



© oluolu3/Getty Images

SUSTAINABILITY & RESOURCE PRODUCTIVITY

How impact investing can reach the mainstream

Clear measurement standards, high-grade operations, specialized products, and more training for entrepreneurs can make impact investing a more influential practice.

Jonathan Godsall and Aditya Sanghvi

Nearly ten years have passed since a coalition of philanthropists and investors introduced the financial-services industry to impact investing, a practice distinguished by its aim to generate social and environmental benefits alongside financial returns. In that time, impact-investing funds have amassed more than \$77 billion in assets under management,¹ and prominent investment managers—Bain Capital, BlackRock, Credit Suisse, Goldman Sachs, and JPMorgan Chase, to name a few—have added impact products to their portfolios.

As the impact-investing business has expanded, it has developed some growing pains. Impact-fund managers, who invest mainly in privately held businesses, are having trouble finding companies that are ready to put large amounts of capital to work.

Evaluating those companies has proven challenging, too. They are highly diverse, spanning various sectors, levels of risk, and expected returns. And the numerous standards for measuring social and environmental impact can be overwhelming, even for industry specialists.

For these reasons, fund managers are able to market a wide array of products as impact investments. Investors, however, find these options confusing to sort through. Some products aim for below-market risk-adjusted returns, which is satisfactory for certain investors. Many more will consider only impact funds that achieve market-rate returns. Investors have also expressed concern that some new impact-fund managers might not have all the investment skills and experience they need to earn appropriate returns.

Strengthening the impact-investing business shouldn't be seen as a priority only for fund managers. Expanding the industry could generate some of the money to improve human welfare worldwide. The United Nations estimates that reaching the Sustainable Development Goals in developing countries will cost about \$3.9 trillion per year—and that private and public sources provide just \$1.4 trillion.²

To chart a path around the challenges in impact investing, we spoke with 25 limited partners and general partners in the UK impact-investing market, which is generally seen as the most vibrant in the world, even with the uncertainty in the country's financial sector since the Brexit vote. We also considered how other new investment approaches have achieved widespread acceptance. In this article, we discuss the attributes of a mature impact-investing market, along with steps that fund managers, investors, governments, and entrepreneurs can take to turn impact investing into a large-scale practice for financing social and environmental improvements.

Envisioning the future of impact investing

As we considered the prospects for impact investing, we were especially interested in understanding what a large, mainstream market ought to look like. Based on our investor interviews and our study of how other investment products evolved, we believe a fully-developed impact-investing industry will have the following four features.

Proven and self-sustaining economics. When the impact-investing industry has matured, investors will generate market-rate financial returns without tax breaks, subsidies, or other help from governments. Until then, governments can play an important role in nurturing impact-investing markets. The United Kingdom's impact-investing market is more sophisticated than any other, in large part because of the government's support. A decisive

shift took place in 2012, when the government funded an entity called Big Society Capital with about £120 million from dormant bank accounts and a levy on the four main UK High Street banks (followed by another £210 million through June 2015). Since then, Big Society Capital has provided seed capital to new impact-investment managers and has served as a clearinghouse for knowledge of impact investing and social entrepreneurship.

The UK government also lent indirect but vital support to its impact-investing industry by going further than many governments in contracting public services, such as welfare-to-work programs, to nonprofits and companies. Some argue that this approach has not always fulfilled its promise to produce better social outcomes for less money. In any case, it has created reliable demand for social enterprises and impact-oriented businesses, which increases these organizations' need for capital.³

A clear, consistent way of describing products.

"Impact investing" means different things to different people. Some see it as a strategy for beating financial benchmarks, because businesses that target unmet social or environmental needs can be profitable but easy for investors to overlook. Others are happy to accept lower financial returns for the sake of backing enterprises whose main interest is creating social benefits. The investors we spoke to believe impact-fund managers need to clarify their intentions as well as the trade-offs inherent in their approaches. In particular, managers should be more objective about the levels of risk and the expected returns, both financial and nonfinancial, of their funds. Just as a mature impact-investing market needs shared standards for measuring impact, it will also need a common language for profiling impact funds.

The family offices and large asset managers we spoke to in the United Kingdom are especially excited about investing in businesses that put profits first and see social impact as a coproduct of their

work. One example is the Gym Group, a UK company offering affordable health clubs to low-income people whom the wider gym industry generally does not serve. With capital from the impact-investment firm Bridges Ventures, the gym expanded to more than 35 locations in under five years and returned more than 20 times its original investment.

A range of well-defined offerings. Another sign that the impact-investment industry has matured would be the availability of specialized products. Just as some mutual funds and exchange-traded funds concentrate on geographies, industries, and asset classes, so should impact investors come up with targeted offerings. Focusing on distinct social and environmental themes can help when it comes to setting goals for how much nonfinancial impact a fund will make. Thematic funds should also be easier for investors to compare. Impact investors have set up funds devoted to education, and healthcare is emerging as another focus area.

A high degree of professionalism. More capital will flow into impact funds when they consistently offer investors the same quality of service as other investment funds. Some impact funds have operated for more than five years and have established sound, disciplined processes. However, UK investors told us they have concerns about newer funds, pointing to shortcomings in areas like financial modeling, business-plan preparation, and the evaluation of management, which can be a major risk in impact-investment portfolios. Funds may also need to offer more competitive pay packages to attract top financial talent.

UK investors credit Bridges Ventures with setting high standards for professionalism and paving the way for other firms. Bridges was founded in 2002 to finance companies that serve the most deprived 25 percent of the UK population. Several of its funds, the last of which raised £200 million, have delivered

returns that match or exceed those of traditional private-equity managers. The firm has consistently developed investment funds with progressive features. For one of its funds, Bridges created a way to invest in social enterprises whose legal structures make it difficult for them to accept outside financing. Many impact-oriented investment firms will also need to combine novel financing mechanisms with professional investment practices to appeal to a wider range of limited partners and increase the assets they manage.

Priorities for making an impact—on impact investing

The investors we spoke with made clear that the global impact-investing market has some way to go before it achieves these four hallmarks of maturity. We see several efforts that are especially urgent for impact investors, asset managers, governments, and entrepreneurs to pursue, since they will help establish a sound basis for the industry's continued development.

Clarifying impact-measurement standards.

Looking at a dozen impact-investing funds that publicly disclose how they measure impact, we found that a majority employ more than one impact-measurement framework. Fund managers tend to use multiple frameworks because no single framework has metrics for all the social or environmental impacts covered by their portfolios, or even by individual funds. This practice burdens prospective investors with interpreting and comparing the various metrics that fund managers apply. Fund managers, investors, and industry bodies must devise a set of metrics for social and environmental results and use these measures consistently. For example, investors that wish to finance improvements in educational outcomes should be able to look at several education-focused impact funds and compare them in terms of the same educational metrics.

Professionalizing the practice of impact investing.

Many impact-fund managers need proven operating processes but lack the resources to create them or train employees accordingly. Investors can help by convening impact-fund managers to share knowledge. For example, the ImPact is a coalition of investment firms that have pledged to share what they learn about impact investing. In the United Kingdom, Big Society Capital gathers and disseminates knowledge of impact investment. Impact-fund managers willingly exchange ideas, particularly with newer funds, to help the entire industry gain standing among limited partners. The flow of knowledge has enabled the industry to become more sophisticated and to establish more consistent standards. Major investment-industry associations could also lend credibility to impact investing by defining the competencies needed by impact-fund managers and developing certification programs.

Supporting social enterprises and impact-oriented businesses.

Mainstream fund managers are usually willing to allocate \$10 million to \$50 million in capital to a promising company, but few social enterprises and impact-oriented businesses have demonstrated an ability to deploy even one-tenth that amount of money. Government agencies and large companies can expand markets for impact-oriented businesses and social enterprises by changing procurement practices in their favor and help them scale. Social-sector CEOs also need better training, as well as seasoned board members to guide them as their organizations grow. Investors and impact-fund managers can help in these respects, in addition to providing capital. One example is a program being run by the UK not-for-profit OnPurpose with support from the Centerbridge Foundation to provide leadership development training for social-sector CEOs.

Improving marketing practices and product development.

The top concern of the investors we spoke with is the difficulty of comparing impact-

investment firms and their products. Impact-fund managers need to be up-front about their overall strategies and about the objectives and risks of individual products, particularly when it comes to how those products balance nonfinancial impact with financial returns. Managers can also create sector- or issue-specific products whose impact can be measured in consistent ways. Investors can help by recommending themes for fund managers to focus on and by setting clear expectations for financial returns and nonfinancial impact.



Impact investing has attracted the interest of major investors and asset managers and has formalized much of the infrastructure that it needs to become a mainstream practice. But some shortcomings persist. Impact-fund managers must lead the way in resolving these problems, with help from investors, entrepreneurs, and governments. By doing so, they can put impact investing on equal footing with other investment approaches and thereby unlock the industry's full potential to respond to global social and environmental challenges. ■

¹ Rachel Bass, Abhilash Mudaliar, and Hannah Schiff, *Annual Impact Investor Survey 2016*, The Global Impact Investing Network, May 2016, thegiin.org.

² *World Investment Report 2014: Investing in the SDGs: An Action Plan*, United Nations Conference on Trade and Development, June 2014, unctad.org.

³ Impact investors generally invest in two types of organizations, which offer different risk/return profiles and different balances between impact and financial performance. Social enterprises are for-profit or nonprofit organizations whose first priority is generating positive social impact. Impact-oriented companies seek market-rate returns on investment using business models that are designed to solve social problems.

Jonathan Godsall is an associate partner in McKinsey's New York office, where **Aditya Sanghvi** is a partner.

Copyright © 2016 McKinsey & Company.
All rights reserved.