THE "AND" STRATEGY OF IMPACT TECH VENTURE CAPITAL

IMPACT TECH IS THE FUTURE OF VENTURE CAPITAL

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The future of venture capital is in impact tech. According to the UN, addressing the Sustainable Development Goals by 2030 requires an additional $2.5T in capital. Yet, of the current $500B of impact assets under management, less than 1% is allocated to impact tech venture capital. Given the current market demand forces, in addition to the global nature of technology, a remarkable opportunity lies right in front of our eyes.

The new wave of impact investing is reaching brand names all around the world. Shops like TPG or Khosla Ventures have fundraised hundreds of millions of dollars for side funds that meet the demands of conscious capitalists. Yet, the creation of side funds fails to recognize that implementing a blended high impact and high profit strategy brings superior returns over traditional finance.

The rapid launch of impact-focused VCs, as well as the co-investments by traditional VCs into impact startups, has allowed the impact tech industry to hit the $2B mark in dollars invested in 2019. More than 3,000 investors around the world have made bets on hundreds of impact tech startups that are addressing social and environmental challenges, while creating profitable and scalable business models. The numbers are reflective of an industry that is nascent but growing rapidly.

Financial markets are moving toward one direction: reimagining how we invest.

**In order to get ahead of the curve, traditional VCs can implement the ‘AND’ strategy, a novel investment strategy that both differentiates them from the crowd and creates value for their portfolios.**

This white paper examines such blended strategy and recommends an implementation pathway.
**WHAT IS IMPACT TECH?**

*Impact tech* is defined as the intentional use of science and technology to benefit people and the planet.

Most of the impact tech investors that have emerged over the last years have built funds that seek to maximize competitive financial and social/environmental returns. The companies they invest in have the following characteristics:

- **Founders are intentional about their impact mission**
- **Technology is core to the company’s product or service**
- **Impact is blended in business model and product/service**
- **Company is committed to measuring and managing impact**
While some strategies like tech-for-good, which also leverages technology to address social/environmental challenges, do not seek competitive financial returns, others like responsible tech only aim to avoid harm or minimize negative impacts. ‘Impact tech’ takes a step further by combining direct positive social/environmental solutions with competitive financial returns.

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<tr>
<th>Impact Profile</th>
<th>Return Profile</th>
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<td>Traditional Tech</td>
<td>Any returns</td>
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<td>No identified impact</td>
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<td>Responsible Tech</td>
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<td>Mitigation of negative impact</td>
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<td>Tech-for-Good</td>
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<td>Impact Tech</td>
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![Diagram showing the impact in the tech industry]
Based on this definition, we can map tech startups based on 3 factors: impact profile, use cases, and return profile.

1. **Impact profile: Where in the impact spectrum does the technology fall, from a ‘do not harm’ approach to a full alignment to the Sustainable Development Goals?**

The 2030 Agenda for Sustainable Development provides a shared blueprint for peace and prosperity for people and the planet, now and into the future. At its heart are the 17 Sustainable Development Goals (SDGs), which are an urgent call for action by all countries - developed and developing - in a global partnership. They recognize that ending poverty and other deprivations must go hand-in-hand with strategies that improve health and education, reduce inequality, and spur economic growth – all while tackling climate change and working to preserve our oceans and forests.

2. **Use cases: Is technology an enabler of the product/service or an engineering/scientific innovation?**

For example, the Omidyar Network’s Beneficial Tech group specifically looks at how technology is deployed rather than for what purpose it is used. Their framework focuses on ethical technology solutions around data privacy, security, portability and user control. On the other side of the spectrum is Fifty Years, an early stage VC investing in companies addressing the world’s biggest problems through deep tech.

3. **Return profile: What are the investor’s return objectives, from concessionary (below market-rate of return) to non-concessionary capital (market-rate of return)?**
WHY IMPACT TECH?

The early iterations of impact investing addressed a market failure or an underserved market opportunity. However, the industry has undergone different pivots. Over the last decade, impact investors – especially those who seek market-rate returns – are drawn to the potential of tech companies to solve global social/environmental challenges at scale.

The why of impact tech companies comes down to how investors can help startups create more value for both shareholders and stakeholders. This additional value, sometimes referred to as ‘additionality’, can be achieved in various ways:

- **New customer segments**: 79% of consumers prefer to purchase products from a brand that operates with a social purpose.

- **Reducing the cost of capital**: In 2019, impact tech startups raised $1B globally in rounds with participating impact investors, and $1B additional from non-impact investors.

- **Talent attraction and retention**: Millennials are 5X more likely to stay when they have a strong connection to their employer’s purpose. Impact-aligned startups can reduce staff turnover by up to 50%.

- **Strategy**: Companies that include sustainability into their purpose and product have shown to grow 30% faster than traditional businesses.

Although impact tech is a nascent industry, we have seen some early successes that prove that impact tech investors can indeed support the value-creation quest of their startups. For example, Techstars reported that between 2012 and 2018 impact tech startups outperformed their general portfolio. Kapor Capital’s impact tech portfolio has delivered 3x TVPI, and is a top quartile VC fund.
# IMPACT TECH EXAMPLES

## DESCRIPTION

### AeroFarms
- Series E startup valued at $500M, U.S., AgTech
- Indoor vertical farming
- Backed by MissionPoint Partners, Goldman Sachs, GSR Ventures

### LEAD School
- Seed startup, India, EdTech
- Making excellent education, accessible and affordable to every child in India
- Backed by Elevar Equity and The Rise Fund

### Goodbag
- Accelerator stage, Europe, ClimateTech
- Reusable bag with communication chip
- Backed by Maze X (from Mustard Seed VC)

### Lulalend
- Series A startup, South Africa, Fintech
- Lending platform for SMEs in South Africa
- Backed by Accion, IFC, Quona Capital

## IMPACT PROFILE

### AeroFarms
- Impact themes: carbon emissions & land, circular economy (water)
- Impact Measurement [here](#)
- SDG 2

### LEAD School
- Impact themes: skill gap years, accessible education
- Impact Measurement [here](#)
- SDG 4

### Goodbag
- Impact themes: Environment, plastic waste
- Impact Measurement [here](#)
- SDG 11, 12, 13, 14 and 15

### Lulalend
- Impact themes: Financial inclusion
- SDG 8 and 17
Demand for impact capital is increasing exponentially among the new generation of tech entrepreneurs. Tech savvy millennials are ahead of the curve when it comes to creating companies with intentional and measurable impact, or impact natives. But their demand is not being fully met with the right supply of impact-aligned capital. The solution: unlocking billions of dollars to address the impact priorities of tech founders.

At the same time, there is a growing demand for impact-aligned investments, a demand strongly pulled by those same millennials who are expected to be on the receiving end of the biggest wealth transfer yet - $30T in the next decade in the U.S. alone. The solution: expanding the pool of highly competitive startups aiming to create accessible, affordable and profitable tech solutions for today’s social and environmental challenges.
In order to take advantage of the demand and supply forces, the market has so far resorted to two distinct strategies:

- **Side Funds**: Some large firms have set aside capital to set up impact funds, creating a clear separation line between impact and traditional assets. Most of the examples in this category come from the Private Equity industry (e.g. Partners Group, KKR, etc.), but there are also some Venture Capital firms as well (e.g. Khosla Ventures).

- **Native Impact Funds**: An accelerated wave of impact venture funds has emerged. There are now around 200 impact tech VC investors. Funds such as Fifty Year or Renewal Fund have an exclusive impact tech mandate. Although this investment strategy has technically been around for decades (e.g. SJF was founded in 1999), the capital funneled to impact tech funds is still a fraction of total venture capital money raised. Most managers have not yet raised the billions of dollars that successful traditional VCs or PE impact funds have, and hence, many of these funds have their hands tied in early-stage rounds, missing the chance to invest in impact startups’ lifecycle. Some exceptions to this trend are Bridges or DBL Partners.
SIZING THE MARKET

The numbers are clear: 2019 marked a new beginning for the impact tech VC industry. In 2019 alone, $2B was invested in impact tech in ~200 deals throughout the funding lifecycle. With an annualized CAGR (dollars invested) of 50% over the last 5 years (as compared to 16.5% for traditional VC), the impact tech industry has the potential to become the largest share of VC investments by 2025.

The author published an impact tech industry landscape report that reveals interesting findings as of 2019:

- **Record number of deals and dollars invested** – $2B in 2019 vs. $1.4B in 2018
- **Increasing late stage activity** 1/4th of deals in 2019 were Series B or later
- **U.S. leads the pack** – 44% of impact tech deals worldwide were recorded in the United States; India followed at 12.5%
- **FinTech is the favorite impact tech theme** – there were 37 FinTech deals attracting $500M+ in 2019.
- **Absence of exits** – there are not many recorded exits in the industry yet; corporates are the number one impact tech acquirers

These trends reflect the combined power of side funds and native impact funds, in addition to the increased co-investments by traditional VCs in impact tech startups. Although the potential to leapfrog impact tech investments is great, it is currently being limited by the traditional view of impact investing as an asset class rather than an investment strategy. The next growth wave for the industry will come from bold traditional VCs who demystify the misconception of impact as a concessionary strategy and bring the power of data to validate above-market returns.
A common misconception in the industry is that impact tech startups are born (impact natives), and not made (impact migrants). This doesn’t hold true anymore.

Startups that have the most potential to make a difference are those created to make an impact. These companies are born out of a desire to better the world by tackling specific social/environmental challenges using impact-intentional business practices. They generate more than just revenue; they cultivate measurable impact in areas such as HealthTech, AgTech, or EdTech. These startups can be defined as impact natives, or companies that are born into creating intentional and measurable impact by tackling a well-defined social/environmental problem.

Although there are more than +800 impact tech ‘natives’, the market opportunity lies in a different type of startup: the impact migrant. Impact migrants are those businesses that, although were not created under the premise of addressing a specific social or environmental issues, have the potential and a desire to transition into impact by defining their impact mission, integrating it within their business targets, and tracking impact in alignment with financial KPIs.

**MyndYou** is an example of an impact native. Ruth Poliakine Baruchi founded this company with the desire to enable healthcare professionals to provide targeted and cognitive-driven care to patients with or at risk of cognitive decline. From the start, she carefully thought about the impact outcomes she wanted to achieve, namely, prolonging the independence and improving the quality of life of senior adults, and reducing the emotional and physical stress of caregivers.

**Via** is an example of an impact migrant. Backed by Pitango Venture Capital, Via is a share riding company for public transportation systems. It is currently working with the Head of Impact and Sustainability at Pitango, Cecile Blilious, to identify its theory of change, stakeholders and impact metrics (including SDGs). The objective is to quantify the positive impact Via’s service is already generating in terms of, for example, carbon footprint. Although Via was not built with the desire to contribute to the Sustainable Development Goals, it has come to appreciate and internalize the value of business growth potential through impact.
Impact tech should not be considered a separate asset class. Impact can – and should – be integrated into every asset class. This is the only way that impact tech VC, and impact investing at large, can truly scale and become mainstream in the investment world. Therefore, instead of raising a separate fund or narrowing the investment universe down to impact natives, Venture Capital firms can integrate the ‘AND’ philosophy: high profits and high impact. VCs can pioneer this blended approach by adopting impact methodologies and metrics based on their desired level of impact alignment.

"A visionary company doesn't seek balance between short term and long-term; it seeks to be highly idealistic and highly profitable."
– Built to Last, Jim Collins
Implementing the ‘AND’ strategy doesn’t have to be a complicated process for VCs. The following 6-step framework is targeted to traditional VCs who want to migrate into a blended impact + profit strategy:

1. **Reviewing startup portfolio**: The first step in examining the startups’ potential contribution to certain impact objectives. Are the startups mitigating ESG risks? Are they positively contributing to a social/environmental issue? Can they be aligned to and measured against SDG indicators? The investor can map the current startup portfolio to the impact spectrum.

2. **Creating blended strategy**:
   - Any intentional investor should do a self-reflection of their goals in pursuing a blended strategy: am I reacting to LP pressure? Do I want to truly understand my startups’ impact (for reporting or marketing purposes)? Do I want to carve out some assets for impact-oriented startups? Do I want to be a market-builder in the impact tech industry?
   - Once these questions are answered, the investor can then identify a series of impact objectives. For example, the VC could decide to take a ‘do not harm’ approach and only integrate ESG factors into its investment strategy. Or it could take a flexible approach with a minimum floor (e.g. startups should at least fall under the ‘responsible’ bucket) while aiming to invest in startups across different impact buckets.
3. **Measuring portfolio impact**: Funds can easily and seemingly adopt international standards in impact measurement and management such as the SDGs, Impact Management Project or SASB. In order to do that, the investor has to choose the different impact dimensions it wants to track (e.g. SDG contribution, additionally, ESG, impact risks, SROI). Second, it needs to choose specific impact KPIs for relevant startups. Finally, it can either measure impact backwards and/or project potential future impact based on the growth rate of financial/impact unit economics (similar to how traditional startups project their financials). For example, if the number of patients using a certain medical device is expected to increase 50% YoY, then we should expect its impact (e.g. increase in life quality) to grow at the same rate if impact is blended into the business model and product.

All startups have an impact. However, a priori we do not know whether it’s net positive or net negative. For example, a company that is developing the next frontier of best available technology in the oil & gas sector is, on the one hand, marginally reducing pollution as compared to the status quo and, on the other hand, is helping the extractive sector continue polluting. What is the net effect?
CONTINUING TO BLEND IMPACT WITH PROFIT

4. Aggregating and measuring fund impact: Impact doesn’t stop at the startup level. In addition to rolling up different metrics at the fund level, the VC can identify additional ways it is contributing to social/environmental challenges directly. For example, gender inequality is an easy example: does my fund have as an objective gender parity at all levels of the VC investment hierarchy?

5. Building impact screening tools: In addition to measuring post-investment impact, the investor should also ensure there are appropriate impact screening steps. This could take the form of a checklist, a social due diligence questionnaire or a combination of both. Moving forward, the investor will have a better sense of what type of startups it is sourcing and diligencing, and where in the impact spectrum they typically fall.

6. Reporting: The last step is to ensure as much transparency as possible. More and more funds are issuing annual impact reports explaining their blended strategies and providing some data points on their startups’ and fund impact achievements.
As Cecile Blilious writes “the highest financial and impact ROI can only be delivered through a thoughtful and integrated impact lens.” The AND philosophy – high impact and high profit – is a new way of redefining what impact investing, and more specifically impact tech, is and can become. It is a way of imaging a better world through every single investment. Needless to say, there is one important risk that impact investors are wary of: impact-washing. Given the demand for both investing in impact assets and reporting one’s impact, investors might feel compelled to take a light interpretation of what impact investing is for branding purposes. That is why individual transparency is so important: it is everyone’s responsibility to report methodologies and results to ensure that those who do not subscribe to industry standards slowly, but steadily, lose credibility.

The opportunities – from the investor and startup side – to embark in the impact tech adventure are plentiful. I welcome you to join me for the ride!
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