Impact Investing and Start-ups

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***Abstract*: A surge in demand for purpose-driven finance has brought about new avenues of putting capital to work the world over. Impact financing has defied the long standing opinion that financial returns should be funded by investors and social returns should be funded by philanthropists. The purpose of this paper is to discuss about impact investing as an emerging industry. This study provides a review of impact investing as an activity that falls under Sustainable Finance. It explores the core components of impact investing and the sources that specialise in measuring and reporting upon impact investment. Finally, it examines how impact investing is another avenue for funding start-ups, and how Venture capitalists are inherently impactful.**

***Keywords*: sustainable finance; impact investing; start-up funding; venture capital**

I. INTRODUCTION

The term “impact investing” came out of discussions among a group of investors and industry pioneers in 2007. They were early investors in green technology and the first institutional investors who placed equity into microfinance funds. They also had launched creative loan structures for low-income housing developers in U.S. cities and were managing public equity investments on a sustainable basis. What united all of them was an interest in assessing the potential and real performance of their capital through more than a passive financial lens. They wanted to use their capital to do something positive. The terms in use at the time did not precisely capture these investors’ interests. “Socially responsible investing” and “ethical investing” seemed burdened with moral obligation, personal judgment, and a history of screening that focused on what type of firms to avoid.

“Sustainable finance” seemed narrowly focused on environmental concerns rather than on the broader array of social justice and development issues, and it also seemed to muffle the excitement these investors felt about their possibilities for meaningful investment. And although “community development finance” resonated with some Americans, it did not capture the breadth of the global investing in which these actors were engaged, did not connect with locally focused investors outside the United States, and did not reflect the premium many investors place on environmental issues or investment opportunities. “Impact investing,” however, evoked the optimism and action orientation of this group. The term provided a broad rhetorical umbrella under which a wide range of investors could huddle.

The microfinance investor, the green-tech venture capitalist, the low-income housing lender: all could now see their affinity within abroader movement and begin to collaborate to address the similar challenges they faced. With its intentional double meaning, the term also cast a wide net. Some impact investors are content just to make investments that directly create a social and environmental impact. Others want their investments ultimately to have an impact on how all investment is conducted. The term has also resonated with a new set of investors who have sensed a desire to integrate their investment and philanthropy but previously lacked the language to articulate it.

II. MEANING

Defining exactly what is (and what is not) an impact investment has become increasingly important as the term has taken off. And, unfortunately, many people approaching this task are still locked into old language and mindsets. They are accustomed to orienting themselves around financial return, and therefore define impact investments as below-market-rate investments that trade off financial return to make a social impact. Although these investments certainly form part of the impact-investing universe, the heart of the movement is the reorientation around blended value as the organizing principle of our work: using capital to maximize total integrated value with multiple aspects of performance. For now the industry is coalescing around a definition that focuses on intention and on the attention investors pay to blended value returns: impact investors intend to have a positive impact as they generate financial return, and to manage and measure the blended value they create.

What does this mean in practice? All investments are capable of generating positive social impact, but some are closer to the action than others. Public equity investors can generate impact, for example, through a shareholder advocacy campaign, and investors pursuing this approach have had a meaningful impact on some corporate practices. Indeed, virtually all the impact investors we know put a portion of their portfolio in impactoriented public equity funds. In this way, impact investing is a strategy across all asset classes. However, the shortest line we can draw between our investment choices and their social impact is to place capital directly into companies and projects, and to make loans and private equity investments as the vehicles to do so.

Therefore, the impact-investing movement tends to focus on private equity and direct lending because of the unmatched power these investments have to generate social impact. Of course, not all venture or private equity investments are impact investments, even when they seem to focus on high-potential sectors or geographic regions. Simply putting capital to work in a poor country does not qualify an investor as an impact investor. Funds and firms earning a seat at the impact investment table are focused on strategies that intentionally seek to uplift rather than to exploit poor customers, and they treat impact measurement as a central business management practice, rather than as an afterthought to use for external reporting and marketing.

Impact investment refers to investments made with socioeconomic and environmental concerns in mind. The impact investor themselves (or, the investment itself) will have a dual focus, rooted in both financial and social purpose.

Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending on investors' strategic goals.

Impact investors want more than financial return – they want their money to be going somewhere positive, and doing something good. In order to invest ethically, they’re prepared to balance potential financial gain – or even uncertainty – with the complex measurability factors involved when tracking the positive, non-financial impact of an investment.

So, while still operating like a normal investment (insofar that the investor will still expect to see an ROI), the ‘impact’ part means that measurable benefits will be created for the environment, and/or society, as a result of the investment.

The growing impact investment market provides capital to address the world’s most pressing challenges in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, and affordable and accessible basic services including housing, healthcare, and education.

What counts as impact?

Job creation, paying above the living wage, women's empowerment, the growth of the small business community through output, revenues and financing – are all examples of social impact factors. Alternatively, a negative carbon footprint, a conservationist scheme, or clean energy generation would all count as environmental impact factors.

So, an example of an impact investment could include investing in a non-profit organisation (thus benefiting the community), or in a clean energy company (which can produce measurable metrics to demonstrate its positive environmental impact) – basically, an investment in businesses that have a positive impact, and can prove it.

III. SUSTAINABLE FINANCE

The growing impact investment market provides capital to address the world's most pressing challenges in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, and affordable and accessible basic services including housing, healthcare, and education.

Activities that fall under the heading of sustainable finance, to name just a few, include sustainable funds, green bonds, impact investing, microfinance, active ownership, credits for sustainable projects and development of the whole financial system in a more sustainable way.

Only an explicit recognition of social and the environmental impacts of the firm's decisions will ensure sustainability of the value created in this process. It should, however, be noted that doing so does not call for the NPV approach to be discarded. Rather, it calls for the full consideration of all incremental, incidental, and opportunity costs as well as such benefits.

Therefore, in addition to the inclusion of usual set of cash flows, the sustainable value creation approach calls for the explicit recognition of incremental cash flows attributable to the firm's sustainability efforts. Examples include enhanced brand value, increased customer loyalty, improved ability to recruit and retain talent, ability to attract new customers (including those demanding social and environmental results) and the option value of entering markets restricted to firms enjoying a reputation for their sustainability efforts. It also calls for the explicit recognition of reduced costs due to lower water and energy usage and the lower costs of: waste, employee health care, agency compliance, labor action, liability and litigation.

Utilizingadatabaseprovidedbyalarge financial institution,Dimson,Karakas,andLi(2011)document an average 4% abnormal return for firms that successfully initiate corporate social responsibility (CSR) engagement.

They also document that when the firm's engagement is in the area of climate change or corporate governance, the market reaction is stronger. This is consistent with the findings of El Ghoul, Guedhami, Kwok, and Mishra (2011), and Plumlee, Brown, Hayes, and Marshall (2010), who show that US firms with superior CSR performance enjoy cheaper equity financing.

Sustainable investing has its roots in socially responsible investing, clean tech investing, and more recently, impact investing. Cleantech investors invest in environmentally benign technologies (e.g. alternative energy, water purification; Parker and O'Rourke, 2006). Wüstenhagen and Teppo (2006) and Bürer and Wüstenhagen (2008) conducted surveys with cleantech venture capitalists on energy policy risks, while Bürer and Wüstenhagen (2009) investigated policy preferences of cleantech venture capitalists.

Ethical or socially responsible investors (O'Rourke, 2003) focus on social benefits (e.g. health; Berry and Junkus, 2013). Social investing and clean(tech) investments each received attention in the academic literature, whereas sustainability investing or 'impact investing' (Bugg-Levine and Emerson, 2011) is relatively new. Impact investors are moving into a space, which may be referred to as "sustainability investments", investments in products, processes and technologies with triple bottom line benefits (Global Impact Investing Network, 2013). Impact investments are made with the intention to generate measurable social and environmental impact alongside a financial return (Global Impact Investing Network, 2013).

Core components of impact investing

1. Intentionality: Impact investments intentionally contribute to social and environmental solutions. This differentiates them from other strategies such as ESG investing, Responsible Investing, and screening strategies.
2. Financial returns: Impact investments seek a financial return on capital that can range from below market rate to risk-adjusted market rate. This distinguishes them from philanthropy.
3. Range of asset classes: Impact investments can be made across asset classes.
4. Impact measurement: A hallmark of impact investing is the commitment of the investor to measure and report the social and environmental performance of underlying investments.

The sources that specialise in measuring and reporting upon impact investment

The following sources specialise in measuring and reporting upon impact investment:

1. IRIS

Operated by the Global Impact Investment Network, IRIS is a rating system that measures impact and closely aligns to the commonly accepted accounting principles, as used by the Securities and Exchange Commission.

The GIIN has also developed IRIS+, which aims to translate impact investing goals – such as gender equity, climate change, and affordable housing – into results.

Both IRIS and IRIS+ are designed with the investor in mind, but will show the metrics of measurability a business will be expected to produce in order to win the confidence of an interested impact investor(s).

2. The Global Impact Investment Rating System(GIIRS)

Created a decade ago, and originally intended to apply sustainability criteria to private investments made through venture capital and private equity funds, GIIRS was the brainchild of the B Lab (the non-profit organisation that administers B Corp certification).

As the GIIRS and B Lab use essentially the same assessment criteria, the metrics of measurability that your impact investor will want to see can also be provided by acquiring B Corp status.

Thanks to the B Lab's 200 point scale, stringent requirements, and transparency of results, B Corps (or Pending B Corps) can send clear signals to investors and competitors alike as to the quality and breadth of their impact.

For more information on how to become a B Corp, read the Startups guide on how to become a UK B Corp.

3. The Sustainability Accounting Standards Board

The Sustainability Accounting Standards Board is an organisation that analyses 77 different industries along a consistent range of environmental, social, and governance metrics. Looking at the metrics they use for your specific industry could be beneficial in formulating your own methods of reporting on, and proving, your impact status.

IV. IMPACT INVESTING AND START-UPS

Impact investing is a rapidly growing industry, fuelled by investors who are determined to generate a financial return and social and environmental impact. The impact investors themselves have notable characteristics of social and environmental governance. The ultimate hallmark of a credible impact investor is the implementation of their mission and vision.

Impact investors tend to track progress over a longer period that 'normal' investments. They are not basing it on reward depth, nor the obvious ROI. Investors can evaluate the companies they support based on how well that company creates meaning for the people they serve and by evaluating the services they provide.

Direct start-up and impact investments promote next-generation engagement in family offices. They also have the potential to encourage innovation and increased agility within these organizations as they expand into new areas. All of which helps to ensure that there's a legitimate place in family offices for future generations.

Impact-driven entrepreneurs play an important part in driving this change as they build viable companies earning profits and solutions that can make the world a better place to be.

Impact start-ups, and particularly those with digitally enabled business models, are the perfect tool to engage the next generation in family businesses and family offices.

As millennials are considered digital natives and, for the most part, are already aligned with Sustainable Development Goals (SDG) ideologies, impact businesses focusing on these areas could attract top next-generation talent. If family offices invest in these types of start-ups, it stands to reason that they would also be positioned to attract and engage the next generation within their own families.

V. VENTURE CAPITAL AND SUSTAINABILITY

Venture capitalists are inherently impactful.By taking a risk on the power of new technologies, VCs and start-ups are driving huge forward leaps in service, convenience and cost, meeting the needs of society more effectively, and more affordably. A reduction in the cost of an essential service provides a clear 'impact' to individuals through higher disposable income and improved quality of life.

Greater market diversity also reduces risk, by improving the ability of society to absorb shocks or 'black swan' events that could bring down the entire system. A constant supply of new start-ups helps industries to respond and adapt to both slow and sudden changes by ensuring there is no single point of failure, while also driving the development of new solutions to protect against emerging threats. This is a major impact that the Venture Capital industry delivers.

Sustainable venture capitalists have the difficult tasks of identifying businesses, which have the potential to generate economic returns while creating positive environmental and social impacts. Investors may use an exclusionary (e.g. filtering out 'bad' products such as weapons) or inclusionary approach (e.g. assigning points to positive efforts), although Berry and Junkus (2013) found that investors prefer a more holistic approach to selecting firms who display overall positive behaviour. This is in line with venture capitalists' vision of what fitstheirportfolio:theinvestmentthesis. Sustainable venture capitalists thus use the investment thesis as a broad guideline to create a balanced sustainable investment portfolio.

VI. CONCLUSION

Ultimately, impact investing for blended value offers an integrated system of thinking and practice that is springing forth in a world where a different system currently dominates. When systems clash, opportunities and frustrations abound. But once we realize that impact investing is a systems-building task, we can draw from the lessons of history about what it has taken to effect similar change in the past. These lessons tell us that great change is possible when people not used to working together collaborate to combine existing ideas into new possibilities. They teach us that we cannot change a system with persuasive analysis alone and must apply the full range of our emotional and spiritual intelligence.

These lessons remind us to recognize the power systems have to shape us all—as well as the power each of us has to participate in changing them. Building this new system will not be a linear process. We will define strategies and move toward goals, but we will also experience ebbs and flows, forward movement and lateral drifts. We will get there, but it will take time, focus, and commitment. And impact investing will always involve the precarious ride at the apex of profit and purpose. Impact investing is not about bumper-sticker solutions to feeding the billions or saving the planet, and you are not passive observers of this new system.

By choosing to jump in or stand back, you influence the system in which we all live. The question is not, “How can I influence the system?” The question is, “What direction will my influence take?” We all have a role to play:

It is only a matter of time before good environmental, social and governance performance will become the new norm. Therefore, and as confirmed by empirical evidence, firms that fail to recognize their environmental and social responsibilities will find themselves valued at a discount relative to their peers.

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