Maximizing The "Impact" Of Impact-Focused Private Investment

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Context

The interest and growth in impact and values-based investing is on the rise. Part of what is motivating this growth is a recognition that capitalism is failing to drive towards or create a world consistent with our values and societal ambitions. Part of this is because markets and businesses frequently ignore and do not price-in negative externalities that occur as a result of their operations, which has perpetuated challenges like climate change, inequality, and resource scarcity. At the same time, the world is recognizing that we are not effectively positioned to combat the systemic and pressing societal challenges that lay ahead of us with historically common tools. After available public, philanthropic, and quasi-public dollars, we still face an estimated $2.5T capital gap[1] in addressing the United Nations Sustainable Development Goals, a global agenda adopted in 2015 outlining a vision to end poverty, protect the earth, and promote global people and prosperity. There is widespread recognition that traditional philanthropy or government support is not capable of driving the change necessary given limitations in scale and structure. As such, we have turned to traditional capital markets in hopes of their help and support, in the form of impact and ESG-aligned investing, to both stave off future social challenges and solve for existing ones.

Within the broader conversation on impact investing, it is important to highlight the role of private equity and private investment specifically, because it has a critical and possibly outsized role to play. In comparison to average investors in public companies, private equity investors can directly and acutely influence the actions of the companies they invest in. Due to this principal-agent governance and ownership dynamic, private equity investors, in theory, have the potential to influence impact within in their investments, and therefore it is important to understand how they are engaging in impact-forward investing. As the investors that set the tone for how a business operates and scales over time, they have the potential to influence the nature of what the public companies of the future look like.

Aside from altruism and limited partner influence, there is another value proposition for private equity to engage with impact and values-based investing. Given growing vilification of the industry, private equity is in desperate need of a re-brand. It's negative attributes (e.g., cost cutting, job losses) are frequently highlighted by more left-leaning political players, and investors (e.g., limited partners) and other stakeholders (e.g., customers, communities, companies) will continue to demand more transparency and accountability. With a potential shift in the federal administration, it is in the private equity industry's best interest to define their value proposition for good, to ensure their long-term viability and positive favor with government and other stakeholders. In part, this may be what is motivating some PE players to enter the impact investing space now. Regardless of intentionality, we can use this momentum to drive towards a private equity sector that is more responsible and impact-forward in nature, in hopes that it can help complement progress made towards a more a just, equitable, and safe world.

Overview of Impact PE

"Impact" and "values" are subjective concepts open to high degrees of individualized interpretation. As such, it makes the impact and values investing space itself – with limited oversight or standardization requirements to date – hard to define. It is often unclear who exactly is an impact investing firm or fund, and who is on the path to being "values-aligned." There has also been the emergence and growing adoption of environmental, social, and governance (ESG) standards within the private investing community, as a way to both mitigate outsized risk and drive value within investments.

ESG and impact investing are definitionally not the same thing and do not seek to optimize for the same outcomes, yet in order to engage in the question of what role private investors can play in helping to mitigate and also solve for societal challenges, both concepts are relevant to consider. As a starting framework, it is useful to consider impact on a spectrum, and recognize that unique investors and firms are at different stages and have different ambitions for impact in their operations.

[1] https://www.un.org/press/en/2019/dsgsm1340.doc.htm

Source: Impact Management Project

This framing from the Impact Management Project is helpful in that it recognizes that investors can engage with impact with varying degrees of intensity and focus. If we think about the goal of trying to mitigate and solve for negative societal and environment outcomes, the ultimate goal should be to bring as many investors and firms onto this spectrum as possible. If the entire private equity industry can get to 'A,' that can possibly have more net impact and positive effect than only a small subsegment of the industry who is playing in 'C.' Further, in an industry that is bound by fiduciary obligations to maximize LP interests and is often reticent to change, some have posited an early theory that perhaps the private equity community could be thinking about engaging in impact as an "adoption curve." This framing invites more investors to begin to engage with impact or values-aligned investing in a way that makes the most sense for them, to at least begin them on the "journey" of thinking beyond just near-term profits. It feels unrealistic that overnight a firm is going to seek to evolve its focus to a be a 'B' or 'C' player, but perhaps incremental adoption towards 'A' can then move the field, over time, towards 'B' and 'C.'

If we then conflate this impact spectrum with how impact is manifesting in firm focus and activities, we then begin to see varieties of ESG and impact investing orientation across firms. In exploring this space, it is evident that there are divisions between ESG and impact investors – each frequently discredits the other as really moving the needle from an impact and values perspective. Many impact-focused experts in the field might take issue with putting ESG and impact investing on a similar spectrum, but for purposes of laying out the space for this paper, it is a relevant framing that highlights that each has a role to play in helping to better our society.

	"Do No Harm"	"Mitigate Risk	"Be Responsible"	"Create Positive Net Impact"
	Passive ESG	**ESG to Drive Value**	**ESG for Resp. Biz**	**Impact Investing**
Description	*Include environmental, social and governance factors in investment decision-process – primarily through negative screens*	*Consider ESG in investment decision-process, and work with portfolio post-investment to mitigate risk and add business value*	*Consider values and impact from the vantage of creating a "responsible" business" throughout operations*	*Intentional investing to advance an impact thesis or area – impact defined what, who, how*
Motivation	• *"My LP cares about it"*	• *"I want to mitigate the business from outsized envir. / social risk"* • *"I see ESG as a way to create direct value in my investment"*	• *"I and/or my stakeholders believe in responsible business, and we want to use our ownership to create values-aligned, responsible operating businesses."*	• *"We want to increase access to quality education."* • *"We want to advance the SDGs."*
Rationale	• *Mitigate GP & LP reputational risk*	• *Mitigate outsized catastrophe or reputational risk* • *Increase revenues (e.g., align with consumer sentiment)* • *Decrease costs (e.g., energy efficiency savings)*	• *Differentiate amongst LPs* • *Belief that responsible business is good business*	• *Value impact returns* • *Move more capital towards a specific impact objective* • *Differentiate amongst LPs*
Artifacts	• *ESG policy* • *Basic ESG reporting*	• *Industry ESG reporting – e.g., SASB* • *ESG team/function* • *Portfolio-specific ESG targets*	• *B-Corporation certification* • *Stakeholder reports* • *"Responsible business" target projects*	• *Impact measurement* • *Post-investment impact management strategy/plan*
Examples	• *"We do not invest in guns, fossil fuel, or tobacco"*	• *Energy efficiency targets* • *Board / employee diversity plan*	• *Business with "good jobs"* • *Responsible energy use, minimal pollution contribution*	• *Investments in edtech that advance education access* • *Investments strategic management of vulnerable population housing*

As we move from left to right, we drive towards more intentional and net positive social impact. Within ESG (first three segments in the visual above), there are different approaches and varieties. On the left, we have the least engaged variety of ESG investing, wherein firms do it primarily to meet limited partner demands or raise capital from ESG-minded investors. As you move to the right, we start to have more engaged ESG approaches that seek to authentically create value, mitigate risk, and intentionally drive towards responsible business practices. There are many firms that are starting to integrate ESG as a core "value creation" or operations component of managing their investments. These firms both seek to both mitigate outsized ESG risk within their portfolio and also seek to drive company performance with ESG. To the latter point, firms begin to see incorporating ESG policies, standards, and initiatives actually improves top-line performance (e.g., drives revue due to taking favorable action in the eyes of the customer) and improves bottom line (e.g., cuts energy costs). Overall, the widespread proliferation of ESG has been a budding movement for decades and so to the extent that we can get private equity investors engaging and then ultimately pushing to the right over time, it is a net positive for impact objectives overall.

There is a big chasm between ESG and impact investing. While not universal, one way to conceptualize the difference between more active ESG investors and impact investors is that ESG is more focused on the operations of a company and responsible business practices, versus impact investors are frequently proactively solving an impact challenge through the product or solution of a company or investment. Within the impact investing category (far right), there exist a lot of readings and debate on the formal definition of impact investing. For purposes of this paper, we will use a simplified, overly inclusive definition that is: an investor who seeks to intentionally invest to advance a specific impact thesis or area. For example, a firm could say "we seek to advance to advance the Sustainable Development Goals" at a broad level, or "we seek to advance inclusive access to quality education." Some firms have specific impact funds that sit alongside their normal investing strategies (e.g., TPG Rise, Bain Double Impact, KKR Global Impact), and some are impact investors across their entire firms (e.g., Bridges Ventures, HCAP). Depending on the DNA and origins of the firm, firms have chosen different strategies here.

While noteworthy that there are firms and funds who have dedicated themselves to being impact focused, it is worth applying a critical eye towards these players to understand what "impact" they are really driving. As on industry expert noted during an interview, "It's possible to have a socially responsible PE firm, such as one doing socially responsible asset management, or investing in minority-backed and governed businesses, or investing in entrepreneurs of color. But to be a truly *catalytic* PE firm – it's hard to do in the venture and PE space. So these kinds of firms can seek to do no harm, but do you really call that impact?" For example, consider some of the investments of the impact funds noted above:

- Bain Capital Double Impact invested in Impact Fitness, a franchise of gyms that operate at affordable price points within underserved communities. This investment seeks to address some of the key barriers to health and wellness by increasing accessibility to fitness activities.[2]
- The TPG Rise Fund invested in EVERFI, a digital learning platform that offers online curriculum for schools and boardrooms (among others), that seeks to empower organizations everywhere to engage on critical topics and opens education to all.[3]
- KKR Global Impact Fund invested in Barghest Building Performance, an energy savings solution for Heating, Ventilation and Air Conditioning systems in commercial and industrial buildings.[4]

These investments advance Sustainable Development Goals, but at the same time, they are contributing to solutions that only incrementally move the needle and result in impact that likely would have occurred regardless of the impact investor's investment. As a field, it is worth questioning whether the work and positioning private capital impact investing is really sufficiently addressing the $2.5T funding gap in addressing the Sustainable Development Goals.

To demonstrate how private equity capital is falling short on this mandate, consider the following definitional components of the impact of an impact investment, as defined by the Impact Management Project:

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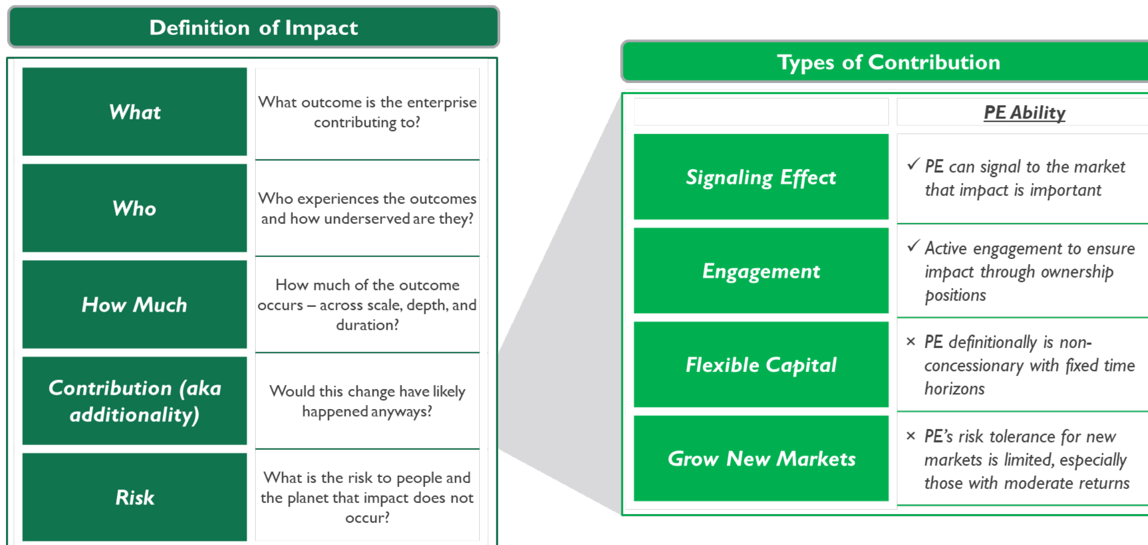
[2] https://www.baincapital.com/news/bain-capital-double-impact-announces-first-two-investments
[3] https://therisefund.com/; https://everfi.com/about/mission/
[4] https://www.kkr.com/businesses/kkr-portfolio?page=Global_Impact



Source: Adapted from the Impact Management Project

On the left, we have the different components of impact. An impact investor should be able to define these elements of their impact thesis. When we dive into the component of contribution (which is sometimes referred to as additionality in other impact investing definitions), we can start to see where private equity investments fall short. The concept of contribution relates to how much an impact investment is creating net new change from occurring. In other words, would the impact have occurred already had an impact investor's capital not been in the deal? An impact investment can have contribution in the form of signaling effect, investment engagement, flexible capital, and new market development. When we dive into these definitions, we can start to articulate where private equity impact investing falls short:

- Signaling effect: PE impact investments can absolutely have signaling affect that ultimately drive more impact. For example, the presence of a legitimate investor (e.g., Bain Capital or KKR) in a deal can signal to other investors and the market that the deal is a legitimate investment opportunity in spite of it also being an impact opportunity. It can also signal to the company and the market broadly that impact is going to be a priority for the company going forward.
- Engagement: PE impact investment can drive contribution and additionality through their engagement with their investments. In part, this is what makes private equity a compelling asset class for impact investing. Due to taking a significant ownership stake and governance control in many assets they work with, private equity investors can directly influence the path forward for an investment and thus impact investors can force a company to take a more impact-forward focus than it would have otherwise. This includes having their investments track impact-focused key performance indicators. For example, Bain Double Impact's Deval Patrick noted (in a class session at Tuck) that they sometimes look for "white space additionality" in their deals, where they recognize that while a company might not be highly impact-focused today, it has the potential to be so in the future based on which customers they seek to serve, how they go to market, and what services they offer.
- Flexible Capital: Flexible capital is the crux of where impact private equity falls short. Flexible capital means that an investor values an impact outcome such that they are willing to take concessionary returns, take on more risk, or offer flexible terms (e.g., duration, capital positioning, uses of funds). PE – as it is constructed now – by and large is not a flexible capital provider (or will not fathom being a flexible capital provider), especially around concessionary returns. Therefore, a question emerges about how much net new impact is actually coming out of their asset class, given that they are only investing in market-rate deals that likely would have been invested in anyways.
- New Markets: Early stage private equity (e.g., venture capitalists) may be able to play an additional / contributory role in helping to build new markets or industries that have high impact potential, but again, the tolerance for this is

limited beyond the early stages. For example, private investors typically are not attracted to markets with limited operating history due to perceived or real risk (e.g., investing in certain assets in developing countries).

The net of this and the inability to be a flexible capital provider ultimately means that impact funds and PE impact investments ultimately do not look that different from a traditional PE investment. Some in the industry have the perspective that PE investments are simply normal investments with some strategic and opportunistic narrative about how an investment advances an impact theme or an SDG. This not to criticize the role and importance of private equity investors in this arena, but it simply highlights the role that they can feasible play given their fiduciary obligations to their limited partners. Once we understand the limitations of the asset class, then we can begin to work around those limitations by innovating where possible and developing complementary investors and resources in the ecosystem that ultimately position private equity to be a high impact player.

Where do we go for here?

The impact investing field began on this path in order to solve the largest systemic social and environmental challenges of our time. It was intended to play a role in helping to bridge the $2.5T gap to address the SDGs. So, given that the field is only investing in what it would have otherwise and therefore not actually filling a capital gap – is it really contributing to addressing the problem we set out to solve?

On the margins, the impact PE space is having positive contribution, especially in terms of the engagement it can have with its investments. This engagement can take place in the form of managing ESG or driving a company to have more net positive impact. Yet recognizing that traditional private investors will likely never be the ones to take an outsized concessionary position, we now need to think about what we can do to ultimately make this asset class work in a high-impact way. From my research and conversations, there are three compelling focus areas that are worth exploration and development:

1) **More effective asset management post-investment:** For deals that already fall within a private investor's risk-return requirements, asset managers and industry bodies should focus on building up capabilities to maximize the impact of an investment through engagement. There are a number of strong examples of this already in the industry (e.g., Turner Impact Capital, HCAP). This could be in the form of both ESG practices or more strategic and intentional impact initiatives. This strategy helps to maximize the contribution of the sector while working within their existing tools and approaches.
2) **New ways to put private capital to work for high impact purposes:** This concept is based on the premise that we need to mobilize private capital for high impact solutions in the near-term, but also recognize that there are limited non-concessionary high impact investible opportunities available for private investors. Therefore, is there a way to engineer investment opportunities such that non-concessionary private investors can somehow get comfortable with investing in high impact assets today?
3) **Create more commercial-grade high impact assets:** Recognizing that private investors are always going to be constrained by risk and return requirements, how can we make sure that the assets that are available for them to invest in are high impact in nature? The existence of a large volume of high impact commercial grade assets will enable more impact returns from impact private equity players, and also enable non-impact focused private investors to invest in assets that inherently create positive impact despite the investor not valuing it.

The first concept is born out of more intentionally and proactive ESG initiatives and impact-forward asset management and exit post investment. The space will eventually evolve this strategy naturally and will be supported by industry organizing and oversight groups such as Impact Capital Managers. The remainder of this paper does not focus on this strategy, though it would be an interesting deep dive for a future student to explore.

The final two concepts, however, are necessary to develop the field in the right way, but also are more nuanced and challenging to execute. Inherently, they involve the use of strategic subsidy in order to execute them. The remainder of this research focuses on assessing the viability of the last two concepts as a possible way to reposition the impact private equity industry for more impact.

Incenting Investment & Building Assets: The Intentional Role of Subsidy

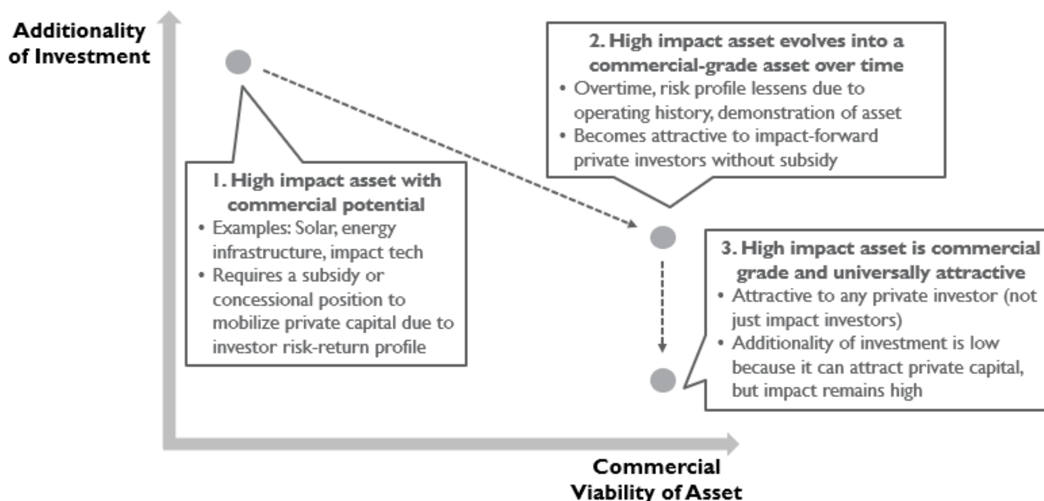
Important to successfully meeting the Sustainable Development Goals is the ability to incent and move capital to invest in solutions and assets that address the major societal and environmental challenges of today. These include investing in underinvested areas (e.g., low-income communities, developing markets), new technologies (e.g., renewable energy solutions), and cost efficiencies that make goods and services accessible to low-income people (e.g., energy, financial services, clean water, electricity, etc.). In their current form, some of these investment opportunities are not attractive or accessible for private investors. However, in theory, these assets could have commercial viability if proven out (e.g., demonstration effect to understand risk), scaled appropriately (e.g., unit economics require scale, bundling of smaller assets to meet investors minimum investment size), or made accessible (e.g., information asymmetry or limited network access). Yet, in order to reach a point where these are commercially viable assets, investment is needed today, so that over-time the asset develops such that subsidy is no longer needed.

This concept is summarized in the following visual:

	Non-Commercial Asset	Asset with Commercial Potential	Commercial Asset
Return-Risk Profile	× Return concern × Risk concern	✓ Viable returns × Risk mitigable (time, demonstration, asset development)	✓ Viable Return ✓ Viable Risk
Subsidy required	Yes – Longer-Term/Indefinite	Yes – Short-Term	No

There are some assets that might never be able to become commercially viable (e.g., left-most category – non-commercial asset). In this type of scenario, there will likely always be a role for subsidy. For these type of assets, we have to be cognizant of market distortion and the long-term sustainability of said subsidy. Yet, with an asset with commercial potential, subsidy has the potential to be strategically applied to "train the market" and then can ultimately be removed once it is a commercial asset.

When we think about this concept in relation to contribution/additionality, an investment in a non-commercial asset or asset with commercial potential would have high contribution, because of the private investor's willingness to invest alongside a subsidy means that an investment is happening and/or happening at a far greater scale than it would have otherwise. Over time, the contribution / additionality of the investment decreases as it becomes commercial grade, but ultimately you're increasing the amount of impact per private dollar invested, because the asset itself has greater impact. This conceptually can be demonstrated in the following:



In order to move from 1 → 3 in the image above, subsidy needs to be strategically applied and then lifted over time. Subsidy can come in many forms, and this research dives into a cursory overview of some specific subsidy and concessionary capital applications and examples within blended finance and tax subsidies.

Subsidy Approach: Catalytic Tools in the form of Blended Finance and Tax Subsidies

The research focuses on two types of subsidy approaches: **blended finance** and **tax subsidies**. Both are examples of catalytic tools that unlock more private investment for impact purposes.

Blended finance is a strategy that combines capital with different levels of risk in order to catalyze risk-adjusted, market-rate-seeking financing into impact investments[5]. In blended finance, there is inherently some concessionary, flexible, or higher risk capital embedded within a capital structure. This concessionary, flexible or higher risk capital is called *catalytic capital.* Catalytic capital is utilized to address risks (perceived or real) facing market-rate investors that prevent them from entering into an investment. It can be especially valuable in situations where asset demonstration is required because the perception of risk is not aligned with actual risk. Ultimately, the existence of catalytic capital enables a private investor to still meet their risk and return requirements, and enables investments to occur that would not have otherwise due to scale limitations from concessionary capital providers and risk-return limitations from market-rate capital providers. A leading industry group estimates that blended finance has mobilized approximately $132B in capital for sustainable development.[6]

There are also non-capital catalytic tools, such as tax subsidies or even technical assistance. These tools help to de-risk or use incentives to direct private investor activity. While not a definitive "blended finance" application, it still is a relevant catalytic tool that brings a form of subsidy into the investment and enables private investors to participate in investments they would not have otherwise given changes in an assets return or risk profile.

The following highlights some definitions, synthesis of themes, and examples of blended finance and tax subsidy being used for impact purposes that were uncovered in this exploration:

- **Tools:** Catalytic tools can come in multiple forms. Capital-focused tools are financing approaches that intentionally seek to have below market-rate returns, or no returns at all. Catalytic capital could be more flexible in terms of time horizons or cash flow. It could also come in the form of taking junior equity, subordinated debt, or first-loss capital position in the capital stack, or be a guarantee in the event of underperformance. Regardless of form, all of these catalytic tools enable other investors to have higher return potential or lower risk in a given transaction. The following are some examples of catalytic tools:

Blended Finance – Catalytic Capital				Tax Subsidy – Catalytic Tool
Junior Equity	**Subordinated or Flexible Debt, First-loss Capital**	**Guarantees**	**Grants**	**Tax Credits**
Subordinate position absorbs highest risk	*Risk reduction tool that protects against first losses and/or shifts risk*	*Risk reduction tool to provide credit enhancement and protects against losses*	*Funds costs and activities that lead to investment*	*Provider investor cost savings to incent certain action*
Equity	Debt and/or equity	Debt; Guarantee	Debt; Grant	Debt; Tax Incent.
Junior equity	Sub Debt or First-Loss Capital	Equity; Guarantee	Equity; Grant	Equity; Tax Incent.

For example, within catalytic capital, there are examples of catalytic investors providing junior equity to leverage debt, junior equity (subject to first losses) to leverage preferred equity, first loss and mezzanine debt to leverage senior tranche debt, subordinated public debt to leverage private institutional capital, first-loss capital (as a grant) to leverage sub-debt and senior debt, and first-loss capital (as a grant) to leverage equity. Risk underwriting instruments can either improve the credit profile of companies and projects seeking to raise more or cheaper capital, or provide comfort to investors that they will be able to recover their investment or absorb smaller losses if events negatively impact their returns, which effectively shifts the cost of capital for an investor. Guarantees can help to ensure that investors receive a minimum level of returns, or can limit an investor's losses if an investment underperforms expectations. 'First-loss' guarantees are one

[5] https://thegiin.org/blended-finance-working-group
[6] https://www.convergence.finance/blended-finance

particular guarantee instrument which states that the catalytic capital funder will absorb the initial losses associated with an investment, and can also function as insurance in the event an investment experiences adverse performance. On the tax front, there are a range of tax tools that can be applied, including tax deferments, tax breaks, and tax credits.

- Participants in blended finance and subsidy transactions: *Providers of catalytic capital* often include foundations (in the form of grants and program-related investments), development finance institutions, public sector or quasi-public sector players, philanthropists, or other flexible capital providers. In this kind of transaction, the metric that philanthropists will be focused on is how much private capital can be leveraged – now and in the future – per a dollar of donated/concessionary capital. This is a fundamental shift in how many traditional philanthropists (e.g., individuals and foundations) think about their "donations" or "grants." In this more "regenerative" and returns-focused mindset, philanthropists might start to adopt a "capital leverage ratio" strategy; e.g., if every dollar of public guarantee attracts five dollars of private investment, this represents a capital leverage ratio of 1:5." There are also tailwinds for more philanthropy to get involved in blended finance transactions as we see more "new philanthropy" players moving onto the scene. In the wake of COVID-19 crisis, we have already begun to see a surge of non-traditional players (e.g., corporations, ultra high net worths) embrace a greater sense of urgency for supporting social causes and breaking down traditional "for profit" and "for mission" barriers. Their approaches are more embracing of innovative approaches and have turned more attention to how philanthropy is and is not solving for issues effectively.[7]

  Private investors participating in blended finance often include impact-forward or oriented private investors today. In the international development finance space, investment in these type of structures is more commonplace. Within the U.S., one expert in the field noted that there were limited private players who were accustomed to engaging blended finance transaction – "It's the same dozen people sitting around the table doing these kinds of deals. It's always the players – Prudential, Goldman, JPMorgan." Those that do participate in blended finance as private investors are typically not pure-play private equity investors; they are often community banking entities, family offices, or other investment managers.

  In fact, one expert noted that the space is might not necessarily be applicable to traditional private equity players. In the U.S., one player in the space noted: "There is a wide gulf between PE firms." Fundamentally, there may be some mismatches in blended finance needs and PE firm constraints. PE firms are set up on a fund basis, not a deal basis, with fixed duration windows, which are not aligned with the needs of some blended finance transactions. There are a couple firms (e.g., Arctaris Impact Fund) doing blended finance at a fund level, and a couple examples of firms doing one-off deals with localized subsidy support, but they are not common and not scaled. On the tax credit side, however, there are many players who have found a way to leverage tax credits for their own investment outcomes that have impact and public good outcomes (e.g., Opportunity Zones, New Market Tax Credits, Low-Income Housing Tax Credits, etc.). Private equity players in general are much more familiar with using tax credits in investing, so this ultimately may be a more approachable way to engage private equity players in using catalytic tools for impact outcomes.

- Performance: There is limited publicly reported data on the returns to private and catalytic investors. A leading foundation interviewed for this research has been playing a catalytic capital role in a variety of public health and financial services investments. The foundation has been executing this strategy for the past seven years and notes that they are very conservative in their underwriting, but have experienced very limited losses on the guarantees they have provided. "We have had very few defaults on our program-related investments. In some cases we have waived interest payments, but we've never had to cut any principal on any of their catalytic tools." Granted, they have been executing this strategy in good great economic market, so COVID-19 and the likely economic fallout from that will test its resiliency. Yet, duration might be a concern here. When the foundation initially launched its blended finance initiatives, it anticipated that deals would have a duration of 4-5 years. Yet, the nature of the assets they are investing in are frequently longer duration (e.g. 7-10+ years). This highlights a possible mismatch in alignment for private investor duration interests, but also a challenge for catalytic capital providers to regenerate their investments in a short timespan that would enable them to deploy more capital on shorter cycles. One blended finance fund manager promotes that it is able to use blended finance and tax

[7] https://www.insidephilanthropy.com/home/2020/1/6/philanthropy-in-the-2020s-16-predictions

subsidies to generate "above-market investment returns"[8]. This is an interesting concept and also interesting market question around whether private investors can use philanthropy and subsidy to generate outsized returns.

- Applications: Blended finance is most frequently used today in international development finance and in the context of advancing the Sustainable Development Goals, but it also has many additional applications. In interviews about this project, the most common industries that were mentioned as having significant applications for blended finance were energy, financial services, agriculture, infrastructure and healthcare. Functionally, blended finance can also have applications for early technology or product development that might be unattractive as is to private investors. With tax credits in particular, experts noted that energy, housing (e.g., workforce or affordable housing), and real estate were most frequently mentioned, but really can be applied to any impact objective.

- Execution Considerations: Resources and experts in this space frequently noted that it is challenging to execute these deals and funds. First, these deals frequently require significant stakeholder alignment in order to execute, given that there are often multiple parties involved. Further, these parties often come from two different worlds – private investment and philanthropy/public sector – which are not accustomed to working together and often lack shared objectives, skillsets, networks, and language. Therefore, identifying blended finance opportunities and market-making can be challenging. Further, each deal requires a careful balance of both incentive alignment and balancing how much risk each party is taking on. Further, many noted that these deals often have high transaction costs, given that accounting and legal structures often do not make public-private investment necessarily easy to execute. One interviewee said, "It feels like we are almost reinventing the wheel every time, and we spend a lot of time and money on legal and accounting services to make these go through." Convergence, an industry group focused on blended finance, has noted that there is a need for scalable and standardized products to help minimize transaction friction and costs in order for this approach to be more widely adopted.

- Examples of blended finance and tax subsidy:

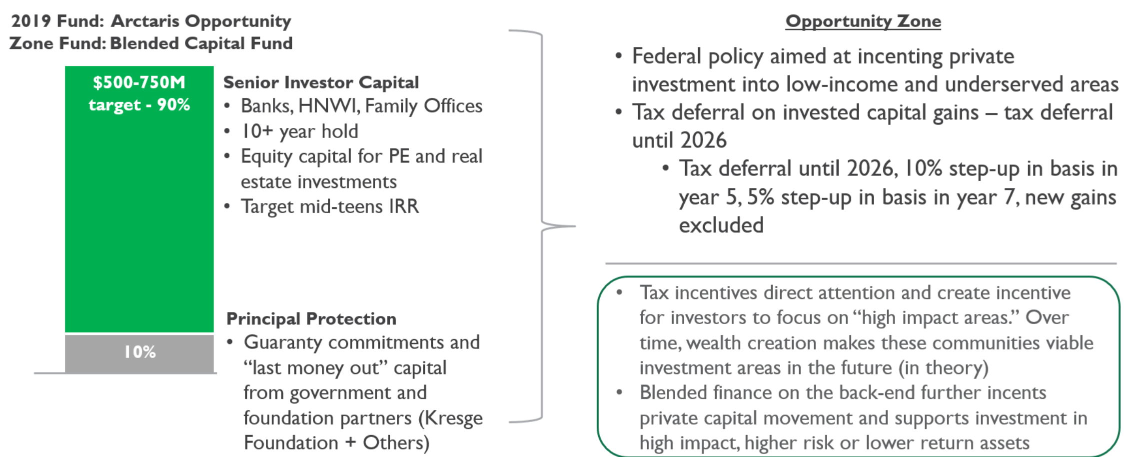
Emerging Market Commercial & Industrial Solar Fund (EMCISF)[9]
EMCISF is a multi-platform investment manager and advisory firm focused on driving positive change in energy in an emerging market. They have launched two separate products, in different stages of their development, that demonstrate the concept of developing non-commercially viable assets into commercially viable entities.

Problem: In sub-Saharan Africa, businesses face high electricity costs and low reliability, which limits enterprise growth potential and has environmental implications. Solar is a viable solution, but it has high upfront costs and access to finance is limited.

Asset:	Solution:	Outcome:
Commercially viable – yet unproven – asset class: Long-term power purchase agreements	• In 2015, investment firm aggregated a portfolio of longer-term Power Purchase Agreements • Pilot fund used a **two-tier equity structure**: $1.3M in first-loss capital from USAID to provide risk-averse investors' with greater protection and increased incentive to invest • Blended structure allowed the fund to raise $30M from private investors – contribution occurred through signaling affect from USAID and lowered the cost of capital for private investors	• Pilot fund performed as underwritten • About to close a $100M Fund II for the same asset, which does not leverage any blended finance $1.3M catalytic capital unlocked $130M in private capital and proved out impact asset class
Non-commercially viable – but developmentally critical – asset class: Solar mini-grids	• In this scenario, investment has low initial profitability; ultimate profitability is unknown; ticket-sizes below investor thresholds • Investment firm aggregated mini-grid assets into a SPV • Used an $18M **grant** from a foundation to adjust project economics to make it viable for private investors • Successfully raised an estimated $180M (undisclosed) fund – equity from private investors and debt from DFIs	• Results still playing out, but profitable • Unknown whether this will become a commercial asset with scale, but it unlocks private capital now to solve a critical need $18M catalytic capital unlocked ~$160M in private capital put to work immediately for impact returns

[8] https://arctaris.com/about/
[9] Name withheld

Arctaris Impact Fund
Arctaris Impact Fund is an impact investment firm that seeks to support underserved targeted rural and low-income urban communities. It uniquely leverages growth debt, blended finance and tax credit investing to execute on its impact mission. In its two most recent funds – its 2018 Impact Fund and its 2019 Opportunity Zones Fund – Arctaris uses a blended finance structure within their funds, where 10-20% of their funds are from public and philanthropy players and used as principal protection or guarantees that enable them to unlock private investor capital. On the deal side, they use tax credit incentives that help support investment in low-income and underserved areas. While they use multiple types of tax credits and approaches, their Opportunity Zone fund is using the Opportunity Zone program from the 2017 Tax Cuts and Jobs Act. In theory, this program is intended to incent private investment into designated low-income and underserved areas by enabling investors to defer capital gains taxes.



It is worth noting that there are lot of criticisms about the Opportunity Zone (OZ) program as it relates to impact, and these criticisms and questions help highlight how subsidies might also be ineffective tools for impact if not constructed correctly. Some of the common impact criticisms on OZs include[10]:

- **Limited accountability and reporting:** Investors and communities do not have any substantive requirements for reporting on the nature and impact of their Opportunity Zone investments. Therefore, there is limited oversight to incent investment in positive economic development, and there will be limited data to determine the efficacy of how these investments were used overall and who benefited from them.
- **Designated areas not always "underserved" and "high need":** Local government had significant autonomy in designating which geographic areas withiun their jurisdiction would qualify for Opportunity Zone investments. While there are were many designated zones that were high need, there were many areas designated that had already experienced significant socioeconomic change and investment. Further, there were opportunities in the process for local government to choose areas that technically were not low-income in order to appease their own interests or stakeholder (e.g., corporate) requests.[11]
- **Low-impact or counter-impact investments qualify as OZ investments:** There was limited oversight in terms of what qualified as an Opportunity Zone investment. For example, an OZ fund could invest in a passive storage facility or other non-economic development driving asset. Further, there are a number of instances of investors using OZ funding to invest in luxury apartment units, which likely have negative gentrifying effects on existing communities.[12] There are also a number of commercial and residential real estate developers who have always operated in low-income areas who are now getting a large tax incentives, but who have had histories of causing

[10]Interviews; NPR;
[11] https://www.niskanencenter.org/these-opportunity-zones-shouldnt-exist-scandal-or-innocent-mistake/
[12] https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2019/09/25/luxury-apartments-get-the-tax-breaks-meant-to-boost-low-income-areas

- **Misaligned benefit:** There is a lot of debate around this bill related to who is really receiving benefit. There is an emerging and strengthening narrative that the real beneficiaries of this bill are well-off investors in the form of tax breaks, while the local residents and communities receive far less objective benefit as a result of this tax opportunity.

Arctaris in particular won anchor investments from The Kresge Foundation and others for its Opportunity Zone Fund, that provide risk mitigation and first-loss protection. In exchange, Arctaris has committed to execute their Opportunity Zone Fund to an impact standard above and beyond what the legislation requires, by focusing on mitigating gentrification and investing in a way that prioritizes affordable housing, mitigating displacement, creating and retaining good jobs, and banning investments in non-productive assets (e.g., storage units).[13] For example, high-impact Opportunity Zone investments might include investment in manufacturing and services businesses that drive local development and job creation, platform businesses that bridge the digital and broadband access divide, and infrastructure projects that promote renewable energy and inclusive transportation. If successful, Arctaris could be a leading example for how future iterations of similar policies could be constructed to maximize impact.

Additional examples

- **Prudential & NatureVest[14]:** Prudential's $1B impact investing portfolio allows 20% of its investments to be catalytic capital. This catalytic capital is more risk tolerant for "seeding" projects that ultimately have the potential to be scaled, viable impact investments for Prudential in the future. One example is Prudential's investment in The Nature Conservancy's NatureVest. DC's stormwater initiative was looking to create a cap-and-trade marketplace of storm-water credits. Given the newness of the initiative, Prudential was unable to effectively underwrite the initiative such that it would meet the risk-return hurdle of their "80%" portfolio. Instead, they made a smaller investment ("a couple million dollars") into the initiative from their "20%" portfolio that catalyzed the asset's development. Once the market established pricing data and completed a pilot, the firm could better underwrite the opportunity. Now that the asset has developed, Prudential has invested in the marketplace from its main, market-rate portfolio and been able to tap into over $15M in deals.
- **Tata Power & The Rockefeller Foundation[15]:** In an effort to bring reliable power to millions in India, Tata Energy and the Rockefeller Foundation collaborated on a blended finance deal where Rockefeller's catalytic capital enabled Tata to invest in 10,000 mini-grids across rural India. "For the Rockefeller and Tata Power deal, 30% of the proposed funding is equity, split 80/20 between Tata and Rockefeller. The rest is debt. [Rockefeller's] contribution [is] "concessional capital": No return-driven investor in his right mind would provide it, based on the risks of currency, rule of law and execution. Rockefeller intends to reap a small return or break even. That allows Tata to seek a 14% return on investment, which helps it get better debt financing—the road to scale." In this case, Rockefeller is helping seed and catalyze an initial investment at a concessionary rate in order to build a "big impact" asset that is sustainable and able to attract market-rate investment in the long-term.
- **Tax Credits for Solar Power[16]:** Solar energy development in the U.S. is an example of using tax credits as catalytic capital tool to develop solar as a viable, investable, and sustainable asset. Historically, solar technology was too expensive relative to coal and other energy sources to be a viable commercial investment. In the 1970s, Congress began looking for ways to make solar more affordable by giving tax credits to investors in solar energy. This, alongside other policy and regulation initiatives, enabled widespread adoption of solar that matured the market and made it competitive. As the industry continues to develop, there will likely be opportunity to remove tax subsidies from these investments.
- **Mitigating the 'Valley of Death' for High Impact FinTech Startup[17]:** Sokowatch is a Kenya-based FinTech startup offering business-to-business e-commerce solutions. In emerging markets, the inability for consumers and small

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[13] https://kresge.org/news/kresge-foundation-commits-22m-back-arctaris-community-capital-management-opportunity-zone-funds
[14] https://beyondtradeoffs.economist.com/implementing-billion-dollar-mandate
[15] https://www.wsj.com/articles/give-philanthropy-the-market-test-11583100757
[16] https://www.energysage.com/solar/cost-benefit/solar-investment-tax-credit/#:~:text=The%20investment%20tax%20credit%20(ITC,no%20cap%20on%20its%20value.
[17] https://nextbillion.net/sokowatch-quona-philanthropic-capital-funding/

business to access basic financial services and products like the ones Sokowatch was developing prevent significant economic growth and wealth building across the continent. Quona Capital is an early stage impact investor who seeks market-rate returns alongside social impact in the form of driving financial inclusion. The fund recognized the potential of Sokowatch, but saw that the business was going to have a hard time getting enough traction to raise a successful Series A. Sokowatch was then able to receive a flexible grant that enabled them to help bridge a funding gap and then ultimately successfully raise a $14M Series A. This is an example of a disaggregated blended finance transaction, that ultimately enabled a high impact solution to reach scale in a way that made it a commercially viable investment.

Overall Outlook: Subsidy as a Way to Drive Additional PE Investment into Impact

This research revealed that investing using subsidy likely has limited applications and is not the next scaled solution for the investing industry, but it is an applicable tool that could be more widely adopted by both private and public/philanthropy players alike to unlock more capital for impact-forward solutions. It expands the tools in the toolbox we have to solve social problems, but it is not the answer to everything. There both benefits of these tools and also considerations:

Benefits

- **More capital moving into high-impact assets:** The use of blended finance and tax subsidy means that private investors who are interested in or willing to put capital towards impact purposes are able to drive more immediate impact per dollar invested. By changing the risk-return characteristics of investments and lowering investor cost of capital, these subsidy-based tools enable capital to move towards impact purposes at greater scale than they are today.
- **More impactful private investment:** As high-impact commercial-grade assets become more available, they are likely to also be able to attract investment from non-impact-first investors. A good investment is a good investment, regardless of whether there are positive externalities resulting from it. Further, as more private investors begin to engage with ESG and other values-based investment practices, investors will begin to internalize the costs of negative externalities and also drive more positive externalities naturally through their operations. Therefore, we are likely to see positive impact benefits even from non-impact investors.
- **More catalytic philanthropy:** In blended finance in particular, philanthropic players are common catalytic capital providers. Across traditional philanthropic institutions (e.g., foundations), it is not always natural or commonplace for philanthropy to think about a return on investment of their "donation." Typically, donations and grants are not recouped and therefore are not regenerative. Yet, in this type of arrangement, a philanthropic player must think about ways to creatively use their capital to unlock impact and investment beyond what would have occurred without a blended finance arrangement. This fundamental shift has the potential to make philanthropic dollars more impactful and efficient.
- **Breakdown barriers between private sector and philanthropic/public sector:** Historically, the private sector and the philanthropic/public sector have been two distinct and separate toolkits and industries. Yet, this bifurcation ultimately limits the breadth of the toolkit that each player can use to achieve their own objectives. As the world starts to recognize that private sector shareholder optimization is not positioning us to achieve a society consistent with our values, there needs to be further breakdown of the barriers between private and public actors. Based on where we are today, stakeholders who deeply understand impact do not sufficiently understand investing and finance. Further, stakeholders who deeply understand investing and finance do not sufficiently understand impact. As such, the ability for these players to work together, expose one another to their unique strengths, and bridge inherent knowledge and capability gaps, the more effective each can be as they work within this impact investing arena.

Considerations

- **Niche asset applications:** Blended finance and subsidy-enabled investing is not applicable to every asset class or impact investing situation. However, it is a solution that has the potential to be applied to a diverse range of issues and industries.

- **Risk of market distortion:** There is some criticism of subsidy-enabled investing because of the potential for free market distortion. The objective of blended finance and subsidy should be to train the market for impact, not create the market. In other words, society likely does not want the existence of long-term subsidized markets. The art of effective blended finance, however, is to provide "market-correcting incentives" only up to the level where risk and return are in line with the alternative investments the investor could choose – a standard called "minimum concessionality." If this level is attained, there is no market distortion and investors do not benefit disproportionately. However, there may be some instances where blended finance and subsidy is applied in a way that disproportionately benefits investors, which has the potential for negative affects downstream (e.g., with Opportunity Zones, where investors clearly benefit but genuine impact is questionable).
- **Execution challenges and risk:** Industry experts have noted that fundraising for blended finance (less so with tax credit subsidy) is still a challenge, especially for unproven assets and philanthropy-enabled deals. Given lack of familiarity with blended finance and high transaction costs associated with it, sometimes investors who are less familiar are likely to not engage. Further, deals are often difficult to construct given the challenge to align key stakeholders and their various objectives. In addition, the legal, tax, and regulatory system are not set up well to support blended finance, given the combination of private and philanthropic/public capital. Those who work on these deals note that transaction costs are high given legal and accounting complexity of each deal. As the field professionalizes and standardizes products and transactions, the execution challenge and high costs will likely go down over time.

Overall, the growing engagement of private investors and private equity in impact investing is a positive trend in the early stages of a broader shift in capitalism and the purpose of business. While there is a long way to go to transition the industry to one consistent with society's values and ambitions, the early engagement in the form of ESG practices and impact investing is a positive indication that further evolution and impact within investing is on the way. While this early traction is promising, it is also important to recognize that we need to be mindful about how the field develops in order to make sure it is really solving for what it was intended to solve. This means standardizing, strengthening, and innovating the approaches that investors are using for both their ESG and impact investing. It also means recognizing that high impact asset development is also a critical complementary component for the industry to develop as it was intended. While not a holy grail solution, blended finance and subsidy has the potential to play a critical role in developing high impact assets, driving more money towards high impact applications in the near and long-term, and ultimately creating more effective impact-minded investors and investment-minded philanthropists who will be better positioned to solve critical social and environmental problems.