FOUNDATION NORTH
Te Kaitiaki Pūtea ō Tāmaki ō Tai Tokerau

Impact Investment

Part One: An introduction to impact investing

Written by the Centre for Social Impact and the Ākina Foundation

CENTRE for SOCIAL IMPACT

ākina
Growing Social Enterprise

Purpose

Foundation North commissioned this report in order to better understand the nature of impact investing, and the possibilities it provides to increase the reach of a foundation's impact.

The original report was prepared by the Centre for Social Impact and the Ākina Foundation in 2017. It has been packaged into two publications for the benefit of community organisations, social enterprises and businesses and foundations in New Zealand.

These reports explore:

Part one: An introduction to impact investing

- The nature and scope of impact investing
- Who and what impact investment can support

Part two: Engaging in impact investing

- Considerations for foundations in New Zealand thinking about impact investment
- Illustrative examples of strategies for impact investing by foundations

The reports will be most useful to community organisations, social enterprises and social businesses that are interested in finding out more about impact investment (Part One) and to community, family and other philanthropic foundations that would like to find out more about how to engage with impact investing (Part Two).

Contents

Summary

Part one: An introduction to impact investing

Impact investing refers to investments made into companies, organisations, assets and funds with the intention to generate a positive social or environmental impact alongside a financial return. While impact investing is a small sub-set of the investment sector, the term still represents a broad range of activity, for example:

A "finance-first" impact fund seeks to deliver market-rate returns for investors while investing in businesses in sectors that are looking at achieving social or environmental outcomes

An "impact-first" fund will provide loans to social service providers or community groups at a below-market rate because they are unable to access finance elsewhere.

The impact investing sector has grown into a significant market internationally. The development of the sector around the world has been driven by the recognition that philanthropic and public funds are insufficient to address the scale of social and environmental challenges facing the world today.

The social sector itself has been transforming in order to find new ways of addressing these challenges, including the rise of trading charities, social enterprises, social businesses and social service providers that are engaging differently with governments. This has created the opportunity for impact investing to serve as an additional tool for financing organisations that are having a social impact.

Members of the Global Impact Investing Network (GIIN), founded in 2009, are now reporting an aggregate US$114 billion in funds under management (FUM). Charitable trusts and foundations are significant contributors to the sector, with a 2012 study undertaken by GIIN showing that investments made by charitable trusts and foundations account for just under 50% of the overall impact investing market.

Internationally, and in New Zealand, philanthropic funders are engaging in impact investment in order to:

- provide access to capital for social impact organisations that cannot access sufficient capital from mainstream philanthropic grant programmes, or other investors
- provide access to capital for social impact organisations where philanthropic capital alone is not sufficient to meet capital requirements
- increase the range of organisations that have a social or environmental impact e.g. social businesses
- increase the range of financing options for both funders and social impact organisations e.g. loans, patient capital, equity, quasi-equity and guarantees
- participate in investment activities (as investor, funder or capacity builder) with other parties in order to unlock new capital that creates impact and furthers mission
- make the available capital go further by 'recycling' funds over time so that the capital can be used more than once
- increase the impact of capital investments under management (compared with mainstream commercial investments) where assets can make a significant difference if intentionally invested for impact with an expected 'market-rate' return

The opportunity for the philanthropic sector is to engage in or leverage the following types of financing:

- **Seed:** patient capital that supports innovation and development of social impact organisations
- **Growth:** investment to scale social sector activities that are proven to work
- **Working capital:** supporting social sector organisations to deliver on large-scale contracts by providing up-front capital in the form of a loan
- **Asset purchase:** providing loans to social sector organisations to purchase large-scale assets that further their ability to deliver on social outcomes. Loans, rather than equity, are preferred, given the not-for-profit nature of the sector.

For organisations in the social sector, new and additional sources of capital such as these will increase their ability to access capital at a level that goes beyond what is traditionally available through grant funding.

In New Zealand, over 50% of social sector income now comes from trading activities. Despite this income generation capacity, the sector is not yet able to address society's challenges sustainably and at a scale that is necessary to overcome them.

These trading activities, however, mean that social sector organisations have capacity to service investment, and these organisations are increasingly seeking to learn more about how they can access this type of funding. This has resulted in a number of parties beginning to build investment infrastructure including managed investment funds, social finance intermediaries and social impact bonds. This new activity is only starting to scratch the surface of the demand. Much more will be required in order to make investment an accessible and efficient option for social sector organisations.

Part two: Engaging in impact investing

Internationally, philanthropic sector impact investment makes up almost half of the impact investing market, and in New Zealand, a number of community trusts and family foundations already engage in mission-related investment.

This report seeks to give practical considerations for engaging in impact investment. Any trust or foundation must act within the bounds of the law and its governing documents. While this report does not seek to give legal advice it does provide an understanding of the relevant duties, and clarifies that “prudent” investment and the “fiduciary duty” do not always require the maximisation of return according to its risk profile for each individual investment. For example, an investment made for the purposes of furthering a foundation’s charitable purposes or strategic programmes that provides a sub-market rate of return may still be prudent if there is careful consideration of the investment and how to offset this shortfall.

The report then sets some context for engaging in impact investing. It sets out the life stages of a trading enterprise and how investment is used to support its activities at each stage. It also explores the pros and cons of investing indirectly, through intermediaries, or directly into social impact organisations, including managing transaction costs, ensuring the right expertise is present, and the extent to which fit-for purpose support to social organisations can be achieved.

Finally, the report sets out some practical guidance on what to consider in determining if and how to engage in impact investment. Five illustrative strategies are provided that cater to different drivers for engaging in impact investment. These are presented for discussion and exploration of options to feed strategy development.

Should any organisation choose to pursue one or more of these options we would recommend that a more intensive strategy development and action planning process be carried out.

Part One: An introduction to impact investing

1. What is impact investing?

Impact investing refers to investments made into companies, organisations, assets and funds that are intended to generate a positive social or environmental impact alongside a financial return.[1] The practice of impact investing involves three core characteristics:

- **Intentionality** – an investor's intention to have a positive social or environmental impact through investments
- **Expectation of return** – the investment is expected to generate a financial return on capital or, at minimum, a return of capital
- **Impact measurement** – a commitment by the investee to measure and report on the social or environmental performance and the progress of underlying investments, ensuring transparency and accountability

1.1 Merging motivations

The practices and motivations of investment and philanthropy have traditionally been divided. Due to a number of factors, however, aspects of these worlds are now converging. This is creating an investment continuum, which links traditional investing with traditional philanthropy (grants) through sustainable and responsible investment, impact investment, and venture philanthropy. These approaches differ in the degree to which they integrate societal and financial considerations.

1 Definition from Global Impact Investing Network

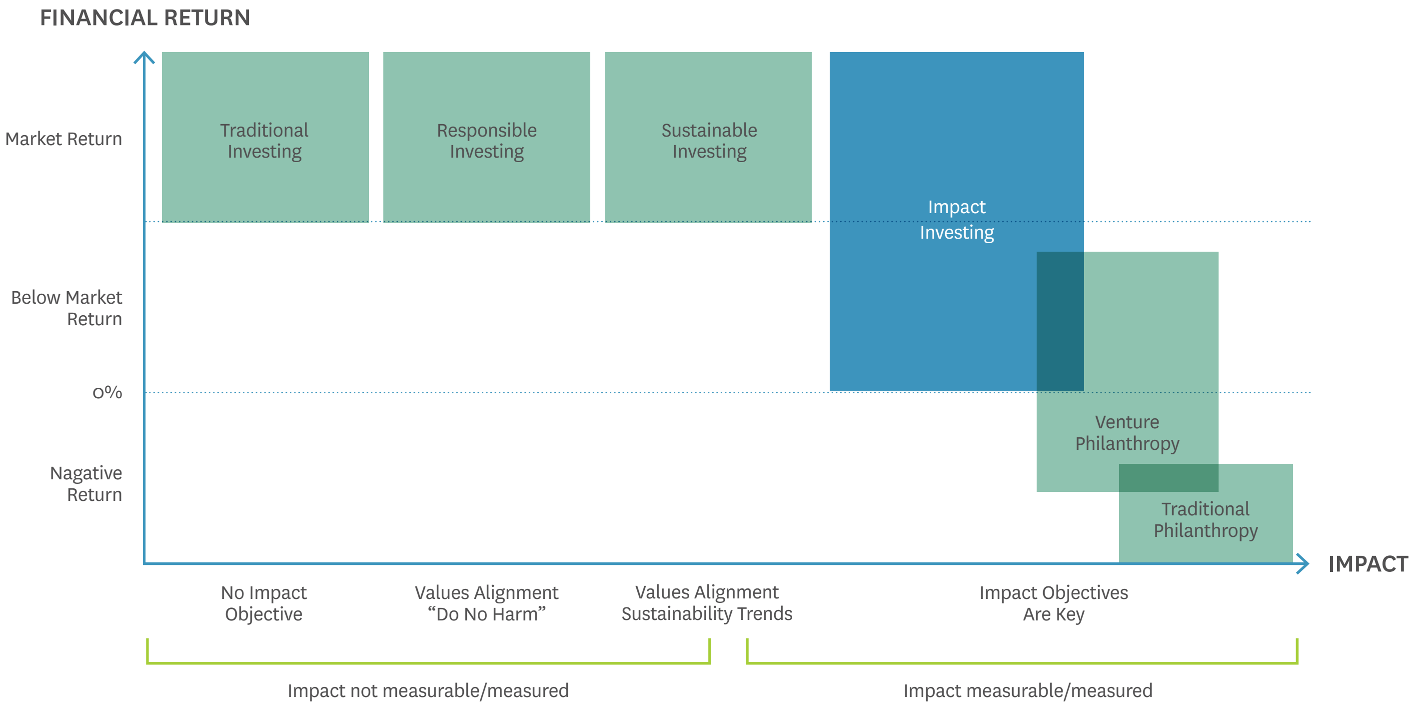


Figure 1: A new investment continuum[2]

Within the term "impact investing" there is a continuum of activity. An impact investment might focus primarily on financial returns (or "finance-first" impact investments), on impact ("impact-first" mission-related investments) or a mix of both. The performance of an impact investment fund must be considered in terms of the purpose for which it was designed.

2 *Catalyzing wealth for change, Julia Balandina Jaquier, 2016*

Table 1: Investment Options[3]

	Responsible Investment		Impact Investment	
Traditional investing	**Responsible investing**	**Sustainable (or ESG) investing**	**"Finance-first" impact investment**	**"Impact-first" mission-related investments**
Considers financial risk and return only	Attempts to screen out investments in stocks, companies and industries based on a set of ethical values.	Integrates environmental, social and governance criteria into investment decisions.	Looks for investments that have positive financial return as well as desired environmental, economic, or social impact.	Places investments in funds, companies or charities that are mission aligned. May require positive financial return or be "impact-first" where some, but not all, finance is returned.
Any investment with a financial return.	Excludes e.g. fossil fuels, private prisons, weapons trading.	Prefers funds/companies with demonstrably good sustainability performance.	May include investments in alternative/clean energy, education, health, underserved communities.	Investments in social service delivery, social enterprise startup, Social Investment Bonds.

The terms "responsible investment" and "impact investment" are indicative of slightly different intentions and assessment frameworks. Responsible investment focuses on a business's operations (e.g., environmental, employment, transparency policies and practices), ensuring that its business practices are ethical. Impact investing is about making a measurable positive impact on the world. It focuses on investing in organisations that are creating this impact.

In practice a single investment opportunity might satisfy the needs of both a responsible and impact investor. For example, a renewable energy company might create a measurable impact that benefits the environment. In doing so it may perform exceptionally well in its stewardship of natural resources (environmental criteria), and it may also act ethically towards employees and other stakeholders and report transparently on its activities and impact.

Finance-first

- Prioritises financial return.
- Designed to deliver financial returns at the level of comparable commercial investment funds.
- Financial instruments and impact measurement are often uniform to reduce the cost of running the fund.
- Impact measurement is less detailed (e.g. allow the investee to put forward some key indicators of success or may assign some metrics to report on based on the aims of the fund.)
- IRIS (Impact Reporting & Investment Standards) metrics are preferred so that funds can be compared against each other.[4]
- Usually invests in scalable social businesses or property-backed investments.

Mixed motive

- Focuses on high-impact investments that provide reasonable returns.
- May accept sub-market rate returns, but a return is still expected, rather than purely covering administrative costs.
- Robust impact measurement processes will be used, may not be bespoke for each investment.
- May invest in later-stage ventures, e.g. growth of social enterprises with proven solutions and business models, structured investments (e.g. SIBs, subordinated debt) or high growth social businesses tackling a very pressing social or environmental issue.

3 Adapted from Aon Hewitt Retirement and Investment Blog: www.retirementandinvestmentblog.aon.com/BlogHome/Blog/January-2017/A-(Re)Introduction-to-Responsible-Investing.aspx

4 IRIS metrics are an initiative of GIIN and represent a catalogue of industry best practice metrics for a variety of sectors.

Impact-first

- Designed to maximise impact.
- Financial instruments and measurement frameworks are tailored for each investment to best serve the subject of the investment and its intended impact.
- Often intends to cover costs rather than make a profit and may charge an interest rate as low as 1%, provide guarantees or even invest at a loss to leverage capital from other parties.
- Invests in trading charities, social enterprises or social service providers (e.g. SIBs) that address intractable social problems.
- Generally will have a programmatic focus rather than being a general impact fund.

There is now a substantial body of evidence that suggests that impact investing funds that are designed to provide market rate returns ("finance-first" impact funds) are not inherently disadvantaged because of their focus on impact. This means that a substantial proportion of impact investments don't require a trade-off between financial returns and social returns. A report undertaken by Cambridge Associates and GIIN reviewed 51 private impact investing funds and found the performance of the two benchmark groups is broadly on par.[5]

2. What's driving these developments?

In New Zealand and comparable countries, demand for impact investing is developing as a result of the changing landscape of organisations focused on the provision of community benefit and social services. This includes:

- An increase in community-based organisations taking ownership of local assets and local service delivery. In the UK, where multi-year data is available, a 2015 report recorded that the community shares market had raised almost £60 million since 2009, with upwards of £20 million raised in 2014 alone, bringing more than 60,000 new investors into the ownership of local assets and services.[6]
- An increasing focus on the benefits of self-sustainability resulted in increased trading activity in the charity and non-profit sector, and increasing numbers of social enterprises. In New Zealand, charitable income from traded goods and services increased from around $5 billion in 2004 to almost $9 billion in 2013[7]. In Scotland, 42% of social enterprises have been established in the last 10 years.[8]
- Changes in public sector commissioning (contracting for outcomes) and devolution of budgets to service users creating a new market for social service delivery (e.g. New Zealand's Disability Support Services Strategic Plan and the Australian National Disabilities Insurance Scheme).
- The scale of funds needed to scale successful interventions. The New Zealand Housing Foundation, for example, raised a $100 million fund to scale its successful intervention and become sustainable.

5 Introducing the Impact Investing Benchmark, Cambridge Associates and Global Impact Investing Network, 2015

6 Inside the Market, Community Shares Unit, Locality & UK Government, 2015

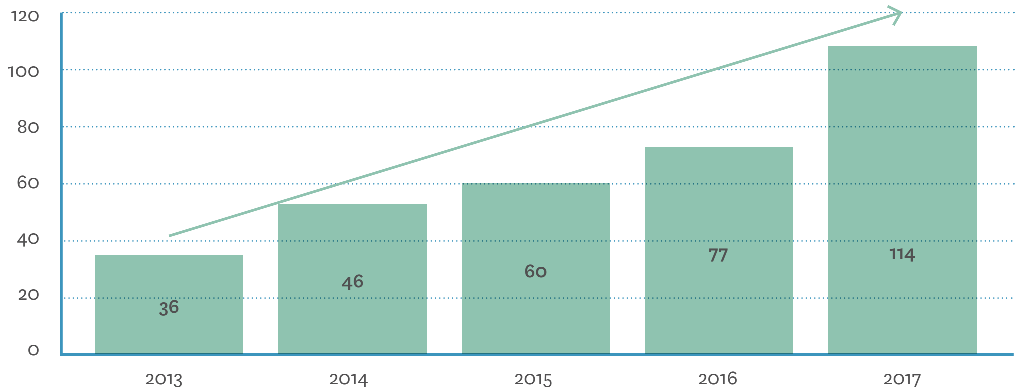
7 The Cause Report New Zealand, JBWere, 2017

8 Social Enteprise in Scotland Census, Social Value Lab, 2015

2.1 What's happening globally

Buoyed by government and legislative support, international impact investment markets have developed rapidly, with members of the Global Impact Investing Network (GIIN), founded in 2009, now boasting an aggregate US$114 billion in funds under management.

Figure 2: Global Impact Investing Network members FUM (US$ billions)[9]



In the UK, the latest figures released by the Government-backed impact investment wholesale fund, Big Society Capital[10] indicate that impact investments (funds under management) in the UK at the end of 2016 amounted to £1,950 million. This is an increase of 30% compared to 2015 figures, double the total market size that was projected by Boston Consulting Group in 2012. In addition, the average deal size had also risen from £108k to £144k, indicating an increasing confidence with investment on the demand side.

In Australia, the Federal Government has made a AUS$30 million commitment to develop a strong social impact investing (SII) market in Australia. The current market size (FUM) is reported to be AUS$4.1 billion[11].

It should also be noted that, globally, the philanthropic sector has driven innovation in this space. Charitable trusts and foundations made up 100% of the investors in the first social impact bond[12] and, alongside government, have been significant funders of Community Development Finance Intermediaries (CDFIs) and Social Investment Finance Intermediaries (SIFIs). They are continuing to play a key role in the development of impact investment. The below diagram from GIIN describes how philanthropic funds formed almost half of the overall impact investment market in 2012.

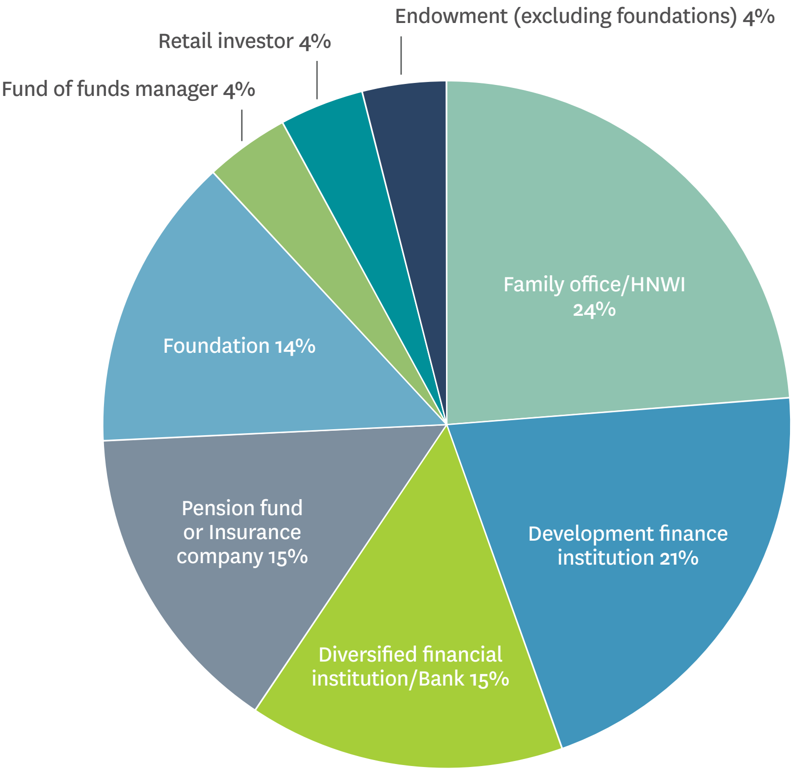
9 Global Impact Investment Network (GIIN), 2017

10 https://www.pioneerspost.com/news-views/20170731/big-society-capital-uk-social-investment-market-worth-2bn

11 Responsible Investment Benchmark Report 2017 Australia, RIAA, 2017

12 Impact Bond Database, Social Finance UK, <www.socialfinance.org.uk/database/>

Figure 3: Source of Funds for Impact Investment Fund Managers, 2012[13]



2.2 Social Impact Organisations

Terms such as "social enterprise" and "social business" are subject to substantial debate in New Zealand and internationally. It is most useful to focus on the activity the sector is trying to promote, which is the activity of trading in goods and services in order to deliver a social or environmental impact. It is the activity of trading in goods or services that allows an entity to be sustainable, or to scale up.

For the purposes of this report, any organisation that exists primarily to further social or environmental impact is referred to as a "social impact organisation". Examples of the range of forms that a social impact organisation can take are described in section 4.

13 Global Impact Investment Network (GIIN), 2012

2.3 The opportunity for social impact organisations seeking finance

Why do organisations seek impact investing rather than grants?

- Organisations may need a scale of finance that is not available from grants alone. The New Zealand Housing Foundation, for example, sought $100 million to scale their operations.
- There may not be a grant funder available with an aligned programme strategy or policy. This is commonly reported by social impact organisations that engage with the Ākina Foundation.
- Commercial investment instruments do not suit the needs of social impact organisations (e.g. equity, issuing shares, is the standard form of patient capital, but requires giving up ownership of the organisation which is undesirable and not possible for organisations that have not-for-profit legal structures).
- Commercial investors and finance providers will not engage with social impact organisations because they are unfamiliar with them and assume that transaction costs and investment risks will be high.[14]
- The costs of capital from commercial sources can be too high. Thought-Wired, a social business, struggled to get early-stage funding from angel investors because its financial projections could not show returns at the level that these investors expected).
- Investment relationships can add value because the investors often have experience and contacts and, once invested, have skin in the game.

3. The New Zealand context

New Zealand's not-for-profit (NFP) sector has an income of around $20 billion15 a year and supports a range of organisations and activities that benefit New Zealand communities. Funding from the philanthropic sector, however, even alongside public spending added, is not able to keep up with the demands of increasing social and environmental issues.

NFP trading activity has increased significantly over the last decade (now representing more than half of the overall sector's income), but the New Zealand social impact sector continues to face fundamental issues regarding scale and sustainability. This is consistent with the international experience.[16]

In addition to introducing a new source of revenue, trading activity unlocks the opportunity for NFPs to access a broader range of financing options. Demand for impact investment services in New Zealand indicates that the market is under-served both in terms of appropriate and aligned investment capital, and technical support to access investment.

As the 'enterprise' capacity in the NFP sector continues to grow, and the number of social enterprises and social businesses increases, impact investment represents an opportunity to expand the capital base available to the social impact sector. This in turn offers the potential to scale social and environmental solutions.

14 See Kilmarnock Case Study < http://akina.org.nz/venture/kilmarnock/>

15 The Cause Report New Zealand, JBWere, 2017

16 The Cause Report, JBWere, 2016

3.1 The demand for impact investing

In 2016 the Ākina Foundation issued a national survey to better understand the demand for impact investing in New Zealand. There were 109 respondent social impact organisations that shared their experience of impact investing. Some key takeaways are set out below:

- 50% of participants were not yet engaging in impact investment, but expressed a desire to see additional funding options
- 25% wanted to engage in impact investment but had no idea where to start – they did not know who provided it or who could support them to access it
- 5% were currently seeking impact investment and were able to service investment but were finding it incredibly difficult to find investors who would engage with them
- 10% had raised investment but reported that it had been a difficult and inefficient process. Many noted that the impact side of their business had been viewed by investors as an undesirable distraction from their trading activities
- 10% reported that they had either raised or were seeking impact investment, but were thinking of grant funding

Impact investing funds and other infrastructure are very new to the New Zealand market. There are currently a number of notable initiatives that are at varying stages of engaging with the market.

Initiatives in the New Zealand market

Strategy	Description
The Impact Enterprise Fund	The Ākina Foundation and New Ground Capital have partnered to build a "finance-first" impact investing fund. The fund will invest in high growth businesses that are having a measurable social and/or environmental impact and are incorporated in New Zealand. The fund seeks to make market-rate financial returns for investors and will focus on providing growth capital to ventures. The fund closed the first round with $8 million committed by investors at the end of 2017.
Soul Capital	Soul Capital is an early stage social finance intermediary. It will provide finance alongside support services to New Zealand social enterprises. Soul Capital made invested in Conscious Consumers with a record $2 million capital raise for international expansion at the end of 2017 [17].
New Zealand Government Social Impact Bond	Earlier this year the New Zealand Government launched its first social impact bond focused on getting people in South Auckland with medium-level mental health conditions back into work. This pilot scheme ($1.5 million invested) represents the continued willingness of the New Zealand Government to find alternative ways of financing social service provision. It has also been building its capability to engage with social service providers on the basis of contracting for outcomes.[18]

17 *http://www.scoop.co.nz/stories/BU1711/S00799/nz-social-enterprise-raises-2m-to-fuel-international-growth.htm*

18 *The* Ākina *Foundation, Accelerator for Results Programme.*

4. What types of organisation can take impact investment?

Impact investing has the potential to support any organisation, programme, or project that creates positive social or environmental outcomes and has the ability to repay the financial capital that it receives.

In order to repay capital, the entity receiving the investment must have a viable model that generates, or has the potential to generate, ongoing revenue. In nearly all cases revenues will be generated through the provision and trade of goods and/or services.

Typically, the following types of entity have the potential, and are in scope, to take on impact investment.

Trading charity

Description

Charity that undertakes trading activities to supplement their income. Any legal structure with charitable status. Sometimes the trading arm is a company that is wholly owned by the charity.

Example

Barnardos is a charitable trust that exists to support the wellbeing of children. It derives some of its income through the provision of early learning and childcare services.

Service provider

Description

A service provider that primarily contracts with government. May take various legal forms.

Example

Ngāpuhi Iwi Social Services was established to be a key service provider to Ngāpuhi, by Ngāpuhi. The service has a number of strategic relationships with key government agencies that enables it to provide comprehensive support.

Social enterprise

Description

An entity with a partial asset lock that sustains itself through trading activity and reinvests the majority of profits back into mission. Could be a company that is wholly or majority owned by a charitable trust or have charitable status. May also be a company that is structured so that the majority of profits must be re-invested.

Example

ĀKAU is a design and architecture studio based in Northland, New Zealand that engages young people in the design of real projects and products.

Social business / Mission-led business

Description

An entity that is able to distribute profits but whose primary purpose is to create and scale social impact. Generally, a Limited Liability Company.

Example

The William Pike Challenge is a subscription-based youth development programme sold directly into schools.

Special Purpose Vehicle

Description

A financial vehicle for a structured project or programme. Usually a limited company or limited partnership. Often owned in trust.

Example

The Murray-Darling Basin Balanced Water Fund was established to invest in permanent water rights. Its purpose is to achieve the objectives of securing water for agriculture, realising a financial return and restoring threatened wetlands

5. What role does investment play?

Impact investment is typically sought for any of the following purposes:

Purpose	Description
Seed	Patient capital[19] that provides resource to explore new products, services and business models. Capital might go directly into research and development or provide income so that individuals can dedicate their time to driving innovation.
Scale	Patient capital provided directly into an operational business on the basis of a validated business model and a solid growth strategy.
Working capital	Providing upfront capital to meet the costs of delivering a contract that will provide sufficient cash flow to repay the investment. Investing in social bonds is an example of this type of investment.
Asset purchase	Providing capital to purchase a premises or other form of large asset that an organisation has the ability to enable or provide revenue over time.

6.What forms of investment can different organisations take?

The legal form of an entity affects the investment instruments with which it is able to engage.

Given that some investment instruments are more suitable for certain purposes (e.g. equity for growth), this can provide an incentive to organisations to select a legal form based on their practical needs, or have multiple legal forms. For example, a registered charity is generally dependent on grants for seed funding as they are excluded from selling equity (i.e. shares in a company) and debt (unless soft/unsecured) is a poor instrument for growth capital, as it generally requires assets to secure the loan, and evidence of existing cash flow.

A Summary of capital options available to each legal form

	Grants	Equity	Patient debt	Secured Debt	
Charitable Trust	✓	✗	✓	✓	Requires security and existing cash flow
Trust	✓	✗	✓	✓	Requires security and existing cash flow
Incorporated Society	✓	✗	✓	✓	Requires security and existing cash flow
Limited Partnership	✓	✓	✓	✓	Requires security and existing cash flow
Co-operative Company	✓	✓	✓	✓	Requires security and existing cash flow
Company	✓	✓	✓	✓	Requires security and existing cash flow

19 Investments offered on a long-term basis (typically 5 years or longer) and on soft terms (e.g. capital/interest repayment holidays and at below-market interest rates).

7. What are the barriers to impact investment?

Beyond considerations of legal form, there are a number of other determinants that affect the ability of an entity to take on investment. Some of these reflect the readiness of the entity, and can be considered as 'demand-side' determinant or barriers. Others reflect accessing investment, and can be considered 'supply-side' determinant or barriers.

Barriers to impact investment: Organisations	
Barriers	**Description**
Investment literacy	- Understanding of investment concepts - Familiarity with language and terms - Realistic expectations of processes and requirements
Culture and attitude	- Comfort of leadership with taking an investment backed strategy - Buy-in from an informed governance group - Entrepreneurial mindset within management team
Viability of business model	- Robustness of business strategy and model - Ability to generate resource and service investment - Reliability of market – i.e. dependence of Government contracts could be a risk
Commercial capability	- Commercial capability of team - Operational management - Access to enabling professional networks and supports
Demonstration of impact	- Articulated impact model - Relevant results framework - Monitoring and reporting mechanisms
Capacity to engage in investment/capital raising processes	- Clarity of process and understanding of the demands - Efficiency and timeframe of process - Cost of participation in capital raising
Alignment	- Finding sources of appropriate and aligned finance exist

Barriers to impact investment: investors	
Barriers	**Description**
Visibility	- Sources of finance are promoted/accessible - Sources of finance are aligned in language and terminology
Suitability and affordability of products	- Investor seeks a compatible balance of social and financial returns - Terms and conditions are acceptable and don't undermine entity - Cost of capital is affordable - Instrument/product fits mission and organisational model
Compatibility / alignment with investor	- Education/sophistication of investor - Values alignment between parties - Communication/rapport between parties