

Investing for impact



Private equity has long been recognised as a tool for economic development, yet it's only over the last few years that it has been possible for investors with a social objective to target the asset class in any meaningful way. Now, social impact investing is becoming big business and it's in desperate need of some reporting tools. Vicky Meek reports

Social impact investing is a hot issue right now. A new movement is gathering pace that attempts to draw together the financial objectives of making investment returns with an altogether more altruistic aim of improving people's lot. "We're seeing a real push-back from the hey-days of the late 1980s and 1990s when everything was focused on pure capital accumulation," says Randall Kempner, executive director of the Aspen Network of Development Entrepreneurs (ANDE). "We are seeing a shift in values as people set different goals for themselves and work out what they want their impact on the world to be. This is being driven by the climate change threat, but is also being precipitated by the economic crisis as people see that the old models don't work."

The trend is illustrated by a new report issued by the International Finance Corporation (IFC) and carried out by the Economist Intelligence Unit. The study, *Sustainable Investing in Emerging Markets: Unscathed by the Financial Crisis*, found that environmental, social and governance (ESG) investment criteria are more important now to respondents (made up of multinationals and asset managers in emerging markets) than they were immediately before the crisis in 2007. "The financial meltdown has brought under scrutiny traditional investment methodology where financial returns are the sole basis of analysis," the IFC said. "Including ESG factors in the investment process casts a wider net on companies' operations and considers their longer term sustainability."

There is also a growing realisation that aid on its own is not enough to improve the lives of the billions of people still in poverty across the world. Even non-governmental organisations are now coming round to the idea that aid is not a sustainable form of relief and in some cases may aggravate problems. Some governments are also starting to push for other alternatives. "The cycle of poverty and aid is durable," said Rwanda's president Paul Kagame in the *Financial Times* earlier this year. "As long as poor nations are focused on receiving aid, they will not work to improve their economies. Nobody owes Rwandans anything. Government activities should focus on supporting entrepreneurship because it unlocks people's minds, fosters innovation and enables people to exercise their talents."

The wider agenda

Private equity in emerging markets is uniquely positioned to do precisely that: support entrepreneurship. Its involvement with portfolio companies provides the expertise growing businesses need to expand. Its governance structure, with private equity fund managers on the board of investee companies, also enables it to ensure that the highest standards of corporate responsibility are being adhered to. "I believe very strongly that, assuming they are run correctly, private equity funds can be good, not just for employment and good returns, but have a wider impact," says Doug Miller, founder and honorary president of the European Venture Philanthropy Association.

"As long as the companies they invest in have certain standards of governance and corporate social responsibility, they can be a highly positive force in helping to develop economies and alleviate poverty. This is more sustainable and effective than giving central governments aid packages."

It's hardly surprising, then, that when the world is looking for commercial solutions to alleviating poverty, private equity is increasingly being seen as an essential tool.

Of course, development finance institutions have been investing in private equity for years, if not decades, as a means of achieving their goals. It's long been thought that private equity investment can kick-start nascent economies. But there are now other investors hoping to harness the potential private equity has for helping to alleviate poverty. "We are seeing the rise of the impact investor and some of those are getting more interested in private equity," says Kyle Peterson of ANDE. "There is a lot more interest among foundations such as the Kellogg's foundation and the Bill and Melinda Gates Foundation in using their balance sheet to offer loans and private equity fund investments. There has been a recognition over the last 18 months about the power of private equity."

Aureos's new US\$100m Health in Africa Fund is a case in point. With capital from the usual suspects of development finance institutions such as the IFC, the African Development Bank and Deutsche Investitions- und Entwicklungsgesellschaft, the fund also has funding from the Gates Foundation. It has so far reached a first close at US\$57m.

New model

Yet the involvement of an investor such as the Gates Foundation places an altogether different emphasis on the way in which the fund operates and rewards its managers. The fund is designed to incentivise managers to achieve maximum financial returns, but it will also be judged on the social impact it has on the communities whose lives investee companies touch and managers will be rewarded accordingly. The theory is that those managing the fund will work to ensure that its investee companies extend healthcare services to a wider proportion of the African population in a sustainable manner because the financial and social goals of the fund are aligned.

Yet one of the problems with this approach is that it is incredibly hard to measure social returns. Private equity associa-

tions in more developed markets have been putting together economic impact studies on private equity for several years now, yet they show aggregated results. The fact is that there is as yet no standard model for measuring social returns.

It's an issue that African Agricultural Capital (AAC), a firm established in 2005 with capital from the Rockefeller Foundation and the Gatsby Trust, has been grappling with. "When we started out, we developed a system for monitoring the developmental impact of our investments," says Tom Adlam, managing director of AAC. "We took baseline figures on areas such as the number of people employed in the company at the point of investment and measured growth from that on an annual basis. This is OK as far as it goes, but it has limitations, especially when you look at the way in which you might devise the fund's reward system."

AAC is set to launch its second fund next year and wants to reflect the social impact of its investments in its reward system. Under a new scheme, carried interest will be split so that 10% is paid out on financial returns and 10% on social ones. The new system uses five proxy indicators for development, including the growth in the number of people affected by a portfolio company, the estimated increase in household income as a direct effect of the investment and growth in its payments to government.

CDC Group has also been tackling the issue. It launched its first ever social report over the summer. A 100-page document, *Growth for Development* could hardly be criticised for lacking detail. "Given our mandate of alleviating poverty, we see this report as significant as our financial report," says Shonaid Jemmett-Page, COO at CDC.

Jemmett-Page says CDC had always planned to produce such a report but that devising a means by which it should measure development has taken considerable time. "CDC Group was completely reconstituted five years ago as a fund of funds, which meant that we had a different business model from the one we'd be working to historically," she says. "That had to bed down first – we've gone from having two fund investments to 59 in that space of time and along with that huge change, we had to come up with a system that evaluated our impact."

The demands that producing the CDC report have placed on the private equity funds in its portfolio have not been inconsiderable, she adds. "This has had a big im-

act on firms. We are asking them to gather a lot of data, some of which they wouldn't otherwise have to gather. It's been a hard process, but it's getting easier as firms have a better understanding now, as do we, of what we need. The report itself should help as it demonstrates to fund managers the effect of what they do."

The other point is that it is almost meaningless to measure social returns on an annual basis. Development takes place over a long time horizon and therefore needs to be measured as such. "You need to look at social returns over the long term," explains Adlam. "Often they will come after the financial returns. You have to keep measuring them right through to the close of the fund to see the real impact."

Reporting standards

It's clearly a tricky task to devise the right system, especially when so many of the elements are subjective and hard to quantify. Yet some believe that they will be able to come up with one that any social impact investor could implement. A new initiative has been set up by the Rockefeller Foundation, non-profit venture fund Acumen together with input from PricewaterhouseCoopers and Deloitte. Impact Reporting and Investment Standards (IRIS) is an attempt at a set of reporting standards. "We want to put together a common taxonomy of definitions," says Margot Brandenburg, associate director at the Rockefeller Foundation. "The problem is that for each measure, you have different parameters, so if you're looking at job creation, different fund managers would have different definitions. We'd like to bring some clarity to social reporting."

IRIS put version one out for consultation over the summer and had, according to Brandenburg, comments from over 150 organisations. The next stage is working on benchmarks, she adds, saying that version two should be ready next year.

If IRIS were to provide a clear set of reporting standards on social returns, it would be a huge step forward not only for funds that have a specific mandate for social change, but also for the private equity asset class as whole. "The old paradigm that it is obvious that you are doing good because you are investing in emerging markets no longer carries weight," says Adlam. "There is a far greater public and media focus on the financial world and there is a real need for managers to measure this and quantify what they are doing."