

# Investing for social impact

**Harold Rosen** explains a model aimed at plugging the financing gap that has impeded for-profit businesses set up with a social purpose

The worlds of development and private equity rarely overlap but, over the past decade, the high growth of microfinance institutions (MFIs) has attracted an increasing number of private equity investors. It was believed that these organisations were the answer to stimulating economic activity. In the past three years alone, an estimated \$300m has been invested in MFIs.

Although MFIs play an important role in development, there is an even greater need to support businesses that have a multiplier effect on employment and economic activity and create wealth that lifts people sustainably out of poverty.

One important catalyst of growth in most developing countries is small and medium-sized enterprises (SMEs). According to the International Finance Corporation (IFC), SMEs range in size from 10 to 300 employees and have total assets or sales of up to \$16m. In low-income countries, SMEs are a dominant component of the economy, providing more than 30 per cent of total employment and generating 16 per cent of GDP; SMEs in middle-income countries capture an even larger share, at 57 per cent and 39 per cent respectively.

Social Enterprises (SEs) are another important segment overlapping with SMEs. They often originate from charitable or donor-driven organisations, evolving to provide market-based solutions that drive social change including improving healthcare. They also address gaps in gender and youth issues.

High Impact Businesses (HIBS), the niche addressed by the Grassroots

Business Fund (GBF), operate at the intersection of SMEs and SEs. HIBS are typically for-profit SMEs founded with a specific social purpose: providing sustainable economic opportunities to farmers, artisans, and micro-entrepreneurs, or affordable basic services to people at the base of the pyramid.

However, HIBS face significant constraints that limit their access to medium-term and long-term financing and targeted capacity building in areas such as financial management, governance, human resources, supply chain management, and sales and marketing. These obstacles are frequently a result of their size, stage, geographic location or lack of collateral. As a result, HIBS are often considered by traditional venture funds to be too risky for commercial investment. The limited financing of HIBS is thus a major hindrance to the productive capacity of an economy.

The GBF model bridges this gap by working in partnership with local governments and investors to provide equity and quasi-equity financing to HIBS in the range of \$500,000 to \$1,000,000, often with returns linked to increased revenues. The fund also provides short-term working capital loans of between \$40,000 and \$150,000 to export-oriented businesses through a separate SME export facility.

All investments are coupled with grant funding for business assistance, which is a combination of technical help funded through grants, and hands-on management support from the fund's staff and its partners. Capacity building programmes include improvements to governance, general management, reporting,

management information systems and business/financial planning.

GBF's model, better known as "impact investing", can help fill the financing gap that currently exists for HIBS. Indeed, drawing on lessons learned from microfinance, a profitable and supportive ecosystem is developing for the field of impact investing. However, platforms must be built to scale up and replicate what has worked, in order to develop a stronger ecosystem of supporting structures.

GBF has developed an Impact Planning, Assessment and Learning (iPAL) Framework to equip HIBS with tools to collect and analyse financial, operational and social data. This data allow our clients to make critical business decisions that improve their operations and increase the social impact they have on their key stakeholders. One component of this is the social return on investment, which estimates the quantifiable social-economic impact that the HIBS's investees will generate and the number of people that its businesses will reach.

This impact, initially calculated during the due diligence phase of an investment, is recalculated throughout the investment life cycle. Its assumptions are refined according to the financial, operational and social metrics reported to GBF on a quarterly basis. In addition, once the fund has been able to calculate the social returns for several investments in a specific sector, it will be able to determine sector benchmarks by which to assess potential investments. While it is by no means the only indicator that GBF uses to determine an investment's social impact, the social return on investment is one data point that it considers.

So, although there are several pieces of infrastructure being developed, such as definitions, metrics and some industry groupings, the impact investing field must do more to develop a robust set of players, practices and principles in order to achieve scale and efficiency.

In addition, at an early stage of development, investment capital usually requires complementary grant-funded assistance to create strong businesses.

In common with the early stages of micro-finance, there is vigorous debate about the appropriateness of blending grants with investment capital and the

proper sharing of risks and rewards. Transparency is critical to justify and ensure the proper use of public and charitable funds. Governments and foundations need to choose where and how their funds can be deployed in combination with investment capital. While there is little consensus on the exact amount, subsidies should be used to facilitate, not to replace, private capital.

Ultimately, the system should be built in a way that decreases the dependence of GBF and other similar organisations on grant funding. This would increase the number of mainstream funding sources that do not provide capacity building funding but can still invest in a way that supports social impact. These funds could find it worthwhile to invest in the HIBS once these businesses reached an appropriate scale.

If a strong ecosystem for impact investing can be developed, the potential impact could be significant. Early results have shown that this blended approach can successfully bring HIBS to sustainability and scale, preparing them to engage the private sector and access long-term commercial financing.

With regard to the GFB's record in the first two years of its existence, the fund's HIBS investees have had an impact on nearly one million people, including smallholder farmers, rural artisans, micro-entrepreneurs and consumers. They have delivered more than \$23.1m in economic value (payments to farmers/artisans, savings to consumers, available financing and productive assets to entrepreneurs) and improved the lives of 5.6 million people.

For philanthropic foundations and investors, impact investing is a way to promote global economic growth and worthwhile social objectives on a scale that is unattainable with microfinance.

A case study is instructive. For the 46 per cent of people who live in rural areas in Latin America, agriculture is the main source of income and employment. However – and here is the challenge – many smallholder farmers practise subsistence farming, which allows them to grow only enough produce to support themselves and their families. They find they rarely have any surplus to sell in the local market.

Typically, they farm small pieces of land, in many cases of one to five hectares. Subsistence farmers often have little or no training in agricultural practices and limited access to credit. They lack knowledge of agricultural techniques that could improve their yields, incomes and ultimately the quality of their lives.

GBF has invested in several high impact businesses, particularly in the agribusiness and artisan sectors, where development of a fair and efficient supply chain is critical to tying micro producers at the base of the pyramid to large, value-adding processing and marketing organisations. Such investments often require a combination of blended capital and co-ordinated partnerships. GBF works with socially responsible agricultural companies in developing countries to build inclusive supply chains, linking smallholder farmers with national and international markets.

## LATCO works with over 1,000 farmers and has benefited 5,500 people

The entrepreneur in this case study is LATCO International, a Bolivian producer and exporter of organic and conventional sesame seed. The company was started in 2003 with the mission to provide economic opportunities to the impoverished farmer communities in east Bolivia by linking them with export markets. LATCO identified sesame as a crop that had great potential in international markets and thus could substantially improve the farmers' incomes. It began working with farmers on switching to, and managing, this new crop, which is not native to Bolivia.

LATCO provides continuous support, input, and financing to farmers through its network of agronomists. The company then takes the product from the farmers, processes it and exports it to Japan, Europe, and the US. While LATCO seeks business efficiency and sustainability, it is also attempting to protect the environment and at the same time create sustainable income-

generating opportunities for extremely poor farmer communities.

What has been the impact? LATCO is now the largest exporter of sesame seeds in Bolivia, working with more than 1,000 farmers and touching the lives of over 5,500 people. It exports sesame seeds to 18 clients in nine countries. For every \$1 invested in LATCO, \$16 is generated for LATCO's farmers. And this does not include the ripple effect on local communities from the increase in disposable income.

To back the enterprise, GBF invested \$700,000 in convertible debt to support financing for new equipment and to increase the amount of land under cultivation. Through grant funding, GBF and its local partner, Fundes Bolivia, are helping LATCO implement a Supplier Development Programme (SDP) to produce more sesame while improving operating efficiency and increasing the economic benefits to farmers.

The SDP aims to achieve this in three ways: first, by attracting more farmers to LATCO's supply chain and by providing training on improving production techniques and yields; second, by increasing land under cultivation by new and existing farmers; and, third, by setting up a network of farmer associations that would function as collection, production and administration centres.

As part of the SDP, community leaders and promoters have undergone extensive training and will become managers of the associations. They will be stationed in the collection centres and will be in charge of assisting the member farmers, preparing contracts, administering payments to farmers and interacting with LATCO's team. They will be supported by agronomist supervisors and receive a salary from LATCO, plus a bonus based on the quantity of sesame seeds delivered to LATCO.

This approach will ensure a gradual building of capacities within the farmer associations level while aligning incentives and enabling them to become more competitive. In this way there should be a marked social impact.

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