Photo by Alex Irvin

"There is an absolute dearth of untied, unfettered, generous, patient capital ready to take risks on business models that haven't yet been proven. The microfinance industry benefitted from what some people estimate was $20 billion of that kind of money, experimenting with business models until we got it right, until it took not 10 years but three years for a new institution to break even."

— **Elizabeth Littlefield** @elittlefield
President and Chief Executive Officer, Overseas Private Investment Corporation

8 Unblocking dealflow in impact investment opportunities

The past decade has witnessed growing optimism for finding commercially viable market-based solutions to global development challenges. Such solutions are attractive from a development perspective because they promise to expand the resources and skills deployed in development efforts, propagate innovative products and business models, and provide a proven sustainable route—market forces—to take these to scale. Clean cookstoves, community water, microfinance and mobile money are examples that vividly demonstrate this potential.

While private firms and social enterprises are busy developing these solutions, a cadre of enlightened investors is playing an important catalytic role. These impact investors include development financial institutions such as the U.S. Overseas Private Investment Corporation, investment banks such as J.P. Morgan, retirement funds such as TIAA-CREF, foundations such as the Skoll Foundation and investment funds such as Root Capital. Today, impact investing is emerging as a standalone asset class, with an estimated value of $50 billion. The participants in the Brookings Blum Roundtable discussed the growing pains associated with this asset class, which provide some useful insights on the broader challenges confronting market-based development solutions.

A central problem cited by roundtable participants was "deal flow": a shortage in the supply and range of high-quality investing opportunities. This is corroborated by a recent survey of impact investors (see table). The roundtable discussion explored the factors that lie behind this problem.

A first step in understanding this constraint is to distinguish between different stages of investment. Most impact capital is focused on the later stages, when business models are already proven and ready to be brought to scale. By contrast, only a handful of investors support the early stages when business models are still being developed and tested. A review of 90 funds by the Monitor Group in 2011 found that only 10 percent provide angel or seed capital to support new start-ups and

Industry survey of the most critical challenges to the growth of impact investing today
Number of respondents = 99; Respondents ranked their top three

RANK	SCORE	AVAILABLE ANSWER CHOICES
1	143	Lack of appropriate capital across the risk/return spectrum
2	140	Shortage of high quality investment opportunities with track record
3	76	Difficulty exiting investments
4	58	Lack of common way to talk about impact investing
5	53	Lack of innovative deal/fund structures to accommodate portfolio companies' needs
6	48	Inadequate impact measurement practice
7	44	Lack of research and data on products and performance
8	32	Lack of investment professionals with relevant skill sets

Source: GIIN, J.P. Morgan, 2013

Need a global first loss fund for early stage, riskier investments -- grant money before investments. **#Blum2012**

"Identifying local investors is key for building an entrepreneurial ecosystem in poor countries. Often, it's not about market entry so much as market creating. Therefore, you need people who know the local systems, the local networks, the local connections. In Silicon Valley, many investors won't invest outside a 10 to 15 mile radius, because they know the human capital they bring is just as important, if not more, than the financial capital they bring."

— **Amy Klement** @amyklement
Vice President, Investments, Omidyar Network

Photo by Alex Irvin

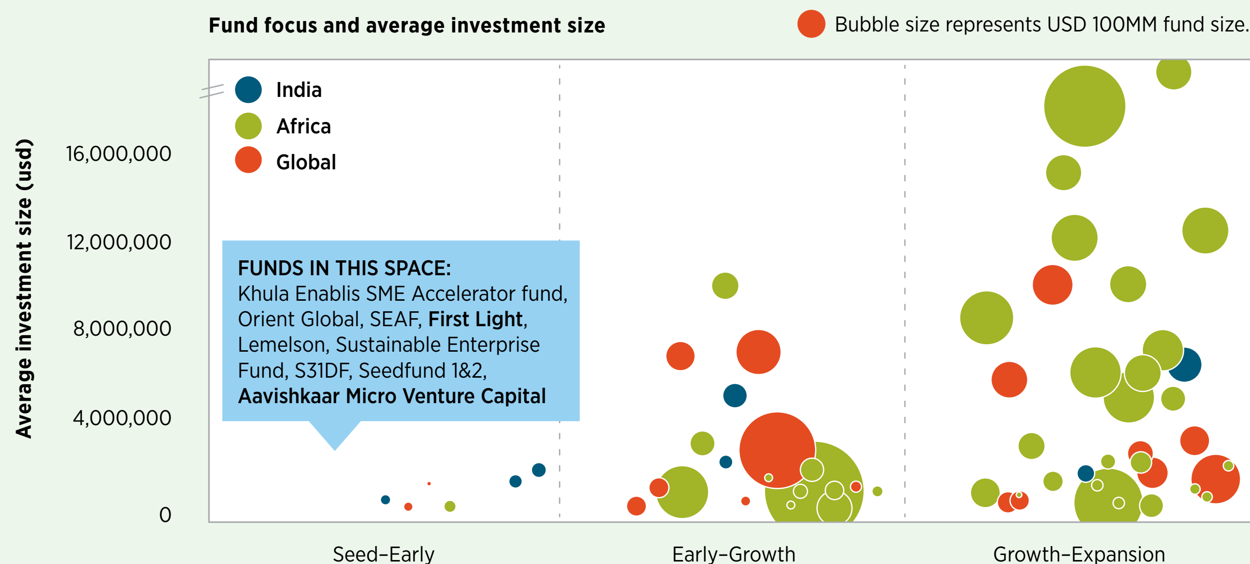
product innovations. The Omidyar Network estimates that of the $50 billion in capital devoted to impact investment, the amount available each year for early-stage investments is in the low hundreds of millions of dollars.[23]

The paucity of early-stage investment in market-based development solutions is easy to explain. Such investments are inherently risky with long, undefined maturities and high rates of failure, but without the upside of occasional outsized returns which venture capitalists can achieve in other markets. Furthermore, investments are typically small in size and complex, implying high transaction costs. This combination of low margins, small size and indeterminate timescale are anathema to investors' bottom line.

With little capital invested in the early stage of the business

Focus of Impact Investment Capital Industry (90 Funds), Mid–2011

Most impact funders currently play primarily in the growth/expansion phases, but with some focus on early phases. There is little capital available at seed stage.



	Seed–Early	Early–Growth	Growth–Expansion
% Total Investors	**13%**	**22%**	**65%**
% Total Investment	**19%**	**29%**	**52%**

Illustrative—Fund landscape not exhaustive.
Analysis by the Monitor Group.

Photo by Alex Irvin

"Getting business models right takes time and requires a lot of trial and error. Our analysis of 50 high performing social enterprises found profit margins of between 3 and 15 percent if they're doing really well, but it takes 10 years or more for most social enterprises to reach any kind of meaningful scale, which means there's almost no return in the early stage financing of these enterprises. And unlike conventional venture capital, you're not going to get your return back from hitting it big on one investment to cover the cost of the others. None of these are making extraordinary margins, extraordinary returns to give you that portfolio effect."

— Mike Kubzansky
Partner, Monitor Group

lifecycle, few validated business models successfully emerge whose expansion subsequent investors could then support. Hence, when investors complain of weak deal flow, they are specifically referring to the later stages of investment in which most impact investors specialize. The demand-supply imbalance indicated by a weak deal flow reflects the inverse problem at an early investment stage when there are a multitude of capital-constrained firms but scant demand for investment opportunities from the very same set of investors.

Supporting the early stage of business development is not just a matter of providing money. An integral part of Silicon Valley's success is the hands-on involvement of investors in the ventures they support, imparting expertise, forging market linkages, and informing recruitment. The same is true for impact investors where the imputed cost of human capital combined with transaction costs can easily exceed the size of financial investments. However, replicating the Silicon Valley model is a challenge for impact investors. Few have a presence in target countries to allow regular contact with firms, or sufficient local knowledge and networks to draw upon. A 2011 study of impact investors supporting small and growing businesses by Santa Clara University found that investors who practiced "high-touch" portfolio management (defined as "monthly contact or greater" with firms) reported significantly higher return expectations than those who employed less frequent contact, but this comes with the trade-off of larger overheads.[24]

The problem of deal flow is exacerbated by the fragmented nature of the impact investment sector in which investors operate and deals are struck largely independently of each other. This increases the transaction and search costs incurred with individual investments. In theory, these costs could be mitigated by increased coordination and information sharing between investors, creating a transparent and efficient pipeline of investment opportunities as businesses transition through different investment stages. However, many impact investors prefer to operate independently and perceive this as integral to their ability to generate profits in challenging markets. Such investors are unlikely to readily disclose information regarding their investments or to rely on information picked up secondhand from rival investors. This is a reminder that impact investors are a diverse group; while they all share an interest in both commercial success and social impact, they vary in terms of the weight applied to these two goals.

A related constraint is the limited enabling infrastructure in the impact investing industry. Compared to mature asset classes, impact investing has few dedicated institutions and services to grease the wheels of investment deals. Most transactions take place without the benefit of market exchanges, rating agencies, investment banks, brokers, or specialist lawyers, making potential deals harder to identify and value, as well as to close.

As the industry grows, this infrastructure is likely to develop. Indeed, there are signs that such changes are already afoot. Open Capital is a deal-broker service based out of Nairobi that prepares businesses for capital raises and helps structure and negotiate investments. The African Enterprise Challenge Fund, hosted by the Alliance for a Green Revolution in Africa, is helping to identify the best new ventures for investment through a competitive mechanism. Industry associations such as the Global Impact Investing Network and the Aspen Network of Development Entrepreneurs are taking various steps to improve the functioning of the market.

These developments are undoubtedly positive but the deal flow problem continues to loom large. An unresolved question posed at the roundtable is whether ultimately more purely philanthropic funding is needed in early stage investment if the potential of market-based development solutions is to be unleashed and if so, how it might be mobilized.