IMPACT INVESTING IN EMERGING COUNTRIES

Insights from the due diligence process

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Linda Darragh and Nurkholisoh Aman from the University of Chicago Booth School of Business prepared this research to be released at the U.S. Secretary of State’s Global Impact Economy Forum.

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DISCLAIMER:
The authors’/institutions’ views expressed in this publication do not necessarily reflect the views of the U.S. Department of State or the United States Government.
Project Background and Acknowledgements

This report began as a student project of the University of Chicago Booth School of Business and Kellogg School of Management at Northwestern University. It was completed in collaboration with the U.S. Department of State’s Office of Global Partnership Initiatives - Global Impact Economy Initiative that seeks to support the work of innovators that are contributing to an Impact Economy by developing and deploying cutting-edge business and financial models that generate financial returns and positive social and environmental change. We would like to thank Lalarukh Faiz from the State Department for her guidance and support.

Kellogg students developed a framework to analyze risk and opportunities in specific countries. Chicago Booth students conducted interviews with social entrepreneurs, investors and technical assistance providers in six emerging countries to understand local nuances that affect risk and opportunities for impact investment. Jamie Jones, Assistant Director of Social Enterprise at Kellogg and Linda Darragh, Director of Entrepreneurial Programs at Chicago Booth, were the two faculty members who oversaw the student projects.

The initial research identified a variety of factors that could affect the ultimate success of an impact investment to create both financial and social returns. Still unanswered was the question which factors were actually being used by existing impact investors to evaluate risk. Impact investors are incented to have the most comprehensive knowledge regarding factors that are the most likely determinants of success. Consequently, Linda Darragh and Nurkholisoh Aman launched a survey to obtain greater understanding of the due diligence process currently used by impact investment funds that have invested in emerging markets.

The survey instrument was vetted by a wide range of impact investors and consultants. Georgette Wong of Correlation Consulting provided major support in the vetting process and later in the distribution of the survey. We would also like to express our gratitude to Adair Morse, Assistant Professor of Finance at the University of Chicago Booth School of Business for her review and insights.
I. Introduction

Impact investing in the United States is an emerging investment field that is gaining popularity as individual and institutional investors seek ways to obtain financial returns while making a positive impact on society and the environment. However, impact investing in the U.S. is not only nascent but complex. Impact investment funds vary significantly with respect to the source of capital, investment vehicle, location and sectors for investment, expectations regarding both financial and social returns, and potential exits. This complexity is further complicated by the fact that good performance metrics, for both financial and social returns, are largely missing. Many existing impact investment funds are not mature and have yet to post any exits. For those funds that have exits from portfolio companies, the number of exits is limited, and the comparison of various investment strategies has not been analyzed with academic rigor.

Impact investment funds which are based in the U.S. can be divided into two groups. One group of funds targets domestic social ventures that are geared to creating impact in the U.S. Like typical angel and venture capital investments, both investors and investees are located in relative geographic proximity. Investors can meet with management teams on a regular basis and they have an intimate understanding of the market and the supporting network.

The other group is composed of those U.S. impact investment funds that are focused on investing in emerging markets. These investments are inherently higher risk as the lack of geographic proximity can affect the ability to gain an in-depth understanding of the economic, political and societal environment and network that impacts a potential investment. Investors need to understand the dynamics of a country as well as the local nuances of the target market and business entity in order to assess and manage investment risk.

This report focuses on the latter group – U.S.-based impact investment funds that invest in emerging markets. The impetus for this focus was driven by the collaboration with the U.S. Department of State. The U.S. Department of State is exploring ways to facilitate and stimulate U.S. impact investment as another instrument to assist emerging markets. Beyond this initial collaboration, the focus on emerging market investments helps to define the parameters for research. Country-specific information takes a center stage and a deeper understanding of the importance of specific country characteristics becomes the research challenge.

The main purpose of the report is to provide guidance to existing and future impact investment funds that target emerging markets. A body of academic research supplemented with information on best practices can provide critical information that can facilitate and accelerate investment by U.S. funds into emerging markets. This report offers a starting point in developing a comprehensive body of research.

Given the current lack of data to evaluate actual portfolio exits in relation to specific investment strategies, this study focuses on revealed preference as to the choice of inputs in an investment decision as an indicator of expected outcomes. This report can therefore offer some baseline analysis for future research.
A secondary goal is to compare inputs in the decision making process of impact investment funds with those of traditional venture capital funds. The hypothesis is that the priorities of investment decisions for venture capital funds should vary from impact investment funds as the former is focused solely on financial returns and the latter strives to achieve both financial and social returns. Once again, this report provides some cursory data that could serve as a baseline for more comprehensive research in the future.

Finally, this report also provides a taxonomy of data sources of country attributes that are considered important in the context of impact investment decision making (included as an appendix). This list was compiled from discussions with a number of impact investment funds.

II. Placement in Literature

The Monitor Institute report was arguably the first to address impact investing as a distinct type of investment, describing it as an active placement of capital in businesses that generate social and/or environmental good and at least return nominal principal to the investor.

In the ensuing three years, a surge in research activities around impact investment struggles with whether the nominal return aspect of this new asset class is correct. The Parthenon Group report maps examples of impact investment on a traditional asset allocation framework with the goal of debunking the notion that socially or environmentally beneficial projects always require charity. Survey data in the J.P. Morgan report highlights the variation in expected financial returns that impact investors demand. This report also presents an important forecast of potential scale and profit of impact investment in selected businesses over the next 10 years.

Santa Clara University examined the potential role of horizontal capital aggregation within the impact sector. The research focused on profiling the following impact-investing attributes: sources of funding, the terms of impact capital prior to investment, the qualitative and quantitative investment outcomes desired, and the market conditions that could serve to facilitate horizontal aggregation.

An important piece of this aggregation is government participation. InSight and Harvard University discussed a framework through which government policy can create an enabling environment for impact investing. The report located various opportunities for government policies to intervene in the impact investing market and provided a tool to evaluate its effectiveness. This framework is further illuminated with 16 case studies, serving as examples of concrete interventions that shape and support impact investing markets.

Whereas most of the aforementioned research advances current knowledge regarding the attributes and environment for impact investment in general, this report is a starting point for a body of research that focuses on assessing investment processes and strategies and their subsequent impact on financial and social returns. Given the limited number of exits of impact investment portfolio companies and even fewer funds that have closed, there is a lack of comprehensive data to evaluate the plethora of investment strategies. We focus on the first stage of the investment lifecycle – due diligence – as an indicator of the priorities in a fund’s investment strategy.
III. Methodology and Survey Instrument

III.a. Due Diligence Approach

The promotion materials of existing, often nascent, impact investing funds suggest that the market is filled with a wide array of “niche” and “broad” targeting of industries, technologies, geographies, and/or financial instruments to achieve success in both financial and social returns. It is essential that mechanisms evolve to evaluate the heterogeneity of approaches that all make success claims.

Our research methodology builds on the fundamental economic principle that, in a setting in which outcome data are not (yet) available to access success across different dimensions of inputs for a specific investment strategy, revealed preference as to the choice of inputs is uniquely informative to outcomes. Thus, through our due diligence survey instrument analysis we hope to offer first reckoning of the tensions between social and financial returns, particularly emanating from the choice dimensions used in impact investing decision inputs.

The premises of this study are as follows:

- Success for impact investing is defined not only by financial returns but also by social and/or environmental returns.
- The ranking of investment criteria dimensions in the due diligence process of a fund are a measure of revealed preference, where revealed preference, in an economic sense, maps to performance across financial and social returns.

These pieces fit together as follows: Impact funds claim to balance social and financial returns. A dizzying array of strategies to achieve such goals comes from the fundraising materials of these funds. In a global setting, the possible niches for impact investing are almost infinite, as each geography-industry-technology combination may offer new opportunities to position a fund. But the same can be said for the array of strategies venture capitalists claim as they build off the diversity of entrepreneurs seeking capital. But, just because impact investing funds have a variety of strategies, does that imply that the inputs into value-creation are also diverse?

This study uses due diligence criteria to indicate anticipated success of impact investment strategies in portfolio companies. Thus, the first step is to quantify the rank ordering of these criteria with a survey instrument.

III.b. Survey Instrument

The impact investment firms selected for the survey were U.S.-based and have investments in emerging countries. This sub-group of impact investment firms represents the type of funds that are achieving the goals of the U.S. Department of State’s Office of Global Partnership Initiatives – ‘the ability to leverage the expertise and assets of the private sector to create market opportunities and revenue-generating solutions to the world’s most pressing problems’.

The list of firms for this survey was assembled from various sources including the GIIN Database, Social Investment Manual, and Impact Asset50, totaling 65 funds (choosing only one fund per fund family series). Of these, 37 were emerging market funds. The on-line survey was vetted by several impact funds and consultants in the impact investing space. The survey was sent out in November 2011, and 17 respondents completed the entire survey. Therefore, the following analysis is based on these 17 completed surveys. It should be understood that this is a small sample with all due qualifiers.
IV. Dimensions of Analysis: Key Factors in Due Diligence

The factors described below are examined along two dimensions. First, there is a set of criteria for which the benchmarks for evaluating a potential portfolio company are very similar across most venture capital firms. The preeminent factor is the requirement for a high quality management team. Other factors that a potential portfolio company should exhibit include a large addressable market, significant barriers to entry, and a time horizon for a potential exit that fits the anticipated lifecycle of the fund. The second set of factors defines the specific investment strategy of a fund. These factors relate to the expertise of the fund’s management team and can vary significantly across funds. These factors can include the preferred growth stage, sector and geographic location of an investment.

IV.a. Comparative Factors

IV.a.1. High Quality Management Team
Venture capitalists often state that the most important factor in selecting a company for investment is the management team. Investors evaluate management teams on their track history and past successes in building companies; ability to motivate and attract talent; superior skill set that can complement the growth objectives for the business; ability to take advice and work with fund managers, and other professional consultants; integrity, accountability, and the ability to make difficult decisions. There is no reason to believe that the importance of management is any less for impact investment funds.

IV.a.2. Large Addressable Market
Venture capitalists do not consider an investment unless the ultimate market which a business might capture is sufficiently large. The business model of a venture capital fund is to take large risks, accepting the reality that most ventures will fail, but counting on the ones that do succeed to generate very high returns.

Impact investment funds likewise should view market size as a necessary input. Even beyond the financial return goal of these funds, being able to achieve high social returns requires impact investment funds to invest in companies able to capture a large market. In the social returns space, a large market may translate into creating a host of jobs or into providing a cleaner source of energy to masses of people.

IV.a.3. Barriers to Entry
Venture capitalists value a business that has intellectual property to sustain its competitive advantage in the marketplace. The Global VENTURE CAPITAL and PE Attractiveness Index 2011 indicates that most emerging markets rank well below the U.S. in offering investor protection and intellectual property protection. These issues should matter for impact investing in emerging markets and have implications for the roles of government in mitigation.

IV.a.4. Favorable Exit Strategy
This due diligence factor is important to both traditional and impact investment funds but the specific benchmarks can vary considerably. The business model of venture capital firms is built on the premise that the fund will be able to liquidate within seven – 10 years and provide distributions to the limited partners. To achieve the large successes needed to compensate for the high number of failing ventures, portfolio companies have to be attractive for an acquisition or IPO by the time the fund is scheduled to close, which means such markets must exist.
Similarly, impact investment funds want to match the exit potential of a portfolio company with the time horizon and expected returns of the fund. However, impact investment funds can vary significantly on these parameters. Given the desire for blended returns, impact investment funds may extend the time horizon for an exit in order to ensure that a company has achieved both anticipated social impact as well as financial returns. Impact investment funds also vary by the anticipated returns and exit strategies for portfolio companies.

IV.a.5. Ability to Syndicate
To increase the probability of a favorable exit for portfolio companies, venture capital funds like to ensure that future rounds of capital are available. There is also often a desire to spread risk of an investment across several funds. These objectives can be achieved through syndication. Given the maturity of the venture capital industry and similar expectations of financial returns, syndication occurs often among venture capital firms.

Impact investment funds may not (as yet) have such an opportunity. In July 2011, Santa Clara University and the Aspen Network of Development Entrepreneurs released a report entitled ‘Coordinating Capital: A New Approach to Investing in Small and Growing Businesses (SGB)’. This report highlighted the difficulty for the impact investor community to “syndicate globally, to extend the scope and scale of impact within a local or distant region”.10 The report concluded that given the diverse range of impact investment funds as well as the relative low number of funds in the SGB sector, there are significant impediments to syndication.

The inability to syndicate may imply different strategies in terms of the growth stage for investment, particularly in portfolio companies requiring significant capital investment such as heavy machinery or infrastructure.

IV.a.6. Investment Type
Venture capital firms by definition invest in companies seeking an injection of equity capital. Not so, with impact investment funds. Current impact investment firms can provide their portfolio companies with a combination of grants, debt, equity, loan guarantees, and combinations thereof. This diverse range of investment types appears to indicate the desire to achieve social returns over financial returns since some of these investment vehicles offer minimum financial returns.

IV.b. Due Diligence Criteria based on Specific Investment Strategies
The next set of survey questions take a more agnostic approach to due diligence and asks fund managers what other characteristics matter in their preferred investment target.

IV.b.1. Growth Stage of the Company
Economic theory suggests that an investment in an early stage venture is inherently higher risk and will be compensated with higher returns given a successful exit as compared to investments in later stage firms with lower risks. In other words, the risk/reward opportunities across various growth stages of a firm should even out. Thus, venture capitalists should focus their filtering of the growth stage of the company to match their specific expertise.
The growth stage of companies may, however, matter to impact investing funds. For example, an impact investment fund whose secondary goal is jobs creation may not want to bet on an entrepreneur in the seed stage when s/he does not have a revenue model. Instead, a more mature company with growth prospects but perhaps large scaling costs (i.e., less profitably overall) may be a better choice. Conversely, as another example, an impact fund going after new green technologies may actually take on more seed risk than a similar venture capitalist would be willing to take.

IV.b.2. Geographic Preference
Impact investors not only need to consider geography in terms of opportunity and information, but also in terms of impact possibility, given a benchmark expected return.

Given the unique political and economic environments of different countries, funds often describe their geographic preference in terms of countries, not regions. Expertise in foreign countries requires comprehensive knowledge of the political and economic environment as well as the target market, coupled with familiarity of local customs and nuances. All of the funds surveyed had members of the management team and/or paid experts on the ground in the countries in which they invest.

IV.b.3. Industry/Sector
Because of the social mandate, the industries targeted by impact investment funds differ from traditional sectors. In fact, the list only sparsely overlaps. Table 1 is a chart that illustrates this statement. On the left hand side is a list of industry categories used by the National Venture Capital Association. On the right, is the list of sectors included on the 2011 Impact Assets50.

Table 1: Comparison of industry categories

<table>
<thead>
<tr>
<th>Industry Categories used by NVCA</th>
<th>Industry Categories used by Impact Assets50</th>
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</thead>
<tbody>
<tr>
<td>Biotechnology</td>
<td>Affordable Housing and Community Development</td>
</tr>
<tr>
<td>Business Products and Services</td>
<td>Alternative Energy, and Climate Change</td>
</tr>
<tr>
<td>Computers and Peripherals</td>
<td>Clean Technology</td>
</tr>
<tr>
<td>Consumer Products and Services</td>
<td>Education and Charter Schools</td>
</tr>
<tr>
<td>Electronics/Instrumentation</td>
<td>Fair Trade</td>
</tr>
<tr>
<td>Financial Services</td>
<td>Health and Wellness</td>
</tr>
<tr>
<td>Healthcare Services</td>
<td>Media, Technology, and Mobile</td>
</tr>
<tr>
<td>Industrial/Energy</td>
<td>Microfinance/Low-Income Financial Services/Microinsurance</td>
</tr>
<tr>
<td>IT Services</td>
<td>Natural Resources and Conservation</td>
</tr>
<tr>
<td>Media and Entertainment</td>
<td></td>
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<tr>
<td>Medical Devices and Equipment</td>
<td></td>
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<tr>
<td>Networking and Equipment</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
</tr>
<tr>
<td>Retailing/Distribution</td>
<td></td>
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<tr>
<td>Semiconductors</td>
<td></td>
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<tr>
<td>Software</td>
<td></td>
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<tr>
<td>Telecommunications</td>
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</tbody>
</table>
IV.b.4. Target Market

The target market is usually defined by entity, demographic, socioeconomic, and psychographic factors. Venture capitalists and impact investors often vary in their focus on specific segments of the target market. For example, whereas venture capitalists may be interested in income characteristics defined as low, middle, and upper income, the Impact Reporting & Investment Standards (IRIS)\textsuperscript{11} offers four choices for the category entitled ‘Target Beneficiary Socioeconomics’ which are ‘Very Poor’, ‘Poor’, ‘Low income’, and ‘Other’.\textsuperscript{12} Meanwhile, IRIS’ Target Beneficiary Demographics has the choices of ‘Children and Adolescents’, ‘Disabled’, ‘Minority/Previously Excluded populations’, ‘Women’, and ‘Other’\textsuperscript{13}

V. Survey Results

The survey instrument was divided into three parts. The first section forced respondents to rank the relative importance of due diligence factors. The second part focuses on factors relating to investing in emerging markets. We highlight 13 factors as significant in evaluating risk and opportunities for investment in a specific country. The third part provides information on the specific characteristics of the funds that responded to the survey. The characteristics chosen for analysis match many of the characteristics used by recent impact investment reports.

V.a. Comparative importance of due diligence factors

The first question of the survey required respondents to rank factors in the due diligence process with respect to their relative importance. Chart 1a presents the frequency distribution of those items ranking first or second in the responses.

The most important factors considered in evaluating the risk and opportunity of a potential investment are the country and industry in which the investment is located. This factor could be related to the social mission of the fund and/or the relative ease and success of investing in a country.
However, these factors do not categorize the whole distribution. Like their counterparts in the venture capital industry, impact investors also highly value the strength of the management team to execute on the business and achieve success. Chart 1b shows that when analyzing the statistical mean of responses, management team is almost as important as target industry.

**Chart 1b: Comparative Ranking of Due Diligence Factors by Statistical Mean**

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Target Industries</th>
<th>Experience of the Management Team</th>
<th>Target Geographic Country</th>
<th>Target Impact Population</th>
<th>Investment Type</th>
<th>Investment Stage</th>
<th>Ability to Syndicate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>2.8</td>
<td>3.1</td>
<td>3.5</td>
<td>3.55</td>
<td>3.8</td>
<td>4.65</td>
<td>6.6</td>
</tr>
</tbody>
</table>

*(1 = most important)*

Other than Target Industry, factors that relate directly to the social mission of a particular fund are ‘Target Impact Population’ and ‘Investment Type’. These factors are next in prominence in the rankings.

The relative lack of importance of the factor ‘Investment Stage’ seems to indicate that the inherent risk of early stage ventures is not a major consideration in the due diligence process.

Likewise, the ability to syndicate is not important in the due diligence process. This is most likely as a result of the fact that there are many hurdles to syndication at this point in time.

**V.b. Comparative importance of factors in evaluating a potential country for investment**

The political, economic, and cultural environment of a given country is a critical determinant in the ultimate success of an investment – both in terms of financial and social returns. The evaluation of risks and opportunities for a specific country can encompass a wide array of factors, which are inherently correlated. Although assessing which factors are most critical in predicting success is difficult, we offer assessment based on 13 factors selected as significant in evaluating risk and opportunities for investment in a specific country.

In the survey, these 13 factors were randomly organized for each respondent. For each factor, the respondent was asked to rate importance on a five point scale from not important to very important. The results are displayed below with respect to the frequency that factors were selected for ‘very important’ and ‘important’, as well as by the statistical mean.
Both charts highlight the importance of a business environment that is transparent and business friendly. The factors above have more importance than other factors that focus on the strength and performance of the environment, infrastructure, and social and human assets.

The appendix of this report lists the publicly available data for each of these factors that can assist impact investment funds in their due diligence of countries.

**V.c. Profile of the Impact Investment Funds included in the Survey Results**

Several questions in the survey inquired about the current investment strategy of the fund as well as other fund characteristics. This background information allows further analysis of due diligence patterns identified above and how they vary by fund characteristics. In addition, given that several recent reports have also analyzed impact funds by similar characteristics, it is possible to make some comparisons across different bodies of research.
V.c.1. Countries of Existing Investments
Respondents were asked to identify up to five countries in which they currently have investments.

The respondents have investments in a total of 34 countries. Forty-one percent of the funds have investments in India, 35% in Mexico, and 29% in each of the following countries: Columbia, Peru, and Kenya. Responses were also aggregated by geographic region in a manner that is similar to the report by Santa Clara University and ANDE.14

This report has a much higher response rate of funds that invest in Latin America. Over 75% of the surveyed funds for this report have investments in Latin America.

Chart: 3 Countries of Existing Investments

V.c.2. Size of Funds
Chart 4 indicates that there is a wide range in the size of the funds included in the survey results. Funds vary from US$22.5 million to $325 million. Fund size is an indicator of the average investment size as well as the stage of growth preferred for the firm’s investment strategy. The smallest funds will likely target early stage businesses that require an investment of a few million dollars or less, while the larger funds likely target growth and later stage businesses requiring significant capital.
V.c.3. Fund Characteristics

As discussed previously, impact investment funds can vary significantly from traditional venture capital firms across such attributes as sources of capital, expected financial returns, the type of investment vehicles, exit strategies, and investment strategies that can vary by sector, target population and geography. Given all the possible combinations, there is a high probability that no two funds will be similar. This reality provides great flexibility to the industry but at the same time generates much confusion.

The following charts provide an overview of the variety of impact investment funds included in this survey.

V.c.3.i. Sectors of Investment

Financial Services and SME Development are the two major investment sectors. Approximately 70% of the firms in this survey stated that they are investing in these two industries.
Charts 5a and 5b compare the survey responses for this report with the impact funds that are listed in ImpactAssets 5015. Both charts indicate the prevalence of investment in microfinance and financial services.

**Chart: 5b Sectors of Investment by Impact Asset50 funds**

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**V.c.3.ii. Sources of Capital**

Chart 6a highlights the wide range of capital sources that have been committed to the funds in the survey sample. Except for only one fund, our survey respondents reported incorporating more than one source of capital in their fund. As the chart 6b indicates, there was one fund that combines 9 different sources of capital, though almost 60% of the funds in the survey include 4 or fewer sources of capital.

**Chart 6a: Sources of Capital**
Similar to the survey conducted by Santa Clara University and ANDE, the majority of capital is from high net worth individuals. In this survey, capital that was sourced from family offices could also be classified as capital from high net worth individuals. As concluded by the Santa Clara University study, “[t]he fact that high net worth individuals and family foundations dominate the inflow of capital is indicative of the high level of risk associated with investing in the social impact sector.”

Over 85% of the surveyed funds that receive capital from high net worth individuals and/or family offices selected one of two categories for anticipated financial returns—Traditional venture capital returns (greater than 25%) and Above Investment Portfolio returns (25% - 10%). This suggests that high net worth individuals are interested in investment-grade financial returns when allocating capital to impact investment funds.

The statement above may indicate a new trend in the philanthropic community. Many high net worth individuals create private foundations that have an annual charitable distribution requirement of 5% of the assets of the foundation. These distributions are traditionally in the form of grants – for which there is no financial return. The other 95% of foundation assets are often invested to maximize financial return as there is no legal requirement to invest in line with their charitable mission. Hence, depending on which ‘bucket’ capital allocations/investments come from in a foundation they are either directed to generate social returns or financial returns, but not both.

However, in the last few years there has been a significant increase in ‘mission investing’ that offer social and financial returns simultaneously. The two forms of mission investing are:

- Program-related investments (PRIs) that include loans, loan guarantees, or equity investments that count toward a foundation’s charitable distribution requirement and create a financial return, and
- Market-rate mission-related investments (MRIs) that “broadly support foundations’ programmatic goals but do not count toward a foundation’s charitable distribution requirements.”
A recent survey found that “[t]he majority of foundations [surveyed] have been making MRIs for five years or less, with just over half of these foundations starting within the last two years.” In addition, “14.1 percent currently engage in mission investing, including program-related investments (PRIs) and/or market-rate mission-related investments (MRIs).”

**V.c.3.iii. Capital Structure**

All but two of the funds surveyed sourced equity capital for their fund. Even in the two funds where equity was not part of the capital structure, either the entire fund or the majority of the fund is capitalized by debt and not grants. As a result, it can be assumed, that most of the funds in this survey sample will be seeking significant financial return.

**Chart 7: Capital Structure**

Most of the funds expect a financial return between 10 and 25 percent, which could reflect the above capital structure or could reflect the social return aspect of impact investing.

**Chart 7: Anticipated Returns**
**V.c.3.iv. Anticipated/Actual Portfolio Exits**

Financial return for venture capital funds usually is realized when a portfolio company is acquired or if the company makes an initial public offering. Similarly, financial returns for portfolio companies of most impact investment funds are also attained through acquisitions and IPOs. However, our survey indicates that there are other ways to generate financial returns from an exit.

For the survey, funds were asked to indicate all the ways they have achieved exits or anticipate exits. The options listed on the survey are represented on the chart below. We also provided an open text section for funds to describe other strategies to generate financial returns.

Chart 8 highlights the fact that while merger & acquisitions and IPOs are identified as both anticipated and actual exits, dividends and loan repayment are also frequent exit options.

Other ways for funds to generate and secure financial returns include:

- Revenue sharing
- On the upside: profit participation or kickers. On downside: protection through full collateral protection which would allow liquidation of other assets in the event the target asset underperforms
- Management buy-back
- Structured exits via profit participation or royalty
- Interest on mezzanine loans, PIK (payable in-kind) interest, fees, royalties, gain on securities, and other assets.

The impact investment industry requires in-depth research in the area of portfolio exits. It appears that there are some creative strategies being deployed but there is little understanding on the ramifications of these strategies on the financial and social return of the investments.

**Chart 8: Exit Strategies**

A cross tabulation of expected exits with anticipated financial returns indicates that most firms anticipating returns of 10 percent and higher were seeking exits through acquisitions and mergers, IPOs, and dividends. As to be expected, a majority of funds deploying debt instruments (in conjunction with other investment vehicles) expected nominal returns (less than 10 percent).
**Vc.3.v Investment Time Horizon**

This attribute exemplifies a key difference between impact investment funds and venture capital funds. As stated above, venture capital funds usually target time horizons of 7 years with extensions that rarely go beyond 10 years. In this survey sample, approximately 60% of the funds have time horizons longer than venture capital funds. Given that returns diminish with time, extended time horizons may indicate a willingness to sacrifice financial returns for the prospect of social returns.

**Chart 9: Investment Time Horizons**

![Chart 9: Investment Time Horizons](chart9)

**VI. Summary**

The main purpose of this report is to provide guidance to existing and future impact investment funds that target emerging markets. Given a lack of information on portfolio company and fund exits, due diligence factors were analyzed as an indicator of the priorities in a fund’s investment strategy. Factors identified in the survey that were considered significant are:

1. **The Specific Country**

Assuming that there are societal and environmental challenges in most emerging countries, impact investors could identify opportunities to invest in any country. However, the importance of limiting investments to specific countries focuses the analysis of due diligence factors to certain country attributes. The attributes that were considered most important were those that facilitated taking innovation and opportunities to market without risk of operational or financial expropriation. These factors included investor protection, corporate governance, political stability and freedom, ease of doing business, lack of corruption, and entrepreneurial culture. Factors that were ranked as least important included depth of the capital markets and infrastructure availability.

2. **Management Team**

Impact investors highly value companies that are led by proven entrepreneurs and managers. Consequently, the management talent pool for this new asset class is more likely to develop through the transformation of existing entrepreneurs than the identification of nascent ones.
3. Target Industries

The importance of target industries in the due diligence process could be attributed to the expertise and social passion of an impact investment fund and/or the ability to generate financial returns.

The initial insights from this research should help impact investment funds in prioritizing inputs in the due diligence process. The appendix provides a list of publicly available data that can assist in the due diligence process to select a country for investment.

As stated previously, this report is only the starting point for more comprehensive, longitudinal research on investment strategies and actual financial and social returns of the portfolio companies of impact investment funds.
Appendix:
Country-specific Factors Relevant in Due Diligence

This report has identified that one of the most important factors in evaluating the risk and opportunity of a potential investment is the country in which the impact investment will be located. The following section discusses country-specific factors in greater detail and provides publicly available data sources that are useful for performing a due diligence process.

Investor Protection/Corporate Governance

The survey respondents rated this factor as most important in determining if their funds will invest in a particular country. This factor is defined as the legal structures and body of law that are favorable to the investment climate, covering issues such as protection of intellectual property and shareholders rights.

A measure of strength of investor protection in a country is provided by The Global Venture Capital and Private Equity Country Attractiveness Index, an annual publication of IESE Business School.

The publication argues that investor protection is important for several reasons:

- fairness and property rights protection largely determine the growth and emergence of new enterprises,
- legal environment determines the size and extent of a country’s capital market and local companies’ ability to receive outside financing,
- quality of a country’s legal system is closely related to facilitating VC/PE backed exits,
- harmony in regulatory aspect of a country increases investor commitments, and
- investment in countries with better investor protection entails less cost of capital, while on the other hand, weak property rights limit the reinvestment of profits in start-up companies.

Another similar measure is provided by World Bank’s Doing Business Report. ‘Protecting Investors’ and ‘Enforcing Contracts’ are two of nine topics evaluated in this annual publication.

‘Protecting Investors’ is mainly dealing with the issue of how well are minority shareholders protected against self-dealing in related-party transactions. It is further broken down into three sub-indices:

- Extent of disclosure index
- Extent of director liability index
- Ease of shareholder suits index

On the other hand, ‘Enforcing Contracts’ deals with the issue of time, cost, and number of procedures required to resolve a commercial dispute through the courts.
**Extent of Corruption**

The next most important factor in the due diligence process according to the survey respondents is the extent of corruption in a particular country. We described this factor as the degree to which corruption is perceived to exist in the private and public sectors.

Publicly available data that can be used to measure this factor is Transparency International’s Corruption Perception Index (CPI). The CPI ranks countries/territories based on how corrupt their public sector is perceived to be. It is a composite index, a combination of polls, drawing on corruption-related data collected by a variety of reputable institutions. The CPI reflects the views of observers from around the world, including experts living and working in the countries/territories evaluated.

According to Transparency International’s definition, corruption is the abuse of entrusted power for private gain. The CPI itself focuses on corruption in the public sector, or corruption which involves public officials, civil servants or politicians. It surveys public perceptions on topics such as bribery of public officials, kickbacks in public procurement, embezzlement of public funds, and the strength and effectiveness of anti-corruption efforts in the public sector.

Another measure of corruption level is given by World Bank’s Worldwide Governance Indicators, particularly the element of Control of Corruption. It is defined as perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as “capture” of the state by elites and private interests.

**Size of Market**

For the purpose of the survey, size of market was described as the potential for scaling up the business and reaching a large number of clients/customers.

Each impact venture has a defined target market. However, given that many social ventures target underserved or poor populations, the number of people living at the base of the economic pyramid is a good measure of the size of market for impact investing funds.

The World Bank’s official statistics on poverty can be used to measure this population. Relevant data includes:

- Percentage of population living below poverty line
- Population living below poverty line

Analyzing the percentage of population by income class is another measure of potential market size. Some investors believe that more impact can be generated by investing in products and services that can be purchased and used by the income classes just above the bottom of the pyramid.

World Resources Institute has published a relevant and innovative metric by taking a “market-based” approach to measure bottom of pyramid (BOP) population. It combines data on population with purchasing power, resulting in a richer BOP portrait. This metric provides insights into expenditure type and its corresponding monetary value of poor populations in nearly every country. This approach is a contrast to the traditional view that the poor are unable to help
themselves and thus need charity or public assistance. A market-based approach starts from the recognition that being poor does not eliminate commerce and market processes; even poor households possess the ability to consume and to satisfy their basic needs.

**Political Stability and Freedom**

Political stability and freedom is among the most important factors considered by the survey respondents in their due diligence process. It encompasses broad but related issues such as the presence of free elections, the presence of a free judicial system, personal freedom, freedom of thought and religion, and economic freedom (the possibility to create private economic activities).

There are a variety of publicly available data sources that can be utilized to conduct country due diligence in this particular aspect. Three of them are listed below:

- **Political Stability and Absence of Violence**
  As part of Worldwide Governance Index, this variable captures perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.

- **Index of Economic Freedom**
  Developed jointly by The Wall Street Journal and The Heritage Foundation, this index looks at economic freedom of 183 countries from 10 different viewpoints; some are external in nature (e.g. the extent of an economy’s openness to global investment or trade) while some others are internal (e.g. the liberty of individuals to use their labor or finances without restraint and government interference).

- **Democracy Index**
  Published by The Economist Intelligence Unit, Democracy Index is based on the ratings for 60 indicators grouped in five categories: electoral process and pluralism, civil liberties, the functioning of government, political participation, and political culture.

**Ease of Doing Business**

Also high in due diligence consideration is the ease of doing business in a particular country. We broadly define this factor as how conducive is the regulatory environment to the operation of business and thereby attracting new business from outside or generating new business internally.

Widely publicized data on this factor is available from Doing Business by World Bank/IFC which provides quantitative measures of domestic laws, regulations, as well as administrative requirements in 183 economies. It focuses on 11 topics, with the specific aim of measuring the regulation and red tape relevant to the life cycle of a firm – from starting to closing a business.

Another useful metric that measures regulatory environment is produced by Worldwide Governance Indicators especially Regulatory Quality indicator. One of six dimensions of governance, it captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
**Entrepreneurial Culture**

Entrepreneurial culture is the level of entrepreneurial activity and innovation in the country as well as the attitude towards entrepreneurship. Countries with culture that encourages the formation of entrepreneurs and innovation will most likely generate new ventures that eventually attract impact investors.

Secondary data to measure this factor is made available by Global Entrepreneurship Monitor (GEM)\(^38\) which provides a comprehensive snapshot of entrepreneurship around the world. It measures the attitudes of population towards entrepreneurship and the activities and characteristics of individuals participating in various phases of entrepreneurship.

BBC Entrepreneurship Friendliness Index\(^39\) provides another measure of entrepreneurial culture by surveying respondents in 24 countries on four questions: how hard they felt it was for people like them to start a business in their country, whether their country values creativity and innovation, whether it values entrepreneurs, and whether people with good ideas can usually put them into practice.

**Depth of Capital Markets**

Without a robust financial market, it is very difficult for any small business, impact-oriented or not, to launch and grow. The more financing options available for small businesses, the more likely there will be an attractive pipeline of potential deals for investors. In addition, investors can leverage their own funding with other forms of local credit and equity. Consequently, access to capital in a country is very important to a prospective investor.

Depth of capital markets is defined as accessibility to capital both in equity and debt markets. Data on the depth of capital markets is available as part of Global VC/PE Attractiveness Index\(^40\). The indicator is built on aggregation of various factors such as size of the stock market, stock market liquidity, IPO market activity, M&A market activity, debt and credit market, bank non-performing loans to total gross loans, and financial market sophistication.

The most common form of financing available in emerging markets is debt, especially bank loans. It is therefore reasonable to also consider “difficulty in getting credit” as an approximation of depth of capital markets. The measure of relative difficulty in getting credit can be found in World Bank’s Doing Business Index\(^41\), which was derived from a query on how favorable is the country’s law in facilitating the borrowing process.

**Infrastructure**

This factor encompasses the availability and reliability of infrastructures such as transportation, communication, and energy supply. According to the survey respondents, infrastructure is not ranked very highly in their consideration when performing due diligence. Less emphasis is put on the quality of infrastructure in a target country than other previously discussed factors.
For impact investment funds that want to assess the quality of infrastructure, there are several relevant sources of data. The Logistics Performance Index\(^42\) of the World Bank provides a tool to compare 155 countries on their logistics “friendliness”. Infrastructure is one of six dimensions that build the overall index and this measure provides data on the quality of trade and transport infrastructure such as ports, railroads, roads, and information technology.

The World Bank also administers a variety of infrastructure related data such as air transport, electric power consumption, water source, and internet servers\(^43\). With the breadth of data available at the Bank’s site, impact funds can easily pick one that is relevant to the investment opportunities they want to evaluate and subsequently run an objective comparison among prospective countries.

**SocioEconomic Factors**

This factor considers socioeconomic conditions in a country, represented by measures such as wealth disparity, concentration of wealth, and unemployment. It takes into account how differences in economic resources might influence social cohesion of a society.

A widely acknowledged measure of disparity is the Gini Coefficient\(^44\) which was produced by a number of institutions. A suggested source is published by UN University as part of its World Income Inequality Database\(^45\). Inequality in economic resources can also be observed by analyzing income distribution among population in a country. The data is made available by the World Bank through its interactive computational tool Poventure capital Net. It contains a rich database on poverty, including percentage of population in each decile of income classes.\(^46\)

The World Bank database also provides unemployment data broken down into gender and age group.\(^47\)

**Human and Social Environment**

This factor includes prevailing conditions on humanity and social aspects of a country. To analyze such an abstract concept, data on a country’s ratification and enforcement of international main treaties on civil and political human rights and the rights of workers was targeted.

Therefore, relevant public data for this factor is based on a country’s compliance on various international conventions such as:

- United Nations conventions:
  - International Covenant on Economic, Social and Cultural Rights
  - International Covenant on Civil and Political Rights
  - “International Convention on the Elimination of All Forms of Racial Discrimination”
  - Convention on the Elimination of all Forms of Discrimination against Women
  - Convention Against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment
  - Convention on the Rights of the Child
  - International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families
International Labour Organization conventions:
- Freedom of Association and Protection of the Right to Organise Convention
- Right to Organise and Collective Bargaining Convention
- Forced Labour Convention
- Abolition of Forced Labour Convention
- Equal Remuneration Convention
- Discrimination (Employment and Occupation) Convention
- Minimum Age Convention
- Worst Forms of Child Labour Convention

Amnesty International conventions:
- Abolitionist for all crimes
- Abolitionist for ordinary crimes only
- Abolitionist in practice
- Retentionist

Environmental Performance

This factor considers policies and the enforcement of policies that affect environmental conditions in a country such as clean water, air pollution, biodiversity, and climate change.

Yale University published a comprehensive measure of environmental issues called Environmental Performance Index (EPI). It ranks 163 countries on 25 performance indicators tracked across ten policy categories covering both environmental public health and ecosystem vitality. These indicators provide a gauge at a national government scale of how close countries are to established environmental policy goals.

Education

Quality of education is measured by the quantity of trained workforce as well as quality of schools and universities.

An approximation to the quality of education in a country is provided by United Nations through its Human Development Index (HDI) annual publication. Education Index is one of the three indices on which the HDI is built. It is based on mean years of schooling (of adults) and expected years of schooling (of children), covering 185 member states of the United Nations.

Taxation

The last factor in our country-specific characteristics is taxation. It addresses taxes and related expenses in business environment and how it supports or inhibits entrepreneurial activity.

A good comparative data source on taxes is provided by The World Bank as a part of its annual publication of Doing Business Index. ‘Paying Taxes’ is a topic that deals with taxes and mandatory contributions that a medium-size company must pay or withhold in a given year, as well as measures of administrative burden in paying taxes. It contains data for 183 economies on several tax-related items such as total number of tax payments per year, the time it takes to prepare, file and pay taxes, and total tax rate as a percentage of profit.
A table summarizing discussion on these thirteen country-specific attributes, as well as its corresponding source of data, is presented below.

<table>
<thead>
<tr>
<th>No</th>
<th>Key Factors</th>
<th>Description</th>
<th>Relevant Data Source</th>
<th>Publisher</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Investor Protection/</td>
<td>legal structures and body of law that are favorable to investment climate, e.g. protection of IP and shareholders rights</td>
<td>The Global Venture Capital and Private Equity Attractiveness Index</td>
<td>IESE Business School</td>
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<td></td>
<td>Corporate Governance</td>
<td></td>
<td>- Investors Protection and Corporate Governance</td>
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<td></td>
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<td>- Doing Business</td>
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<td></td>
<td></td>
<td></td>
<td>- Protecting Investors</td>
<td>World Bank</td>
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<td></td>
<td></td>
<td></td>
<td>- Enforcing Contracts</td>
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<tr>
<td>2</td>
<td>Extent of Corruption</td>
<td>the degree to which corruption is perceived to exist in the private and public sectors</td>
<td>Corruption Perception Index</td>
<td>Transparency International</td>
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<td></td>
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<td>- Worldwide Governance Index</td>
<td>World Bank</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>- Control of Corruption</td>
<td></td>
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<tr>
<td>3</td>
<td>Size of Market</td>
<td>potential for scaling up the business and reaching a larger number of clients/customers</td>
<td>Poverty Data</td>
<td>World Bank</td>
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<td></td>
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<td></td>
<td>- Percentage of Population living below poverty line</td>
<td></td>
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<td></td>
<td>- Population living below poverty line</td>
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<td></td>
<td>- Percentage of Population by Income Class</td>
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<td>- The Next 4 Billion</td>
<td>World Resources Institute</td>
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<td></td>
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<td>- BOP expenditure by Sector</td>
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<td>4</td>
<td>Political Stability and Freedom</td>
<td>Factors such as the presence of free elections and free judicial system, personal freedom, freedom of thought and religion, economic freedom (the possibility to create private economic activities)</td>
<td>Worldwide Governance Index</td>
<td>World Bank</td>
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<td></td>
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<td></td>
<td>- Political Stability and Absence of Violence</td>
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<td>- Index of Economic Freedom</td>
<td>The Wall Street Journal</td>
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<td>and The Heritage Foundation</td>
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<td>- Democracy Index</td>
<td>Economist Intelligence Unit</td>
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<td>Key Factors</td>
<td>Description</td>
<td>Relevant Data Source</td>
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<td>5</td>
<td>Ease of Doing Business</td>
<td>How conducive is the regulatory environment to the operation of business and thereby attracting new business from outside or generating new business internally</td>
<td>Doing Business Index&lt;br&gt;Worldwide Governance Index&lt;br&gt;- Regulatory Quality</td>
<td>World Bank</td>
</tr>
<tr>
<td>6</td>
<td>Entrepreneurial Culture</td>
<td>The level of entrepreneurial activity and innovation, attitude towards entrepreneurship</td>
<td>Global Entrepreneurship Monitor&lt;br&gt;- Entrepreneurial Attitude&lt;br&gt;- Entrepreneurial Activity</td>
<td>Global Entrepreneurship Research Association (GERA)</td>
</tr>
<tr>
<td>7</td>
<td>Depth of Capital Markets</td>
<td>Sophistication of capital markets and effort to access capital</td>
<td>Global Venture Capital and Private Equity Attractiveness Index&lt;br&gt;- Depth of Capital Markets</td>
<td>IESE Business School</td>
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<td></td>
<td>Doing Business Index&lt;br&gt;- Difficulty in Getting Credit</td>
<td>World Bank</td>
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<td>8</td>
<td>Infrastructure</td>
<td>Availability / reliability of infrastructure (e.g. transportation, communication, energy)</td>
<td>Logistics Performance Index&lt;br&gt;Infrastructure Data (various)</td>
<td>World Bank</td>
</tr>
<tr>
<td>9</td>
<td>SocioEconomic Factors</td>
<td>Wealth disparity, unemployment, concentration of wealth</td>
<td>World Income Inequality Database&lt;br&gt;- Gini ratio</td>
<td>UN University/World Institute for Development Economics Research (UNU/WIDER)</td>
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<td></td>
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<td>Labor and Social Protection&lt;br&gt;- Unemployment</td>
<td>World Bank</td>
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<td>Poverty Data&lt;br&gt;- Percentage of Population by Income Class</td>
<td>World Bank</td>
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<td>Key Factors</td>
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<td>10</td>
<td>Human and Social Environment</td>
<td>Prevailing conditions on humanity and social aspect of a country (e.g. country's ratification and enforcement of international main treaties on civil and political human rights and the rights of workers)</td>
<td>Various conventions, among others: - International Covenant on Economic, Social and Cultural Rights - International Covenant on Civil and Political Rights - “International Convention on the Elimination of All Forms of Racial Discrimination” - Convention on the Elimination of all Forms of Discrimination against Women - Convention against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment - Convention on the Rights of the Child - International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families</td>
<td>United Nations</td>
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<td>Amnesty International</td>
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<td>11</td>
<td>Environmental Performance</td>
<td>Policies and the enforcement of these policies that affect environmental condition (e.g. clean water, air pollution, biodiversity, and climate change)</td>
<td>Environmental Performance Index</td>
<td>Yale University</td>
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<td>12</td>
<td>Education</td>
<td>Quality of education (trained workforce, quality of schools &amp; universities)</td>
<td>Education Index</td>
<td>United Nations</td>
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<tr>
<td>13</td>
<td>Taxation</td>
<td>How supportive the tax regime is on business activities</td>
<td>Doing Business Index - Paying Taxes</td>
<td>World Bank</td>
</tr>
</tbody>
</table>
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Yale University. Environmental Performance Index. 2011. Also available online at http://epi.yale.edu/