Focusing on the 'impact' in impact investing

By Priyanka Sunder
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Much has been written about the urgent need for new sources and forms of finance for development. UN estimates suggest that developing countries will need more than $2.5 trillion a year to achieve the SDGs by 2030 and that the vast majority of these funds must come from non-government sources.

Since the term was first coined, impact investing has been touted as a key solution to the global development financing gap. Generally speaking, impact investments are projects that deliver financial returns alongside positive development outcomes. They are a rare 'win-win' for development, enabling private investors to contribute to social and environment causes while still pocketing profits.

Impact investing undoubtedly has significant potential for attracting private investment for development. The global impact market is growing rapidly with more than $US30 billion invested in impact funds and products in 2015 and at least $US77 billion invested in impact assets. Estimates suggest that half of impact assets under management are in emerging markets, with around 20 per cent invested in Sub-Saharan Africa. Within a decade, the market is expected to reach between $US600 billion and $US1 trillion. Though in its nascence, Australia's impact market is projected to reach $A32 billion in just five years.

Despite early promise, however, there is growing evidence that impact investments are struggling to tackle complex development problems. A survey by the Global Impact Investing Network (GIIN) shows that many impact investments are made in mature, established businesses; and that nearly 60% of impact investors expect market, and above market, rates of financial return. This means that while investors are happy to invest in projects that achieve social impact, the majority are unwilling to sacrifice the level of profit they make. This lack of 'impact first' investors – investors who are willing to accept higher social impact in lieu of higher financial returns – is the greatest challenge facing the industry.

To address complex entrenched development challenges, patient long-term capital is critical to find, test and retest solutions. Impact first capital, capital which prioritises development impact, is critical to supporting early stage firms or pilot projects to refine business models and commercial approaches, and withstand external shocks. Over time, once they are established and reach scale, these projects are more likely to generate market returns. The microfinance industry is a prime example of the catalytic role of impact first capital. When microfinance was in its infancy, the industry was heavily reliant on impact first capital such as donations, grants and philanthropy. This capital enabled microfinance to innovate and grow into an industry which today attracts a large portion of impact capital seeking competitive financial returns.

Impact investors chasing high financial returns tend to overlook these kinds of opportunities and choose investments that target less complex social problems, are less risky and have shorter timeframes. In practice, this means investing in a commercial canning factory in Nepal rather than an emerging digital business which helps small-holder farmers access market data. Or investing in increasing child vaccinations over addressing systemic gender-based violence in a community.

The demand for higher financial returns can push social impact organisations seeking impact capital to shift their business models to focus on beneficiaries who are easier to reach and less marginalised. Others are dissuaded from pursuing impact investment opportunities at all. NGOs – particularly international development NGOs – are open to engaging in the impact investing space but are reluctant to compromise on development outcomes. This has contributed to a serious shortage of investable projects which generate both positive development and financial returns.

This is problematic. The appeal of impact investing is its ability to marry the growing desire of investors to contribute to social good with their need to invest their capital productively. While both aims can be achieved, there is an inevitable relationship between risk, return and social good. To thrive, the impact investing market must attract investors across the return/impact spectrum – ranging from those that prioritise development impact over financial returns to those that seek competitive returns alongside some social impact. Without a diversity of investors seeking a diversity of both social and financial returns, the impact investing market risks stagnation.

As the Australian Government recognised in a recent discussion paper, Government action is critical to address weaknesses in the impact investing market. Governments are uniquely positioned to provide impact first capital which prioritises development returns and can be used to trial solutions to complex development problems. Government support could be in the form of interest free or low interest loans, grants or Government guarantees that can be used to encourage private investors to co-invest.

Similarly, tax incentives have been used effectively by governments in the US and UK to attract impact first capital from non-government sources. In Australia, offering tax deductions to philanthropic funds, foundations and private and public funds could be used to great effect to unlock capital which is inherently values-driven.

The Australian Government could play a pivotal role in addressing the information asymmetry within the impact investment market. Currently, the market is a noisy mix of players with varying appetites for risk, financial returns and social impact. This makes it difficult for investors to identify impact investments that suit their financial and impact objectives, and for NGOs to find suitable backers. By developing a framework that classifies impact investments according to their risk/return/impact characteristics, the Australian Government could bring together investors and social enterprises and help them find the right capital and impact investment product for them. The framework developed by the Tideline Group provides a useful starting point.

To boost the supply of investable projects, the Australian Government could help NGOs access training and financial assistance so they are better equipped to attract impact capital and develop investable projects. NGOs often lack the funds and expertise to turn their development programs into financial products for investors, particularly within Australia's complex tax and regulatory environment.

Impact investing remains a highly promising sweet spot for development finance. Impact investments align the interests of private investors with positive development outcomes, and can unlock capital that would not otherwise flow to developing communities. But the market desperately requires more investors who are not only willing to commit impact first capital but understand the full spectrum of impact and financial returns that impact investments can deliver.

Priyanka Sunder is the Senior Economic Development Policy Advisor for World Vision Australia.

For further information, see World Vision Australia's Submission to the Australian Government's Social Impact Investing Discussion Paper.

About the author/s

Priyanka Sunder
Priyanka Sunder is the Senior Economic Development Policy Advisor for World Vision

Australia and focuses on economic development, private sector engagement and development finance policy. Priyanka has a Masters in Public Policy from Georgetown University with a specialisation in development economics. She previously worked for Macquarie Bank as an investment banker and as the Senior Policy Advisor for the Australian Council for International Development (ACFID).