PitchBook

Sources of Impact Capital

A deeper dive into LPs committing to impact funds

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Key takeaways

- Sources of capital for impact funds are a blend of for-profit and not-for-profit limited partners, including development finance institutions (DFIs), foundations, high-net-worth individuals (HNWIs) and family offices, and pensions and insurance companies.

- Because of their long-term financial positions and social/environmental development goals, development finance institutions (DFIs) are uniquely positioned to commit capital to impact funds. DFIs are amongst the greatest contributors of "impact capital" and often provide catalytic funding to first-time impact fund managers. However, impact funds must engage a greater base of limited partners (LPs) and break out from dependency on DFIs if they hope to achieve long-term success.

- Foundations have become increasingly active in the impact investing space in the last five years as they have leveraged mission- and program-related investments (MRIs and PRIs) to commit capital to impact funds that are within their philanthropic mandates. MRIs and PRIs are an efficient way for foundations to leverage more of their financial resources to further their programmatic goals.

- Pension funds and insurance companies constitute the institutional segment of for-profit LPs that, due to fiduciary duties, exclusively target market-rate impact fund investments. While these institutional investors have been hesitant to commit to impact funds because of the perceived risks, we expect to see greater participation as impact investing becomes more mainstream.

Introduction

Impact investing is a strategy of investing in enterprises, organizations and funds that seek to create both financial returns and measurable social and/or environmental impact. Impact investments are most commonly made through the familiar investment structure of closed-end PE and VC funds. For more details, see our previous report, Poised for Impact.

Impact investing has gained traction in recent years as calls to use finance to catalyze social and environmental change have spawned growing demand for sustainably managed assets. With a 2017 study by BNP Paribas suggesting that 20% of institutional investors intend to increase alternative allocations to ESG/impact assets, GPs stand to tap into new pools of capital set aside for impact funds. However, some LPs are hesitant to commit capital without sufficient data about impact funds or insights into other LPs that have committed to the strategy. This note serves as a deeper dive into LPs active in the impact investing space. By profiling different providers of impact capital, we hope to shed light on where funds are currently sourcing commitments and highlight opportunities that may arise in the future.

We seek to answer the following questions:

- What types of institutions are the primary contributors of capital to impact funds?
- What are their investment preferences and considerations? What are their social or financial motivations behind impact investing?
- Are there special approaches used by these LPs to commit capital within their investing mandate?

LP Profiles: Motivations, Expectations, Considerations

	FOR-PROFIT	DUAL-INTEREST	NOT-FOR-PROFIT
Example Institutions	Pension funds, insurance companies	Development finance institutions, family offices, HNWIs	Private foundations
Financial Motivation	Market rate only	Mix of return expectations, some market rate, some concessionary in exchange for impact	Market rate when using mission-related investments, concessionary when using program-related investments
Social Motivation	Business risk mitigation, plan-holder demand	Economic development, thematic interests such as education or clean energy	Dependent on foundation's mission

Development Finance Institutions

Development finance institution (DFI) is a blanket term to describe varying types of financial institutions (e.g., investment banks, institutional investors, advisors and managers) with mandates to support economic development via investment and financial service provisions. DFIs tend to target investments in emerging markets, as their support can catalyze and stimulate economic development in underserved regions.

Development finance institution (DFI)[1] is a blanket term to describe varying types of financial institutions (e.g., investment banks, institutional investors, advisors and managers) with mandates to support economic development via investment and financial service provisions. Also referred to as economic development agencies or multilateral development banks, these institutions are owned and backed by one or more governments. DFIs have been established across developed and emerging markets, and are structured to last in perpetuity. These institutions make direct debt and equity investments into companies as well as commitments to funds to achieve their development mandates. Because of their long-term financial positions and social/environmental development goals, DFIs are uniquely positioned to commit capital to impact funds. With commitments to over 100 impact funds since 2002, DFIs are amongst the greatest contributors of capital, per PitchBook data.

DFIs tend to target investments in emerging markets, as their support can catalyze and stimulate economic development in underserved regions. The International Finance Corporation (IFC), for instance, has a mandate to support the growth and development of private markets in emerging economies and has backed fund managers from over 35 emerging market countries. Additionally, a select few DFIs make investments in developed regions. The European Investment Fund (EIF), for example, seeks to spur entrepreneurship and innovation throughout Europe.

For DFIs, fund commitments are an efficient means to facilitate direct small and medium-sized enterprise (SME) investments, as they can accelerate the capital deployment process and, if operated locally, ensure greater familiarity with a region's market and entrepreneurial ecosystem. Some have specific impact targets, like infrastructure

1: DFIs in this report include multilateral, bilateral and regional finance institutions.

development, or sustainable agriculture and energy, but others concentrate more on macro goals like job creation and economic development. Certain investment strategies are more conducive to specific impact targets. To support small-business development, DFIs will typically seek out early-stage investors; to support growth and scale for established businesses to enter new markets, DFIs look for growth equity funds.

The impact investing ecosystem is still nascent and filled with first-time managers who encounter challenges in fundraising due to a lack of track record or proof of strategy. DFIs are a crucial source of risk capital for these funds, as they are willing to provide catalytic funding to first-time fund managers and encourage impact via private investment.

While they have motivations beyond financial returns, DFIs are still prudent investors that take extensive measures to screen and perform due diligence on fund commitments. Raising capital from DFIs can be a long and strenuous process, as there are considerable bureaucracy and stringent requirements (such as ESG criteria) required for consideration. Funds who do secure DFI funding, then, also procure a signal of credibility, helping to attract further commitments from other LPs.

Select DFIs

Limited Partner Name	AUM ($M)	HQ Location	Preferred Geography
European Investment Bank (EIB)	708,497	Luxembourg, Luxembourg	Central Asia, Europe, Caucasus, Middle East, North America, South Asia, Southeast Asia, Western Europe, Africa
Brazilian Development Bank (BNDES)	267,736	Rio de Janeiro, Brazil	Americas, Brazil, South America
European Bank for Reconstruction and Development (EBRD)	69,208	London, United Kingdom	Asia, Caucasus, Europe
African Development Bank Group (AfDB)	43,440	Abidjan, Ivory Coast	Africa, Americas, Asia, Caucasus, Europe, South Asia, Southeast Asia
International Finance Corporation (IFC)	41,615	Washington, DC	Africa, Americas, Asia, Australia, Caucasus, Middle East, Oceania, South Asia, Southeast Asia
Inter-American Development Bank (IADB)	32,079	Washington, DC	Asia, Central America, Europe, North America, South America
European Investment Fund (EIF)	30,444	Luxembourg, Luxembourg	Central Asia, East Asia, Europe, North America, Northern Africa, South America, South Asia, Southeast Asia, Southern Africa
Asian Development Bank (ADB)	26,010	Mandaluyong City, Philippines	Africa, Americas, Asia, Australia, Caucasus, Middle East, Oceania, South Asia, Southeast Asia
Netherlands Development Finance Company (FMO)	10,277	The Hague, Netherlands	Africa, Americas, Asia, Caucasus, Europe, Middle East, South Asia, Southeast Asia
CDC Group	6,683	London, United Kingdom	Africa, Asia, South Asia
PROPARCO	6,579	Paris, France	Africa, Americas, Asia, Caucasus, Europe, Middle East, South Asia, Southeast Asia
Overseas Private Investment Corporation (OPIC)	5,694	Washington, DC	Africa, Americas, Asia, Australia, Caucasus, Europe, Middle East, Oceania, South Asia, Southeast Asia
Finnish Fund for Industrial Cooperation	459	Helsinki, Finland	Africa, Americas, Asia, Europe, Middle East, Oceania
Deutsche Investitions- und Entwicklungsgesellschaft (DEG)	323	Cologne, Germany	Africa, Americas, Caucasus, East Asia, Europe, Middle East, Oceania, South Asia, Southeast Asia

Source: PitchBook

Foundations

This section is focused on private rather than public foundations. Many private foundations have endowments funded by one or more private sources. In the US, these entities are required to distribute at least 5% of their endowment's corpus annually to charitable purposes to maintain their exemption from income taxes. The remaining 95% may be invested for profit to maintain financial longevity, and net investment income is subject to an excise tax.[2] While private foundations can make concessionary impact investments from that 5% distribution, some foundations have started to tap the remaining 95% of their endowments to make for-profit allocations to impact funds. The Ford Foundation, for example, announced a plan to commit $1 billion of its $12 billion endowment to impact funds in 2017.

Whereas DFIs may accept more macro-level impact targets like job creation or economic development, foundations seek out strategies that adhere closely to their missions, such as access to education, gender equality or affordable housing. Accordingly, the process for fundraising from foundations can also be long-winded and bureaucratic, as investments need to be a strong program- or mission-related fit to justify a commitment. The Ford Foundation, for instance, stipulates that it will only allocate to funds addressing affordable housing and financial inclusion. US foundations typically commit capital to impact investments through program-related investments (PRIs) and/or mission-related investments (MRIs).

Program-Related Investments

According to the IRS, PRIs are investments made by private foundations whose primary goal is to advance the programmatic goals of the organization, where capital appreciation or income production is "not a significant purpose." Though PRIs tend to receive concessionary returns, the IRS also dictates that "a potentially high rate of return does not automatically prevent an investment from qualifying as program-related."[3] PRIs are made from the 5% required distribution typically used for grants or donations.

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PRIs can be structured as direct debt or equity investments, or fund commitments. One advantage of making direct equity investments as opposed to grants is the long-term strategic relationship formed with the enterprise that foundations hope will deliver a greater scale of impact for their designated programmatic goals. However, given the current "easy money" venture funding environment, foundations can encounter challenges when competing with purely for-profit investors for investment opportunities.

2: "Private Foundation Excise Taxes." Internal Revenue Service, August 2017.
3: "Program-Related Investments." IRS, September 2017.

Unless a startup strongly fits a foundation's mission at the onset, a foundation might request it makes operational adjustments to better align with the foundation's programmatic goals. Startups may not encounter the same requirements when fundraising from general venture funds.

With regard to fund commitments, investing in impact funds can make for an agreeable PRI should the fund meet a foundation's criteria. Impact funds are already explicitly committed to delivering and measuring the impact they create, and often target thematic areas shared by many foundations, making for a well-aligned investment candidate.

Mission-Related Investments

Mission-related investments (MRIs) are similar in theory to PRIs, but target market-rate returns because they are made from the portion of a foundation's endowment that is invested for profit.

MRIs, on the other hand, are made from the other 95% of a foundation's endowment that may be invested for profit, and thus target market-rate returns. Similar to PRIs, foundations can use MRIs to invest directly in companies or commit to funds. MRIs enable foundations to put a greater proportion of their financial assets toward impactful investments, but they are made with more prudent risk/return considerations characteristic of a traditional long-term financial strategy. Foundations must be cautious in making MRIs, as their success or failure will directly impact the financial longevity of a foundation. Additionally, if the investment is considered by the IRS to jeopardize the foundation's financial needs, a foundation can be subjected to a sizable penalty tax.

Unlike the smaller base of capital available from PRIs, tapping the larger for-profit portion of foundation endowments via MRIs can be a significant source of capital for impact funds.

Select program- and mission-related investments

Foundation	AUM ($M)	Select Foundation Mission Themes	Investment Example
Bill & Melinda Gates Foundation	$40,413	Polio eradication, HIV treatment, agricultural development, access to financial services, gender equality, US education	CureVac – platform technology to reduce time and costs for developing vaccines against diseases that disproportionately impact developing countries
Ford Foundation	$12,106	Racial justice, equality in cities and geographic regions, climate change	Springboard Community Development Finance Institution – enhancing access to affordable credit in US states
MacArthur Foundation	$6,120	Climate change, criminal justice, economic development, education, affordable housing	Fund to Preserve Affordable Communities – protecting affordable housing for low income individuals across the US
Rockefeller Foundation	$4,107	Healthy communities, sustainable food, clean energy, equity in cities	REDD+ Acceleration Fund – targeting reduced emissions from deforestation in emerging economies
W.K. Kellogg Foundation	$353	Racial justice, children's health, economic equity, healthy communities	Northwest Louisiana Community Development Fund – financing real estate projects to revitalize low income communities

Source: PitchBook, foundation websites

HNWIs & Family Offices

More than 90% of HNWIs globally, particularly those under 40, believe that driving social impact is important.[4] Many philanthropically motivated, wealthy investors choose to act on this conviction through their investment choices, and asset managers have increasingly adopted impact asset offerings to serve this demand. A 2017 family office survey reports that 28.3% of family offices utilized impact investing as a strategy and 40% of surveyed investors expect to increase commitments to impact/ESG investments in 2018.[5] Similar to those made by foundations, these commitments tend to be thematic, allocated according to the desired impact theme of the capital provider.

Unlike both foundations and DFIs, LPs in this category can allocate capital to funds on a faster timeline, as they have fewer bureaucratic limitations; it should be noted the relative base of capital may not be as large as other sources. However, HNWIs can be secretive about their investment preferences (typically to maintain privacy about their actions) and thus are difficult to access from a fundraising standpoint. Additionally, because family offices do not share the same non-financial motivations as DFIs, they may be less inclined to place bets on sometimes riskier first-time managers. However, the smaller check sizes most family offices or HNWIs target might make them ideal prospects for emerging managers raising smaller funds.

Pension Funds and Insurance Companies

Pension funds and insurance companies constitute the primary institutional base of for-profit LPs that commit to impact funds. Participation in impact investing by these institutional investors has been a product of two factors: demand by their plan holders, and the larger movement toward ESG investing by European LPs. Switzerland-based Zurich Insurance Group, for instance, announced in 2017 it would expand its target allocation to impact investing to $5 billion in the coming years, aiming to obtain market-rate returns while still “doing something good.”

Pension funds and insurance companies constitute the primary institutional base of LPs that commit to impact funds. Because of their fiduciary duties, these institutional investors exclusively target market-rate impact fund investments.

These entities exclusively target market-rate impact fund investments because, as part of their fiduciary duty, they are legally held accountable by measures such as the Employee Retirement Income Security Act (ERISA) in the United States. ERISA requires fiduciaries to prioritize financial obligations to plan participants, which has brought into question whether impact or ESG assets are an appropriate allocation if they prioritize non-economic factors.

However, in 2015 the US Department of Labor posted an interpretive bulletin clarifying that it “does not believe ERISA prohibits a fiduciary from addressing ETIs [economically targeted investments] or incorporating ESG factors in investment policy statements or integrating ESG-related tools.”

4: World Wealth Report 2014, Capgemini and RBC Wealth Management
5: Global Family Office Report 2017, UBS

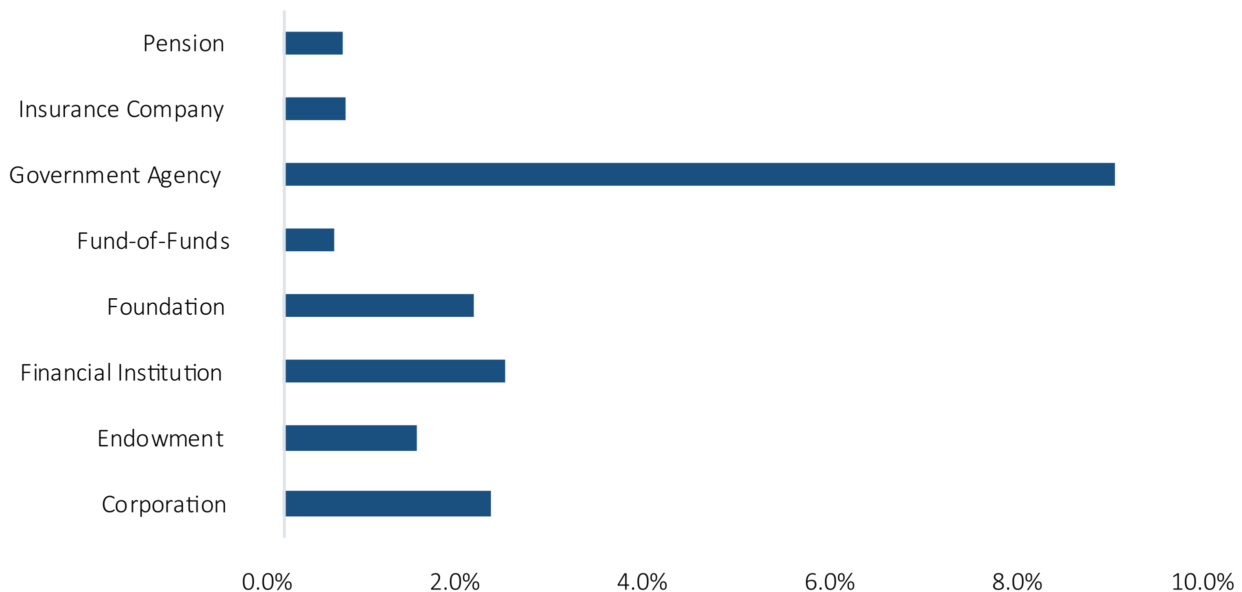
The bulletin adds that if impact/ESG criteria are appropriate components of financial analysis and contribute to an asset's value, an investment may be made "without regard to any collateral benefits the investment may also promote." This clarification has aided pensions in justifying allocations to impact assets, allowing them to join the ranks of socially minded European institutional investors that consider ESG criteria to be both a risk mitigant and value add. Accordingly, for-profit LPs allocate to impact funds as they would to regular private investment funds, where GPs will only be considered if their approach meets the institution's financial goals and strategic allocations.

Because pension funds and insurance companies are generally larger than foundations or family offices, smaller impact funds have weaker chances of raising funds from such entities, as their required check sizes would be too small to be a reasonable allocation. Even so, pension funds and insurance companies have the potential to catalyze impact funding should they find a sufficient pipeline of investable funds. The risk considerations for these investors are significant, however, as they cannot compromise their financial obligations by committing to unproven managers.

Analysis

DFIs as a group have maintained a steady and robust allocation to impact funds over time. This is likely a product of their mandates to encourage private investment. Of all LP types, DFIs also show the strongest aggregate commitment to impact funds, with almost 9% of all commitments to PE and VC funds being impact funds. Even dating back to 2004, over 10% of all PE and VC fund commitments made by DFIs were to impact funds.

Commitments (#) to impact funds as a percentage of all PE & VC commitments since 2002



Source: PitchBook

This data point suggests this type of institution has been an active participant and financial driver of impact investing for an extended period. PitchBook data suggest that foundations were not active contributors of impact capital before the financial crisis, but their activity in the space has multiplied in recent years. Though the proportion of all commitments made to impact funds by foundations sat below 4% 10 years ago, activity has trended strongly upward in the last five years, with commitments at around 11% as of 2016. Large commitments and capacity-building efforts from leaders in the space like the Bill & Melinda Gates Foundation and the Ford Foundation have paved the way for other nonprofit organizations to explore implementing impact investing in their portfolios. Additionally, an increase of offerings by mainstream fund managers may have served to provide less risky products to which foundations can justify making commitments.

Finally, the portion of commitments by pension funds has been low for the last 15 years, remaining near or under 2%. Of all LP types, pensions show one of the lowest values when it comes to percentage of total allocations that are made to impact funds. This is likely a reflection of pension fund managers' explicit fiduciary duty, particularly with many schemes facing underfunding issues. With concerns about fund manager experience and profitable investment opportunities, this class of LPs may be waiting until impact funds can provide evidence their strategies can deliver sufficient returns.

Commitments (#) to impact funds as a percentage of all PE & VC commitments

Source: PitchBook