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HOW CAN EMERGING MARKETS RIDE THE IMPACT INVESTING WAVE?

Burak Dalgın | Managing Director at Darby Private Equity and EDAM Board Member

Ussal Sahbaz | CEO of EDAM

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"Society is demanding that companies, both public and private, serve a social purpose."
Larry Fink - CEO, BlackRock

"This new way of business–where companies focus on people and not just profits, try to make the world a little bit better–should be at the heart of every modern company."
Hamdi Ulukaya – Founder & CEO, Chobani

Impact investing is a very hot topic. From global financiers to academics, from successful entrepreneurs to development professionals, a diverse set of people talk about this relatively new phenomenon. Optimists hail it as the way to mend the rift between Wall Street and main street and a panacea for social issues that governments can no longer cope with. Pessimists see it as finance industry's latest marketing gimmick to lure new clients or to "buy indulgences with the public"[1]. The reality is a bit more nuanced. We believe impact investing can indeed make a real difference in accomplishing sustainable development goals (SDGs), particularly in emerging markets[2].

However, meaningful challenges exist, as well. Just like emerging markets private equity has achieved over the past two decades, impact investing needs to develop capable teams, demonstrate track record and have long term backers to achieve scale and sustainability. This paper outlines seven potential ways for emerging markets to ride this wave.

I. What is impact investing?

Global Impact Investing Network (GIIN) defines impact investments as "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return". IFC further crystalizes this with three attributes: (i) intent (deliberate intention to have a positive social or environmental impact); (ii) contribution (how to accomplish the intended goal); and (iii) measurement (specific performance indicators). Some practitioners also include another criterion: investments made to specifically benefit disadvantaged populations or environment.

The ultimate test for any definition is what is excludes, rather than what it includes. Based on the GIIN definition, building a wind farm generating green energy or establishing a factory creating 1,000 jobs would *not* qualify as impact investing if the original intention was to make financial returns (regardless of the actual social and environmental

[1] Wall Street Journal columnist Holman W. Jenkins, Jr.

[2] This view has been enforced through our leadership role in the SDG impact accelerator (sdgia.org) established by Turkish Ministry of Foreign Affairs, and supported by Bill & Melinda Gates Foundation, World Food Programme, Qatar Development Fund, and Turkish corporates (Eczacibasi and Limak).

impact). Similarly, grants would *not* qualify for the impact investing, regardless of their social benefit – there needs to be an expectation of return on (at a minimum, return of) capital. That said, a continuum of return expectations, expanding from concessionary capital to market risk/ return, is included.

Another important point is the difference between impact investing and two broadly related concepts: socially responsible investing (SRI) and environmental, social, and governance (ESG) integration (also known as sustainable investing). SRI, which started in 1960s, is essentially about exclusion of certain assets from investment portfolios. These could be "sin sectors" (e.g., tobacco, firearms, and gambling), assets deemed to be environmentally negative (e.g., fossil fuels), or investments associated with certain civil/ political situations (e.g., apartheid). ESG, a term coined in 2004, is more of a risk management tool, broadening the scope of potential risks to the investments. Impact investing goes beyond these and include social and environmental impact as a primary investment objective.

II. Seismic shift or fad?

It is hard to put an exact figure on the size of the impact investing market, given various definitions. For example, the total assets managed by the 226 respondents to GIIN's 2018 annual survey amount $228 billion. Arguably, this is the low end of the range. At the other extreme is $1.3 trillion, which includes the direct and indirect investments by over 450 signatories to the UN's Principles for Responsible Investing (PRI). While these investments have been made in companies generating revenues from goods or services linked to specific environmental and social themes, some of which may not technically qualify as impact investing. Finally, IFC has a more bottom up perspective, including private impact funds ($71 billion), investments by development finance institutions (including over $700 billion by those following harmonized measurement metrics), green and social bonds (over $400 billion outstanding). The space seems to be several hundred billion dollars – meaningful, but still relatively small, given the $260 trillion global financial assets.

So how far can this go? Let's look at the actions of market players. Larry Fink, CEO of BlackRock, wrote "every company must not only deliver financial performance, but also show how it makes a positive contribution to society" in his letter to the CEOs of his funds' investee companies. When the top executive of a firm with $6 trillion in assets under management makes a point, people tend to listen. Moreover, forecasting that ESG-focused exchange traded fund assets will increase from $25 billion today to more than $400 billion by 2028, BlackRock introduced a line of products focused on sustainable investing. A number of other large global financial institutions are taking similar actions. Net net: Wall Street is betting that the impact investing is here to stay.

The underlying driver for this optimism is millennials, who are expected to inherit $24 trillion assets from baby boomers. They seem to be quite conscious of the social effects of business. According to Deloitte Global Millennial Survey 2019, when asked "what should businesses try to achieve", millennials rank improving society or generating jobs higher than generating profits. Moreover, only 37% of them believe business leaders make a positive impact on the world. The increased role of women in owning and managing financial assets also augments this shift.

IFC's "Creating Impact: The Promise of Impact Investing" report estimates that impact investing "could total as much as $26 trillion", which is 10% of the global financial assets. The report estimates that "in public markets involving stocks and bonds, investor appetite could be as high as $21 trillion [and] an additional $5 trillion could come from private equity, non-sovereign debt, and venture capital" with the understandable caveat that "turning this appetite into actual investments will depend on the creation of investment opportunities and investment vehicles that enable investors to pursue impact and financial returns in ways that are sustainable."

III. How is this relevant to emerging markets?

Quick answer is three words and a number: sustainable development goals (SDGs) and $4 trillion.

SDGs are global objectives which "form a program of sustainable, universal and ambitious development" for 2030, as adopted by heads of state and government, senior United Nations (UN) officials and representatives of civil society gather in September 2015[3].

The $4 trillion is the annual spending in developing world needed to accomplish SDGs. In 2014, UN Conference on Trade and Development estimated global investment needed to meet the SDGs to be $5-7 trillion. $3.3 to $4.5 trillion of this expenditure was related to developing countries. A 2019 note by IMF staff[4] estimated that meeting the SDGs in five key areas (education, health, roads, electricity, and water and sanitation) would require additional annual spending in 2030 of $0.5 trillion (15% of GDP) in low-income developing countries, and $2.1 trillion (4% of GDP) in emerging markets (EMs). Clearly this cannot be financed by governments or development finance institutions alone - private sector involvement is essential.

EMs are not only where most of the social impact would occur, but also are in need of capital. Therefore, they are the natural homes for impact investing. There are two additional factors that need to be considered. First, most of the private sector investing in EMs already creates positive impact, even if they don't technically qualify as impact investing. Bringing some disciplined approach and establishing measurement systems could help attract impact investors attention and thus expand EM private sector's financing options. Secondly, several EMs strive to become financial centers. While it is unlikely for many of them to become traditional financial services hubs, they may become important locations for impact investing, given their proximity to the actual impact and their firms' ability to operate in challenging geographies, including frontier markets.

Chart 1. United Nations SDGs

[3] For details, https://sustainabledevelopment.un.org/

[4] Gaspar, Vitor, David Amaglobeli, Mercedes Garcia-Escribano, Delphine Prady, and Mauricio Soto. 2019. "Fiscal Policy & Development: Human, Social, and Physical Investments for SDGs." IMF Staff Discussion Notes No. 19/03

IV. Too good to be true?

While it works in theory, impact investing needs to address four key challenges to work in practice.

1. *Measurement/ reporting.* A clear and simple impact measurement and reporting system is essential both to measure performance and attract capital to the space. Several institutions, such as GIIN and IFC, are already working on standard metrics. However, there are two risks: (i) overkill - too many sophisticated metrics which become hard to follow and (ii) too much customization, potentially making like-for-like comparisons quite difficult (a teenage girl's education in Africa vs. cutting carbon emissions in Southeast Asia).

2. *Financial return/ impact trade-offs.* Most market players claim that there is no trade off between impact and financial performance. "Having your cake and eating it too" approach might over-simplify the diversity of challenges. Specifically, this approach might cause three risks: (i) rewarding over-promisers (naturally "no trade-off" managers have upper hand in fundraising, particularly when capital is represented by fiduciaries); (ii) inhibiting financial instrument creativity (e.g., blended finance, below-market but positive return, market return by assuming more risk); and (iii) eliminating investor segregation (primarily impact-oriented investors vs. investors who would not accept lower returns for higher impact). A clear and honest appreciation of trade offs (if any) would open ways to solve potential problems.

3. *Proven track record.* Like any young sector, impact investing -to a significant extent- lacks a proven track record, both as an industry and at the fund management team level. This is particularly important given the inherent challenges in sourcing, executing, monitoring and realizing illiquid investments in EMs, as demonstrated by retreats of several global investors. Therefore, market building efforts by international financial institutions or impact-oriented investors' willingness to provide capital to emerging managers (even if some funds do not have the scales of their regular investees) could help address this meaningful challenge.

4. *Scale and financial/ operational sustainability.* Many examples of social entrepreneurship or impact investing tend to be highly boutique efforts. Some players, with the best of intentions, completely ignore the risk/ return angle and call grants as "investing". Naturally, touching ten people's lives, making a $25k investment or donations may have positive impact. However, business models lacking a path to scale (often through disruption) or not focusing on financial/ operational sustainability cannot go too far from being "feel good" activities or public relations exercises.

V. Ways to play

There are several stakeholders with diverse priorities: governments, charities, development finance institutions, private investors, asset managers, corporations and entrepreneurs to name a few. The following actions would benefit them and help build a functioning impact investing sector in EMs.

1. *Recognize the potential of impact investing.* This is the first natural step to start building a new market. Having companies or funds report on impact (even if they are not impact focused) would diversify their investor base, and hence create value for them. Moreover, this would help build new markets around the idea. At a minimum, emerging markets stakeholders need to acknowledge the upcoming wave. GSG National Advisory Boards is a noteworthy effort.

2. *Foster new funds.* Fund anager development is an essential component. Some ideas to start acting on: invest in first time funds with experienced teams, include impact investment capabilities in accelerators, use co-investments with traditional funds in their portfolio companies which can generate positive impact or leverage technology to make smaller funds operationally feasible.

3. *Use blended finance.* Impact can be maximized through both uses (i.e., investments) and sources of capital. For

example, impact-oriented investors may subsidize private capital or catalyze extra funding through accepting lower returns or higher risk. Rockefeller Foundation was able to mobilize significant capital for a regular private equity fund by simply underwriting FX risk, a key issue in EM investing. Various organizations could provide grants not directly to companies but to investment vehicles qualifying certain criteria, so that they can mobilize (non-impact) capital and help build an impact investing sector, while also funding their goals.

4. *Leverage large corporations.* A typical problem in start-up investing is an excessive focus on funding with limited time spent on markets (who will buy?) and capability development (how will the business operate at a bigger scale?). An active twinning of impact-oriented start-ups with large corporations would help address them. If the corporations have some stake in the success of start-ups (e.g., through accelerator programs or impact funds they invest in), these relations could go a long way. John Tierney, a columnist for The New York Times, once wrote "Has any organization in the world lifted more people out of poverty than Wal-Mart?". In a way, collaborating with large corporates in various capacities (e.g., vendors, partners, investees) could certainly enable impact-oriented ventures to overcome the two typical death traps– scalability and financial/ operational sustainability. Turkey's SDG Impact Accelerator, which both of us are involved in, included industry leaders as "challenge owners", providing direct access to start-ups.

5. *Attack on global issues.* Focusing on problems relevant for multiple geographies or broader populations and establishing mechanisms that could be replicated elsewhere would not only maximize impact but also bring scalability. For example, the SDG Impact Accelerator's initial focus is on displaced persons (a highly global issue) and its two pilots are on non-sewage toilets and digital identification (highly relevant for populations beyond refugees). Therefore, any solution developed could be leveraged well beyond the area of initial focus. No wonder the program attracted start-ups from thirty countries.

6. *Use it as an anchor to orient government spending.* The impact investing principles are -in essence- relevant for any initiative using taxpayer money: there should be an intention to generate positive, measurable social and environmental impact; there should be measurable goals, which are traced along the life of the project; and there should be the financial angle (not necessarily in the form of return on/of capital, but certainly as a clear cost/ benefit analysis). This would not only bring discipline, transparency and effectiveness, but also make it easier to analyze the roles of public vs. private money (or partnership) in various situations.

7. *Get involved.* Various organizations from GIIN to IFC are working on developing certain global standards for impact investing. EM stakeholders can contribute and have a clear incentive to participate in this debate – however, they are not as active as they should be in shaping the debate. This needs to change.

In conclusion, impact investing can make a real difference in accomplishing sustainable development goals (SDGs), particularly in EMs. While the challenges are real, establishing appropriate mechanisms could create attractive investment opportunities and help make the world a better place. Ensuring this is incumbent on all stakeholders in EMs. After all, as John C. Bogle, founder of the Vanguard Investments, said "we are the invisible hand of the marketplace".

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