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Acumen Fund Investors

The Nature and Type of "Social Investors"

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Executive Summary

Over the last decade, a new breed of venture capitalists has emerged: social investors. These so called "impact investors" seek to combine financial returns with social impact by using the tools of venture capital to make principal investments in private, high-growth companies that have the potential to deliver some measurable social or environmental benefit. Building on the success of microfinance in demonstrating the commercial viability of an overlooked asset class, social investors believe that you can achieve a commercial or quasi-commercial return and outsized social impact by betting on innovative entrepreneurs addressing underserved markets. For the social investor, the hockey stick is not a company's valuation, but the liters of clean water delivered, the cases of malaria prevented, the tons of CO2 emissions averted, the lives changed.

With several billion dollars raised for social investment funds in the last few years, social investors are a growing and influential phenomenon, but are still a relatively small part of the global capital markets. While social investors share a desire to do more with their capital than simply maximize financial return, there are as many differences among social investors as there are differences among venture capital funds. Some take product risk, others avoid it; some are stage specific, others invest across company lifecycles. Some are shrewd investors; some are not. And the commercial versus social orientation of funds is all over the map, and is in large part is driven by their sources of capital.

This note seeks to outline the rise of the social investors and touch on a number of key points where they diverge from traditional profit-maximizing venture investors. Professional venture capitalists may disagree with the fundamental assumptions of social investing—that you can do well and do good—but it is important to understand what role they play in the venture capital ecosystem. And some venture investors may view impact investors as soft, perhaps even more uncharitably, as "dumb money".

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Venture capitalists risk doing so to their own peril: impact investors can be a great source of deal flow, co-investors who bring experience in underserved or emerging markets, or more patient capital that is willing to assume a higher risk for lower returns. Understanding the diverse motivations, strategies and styles of this new and rapidly growing segment will become essential for traditional venture capitalists over the coming years.

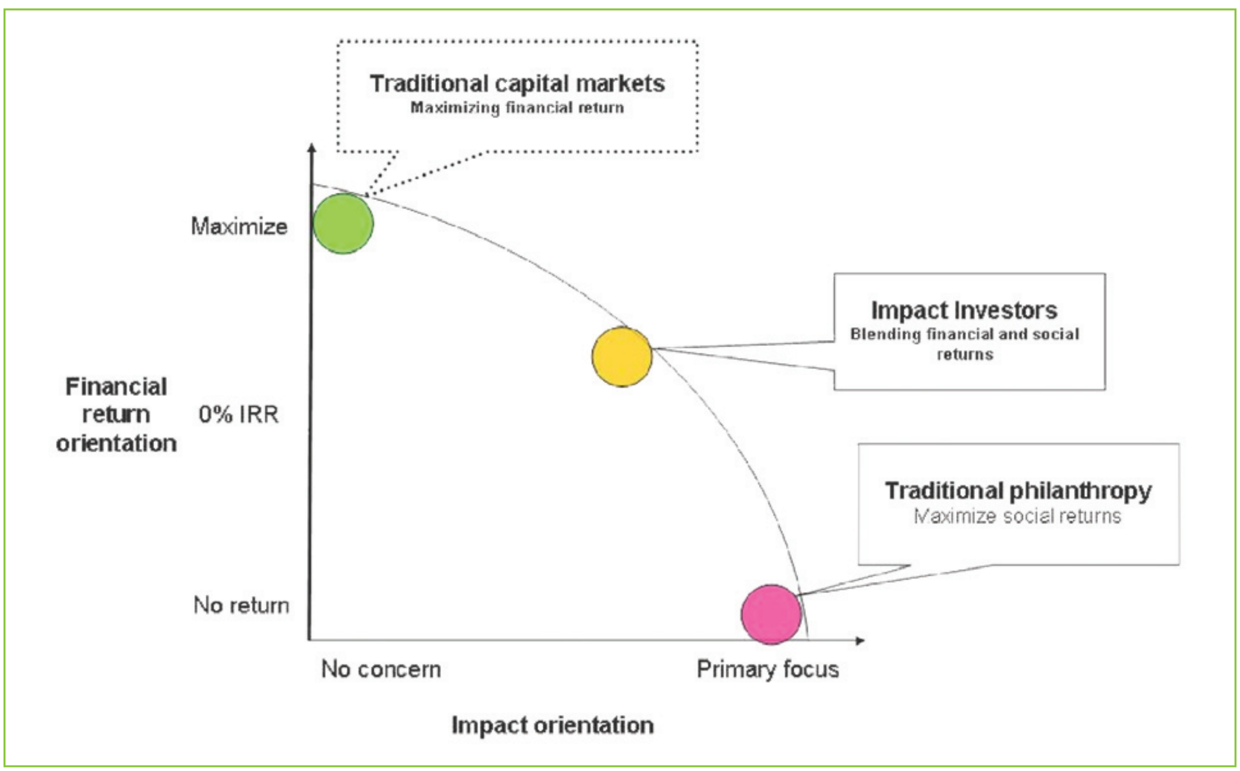
The rise of the social investor

All investors, to some extent, are impact investors. Google has changed the world. So has Genentech. Venture-backed companies that scale to serve hundreds of millions and alter the landscape of health services, energy or technology have reshaped the world we live in, often for the better. The scale of the potential impact is usually an important part of the logic which drove the ultimate financial return. No one who invested in Google really cared about search for its own sake; they cared that search would solve the problems of millions of people, and that millions of people spending time on a simple website could somehow be monetized. And that those cash flows would make the investors really rich. Really, really rich.

Any investor that wants to succeed in early stage investing is by definition an impact investor. So what differentiates them from traditional investors? We define a social or impact investor as someone who takes a double (or in some cases triple) bottom line approach to their capital, and attributes real value to the social or environmental return in their investment decision-making. They will often, but not always, be willing to exchange a lower economic return for potential social or environmental impact. There are several rationales for this approach – some are mission driven (poverty alleviation, environmental impacts), some are government sponsored (the International Finance Corporation, etc.) and some are driven by regulatory and political frameworks (community redevelopment in the United States).

Consider the "spectrum of capital" in **Figure 1**. While it presents a simplistic trade off between (non-risk adjusted) financial return on one axis and (non-risk adjusted) social impact on the other axis, it is useful as an orientation to the world of impact investing.

FIGURE 1: A SPECTRUM OF CAPITAL



Traditional profit maximizing investors exist on the far left, trying to get as much money as possible for their investors as possible. Benchmark and Sequioa have a fiduciary responsibility to their limited partners to maximize the return on their investments. Whether the general partner cares about the social impact of their investments is secondary to their need to generate an internal rate of return (IRR) for their investors. New funds like Kleiner's pandemic fund, or the new generation of clean technology funds, or the success of emerging market funds like Zephyr might imply that traditional venture funds are inching further to the right on the social impact axis in search of blended value[1], but what is more like is that they are fundamentally spotting market imperfections or disruptive new opportunities that will have significant financial returns, that by the way, could save lives, reverse climate change or rebuild the economy of sub-Sahara Africa in the process.

At the other end of the spectrum are traditional foundations, whose grants generate a reliable -100% IRR. Some foundations, particularly newer ones, have waded into the space of "venture philanthropy," using the tools of venture capital to make grants in high-growth social ventures. These foundations and venture philanthropists often support social enterprises and innovative nonprofits that can generate fees for service to cover some of their financing needs. Funders like Draper Richards Foundation, New Schools or New Profit use venture capital methods of high engagement philanthropy, milestone based "term sheets" and intensive management assistance to help scale these effective social programs. Some are stage specific (Draper Richards for seed), region specific (Venture Philanthropy Partners in Washington, DC) or issue specific (New Schools in education).

Nonprofits and other social enterprises, like Visionspring or College Summit, have used the techniques of venture-backed companies to raise money: developing a business-like prospectus and taking the team on a "road show" to "investors" (really donors). These organizations are moving up from the bottom right of the chart into the world or impact investing, but much like a venture fund will always seek to maximize financial return, a foundation that gives grants or a social enterprise that seeks them, no matter how much business parlance they throw around, primarily cares about maximizing social return.

In the middle is everything else. This messy world of "impact investor" includes for-profit funds, nonprofit organizations, government-sponsored funds, domestic funds, global funds, technology funds, IP funds, you name it. It also includes, somewhat confusingly, the financial managers of Foundation endowments. Most investment managers at foundations strictly adhere to their fiduciary responsibilities to grow the endowment as aggressively as possible. Remember, most foundations have dead donors, and the only way to grow the asset base and the foundation's influence is to successfully invest the corpus and grow it. At some progressive foundations, however, like the Rockefeller Foundation or the FB Heron Foundation, we have started to see more risk-seeking investments within their endowments, using "Program Related Investments" (PRIs) and "Mission Related Investments" (MRIs) to achieve modest financial returns more aligned with their grant making missions.[2]

How is a venture investor to tell where on the spectrum of capital an impact investor might fall, whether they care more about financial or social return, and how to treat them as a co-investor? What follows are a few important characteristics of impact investors that can help illuminate their motivations and anticipate their actions.

Types of LPs who support impact investors

The first and most important question to ask of an impact investor is their source of capital. There are virtually no social investment funds that have moved a material amount of commercial capital; the risk return trade-off just doesn't compute. The more commercial the source of capital, the more likely the fund managers will act like commercial managers. Conversely, the more philanthropic the source of capital,

1 Jed Emerson has written extensively about Blended Value and SROI; links can be found at Blendedvalue.org.

2 For more on PRIs and MRIs, see Rockefeller Philanthropy Advisors' new report on "Philanthropy's New Passsing Gear: Mission Related Investing" at http://rockpa.org/ideas_and_perspectives/publications/

the more unpredictable the fund might be in working with traditional investors. Below I outline a few major categories of sources of capital, from the most commercial to the least commercial, and the types of funds they typically prefer:

+ Financial institutions in the US are often compelled by Community Reinvestment Act requirements to invest in distressed communities and have thus invested in social investment funds. Bank of America's Capital Access Fund is a limited partner (LP) in Pacific Community Ventures, a fund that invests in job creation in distressed communities in California.

+ Pension funds and screened funds are looking to diversify their risk and fulfill the social obligations of their clients and members. Funds like Calvert are primarily invested in community housing (which often receive tax credits to generate competitive risk adjusted financial returns), while pension funds sometimes wade into clean teach or more progressive funds that foster innovation in new sectors.

+ Multiple high-net-worth individuals. There are a few funds that have raised tens of millions of dollars from high-net-worth individuals who are expecting commercial returns. Some of these funds are aiming to deliver "microfinance" like returns in the low teens; others are promising commercial returns (although the jury is out if they can achieve them).

+ Single LPs. High-net-worth individuals are often the sole capital sources of social investment funds. The Omidyar Network, Legatum and Gray Matters are examples of funds that have been founded and capitalized primarily by one high-net-worth individual. The investment teams are driven to maximize financial returns, but often have the flexibility to take higher risks so can at times be unpredictable. Another such single LP funds is the Aga Khan's Fund for Economic Development, which focuses on economic development in regions where Ismailis live: Central Asia through South Asia into East Africa.

+ Governments. There are a range of "development finance institutions," most notably the International Finance Corporation. The IFC and its many regional and national counterparts (the Inter-American Development Bank, the German Development Bank or Actis and Aureous, the former members of the United Kingdom's Commonwealth Development Corporation), are largely private equity players with an economic development angle. They have invested, however, in several funds (like E+Co or Ignia) that have a range of investment strategies.

+ Foundations. Foundations can make grants or invest in funds using PRIs. E+Co, an energy investment fund, was launched with a grant from the Rockefeller Foundation in 1994 and has raised other foundation, government and individual contributions. PATH's new health venture fund was seeded by a grant from the Gates Foundation. It is important to know whether the foundation wants its money back, or not. Obviously, a fund that has raised grant funding will be more risk seeking.

+ Individual donors. There are some funds that have raised significant amounts of capital from diverse pools of individual donors, but not many. The philanthropist as "LP" is an unusual case, but Acumen Fund, for example, has raised about $100m in individual contributions, coming from donors contributing from $10,000 to $5m, with the "partnership" typically being a $100,000 contribution over 3 years. In Acumen Fund's case, the donors are not expecting their money back, so are not traditional LPs, but instead are hoping to catalyze social change through their "investments."

Fund structure and economics

After the LP composition, the fund structure and economics are the next most important differentiating factors and probably the most difficult to synthesize. Many social investment funds are closed-ended limited partnerships, with offshore structures that aim to optimize the taxes on investment returns for their

LPs. They will act like typical investors: savvy at doing deals, aggressive at maximizing returns and not so different from a typical venture fund manager. Some funds are evergreen, quasi-government agencies with the ability to navigate restrictions on foreign direct investments (helpful in markets like India that restrict capital flows into and out of the country). These funds are risk averse, but commercially savvy and often bring considerable experience and resources to nontraditional investment or turbulent economic situations. Finally, a minority of funds are evergreen non-profits: tax exempt institutions that can make commercial investments without having to deliver commercial returns to their investors or employees. These are the wild cards: hard to predict their actions, more motivated by social impact than financial returns, and often far more entrepreneur-friendly (if there is little money at stake, why go through the pain of firing a management team?).

Few if any of these funds operate with the classic 2 and 20 economic structure, in part because it is really hard to define their financial returns, and in part because of structure or investor profile. For some of the single LPs, there are no general partners (GPs), just employees who typically don't share in the upside of the fund. Some of the funds with multiple limited partners have taken higher management fees (3 to 4%) to reflect the higher costs of finding and structuring social investments, but will deliver the 80% investment returns. The nonprofit funds often have affiliated management assistance or business development arms that can provide grant-funded consulting and business support that can cost up to 20% of the invested capital. Some of the funds will offer fixed returns to investors (sometimes with first-loss provision from subordinated investors who get to share in the upside), while a handful offer 80% of the carry.

Fund size and average investment size

Unlike a venture capital fund, it is sometimes hard to define the size of a social investment fund. Some use traditional fund terminology (amount raised, capital deployed, etc), while some are more aggressive and talk about "capital mobilized"—the money they have catalyzed by making direct investments. Others are more conservative and only talk about the investment dollars disbursed that sit on their balance sheets. But no matter how you cut it, most impact investors are relatively small players. Most funds seem to be in the $50-$100m range. Acumen Fund is trying to raise $70m in philanthropic capital and $30m in quasi-commercial capital to make and manage investments in South Asia and East Africa. The Kellogg Foundation just announced $100m fund to invest in job creation initiatives in the United States and South Africa. SNS Real has a 50m Euro water fund. The larger funds, in the $1B+ range, are typically development finance institutions like the IFC, which has an $8B portfolio invested globally. Smaller funds, like the Google.org, Soros Economics Development Fund and Omidyar Network SME Fund are often geographically targeted and stage focused; in this case, they have announced a $15m fund to invest in small and medium enterprises in India.

Even the largest funds, except for the international finance institutions, can rarely invest more than a few million dollars in any given company. The average investment size varies tremendously, but most social investment funds seem comfortable investing $1-$2m per deal, willing to double down to twice that amount, but usually unable to help carry a deal through to a public offering or lead larger rounds. Some can do investments as small as $50,000 to $250,000, but for most funds, the transaction costs of anything less than $500,000 become hard to justify.[3]

Investment types, exit strategies and return expectations

Social investment funds can use any combination of investment structures: debt, equity, preferred shares, guarantees, and even revenue participation or royalty structures. Whatever best supports the business at its current stage of development, some funds will seek to do. Again, the investments used will depend on the fund's capital source, the fund structure, and the time horizon for return expectations. Investment structures are most often driven by the exit options available in the local

[3] Note, many social investment funds rely heavily on pro bono support from law firms, so the full transaction costs are often clouded by the generosity of these firms.

markets. In some markets and asset classes, there is little liquidity for privately held companies. There are limited options for strategic buyers and the public equity markets are nascent.

As a result, some social investors favor debt or preference shares (where allowed) or will only invest in markets with more vibrant capital markets or in sectors where acquisitions are possible. Others are willing to take risks on the exit. Acumen Fund, for example, worries first about whether the company can become viable with positive cash flows, and then thinks about exit options. As far as return expectations, they are also all over the map and dependent on the same factors: LP, structure, time horizon and exit options. At the more commercial end of the spectrum, investors are expecting 25 to 30% IRRs, while some funds will be fine with real return of principal.

Investment strategy

A fund's investment strategy is often articulated as its "theory of change," or why it believes the world will be a better place because of its investments. Most are less disciplined than their for-profit venture colleagues at defining a clear investment thesis; the sector is still nascent, and opportunism abounds. There is also a less well-defined track record for investment performance, and very little evidence (yet) of consistent social impact. Most social investment funds seem most comfortable with seed or early stage investments. Few have the resources to be mezzanine investors (unless the fund invested in an earlier round), and they would rather hit the social home run by getting in early.

Funds are often explicit about geographic focus (Africa and India are recent favorites) or issue (global public health is a hot sector, as are renewable energy funds). Some will do multiple issues in single geographies (Aavishkaar in India), others will do single issues in many countries (E+Co), and some funds are issue and geography agnostic.

Investment Teams, Board Participation and Decision Making

The investment professionals at social funds come from diverse backgrounds, but many do not have principal investing experience prior to joining their funds. Some come with significant private sector experience (consulting, product management), but are excited about the opportunity to support new venture creation in the context of social change. Very few come for the money.

Again, the structure and economics of the fund will dictate how active or passive the investment officers are, and how the fund makes decisions. More commercial funds are often more passive investors, with smaller, centrally located teams that can't sit on boards or provide intensive management assistance. But these funds can make decisions internally (and sometimes very quickly). The more socially-oriented funds have distributed global teams, love to help structure the business opportunity pre-investment, and will be very active board participants. These funds often complement less experienced investment teams with very seasoned external investment committees, which can often take time to iterate through major changes to terms or deal structures. The larger the fund, and the more socially oriented, the more convoluted the investment (and credit risk) committees can be for decision making.

Impact investors: reasonable returns

Impact investors are here to stay. There is too much evidence that combining social or environmental criteria with a disciplined approach to principle investing generates real change and sufficiently attractive but perhaps not-quite risk-adjusted commercial financial returns. The Obama Administration is proposing a social innovation fund that might use a range of tools from grants to patient debt to stimulate social innovation in the United States and abroad. The Rockefeller Foundation's Global Impact Investment Network is looking to build the infrastructure for the sector, particularly in emerging markets. Even traditional large foundations like the Bill & Melinda Gates Foundation have recognized the need to use a wider range of tools to generate positive social change through "creative capitalism" as Bill Gates has called it.

Savvy venture investors should not dismiss impact investors as mere philanthropists, dumb money, or part a passing fad. Rather, impact investors are part of an emerging asset class that can generate serious deal flow, test new ideas, or expand into new market and in the process contribute to solving some of the most intractable environmental and social problems of our time; certainly a reasonable return on investment by most measures.

Acumen Fund is a 501(c)3 social venture fund that invests in non-profits and socially directed for-profits distributing vital products and services to the poor through scalable, market oriented approaches. Our investments currently focus on four key areas: water, health, housing, and energy.

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