



A PRIMER ON INVESTING FOR IMPACT AND THE ROLE OF PHILANTHROPIC IMPACT INVESTING

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Impact investment

Coined in 2007 by the Rockefeller Foundationⁱ, the term “impact investing” was first used during an event to discuss the creation of a new global investment industry focused on achieving purposeful, positive social and environmental impact. It connects financial markets with the real economy by **supporting organizations that create positive social and environmental benefits in addition to financial returns.**

Despite ongoing discussion among practitioners and academics around the definition, motivation, intentions and scope of impact investing, two key elements are widely agreed upon, namely identifying an **intentional pre-determined social impact**, combined with some **analytical approach for impact measurement**.ⁱⁱ

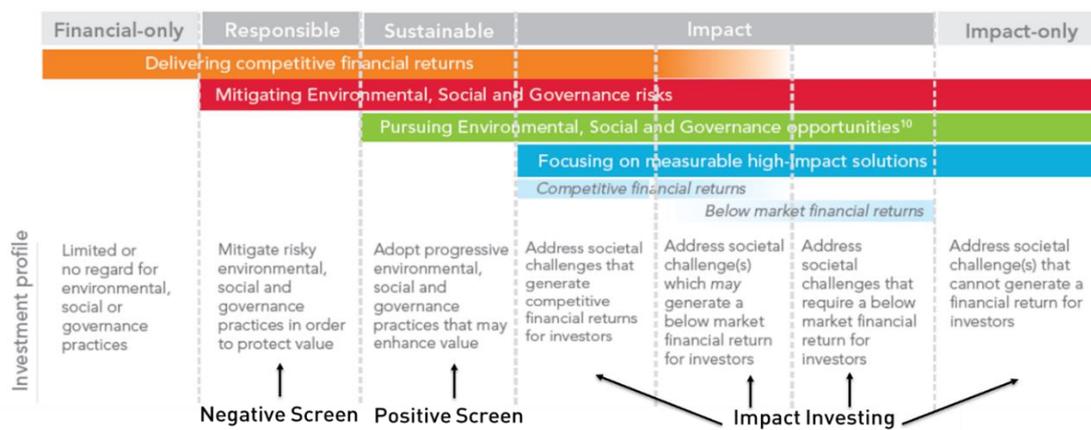
Another key aspect of impact investing is the **concept of “additionality”**. Brest and Born (2013) make the case for a wider view of impact investment through the concept of additionality, e.g. participation in an investment that increases the quantity or quality of a social or environmental outcome **beyond what would otherwise have occurred**.ⁱⁱⁱ Because impact investments often accrue in imperfect markets, non-concessionary funders may have the ability to circumvent market failures that a socially neutral investor may not observe, for instance by identifying potential hidden concessions in the form of risk or extra and costly due diligence that ordinary investors would not undertake. Based on this thinking, philanthropists and concessionary investors (i.e. investors who accept below-market returns) are key actors in the impact investing landscape.

The additionality principle encourages investors with scarce capital to concentrate their investments where it makes a difference.

Scope

The scope of impact investment is somewhat more controversial: Many practitioners see impact investing primarily through private equity and debt structures, whereas some authors also include public instruments among impact investments such as social impact or green bonds, or even publicly listed corporations. The broader the scope, the more difficult it becomes to differentiate impact investments from socially responsible investment (SRI) and/or environmental, social and governance (ESG) investment criteria increasingly pursued in public and private investor markets.

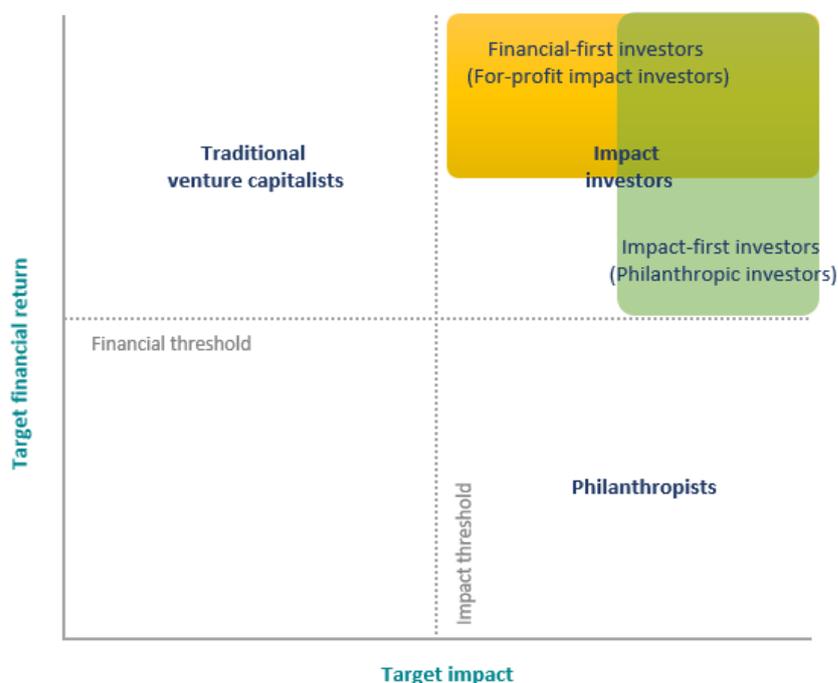
A useful way to think about the scope of impact investing was developed by Bridges Fund Management, a pioneer in the field of institutionalized investment firms, founded in 2002, with a special focus on sustainability and impact. Their model embeds impact investments within a spectrum of extremes ranging from “financial only” to “impact only.”



Source: Bridges Fund Management

According to the Global Impact Investing Network (GIIN), approximately 60% of impact investment assets were made through private equity or private debt vehicles, whereas the rest was executed through public instruments, real assets or other vehicles.

The **capital allocation decisions of impact investors involve a complex blend of logic** that relies on cultural and personal values as well as calculations of expected return on investment. The motivations of impact investors are varied: Philanthropic investors put impact first and may deliberately accept no or below-market financial returns, whereas for-profit impact investors seek to prioritize financial returns with a targeted social impact threshold.^{iv} This concept is often visualized through financial return and social impact floor, which is presented in the following figure.

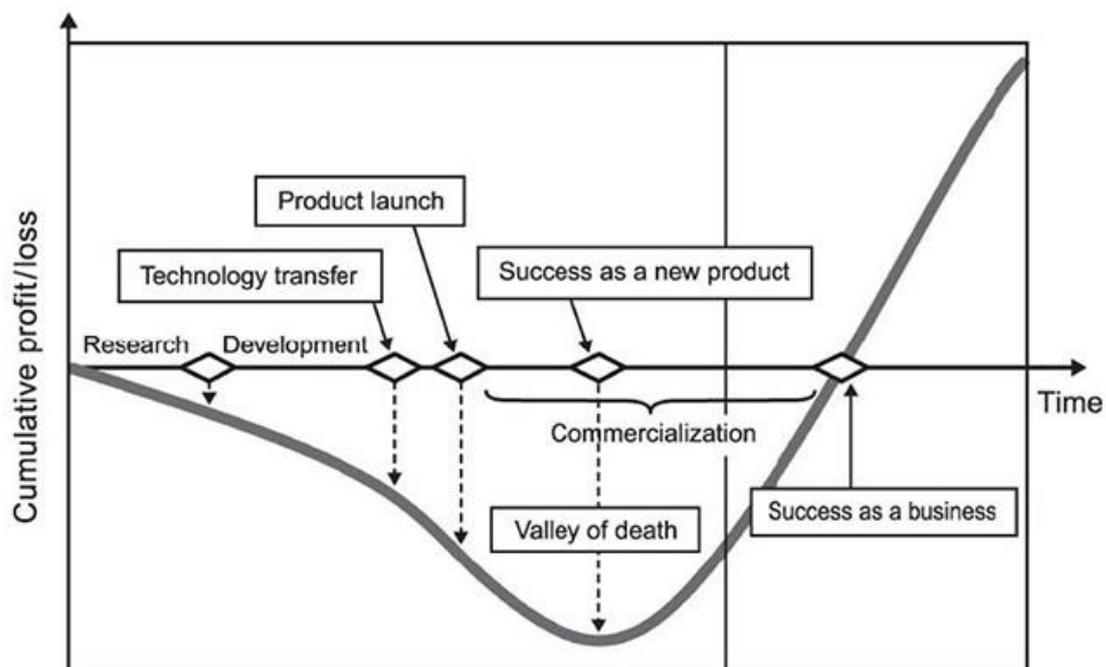


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Philanthropic impact investment

Philanthropic impact investment aims to create impact by supporting social enterprises building viable organizations and unlocking sustainable social innovations. Efforts to help new ventures navigate from a stage of proven start-up to early growth involves serious (i.e. multi-year) professional and personal commitments of key individuals and substantial resources (in the hundreds rather than the tens of thousands of USD often provided by traditional philanthropic gifts). Due to the many uncertainties combined with a lack of experience and resources at this early stage of enterprise development these commitments carry a high-risk profile.

Despite promises of an innovative business model to result in both financial success and social impact over the long term, a systematic expectation of positive financial return at this stage is simply not realistic: strategic and organizational viability is too uncertain, scale is too limited, and risk of failure is too high. From a purely commercial investor perspective, the small size of an investment relative to the high cost of both sourcing and performing due diligence, as well as the advice and support during an investment, put an additional burden on net returns that eats massively into the profitability of those (relatively few) candidates that evolve into profitable growth companies. An accurate characterization of this phase is the “Death Valley curve” that the Venture Capital industry sometimes use, referring to the dangerous phase in enterprise development when negative cash flows from operations need to be funded.



Philanthropic impact investment is best suited to overcome the challenges of the “Death Valley”-phase of social enterprise. Importantly, philanthropic impact investment is distinct from charity since it provides resources with the goal of generating a cash-on-cash return, therefore “investment.” However, as it does not systematically lead to positive financial net

returns within a reasonable time frame, this patient form of impact investment can be considered “philanthropic.”¹

A typical philanthropic impact investment size in terms of financial capital is between USD 300,000 -500,000. The risk of either complete failure or of middling performance without really taking off is substantial at this phase of enterprise development. The business model is usually not yet robust enough and exposed to gaps between ambitious social targets and commercial realities. Organizations are in constant flux, with inevitable disappointments regarding the performance of key people. Leadership teams are usually in transition from the charismatic and visionary, yet often not enough skilled, social entrepreneur towards a professional management team of experienced executives.

A philanthropic impact investment approach **differs from venture capitalists** since a clear, explicit and measurable impact goal is pursued, and capital follows more patient, longer term financial return expectations. It is also **different from traditional philanthropic giving** since a clear financial return expectation increases the focus on market solutions and hence a higher likelihood of longer-term sustainability.

Philanthropic impact investors integrate the socially oriented approach of charitable organizations with investment practices developed by traditional venture capitalists. They use tailored financial instruments such as grants, debt and equity/quasi-equity. Value-added services are similar to traditional venture capital, including:

- Contribution to strategy and governance (e.g. board seat)
- Leadership mentoring and development
- Fulfilling a networking and support role to facilitate connections between investees and other potential investors
- Helping to professionalize the investee through financial and accounting management, human resource services, or marketing and communications. However, compared to traditional venture capital, it is still difficult to find exit possibilities, and the social value of this work is often not (yet) reflected in the form of a premium.

Key criteria for positive investment recommendations include:

- The business model should be sufficiently visible and allow for a ballpark estimation of the targeted social impact.
- There should be an element of bringing a non-traditional solution to market that unlocks social innovation.
- A medium term (3-5 years) path to economic sustainability must be plausibly articulated. This should capture the market potential and how future competitors affect growing revenue and gross margin projections. It also requires an analysis of both one-time investments and regular running cost that provide a plausible path to break-even within 3-5 years.

¹ Balandina Jaquier clearly sets venture philanthropy apart from impact investing when return of principal is not required or expected ((Balandina Jaquier, 2011, S. p.20). With our three-stage model we disagree with this view and rather see impact investment opportunities gradually evolving through philanthropic stages up to systematic financial net returns.

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- Good ideas ultimately only become realized if combined with entrepreneurial energy and relevant skills: Therefore, the most critical criteria is the existence of either an individual entrepreneur or an entrepreneurial team that has the essential intrinsic entrepreneurial qualities and skills mix that are necessary to succeed.

Conclusion:

Impact investment is a rapidly growing phenomenon that has sparked enthusiasm across a wide range of actors, including investors, policy-makers, entrepreneurs and citizens. In the wake of the 2008 global financial crisis, impact investments are an important element towards building a more inclusive capitalism that serves society better. Such investments also can enhance effectiveness and efficiency to tackle the ongoing global economic, social and ecological crises of our time.

Rather than run the risk of distorting market mechanisms through unsustainable charitable gifts, the unique and differentiating mission of impact investors is to build better, more competitive markets by investing in businesses with potentially large social benefits, such as better livelihoods and perspectives for underprivileged people or a reduced ecological footprint on our planet.^v Those socially beneficial goods and services—be they improved value chains, solar panels, seeds, or medicines—are, after all, the “purpose” of businesses. Impact investors also understand that profit is a condition—and result of—achieving purpose. Comprehending this is critical to impact investors’ ability to leverage their scarce capital with that of traditional market-rate investors.

References:

ⁱ Harji, K., & Jackson, E. T. (2012). *Accelerating impact: Achievements, challenges and what's next in building the impact investing industry*. New York, NY: The Rockefeller Foundation

ⁱⁱ Grabenwarter, U., & Liechtenstein, H. (2011). *In Search of Gamma – an unconventional perspective on Impact Investing*. Barcelona: IESE.

ⁱⁱⁱ Brest, P., & Born, K. (2013). When can impact investing create real impact. *Stanford Social Innovation Review*, 11(4), 22-31.

^{iv} Höchstädter, A. K., & Scheck, B. (2015). What’s in a name: An analysis of impact investing understandings by academics and practitioners. *Journal of Business Ethics*, 132(2), 449-475.

^vhttps://ssir.org/articles/entry/almost_everything_you_know_about_impact_investing_is_wrong