We Need to Talk About Impact…

Impact Investment Provocations Series

The "Missing Middle" is still Missing

If you're a non-profit, community service or social enterprise seeking to deliver great outcomes for people and places, then chances are, you are juggling resources from a range of sources. Running a 'for purpose' organisation or business in the current environment increasingly requires managers and boards to become familiar with blending grants, contracts, donations and investment to make their business models work and deliver impact. The demand for a range of capitals to support impact has grown over the past two decades. However the supply of capital (though subject to much hyperbole) has not been adequately matched to the demand. The result has been an impact capital market that is skewed towards certain kind of capital for certain kinds of returns and therefore limited ranges of purpose. As a result, investors are screaming for pipeline development, saying they are ready to invest at scale; suggesting that for-purpose organisations need to change their appetite, grow their readiness and account for their impact. Meanwhile for-purpose organisations and social enterprises are seeking a more diverse range of capital offerings; capital structuring that benefits their constituents not just investors; and a scale of investment that matches their capacity to deliver real impact in alignment with their purpose. When it comes to impact investment what is evident is a mismatch between supply and demand (see figure 1), or the 'quality' of demand being

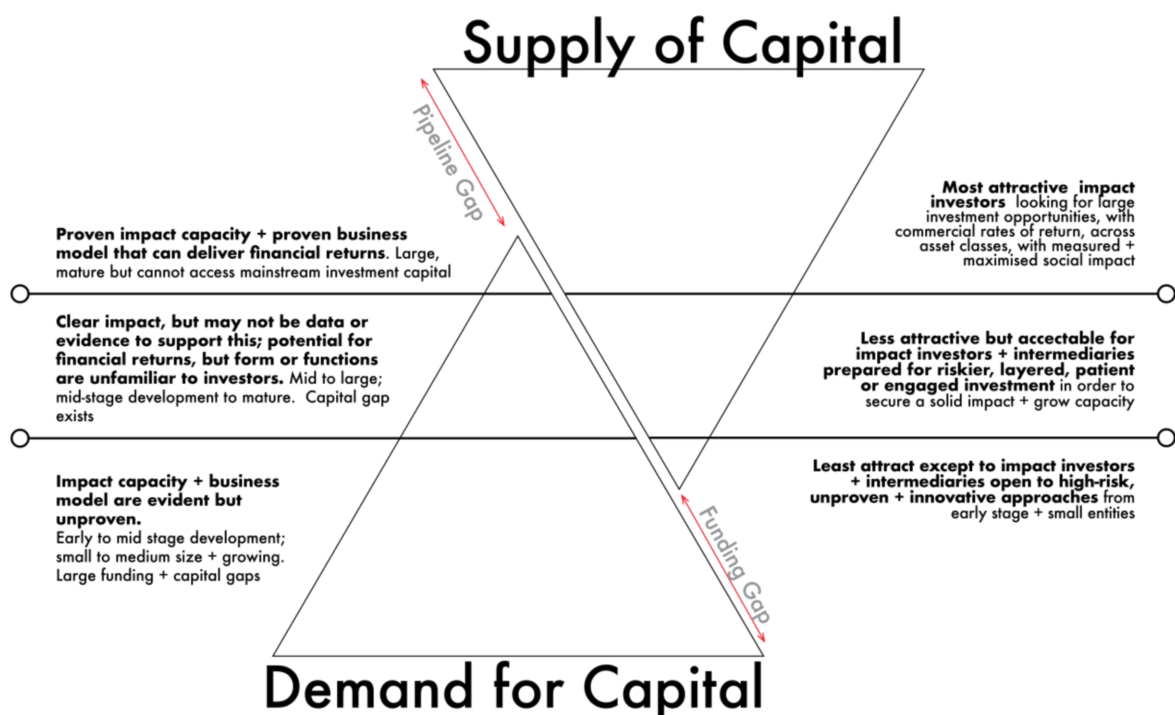

Figure 1: There is currently a mismatch between supply and demand in impact investment

largely a construct of supply side interpretation.
There is no doubt that impact investment has grown in Australia - in 2018 almost $6billion was identified under the banner of impact investment (and this has continued to grow) (CSI, 2019). However, it also needs to be said that 96% of this investment was directed at environmental outcomes. (RIAA + CSI, 2019;pp 21-22). There is no doubt that this is crucial given the critical nature of climate change, biodiversity decline and extinction rates, but these are also areas where often established markets (and financing) are in operation. If we are wanting to be serious about impact, we are going to have to get serious about articulating what this impact actually is - and what the different kinds, intensities, nature and intent of impacts are across the increasingly diverse field of impact investment. Equally, we are going to need to become much more attuned to the relationship between financial instruments and their potential to unlock and deliver different kinds of impacts in order to really start to align and better match supply and demand in Australia.

To emphasise this point, most of the significant growth in impact investment is at the intersection with mainstream capital markets,

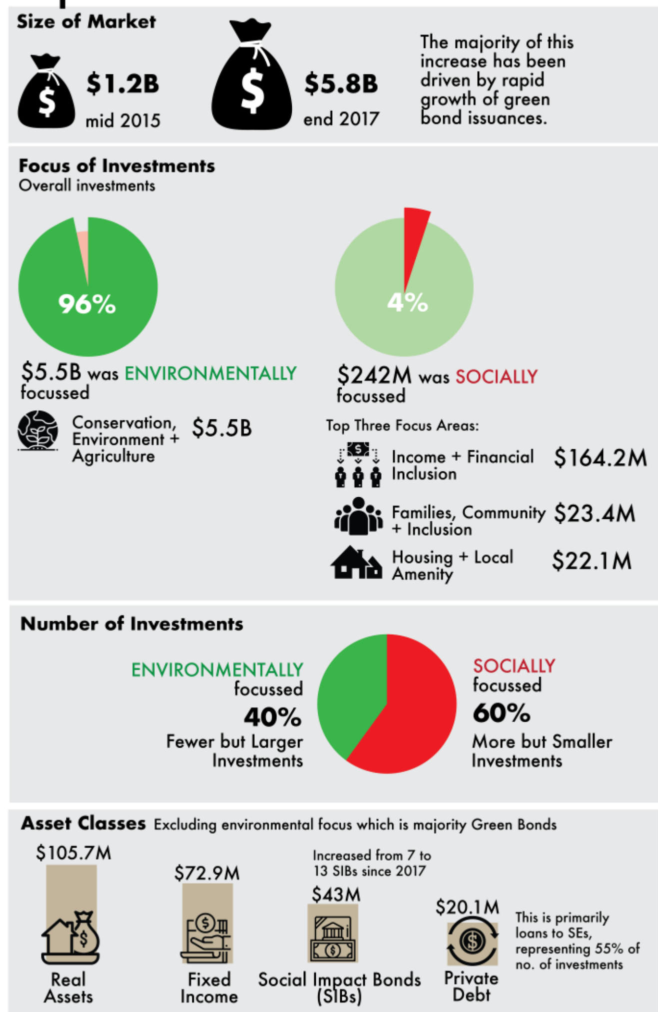

Figure 2: Impact Investment in Australia (RIAA + CSI, 2018)

where impact can be pursued and incentivised without requiring concessions on financial returns (IFC 2019). This primarily relates to sectors and opportunities where societal need and market opportunity overlap, such as renewable energy and health, or asset backed investments that promise to retain and appreciate in value regardless of their proposed use.

However, impact investment continues to experience headwinds where propositions intervene in areas of market failure and are unable to generate commercial returns. This basically results in 'impact' being an investment preference rather than a commitment to advance genuine reform. This is a fundamental flaw that needs to be addressed, as many of the biggest opportunities for preventative intervention and impact exist in emergent spaces, and finding ways to resource these opportunities was an intrinsic part of the original purpose of the movement.

Rather than determining these spaces as concessionary or uncommercial, which is pejorative and implicitly creates siloes, a more constructive narrative may be to reframe them as challenges for market and financial innovation. All markets are constructed and, at the basest level, simply reflect an agreement on what is considered valuable and how newly created value is quantified and exchanged. It follows that many 'uncommercial' opportunities reflect our current inability to accurately appraise and reward the value being created, or the potential value that stands to be unlocked.

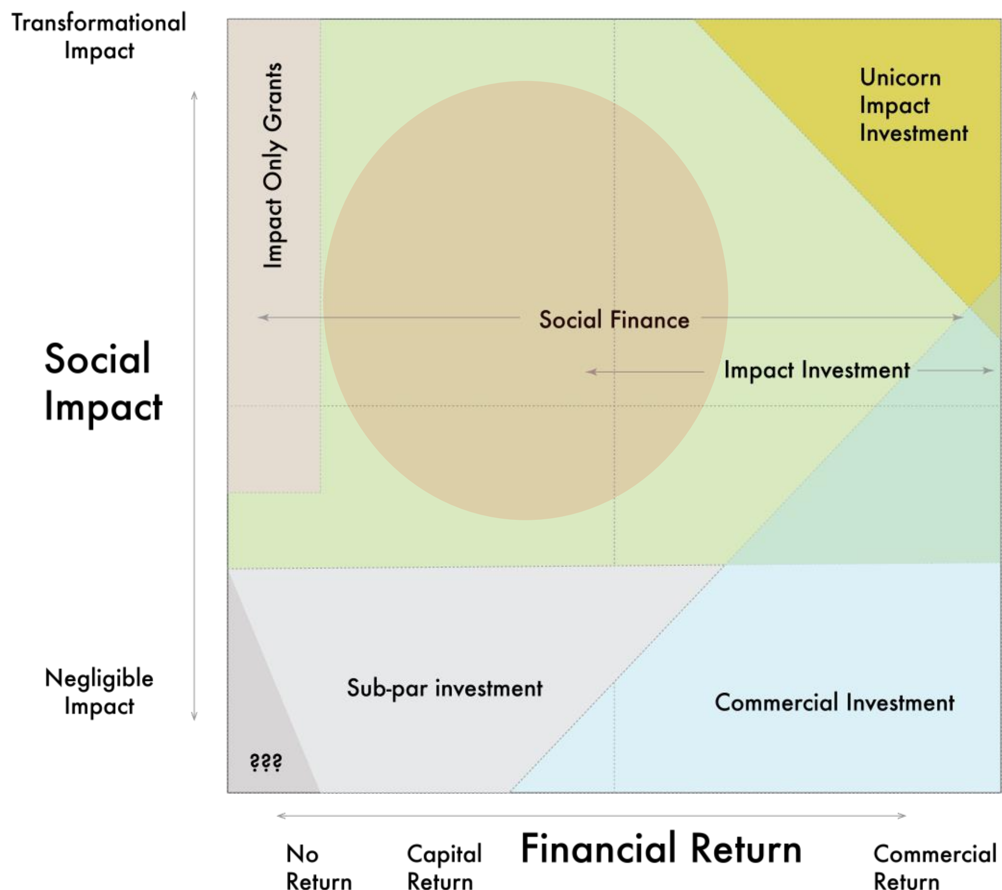

Figure 3: The missing middle in the Australian Landscape

This points to what could be seen as a 'missing middle' in the Australian landscape (see figure 3). In this space sit both those arenas where the mismatch in supply and demand are most acute for impact investment, but also those areas that could better be served by 'social finance'. Though in Australia the field of social finance has largely been subsumed by the growth of interest in 'impact investment', we argue that, in fact, we need to reconstitute this as the larger field, in which impact investment sits (rather than the other way around). Social finance, according to the Said Business School in the UK, captures a much broader range of "instruments, hybrid funding models and structured deals blending various types of capital… that includes conventional financial assets of debt and equity, but also includes grants and bespoke asset types such as quasi-equity or upside revenue participation bonds" (Nicholls and Emerson, 2015;p.4-5). Social finance is much broader framing than 'investment' (for example, it includes granting and consumption like instruments), and, as a result, offers a more diverse range of financial instruments that can be deployed to address complex or 'wicked' social issues such as place-based disadvantaged. Further, it is a reconstitution of the social finance field that will enable us to more effectively realign the current mismatch between supply and demand.

To fill the missing middle, it will be important to keep exploring ways to recognise the value of outcomes via reliable payments, and create market mechanisms that enable promising interventions to be tested and effective ones to scale. In this, the voluntary carbon markets (especially approaches such as Plan Vivo) may provide a better blueprint than impact bonds. Certainly, to enable broader adoption of outcomes-based payments: compliance costs need to come down, impact producers need to be better enabled, demand for outcomes needs to be cultivated (through multiple means), and extractive industry building needs to be constrained. We should also explore where the required level of evidence best sits on the efficacy-accuracy continuum, and consider what other proof points can work alongside measurement to enable effective interventions to be resourced efficiently, in proportion to their maturity and performance.

Another way to develop opportunity in this missing middle, especially in relation to hybrid enterprises, is to calculate and separate the additional liabilities associated with delivering the impact aspects of a business model – the 'social costs' of creating blended value. REDF has developed a 'double bottom-line' accounting mechanism that is both transparent and easy to implement, and makes it relatively simple to appraise the underlying viability of any given impact enterprise by distinguishing the nature

(impact related or straight-up commercial) of revenues and costs. This enables both entrepreneurs and investors to distinguish between a bad business and viable business encumbered by the additional costs of tackling market failure. If the latter, it then provides distinct propositions for both funders who are primarily interested in impact (who can underwrite the social cost), and investors who require a market rate return. Conceptually, at least, it would be straightforward to establish a ‘blended value fund’ that underwrites the social costs of high-potential impact enterprises using this accounting model (unlocking opportunities for market-rate investment), with the co-benefit of also driving better practice around accounting and reporting.

There are a number of other promising approaches being advanced to fill the missing middle. On a small scale it is interesting to see the (Australian-based) Impact Investment Group’s new loan vehicle, designed to help start-ups focus on their impact. In this facility, repayments are based on the start-up’s revenues (turned up and down depending on their capacity to repay), while interest rates will be tied to the level of impact they achieve.

A promising response at a higher level of capital intensity (required for asset-backed and large-scale systems interventions) is the Catalytic Capital Consortium (C3), which was launched in 2019 by the MacArthur Foundation in collaboration with the Rockefeller Foundation and the Omidyar Network. C3 will constitute a significant investment in direct finance and support of intermediaries who will be able to unlock significant amounts of investment through backing high-potential and high-performance impact-first actors. In the words of Debra Schwartz, Managing Director of Impact Investments at MacArthur, “the real story is about the value of patient, flexible, equity-like capital for high-performing non-profits” (Schwartz, 2020; https://tinyurl.com/yc3pcb9o).

There is a huge dividend for governments in these approaches, and perhaps a considered investment case could be prepared and socialised as part of pandemic recovery measures.

A final point to consider is the degree to which the conventional supply / demand relationship is a contributor to the missing middle, and needs to evolve. Reframing this relationship from one of shared risk and mutual gain, to one of shared purpose and complementary capacity, changes the nature of this relationship from one of negotiated prospecting to one of generative partnering – the pursuit of stakeholder value rather than shareholder value necessitates a different type of relationship, that needs to function in different, and more equal, ways.

If we are serious about applying 'impact investment' to addressing complex social problems such as entrenched disadvantage, we need two things - one, reconstitute the field of social finance as umbrella that impact investment sits underneath; and catalyse innovation in the 'missing middle', which will lead to better matching of supply and demand of capital, and better supply and demand side relationships, to address social problems in Australia.

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Authors

Professor Ingrid Burkett

Co-director The Yunus Centre, Griffith University

Ingrid is a social designer, designing processes, products and knowledge that deepen social impact and facilitate social innovation. She has contributed to the design of policy and processes in a diversity of fields, including community development, local economic development, disability, procurement and social investment.

Professor of Practice Alex Hannant

Co-director The Yunus Centre, Griffith University

Alex has a background in capacity building, partnership brokering, and social innovation. He has broad international experience, working in a range of fields, including poverty alleviation, sustainability, climate change, education, social enterprise, and impact investment.

The Yunus Centre equips people with the know-how to navigate change and create positive, societal impact. We are interested in how a progressive, regenerative and inclusive future can be achieved through new models of innovation, entrepreneurship, and enterprise.

Specifically, we're focused on navigating impact-led innovation, developing impact literacy, growing the impact economy and fostering impact entrepreneurship.

griffith.edu.au/yunus-centre
yc@griffith.edu.au