Financial

Greater Capital Sasix

Gray Ghost Venture Fund

Heart Social Partners

Innovación Investments

Innovations for Poverty Action

Invested Development

Investor & Partner for Development

Israel Venture Network

J.P. Morgan Social Sector Finance Unit

Kauffmann Foundation

Lemelson Foundation

Media Development Loan Fund

Omidyar Network

Oxfam Great Britain

Root Capital

RSF Social Finance

Renewal 2 Investments

Renewal Partners

Rockefeller Foundation

SA Capital Limited

Skoll Foundation

Social Capital Partners

Synergy Social Ventures

Toniic

Venture South International

Vox Capital

WillowTree Impact Investors

PROJECT BACKGROUND

The Center partnered with The Aspen Institute and ANDE in 2010 to develop the scope of this small-scale research project to accelerate the understanding of practices that may lead to horizontal capital aggregation among the impact-investing community. The community is focused on small and growing businesses (SGBs) and for the purpose of this paper, SGB is synonymous with social enterprise. The reason impact investors support SGBs is to establish commercially viable businesses that have significant potential for growth and social impact in the area where they operate. We define horizontal aggregation as the process of syndicating distinct pools of impact capital matched to the multiple phases of an SGB's development and growth. This approach is in contrast to the more widely used "moment in time" form of syndication such as a financing round. Both forms of syndication are examined in this study, but the underlying focus is on whether a phased approach to capital syndication can be achieved.

This project was an outgrowth of a breakout session on the topic of "capital aggregation" involving a subset of ANDE members at the annual ANDE member conference in October 2009. It was guided by a document commissioned by ANDE and prepared by Dalberg Global Development Advisors, which pointed to the "missing middle" of funding to SGBs and identified restrictions to capital flow to support this sector. The session resulted in the formation of a Working Group focused on issues related to the flow of interested capital to SGB initiatives worldwide. One of the areas identified was a phased or horizontal aggregation of capital, which became a spirited topic of discussion within the Working Group.

Project Objective

To examine the potential role of horizontal capital aggregation within the impact sector, our research focused on profiling the following impact-investing attributes: sources of funding for SGBs, the terms of impact capital prior to investment, the qualitative and quantitative investment outcomes desired, and the market conditions that could serve to facilitate horizontal aggregation. The paper aims to identify market mechanisms, which can be used to increase the efficiency of invested capital, resulting in greater liquidity opportunities for investors.

"Our sector requires a rethink of how to organize social capital across a social enterprise's growth phases. We must unite on the importance of follow-on capital for our investments."

— a Foundation

Executive Summary

The intent of this project is to unearth actionable suggestions for achieving horizontal capital aggregation and to identify market mechanisms that need to be built. In the venture capital community, investors most often find investment targets locally and syndicate locally, resulting in a product or service capable of reaching global markets. In contrast, the impact investor community usually finds investment targets remotely, but must syndicate *globally*, to extend the scope or scale of impact within a *local* or *distant* region. Consequently, capital support for SGBs is more *difficult* to coordinate than in venture capital. Market inefficiencies combined with the inherent social and economic challenges of the developing world hinder independent investing and results. Syndicating throughout multiple phases of development in an SGB, rather than at a single moment in time, is critical to the realization of improved outcomes. Different players with capital support are required for the infrastructure, capacity

development, and business development phases and the associated accomplishments or milestones are needed before a convincing case can be made that a business is ready for explosive growth.

We interviewed more than 45 organizations, some of whom chose not to be included in our participant list, investing in SGBs to understand their organization type, direction of capital, target SGBs, and desired outcomes. Capital sources supporting these organizations are still largely from high net worth individuals and family foundations. We have observed that funding participation by the financial sector and corporations to SGBs remains comparatively small.

The cohort of organizations we interviewed use the following investment vehicles: 14 percent grants, 20 percent short-term loans (generally one- to three-year maturity), 26 percent long-term loans, 14 percent convertible notes, and 26 percent equity. Of the organizations interviewed, 41 percent use only one form of investment and 59 percent use multiple investment vehicles. Surprisingly, we observed a lack of technical assistance (also referred to as “capacity development” in this report) utilization in the social impact sector: only 17 percent of the organizations interviewed state that they used capacity development organizations (CDOs) during their investment processes. Although CDO use varies by region, we recommend that further analysis be devoted to understanding the possible benefits of involving CDOs, including the identification of a possible correlation with better outcomes. One of the key attributes of Silicon Valley’s success is the depth of technical and innovation services that are accessible to start-up ventures—a factor that is in marked contrast to our observations in the present study.

Investors who practiced “high-touch” portfolio management (defined in our study as “monthly contact or greater”) reported significantly higher return expectations than the 50 percent of respondents who employed less frequent contact with SGBs in their portfolio.

In a related query, firms using a financial intermediary to deploy capital, implying a more arms-length

relationship with the SGB, did not expect as high a rate of return compared to those that invest capital directly. The majority of respondents believed they were best situated to select SGBs when they were operating “in country.” This implies that an arms-length relationship with SGBs reduces return expectations relative to a direct investment relationship; more research is warranted to discern actual differences in rates of return between direct and intermediary deployment of capital.

Investors also report that they find better opportunities for “market rate” returns from urban areas, where per capita income levels and entrepreneurial talent are higher, than from rural areas. Interestingly, the majority of respondents expressed no preference for an urban versus a rural focus in their investments. Moreover, the majority of respondents do not measure income levels in the target markets of their SGB investees as a factor in their investment decision. Without factoring other assets such as land ownership, there is a large disparity between rural and urban base of the pyramid (BoP) per capita income levels. By some industry measures, rural BoP income is less than \$3 per day, whereas urban dwellers in BoP communities typically earn closer to \$9 per day. Respondents who do measure target market income levels did express an expectation for higher returns from SGB investments operating in urban markets.

Overall, our analysis confirms that a variety of contrasting investment models and investment expectations exist, and the poor coordination of impact investors creates inefficiencies and redundancies that obstruct the efficient flow of capital system-wide. We conclude that the aggregation of capital can benefit businesses when investors are first and foremost aligned by return expectation.

Our research indicates that social capital mobilization is early in its development and lacking market mechanisms common to other asset classes. While developed markets enjoy a well-worn path of “up-round” private equity sources, there is little, if any, of this “vertical” capital aggregation ladder for social entrepreneurs operating in underserved markets. Consequently, much of the capital formation needed

to support the scaling of social enterprises will necessarily be “horizontal”—meaning that capital sources are much more varied than pure equity investors and may include philanthropy, “soft” loans, quasi-equity, and private equity. The hand-off between these participants would not necessarily require valuation increases. Instead, such participants may require systems or organizational infrastructure development, increased management capacity, and a more rigorously stress-tested business model to attract follow-on investors.

Our research also supports the following assertions regarding syndication, which we elaborate in this paper:

1. Horizontal capital aggregation may allow for the steady building and growth of SGBs, where various pools of capital are brought into a syndicate to provide appropriate capital support for each phase of SGB development.

2. New financial instruments should be adopted to improve return predictability and unleash new investment capital; equity may not be the appropriate instrument at every stage of enterprise development and scaling.
3. Internal horizontal syndication is emerging. For example, social funds and social venture capital funds have formed several pools of capital internally to support their investment targets through a sequence of grants, convertible notes, and equity.

We envision future phases of this project, including the pilot development of practical vehicles to improve capital flow. More broadly, we aim to develop a “toolkit” for social capital investors and enterprises to establish best investment practices and characterize market mechanisms to form both a syndicate of professional investors who can share due diligence costs and a “basket” of related social enterprises that can share operational strategies.

Research Methodology

Throughout this paper, we refer to the thoughtful comments and conclusions of the following papers and reports: ANDE’s “2010 Impact Report”; Dalberg Global Development Advisors’ “Capital Aggregation Briefing Paper for ANDE Conference Session”; The Parthenon Group and Bridges Ventures’ “Investing for Impact – Case Studies Across Asset Classes”; J.P. Morgan’s “Impact Investments”; Monitor Institute’s “Investing for Social and Environmental Impact”; and Desa and Koch’s “Scaling Social Enterprise: A Comparative Study of Naandi and Drishtee in Rural India.”

Initially we created a list of interview questions, which focused on profiling investors within the social impact community. We conducted research on 150 impact investors from different groups including foundations, non-governmental organizations (NGOs), family foundations, impact investment funds, social venture capital funds, debt providers, and capital aggregators; of these, 60 organizations are ANDE members that make investments in SGBs. Our secondary research included in-depth analyses of organizations’ websites, press releases, and case studies discovered throughout the Web and word-of-mouth references from the social impact community.

To ensure our interviewees represented diverse classes of organizations, we shortlisted 85 candidates based on evaluation criteria such as organization type, geographic coverage, and active involvement in the social impact space. We contacted the 85 candidates via email and subsequently conducted over 45 surveys and in-depth phone interviews, of which 36 were used for data analysis. The interviewees represented NGOs, foundations, family home offices, social funds, social venture capital funds, banks, and capital aggregators. A tool was built in Survey Monkey to guide the interviews and focus on the following four areas of examination:

- Sources of capital and vehicles used to deploy capital
- Requirements of investment capital by mission, geography, investment size, and form
- Characteristics of the SGB target such as legal structure or growth aspirations
- Outcome expectations, investment duration, governance, and reporting requirements

Each phone interview was one to two hours in length and covered 25 interview questions spanning these four areas. Interviews were conducted with the survey tool and the responses were aggregated and analyzed quantitatively. We kept all information provided by the participants confidential and have not attributed any commentary from any individual interviewee unless his or her permission was obtained.

THE NEED FOR CAPITAL AGGREGATION

The members of ANDE have long recognized that accelerating the flow of interested capital toward SGBs in developing countries must be complemented by staging, syndication, and outcome expectations. While developing country SGBs face similar gestation stages experienced by all small companies in origination, establishment, growth, and scale, their capitalization opportunities are quite distinct from small businesses or venture-backed companies in the developed world.

From the perspective of SGB growth, there is clear evidence of phased development in building SGB value. SGBs in developing nations often originate with a mission focused on social, economic, or environmental benefits. Development of a cohesive business model frequently follows mission setting. Mission-based investors—such as foundations, philanthropic organizations, or local governments—support the development of enterprise infrastructure or capacity, which is critical to the mission identified by the SGB. However, this support, through grants or “soft capital,” usually does not result in a profitable, self-sustaining business. A second development phase, supported by investment capital, concentrates on a cohesive business model, ability to scale, and subsequent growth and profitability. This new source of investment carries much different measures and priorities. SGB management is often unable to adjust to these expectations without intercession by capacity development organizations. A third phase focuses on sustainable operations, predictable growth, and consistent free cash flow to make the SGB “bankable” and ready for commercial debt sources to support its growth capital needs.

Venture Capitalists Have it Easy

Venture investing in the developed world

- Targets of opportunity are sourced locally
- Investment syndicate drawn from local venture capital relationships
- Results of venture capital backed product or service has a global impact
- Ready-made pools of “up-round” capital waiting for winners to emerge from previous financing

Venture investing in the developing world

- Targets of opportunity are sourced remotely
- Investment syndicate drawn from the global impact-investing community
- Results of venture capital backed product or service has a local impact
- Scarce “up-round” capital

“We found that projects we funded on their own were less successful than projects we funded with other investors.”

– a Social Fund

The broad span of investor interest is accommodated in other sectors—such as microfinance or private equity—by the availability and diversity of funding vehicles from which investors can choose. When an investor wishes to invest via microfinance or private equity, they can choose from a variety of financial products by sector, return, geography, and beneficiary. The SGB sector has not yet established such a structured and robust “market” for financial products with predictable return or outcomes.

Increasing the number of capital vehicles focused on the SGB segment that aggregate investor interest may become one solution. ANDE members could play a catalytic role in facilitation or seeding of various vehicles according to investor need.

Restrictions within the impact-investing sector include:

- A highly diverse range of investors interested in the SGB sector
- Highly diverse and variable set of investor goals
- High fund search costs for the identification of deal flow
- Poor information on SGBs and return expectations
- Lack of knowledge of the cultural, political, and social challenges faced by the SGB sector
- A highly fragmented intermediary market
- High transaction and diligence costs (term sheets, reporting requirements, etc.) relative to the size of the investment
- Low number of funds and realized returns across the SGB sector
- Difficulty in identifying and targeting interested investors
- Difficulty in identifying intermediaries and financial institutions in developing countries
- Wide diversity of SGB business models, goals, and legal structures

Adapted from Dalberg Global Development Advisors Capital Aggregation Briefing Paper for ANDE Conference Session

A Note from **Jim Koch**, Director of the Global Social Benefit Incubator

Social entrepreneurs face the same development stages experienced by small and growing companies—from founding, to establishment, growth, and scale—but operate in highly fragmented and inefficient capital markets. In this report, Kohler and Sawhney seek to understand how capital markets for social benefit organizations can operate in a more efficient manner across these stages. A better understanding of the common investment criteria of various funding sources and the aggregation of capital within each of the respective organizational life stages is needed to improve efficiency in capital markets. This knowledge will benefit the demand side interests of entrepreneurs with scalable social businesses and create opportunities for syndication on the supply side.

In principle, syndication should increase the amount of capital available to invest in social ventures. Questions remain, however, as to whether investor expectations are appropriate and whether adequate funding exists for each life cycle stage. In addition, there are several “investment readiness” factors on the demand side that are critical to increasing the flow of capital to social ventures. These factors pose the question of whether there is too little capital available at various life cycle stages, or whether in fact the “deal flow” (of investment-ready ventures) is inadequate. Kohler and Sawhney suggest a third question—if social capital markets are inefficient, what can be done to increase their efficiency? For example, their work suggests that there is a need for field verification and affordable due diligence if the flow of investment capital to BoP ventures in distant locations is to increase. The ability to address issues such as this will clearly benefit from network effects of a yet-to-be constructed ecosystem that can aggregate capital and cluster innovations into denser networks of shared information, knowledge, resources, and capabilities.

The GSBI program at Santa Clara University’s Center for Science, Technology, and Society provides access to professional knowledge and skills development opportunities and connects ventures to seasoned mentors who can share tacit knowledge. Similar to the Kohler and Sawhney findings, we have found that aggregation—or the clustering of solutions within vertical market sectors—facilitates cross-learning. In this instance, aggregation increases the slope of learning curves by reducing the cost of search or discovery, the cost of information, and transaction costs within networks of interdependent actors and potential partners. Each of these factors can speed learning and improve deal flow. Analogous mechanisms are needed to foster positive network externalities in the capital markets for small and growing social businesses.

The GSBI experience with 140 social ventures confirms that a cohesive business model that fully reflects founding values can result in a scalable enterprise with significant social impact. Kohler and Sawhney caution, however, that successfully navigating the growth and profitability stage of a social business requires substantially greater attention to formalizing processes, management information systems, effective governance, and the staffing of pivotal positions with the right skills. Their work suggests that greater attention to these considerations in the growth stages of social ventures can attract equity investment, but it is essential that investor expectations and term sheets be properly aligned with the unique characteristics and ambiguities of these new markets. In addition, attention to the execution hurdles of achieving predictable cash flows will be a key success factor for social businesses if they are to access traditional debt at market rates of return. It is for these reasons that Kohler and Sawhney posit that as social mission organizations move through growth and scaling stages, technical services and capacity development become more critical. Here, again, global networks will play a vital role if the needs of ventures at the BoP are to be served.

To some degree, the work of Kohler and Sawhney suggests the metaphor of a chicken-and-egg dilemma. Fragmentation in the social sector contributes to market inefficiency in the supply and demand for capital, but this efficiency cannot be overcome without aggregation. Intermediate mechanisms are needed to solve this chicken-and-egg problem. The insights in this report are clear and actionable on both the supply and demand side of capital markets.

A Note from **Thane Kreiner**, Executive Director of the Center for Science, Technology, and Society

The Center's work of helping social entrepreneurs to build sustainable ventures that can scale to create significant impact now spans nearly a decade through our signature Global Social Benefit Incubator program. As described by Jim Koch, this practical experience enables elaboration of key success factors across a wide range of goods and services that benefit BoP communities. In particular, in the last several years, our off-grid energy sector focus has revealed a variety of lessons regarding business models, technology solutions, and contextual considerations that can impact whether an enterprise will survive and its potential to scale. Our sector focus provides depth in each of these dimensions, enabling identification of best practices at a level that can translate to risk reduction for investors across the capital spectrum.

One lesson is clear: the lack of capital flow from investors constrains the rate of scaling, even when the SGB has a strong business model, appropriate technology solutions, and strong business partners to help drive adoption. Given the pressing nature of the issues affecting the global poor, the importance of accelerating efficient capital markets for SGBs in the developing world is hard to overstate from humanistic or free-market perspectives. Taking energy alone as an example, 1.5 billion people live "off-the-grid," without reliable access to power. Without power, education and economic generating activities cannot occur after dark; safe childbirth and other healthcare provision are challenging or impossible; high-pressure reverse osmosis water filters requiring power to remove arsenic from groundwater cannot operate;

and so forth. The world's population is projected to increase from 7 to 9 billion by 2050; all but 50 million of the increase will be in what we currently term the developing world. Any corporation seeking significant long-term growth has a vested interest in the purchasing power of these nearly 2 billion additional people, as well as the current 4 billion people living on less than \$3,000 per year.

More social entrepreneurs capable of building sustainable and scalable ventures providing goods and services that meet basic needs of billions of people are clearly required. In our view, it is imperative that many of these ventures provide the nuclei for economic growth in the communities they serve. Further understanding of the "best practices" in every dimension will hence accelerate social justice and efficient capital deployment.

The Center will strive to increase the number of capable social entrepreneurs by expanding elements of its successful GSBI program, and to catalyze appropriate technologies through its recently launched frugal innovation initiative. It is our hope that this work by Kohler and Sawhney will serve as the foundation both for the Center and the community at large to test empirically specific mechanisms that facilitate investment capital flows to SGBs in the developing world. As with any pilot, many of these mechanisms will initially be imperfect, or may not work at all; but theories alone will have no impact. To move towards effective horizontal capital aggregation, we must begin to test a new set of practices.

A Note from **Mitchell L. Strauss**, Special Advisor for Socially Responsible Investment Finance, Overseas Private Investment Corporation (OPIC)

The work the Center for Science, Technology, and Society has done to advance an understanding by all participants on possible structure and coordination of impact capital is very important. Their findings help to clarify current practices in the impact-investing community and help point the way to a change in investment approach that could be far more efficient. In particular, we appreciate the Center's emphasis on "actionable research."

We at Overseas Private Investment Corporation (OPIC) would like to help expand the market for impact investing; to that end we recently completed a call for impact-investment proposals. Most OPIC calls are focused on equity funds, but this one was to be open to equity funds, debt funds, and other kinds of financing vehicles that hold positive social impact as a core ambition. We are looking for the most innovative opportunities, large or small, in any sector that relates to social impact.

The truth is, OPIC's staff have been investing for both social and financial returns for decades and have a lot of experience to bring to the table. We see our role in the impact-investing sector as working with investors, managers, and businesses to mitigate risks and fill financing gaps. To that end, we certainly welcome the Center's valuable contribution to this growing sector.

PROJECT FINDINGS

Sources of Capital

Within the past decade, the SGB sector and alternative asset markets have slowly begun to converge in regard to expected return, even though dissimilar types of investors are providing the investment capital. Among traditional markets, investor profiles can take on a variety of forms, ranging from high net worth individuals, corporations and endowments, to other retail and institutional investors. However, as Figure 1 illustrates, the vast majority of social capital is contributed mainly by high net worth individuals and family foundations. Whereas most investors within traditional markets allocate assets based on risk and return, assets allocated to the social impact class are contingent on criteria such as personal mission, duration of investment, as well as social and financial return on investment (ROI). These desired “social” outcomes focus on job creation, economic development, number of

beneficiaries, and other quality of life metrics. This multifactorial asset allocation results in a more complex distribution of investor characteristics, and increases the challenge of classifying these investors as a single united entity. Although many investors value a financial return, the focus appears to be on generating social impact in the regions where their capital is put to work.

The fact that high net worth individuals and family foundations dominate the inflow of capital is indicative of the high level of risk associated with investing in the social impact sector. Political and economic volatility hinder the number of liquidity options for any given investment. This, combined with the general lack of understanding of these developing markets, deters the participation of retail and institutional investors in this sector. Further investors committing

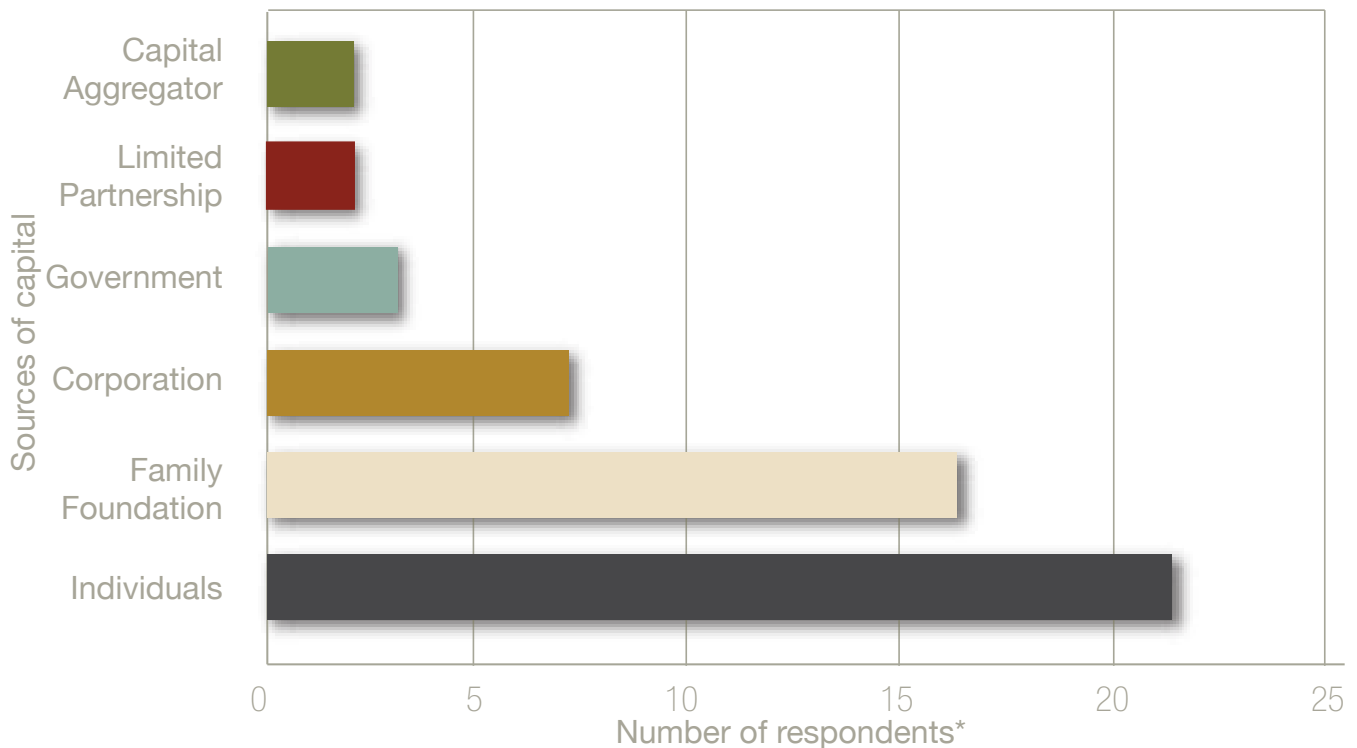


Figure 1. Sources of Capital

*Respondents may have reported multiple sources of capital.

capital must ensure that they can tolerate a high level of illiquidity in their investments for an extended time frame, affirming why the current sources of capital are so concentrated. Illiquidity would also imply larger pools of capital are required, similar to the

experience of the U.S. over-the-counter derivatives market. One way to create larger pools of capital is through syndication among investors as discussed in this report.

Form of Investment

Among traditional markets, returns vary depending on asset class as well as investor risk tolerance and preference. Within the social impact sector, expected returns vary by investment vehicle. Depending upon the investing organization and its particular preference, funds will invest at different points in the SGB's investment life cycle with specific tools and vehicles that will best support the SGB at each given stage. As Figure 2 suggests, a trend towards utilizing multiple financial instruments to invest in an SGB is beginning to develop. Fifty-four percent of the organizations we interviewed indicate that they use multiple forms of investment. Though organizations generally employ vehicles they are capable of and comfortable using, we observed a trend in organizations expanding the types of investments they make. We refer to this as "internal syndication" because it allows organizations to use grants or other contributed capital to prime their follow-on investment in a company. Initial efforts to help with capacity building can be rewarded later via an equity investment. Some organizations, such as Omidyar Network, informally institute a combination approach in which for every three for-profit equity investments, they make one nonprofit grant to another organization.

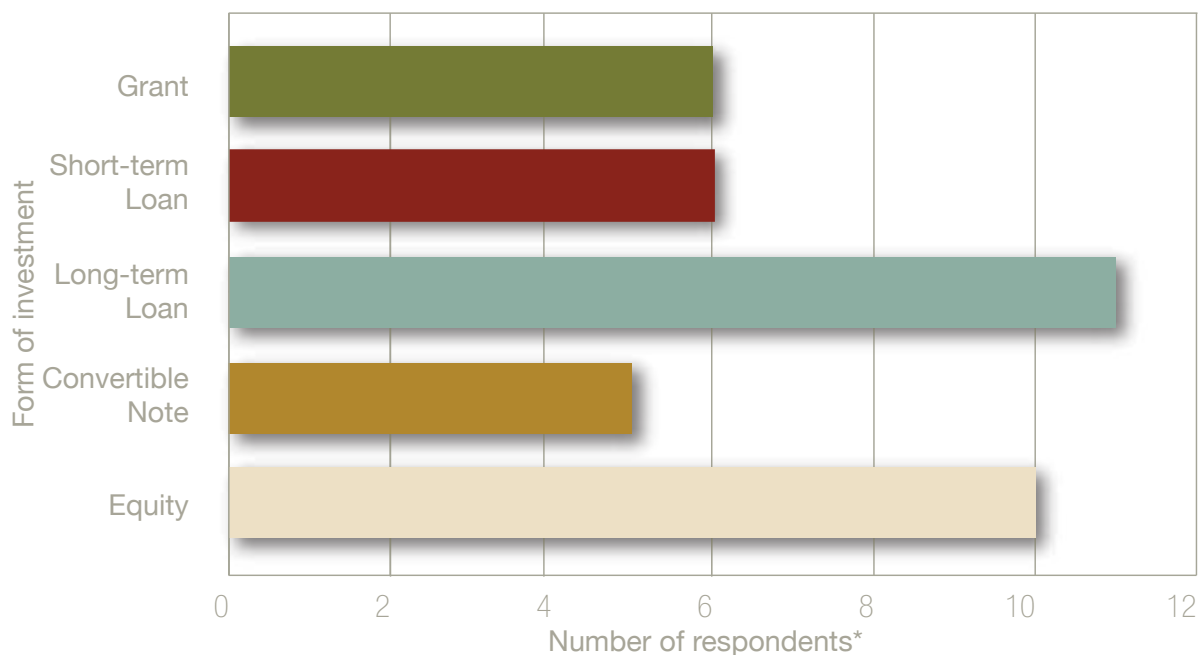


Figure 2. Form of Investment

*Respondents may have reported multiple sources of capital.

SGB Life Cycle

An SGB's life cycle can be broken down into three main stages: seed, growth, and scale. The financing life of many SGBs starts off with “friends and family” seed funding. Foundations and nonprofits can also provide seed capital as grants and grant-like instruments such as forgivable loans. This initial capital enables the SGB to build capacity, thus creating the potential for future growth. In most cases, a return on investment cannot be generated until sufficient capacity exists to reach a break-even point through an earned income model; hence, the first investment acts as “first-loss” capital for the social business. Consequently, investors in this stage of an SGB are currently limited to those not bound to generate returns.

Often, foundations and nonprofits serve as the genesis of an SGB's business life cycle, playing a pivotal role by providing seed financing, arguably the riskiest stage. It is during this phase that entrepreneurs establish the foundation to transform their ideas into tangible products or services. If the grant money runs out before the business is strategically positioned to qualify for a soft loan, the probability of the business receiving a second grant is low, resulting in the failure of the enterprise. Consequently, this is the most volatile period of the investment life cycle. The fact that the seed stage attracts more mission-aligned investors represents a risk unless a clear hand-off to follow-on investors is accomplished.

The second stage of the SGB life cycle, growth, is funded primarily by social funds through a series of soft loans, trade credit, and equity. International development organizations will also “vote” their balance sheets or provide guarantees to local banks to make “risky” loans to growth SGBs. In this stage, it is assumed that enough operational capacity exists to provide cash for daily operations and locally grow the business. These investments start out with below market rate, or soft loans, and evolve into market-rate loans as the ventures grow. When the SGB is ready to scale, additional capital will be required, but the possibility for exits improves, which makes the SGB more attractive to equity investors (see Figure 3, next page).

As they scale, SGBs may attempt to replicate their success in other regions where unmet demand for the value of their products or services exist. The scaling stage is dominated by social venture capital funds that invest primarily through convertible debt and equity instruments. These investors can inject a greater amount of capital and generally have expertise in bringing businesses to scale in new target markets.

“Social impact is an inherent by-product of the companies we invest in. We look for companies that can thrive and expand into new markets.”

– a Social Fund

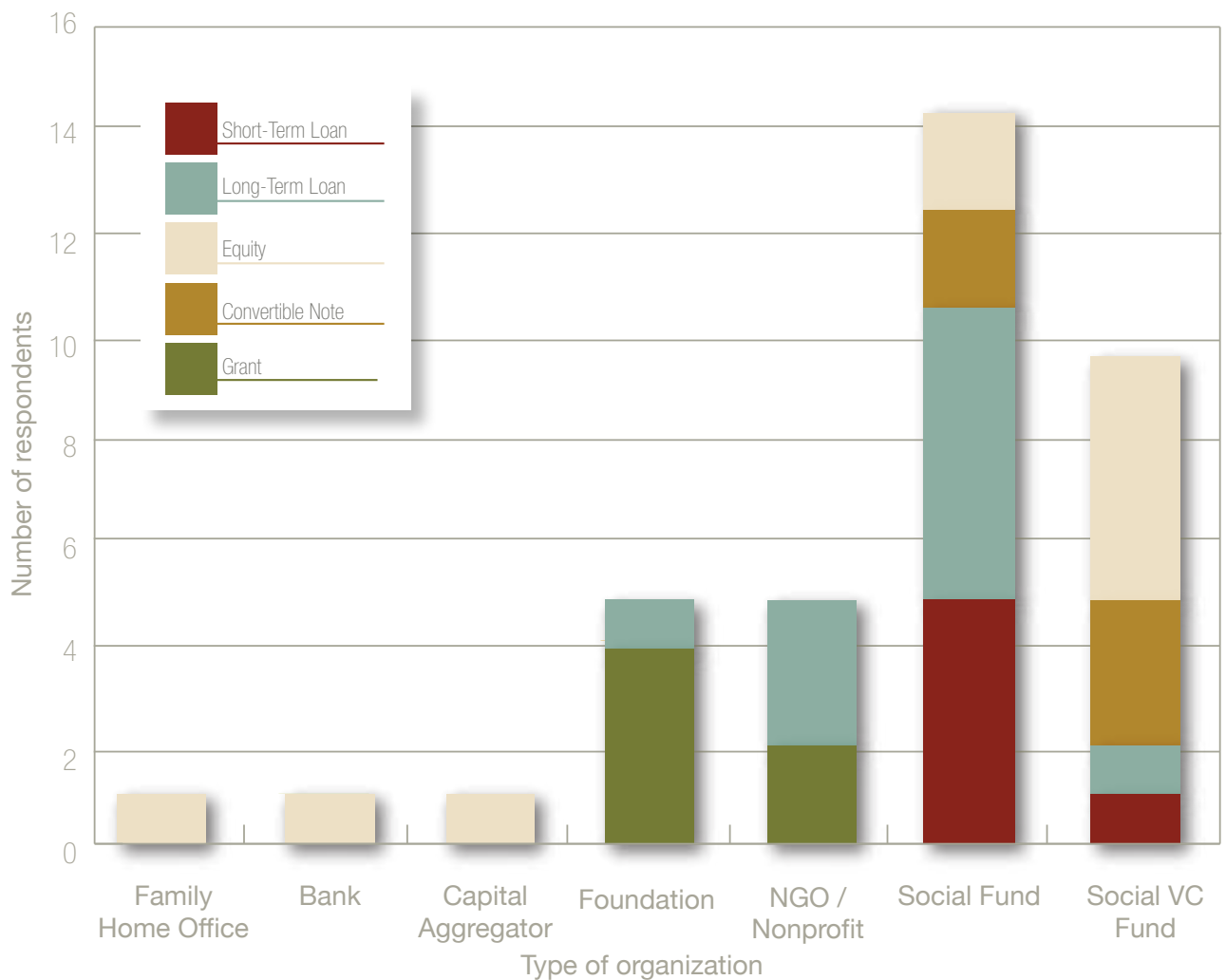


Figure 3. Sources and Forms of Capital

Expected Returns

Although a majority of initial investors within the social impact sector are not interested in financial returns, there exists a pool of investors that expect traditional market returns; this pool represents a diametrically opposed investor profile in the social impact sector. Returns are expected to be competitive with standard market rates, ranging from 10 to 25 percent internal rate of return (IRR). A specific example is Elevar Equity, an Indian-based social venture capital fund that invests money in partnership with Sequoia Capital, a developed world, growth venture capital firm. Funds seeking a market rate of return need to be much more selective in their investments since the risk profile of social ventures operating in the developing world is necessarily higher.

Different social impact investors possess unique preferences, risk appetites, missions, and ultimately desired outcomes. Foundations and nonprofit organizations focus on a social return on investment (i.e., an increased social good more often within the developing world). Among investors declaring themselves as impact-first, a majority use grants as a vehicle to invest capital to support SGBs. Occasionally, foundations or nonprofit organizations will

employ low-interest loans as a form of investment, and therefore realize a 1x return plus interest on investments; however, as a whole, social funds are less concerned with financial returns and more focused on increasing social benefit throughout BoP markets.

Social funds play a pivotal role in promoting and establishing sustainability for individual SGBs. Through a series of soft loans, trade credit (e.g., receivables line of credit) or commercial loans, social funds provide SGBs with the necessary capital to increase production capacity and revenue, while simultaneously improving social and economic conditions in their target market. It is during this stage that development entrepreneurs streamline their efforts and focus on building sustainable enterprises.

Most social funds reported they realized a comparatively low default rate in relation to the risk implied from the loan they originated. This low default rate results from numerous factors, including social pressure for repayment, government enforcement, and a tight filter using financial metrics to screen possible investments. As a result, we found that impact investors leverage this low default rate to generate returns on their debt investments, ranging from a simple return plus interest to IRR targets of 8 to 12 percent (Figure 4).

Social venture capital funds are a key component and an integral part of scaling SGBs to commercial levels. It is within this stage that an entrepreneur focuses on increased internal profitability, sustainable growth, increased revenue, and shared company ownership. As discussed in more detail, impact investors focused on scaling generally operate on a longer-term time horizon for their investments. Sixty-seven percent of social venture investors interviewed expect returns ranging from 10 to 24 percent IRR (15 percent IRR on average).

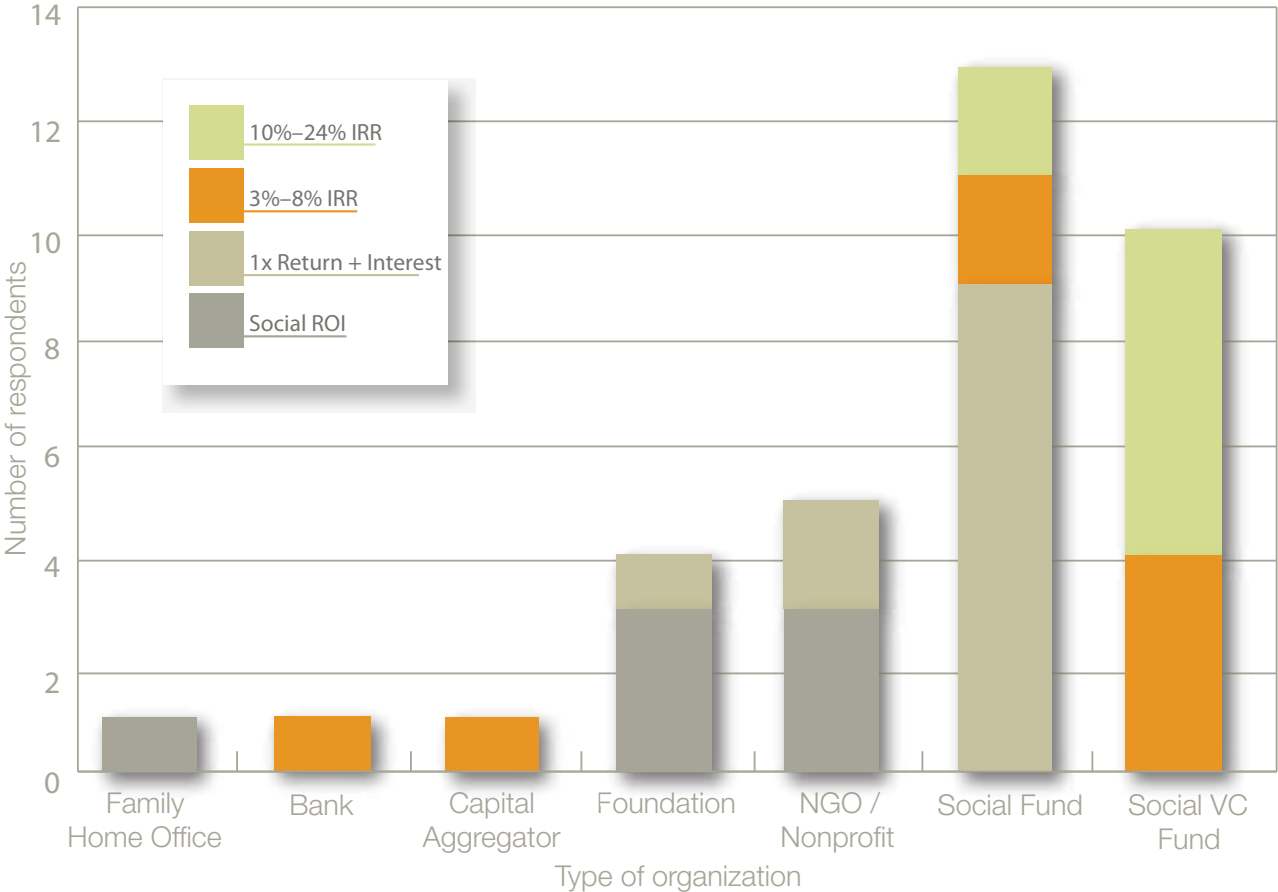


Figure 4. Expected Returns

Deployment of Capital

Due to the remote location of many SGB investments and less than optimal trade, currency, and regulatory conditions, BoP investors have additional inefficiencies to overcome that are not common to traditional markets, including capital deployment. The use of an intermediary depends on the type of investment vehicle. Impact investors who utilize debt instruments are subject to more stringent in-country regulations than if they were to invest through grants or equity. Compliance may require an intermediary, such as a local bank, to deploy capital. We observed that 50 percent of social funds interviewed use an intermediary when making debt investments.

Local intermediaries are seeing a shift in their roles. Originally, they acted as vehicles to originate and service loans to target SGB investments, backed by investor guarantees. Increasingly, they find, fund, and support local SGBs. For example, Oxfam is initiating an innovative fund to take an interest in and provide investment capital for a network of financial intermediaries, inclusive of

support to the underlying investments.

Developed world foundations are more likely to make investments through intermediaries or funds rather than placing direct investments. This is because they are not well positioned to deploy capital in regions where they may not want to place capital. Most impact investors agree that intermediaries can provide increased understanding of cultural and social complexities. Some of the more established impact investors are opening offices in the regions where they invest because they find that having a high level of trust and familiarity with their SGBs can increase the likelihood of success.

Compared to all types of organizations interviewed, social venture capital funds are more regularly involved with the SGB's progress, either through offices in locations where they invest, or by exercising board participation. They believe that having a local presence helps them to efficiently and effectively deploy capital to the SGBs.

Capacity Development Organizations

Distinct from local organizations employed to “place” investments, capacity development organizations (CDOs) help build systems and management capability of local SGBs. These organizations are also referred to as technical assistance organizations. During the initial dialog of the Capital Aggregation Working Group, members questioned why investors did not use CDOs more frequently. Our results confirm a lack of involvement. We discovered that of the organizations interviewed, only 17 percent use CDO services. Although CDOs can help improve SGB operations and indirectly generate revenue, many impact investors indicate they have trouble locating effective CDOs. In addition, many impact investors feel that CDOs represent a large overhead expense and that it is easier to manage their own capacity building services, whether business mentoring, management improvement, or operations consulting.

We find this result somewhat surprising. When viewed in conjunction with the increased return expectations reported by investors who practice “high touch” portfolio management, it follows that greater use of CDOs would increase successful outcomes. The Center's own experience indicates the same—of 140 SGBs who have completed all phases of our GSBI, 92 percent are still operating and 55 percent of operating GSBI-trained social enterprises have entered the scaling life cycle stage referenced above. In contrast to venture capital investors in the U.S. and Europe who enjoy both local targets of investment opportunity and local syndicate participants, impact investors targeting SGB investments are usually working with the added complexity of remote opportunities and geographically dispersed syndicate partners.

We conclude that involving CDOs in the investment syndicate (and local investors) will increase positive outcomes and lead to greater investor confidence in the SGB sector. This hypothesis can be empirically tested in future phases of the project.

Geographic Focus

When examining boundary conditions of capital prior to investment, restrictions by geography or mission come immediately to mind. While our sample size is too small to make statistically significant conclusions about return expectations by geography, respondents revealed two trends. The first is a migration of geographic focus—funds beginning with a narrow or country specific focus reported later migration to regional or global focus. Second, funds with a global focus prefer opportunistic investments across vertical sector versus artificially restrictive investment. In-depth understanding of a particular region does not always allow an organization to hedge the inherent macro, political, and economic risks of the region; thus, basing an investment decision on theoretical

outcomes of a country may limit investment upside. With local political and socioeconomic factors introducing additional risk to investment outcomes, a geographically diverse strategy will yield higher results than a more narrow investment exposure. Those who carefully examine each investment to see how well it will succeed within its political and environmental framework are more effective in meeting their return expectations. Of those respondents that had a financial return expectation (subtracting out funds that reported a social only return expectation), respondents who had a global focus expected far greater returns than those with a region specific approach (see Figure 5).

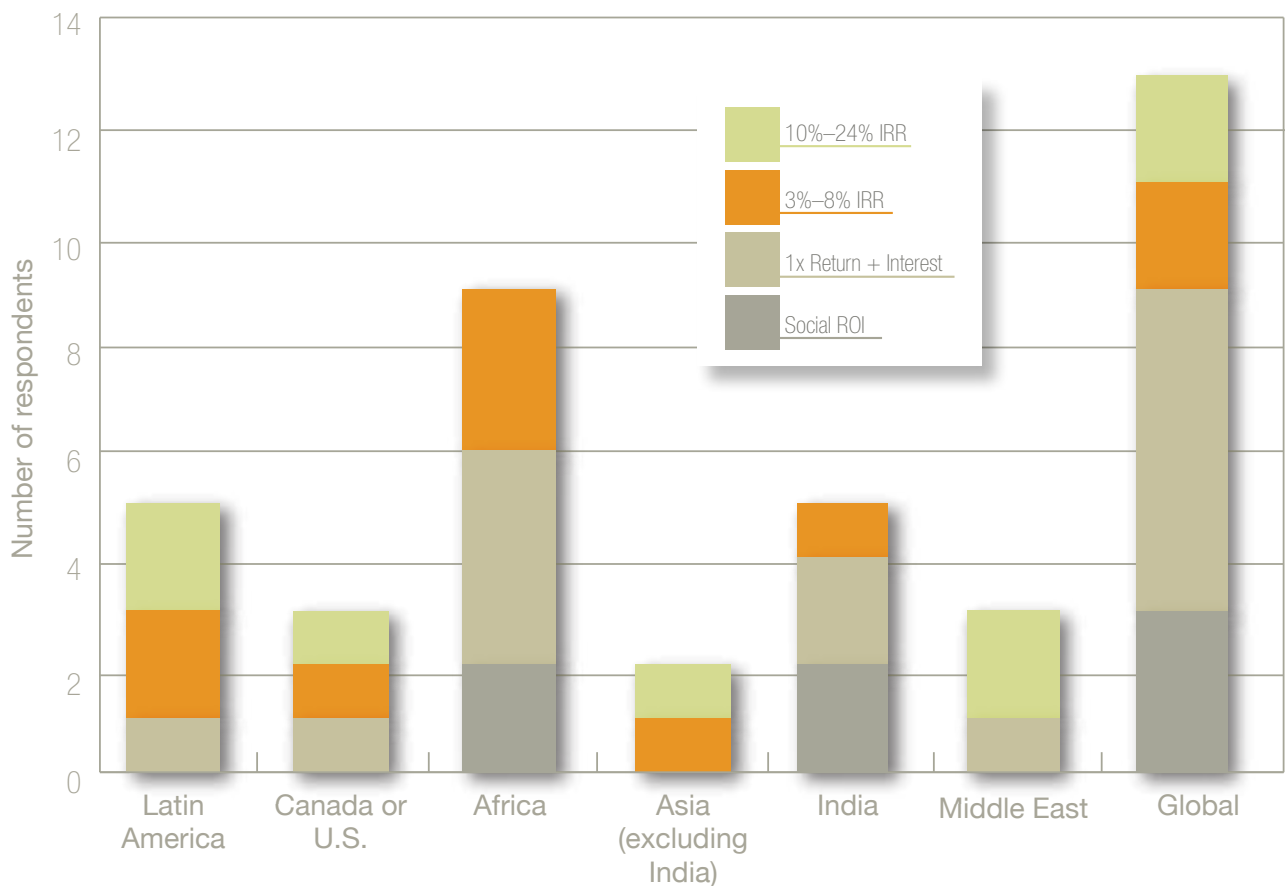


Figure 5. Geographic Focus and Expected Returns

Sector or Mission Focus

“We do not pass up on opportunities just because they fall outside of our sector preference.”

– a Social Venture Capital Fund

Another possible restriction on investment capital is a concentration on a sector (water, energy, agriculture, etc.) or to support a mission (higher literacy rate, lower child mortality, eradication of a specific disease, etc.). We were somewhat surprised to hear few respondents indicate this kind of pre-investment

restriction. Further, when a sector had been declared by the fund, many indicated a very broad definition, allowing wide qualification of deal flow. We continue to see more impact-investing organizations moving towards a broader investment approach focused on economic development, job creation, or number of beneficiaries. Also, organizations that have been in existence for three or more years argue that geography often trumps sector in terms of choice. When searching for viable investments, many organizations focus on the needs specific to the regions in which they operate. The most common sectors that the organizations interviewed are agriculture, healthcare, microfinance, and education.

Segmenting the BoP Market

Success in syndication requires alignment of purpose and expected outcome by participating investors. Measuring the total available market and target market being addressed by the SGB is very important as it affects key downstream decisions such as manufacturing costs, pricing, and distribution channels.

There are several operational definitions for segmenting BoP populations that make up two-thirds of our global community. C.K. Prahalad identifies the BoP as “Tier 4” of his pyramid with per capita income averaging less than \$5 per day. In his monograph, “The Next 4 Billion”, Al Hammond scales per capita income (and consequent spending power) up to \$9 per day, consistent with measurement by the World Resources Institute (WRI). Recently, the J.P. Morgan report on Impact Investments, also citing WRI, maintained a BoP definition at \$9 per day and lower, but proposed a BoP+ category for per capita income above \$9 per day. In our segmentation analysis for this report, we focused on urban versus rural income levels in BoP markets.

When asked, the vast majority of respondents do not measure income levels of the target market or beneficiary base of the SGBs in which they invest. In contrast, venture capital practitioners routinely assess target market income levels in their pre-investment diligence.

BoP market segmentation and measurement of target markets thus represents an important area for further study. It is becoming more accepted that economically viable BoP ventures with earned income business models are concentrated at the “top of the bottom” and the difficulties of market penetration and means of assessing associated investment risk for serving the poorest of the poor are less understood. We did not take into account others assets owned by these communities such as dwellings and land.

Urban versus Rural Focus

As discussed in recent reports, wide disparity in per capita and disposable income exists between rural and urban BoP communities. The reported income levels in urban BoP areas consistently ranged between three and six times higher than income levels in rural BoP areas, a factor that underlies the mass urban migration phenomenon that is being witnessed across less developed countries.

Sixty-eight percent of our respondents indicated “no preference” when asked if they targeted rural versus urban BoP markets for investment. Of those who did express an interest, most focused on rural BoP communities—perhaps explained by impact-first investment practices. The few respondents who concentrate on urban markets also cited a significantly higher return expectation (IRR). It is clear from most analyses that SGBs operating in urban markets enjoy both customers with higher disposable income and lower customer acquisition and service costs. We agree that great impact can be achieved in rural communities; however, the wisdom of our respondents pointed to establishing social enterprises first in urban areas before attempting outreach to more difficult, rural markets.

“Unless a company succeeds [in an urban market], there’s no point to go to rural areas. Product adoption [in urban markets] must happen before you can take it to rural markets. It is more expensive to promote your product...or service in a rural setting.”

— a Social Fund

Rural areas of the developing world would greatly benefit from successful SGBs, though impact investors are finding it increasingly hard to ensure that capital is properly deployed and effectively allocated among businesses that operate in rural areas. In addition to political and economic difficulties, it costs more to get products and services into the hands of consumers in rural areas because of the inherent geographic remoteness and low population density. Notwithstanding, there are successful enterprises that are architected specifically servicing rural populations.

For syndication, a conundrum lies in the finding that impact-first investors believe that rural areas exhibit the biggest need for market-based solutions to alleviate poverty (in this context, SGBs are suited to provide such solutions). This “purpose” of capital investment must be identified and agreed to before successful syndication can take place.

For-profit versus Nonprofit SGBs

Not surprisingly, for-profit SGBs are the best candidates for capital investments according to the organizations we interviewed. However, this broad consensus was guided not by a “financial-first” priority but rather on the reported observation that for-profit SGBs had a higher probability for sustainability and scale. Retained earnings allow for organic (self-funded) growth and scaling as well as for profitability, which ultimately can provide enhanced social and economic benefit.

The Center’s experience is that many SGBs begin as nonprofit organizations but later adopt for-profit or hybrid structures when they reach revenue generating and growth stages.

We found that impact-first investors prefer “investing in the entrepreneur,” whereas financial-first investors primarily screen for a great idea and business model.

Investment Time Horizon

Interviewees reported that they initially invested with a three- to five-year time horizon, but almost uniformly experienced greatly extended holding periods for their investments—up to double their expectations. Roughly 75 percent of impact investors now target

time horizons ranging from 5- to 10-plus years (see Figure 6).

“Every single business (whether a grant to get it started or investment to build it) has yet to do everything on track and on time. This isn’t because we’ve picked the wrong businesses; everything is taking longer than we’ve expected.”

— a Foundation

The extended holding period is a major concern for the impact community. Time is the enemy of market rate returns (IRR) and expectations from sources of capital will not be met if they are at or near historic market levels. To gain investor confidence, market mechanisms and forms of investment that allow for predictable and consistent “round trips” of investment capital need to be constructed. To an investor, round trip connotes both investment and subsequent return of capital, hopefully with a profit. Alternatives to equity instruments and intermediate stage liquidity events that reward early and brave investors should be explored.

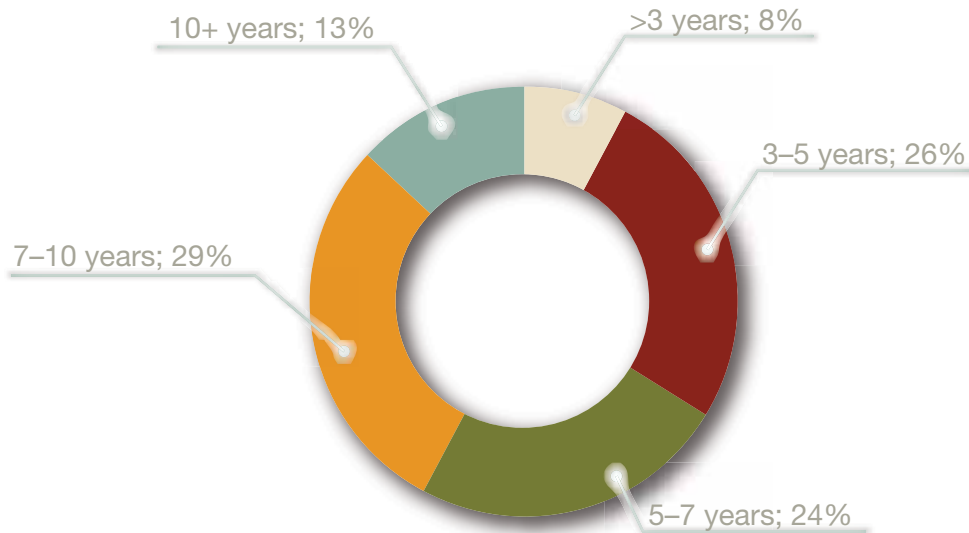


Figure 6. Investment Time Horizon

Average Size of Investment

A report by Dalberg previously identified a lack of investors willing to provide capital in the \$25,000 to \$2 million range, referred to as the “missing middle.” Difficulty achieving expected returns along with high transaction costs and low levels of liquidity have led to a dearth of pivotal funding that is best suited to help improve SGB sustainability, before reaching the scaling stage. However, we found that impact investors are beginning to address this “missing middle” (see Figure 7). Reported investment sizes now appear to address a gap in SGB funding prevalent a few years ago in this \$25,000 to \$2 million range. Equity investments disclosed by respondents generally ranged between \$500,000 and \$1 million and were mostly aimed at scaling a proven SGB business. The average size of a loan varied much more, ranging from \$20,000 to \$2 million. An odd “low point” in debt financing was evident in funding size between \$500,000 and \$1.5 million.

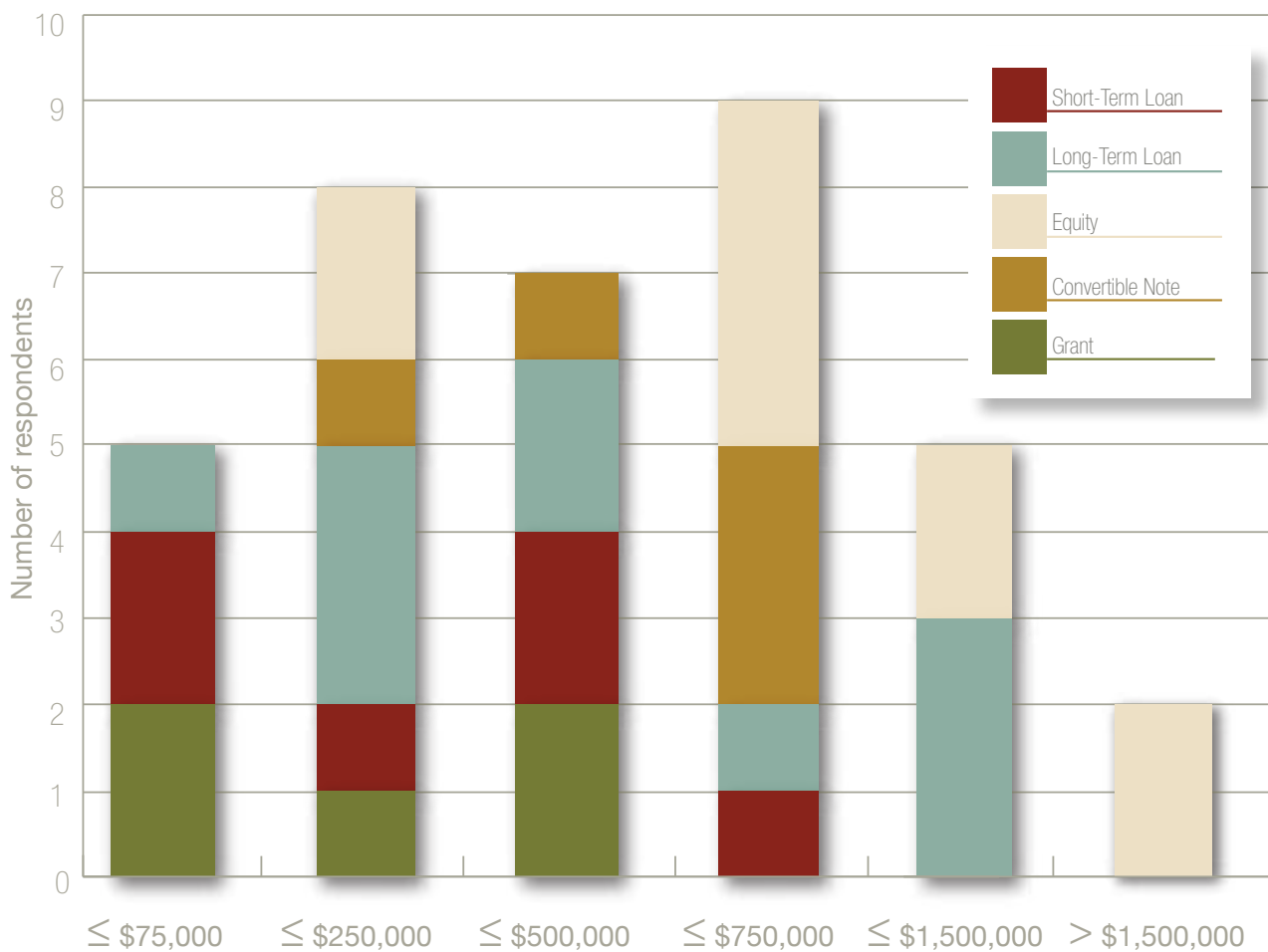


Figure 7. Average Size of Investment

OBSERVATIONS ON CAPITAL SUPPORT FOR SMALL AND GROWING BUSINESSES

The basis for our work on capital aggregation was an effort by ANDE members to identify ways to trigger additional sources of interested capital into the impact-investing arena. Second-level questions immediately surfaced as key concerns such as: what market mechanisms are missing for capital support to SGBs? is there a trade-off between financial return and impact? and why local (in-country) capacity development organizations are not utilized more frequently? The subsequent debate around how to move impact investing forward is both healthy and intellectually honest. Without properly set expectations of investment risk and return, market mechanisms that provide transparency and trust, and local partners that are part of the “investor syndicate,” we will be hard-pressed to generate increased levels of confidence that encourage new entrants to impact investing.

Comparisons to the venture capital industry, although not directly related, can be instructive on ways to build additional investor confidence. Some of the key criteria venture capital investors look for are:

- 1. Team**—Probably the most important of all criteria. An experienced entrepreneur and management team must be skillful, smart, and willing to adapt their business to changing conditions. The team must also be willing to take guidance. Venture and social impact investors realize they are investing in imperfect companies and incomplete teams—that is part of the risk. It is execution that drives success.
- 2. Value Proposition**—Must be unique, defensible, and solve a real problem. We often ask, “Is this a product masquerading as a company, or is this a value proposition capable of generating whole families of products and services?” This question is closely followed by an analysis of the total addressable market (TAM) and the target market within the TAM that should realistically feed the assumptions in the business model. The value proposition must also be adoptable by members of the target market without much difficulty.
- 3. Business Model**—Credible financial assumptions and rational forecasts serve as the foundation for any business model. From there, we ask whether enough money is being raised to reach a cash-flow-break-even point or to reach a clear jump in valuation. We also analyze the smallest economic unit on which the company can profitably operate and how much financing it takes to get there. It is surprising how often the costs of scaling up makes the economic unit more of a vision than a reality.
- 4. Governance**—A critical analysis in a number of dimensions. Is the legal structure of the company able to accept multiple forms of investment (grants, quasi-equity, preferred equity, loans from development banks, etc.)? Are there checks-and-balances in place for key decisions the company will face? Is the company supported by key advisors and outside board members who will both guide the management team and open doors of opportunity or eventual liquidity? Finally, is the company held too closely or by too many related parties? All of these issues are especially present with candidates for social impact investing.
- 5. Validation**—Although a normal course in venture investing prior to any funding going in to the company, validation is a significant issue with social enterprises. Often, social impact investors rely on company-reported information only. It is a huge mistake and could “taint the well” for future investments if our community is not careful. Impartial validation and reporting is one of the missing pieces in the social impact “market” and should be addressed. It strikes to the core of what can help scale the market—investor confidence.

Another way to build investor confidence is to exceed expectations. In the SGB sector, this is more about setting achievable expectations than chasing developed market rates of return. Still, a large portion of impact capital has a financial-first mandate and puts the conversation about investing in local SGBs on par with returns that are expected from investments in the developed world and its corresponding market efficiencies, low cost of capital, stability, liquidity mechanisms, etc. A simple “risk adjusted return analysis” of investments

in a developing country quickly shows risk going to infinity sooner than liquidity can rationally be earned. A conclusion is that we need to change the expectations and mobilize capital from sources that have accurately set expectations of return.

One of the other problems of overly high return expectations is the resulting “screen” that portfolio managers have to use when evaluating SGB investment opportunities (see Figure 8).

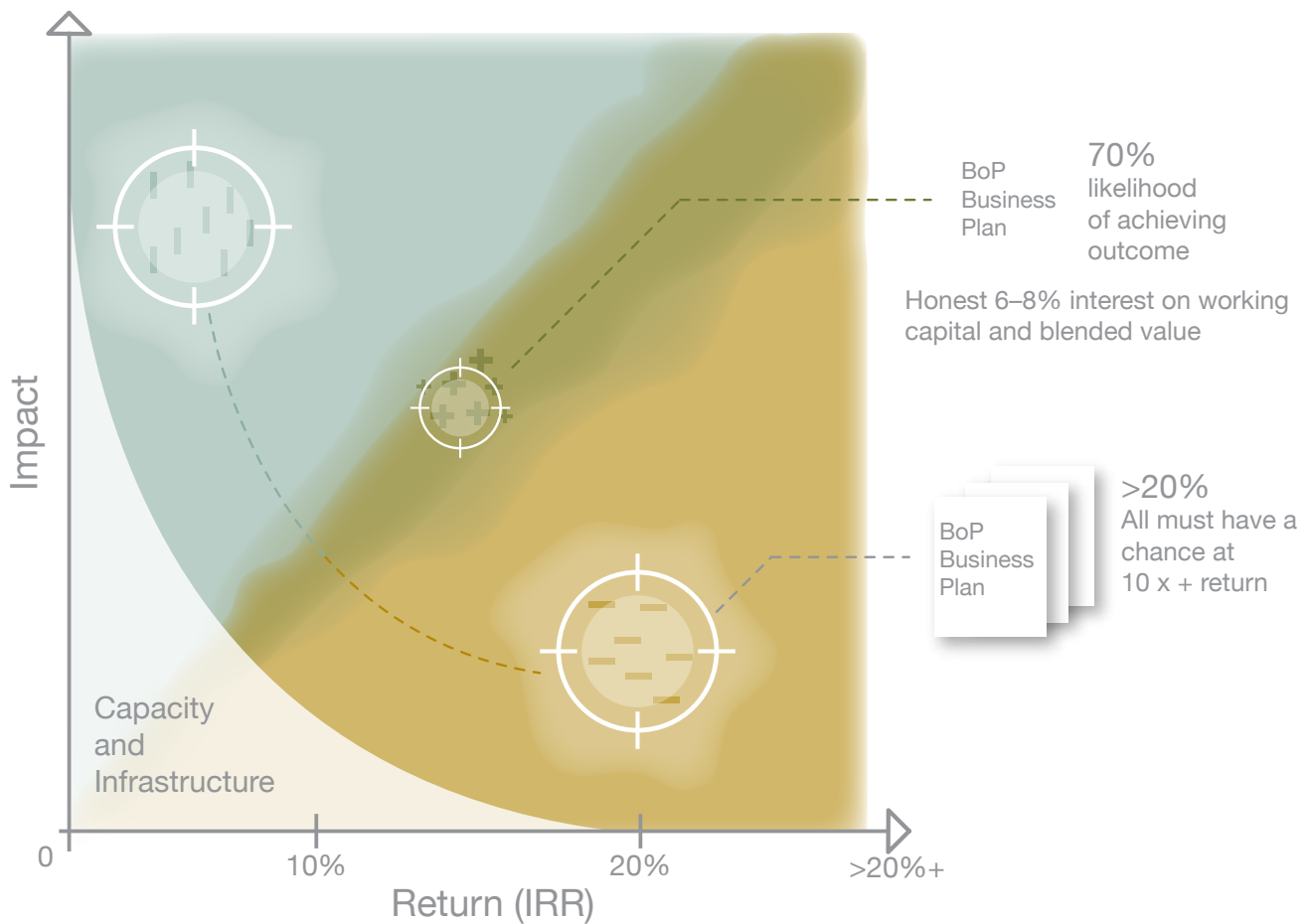


Figure 8. IRR Targets Cause a Tight Screen

A social venture portfolio manager targeting an IRR of 18 would need to screen each opportunity with a high multiple expectation (10x return) in order to have even a remote chance of achieving this “near market” return. While 10x investment multiples can be found in the SGB sector, such a tight screen leaves the vast majority of SGBs out of the funding picture. As revealed in this report, investment duration is still not predictable and funds should expect a five- to seven-year holding period or longer. Observations that are inferred from our findings call into question equity as a funding instrument for SGBs and perhaps suggest the development of cash-flow backed investment vehicles. In either case, many solid SGBs would be better served by a change in return expectations and investment vehicles to deliver those returns with a higher frequency.

Return of capital with some appreciation would be a good place to start. Then, market mechanisms need to be built:

- Deal flow of credible social enterprises and entrepreneurs building sustainable companies
- “Blended return” metrics that value positive social and environmental outcomes on par with financial return and allow consistent and auditable measurement
- A network of in-country business advisors, board members, capacity development organizations, and auditors who can be the

“eyes-and-ears” of the investors, provide validation of reported information, provide governance and guidance, and help with periodic reporting. Such a network can also play proxy for lowering the cost of due diligence. Many of the “new” sources of interested capital (corporations, family foundations, donor advised funds, etc.) do not have the facility or staffing to perform their own diligence. This is one of the reasons Toniic was formed—to create a “self-help” investor network that would share the diligence effort for interesting impact investments.

- Liquidity mechanisms. Sadly, the more underserved the market, the less likely there will be local stock exchanges or other modes of liquidity to reward investors who take a risk and the founders of the social enterprise. There are social stock exchanges that have been tried in Lisbon, Brazil, and London—but without some of the market elements listed above, very few “deals” make it to the exchange and investor confidence is almost nonexistent.
- Syndication among investors can solve several challenges present within the SGB investing process, including risk management, sufficient capital to support long SGB development cycles, and higher touch portfolio management.

“We try hard to syndicate everything we do; we wouldn’t want to fully fund any project.”

– a Social Fund

THE CASE FOR SYNDICATION

Syndication can play a pivotal role in reducing investment risk and lowering due diligence costs by bringing more partners to the table that are aligned across key objectives. The SGB sector, unlike developed world venture capital, is much more collaborative and supportive of sharing successful outcomes. The majority of organizations we interviewed stated they had an interest in linking with like-minded investors to make investments. This key finding of our research suggests that the obstacles preventing sector-wide adoption and implementation of syndication seem to be more logistical than fundamental.

While developed markets enjoy a path of “up-round” private equity sources, there is little if any of this “vertical” ladder for social entrepreneurs in underserved markets. Much of the capital formation needed to support social enterprises will need to be “horizontal.” The hand-off between investors would not necessarily require valuation increases; instead, investors may focus on infrastructure development, capacity building, or establishment of positive cash flows first, which are leading indicators of a sustainable business model that is attractive to follow-on investors. This hand-off represents a possible advantage that the SGB sector possesses over developed markets. While players whose return expectations necessitate continuous valuation increases dominate developed markets, the SGB sector is able to support syndication starting at earlier stages of the SGB life cycle. Discussion among members of the ANDE Capital Aggregation Working Group included the formation of a “mother-of-all-term-sheets” to guide phased investment by various capital sources over time. It was an idea deemed too difficult. Perhaps a better way to ensure hand-off of portfolio companies to the next phase of capital is to encourage the SGB to achieve operating milestones that set them up as good candidates for the next round of investment. We will elaborate on this later.

Our research has identified three common forms of syndication: internal syndication, co-investing, and phased investing (see sidebar on page 32). Co-investing is also referred to as a “one point in time” form of syndication and occurs when multiple investors invest at a given stage in the SGB’s life cycle. From an investor’s point of view, co-investing allows participation in an investment opportunity without being the sole investor, bearing all the risk. Also, it allows for a sharing of deal transaction costs and most likely results in the SGB receiving a larger capital commitment than it would otherwise have received from any single investor. Although co-investing works well by bringing investors together at a specific point in time (such as a financing round), it does not help the SGB throughout the duration of its life cycle. Unless there is a commitment for follow-on capital from existing investors, it can expose the SGB to difficulties when it needs to raise its next round of funding. For example, if multiple investors combined to give a soft loan to an SGB, our data suggests that it is unlikely for these soft loan providers to engage in later-stage forms of investments, such as long-term loans or equity. This assertion is not to detract from the usefulness of co-investing but rather to suggest that it is not the most optimal form of syndication for impact investors.

Internal syndication occurs when a single investor deploys capital to an SGB at different points in its life cycle. A foundation extending a grant that builds basic infrastructure and capacity, followed by a soft loan from the same foundation after grant work has been completed, is one example. Internal syndication benefits the SGB for the long term because it provides a steady stream of capital from one known capital source. Since the investor does not need to coordinate the terms of the investment with others, it is also the least complicated form of syndication. However, internal syndication is not optimal from a risk management point of view. By making two

different investments in the same SGB, it makes the investor's portfolio more sensitive to adverse changes in each SGB's performance. While this may not be as important at the grant level, diversification preferences may hinder internal syndication at the subsequent debt and equity phases.

Of the three forms of syndication, we believe that phased investing is the most effective form. Phased investing involves two or more investors investing during different development phases of the SGB. This form is beneficial for both the SGB and the investor. By having access to a stable stream of capital inflow, the SGB is free to focus on its operations and run itself in a way that maximizes impact. In addition, having investors over time that can provide mentoring assistance is an important asset to the business: these benefits will be realized in the future by follow-on investors. In the first phase, the grantmaker can create greater impact if the grantee continues to operate after the useful life of the grant. Other impact investors also benefit from successful businesses because there are now more robust investment opportunities to choose from in the ecosystem.

In an effort to facilitate phased investing with actionable suggestions, we focused our research on the investment outcomes that organizations cited as the most important. We examined not only return expectations, but also analyzed the qualitative metrics used to measure success. We also reviewed term sheets provided by several project participants, dividing them by type of capital and exploring the common and important provisions. We believe that supporting the expectations of follow-on capital sources can unite investors throughout an SGB's life cycle. A starting point is articulated in the Appendix, though further study would make an important contribution to the sector.

We begin with the grant and soft loan phases. Aside from philanthropy, these are the first two funding stages for an SGB. Grants help propel the business from idea to required infrastructure and proof-of-concept. Soft loans can be utilized to help the SGB move to a full operation and eventually, a sustainable business. Of the grantmakers interviewed, the majority stated that job creation, the number of

Reasons to create a syndicate (it takes two!)

1. Achieve a successful outcome (draw in or prearrange sources of capital that are appropriate for SGBs)
2. Risk sharing (if more capital is needed)
3. Bring more partners to the table; source local business leaders and sector experts

Models of Investing

- Phased investing (baton pass)— Different impact investors contributing capital at each phase of the SGB's development cycle. Examples of this may include:
 1. Grant (capacity building)
 2. Soft loan (proof of concept)
 3. Quasi equity/equity investment (scale the business)
 4. Debt provider (long-term, commercial loan— scale the business)
- Co-investing— Multiple investors pooling capital to make one type of investment.
- Internal syndication— An organization participates in multiple phases of the same small and growing business investment cycle; i.e., providing capital in the form of a grant that is later followed by an additional investment in the form of debt or equity.

beneficiaries impacted per year, and economic development are the three main outcomes they expect of the grantees. Soft loan providers shared these same metrics; however, we found they preferred businesses that exhibited stable free cash flows and a plan towards a sustainable business model. For example, a soft loan provider may only invest in businesses that are 70 percent sustainable, or that demonstrate they can generate enough cash from operations to pay back the loan. Root Capital, a social fund providing short-term credit to agriculture-related SGBs, makes investments in coffee bean growers. The size of their soft loans is determined as a percentage of the expected value of the coming year's harvest. If the coffee growers cannot demonstrate a history of stable cash flows or tangible assets to act as collateral, they are not eligible for Root Capital's soft loans. This restriction exists despite any social metrics that might have been achieved by the coffee growers through previous grants.

“We would never invest in a company unless we have a co-investor.”
– a Social Venture Capital Fund

As we have described, there is misalignment of expectations between the first and second phases of capital. To receive a grant, SGBs must exhibit that the grant will be used to meet appropriate impact metrics. However, because these metrics do not focus on how the business operates, the achievements of these social metrics may deter the ability of the SGB to appear attractive to soft loan providers. It is assumed that soft loan providers are concerned with the ability of the business to repay the loan and generate stable cash flows. We suggest that to help prepare SGBs for the next phase of financing, grantmakers should add provisions to grants that better position the SGBs to secure soft loans. For example, including a condition that the business must incrementally increase its percent sustainability (for example, revenues growing faster than expenses) each year can help the grantee plan for the next phase of capital. By having the entrepreneur operate the business in a way that works toward a fully sustainable model, the business will be much more

attractive to soft loan providers, thus allowing the business to continue to make an impact.

Drawing from an example of an SGB in rural India that sells water purification devices, we can follow the trend of syndication. When it receives a grant, the SGB will need to utilize the funding to affect the largest amount of beneficiaries possible. Because the SGB is serving a BoP market, it must set a low price point to ensure that its target number of beneficiaries have access to clean water. In three years, when the grant money has been depleted, the company will need to identify new funding sources. Because of the low price point, the SGB will not have the required financial metrics such as stable cash flows to qualify for a soft loan. In order to continue to operate, its option of last resort is to reapply for a grant. However, demand for grant capital appears to significantly exceed supply, making survival of the SGB much more difficult.

While requiring SGBs to be financially independent sounds plausible in theory, the real challenge is identifying and implementing appropriate strategies to bring about this result. In our example, the absence of significant economies of scale will likely force the SGB to raise its product price to make its business more sustainable. However a fewer number of people may have access to it. Since this contravenes the core objectives of the grantmaker, what incentive does the grantmaker have to implement these terms into their grant agreements? While the SGB will be serving fewer people initially, it will incrementally decrease its dependence on grants, which will increase its attractiveness to the next phase of capital and allow it to make a greater social impact. Instead of future capital being required for the SGB to continue operating, it can be used to scale the SGB. It should be noted that social metrics such as the number of beneficiaries, job creation, and economic development grow as a function of time, and not as a function of the size of an investment.

The idea of “passing off” terms to prepare SGBs for the next stage of financing should be implemented throughout the entire life cycle of SGBs. After the transition from grants to soft loans, a common next step is to apply for trade credit or long-term loans

that generally have higher interest rates and are made in larger amounts. At this point in its life cycle, the SGB will need to be fully sustainable and be able to demonstrate organic growth in order to be attractive to a commercial loan provider. Once again, these provisions to become fully sustainable and to develop plans for growth can be implemented at the soft loan level. The goal of securing a commercial loan will have become a priority for the SGB at a much earlier point in time. Incorporation of such provisions will give the SGB more flexibility to structure its operations in a way that satisfies the objectives of its future capital source. Instead of rushing to change the business model (i.e., when the soft loan is nearing maturity), the SGB will have several years to transition from a partially sustainable model to a fully sustained growth model.

A business needs to be mature enough to demonstrate strong growth prospects as well as the ability to scale in order for equity investors to commit capital to an SGB. Although growth is important to debt investors, the levels of growth required by equity investors as well as the ability to scale are not as crucial for successful debt investments. At this transition phase, we recommend that the debt investor add provisions to its term sheet to address future financing needs. Specifically, these provisions could include the necessity for the SGB to trend toward 20 to 25 percent growth over three to five years. Around year three, the debt investor could require a business plan that details how the business will scale its operations. Both of these additional terms should increase the probability of the loan being repaid on time as well as prepare the SGB for equity investment.

Another argument for syndication from an equity investor's point of view is that syndication would allow a higher level of liquidity in the market. Equity investors may be in a position to retire the last portions of debt instruments provided by earlier syndicate players, converting that amount to an equity share at a time when the value of an SGB is higher and its long-term prospects are more certain. Empirically, SGB investors are experiencing later time horizons than initially expected. In part, this is not the choice of the impact investor community, but a necessity because of the absence of market mechanisms allowing for timely exits. Mechanisms to attract up-round capital need to be created for equity investors within a syndicate to see a consistent appreciation of their holdings.

Organizations that primarily invest through equity (social funds and social venture capital funds), have high return expectations, with many funds targeting a market rate of return. In alternative asset markets, this typically translates to a 22 percent IRR. Although not impossible, it is difficult to accomplish this IRR on a consistent basis across developing markets due to the nature of the social impact sector and its lack of exit opportunities. As shown in the chart below, the lifespan of an equity investment is made in the form of preferred equity, which carries a 6 percent coupon yield. It is assumed by the investor that the SGB will either be acquired or the investor's equity share would be bought back in five years. Because the investor is targeting a market rate of return, the assumption is that 6 percent of the IRR will come from an annual coupon payment, while the rest of the returns will be generated by the capital appreciation on the equity at the time of exit.

Preferred Equity – 6% Coupon

Year	5	6	7	8	9	10	11	12
IRR	22.00%	18.45%	15.98%	14.15%	12.74%	11.62%	10.71%	9.95%

Common Equity – No Coupon

Year	5	6	7	8	9	10	11	12
IRR	22.00%	18.02%	15.26%	13.23%	11.68%	10.45%	9.46%	8.64%

As illustrated in the Preferred and Common Equity tables, the IRR is cut in half after year 10. While this may seem extreme, our research suggests that it is not unusual to see an investment's time horizon extend far further than expected. Even if the exit is delayed by two years, the fund will underperform its benchmark by more than 5 percent.

In the first example, the annual dividend payout helped cushion the IRR decay, since the investor receives the dividend as long as the equity is held. If there is no dividend instrument to the investment, the IRR decays at a much more alarming rate, resulting in the fund underperforming its benchmark by more than 7.5 percent if the exit is delayed by two years.

Some financial-first investors have accepted 22 percent as a performance benchmark in the impact sector because 22 percent is the benchmark for other alternative asset classes such as hedge funds, private equity, and venture capital. These return expectations are driven by the risk that is involved in each investment, thus resulting in a higher expected return than other traditional asset classes such as public equity and fixed income. However, as modern portfolio theory continues to make advances in defining risk, new innovations in quantifying risk could prove to benefit the impact sector.

“Additional sources of capital are usually welcome... But if you are asking if there is need for a Goldman Sachs for impact investing, the answer is yes.”

– a Social Fund

Impact-first versus Financial-first

Drawing a distinction between “impact-first” and “financial-first” investors is important to understand the potential for syndication. “Impact-first” investors such as foundations and nonprofits state that the primary goal of their investment is to drive social benefit. We observed that because market rates of return have not typically been experienced in underserved regions of the world, having a financial-first approach could disqualify worthy businesses in the social capital sector from funding. However, many organizations we interviewed believe that financial-first metrics enable SGBs to grow and ultimately benefit the most number of people.

Financial-first investors argue that any business, whether social or profit focused, should ultimately transition to a company that can scale and provide returns to its investors. It is not sustainable for a business to depend on contributed income from grants, government subsidies, or soft loans. Because the investments made by financial-first investors are generally in the form of quasi-equity or equity, these investors attempt to augment their risk by playing a much more active role guiding the operation of the SGB. Guidance takes the form of board representation and regular mentoring. Financial-first investors also state that because expected returns can be generated through scaling the business (a stage of the SGB life cycle that impact-first investors typically do not participate in), they allow the SGB to reach more people and therefore create more social impact than an impact investor may create.

“Financially focused companies have more of a chance of reaching scale and social impact.”

– a Social Venture Capital Fund

Our research indicates that nearly all of the currently utilized social return metrics can be grouped into three categories: *depth impact*, *scale impact*, and *overall economic impact*. (For a comparison of *depth impact* and *scale impact*, see Desa and Koch, 2010.) *Depth impact* refers to the degree to which a person's life is affected and subsequently improved by the goods or services of an SGB. *Scale impact* refers to the number of people whose lives are impacted. Although the goal is to achieve superior ratings in both metrics, an SGB typically starts out addressing one, with the intention of ultimately moving to a model to address both. It should be noted that although *overall economic impact* is an organizational metric listed by many investors, it appears to be a qualitative metric that can often overestimate the amount of economic development attributable to the investment in the SGB.

There is a fourth dimension to social impact that seems to be overlooked by both impact- and financial-first investors: the *operating life* of an SGB. An organization's ability to sustain long term is typically not factored into the social impact that is being made by an SGB. It is implicit that an SGB will increase the number of beneficiaries the longer it has been in existence; neglecting to factor in longevity vastly understates the impact of mature SGBs.

To illustrate *depth impact* and *scale impact*, we examined two social enterprises, D.Light and Anudip. D.Light is a social enterprise that operates in 20 countries and provides solar flashlights at very low cost, allowing its product to positively impact the BoP market (for additional details on D.Light, see page 39). Anudip works in India providing skills development to people living below the poverty line, placing them in knowledge-economy jobs or businesses. Although Anudip makes a *deep impact* on the lives of its target market, its scale cannot approach the number of people that D.Light can reach, given the nature of its service and skills development model. Both of these SGBs are important and can create *overall economic impact*.

Anudip is an example of a livelihood services organization employing an earned income model to sustain its operations. As of 2011, Anudip has been

operating through donations and grants from India- and U.S.-based organizations whose foci have been primarily social impact. Anudip has successfully trained and placed more than 5,000 youth and women in jobs that have more than tripled their daily incomes. After achieving the milestones laid out by its initial grantmakers (training and placing X number of people and becoming Y percent sustainable), Anudip is now applying for a long-term loan with the intention of becoming fully sustainable in the next few years and scaling to other regions in India. As Anudip achieves its goal of 100 percent sustainability, it will become more attractive to financial-first investors. Financial-first investors will likely look at scaling the business even further in order to generate cash flow with lower expense ratios, which can achieve a competitive return in addition to social impact.

Assume that by year seven, Anudip is completely sustainable and receives an equity investment that allows it to scale and guarantees that it will continue to operate for another five years. During those five years, Anudip could penetrate other regions, eventually scaling throughout India and moving into other nearby countries. It could be expected that from a *depth impact* and *scale impact* point of view, social impact will increase at a rate that will be less linear and more exponential.

Consider what would happen if Anudip was not successful in becoming 100 percent sustainable by the time the loan needs to be repaid. It would not qualify for investment from financial-first investors, resulting in a need to apply for another grant or soft loan. Since the previous soft loan was given under the assumption of becoming fully sustainable, the odds of receiving another loan are low. From the grantmaker's perspective, the demand is simply too high for foundations to give another grant to an SGB that was not able to capitalize on the first grant. For example, if Anudip were to go to a foundation and request a grant, the foundation would have to decide whether their capital should go to Anudip, or to the many new social enterprises that claim that their business will be the next D.Light or BetterWorldBooks. Because the business is not fully sustainable, it would be only a matter of time before cash flow problems force Anudip to shut down.

So, assuming an equity investment guarantees that Anudip can operate for another five years, what is the social value of those five years? Anudip projects that over five years it will have cumulatively generated 40,000 new livelihoods. Because Anudip's forecasting assumes that each person who is trained and placed in a job is a member of a family of six, the result is an estimated 240,000 lives positively impacted with the use of investment proceeds. The vast majority of Anudip's trainees are the sole income earners in their families. While the unit economics of D.Light is a calculation of the number of products it sells, the unit economics for Anudip has to be calculated taking the income earned over the person's lifetime and the purchasing power it brings to the local community.

If Anudip is not sustainable, how many grants must a foundation give in order to affect the same amount of people? Since Anudip impacted 30,000 lives in its first five years of operations (5,000 people trained times six members in each family), it follows that the foundation would have to give grants to six entrepreneurs in order to achieve the impact Anudip would scale to in its second five years.

This also assumes those six businesses can operate with the same efficiency as Anudip and will each help 30,000 people over the next five years, coming close to matching Anudip's projected 240,000 people. It should be noted that Anudip is forecasting this *overall economic impact* assuming they get approved for a loan and additional equity funding. An equity investor may push Anudip to scale even more quickly. Although Anudip does not represent the social sector as a whole, it is interesting to note that an investment made in year five has six times the social impact as an investment made at inception. The point is to illustrate that although an SGB may be designated as financially focused, its social impact can also be substantial.

Although the merit of impact-first versus financial-first business models can be debated, investors pursuing both aims are dependent on each other to achieve success. Financial-first impact investors would have little deal flow if it were not for the first loss and development capital preceding their investments. Because social venture capital funds have obligations to their limited partners, they cannot afford to invest first loss capital into a company with merely hope of it becoming investment ready in the future. Impact-first investors are reliant on financial-first investors to pick up where their grant or soft loan capital ends and take the SGB to the scaling phase to maximize social benefit.

Many early stage participants end their capital support before an SGB has reached self-sustaining operations. We suggest this is due to the lack of time and resources rather than a perceived lack of importance. The number of start-up SGBs in their first year of business is an order of magnitude larger than the number of SGBs who have been in operation for at least one year making it difficult for those deploying capital at the beginning of the SGB life cycle to expand their focus further down the road without neglecting the SGBs at the beginning who are seeking funding. Although impact investors should guide their investments to success beyond the effective use of their capital, coordination with financial-first investors is the most important step.

Organizations with stable sources of capital or longer-term endowments (e.g., Omidyar Network and Rockefeller Foundation) are less risk averse when making investments. Hence, organizations that are required to raise capital on an annual basis or frequent basis are much more cautious in their investment decision as poor performance makes a future raise difficult. Thus, these organizations should focus on short-term loans when syndicating with

“It is critical to have different types of funders at different points in the social enterprise's life cycle. That allows for making the enterprise replicable, sustainable, and thereby scalable. We would love partners that can do the follow-on investments.”

– Radha Basu, Founder of Anudip

other investors. By focusing on investments with a short time horizon, the nonsystematic risk factors that are associated with raising capital on an annual basis are less likely to affect the success of their portfolio SGBs. If those organizations (e.g., Root Capital and

Grassroots Business Fund) with less predictable capital flows were to invest in long-term convertible debt or equity instruments, the volatility of those returns could adversely affect their ability to raise future capital.

EXAMPLES FROM THE FIELD

Investor Syndication Example by Gray Ghost Ventures

A syndication example shared by Gray Ghost Ventures highlights how one investor was able to horizontally aggregate capital. Arun Gore, managing director and principal of Gray Ghost Ventures, offered to discuss his firm's experience with syndication, in this case, with their investment in D.Light Designs.

Gray Ghost was the first investor in D.Light, following D.Light's initial grant phase, and invested by using a convertible note that gave Gray Ghost a seat on D.Light's board of directors. When D.Light was ready to raise capital in a Series A equity offering, Gray Ghost informed other investors such as Omidyar Network and Acumen Fund, leading to broader participation in the equity offering. In each subsequent phase of the business life cycle, Gray Ghost worked closely with D.Light to attract new investors and increased its own investment in D.Light.

In this example, the benefits of syndication can be evaluated from financial and operational perspectives. Financially, Gray Ghost benefited from the company development enabled by its initial grant. Later, Gray Ghost's decision to reach out to other like-minded investors resulted in D.Light raising more capital than it may have been able to raise from any single investor. This allowed D.Light's management to focus on running the business rather than finding its next source of capital. Gray Ghost also assisted in attracting new investors by willingly sharing its due diligence and verification with follow-on investors. Spreading investment risk and its due diligence is a benefit for investors participating in this syndicate.

Operationally, syndication allows greater diversification of investors in ways that can favorably impact the SGB. When D.Light decided it wanted to expand to Africa, it approached its investors for assistance. Although Gray Ghost did not have expertise working in Africa, it called on Acumen Fund, which had multiple investments in Africa and was able assist D.Light in hiring a local work force as well as in creating local distribution networks. As SGBs saturate their local markets and pursue opportunities to scale their operations, investor expertise could prove to be pivotal in determining whether or not the SGB can successfully penetrate new markets.

Investor Syndication Example by D. Capital Partners

To illustrate the impact that local business leaders can have on a business, we highlight the efforts of D. Capital Partners. D. Capital is a global advisory firm that assists private investors, family offices and foundations put capital to work in emerging markets through impact investments. For this study, we will be focusing on one of their client's investments in a South

American fruit exporter to demonstrate how bringing together a syndicate that can offer complementary skill sets adds beneficial value to an SGB.

D. Capital is the investment advisor to a private foundation that makes investments in agribusinesses and supply chain businesses in developing countries.

The foundation had historically been active in the primary production of a fruit value chain and was interested in vertically integrating into the packaging and exporting business. Together with its client and various network contacts, D. Capital identified and convened different business leaders active or interested in co-investing alongside the foundation in the investment target that was identified through a diligent vetting process. Though the private foundation kept social impact at the top of its decision, each member in the syndicate viewed this as a good investment opportunity.

D. Capital did not have a presence near the business and thus the involvement of the two local business leaders was crucial for several reasons. First, it was the local leaders who helped traverse the company through the complex legal system of the country where it operated. One business leader brings rigor

around financial processes while the other brings a level of operational acumen to the team. The two local business leaders play integral roles on the audit committee of the business. By working so closely with the business, the business greatly benefited from a financial and operational standpoint and the business has grown significantly since the start of D. Capital's client investment and involvement. The local business leaders understand the local business environment and have been able to add significant local knowledge to the investor syndicate.

In addition, it provided corporate governance measures for the business and mentoring assistance that proved valuable to the business. Through the use of partnerships and the creation of a syndicate bringing in local experts, D. Capital Partners enabled the business to grow from a small, cash break-even business to a scaling and profitable, medium-sized company.

Capital Aggregator Example by Toniic

Toniic was formed in 2010 as an international network of impact investors, primarily comprised of individuals (impact angels). It is structured as a member network and does not aggregate capital into a fund. Instead, Toniic promotes syndication of member investment appetite into SGBs within its robust deal flow. Investment candidates are collectively sourced from members. This brings existing diligence and an existing working relationship with the entrepreneur to the investment consideration. A committee screens the nominated SGBs and the most promising are discussed at monthly member meetings. Members also share best practices and experience. Toniic is also an example of an early stage effort to facilitate syndication across key investment terms. Given the active profile of Toniic's staff and management team, they are regularly made aware of opportunities across multiple sectors, which are added to the screening process.

The membership now includes several impact funds and family foundations, some of who were interviewed for this report. Members benefit from a deal flow they would not have sourced on their own. It is a huge strength. An SGB is not a "Toniic deal" unless at least two Toniic members have syndicated their investment. The pace of Toniic syndication over the past 12 months places Toniic as one of the most active organizations in impact investing.

Toniic foresees more opportunities for phased-investing as SGBs in the marketplace mature. Because Toniic's members range from wealthy individuals to social venture capital funds, they provide enough diversity for Toniic to facilitate multiple phases of the syndication process. In addition, Toniic members enjoy reduced pre-investment costs when they share in deals with other investors. Although the value is difficult to quantify, Toniic members share due diligence and other key insights about the SGBs with one another, greatly decreasing the up-front work required by an interested investor.

APPENDIX

Illustration of Phased Investing

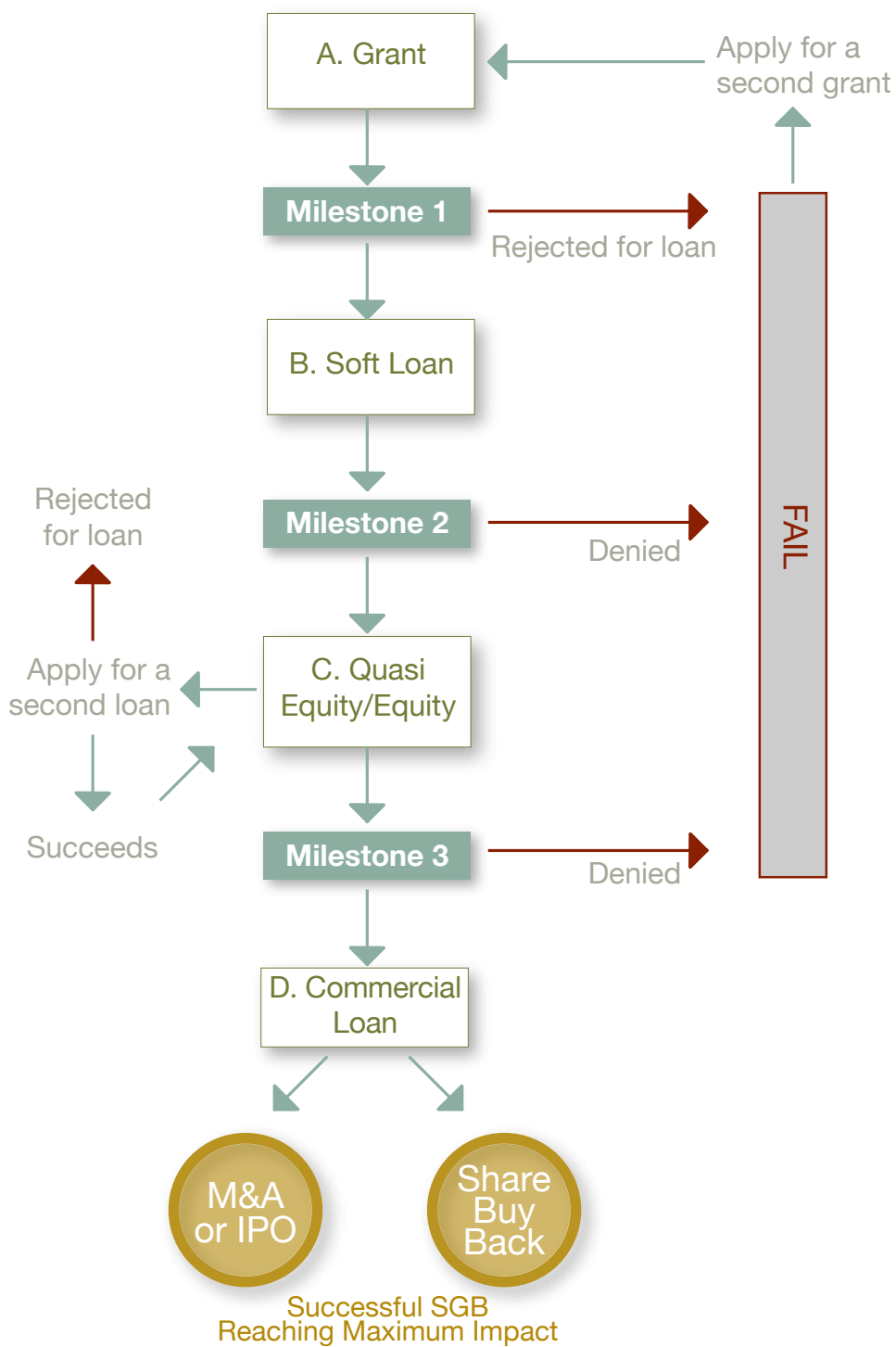


Figure 9. Illustration of Phased Investing

Comparison of Terms and Suggestions for Transition Milestones Encouraging Syndication

Existing:	Suggested Additions for Transition:
<p>Grant Milestones</p> <ul style="list-style-type: none"> ○ Product or service formation ○ Job creation ○ Target beneficiaries and affordability are identified ○ Beneficial outcomes are delivered and measured ○ Required infrastructure (plant, equipment, distribution lines, etc.) is built 	<p>Transition from Grant to Soft Loan</p> <ul style="list-style-type: none"> ○ Revenue absorbs 70% or greater of operating expenses ○ Scale: revenue is growing faster than expenses ○ Banking relationship is established ○ For-profit accounting standards are in place ○ Management team is built out ○ Legal and tax structure is formed
<p>Soft Loan Milestones</p> <ul style="list-style-type: none"> ○ Book value of assets is maintained ○ Receivables are growing faster than payables ○ Revenue is at 70% of expense ○ Clear path to cash flow break even (CFBE) ○ Product or service replication is established 	<p>Transition from Soft Loan to Quasi Equity/Equity</p> <ul style="list-style-type: none"> ○ Business plan and forecast for growth is in place ○ Enterprise value is measured ○ Core economic unit is established (minimum operations required for profitability) ○ An independent governance structure is formed ○ Critical supplier contracts are completed ○ Critical distribution contracts are completed ○ Key customer agreements are in place
<p>Quasi-Equity/Equity Milestones</p> <ul style="list-style-type: none"> ○ Proven social return ○ Favorable margins (gross, operating, and profit) ○ Strong 3-year business plan ○ 3-year growth forecasts ○ Legal structure that allows equity ○ Critical customer and supplier contracts in place ○ Independent governance structure 	<p>Transition from Equity to Commercial Loan</p> <ul style="list-style-type: none"> ○ Established banking and credit relationship ○ Quick ratio of 1.5 or greater ○ Greater than 10% net profit margins ○ Greater than 20% revenue growth

Acronyms

ANDE Aspen Network of Development Entrepreneurs

BoP Base of the pyramid

CDO Capacity development organization

CSTS Center for Science, Technology, and Society

GSBI Global Social Benefit Incubator

NGO Non-governmental organization

SGB Small and growing business

Glossary

Base of the pyramid: The “base of the pyramid” describes groups of people in emerging markets who earn less than \$3,000 a year (World Resource Institute).

Capital aggregator: An entity responsible for identifying suitable investment opportunities for its clientele. This differs from a social fund in that the capital aggregator serves as an advisor and does not have discretion over investor funds.

Co-investing: Multiple investors pooling together capital at one point in time to make a combined investment in an SGB.

Commercial loan: A debt instrument with a longer maturity and an interest rate that is more reflective of the risk associated with the SGB.

Convertible debt: A debt instrument that carries the option of being traded in for an equity interest in the SGB.

Family home office: An investment entity set up by a high net worth individual in order to execute the investment objectives of the individual.

Horizontal aggregation: The process of syndicating distinct pools of impact capital matched to the various growth phases of an SGB’s development.

Impact investing: Actively directing capital toward businesses that generate social and/or environmental good.

Internal syndication: When a single entity participates/invests in multiple phases of a single SGB (i.e., initially giving an SGB a grant, followed by a soft loan at a future financing).

Non-governmental organization: An organization that is registered as a nonprofit entity according to the rules/regulations of the country in which it is based.

Small and growing business: Commercially viable businesses that have significant potential for growth and social impact in the area where they operate. Typically they seek capital from \$20,000 to \$2 million (as defined by ANDE).

Social fund: An investment entity that is focused on social impact but has an obligation to its investors to generate a below market rate of return.

Social venture capital fund: An investment entity that is focused on social impact but generally aims to generate a competitive market rate of return.

Soft loan: A short-term debt instrument (usually one- to three-year maturity) that carries a below market rate of interest.

Syndication: Two or more investors agree to support the same investment either at a moment in time or with staged investment based on milestones.

Trade credit: When a supplier of goods or services provides credit to a customer, allowing the customer to pay for the goods or services at a later date.

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We invite reader comments.

Please direct queries about this report to its lead authors at sts@scu.edu.

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