Impact Investing for Angels?

A beginner's guide to impact investing

Impact Investing is simply investing in companies that have not only a financial return focus but also a social and or environmental focus. Investment returns range from below 'market rate', to well above. Its unlikely many impact investments will talk the 10X+ returns that Angel investors expect but that's a whole other topic.

What are Social Enterprises

Social Enterprises are purpose-driven organisations that trade in order to deliver social and environmental impact.

If we reflect on it we'll probably all be able to think of a NZ social enterprise (Trade Aid, Ooooby, Little Yellow Bird) and Angel investors may be surprised to find an impact investment or two lurking in their portfolio! (Heilala Vanilla, Cogo, Mint Innovation). And there's no question, the development of social enterprises and impact investing is growing. Some say it's to plug the gap left from less or ineffective government and philanthropic funding. Others feel we are at a tipping point, where ordinary investors are telling their advisers they want some or all of their investments to be making a positive impact.

Billions of dollars are going into impact investing each year in the US, UK, Europe and more recently Australia. New Zealand is a bit behind and always will be when it comes to the dollars invested but I'm confident as we've seen with the growth of entrepreneurship and early stage investing we'll see an equally rapid growth in social enterprises and impact investing here in New Zealand.

The Intersection of Money and Meaning

Whether it's described as a tipping point, 100th monkey effect or 'something in the water' the dramatic rise of interest in social enterprise and impact investing is real.

Bill Murphy, Enterprise Angels Executive Chair, was fortunate enough to attend the 10th SOCAP Conference held in San Francisco in 2017. It attracts 3500 attendees over 3 days, with the leaders of the industry delivering inspiring and provoking talks leading the 50 daily breakout sessions that touch on every aspect of the industry. Bill's key takeaways ..

All investing has impact. Since much of this impact involves externalities that are not measured in our current financial reporting, people tend to not think or be aware of impact.

Kevin Jones' 2 pocket analogy – we – Investors, Foundations, Trusts tend to think of capital and returns we earn on conventional investments as being in 1 pocket. We allocate 5% of this to our other pocket for 'doing good' – philanthropy or aid. This way of thinking and investing is being challenged.

Philanthropy and public sector support while critical are not sufficient to solve the world's toughest challenges; we need market based solutions and investment to play their role to fill the capital gap. Impact investors are proving that financial markets will be a significant catalyst for good in the years ahead.

Challenges when Financial Markets meet Impact Investing

Building an ecosystem – the philanthropic sector is the critically important leader in establishing impact investing in a community / country. Key activities include providing resources and de-risking investment opportunities through patient capital, concessionary funding, below market rate return requirements.

The role advisors and consultants play in the impact investing ecosystem can be controversial. Are they coming out of the conventional finance industry without a real understanding and grounding in social enterprise? Is impact investing just the latest financial product to sell?

With these concerns as a backdrop at SOCAP17 we heard from some of the leading US intermediaries. Following are Bill notes and some *questions*.

Foundations / Trusts

In the US there tend to be huge funds that can't deploy as they need to and small funds that can't live off the management fees.

Smaller amounts of money into lots of small ventures is key. Funds and Foundations with a minimum investment requirement of $1 to $2M are often misaligned.

Deep impact takes resources and time – large funds and Foundations have the resources to do this.

Philanthropic wealth leading to funds that are too large is not a problem we are likely to face any time soon in NZ! Funds that are too small is.

How do we build funds that provide right sized, smart capital to NZ social enterprises? How can the philanthropic and commercial sectors work together to achieve this?

Impact Investing vs. Venture Capital

Many investors will judge an impact investment opportunity on its financial return – above or below 'market rate', fair enough but...

We need to really question what 'market rate' is given it does not price in externalities.

Kaufman Foundation study shows 1995 to 2005 VC's significantly underperformed compared to the 'market'.

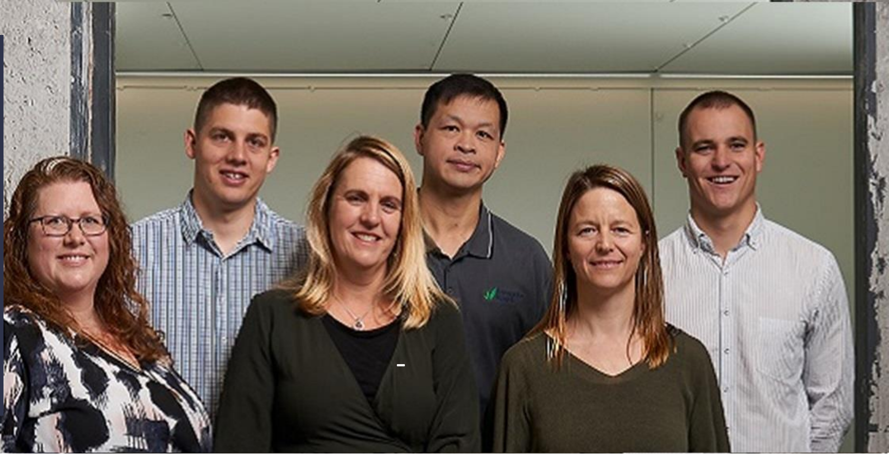
The Silicon Valley / VC mindset (very high risk IT startups that must 'exit' achieving 10x+ returns to investors in under 10 years) is an anomaly but is deeply embedded in angel and VC investing. What will it take for us to return to a more sustainable model of business building and how can social enterprises contribute to this?

Innovative Deal Structures

Some Angel / VC terms can be inappropriate for impact investments. Alternative approaches were discussed:

Equity based alternatives: Staged dividend payments to investors. Payments are variable – linked to a percentage of revenue or cash flow. Mandatory redemption of an investor's equity stake in the business at a specific time contingent on the business having sufficient cash.

Impact Investing That Packs a Punch



Debt based alternatives: More flexible repayment: Like some of the equity structures, linking debt repayments to a percentage of revenues or cash flows. Extending the term of the debt repayment.

Company friendly terms: no pre-payment penalties and, in some cases, pre-payment discounts.

See TranformFinance.org for a study on alternative forms of structuring deals and providing capital

How can impact investments be structured so that they are fair to founders, mission and investors?

Of all the speakers at SOCAP I found Jed Emerson of Blended Value Group the most 'straight from the heart' and challenging. I highly recommend Jed's address .

Some of the points Jed made are:

We really miss the point if we focus solely on the mechanics and measurement of impact

Impact investing is primarily a form of resistance and radical change

In the course of our work, we need to leave space for a more complex and nuanced understanding of impact and the purpose of capital to emerge.

If we don't have a deeper understanding of what we are trying to achieve through impact we are going to end with folks who are really good at deal structure, but who have very little comprehension of the intent and purpose of that deal structure.

Capital is to be applied as a fuel for freedom to fund disruption of the social and economic status quo, to be a tool of resistance. Otherwise it is simply capital as economic and traditional finance.

The purpose of capital is to advance a more progressively free and just experience of life for all.

The goal is to extend these impact values into the entire capital market.

Much of the discussion to date about impact investment in New Zealand has naturally been about impact investing in New Zealand. No doubt about it - we've got social and environmental issues that need addressing.

But are we making real change by only recycling capital within a first world economy or do we need to be investing in developing economies as well?

And what about addressing the system that has created so much inequality? Will changing the system be enough or do we also need a change of hearts and minds?

What are the next steps?

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