Conference: SOCAP Europe, May 31, 2011

Panel Name: Transitioning from Non-Profit Loan Funds to For Profit Equity Funds

Panel Description:

Comparative experience with non-profit impact investment vehicles vs. the use of for profit equity funds

Moderator and Panelists:

Jennifer Pryce, Calvert Foundation (MODERATOR)

Aleem Walji, World Bank Institute Development Marketplace

Harold Rosen, Grass Roots Business Fund

Paul van Aalst, E and Co

Catherine Gill, Root Capital

Design, Methodology and Approach:

Comparative perspectives on funding strategies both from the perspective of the investment vehicle and the investee entities, SMEs in particular

Main Panel Discussion Points:

Panelists discussed the challenges and benefits of varied approaches to non-profit investment vehicles and the opportunities and constraints posed by moving to for-profit, equity-driven models, discussing not only the impact of vehicle-level funding choices but also the capacity to support effective investee enterprises. Among the main points:

- Organizations that are already scalable, commercially viable and delivering high social impact are easy to finance.
- The ecosystem for impact investment lacks key elements to promote enterprise development, such as capacity building, incubation and seed funding.
- Grants can play a key role in kick-starting investee enterprises, but the ratio of rejected to accepted investments can be very high.
- Narrow sectors are not likely to deliver sufficient scale or pipeline, hence a need for diversification.
- Investment decisions have to be made in a disciplined fashion to avoid drift.

Development Marketplace (DM) is an early-stage social enterprise marketplace. Although the DM supports experimentation and can catalyze new investments, it primarily works with enterprises in an early growth stage to help bring them to scale. These are established organizations with a business plan but lacking access to pipeline development money. Although the right kind of funding depends on the organization's growth stage, DM targets catalytic grant funding to build capacity among enterprises in contrast with most impact investors who enter with early stage growth capital, only after which funds may provide financing. DM looks for organizations that are not yet ready to scale but that do aim at earning a predictable revenue stream, whatever the source of the cash flow.

Grassroots Business Fund, a spin-off from the IFC, is now a 501(c)3 funded with grants from the IFC, Omidyar and private individuals, among others. The fund both makes investments and offers capacity building advisory, both for business potential and social impact, having made 30 investments with a $9 million corpus in agriculture and agricultural processing, processors and sellers of crafts and providers of goods and services for the poor in East Africa, the Andes and India. The typical investment of $750,000 to $1.5 million went into a mix of debt and equity featuring fallback redemptions in cash, subordinated loans with equity kickers, conversion rights where possible and participation in revenues.

Although many investments generated cash yield and upside participation, enterprises often needed technical assistance. Currently offering its investments for sale into a for-profit vehicle, the fund is working to become sustainable by raising capital from socially minded for-profit sources. The straight for-profit fund is aiming at returns of 7-10% on debt and mezzanine financing while still offering a side car for technical assistance to investees. Meanwhile, the non-profit would be refinanced with grants of about $12-15 million, and the organization aims to continue its active technical assistance programs.

E and Co has invested in 194 local energy enterprises in 20 developing countries with $46 million invested, $56 million under management and $213 million mobilized. Returns on E and Co investments average about 8% with a default rate of approximately 5%-7%. Yet, the organization is not just measuring return in dollars as its mission entails making small investments, delivering services to help build the marketplace and support the entrepreneurs' growth (such as providing help with business plans, promoting legal infrastructure, etc.). Starting with simple debt products for SMEs in off-grid electrification and grid-connected enterprises, E and Co now offers debt, equity and venture-debt for project development, as well as equity and debt for product development. E and Co is currently working on equity funds in Africa and Asia and a mezzanine fund in Latin America. Expected returns of 15% in Asia exceed those in Africa, where more technical assistance leads to a lower equity return.

Root Capital's model extends shorter-term working capital to rapidly growing rural grassroots enterprises in the "missing middle." With cumulative investments of over $250 million, Root has been able to leverage future contracts from large buyers to support these key businesses providing ecosystem services and promoting environmental stewardship, such as fair trade coffee and cotton producers. Their portfolio is unusual in the impact investment universe in turning capital over quickly, about twice a year, with 99% repayment rates. As a result, investee enterprises receive the crucial support they need to fund near-term growth drivers. Return on investment reflects the shorter term and lower risk at approximately 2.5%. As with others in this group, the organization is also building the institutional ecosystem through partnerships with buyers, banks, and entrepreneurs, as well as offering training and other capacity building activities.

Outcomes and Analysis:

Main challenges and concerns expressed:

- When funds transition to become for-profits, there is a real concern that asset growth will become a goal in itself as is common with a traditional "2-and-20" GP/LP (general partner/limited partner) structure (with 2% management fee and 20% management carried interest).
- Great stories and enthusiasm for the investments can get in the way of investment discipline, resulting in a mismatch between money going in and good investments. DM particularly noted that competitions sometimes had mixed results because of the wide range of entrants.
- The need for slow capital, high engagement and ongoing monitoring may preclude rapid scaling.
- The need for market development generates costs beyond what management fees can cover, and private sources of financing rarely include business development activities.
- Deals can be difficult to source, especially among enterprises that show promise, and compelling start-ups are particularly challenging to identify. Root Capital discussed a multi-channeled approach to sourcing through regional partners, staff who are industry experts, strong local presence, conversations with partners at trade shows, etc.

Panelists suggested the following success factors helped to reconcile capital with organizational mission:

- Focusing on mission and on central investment objectives is key to avoid investment drift.
- Keeping some grant funding as part of the intermediaries' capital mix may help them to avoid chasing deals.
- Partnerships offer a useful means of achieving scale without compromising mission.
- Private investors' involvement in early stages can help intermediaries maintain their bearings.
- Intermediaries need to get the capital mix right for investees so that they're getting the appropriate capital at the right point of their evolution.
- Good investment decisions often rest on good due diligence, such as knowing the investee enterprise's team and their interaction on the ground and doing thorough fact cross-checking.

Keywords: impact investment, venture philanthropy, equity investment, debt investment, working capital, investment returns

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