KEY POINTS

- Social impact bonds are an effective way of delivering social impact and financial inclusion around the world. A social impact bond is a performance-based contractual arrangement rather than a capital markets security, as the name suggests.
- Private equity funds have played a central role in the development of impact investing.
- The authors believe private equity funds could prove to be an effective model for financing social impact bonds.
- There is significant momentum amongst market participants to address challenges around scalability, consistency and quality of data for impact measurements across various jurisdictions, which once addressed could result in major growth of the market.

Feature

Authors Ranajoy Basu and Aaron Bourke

Social impact investing: the growing trend of financing for good

This article discusses the growing social impact investing sector (often described as "impact investing") and highlights the increasing use of social impact bonds and social impact funds to fund and deliver positive social impact around the world.

The article is divided into three parts. Part I is an introduction to impact investing and describes the various forms of impacting investing. Part II focuses on the rise of social impact bonds, their typical structure, and legal considerations. Part III describes the role of private equity in impact investing and considers whether private equity can be an effective means of financing impact bonds.

PART I: INTRODUCTION TO IMPACT INVESTING

The Global Impact Investing Network (GIIN), one of the major impact investing industry organisations, defines impact investments as 'investments made into companies, organisations, and funds with the intention to generate social and environmental impact alongside a financial return'.[1] What differentiates impact investments from other investments is the positive social or environmental impact the investor seeks to achieve. A specific feature of impact investing is the investor's commitment to measure and report on social and environmental performance. Impact investors take an evidence-based approach to measuring the "social return" on their investments. There is, however, no one-size-fits-all approach to impact investing.

A 2014 survey of 125 investors, conducted by J.P. Morgan and GIIN, found its respondents managed US$46bn of impact investments, of which US$32bn was invested in developing countries.[2] While these numbers do not capture the entire impact investing market, they demonstrate the market is fairly substantial in absolute terms. There are also signs that the market is rapidly growing, though it still represents a relatively small portion of the investment market.[3]

Impact investments run the gamut of traditional asset classes, from private debt, bilateral loan agreements, deposits and guarantees to equity-like debt, private equity and real assets. Investment terms and structures may replicate those found in the mainstream investment world, or they may be new and bespoke arrangements created to serve a specific function. An investor can create a portfolio of impact investments that resemble their existing traditional investments, or one entirely tailored to their particular social or environmental objectives (or a combination of both). The intention of investors to create social impact sets these instruments apart from mainstream capital investments.

Social impact investments can take a variety of forms including:

- **Loan guarantees**: There are a number of international institutions that provide credit support for projects. The Bill and Melinda Gates Foundation, for example, now issues loan guarantees, rather than direct funds, to some of the enterprises it supports. Its first guarantee allows a charter school in Houston to raise US$67m in commercial debt at a low rate, saving the school (and its donors) almost US$10m in interest payments.
- **Quasi-equity debt structures**: Some organisations have developed financial vehicles that combine the properties of equity and debt. A quasi-equity debt security is particularly useful for enterprises that are legally structured as non-profits and therefore cannot obtain equity capital. Such a security is technically a form of debt, but it has an important characteristic of an equity investment: its returns are indexed to the organisation's financial performance. The security holder does not have a direct claim on the governance and ownership of the enterprise, but the terms and conditions of the loan are carefully designed to give management incentives to operate the organisation efficiently. Social investors purchase these securities, which perform the function of equity and enable social enterprises to offer banks and other profit-seeking lenders a competitive investment opportunity. The Bridges Social Entrepreneurs Fund recently committed £1m for a social loan to HCT, a company that uses surpluses from its commercial London buses, school buses, and "park and ride" services to provide community transportation for people unable to use conventional public transportation. This social loan has a quasi-equity feature: the fund takes a percentage of revenues, thereby sharing some of the business risk and gains. Because the loan is tied to the top revenue line, it provides HCT with strong incentives to manage the business efficiently. Covenants on such loans are often added to avoid mission drift from the social goals.
- **Pooling**: Techniques that involve pooling funds have also opened new financial doors to social enterprises, because the

pooling institution can tailor its liabilities to the needs of different kinds of investors. Switzerland-based social capital investor BlueOrchard, for example, assembles portfolios from many microlenders and bundles them into three tranches. The bottom tranche is BlueOrchard's equity, which offers high returns but takes the first loss. The next tranche offers a lower expected return but has less risk. It takes the second loss, after equity is wiped out, and is analogous to a convertible bond. The top tranche promises a low but relatively safe return; it is purchased by conventional debt investors. The pooling model has spread globally, with innovators such as IFMR Trust, in Chennai, engaged in the securitisation and structured finance of microfinance loan portfolios in which they retain an investment share.

- **Pay-for-performance models or social impact bonds**: The growth of the social impact bond, a new financial instrument for achieving social impact, is discussed in Part II.
- **Social impact funds**: The role of private equity funds in impact investing is discussed in Part III.

PART II: 'THE NAME IS BOND – SOCIAL IMPACT BOND'

New financial instruments called social impact bonds (SIBs) (also called "pay-for-success" or *PFS* in the US, and social benefit bonds (SBBs) in Australia) have gained attention in recent years. "Development impact bond" (DIB) is a term used for a SIB that is implemented in low- and middle-income countries where a donor agency or a foundation, as opposed to the government, is the outcome payer.

The first SIB was implemented in 2010 in the UK to reduce prison recidivism among short-term male prisoners. Since then, the social impact bond market has grown to include 44 transactions.[4] There are four fundamental elements to the SIB structure:

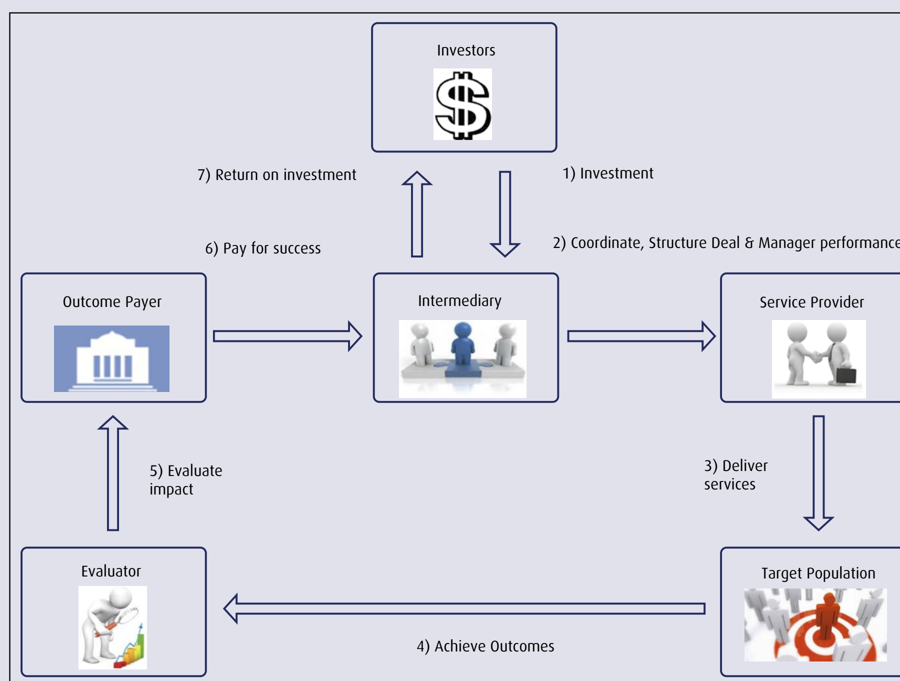
(i) meaningful and measureable outcomes.
(ii) reasonable time horizon to achieve outcomes.
(iii) evidence of success in achieving the outcome.
(iv) appropriate legal and political conditions.

Key parties to the transaction

The term "bonds" can be misleading when used to describe such transactions: these are performance-based contractual arrangements rather than capital market "securities". A SIB is a partnership model involving four principal transaction parties:

(i) the **service provider** – the service provider delivers social intervention to a specified target population;
(ii) the **investor(s)** – the investor(s) provides upfront capital (the investment) to fund the programme delivery and bears some or all of the financial risk;
(iii) the **outcome payer** – the outcome payer (which could be the government) pays investors if agreed outcomes are met. These payments repay the investment plus a return on capital that depends on the degree to which the outcomes are achieved;
(iv) the **intermediary** – this is the counterparty to the outcomes contract with the outcome payer. The role of the SIB delivery organisation includes brokering relationships between key stakeholders, sourcing capital, leading deal construction and managing ongoing performance of the SIB programme. In some cases, the SIB delivery organisation or intermediary may identify and select service providers.

An example of a typical SIB structure is:



(1) An outcomes contract is negotiated pursuant to which the outcome payer agrees to pay for social outcomes.
(2) Based on the outcomes contract, the SIB delivery organisation raises funds from investors, who provide upfront capital for the social service intervention.
(3) The social service providers agree to deliver services and receive funds to address the social issue for a target population.
(4) Outcomes are evaluated or validated by an independent evaluator.

If the outcomes are achieved, the outcome payer repays the investors for the achieved outcomes (usually through the SIB delivery organisation). In most cases, the positive outcomes result in cost savings for the government (when it is the outcome payer) and a portion of these savings is passed on to the investors as outcomes payments. These payments repay the investment amount, plus a financial return that depends on the degree to which the outcomes are achieved.

Key transaction documents

Framework agreement: Provides the framework for the entire project and the other related transaction documents; sets out the key contractual relationship and the governance structures during the life of the SIB.

Grant and services agreement: Documents the investor's commitment to advance amounts to the intermediary in order for the intermediary to distribute such amounts to the service providers and to pay costs and expenses of the SIB. This also documents the intermediary's intention to use the grant to implement the interventions with a view to achieving the outcomes.

Outcomes payment agreement: Identifies the metrics for payment by the outcome payers on the basis of the outcomes.

Evaluation agreement: Documents the evaluation metrics (a critical part of the impact bond) and the related services to be provided by the independent evaluator.

Other documents: there may also be several memorandum of understandings and servicing agreements relating to the underlying services to be provided for delivery of the outcomes.

The Educate Girls DIB, the world's first DIB (on which Reed Smith advised), was launched in April 2015. The funds raised support a programme to enrol more girls in school and improve children's literacy and numeracy in Rajasthan, India. On 5 July 2016, the results from the first year of the DIB were announced.[5] They show that UBS Optimus, the investor in the DIB, has already recouped 40% of its investment, with two years of the programme still to run. Educate Girls has enrolled 44% of the girls identified as being out of school across 140 target villages.[6]

PART III: PRIVATE EQUITY'S ROLE IN IMPACT INVESTING

Current landscape

By necessity, early examples of impact investments have largely been funded by investors either well positioned to experiment and take risks (ie, family offices and high-net-worth individuals), or with specific developmental or other socially-oriented mandates (ie, foundations, sovereign wealth funds and development finance institutions). Still in its "proof of concept" stage (though rapidly growing), impact investing needs investors that are nimble, flexible and willing to explore investment opportunities with a varying range of financial and social returns. Large institutional investors, especially those subject to a heightened fiduciary duty standard (ie, pension funds), have been more hesitant to put money into impact investments.

Private equity funds have emerged as vital intermediaries for aggregating the capital of the typically smaller investors that have traditionally been the most active impact investors. In 2012, Pacific Community Ventures InSight (PCV InSight) valued the total assets managed by US private equity managers with the goal of achieving both financial returns and intentional social benefits at approximately US$4bn.[7] Drawing on a framework developed by the Monitor Institute, PCV InSight divided the market for "impact managers" into three categories: (i) "impact first" managers (those seeking social impact primarily and financial return secondarily); (ii) "financial first" managers (those seeking financial return primarily and social impact secondarily); and (iii) "double-bottom-line" managers (those placing equal priority on financial returns and social impact). PCV InSight estimated impact first managers managed US$400m in assets dedicated to impact investing, with an investor base primarily comprised of governments, foundations and individuals; financial first managers managed US$2.1bn in assets dedicated to impact investing, with an investor base primarily comprised of institutional fiduciaries and other "market-rate" investors and intermediaries; and double-bottom-line managers managed US$1.5bn in assets dedicated to impact investing, with an investor base primarily comprised of foundations, banks, individuals and institutional fiduciaries.

In its 2016 Annual Impact Investor Survey, GIIN confirmed the growth of private equity as a key driver of impact investments.[8] Seventy-one fund managers reported raising a total of US$6.7bn in capital for impact investments in 2015. Seventy-eight fund managers indicated plans to raise a total of US$12.4bn in capital for impact investments in 2016. The typical private equity fund raised specifically for impact investments remains relatively small, with the GIIN survey yielding a median fund size for private equity funds of US$40m.

An encouraging recent trend has been the entry into the impact investing market of large institutional private equity managers. For example, the GIIN survey notes the creation by both BlackRock Inc and Bain Capital, LP of impact investing units in 2015. A March 2016 article in *Law360*[9] noted a move towards impact investing by private equity giants KKR & Co LP, Blackstone Group LP and Apollo Global Management. These investors view impact investing as more than a branding gimmick or philanthropic endeavour – Henry R Kravis and George R Roberts, co-chairmen and co-CEOs of KKR, say impact investing 'is also essential for smart investing … Our commitment to creating sustainable value has never been stronger'.

Feature

Biog box
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Why are private equity and impact investing such a good fit?

It is no coincidence that private equity funds have played a central role in the development of impact investing. They are particularly well-suited to the needs of both impact investors and the social enterprises in which they invest.

For investors

Private equity funds are an attractive vehicle for investors to aggregate their capital to make impact investments. They offer investors the ability to leverage the expertise of a fund manager to invest at scale, drive higher returns and access specific industries. In impact investing, where investable opportunities are relatively scarce, investee companies pursue double-bottom-line strategies that balance financial return and social impact, and models for measuring social impact are varied and often bespoke, the value of an experienced fund manager is even greater. When asked their motivation for investing through impact funds, respondents to the GIIN survey identified the most important factor as 'GP expertise in investment selection and management'.

Private equity funds also offer a powerful means of mitigating some economic challenges posed by impact investing, which is often characterised by small transactions that are more complex than their larger traditional commercial counterparts. By aggregating the capital of several investors and paying a fund manager to deploy capital, investments can be made more efficiently and common standards can be applied across investments (eg, with respect to measuring social return on investment). GIIN survey respondents identified 'deploying capital efficiently/ avoiding transaction costs associated with small investments' as a motivation for making impact investments through funds.

As Impact Assets noted in a 2012 brief,[10] one of the most powerful reasons private equity funds have proved to be such a popular vehicle for making impact investments is simply that 'traditional, sophisticated investors are familiar with the private equity model and its basic structure'. As the authors note, 'investors are drawn to a PE strategy because they are comforted by the maturity of the industry. It is a proven investment strategy that has repeatedly secured premium returns'. In short, attracting investors at scale to an untested, novel or confusing investment model will be a struggle. The familiarity of private equity provides an excellent springboard for bringing new investors to the impact investing table.

For investees

Just as private equity provides an attractive model for investors looking to engage in impact investing, it also provides a model that fits well with the capital/resource needs and growth trajectory of many social enterprises seeking capital from impact investors. As ImpactAssets notes: 'PE offers patient capital with control features and alignment of interests. Private equity investors identify and select companies with the intention of holding them for long periods of time to make strategic and operational improvements as well as adding capital'. Growth-stage social enterprises that pursue double-bottom-line business models generally need ample time to generate attractive financial returns and achieve their social impact goals. Indeed, given the delicate balance of profit and purpose that these companies must strike, they often require capital that is prepared to be particularly "patient". Private equity, with its focus on close engagement with management to build lasting value, is well suited to meeting this need. Private equity funds are illiquid by nature and most have five-year investment periods with harvest periods of five-to-seven years, meaning investee companies have a built-in time period to grow.

Private equity funds can only accept capital from sophisticated investors that are able to bear the loss of their entire investment, so they are also well-suited to taking on the additional risks that can come with investing in young companies that may have inexperienced management teams or operate in countries with relatively undeveloped infrastructure or political instability. Accordingly, the risk appetite of an impact fund is often well aligned with the characteristics of the companies in which it invests.

In *Institutional Investor*,[11] Susan Balloch (chief operating officer of GIIN) summarised the fit between private equity and impact investing as follows:

- Impact investing seeks long-lasting change.
- Focusing on supporting profitable businesses is one of the best ways to create an enduring impact.
- The private equity approach to nurturing and building businesses aligns with that ideal.

Are private funds appropriate for investing in SIBs?

We believe that private equity funds could be an effective model for financing SIBs. SIBs have generally been financed by a single investor or a small syndicate of investors.[12] This is likely the result of SIBs' nascent nature and the high degree of planning and collaboration needed for their proper execution. There is insufficient deal flow to justify aggregating the capital of several investors into a single vehicle, and each deal requires a unique level of commitment and engagement that may be better suited to direct investment.

Nonetheless, as the SIB market matures and investable opportunities become more prevalent, we believe there will be an opportunity for investment managers with specific SIB expertise to raise private equity funds to invest in SIBs. The "patient capital" approach of private equity funds – with their five-to-seven-year harvest periods – provides sufficient time for SIB service providers to implement their programmes, and for intermediaries to measure outcomes. SIB fund managers could become efficient "gatekeepers" of investor capital, placing it into the most promising SIBs, developing standardised methods for measuring impact (working with SIB intermediaries as need be), and reporting that impact to investors. Private equity funds and their sophisticated private investors are uniquely positioned to take on the risks inherent in investing in a novel financial tool with substantial execution complexity.

The potential roadblocks to private equity funds investing in SIBs include the relative

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paucity of investable opportunities and lack of track record for SIB projects. Perhaps most importantly, it remains to be seen if SIBs (even assuming continued growth and maturity of the market) can provide investment returns that would attract private equity funds, which typically target relatively high risk-adjusted returns. Despite these potential roadblocks, we remain hopeful for the potential of private equity to finance social impact bonds.

CONCLUSION

The range of investment opportunities available to impact investors is broad and growing. Such opportunities vary by impact objective, asset class and return expectations. So why does it still seem like the impact investing market is constrained? The answer seems to be that it is not easy to both create a profitable business that has a significant social impact and also scale that business so that it generates commercial returns for investors and continues to advance its social mission. Despite this challenge, however, it is clear that the opportunities for impact investing are growing. What is needed for impact investing to achieve its potential is continued coordination efforts among participants on the buy and sell side.

The positive momentum of the impact investment sector continues, despite the recent turmoil in global capital markets. While the basic investment infrastructure needs to be developed, impact investment is becoming a stable and sustainable alternative for institutional investors and high-net-worth individuals. As the infrastructure builds further and more funds across asset classes achieve market-rate performance, the impact investment sector stands poised to become a powerful vehicle to address significant social and environmental issues. ■

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3 As of 2012, total assets under management were estimated to be US$64trn, and they are estimated to exceed US$100trn by 2020. '*Spotlight on the Market – The Impact Investor Survey*', Global Social Finance, 2 May 2014.
4 '*The Potential and Limitations of Impact Bonds*', Brookings Report, 2015 at p 12.
5 http://www.brookings.edu/blogs/education-plus-development/posts/2016/07/18-educate-girls-development-impact-bond-gardiner-gustafsson-wright
6 https://www.theguardian.com/global-development/2016/jul/05/new-financial-bond-helping-us-get-more-girls-into-schools-india-education
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8 Abhilash Mudaliar, Hannah Schiff and Rachel Bass, 'Annual Impact Investor Survey (sixth edition)', available at https://thegiin.org/knowledge/publication/annualsurvey2016.
9 Benjamin Horney, 'The Rise of Impact Investing in Private Equity', available at http://www.law360.com/articles/773413/the-rise-of-impact-investing-in-private-equity
10 Gerhard Pries and Vivina Berla, Sarona Asset Management Inc. with Jed Emerson, 'Private Equity in Emerging Markets: Exits from Aid, Steps Toward Independence', available at http://impactassets.org/files/ImpactAssets_IssueBriefs_6.pdf.
11 Susan Balloch, 'How Private Equity is Heeding the Call of Impact Investing', available at http://www.institutionalinvestor.com/blogarticle/3535673/blog/how-private-equity-is-heeding-the-call-of-impact-investing.html#.V5GWXDkrL-Y.
12 The UK government has formed two impact bond funds: (i) the Fair Chance Fund, a £15m fund that has financed seven social impact bonds designed to provide tailored support to homeless young people to find accommodation, receive training, and begin working or attending school; and (ii) the Innovation Fund, which has financed ten social impact bonds with an aggregate maximum payout of £28.4m to support disadvantaged young people. However, these funds have been capitalised with government funding, and they are outcome payers, not investors. To date, the authors are aware of no impact funds capitalised by private investors to place risk capital into social impact bonds.

Further Reading:

- Bond, green bond: a licence to tackle climate change [2016] 4 JIBFL 228.
- Corporate sustainability from the legal perspective: the German Sustainability Code [2013] 8 JIBFL 512.
- LexisNexis Loan Ranger blog: Mini-bond masterclass.