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SAID BUSINESS SCHOOL

UNIVERSITY OF OXFORD

Impact Investing in Emerging Markets Conference

Post Conference Report

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Introduction

As official development assistance supports early stage SME growth in emerging markets and philanthropy largely supports the 'social enterprise' sector, impact investing has come to exist at the intersection of aid and investment. The appeal of impact investing in emerging markets continues to grow; however, challenges to address the 'gap' between early-stage grant funding and later-stage commercial investment still persist. The prevailing sentiment of many institutional investors, who cautiously avoid significant 'impact investment' allocations, contrasts that of aid agencies, philanthropists and foundations, many of whom are enthusiastic at the prospect of this investment approach.

The key question at the centre of the conference was: can Impact Investing in emerging markets successfully address social and environmental issues and achieve expected financial returns?

This one-day conference explored some of the key themes and challenges at the core of Impact Investing in emerging markets including, but not limited to, the following:

Exits

- Impact Investment as an 'exit' opportunity for aid/grant funding in order to catalyse commercial investment
- Exit strategies for impact investors in emerging markets that provide a viable pipeline to commercial investors where 'dry powder' assets under management await

Financial Returns

- Relevant cost structures, fund economics and realistic expected financial returns
- Appropriate measures of financial return for impact investing in emerging markets

Impact Reporting

- Useful social return measurement approaches that incorporate investee perspectives and capacity
- Lean data integration into evaluation methodologies and operational improvements

Innovative Financing

- Effective investment vehicle structures and appropriate jurisdictions for impact investing in emerging markets
- Structures incorporating risk profiles in order to leverage commercial investment at various stages of the investment cycle (i.e. blended finance)

Geographic Considerations

- Viable deal sizes for ventures and markets to absorb capital in emerging markets
- Political volatility and currency fluctuations affecting investment risk/reward profiles

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Opening Plenary: Building the Pipeline

Impact Investing

- Impact investors have to define their own mission, the best way to achieve this mission (is it actually investing?) and, accordingly, how to measure success
- Be honest - why are you doing this? Find activities that align with your interests and build expertise in your organisation
- Two basic models:
    1. Build own team and invest directly
    2. Invest via intermediaries

Why go direct?

- Ability to maintain bespoke investment mandate and incorporate sector expertise
- More control
- Conception that it is faster deployment, but it takes time to find investment opportunities
- Conception that it is lower cost: PE funds and debt funds have higher fees and performance incentives but the question is how much is the alternative including open a new office and hiring supporting staff?

Why choose funds?

- Access local networks - finding interesting deals, avoiding uninteresting deals, biggest risk of remote investing is adverse selection
- Building local value, capacity building

How?

- Start with strategy then choose operating model, hire the right team and then start hunting
- For direct investors: start with familiar sectors, closest networks and other impact investors
- For fund investors: contact other fund investors and attend conferences
- RFP may not be the best way to reach successful entrepreneurs with a strong vision (caution: RFPs can reinforce supply side driven industry trends)

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Core Session 1: Institutional Investor Outlook

Trends:

- Liquidity: liquidity is desired more in traditional PE and private debt, but there is also potential for impact investing funds to list
- Direct investments are an increasing trend: DFIs are looking a lot closer at direct investment - this allows investors to get closer to their investments
- Trend towards impact and ESG across traditional private equity and debt funds

Challenges:

- The pipeline for funds is a big issue: there are significant discrepancies between the mandate of the pension fund and what investments are available
- More private capital is needed in emerging and frontier markets so that DFIs can concentrate on more challenging markets and regions
- Regarding SDGs: can we have more money moving into new things rather than just relabelling existing allocated funds?
- Costs involved in putting together an operations team on the ground in emerging markets on a 2% fund management fee
- Perception is that moving to emerging markets is expensive, so positioning it as a means of diversification is essential. Mismatch for the product provider as there is a preference for mezzanine tranche (higher risk)

Key Takeaway:

The danger here is that you cannot simply dump money into emerging markets; you need an experienced manager who knows how to do this correctly

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Core Session 2: Expected Returns & Valuations

- Observation and worry in the market: investors tend to look for certain returns but investees priorities could be more on impact, which may not result in highest return
- Emerging markets can be underserved and inefficient, but there is an opportunity for both return and impact. There doesn't need to be a sacrifice between return and impact in emerging markets. Ideal goal is to invest in companies where impact is embedded in their business model (not secondary). Every dollar the company makes will therefore also bring impact
- Impact Investors need to avoid the 'Silicon Valley' mindset that problems can all be solved by technology and return expectations as high as traditional VC
- There can be a tendency to blame countries for failure vs. poor due diligence in the first place
- More need for intermediary work to prepare investees ready to take up the investment. Intermediaries can also ensure the right balance between a commercial return and an impact return

Key Takeaway:

There is a limitation of the PE model to be applied to impact space: it takes longer to bring results to fruition in emerging markets (especially in impact investing)

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Core Session 3: Talent & Recruitment

- There is a growing trend of impact investing and social enterprises and thus there is a growing supply of people wanting to enter the arena
- Investors need to identify talent gaps in the companies they invest in and then try to fill the gaps that they see
- Employee mentoring, development, training and learning and performance-based pay are the factors that make people stay at companies
- Underfunded education systems in emerging markets are leading to talent calibration issues and the lack of growth of the sector
- In the long term, the compensation and personal development opportunities that smaller companies are not able to provide will be seen as a challenge
- Smaller entrepreneurs do not want to pay large sums to hire as it leads to lower pre-money valuations. The solution is technical assistance facilities, which have drawbacks
- Salary benchmarking in the impact investing business is needed
- Mistakes happen in every sector but there is recognition for best hiring practices in most of the big firms. The smaller firms need to set up a more robust system of hiring executives in higher posts

Key Takeaway:

When the investors provide a consultant to the company with full cost covered they have seen that the consultant's talent is not used to the best of their capability. Companies need to invest directly in talent, or at least have 'skin in the game'

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Core Session 4: Fit-for-Purpose Innovative Financing Structures

- There isn't enough activity from philanthropic players who can use funds as a rewarding instrument to draw in more private capital, which is attractive in the current environment
- Encouragingly, institutional investors are realising that stakeholders are asking for more indicators of social impact, which is the main lever to bring impact investment to the mainstream
- Research shows in the long run ESG integration into investment has zero or positive returns, so fund managers can no longer use "fiduciary duty" as an excuse
- There is a need to incorporate monitoring metrics very early on and partner with academics/third parties to evaluate
- Exchanges about challenges are important and there is a need to speak candidly

Key Takeaway:

To scale the market, we need to recognise philanthropic capital is finite – there is a significant need to move private sector capital

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Core Session 5: Ecosystem Creation

- It is important to support how to facilitate a transition from an aid-based project to a bankable business
- The impact investing market is very early stage - every participant (sell/buy) is needed. The question is: do we have the right discipline to be applied to the right people/stage of growth/organisation? Sometimes, we see organisations taking risks that are not fit for them - this results in market distortion
- Partnerships with foundations are helpful to start a dialogue with potential investees
- Too much focus has been on the supply side – more focus should be on the demand side so that there will be more investable opportunities. Strengthening the local ecosystem is critical. Global ecosystem/market is becoming more established and a decentralised business model is the way forward
- Partnerships with donors also help identify new investment opportunities. We should think beyond the traditional PE players (i.e. GP and funds)
- A local bank normally does collateral-based lending. Cash flow based lending is not an option for entrepreneurs in some countries. There exists a mismatch of financial instruments and business needs

Key Takeaway:

There are not enough GPs, particularly not enough support for a first-time/ emerging fund managers. Dilemma - track record is required to raise capital, but without capital no track record can be established

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Core Session 6: Investee Perspectives

- The aid model can be problematic with time-bound projects (example: training thousands of farmers to grow cash crops, but provide no market for these crops)
- Software can have a huge impact on health and education, but we need to focus on distribution and hardware as well
- Donor-funded projects are often just about putting hardware into place, not about the sustainability of the solutions
- Impact investors place a strong emphasis on metrics: this is doable in healthcare via data collection and digitisation process, but very difficult in education and dependent on execution. It's hard to gather metrics at a low price point
- Top investor gaps include:
  - Feedback loop and communication channels
  - Lack of appropriate skills/knowledge from investors
  - Attitude: if investors are serious about impact, they need to be flexible
- A disproportionately large amount of time is spent looking for the right type of investment and capital, (about 30% of management time) because of lack of flexibility on investors' side
- If businesses don't fit neatly into one category, investors may not be interested. This can stifle innovation and frustrate entrepreneurs
- It's important for entrepreneurs to understand the entire value chain of investing beginning with grants all the way through to IPO. They need to know what stage they are at and who to approach
- Although impact investors can be frustrating, commercial money (i.e. traditional VC and private equity) timeline and returns expectations are often too short and too exorbitant, respectively
- The process of preparing for the next round of funding is beneficial for a company (i.e. increasing ESG standards and formalising processes as well as financials)
- Entrepreneurs need to have an exit strategy (not necessarily for themselves, but for investors)

Key Takeaway:

Financial accounting is seen as a sunk cost, but social impact accounting is an unrecognisable cost

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Core Session 7: Geographic Considerations

- Invest in companies that can keep to their operational plan and have a strong execution team
- Macro risks include new governments and prolonged periods of uncertainty
- Foreign exchange fluctuations are a big issue when investments is made in dollars
- Although there may be a 'zero tolerance' policy towards corruption, it is impossible to audit all transactions on the ground level
- Partners should go through rigorous reference checks before any relationship is formed
- Exits: possibility to structure investments differently and have a revenue share and paybacks kicking in so that repayments are on an ongoing basis instead of wanting to cash in only at the time of exit
- Insurance: depends on the scale of investment that is going in and the returns expectations. Larger investments may need more insurance even if they are expecting lower returns and have low risk tolerance
- Innovative non-profits have an interesting role and there are opportunities. There are NGOs investing in debt instruments, R&D, in social ventures: this makes things easier for institutional investors
- Culture plays a role in exit – it is important to understand the context that the entrepreneur is coming from
- Different structures are required to manage forex in times of volatility but tax implications are important

Key Takeaway:

Investing in a country that you don't know well or don't have a resource in makes the risk higher. Co-investment from a local partner is good but needs an alignment of vision and due diligence

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Core Session 8: Monitoring Social Return

- Three main questions:
  - What is the change that is trying to be accomplished?
  - How do you monitor that?
  - What are the right metrics?
- Much more analysis on the investor level is needed rather than just done by the investee
- Goal should be optimisation rather than maximisation of social impact - most social impact is reported independent of the business performance or aims. At the moment impact reporting is not integrated with financial reporting
- Theory of change: developed as an evaluation tool (i.e. how to evaluate complicated programs), but there is an issue if you do not think about this at the start of the project rather than just at the end. As a causal impact pathway (steps from investment to impact), theory of change sets up a useful framework to guide conversation on what to measure
- From a company's perspective, measuring impact only makes sense (or is only seen to make sense) if it feeds information back into the company on how it is running

Key Takeaway:

Monitoring and evaluation can become the platform through which investors and investees talk to each other (on metrics and theories of change). It's a two-way conversation, not a top-down approach

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Breakout Session Quotes:

"Naivety is the curse of agriculture: we all think we know about growing things and farming is easy, but you need to understand engineering and biology, very few people actually know what they are doing."

"Ed-tech has massive capacity to have both impact and financial gains."

"[In off grid renewables], capacity building is often needed more on the side of the investor rather than entrepreneur."

"The biggest hindrance [to healthcare in emerging markets] is incomplete data."

"We talk about scalability [in fintech] but is the product replicable, too?"

"[In water and sanitation], the mind-set of 'poor people will not pay' is a hurdle that needs to be overcome."

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Closing Plenary:

- There's a business proposition that impact is embedded at the asset level
- Not about selling to someone who looks like you - but who's the best to extend and fulfil the company's mission
- How does Impact Investing differ from typical M&A? Material differences: explicit expectations on missions, more than money, investee maturity (very important, correlation between need to protect mission and maturity), stakeholder interests e.g. employees, founders, foundation –> customised process
- Metrics are important, but sometimes we are raising the bar too high ex-ante; set out hypothesis at the beginning and observe during. Metric measurements should start from a learning perspective rather than an auditable conversation.
- Microfinance is the most mature industry with the most number of exits: mostly majority stakes, mostly mature companies, diverse geography (but high potential large market profile), buyers are also diverse (some corps, some fintech, MFI networks)
    - How many of these MFIs were started with aid funding or supported by aid funding? Need to acknowledge and celebrate how they started, and how critical was that aid funding
- Remember the why: People, Principles, Prosperity

Key Takeaway:

Bridging the gap between aid and investment from grants to equity investment, the process is not always smooth but there's a progression expectation that can also be combined. The combination of these tools is powerful – it's not either/or but which and when

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31. Dan Farrell, CEO - Privos Capital
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34. Sarah Forster, CEO & Founder - The Good Economy Partnership
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Our clients' success in the impact economy is supported by one or more of the following four pillars:

- International Development with an emphasis on increasing the performance and outcomes in health, economic development, education, governance and the environment;
- Strategy Execution Consulting to enable order-of-magnitude improvements in both private and public sectors through a framework that translates strategy into action;
- Impact Investing to re-imagine innovative ways to finance impact economy initiatives for optimum financial and social results; and
- Research, Professional Development and Training to encourage boundary-breaking thought leadership buttressed by a powerful knowledge transfer engine that equips clients and partners with necessary skills.

With our collective expertise and abiding commitment to exceeding clients' objectives, Palladium transforms lives, businesses, governments and societies around the world.

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