RICE UNIVERSITY'S
BAKER INSTITUTE
FOR PUBLIC POLICY

ISSUE BRIEF 11.04.15

Understanding Impact Investing: A Nascent Investment Industry and Its Latin American Trends

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INTRODUCTION

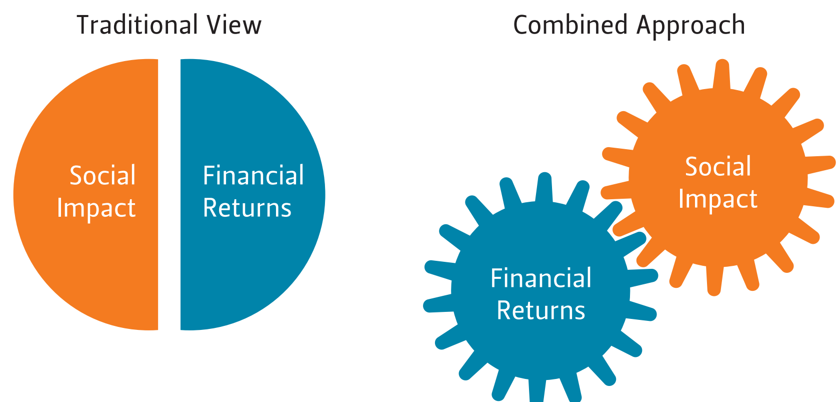
The concept of impact investing has been growing in popularity in recent years, attracting an increasingly diverse set of investors and donors seeking both financial returns and social impact. While similar investment approaches have existed for many years under varying terminology, "impact investing" was first coined in 2007 at a convention sponsored by the Rockefeller Foundation that brought together leaders from the worlds of finance, philanthropy and development.

Since then, and with strong support from philanthropic and public donors, impact investing has gained momentum in both developed and developing countries through ambitious industry initiatives and cross-sectoral collaborations. While significant uncertainties remain regarding its projected growth path, a prominent estimate by JP Morgan predicts that the impact investing market will reach between US$400 billion to US$1 trillion by 2020.[1] Since recent studies calculate the outstanding assets under management (AuM) for impact investing to be between US$25 billion and US$40 billion,[2] a significant gap still separates the current reality from these optimistic forecasts.

One factor that has been key in driving impact investing's growth is its presumed ability to overcome the binary or "zero-sum" view of capital allocation that has traditionally differentiated investments from philanthropy. Instead of having to choose between financial returns and social impact, it is assumed that this investment strategy makes it possible to achieve both goals simultaneously (see Figure 1).

Experts consider the climate for impact investing in Latin American as favorable. The region weathered the recent global recession well and it has been an important contributor to the global recovery, despite some challenges of late. On the other hand, in the past decade, Latin America made important progress in terms of strengthening institutions and reducing poverty, although there are still outstanding challenges in both democratic governance and income distribution. Poverty rates have dropped from 48 percent of the population in 1990 to around 31 percent today. What's more, in the last decade the actual number

FIGURE 1 — A COMBINED APPROACH TO INVESTING



SOURCE responsAbility Investments AG

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Experts consider the climate for impact investing in Latin American as favorable.

of people living in poverty has declined from 221 million to fewer than 180 million. Despite these remarkable improvements, income gaps are still wide. Impact investors can play an important role in helping the many millions still in need of viable solutions for better housing, education, health services, and access to credit.[3]

DEFINING "IMPACT INVESTING"

The term "impact investing" is often used interchangeably with terms like "sustainable finance," "socially responsible investing," and "ethical investing." While these terms capture the notion of combined returns, impact investing is a separate category and needs to be clearly differentiated. In contrast to these three investment approaches, which seek mainly to avoid social harm, impact investments actively intend to generate positive social and environmental impacts and, in doing so, are willing to tolerate a higher level of risk.

The Global Impact Investing Network (GIIN), the leading industry body, defines impact investments as "investments made into companies, organizations, and funds with the intention of generating measurable social and environmental impact alongside a financial return."[4] Therefore, impact investing can more generally be understood as an investment strategy that seeks combined returns by channeling funds into entities that provide goods and services to economically disadvantaged people. In its attempt to generate combined returns, impact investments focus on countries and markets where poverty and exclusion are particularly prevalent. These investments are often privately rather than publicly held and can be structured for any sector. Moreover, they employ the same categories of capital that are common in mainstream financial markets: seed, debt, shareholder equity, and hybrid. While the private debt space is at a more advanced stage in terms of product structuring and capital flows, a strong uptick of interest in private equity and venture capital has been seen of late.

At the moment, the principal sectors receiving impact investments are:

- *Financial Services:* Financial inclusion for marginalized individuals and micro-, small-, and medium-sized enterprises (MSMEs). Microfinance is one of the most prominent themes in this sector.
- *Education:* Enhanced academic opportunities, access, and quality of education.
- *Health:* Expanded access to basic, low-cost preventive and treatment health services, particularly among low-income and rural populations.
- *Energy and Environment:* Expanded access to clean energy technologies, reduction of carbon emissions, climate change mitigation, conservation of natural resources, and reduced threats to biodiversity.
- *Agriculture/Fair Trade:* Environmentally and socially sustainable agricultural production and food systems.
- *Water and Sanitation:* Access to safe drinking water and sanitation; water conservation.
- *Housing and Community Facilities:* Access to quality and affordable housing, as well as sustainable and accessible community facilities.

An emerging market-focused assessment of impact investments reveals that financial services (especially microfinance) have captured the majority of funding so far (see Figure 2). Given the early stage of the industry, most investments are directed toward the non-listed securities sectors where private debt, private equity, and seed capital are the most widely used financial vehicles.

While all investments in this industry have the intention of generating combined returns through their activities, they can be differentiated according to the sectors where they are most typically placed (i.e., the seven sectors listed in Figure 2), their risk and return preferences, their main sources of funding, and the dynamics driving and limiting their growth. As a general rule

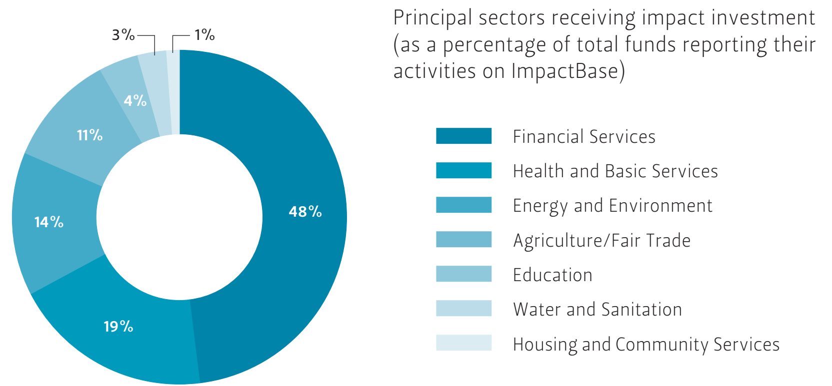
of thumb, impact investments fall into a continuum that ranges from concessionary—they tolerate no to below-market returns—to non-concessionary—they seek risk-adjusted market-rate returns (see Figure 3).

A further point to emphasize is that, historically, the development of the impact investing marketplace has been concentrated in high-income markets like the United States and Europe. If impact investing is going to mature into a mainstream and global investment strategy, however, it must harness the vision and innovations of entrepreneurs and investors in emerging economies. The industry needs to look to these growing economies as sources of skills, expertise, and capital, not simply as financing destinations. Holding solely to a north-south view of capital raising and allocation might clip this innovative investment strategy's wings by depriving it of vital funding and insight.

Some of the pioneering efforts for impact investing in Latin America have come from the multilateral development banks (such as the Inter-American Development Bank or IADB), which consider this investment approach as an integral part of their work related to private sector development. They see it as a powerful tool to fulfill their mission to reduce poverty and inequality. As noted by Luis Alberto Moreno, president of the IADB Group, "it is a win-win-win situation for all: the IDB Group boosts its development impact, impact investors diversify their portfolio by getting access to underserved markets, and local businesses get access to the financing and technical expertise they need."[5]

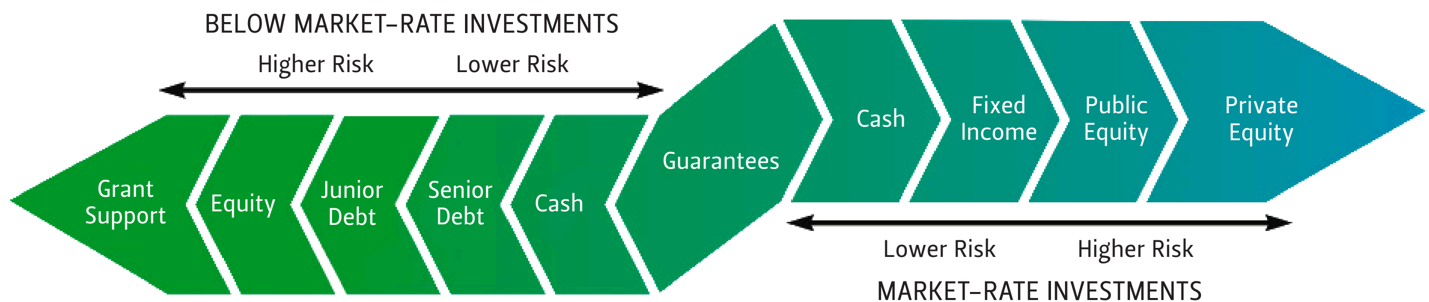
The IADB's Multilateral Investment Fund (MIF) has been involved in impact investing since 1996 and currently has 54 funds under operation investing in a wide range of areas including: clean and renewable energy, agribusiness, and businesses that deliver goods and services to low-income populations. On the other hand, its "Opportunities for the Majority Initiative" was set up in 2007 to support market-based and innovative projects that generate measurable social and economic benefits to people living at the base of the socioeconomic pyramid. This initiative has channeled nearly US$200 million in loans, quasi-equity, equity, guarantees, grants, and technical assistance.

FIGURE 2 — SECTORAL BREAKDOWN



SOURCE responsAbility Investments AG, based on 2013 ImpactBase data from the GIIN.
NOTE The seven above categories group together several investment categories reported by funds on ImpactBase. See link for further details on this database: http://www.impactbase.org/

FIGURE 3 — THE IMPACT INVESTING RETURNS SPECTRUM



SOURCE F.B. Heron Foundation

Moreover, it has leveraged approximately US$$120 million in additional funds through co-lenders or equity investments.

IMPACT INVESTING DEEPENS IN LATIN AMERICA

In the context of deepening this nascent impact investing industry in emerging economies, there is a positive momentum in Latin America as capital committed by funds increased from US$160 million in 2008 to roughly US$2 billion by the end of 2014, according to the GIIN and JPMorgan's latest annual survey. This represents growth by a factor of 12 in just six years, which is indeed encouraging. It allows new sources of capital to provide economic solutions for the 164 million people (28.2 percent of the population) who remain marginalized and in poverty across Latin America.[6]

Impact investments focus on countries and markets where poverty and exclusion are particularly prevalent.

As of the end of 2014, roughly US$10.6 billion in capital was committed to impact investment funds globally.[7] Latin America accounts for approximately 20 percent of this market. Brazil has the largest regional share followed by Mexico and Colombia. While funding from impact investors in Latin America originally came mainly from abroad (Europe and the United States), recent trends show an increasing shift toward locally created and developed impact investment funds.

A recent survey report carried out by Bain & Company highlights the following key characteristics of the Latin America Impact Investing landscape:[8]

If impact investing is going to mature, it must harness the vision and innovations of entrepreneurs and investors in emerging economies.

Local funds such as Ignia in Mexico, Inversor in Colombia, and Vox Capital in Brazil were among the first movers and have led the way for 40-plus locally originated funds now headquartered in the region. Such locally grown funds tend to invest in a greater number of earlier stage investment projects with a strong focus on private equity or venture capital. Cross-border funds tend to focus in more mature segments for investing primarily via private debt. However, the latter still out-invest local funds by a significant majority.

Most of the region's impact investment funds surveyed focus on multiple investment themes. Housing, agriculture, education, financial inclusion, and health are cited as those attracting the most investments.

Impact investment funds founded and based in Latin America typically have narrower geographical and sectorial focus. This approach aims to develop deep expertise and local proximity to add value to the investments made. Some examples cited are Gera Venture Capital with a focus only on education investments in Brazil, while EcoEnterprises Fund (Costa Rica) has a regional approach on sustainability investments across Latin America.

The return orientation of impact investment funds in Latin America varies as well. Impact fund return targets in the region depend on the stage of the venture in which the investment is made, as well as on the type of fund and its orientation or philosophy regarding expected returns. Nonetheless, most funds aim at achieving risk-adjusted market returns.

Impact investment funds are involved in every stage of the venture life cycle. While most funds currently work in either the growth or scale stage, there is a recent and welcome trend of an increasing number of seed capital providers, crowd-funding platforms, and accelerators working to grow the pipeline of opportunities.

A cadre of service providers, mainly incubators, capacity-building experts, and a host of intermediaries have emerged to catalyze the establishment of social enterprises on the receiving end of impact capital. Even traditional philanthropic organizations are co-creating hybrid impact investing models, filling in critical resource gaps while the industry learns and develops from experience.

Despite its early stage, one can argue that, to date, impact investing has successfully been launched in Latin America and has the potential to contribute to the transformation of the development and business sectors while providing an expanded range of investment options for new and long-standing investors. Its visibility has increased in the mainstream media; new academic programs and industry associations have been created;

and favorable governmental policies are being deployed to sustain and support this growth with the right incentives needed to reach scale.

CHALLENGES AND OPPORTUNITIES AHEAD

Going forward, stakeholders in Latin America and the world over must realize that the industry is facing a crucial inflection point. While an increased visibility among private players is certainly a positive development, significant barriers remain that could—if not properly dealt with—derail the rise of this promising industry. The following are three key challenges the industry needs to address if it is to capitalize on its tremendous potential:

- *Need for a more coherent infrastructure and more efficient intermediation:* Currently, the investing space is characterized by a fragmented investor and investee base, small and complex deals, and a lack of understanding of risk, resulting in high search and transaction costs.
- *Need to increase the absorptive capacity for capital being invested:* The industry's demand side needs to be strengthened by increasing the number of investable opportunities.
- *Need to increase mainstream investor engagement:* Jargon, technicalities, and lack of clarity on impact measurement act as barriers to the wider engagement of new audiences, including the institutional investment community, financial consultants, and the corporate sector, all of whom might find this industry to be too "niched."

Despite the challenges outlined above, impact investing will likely continue to grow globally at a fast rate over the next five to 10 years. Three main reasons could explain the endurance of impact investment funds that anticipate opportunities ahead, all of which are applicable to the Latin American region:

- *Track record:* The first and most important reason for optimism and wider engagement is that some of the early impact investment funds have begun to show results and raise additional capital, reaching significant size and attracting more institutional investors. Microfinance makes up close to three-fourths of total impact, investing assets under management focused on developing countries,[9] with the Latin American region considered as a mature market.
- *Marketplace development:* Another promising impact investing development is the move from the period of uncoordinated innovation and new fund creation (from 2009 to 2011) to the next stage: the formation of clusters of activity and the coordination of activities. Over the last few years, clusters have emerged in large Latin American cities, such as Bogota, Mexico City, and São Paulo (each with five to 10-plus funds). Pools of impact investment funds have emerged, the members of which have begun to coordinate and act together. By creating hubs of activity, the needed legal and regulatory infrastructure can be built, lowering the transaction costs of doing business and attracting additional outside capital.[10]
- *Unmet needs and vast potential:* Large numbers of households and micro-, small-, and medium-sized enterprises (MSMEs) whose basic needs were not previously met are increasingly being served by companies with innovative business models. This applies especially to development-related sectors such as finance, energy, agriculture, health, and education. In addition, a middle class with purchasing power is slowly emerging and, as a result, business models that are targeted at poorer people are becoming viable more rapidly.[11]

All of these factors give grounds for optimism, since investors with a long-term focus can make a critical contribution from a development perspective by allowing impact investing to move from niche to mainstream. Despite its relative early stage

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of maturity, impact investing is fully aligned with the recently concluded United Nations Third International Conference on Financing for Development, which enacted the "Addis Ababa Action Agenda"[12] as a foundation for countries to finance and adopt the recently agreed-upon Sustainable Development Goals agenda (SDGs).[13] Financing is considered the linchpin for the success of this new global partnership. More flow of private investments along with public policies and regulatory frameworks will set the right incentives to achieve sustained and prosperous global economic and social growth.

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Cite as:
González, Henry 2015. *Understanding Impact Investing: A Nascent Investment Industry and Its Latin American Trends.* Issue brief no. 11.04.15. Rice University's Baker Institute for Public Policy, Houston, Texas.