Nesta...

IMPACT INVESTING: BLOG SERIES

The field of impact investment is growing in activity, interest and potential in the UK and internationally. 2012 has been a year of significance for development of the field, with the launch of Big Society Capital, DFID's Impact Fund, a proliferation of research output, and most importantly a series of pioneering transactions from Oxfam's first SME investment in Mongolia, to the Vulnerable Children Social Impact Bond in Essex to Scope's £2 million bond issue.

Nesta has been involved in this field for five years, and we continue to support its development because we want to see finance for social innovations so that they can grow and maximise their impact. Investment is needed to fund the creation of new innovations, to support their development and testing and to scale up those innovations that work. This is as true of innovation that seeks to achieve social impact as it is of those motivated by creating financial value.

Nesta's work on impact investment includes:

- Nesta Impact Investments, our fund for high–potential early–stage social innovations through our fund management subsidiary **Nesta Investment Management.**
- Investing to create new **impact investment funds and products** such as Bridges Ventures Social Entrepreneurs Fund or Big Issue Invest's Social Enterprise Investment Fund.
- Funding the strengthening of **social venture intermediaries** who provide incubation, business support or corporate finance advice to innovative social ventures, such as Shaftesbury Partnership, Bethnal Green Ventures or Resonance.
- Researching major issues in the development of the market for example the demand for impact investment, the interest in the field amongst individual investors and their advisors, and the regulatory barriers to impact investment.
- Working with practitioners to develop and test **evidence standards for impact investment**, an approach embedded within our fund.

We want to see the impact investment market develop to so there is more focus on:

- Inclusive, accessible, affordable innovations that address major social needs.
- Delivering positive social outcomes regardless of legal form.
- The standard of evidence of a venture's impact.
- Profitable, sustainable and resilient business models capable of scaling their impact.

The following blog series sets out our thinking on impact investment in the UK. We very much look forward to hearing your comments.

Joe Ludlow, December 2012

IMPACT INVESTING: A VERY OLD IDEA

Joe Ludlow and Jo Casebourne – 01.11.2012

At the Socap conference in San Francisco in early October, over 1,500 people gathered to talk about the 'intersection of money and meaning'. Socap is the biggest gathering of impact investors in the world, and participants who travel to San Francisco from every continent are described as 'pioneers' seeking to 'direct the power and efficiency of market systems toward social impact'.

In the UK, impact investment (or social investment as the UK has historically described it) is experiencing a surge of publicity thanks in no small part to the launch of Big Society Capital, a £600 million fund of funds established to develop and shape a sustainable impact investment market.

From this, anyone would think that impact investing is a radical new idea. But arguably it is a rediscovery of a very, very old approach to investing. Impact investing can probably trace its history back to the foundation of the building society movement in the coffee houses of 18th century Birmingham. There, the early industrialists pooled their resources as a co–operative so as to provide finance for their own community to build housing. Those pioneers were using their money to achieve a community or social goal and a financial return – not a bad definition for impact investing then and now.

Since then the financial system has changed rather radically. Building societies have mostly demutualised, financial supply chains have lengthened and become more sophisticated so that savers and investors know very little about the ultimate use of their capital, and latterly the financial crisis has driven an immense distrust amongst the public in our financial institutions.

So it isn't surprising that the Government and investors are focussing on this old idea. But only ten years ago the market for impact investment in the UK barely existed[1] and it remains tiny with a particular lack of risk capital for innovations and early–stage social ventures being a real problem.

If we look back to the early 2000s, the UK social investment movement was focused on getting better access to finance for charities and community organisations. It was argued that organisations in this sector need finance like any other and that they experience worse access to it than private companies. The pioneers of the industry focused on investing in certain legal forms or under–served postcodes to address this. As a result UK social investment funds and other financial intermediaries have continued, in the main, to organise themselves with this focus. As the market has developed we have seen intermediaries become further segmented by the type of finance they cover. For example, Charity Bank mostly supplies long–term mortgages, Bridges Ventures and Big Issue Invest manage social enterprise venture capital funds and Venturesome provides working capital loans to charities and social enteprises.

We think that it's surprising that so few impact investment funds focus on particular areas of social impact e.g. education, health, social care, and that there is little specification at

the fund level of which outcomes funds are investing to address. If this old idea is to make a big difference in the future, then investing for specific outcomes has to become the market norm – in fact just like it was for the building society pioneers of the 1770s.

1. NPC (2011) 'Understanding the demand for and supply of social finance.' London: Nesta. http://www.nesta.org.uk/library/documents/BSFFUnderstandingthedemandprint.pdf

RATHER THAN FEAST OR FAMINE, WE NEED A BALANCED DIET

Joe Ludlow and Jo Casebourne – 05.11.2012

Is a £1 billion forecast impact investment market in the UK a welcome feast for capital–starved social entrepreneurs? Isn't £1 billion really just crumbs falling from the financial system's table? And feast or famine, is impact investment offering the right diet for the social venture market?

The UK impact investment market remains at an early stage, despite much progress in the last 15 years. The size of the total impact investment market is very small compared to other sources of finance available to social ventures. In 2010–2011 it was £165 million[1] – if we compare this to voluntary organisations alone having an income of £35.5 billion in 2007–2008 on assets of nearly £100 billion, we see that right now impact investing is far from being the mainstay of social venture financing.

And this new market is not equally serving the full spectrum of financial needs of social ventures. Asset–backed debt finance dominates with four social banks collectively responsible for around 70 per cent of social investment activity in 2010, and four–fifths of investment being secured lending. As others have pointed out, this is a long way from the vision of impact investors taking risks to stimulate social innovation and growth of successful social ventures, with only 5 per cent of the investments made in 2010 being categorised as equity or quasi–equity. This is the market failure in the supply of risk capital to social ventures that was recognised by the European Commission[2] in approving the creation of Big Society Capital.

So there is a convincing argument that right now social ventures are going hungry, and being fed an imbalanced capital diet. The forecast of rapid growth – reaching c.£1 billion by 2016 according to one source[3] – should therefore be welcome; but even at this rate of rapid development, it is unlikely to be at a significant scale relative to mainstream finance in ten years' time.[4,5]

However, anecdotally, we hear that demand for investment from 'investment–ready' social ventures is patchy; and the Government[6] and the Big Lottery Fund are each taking steps to boost demand – for example funding investment readiness and social incubators.

Does this mean that the upturn in the supply of impact investment will go uninvested, that social entrepreneurs aren't as hungry as they appear? Certainly there are those who believe that the increased supply of money doesn't match with the taste of social ventures,

in terms of price and risk profile.[7] But this is an emerging field, without established market norms and so perhaps such tensions are inevitable as customer and supplier adapt to one another, and indeed new entrants join in on both sides.

And there are good reasons to believe the new capital being made available can be put to work. There is a highly favourable policy environment for social ventures in the UK at the moment – not just directly supporting the supply of capital, but also through opening up public service provision,[8] devolving expenditure to local commissioners and service users, and disrupting the established market structures in health and education. This is creating space for social innovations, and new markets for social ventures to serve – and that in turn we believe is driving a growing demand for capital with impact as well as financial objectives.

There's no doubt the supply of impact investment has thus far been limited, starving many social innovations of capital or feeding them with an imbalanced debt-based diet. There's no doubt that in comparison with even five years ago, the number and value of funds available has radically increased. With policy stimulus on both the demand and supply side of the social venture sector, there's reason to be confident that the new impact investment funds entering the market will be readily consumed by hungry social entrepreneurs whose appetite for this new menu is growing.

1. Brown, A. and Norman, W. (2011) 'Lighting the touchpaper: Growing the market for social investment in England.' The Boston Consulting Group and The Young Foundation. http://www.youngfoundation.org/files/images/owing_the_market_for_social_investment_FINAL.pdf
2. European Commission (2011) State Aid n° SA.33683 (2011/N) – United Kingdom Big Society Capital. http://ec.europa.eu/eu_law/state_aids/comp-2011/sa33683-2011n.pdf
3. Brown, A. and Swersky, A. (2012) 'The First Billion: A forecast of social investment demand.' The Boston Consulting Group and Big Society Capital.
4. Ludlow, J. and Jenkins, J. (2011) 'Twenty catalytic investments to grow the social investment market.' London: Nesta. http://www.nesta.org.uk/library/documents/BSFF20CatalyticInvestprint.pdf
5. Ibid.
6. Cabinet Office (2011) 'Growing the Social Investment Market: a vision and strategy.' http://www.cabinetoffice.gov.uk/sites/default/files/resources/404970_SocialInvestmentMarket_acc.pdf
7. Big Lottery Fund Research (2012) 'Growing the social investment market: Investment Readiness in the UK.'
8. See: www.openpublicservices.cabinetoffice.gov.uk

WHO WANTS IMPACT INVESTMENT? PART A

Joe Ludlow and Jo Casebourne – 07.11.2012

As we discussed in the first of these blogs, the UK impact investment market developed initially through a desire to see better access to capital for registered charities and other traditional social sector organisations.

These organisations have typically been non-profit distributing legal vehicles, and low-profit making business models – with revenues from grants, donations, tightly-specified public contracts and some investment income.

In this blog and the next, we want to expand on some of the key trends we see as driving a different sort of demand in the UK impact investing market, namely:

- Shifts from buying products and services to buying outcomes;
- Shifts from central procurement to localised purchasing;
- Increased application of technology to address social needs.

We think these trends are supporting a new breed of social venture to emerge that could sit comfortably in any of the traditional public, private or social sectors. It appears that the traditional sector boundaries are blurring, especially as the focus of customers and investors switches to outcomes achieved over legal form and service specification. These social ventures, motivated by maximising their impact, have business models that intend to be profitable because generating profit is seen as essential for sustainability and growth of the venture, leading to an increased scale of impact. And there is early indication that the impact investment market is designing responses to these trends.

From buying services to buying outcomes

There is a growing recognition that old models of delivering public services are failing to meet our growing needs in a cost–effective way – and plain outsourcing services doesn't appear to be the answer. The basic outsourcing 'fee–for–service' contracts assume that service delivery and the buying of outputs automatically leads to positive social outcomes (such as jobs for the unemployed, reduced reoffending, and improved education and skills levels).

In reality such contracts often don't achieve those outcomes and so public service purchasers are looking to 'outcomes–based commissioning'[1] to do better. This move potentially drives demand for impact investment in two distinct ways:

- Firstly, as payments for outcomes are often paid in arrears and only when outcomes have been shown to be delivered (potentially years after service has been provided), this creates a particularly higher–risk working capital need – social impact bonds are one way impact investors are financing this need.
- Secondly, outcome–based commissioning creates an opportunity for innovative products and services – outside of standard service specifications – to be purchased. We think this will create an incentive for earlier–stage investment to develop social innovations with the potential to be a purchased on a high scale.

Outcomes–based commissioning is in its infancy. It represents a radical change in the way public goods and services are provided, and a substantial change to this model is going to take many years to take hold.

But we already see specialist products (like social impact bonds) and specialised investment funds being developed to address this market (e.g. the recently announced 'Results Fund' cornerstoned by Big Society Capital and a group of charitable foundations)[2] – a clear sign of confidence that demand for impact investment of this sort is on the up.

1. Cumming, L., Dick, A., Filkin, G. and Sturgess, G. (2009) 'Better Outcomes.' 2020 Public Services Trust at the RSA. http://clients.squareeye.net/uploads/2020/documents/Better%20Outcomes.pdf
2. http://www.thirdsector.co.uk/Finance/article/1142096/Big–Society–Capital–launch–fund–will–invest–charities–seeking–contracts/

WHO WANTS IMPACT INVESTMENT? PART B

Joe Ludlow and Jo Casebourne – 13.11.2012

In our last blog post we looked at how the shift to outcomes–based purchasing in the public sector is changing the nature of demand for impact investment, and how investors are responding to that.

In this post we continue to look at some of the trends we see changing demand for impact investment.

From central procurement to local and individualised purchasing

While the terms of trade with the public sector are changing towards payment on outcomes, so is the scale and the nature of the entities purchasing public goods. Central government policy increasingly encourages decentralisation, localism and competition among service providers, for example: the abolishment of Primary Care Trusts in the NHS in favour of GP Commissioning Consortia; or the conversion of local authority managed schools to independent academies alongside additional competition from free schools.

These significant changes in management structures and disaggregation of demand for services is creating opportunity for social ventures to compete for business, and for a range of product and service innovations to be purchased when individual commissioners adopt different specifications for services.

Alongside government purchasing, public expenditure is increasingly being put in the hands of service users, making public service markets increasingly consumer markets. For example, funding for adult social care, for care of children with disabilities is paid to service users to select a package of care from a range of providers.

And indirectly, government policy is stimulating demand for social ventures in the energy efficiency and renewable energy markets, e.g. the feed–in tariff has created a consumer market for renewable energy products; the Green Deal will create a consumer market for retro–fitting of energy efficiency measures in low–income households in poor housing stock. New social ventures are starting up with consumer product and service innovations and sales skills e.g. Cool2Care (backed by the Innovation in Giving Fund, managed by Nesta), helps match families with disabled children with appropriate personal assistants, paid for with family income and personal budgets.

These changing public markets, and the social ventures operating within them need investment capital to start up, develop their products and grow sales. We have already seen specialist funds in the UK market attuned to the needs of social ventures operating in this environment: the Department of Health/Social Investment Business Social Enterprise Investment Fund invests in social enterprises providing healthcare; the FSE Community Generation Fund is providing capital to communities installing renewable energy products.

These are impact investing funds established to specialise in particular public service markets, and we think there will be more of them.

New social ventures often with technology at their core

The final trend we want to highlight is the increasing application of technology by social ventures to enable product and service innovations that have impact on social outcomes, at a price and cost that creates profits.

This is the application of technology, far more than it is the development of new technology – applications that speed up services through automation, enable better access, and creating more sustainable business models.

For example: telehealth solutions help medics to have easier communication with, and monitoring of, older people in the patient's home, improving their quality of life and reducing the NHS' costs; adaptive learning technologies use artificial intelligence to bring the benefits of really high quality personal tutoring at very low cost and so within reach of families on middle and low incomes.

Again, the impact investment market is responding to this trend. Omidyar Network, now with a UK office, has a specialism in consumer Internet and mobile technology investments for social impact. Bethnal Green Ventures is an accelerator programme focused on start–ups applying digital technology for social impact, and our own fund – Nesta Impact Investments – has a particular interest in technology.

We think that demand for impact investment is growing – but in different ways now in comparison with a decade ago, when so much focus was on the traditional charity sector. These are social ventures that are innovating both in the design of their products and services, and in their business model, to serve very different public service markets.

FOCUSING ON IMPACT

Joe Ludlow and Jo Casebourne – 16.11.2012

The impact investment market is increasing its focus on defining, evidencing and measuring the impact of organisations receiving finance and of the organisations providing it.

This hasn't always been the case. When the field was primarily focused on providing access to finance for charities, it was often assumed that assuring registered charity status was a sufficient indicator of impact, and success measures for investments were primarily financial.

Much progress has been made. Initiatives such as Inspiring Impact and the UK Social Investor Group are convening stakeholders in the field to develop common approaches and agreed frameworks for impact measurement and reporting. It is increasingly commonplace for impact investors to consider investment in companies limited by shares as legitimate ways of maximising impact and this is further focusing investors on measurement of impact performance.

Despite this commendable progress, there often continues to be an assumption among impact investors that if the impact of an organisation (or its products or services) is judged

to be sufficiently positive at the point of investment, then the primary objective of an investment should be an increase in scale.

Yet there are very few social interventions with high quality evaluations justifying this assumption of sustained impact with increased scale. And this assumption is least valid when working with early–stage innovations whose product/service, process of production and means of delivery are often moveable feasts and subject to constant iteration.

Initiatives in Government[1] and in the public policy and social research community such as the Alliance for Useful Evidence[2] are bringing a greater focus on the standard of evidence for impact used by purchasers of products and services. Meanwhile, impact investors are increasingly grappling with the complexities of investing for outcomes, most obviously when financing organisations which are paid on achievement of outcomes, such as through social impact bond mechanisms – so investors need to get to grips with using evidence pre– and post–investment too.

Nesta is developing and testing a set of standards of evidence to support investment decision making[3] when evidence is not strong. We see improving the standard of evidence of impact as an impact investment objective in itself, much as seeing a consumer product achieve a kitemark, or seeing a pharmaceutical deliver a successful clinical trial is a legitimate use of investment in other sectors.

The goal isn't evidence in itself. It is to see capital deployed to grow the impact of the products and services most likely to have a positive effect for people and communities.

1. For example HMG's Open Public Services White Paper (June 2010) states "To support better commissioning and innovation in public services, open public services require robust accreditation of what works. Both commissioners and providers need to know which programmes are proven to work. We will consult on how to establish credible accreditation bodies for public services which can mirror the work on the National Institute for Health and Clinical Excellence in the health services."
2. http://www.nesta.org.uk/areas_of_work/public_services_lab/alliance_for_useful_evidence
3. Puttick, R. and Ludlow, J. (2012). 'Standards of evidence for impact investing.' London: Nesta.

THE PATH OF FUTURE MARKET DEVELOPMENT: FROM SOCIAL INVESTMENT TO IMPACT INVESTMENT?

Joe Ludlow and Jo Casebourne – 19.11.2012

The UK's comparative advantage in developing the impact investment market, together with the relatively small size of supply relative to present and future demand, provides an opportunity for the UK to lead the world in investing in public and social innovation, and in developing innovations in ways of financing for impact. The impact investment industry could be a great British success story.

But it is becoming clear there are competing views on how the market should develop.

We think these competing viewpoints are broadly clustered into three main visions of the role of impact investment:

1. Access to affordable capital for the social sector – this view focuses on the demand for finance from social sector organisations and holds that the social sector needs 'affordable' finance because there is a market failure in both the price paid for the social sector's outputs reducing profitability, and a market failure in the provision of capital by mainstream financial institutions to the social sector. Together this puts social sector organisations at a comparative disadvantage compared to private sector organisations e.g. social sector organisations struggled to compete with the private sector for contracts from the DWP's Work Programme, and struggled to access working capital to deliver on those contracts that were won.[1]

   Whilst there is no doubt that the social sector needs access to finance, this traditional sector–based view of demand can see finance as being an end in itself, or at least the only barrier to greater impact.

2. The lack of finance is a problem of perceived not actual risk – this view considers that it is possible to make attractive financial returns from impact investments, but that the mainstream market does not yet understand the risks and returns of impact investments and so does not provide finance. It is hoped that by demonstrating impact investments further, new mainstream investors will be attracted into the market to supply finance. This view assumes that investors are primarily motivated by financial return and see impact as a differentiator between assets.

3. Creating a different type of investment market – this view:

   - Is focused on impact and emphasises the centrality of achieving positive social outcomes (and evidencing their achievement) as the key factor in allocating impact investment capital.

   - Is neutral on legal form and sector of organisation seeking to achieve social outcomes – whether an organisation is in the private sector, public sector or social sector, if they are aiming to improve social outcomes the impact investment market should serve their needs.

   - Believes specialist impact investment intermediaries are needed who understand the needs of impact investors and investees and who have built business models around serving these needs. Demand and supply of impact–focused capital exists but intermediation is not easily delivered via the existing financial market infrastructure. There is growing evidence that a segment of individual investors are motivated to invest to achieve a positive impact on society (see Nesta 2011[2] and Worthstone 2012[2]) and are prepared to take risks to stimulate innovation and to achieve positive social outcomes (with financial returns actually being secondary).

   - Sees finance as only one tool in the tool bag, not an end in itself. The supply of finance is seen as necessary, but not sufficient, to enable organisations to develop successful business models that deliver positive impact on social outcomes. In this view, the primary focus is on finance for innovation, rather than innovations in financial mechanisms.

Nesta's work on impact investment is built upon the last of these market viewpoints. This is not to say our view is right and others are wrong. However, we find this view most consistent with:

- Our wider work on public and social innovation.
- Our experience of social ventures operating across the public, private and social sectors.
- Our experience of individual investors – for whom impact investment is a new and different way of deploying their wealth, distinct from both philanthropy and their existing investments.

In this series of blogs we've sought to discuss some of the dynamics of the impact investment market in the UK as we see them. We hope you've enjoyed them and welcome your comments and experiences.

Much of this thinking is reflected in the approach of Nesta Impact Investments, the new early–stage social venture investment fund managed by Nesta Investment Management.

1. Nesta (2011) 'Investing for the good of society: why and how wealthy individuals respond.' London: Nesta. http://www.nesta.org.uk/library/documents/BSFFGoodofSocietyprint.pdf
2. Worthstone (2012) 'Financial planners as catalysts for social investment.' London: Nesta. http://www.nesta.org.uk/library/documents/Financialplanners2.pdf