



Private Capital for Sustainable Development

Concepts, Issues and Options
for Engagement in Impact Investing
and Innovative Finance

Evaluation Study

Private Capital for Sustainable Development: Concepts, Issues and Options for Engagement in Impact Investing and Innovative Finance

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The authors of this study are:

Anja-Nadine Koenig, Founder and Managing Director, Social Impact Markets,
Berlin (Germany), akoenig@socialimpactmarkets.org

Edward T. Jackson, President, E.T. Jackson and Associates Ltd.,
Ottawa (Canada), edward_jackson@etjackson.com

With research support from:

Brian Carriere, Researcher, E.T. Jackson and Associates Ltd.,
Ottawa (Canada), brian_carriere@etjackson.com

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Abbreviations

<i>AACF</i>	African Agricultural Capital Fund
<i>AECE</i>	African Enterprise Challenge Fund
<i>AMC</i>	Advanced Market Commitments
<i>BoP</i>	Base of the Pyramid
<i>CalPERS</i>	California Public Employees Retirement System
<i>CIC</i>	Climate Innovation Centres
<i>CRISA</i>	Code for Responsible Investing in South Africa
<i>DCED</i>	Donor Committee for Enterprise Development
<i>DEG</i>	German DFI (Deutsche Investitions- und Entwicklungsgesellschaft)
<i>DFID</i>	Department for International Development (United Kingdom)
<i>DFI</i>	Development Finance Institution
<i>DIB</i>	Development Impact Bond
<i>EDFI</i>	European Development Finance Institutions
<i>EBRD</i>	European Bank for Reconstruction and Development
<i>ESG</i>	Environmental, Social, and Governance
<i>EVPA</i>	European Venture Philanthropy Association
<i>FMO</i>	Dutch Entrepreneurial development bank
<i>GAGF</i>	Greater Anatolia Guarantee Facility
<i>GHG</i>	Greenhouse Gas
<i>GIIN</i>	Global Impact Investing Network
<i>GIIRS</i>	Global Impact Investing Rating System
<i>GIMPA</i>	Ghana Institute of Management and Public Administration
<i>GPs</i>	General Partners
<i>HIPSO</i>	Harmonized Development Results for Private Sector Investment Operations
<i>HNWI</i>	High Net-Worth Individuals
<i>IB</i>	Inclusive Business
<i>IDB</i>	Inter-American Development Bank
<i>IFC</i>	International Finance Corporation
<i>IFU</i>	Investment Fund for Developing Countries (Denmark)
<i>IIR</i>	Internal Rate of Return
<i>IMWG</i>	Impact Measurement Working Group
<i>IPO</i>	Initial Public Offering
<i>IRIS</i>	Impact Reporting and Investment Standards
<i>KfW</i>	German development bank
<i>LHGP</i>	Lion's Head Global Partners
<i>LPs</i>	Limited Partners
<i>M&E</i>	Monitoring and Evaluation
<i>MDB</i>	Multilateral Development Bank
<i>MFI</i>	Microfinance Institutions
<i>MSME</i>	Micro, Small and Medium-Sized Enterprises
<i>NGO</i>	Non-Governmental organisation
<i>OBA</i>	Output Based Aid
<i>ODA</i>	Official Development Assistance
<i>OECD</i>	Organisation for Economic Cooperation and Development
<i>OPIC</i>	Overseas Private Investment Corporation
<i>PE</i>	Private Equity

<i>PFS</i>	Pay-for-Success
<i>PIDG</i>	Private Infrastructure Development Group
<i>PPI</i>	Progress out of Poverty Index
<i>PPP</i>	Public-Private Partnership
<i>PRIs</i>	Program-related investments
<i>RBF</i>	Result-Based Financing
<i>RCTs</i>	Randomised Controlled Trials
<i>RDFI</i>	Redesigning Development Finance Initiative
<i>SAIIN</i>	Southern African Impact Investing Network
<i>SDC</i>	Swiss Agency for Development and Cooperation
<i>SDGs</i>	Sustainable Development Goals
<i>SDIP</i>	Sustainable Development Investment Partnership
<i>SIB</i>	Social Impact Bond
<i>SME</i>	Small and Medium Enterprise
<i>SRI</i>	Socially Responsible Investment
<i>TEF</i>	Tony Elumelu Foundation
<i>TCX</i>	The Currency Exchange Fund
<i>UNDP</i>	United Nations Development Program
<i>USAID</i>	United States Agency for International Development
<i>VC4A</i>	Venture Capital for Africa
<i>VCFCs</i>	Venture Capital Financing Companies (Ghana)
<i>VCTF</i>	Venture Capital Trust Fund (Ghana)
<i>VP/SI</i>	Venture Philanthropy and Social Investment
<i>WEF</i>	World Economic Forum

Currency cited in the report

Average rates between commencement date 22 June-30 November 2015:

<i>DKK – USD</i>	= 0.148
<i>DKK – Euro</i>	= 0.134
<i>DKK – ZAR</i>	= 1.949
<i>DKK – GBP</i>	= 0.097
<i>DKK – AUS</i>	= 0.205

Executive Summary

Introduction

This report summarises the findings of a study on the strategies and tools available to donor agencies and their partners to leverage and deploy private capital for sustainable development. Reviewing experience with funds and investment vehicles in the fields of innovative finance and impact investing, the study is intended to inform the future engagement of Danida and other bilateral donor agencies in these fields. The report is divided into the following chapters: introduction, key concepts, critical issues in impact and financial performance, critical issues in fund design and institutional considerations, and conclusions and options for action. Annexes provide more detail on the methodology used for the study, key concepts and additional background research.

Background

Mobilising private capital for sustainable development has become a priority for governments and development agencies around the world. For there to be any possibility of achieving the ambitious Sustainable Development Goals (SDGs) by 2030, as much as USD 2.5 trillion in private financing worldwide is required per annum to supplement local tax and fee revenues and official development assistance. However, the private sector makes its basic investment decisions on the basis of three core criteria: risk, return and exit. How, then, can donor agencies and their partners in the Global North and South most effectively engage private investment with sufficient scale and targeting to significantly contribute to reducing poverty, eliminating hunger and mitigating climate change?

Purpose

The purpose of this study was ‘to provide a better basis for future Danida engagement in impact investing by analysing how development objectives can be achieved through impact investment funds, and what role donors can play to leverage private funding for impact investing for development... The study should be focused on potential use in Danida partner countries within the area of green growth/climate investments and small and medium-sized enterprises, including financial services.’ Research questions to be addressed by the study centred on the following issues: the definition of impact investment; the typology and set-up of impact investment and other relevant funds; investor risk and risk-mitigation strategies; the imperative of additionality; good practices and tools in results measurement; the challenge of maintaining a sufficiently full pipeline of bankable projects; and the coordination and sharing of information among impact investment funds and other actors.

Methodology

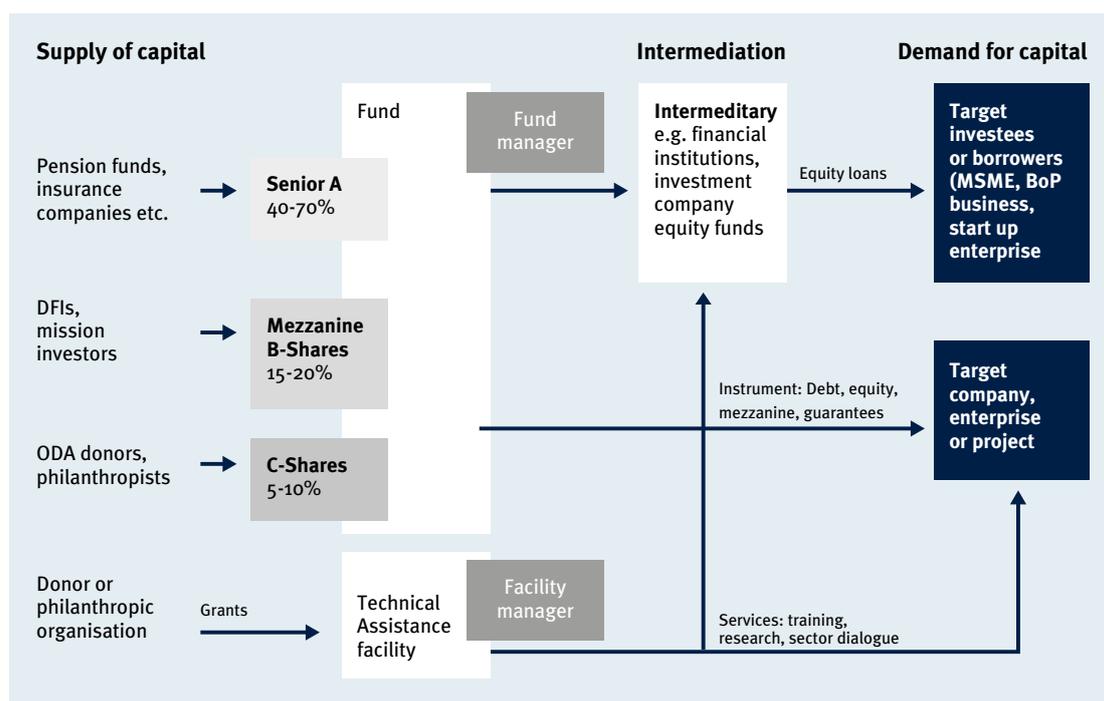
The methodology employed to carry out the present study had four components: First, through an extensive literature review, more than 100 key reports, papers and books were collected and reviewed. Second, using publicly available information and online databases, the team created fact sheets on 23 investment funds and vehicles with a range of the risk mitigation measures, capital structures and impact objectives that enable donor agencies to mobilise private-sector capital on significant scale for sustainable development, particularly in Africa. Third, the team carried out open-ended interviews with 51 managers, thought-leaders and policymakers in impact investing and blended finance, business, and development, including project managers of a sub-set of the funds sample. Finally, through other projects, the research team collected supplementary information as participant observers at professional events on impact investing and development finance. The research for this study was carried out from July 2015 through October 2015, and the report was finalized in February 2016.

Definitions

The term innovative finance encompasses new and more efficient ways of sourcing funds and also new ways of deploying them, and includes mechanisms for raising public and private finance, and for achieving better results. In contrast, impact investing refers largely to the way capital is deployed, and is defined by the G8 Social Impact Investment Task Force as ‘investments that are made with the intent to generate and measure both a social and a financial return. In the case of international development, these investments are targeted at enterprises that benefit the poor as consumers, producers, suppliers or employees.’ In addition, for the OECD and the World Economic Forum, the term blended finance refers to an ‘approach to development finance that employs the strategic use of development finance and philanthropic funds to mobilise private capital flows to emerging and frontier markets.’ Blended finance techniques have been used to structure green investments, such as large-scale renewable energy projects. Efforts to build the markets of impact investing and blended finance have rarely overlapped, but appear now to be converging.

Findings and Lessons

The main finding of the present study is that more is known than ever before about how donors and Development Finance Institutions (DFIs) can mobilise private sector investment for sustainable development. In particular, structured funds, result-based financing and guarantees, and early-stage and innovation funding all are being used to mitigate risks, structure deals and achieve stronger impacts at substantial scale with the capital of private equity funds, banks, insurance companies, foundations, pension funds, family offices, high-net-worth individuals, and corporations. Layered, structured funds, especially, can aggregate capital for larger-scale investments, using a ‘waterfall’ structure to offer opportunities for private and public investors with different risk, return and exit requirements.

Figure 1: Typical structured fund

Source: The Authors.

The structures, instruments and critical issues discussed in this report point to a number of emerging lessons in innovative finance and impact investing. Five such lessons are worth noting. First, with the exception of a handful of regional centres (notably Kenya, India and Brazil), the impact investing industry in many developing countries is still characterised by inadequate infrastructure and a small number of investors and investees. Second, more generally, businesses in developing countries still lack sufficient access to financial products such as venture capital, working capital and long-term debt finance. Third, in recognition of these and other challenges, a number of governments (such as Ghana and South Africa) have taken steps to provide a more conducive regulatory environment for impact investing and to mobilise private capital for the public good. Fourth, there are promising recent examples of high impact, high risk funds led by DFIs, including those that focus on post-conflict and volatile areas, or target the Base of the Pyramid. And fifth, funds and programmes have demonstrated that quality investment deals can be generated and de-risked in the field, through technical assistance, training, accelerators and other means.

The present study also finds that there is a need for further work to strengthen reporting on the additionality of private investment, to improve the transparency of funds and vehicles, and to share and integrate industry-wide taxonomies and standards for performance assessment. Finally, there is a wider range than ever before of platforms and mechanisms in the fields of development, environment and philanthropy to enable public and private investors to learn about and engage jointly in impact-targeted investing.

Options for engagement

Mobilising private capital for sustainable development will remain a priority for the development community throughout the life cycle of the Global Goals, and no doubt, beyond. Donor agencies and their development partners can engage in this work in many ways, especially through their roles as investors, market builders, commissioners of products and services, and advocates for quality standards.

In particular, through platforms, existing funds and vehicles, or their own countries' development finance institutions, development agencies can become co-investors in innovative financing vehicles and impact investing funds that focus on the thematic issues (such as agriculture, education, water, or renewable energy) and geographies of greatest priority to their governments. After substantial experience and learning, taking a lead role in setting up and directing a new fund or vehicle is also an option for donor agencies. To play these and other roles effectively, it is likely that development agencies will need to build their own internal capacity in innovative finance and impact investing, through support for and involvement in networks and conferences, executive education, and the establishment of specialised career tracks. Donors can also use targeted networking and education, including e-learning offerings, to mobilise private investors, especially local investors in partner countries. In this effort, development agencies should consider helping to increase the availability of long-term capital, finance in local currencies, and credit lines for renewable energy and inclusive business.

In addition, donor agencies can also play important roles in strengthening the strategies, tools and standards for impact assessment; in bolstering and policing the reporting of additionality, particularly by supporting ex-ante and ex-post studies; in ensuring, more generally, transparency in the reporting practices of impact-oriented funds; and in using business support and market development programmes to bring many more enterprises and projects to investment-ready status. Moreover, development agencies should consider creating, commissioning and disseminating research on critical issues in impact investing and innovative finance. Finally, donors are presented with an opportunity to make Africa the priority in their market-development and field-building efforts; a strong case can be made for doing so.

Conclusion

Overall, from the literature examined here, the sample of funds and vehicles reviewed, and the experts consulted, it is clear that the nexus of impact investing and blended finance holds considerable promise for mobilising and deploying private capital for sustainable development and for contributing in significant ways toward the achievement of the Sustainable Development Goals. While there are limits and complexities at this convergence point, there are also innovations and early successes that demonstrate not just potential but real, tangible results. Donor agencies and their allies in sustainable development now have an opportunity to continue to scale these funds and vehicles, monitor and evaluate them systemically – expecting failure and surprises as well as ingenuity and success – and to accompany and animate this important work over the next 15 years.

1 Introduction

1.1 Background

Mobilising private capital for sustainable development has become a priority for governments and development agencies around the world. For there to be any possibility of achieving the ambitious Sustainable Development Goals by 2030, as much as USD 2.5 trillion in private financing worldwide¹ is required per annum to supplement local tax and fee revenues and official development assistance. However, the private sector makes its basic investment decisions on the basis of three core criteria: risk, return and exit. How, then, can donor agencies and their partners in the Global North and South most effectively engage private investment with sufficient scale and targeting to significantly contribute to reducing poverty, eliminating hunger and mitigating climate change?

Over the past decade, relevant new strategies and tools for leveraging and deploying capital have been generated in two, mostly separate, fields of practice: The first involves innovative forms of financing that use funds and other vehicles to blend private and public capital in the service of development objectives. Often involving large-scale infrastructure investments, including green energy projects, this field is primarily driven by Northern-based development finance institutions, donor agencies, private equity funds, and some foundations and pension funds.

In innovative finance, the traditional roles of donor agencies and Development Finance Institutions (DFIs) have begun to shift. Grants have found a significant role as development agencies test ways of converting grants into financing and investment instruments or risk-mitigation instruments. Many of these interventions are at points in the systems where markets fail or no markets exist. In this sense, these organisations are intervening to build ‘markets that work for the poor’ as a way of promoting scalability and system change.² For their part, development banks have used their relative flexibility and access to concessionary funding for mobilising additional resources of capital. Development finance institutions are increasingly active as asset managers and investors in aggregated financing vehicles, in addition to their direct lending to and investments in private sector companies and projects.

The second field of practice is known as impact investing, where investments are made with the intention of achieving a social or environmental impact as well as a financial return, and with a commitment to measuring that impact. These funds so far have tended to focus on smaller investments in SMEs and social enterprises. Leading impact investors include major foundations, high net-worth individuals, investment banks, private equity funds, non-profits, and also some pension funds. Over the past decade, impact investing has grown steadily to become a USD 60 billion industry worldwide, with professional networks, a lexicon and standards, a funds rating system, and a wide range of industry participants, including asset owners, asset managers, investee firms

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- 1 UNCTAD. *World Investment Report 2014, Investing in the SDG: An Action Plan*, United Nations Conference on Trade and Development, New York and Geneva, 2014. More recent estimates are found in Schmidt-Traub, G. *Investment Needs to Achieve the Sustainable Development Goals*, Working Paper, Sustainable Development Solutions Network, 2015.
 - 2 DCED website: <http://www.enterprise-development.org/page/m4p>

and projects, and service providers. Most impact funds focused on developing countries invest in financial services and agriculture and, recently, increasingly in health, education and housing. Social-mission businesses that provide affordable products and services to the Base of the Pyramid are especially attractive investees. Among the constraints to this emerging industry's growth are regulatory and policy barriers, lack of market infrastructure, few investment products, lack of exit options, and competition among impact investors for deals that are still too few in number and too small in size. Annex E provides a more detailed landscaping of the current impact investing market in emerging countries.

1.2 Study purpose and methodology

This report summarises the findings of a study on the strategies and tools available to donor agencies and their partners to leverage and deploy private capital for sustainable development. Commissioned by the Evaluation Department of Danida in Denmark's Ministry of Foreign Affairs, the purpose of the present study was to 'provide a better basis for future Danida engagement in impact investing by analysing how development objectives can be achieved through impact investment funds' and to assess 'what role donors can play to leverage private funding for impact investment for development.' The terms of reference, reproduced as Annex A, directed that the study focus 'on potential use in Danida partner countries within the area of green growth/climate investments and SME development, including financial services.' In 2015, more than half of Danida's partner countries were in Sub-Saharan Africa and another third were in Asia, including low-income and lower-middle income countries as well as fragile states.

The research issues examined by the present study included: the definition of impact investment; the typology and set-up of impact investment and other relevant funds; investor risk and risk-mitigation strategies; the imperative of additionality; good practices and tools in results measurement; the challenge of maintaining a sufficiently full pipeline of bankable projects; and the coordination and sharing of information among impact investment funds and other actors.

The approach employed to carry out the present study entailed four components: First, through an extensive literature review, more than 100 key reports, papers and books were collected and reviewed. Second, using publicly available information and online databases, the study team created fact sheets on 23 investment funds and vehicles with a range of the risk mitigation measures, capital structures and impact objectives that enable donor agencies to mobilise private-sector capital on significant scale for sustainable development, particularly in Africa. Third, the team carried out open-ended interviews with 51 project managers, fund managers, thought leaders and policymakers in impact investing and blended finance, business, and development. Finally, through other projects, the study team served as participant observers at professional events on impact investing and development finance. The research for this study was carried out from July 2015 through October 2015, and the report was finalized in February 2016.

Table 1 lists the funds and vehicles for which fact sheets were prepared. In constructing this sample, the study team aimed to identify funds with substantial assets under management and a demonstrable track record in mobilising and deploying private capital, and that have been either led by donor agencies or development finance institutions or in which these public-sector actors have played key roles as co-investors or grant-makers. Furthermore, the team sought to identify a range of funds that have engaged a variety of private investors (i.e. foundations, pension funds, high net worth individuals, venture capitalists), have used a range of investment instruments (including both debt and equity), have offered their investors different arrangements in terms of risk, return and exit, and have targeted a mix of different themes and sectors (e.g. renewable energy, sustainable agriculture, health care, small and medium enterprise). To gain further insight, interviews were arranged with representatives of donor agencies, DFIs, and private investors that have played key roles in multiple funds in this sample and that are visible leaders in work at the nexus of blended finance and impact investing. To this end, the team focused, in particular, on the DFIs of Germany, The Netherlands, Denmark, the United Kingdom and the United States, and private investors such as the Rockefeller Foundation and the Omidyar Network.

Table 1: Funds and vehicles for which fact sheets were prepared

Aavishkaar	Essential Capital Consortium Fund
African Agricultural Capital Fund	Global Climate Partnership Fund
Africa Health Fund	Global Health Investment Fund
African Guarantee Fund	Global Innovation Fund
African Local Currency Bond Fund	Grassroots Business Fund
AgDevCo	Green for Growth Fund
Althelia Climate Fund	LeapFrog Investments
Danish Climate Investment Fund	Private Infrastructure Development Group
DFID Impact Fund	Regmifa
Dutch Good Growth Fund	SANAD Fund for MSME
EIF Social Impact Accelerator	Voxtra East Africa Agribusiness Fund
European Fund for Southeast Europe	

Source: The Authors.

The bibliography highlights the main documents drawn upon for this study. Annex B lists the persons interviewed. Annex C provides a more detailed description of the methodology used to identify and examine the funds and vehicles, and the key questions that guided the interviews. Annex D presents the fact sheets for the 23 funds and vehicles.

There are three main limitations to the present study. First, the funds selected for review here are not presented as a representative sample of the global landscape of impact investing and innovative finance. Instead, they constitute an illustrative sample of the diversity and innovation in this space. Second, while field work was not part of the design of the present study, verifying the on-the-ground results being achieved by these funds would have augmented the findings of this research. Such field work would be useful in future studies. Finally, a number of funds and vehicles discussed in the report operate in middle-income regions (notably India, Mexico and Eastern Europe) whose local economies differ considerably from those of many Sub-Saharan African countries. The study team used its broad knowledge and networks in impact investing and innovative finance to mitigate the effects of these and other limitations.

Notwithstanding these limitations, the study team is confident that the findings, lessons and options for engagement presented here are valid, relevant and actionable.

1.3 Report structure

The report is structured as follows:

- Chapter 2 sets the stage for the study by introducing key concepts and definitions.
- Chapter 3 looks at critical issues relating to impact from different perspectives, and reviews evidence on financial sustainability.
- Chapter 4 focuses on critical issues in relation to fund design and institutional dimensions.
- Chapter 5 concludes and presents options for future engagement.

Annexes provide more detailed information on the background of the issues examined here as well as new material prepared during the course of the study. The annexes include the study's terms of reference, a list of persons interviewed, the methodology employed, the 23 fact sheets of funds and vehicles, an overview of the impact investing market, further background on additionality, investor profiles and a typology of funds, the private sector investment programmes of multilateral banks and international financial institutions, a scan of trends in impact assessment, and profiles of field-building needs in Ghana and South Africa.

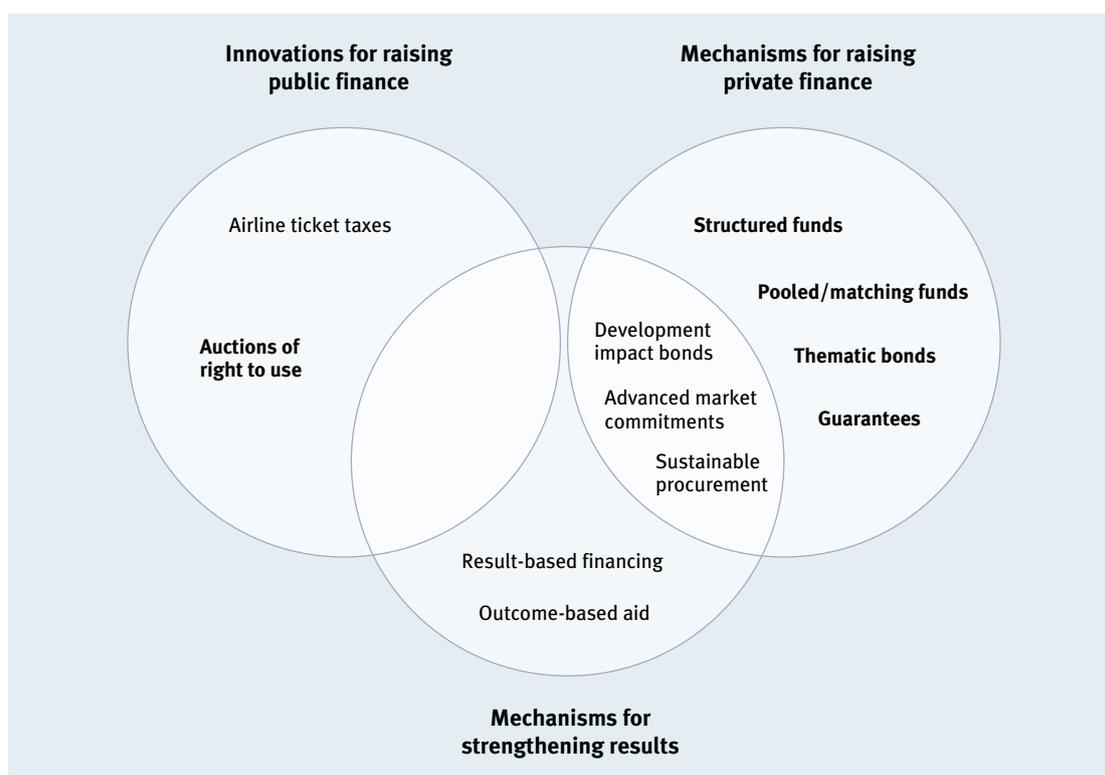
2 Key Concepts

2.1 Definitions

Innovative finance and impact investing

While the term *innovative finance* was initially associated with the means of attracting any kind of additional funds to ODA for development, the term has been broadened to capture ways of enhancing the efficiency and result-orientation of public and private financial flows.³ More specifically, the ‘innovation’ dimension includes the introduction of new products, the extension of existing products to new markets, and the presence of new types of investors.⁴ Innovative finance encompasses both new and more efficient ways of *sourcing* funds and new ways of *deploying* them. Broadly speaking, there are three types of innovative finance mechanisms: mechanisms for raising additional public finance; mechanisms for raising additional private finance; and mechanisms for achieving better results.

Figure 2: Classification of innovative finance mechanisms



Source: A. Koenig, based on KfW, 2012.

³ Definitions used by the World Bank (2009, 2013), UN (2011) and OECD (2010).

⁴ Dalberg, *Innovative Financing for Development: Scalable Business Models that Produce Economic, Social, and Environmental Outcomes*, Innovative Financing Initiative. An initiative of the Global Development Incubator, 2014.

In contrast to innovative finance, the focus in the international debate on *impact investing* has been largely on the way capital is *deployed* rather than the way capital is raised. Impact investments are defined by the Global Impact Investing Network (GIIN) as ‘investments made into companies, organisations and funds with the intention to generate social and environmental impact alongside a financial return.’⁵ The International Development Working Group of the G8 Social Impact Investment Task Force expanded on this by defining impact investment as ‘investments that are made with the intent to generate and measure both a social and a financial return. In the case of international development, these investments are targeted at enterprises that benefit poor people as consumers, producers, suppliers or employees.’⁶ The OECD added three more ‘eligibility criteria’: the intentionality of the investee; the target area or sector; and the beneficiary context.⁷ Returns in impact investments may range from below market rates to market rate returns, and investments are made in both emerging and developed markets.

The boundaries demarcating what constitutes, and what does not constitute, impact investing still remain fluid. Multilateral development banks and development financing institutions have adjusted the concept to make a clear distinction between private sector development finance and impact investing activities. For example, OPIC, America’s Development Finance Institution, has begun to segment its portfolio, differentiating the agency’s general development finance activities from its investments in high-impact areas that face challenges in attracting capital – notably agriculture, education, access to finance, housing for the poor, SME finance, healthcare, renewable energy, water and sanitation – sectors in which investors clearly seek to achieve impact. Even more targeted are OPIC’s impact investments per se, which are defined as those that have an explicit and inherent intent to achieve impact together with an investee business model expressly designed to achieve both social or environmental impact and financial returns.

Green investments – such as reducing greenhouse gas emissions, increasing resilience, securing food systems, water, forest, transport and water management – are sometimes included in the definition of impact investment. However, the focus of the international debate on impact investing, as led by the Social Impact Investment Task Force or OECD, has largely been on *social* impact.

Consequently, impact investing and green investing have, so far at least, been promoted in two parallel spaces. Furthermore, impact strategies applied by impact investors that would define themselves as such range from focusing on general economic growth or employment, to tax generation and targeting the poorest of the poor. These different priorities are, in turn, reflected in how individual investors identify and assess investment opportunities, evaluate and report on performance, and mobilise additional funds.

5 Open Capital Advisors and the Global Impact Investing Network, *The Landscape for Impact Investing in East Africa*. OCA, GIIN and UKaid: New York and Nairobi, 2015.

6 Department for International Development (UK) (DFID). *What is impact investment?* The Impact Programme: London, 2014.

7 OECD. *Social Impact Investment: Building the Evidence Base*. Technical Report, Paris, 2015, p. 48-58.

Figure 3: Impact strategies of impact investors



Source: Based on DFID, 2015.

The debates around definitions reflect the fine balance between two sometimes competing objectives pursued by practitioners. On the one hand, practitioners aim to protect the integrity of the market and prevent ‘green washing.’ On the other hand, they seek to facilitate greater integration of impact investing into traditional capital markets and to make the field appealing to large scale institutional investors.

Development finance institutions, for their part, play a crucial role in the international impact investment eco-system. In fact, in many developing countries, DFIs have been the most important (and sometimes only) provider of development oriented, private sector capital. Yet a recent study on the role of DFIs in impact investing found that: ‘DFIs themselves have sometimes conflicting views about whether their activities are best understood as impact investment, mainstream investment, both impact and mainstream investment, or something in between.’⁸

The present study has taken a pragmatic approach in delineating the scope of innovative finance and impact investing. The primary interest of this study has been to examine the experience with funds and vehicles which work at the intersection of impact investing and blended finance. At the same time, the study reviewed funds and vehicles that engage in more traditional types of investments in SMEs and in renewable energy and energy efficiency.

Concessional finance and blended finance

According to the European Bank for Reconstruction and Development (EBRD), *concessional finance* comprises ‘financial products [...] that are provided on terms that are more favourable than those available from the market.’⁹ Concessional finance can take different forms, such as grants, debt, equity or guarantees and other risk-mitigation measures, and each form can be deployed through specific financial instruments. Grants, for example, can be disbursed as capital expenditures or operational subsidies, as interest rate subsidies, or as periodical payments for achieved and verified results (i.e. results-based payments or performance-based financing products). Debt instruments can be concessional, based on price (including interest rates and/or fees), tenure, subordination, repayment profile, and/or security. By its very nature, as a lower ranking instrument, equity can leverage debt finance, but it is only considered concessional if the provider of the concessional

8 Garmendia, C. and A. Olszewski. *Impact investing in development finance*, Report, Initiative for Responsible Investment and Impact Investing Policy Collaborative, September 2014. <http://apsocialfinance.com/wp-content/uploads/2014/11/Final-DFI-Self-Reporting-Paper.pdf>

9 European Bank for Reconstruction and Development (EBRD). *DFI Guidance for Using Investment Concessional Finance in Private Sector Operations*. London, UK, 2013. <http://www.ebrd.com/downloads/news/roundtable.pdf>

equity agrees to accept a lower return for the risk undertaken, or buys the equity at a less favourable price than commercial investors.¹⁰

Blending is one way of delivering concessional finance. Each instrument of concessional finance can be blended. That is, when non-concessional resources are mixed with concessional funding provided by public agencies to mobilise additional funding. In the past, blending used by public grant makers, such as the European Union, has mostly resulted in mobilising additional funding from DFIs rather than from the private sector. However, the OECD/WEF Redesigning Finance for Development Initiative defines blending as an approach to development finance that employs ‘the strategic use of development finance and philanthropic funds to mobilise *private capital flows* to emerging and frontier markets.’¹¹

2.2 Public support for private investment

Public sector rationale

The current interest by donors in leveraging private capital for sustainable development, and support for blended finance models, can be seen in light of a number of contextual factors:

- the active promotion of the private sector as a key driver of growth and development for two decades;
- increased recognition that private capital and functioning financial markets are pre-conditions for wider private sector activity in developing countries;
- budget cuts to ODA, encouraging some donors to look for new sources of capital;
- increased calls for pooled financing instruments; and
- looking ahead, there is growing recognition of the financing gap for the SDGs, estimated to be as much as USD 2.5 trillion a year, that cannot be met by public resources alone.

The main economic rationale that has been used to justify directing concessional public resources to the private sector for development relates to market inefficiencies and/or institutional failures. Public sector development agencies intervene where there is a gap between private and social returns, normally resulting from positive (or negative) externalities. Relevant externalities in the context of the present study are, typically, public goods, such as emission reductions, reduced inequality, diversity, research and innovation, or physical and market infrastructure.

10 EBRD 2013.

11 OECD and World Economic Forum. *Blended Finance Vol. 1: A Primer for Development Finance and Philanthropic Funders*. A Report. OECD and World Economic Forum, 2015a, p. 8.

In practice, donors find engagement with private investors attractive because of a number of factors:

- First, and most importantly, such engagement is expected to increase the pool of resources available for development, thus enabling entrepreneurs to access funds that would not be available under ‘normal’ market conditions.
- Second, it also encourages the private sector to start investing in projects with significant social and environmental benefit that the private sector would otherwise not undertake.
- Third, compared with traditional grant funding, the involvement of private sector capital has a positive effect on financial discipline and enables donors – at least, in some cases – to recycle repayment and financial returns for other development purposes.

According to a recent survey on blended finance by WEF/OECD, more than one third of development finance institutions and development funders report that their key motivation for investing in blended finance structures is ‘to demonstrate viability and potential for sustainable capital flows in unpenetrated sectors and markets’ in addition to ‘increase capital for development.’¹²

Private sector barriers

Financing impact projects and companies in developing countries involves a range of barriers and risks for investors. For the reasons noted above, public sector agencies have an interest in removing these barriers. As returns are generally seen as too low for the level of real or perceived risk, the investor will only invest if risk is reduced or the expected reward (i.e. financial return or impact) is increased.¹³ In addition, there are also certain private sector constraints that are unrelated to risk/return characteristics, such as investors’ individual asset allocation strategies or minimum investment sizes.

Barriers in impact investing in developing countries are related to the inherent nature of potential investment opportunities, to the local context, as well as to the generally limited track record and maturity of the impact investing field. Some key barriers in impact investing include: regulatory and policy barriers; limited opportunities through government procurement; lack of market infrastructure; small and segmented investment opportunities; lack of awareness, information and capability; lack of consistent terminology, impact measurement and evidence; and, in the case of institutional investors, the typically small percentage of private equity investments in their portfolios.

Risks and barriers depend on the individual profile of each investor. More detail on investor profiles is provided in Section 2.4 below.

12 OECD and WEF. *Landscape Survey of Blended Finance Investment Vehicles*. July 2015 by Monitor Deloitte, unpublished draft, October 2015c, p. 13.

13 Risk is defined as the probability that the performance of an investment will be different than expected. <http://www.investopedia.com/terms/r/risk.asp>

Additionality

Donor agencies and development finance institutions using public funds to mobilise private capital need to clearly demonstrate additionality. Additionality in the context of private capital mobilisation is seen as the unique inputs and services that public sector organisations (and indeed any other impact oriented organisations such as impact investors, philanthropic organisations and support organisations) can provide in addition to those available in the market. A donor intervention is additional in this context if: the interventions are necessary to make the project happen, i.e. the private investor would not have engaged without public sector involvement (this is financial additionality); or the interventions increase the development impact and sustainability of a project with positive implications for growth and poverty reduction (this is development additionality).¹⁴

Development finance institutions achieve high additionality in complex, high risk and high impact projects, especially in fragile, low-income countries and regions.¹⁵ Using both financial and non-financial instruments, donors can achieve additionality, depending on the unique strength and instruments of a specific donor, the context and the particular project.

Table 2: Types of donor additionality

Types of additionality	Examples
Financial	Offering better terms, longer maturities, countercyclical finance, lower price, subordination, holding riskier portfolios, providing smart subsidies, guarantees and other to enhance returns and reduce risks.
Aggregation	Supporting projects at regional or global level for aggregation of opportunities, diversification of risk and cross boundary sharing of experience.
Signalling	Providing a stamp of approval, providing credibility, attracting other investors, acting as honest broker.
Knowledge	Strengthening the quality of the investment model and technology; sharing knowledge building the capacity of local partners, facilitate technology transfer, publicly share experiences and learning (beyond project boundaries).
Demonstration	Support innovative pacesetter to de-risk new business models; attracting capital in lower income, fragile countries and frontier markets that are not (yet) able to attract significant level of commercial capital.
Poverty	Influencing design to reach lower income market segments; reduce inequalities, improve local participation, generate employment of the Base of the Pyramid (BoP).
Standards	Promoting high environmental, social and governance standards in investee companies, financial institutions, funds and at industry level.
Market building	Strengthening policy environment, build eco-systems and support market infrastructure, generate market data and support industry research.

Source: Based on S. Mustapha et al, 2014.

14 UK Aid Network (UKAN). *Leveraging Aid: A literature review on the additionality of using ODA to leverage private investments*. UK Aid Network: UK, 2015.

15 International Finance Cooperation. *International Finance Institutions and Development Through the Private Sector*. A joint report of 31 multilateral and bilateral development finance institutions. International Finance Corporation: Washington, DC, 2011, p. 28.

Engagement by public sector officials, however, can also result in market distortions and other unintended consequences. The challenge is to understand intentions and incentives between opportunities suitable to achieve high additionality and areas that are not viable – and are unlikely to become so in the medium to long term. Furthermore, if poorly designed and implemented, donor engagement with the private sector may result in:

- crowding out market players that could provide needed finance at market rates;
- subsidising selected investors or companies resulting in a competitive advantage vis-à-vis other investors or companies; or
- wasting public resources by supporting an activity that would have happened anyway or by supporting much more than would have been required to mobilise the private sector.

Some donors have explicitly defined their approach to achieving additionality in leveraging private capital for development. For example, Norfund states: ‘Norfund strives to be additional quantitatively by accepting higher risks and lower income than private investors would, and qualitatively by contributing to better investments through high requirements for environmental, social, and governance (ESG), active ownership and effective support for business development. Moreover, Norfund has made a strategic decision to focus on specific sectors and regions and it also prefers to invest in SME companies, greenfield businesses and equity instruments which, as such, guide investment towards projects which are assumed to be more additional.’¹⁶ Annex F provides further perspectives on the concept of additionality.

Financial and non-financial instruments

Financial instruments that the public sector commonly uses to mobilise private investment fall within three categories:

- *concessional finance*, which includes a subsidy element either in lending or subordination in investing that raise the investors expected risk adjusted returns, lower project costs and/or enhance potential returns;
- *paying for results* using contracts, such as advanced market commitments, development impact bonds, vouchers, or public-private partnership contracts; and
- *guarantees* that reduce risk by promising to repay all or some of the project’s value is to the lender or investor in the case of default.

It is important to note that public sector agencies can also use a number of non-financial instruments strategically to attract private investment and to develop private sector activity and entrepreneurship. Such non-financial instruments include access to information and research, technical assistance, networking and policy dialogue. For example, some donors make their specific technical and market knowledge available; this is especially useful in frontier markets that are considered too risky by traditional investors. Donors also initiate investment vehicles and therefore helping with the aggregation of investment

16 Norad. *Evaluation of the Norwegian Investment Fund for Developing Countries, Norfund*. Norad Evaluation Department: Oslo, Norway. Report 1/2015, p. 42.

opportunities and using their networks to mobilise additional investors, partners and service providers. In doing so, donor agencies and DFIs leverage their roles as trusted public entities and neutral brokers together with their ease of access to host-government officials. Donors have supported the establishment of market infrastructure (e.g. the Financial Services Development Trust in various African countries) and have supported local product development (e.g. long-term lending or green-energy efficiency products with commercial banks), have helped introduce green and social criteria into government procurement processes, and have enabled the establishment of a sound policy and regulatory framework (e.g. microfinance legislation or regulatory frameworks for mobile banking).

Table 3 presents an overview of the potential roles that public sector players, both development partners and governments, can play in partner countries, and the financial and non-financial instruments they use.

Table 3: Potential roles of the public sector

	Investor	Promotion of market infrastructure	Policy and law maker	Commissioner of public services	Quality assurance
Objective	Mobilise private funding, capitalise nascent (impact) investment market	Build strong market infrastructure to match supply and demand	Remove legal barriers and provide enabling policy framework	Increased demand for impact oriented entrepreneurs and projects	Achieve assurance, standardisation of impact to reduce risk and increase transparency
Instruments	Concessional finance, guarantees, RBF, grants	Capacity building and project development Research and open data Support joint platforms Convening	Policy dialogue Legal and regulatory changes Sector reforms	Support sustainable procurement systems and outcome based commissions	Endorse and promoting, accreditation, measurement systems

Source: The Authors.

2.3 Theory of change

A theory of change is a comprehensive depiction of how and why a desired change is expected to happen in a particular context. It maps out between what a programme or change initiative does (its activities or interventions) and how these are expected to lead to desired goals.

In the development finance field, theory of change has been used since the 1990s. In the impact investing industry, theory of change has become an important tool not only for monitoring and evaluation, but also for strategy development and management. For example, theory of change was a key tool used in the evaluation of the Rockefeller Foundation's influential Impact Investing Initiative. Theory of change has also been employed in combination with other development evaluation strategies such as utilisation-focused, developmental or participatory evaluation to carry out more systematic

evaluation and monitoring of impact investing funds and investments and investee enterprises and projects.¹⁷ A more recent conceptualisation of theory of change in the evaluation of impact investing attempts to clarify the sequence of relationships among the various stakeholders involved, and to especially give prominence to the actors at the far end of the chain – the beneficiaries of the capital. These are, in particular, owners, employees, customers, community residents, and their households. This model is particularly concerned with examining the extent to which households convert (or fail to convert) additional income or savings from investee businesses into real gains for household members in, for example, access to health and education, nutrition, real assets, diversified business revenue, and more.¹⁸ Developing credible counterfactuals, through experimental or natural-experiment designs or theory-based contribution analysis with stakeholders, are important ways of interrogating and strengthening theories of change.

2.4 Investor profiles

The term ‘private investors’ is better understood as an umbrella concept for a range of different entities with varying motivations as well as impact-risk-return expectations. This includes impact investment funds often set up by high net-worth individuals, foundations of financial institutions. Other investors attracted to the field of impact investing in emerging countries include institutional investors such as pension funds and insurance companies, banks, corporations, high net-worth individuals (HNWIs) and family offices as well as foundations. While not privately owned, per se, non-governmental organisations that set up investment funds using private sector instruments have been added here to the list of potential impact investors. Combining a public sector mandate and private sector investment logic, development finance institutions are an important link between the private and public sector worlds.

Detailed research on investor profiling remains limited. The present study provides a broad and tentative overview of tendencies in relation to typical investors’ motivations, impact strategies, risk and return expectation. Annex G provides a more detailed description of key investors and their propensity to engage in impact investing and in emerging markets, as well as an overview of the motivations, impact, and risk return profiles for selected investor categories.

Motivation: Engagement in impact investing in developing and emerging countries supported by development agencies can be attractive for a variety of reasons. Some investors are interested in exploring opportunities in new geographical markets characterised by significantly higher growth rates than in home countries. Corporations are often driven by concerns around limiting reputational risks and engage in corporate impact venturing in order to bring in innovation and reach new market segments. Others, such as wealth managers or banks, respond to client demand for a wider choice of responsible or even impact-driven investment products. In fact, a survey by OECD/WEF research suggests that nearly one third of private investors see blended finance as a way of helping private

17 For a broad discussion of applying theory of change to impact investing at all levels, see E.T. Jackson, ‘Interrogating the Theory of Change: Evaluating Impact Investing Where It Matters Most,’ *Journal of Sustainable Finance and Investment*, 3(2), 2013, pp. 95-110.

18 E. Jackson. *Evaluating Market-Oriented Approaches in International Development: The Evaluation of the Global Impact Investing Initiative*. Presented to the Annual Conference of the American Evaluation Association, Chicago, 2015, p. 10.

investors ‘to respond to client demand for responsible investment.’¹⁹ Just under a quarter views blended finance as constituting ‘financially attractive investment opportunities’ and one-fifth as a way to ‘access high growth markets.’²⁰ The most recent JP Morgan survey found that impact investors engage in impact investing mainly because, they report, it is ‘part of our commitment as a responsible investor’ (80%) and as ‘an efficient way to meet our impact goals,’ (69%), as well as ‘responding to client demand’ (54%).²¹

Impact: Impact strategies mostly fall within one of three categories: investors may wish to limit risks in relation to environmental, social or governance issues and ensure compliance with international standards (e.g. institutional investors, banks or corporations); they may actively promote and support investees through establishing best practice standards (e.g. impact investment funds and DFIs); or they actively engage in opportunities that define impact at the core of the investment or business model (e.g. impact investment funds, foundations). The International Finance Corporation (IFC) found that its private sector investees, in comparing the IFC to a commercial bank, accorded the highest value to the IFC’s input on environmental and social issues.²²

Risk: In an investment context, risk is the probability that the performance of an investment – both in relation to financial returns and impact – will be different than expected. Risk is subjective, as it depends on the perception of the investors. Furthermore, risk has not one but many angles that play out differently for different types of investors. Risk often refers to an asset owner losing any amount of the original investment, in either real or nominal terms. Lower risk asset owners, such as banks, are often more concerned about loss of principal (downside risk) than about the extent to which the value investment may increase beyond forecast levels (upside risk) in considering impact investments. The ability to sell or transfer the assets is another important risk (exit or liquidity risk). While illiquid products or ‘patient capital’ are critical for many deals in the impact investing field, institutional investors or wealth advisors in particular may have a fiduciary duty to ensure liquidity of products invested for, or offered to their clients. Angel investors are much more flexible, but even they may worry about their ability to turn their investments into cash in times of need. Different investors have different knowledge and skills about a specific investment opportunity and/or business model (unquantifiable risk). Transaction costs, the time and money spent on due diligence, deal structuring and monitoring may also result in costs being out of proportion with potential returns, in particular if transaction sizes are small (transaction risk).²³

19 OECD and World Economic Forum. *A How-To Guide for Blended Finance: A practical guide for Development Finance and Philanthropic Funders to integrate Blended Finance best practices into their organizations*. A Report. OECD and World Economic Forum, 2015b, p. 15.

20 OECD and WEF 2015.

21 Saltuk, Y., A.E. Idrissi, A. Bouri, A. Mudaliar and A., *Eyes on the Horizon: The Impact Investor Survey*. JP Morgan and GIIN, 2015.

22 International Finance Corporation. *International Finance Institutions and Development Through the Private Sector. A joint report of 31 multilateral and bilateral development finance institutions*. International Finance Corporation, Washington, DC, 2011, p. 29.

23 Bridges Ventures and Bank of America Merrill Lynch. *Shifting the Lens. A De-Risking Toolkit for Impact Investment*, Report, Bridges Ventures and Bank of America Merrill Lynch, January 2014, p. 7.

Return: In impact investing, risk adjusted financial returns may range from return of principal to average or above average market rate returns. Some investors are prepared to forego short-term financial returns for higher impact. Some, like corporations or inclusive businesses, may seek strategic returns, such as entry into a new market segment. The most recent JP Morgan impact investing survey found that impact investors tend to target competitive, or close to market, returns but return strategies vary greatly and some impact investors are indeed satisfied with capital preservation. Capital preservation is also a priority for some foundations investing their endowment, as they seek to recycle their capital for developmental activities.

An interview with an institutional investor in one of the funds reviewed here illustrates some of the foregoing considerations:

‘We trust the experience of [the DFI] in these markets where we have limited experience. For us, it is a great opportunity to explore new markets. By law we are requested to maximise returns and protect our investments against risks. Sustainability standards are mostly a protection against reputational risks, not an end in itself. The involvement of... government also provides great comfort to us: we like to hide behind the crown.’²⁴

Risk mitigation strategies are only effective if they define suitable target investors for a specific investment opportunity and define risk mitigation (and impact investment) strategies that match the specific profiles of these investors.

Table 1 of Annex G presents a basic overview of the various profiles of motivation, risk, return and impact, by type of investor.

2.5 Typology of funds

The term ‘fund’ is frequently used in a very broad sense, to include a variety of pooled funding and investment vehicles, as well as donor programmes that are set up to delegate the authority for the deployment of capital to an external party. It is possible to distinguish between commercial funds, which seek to maximise financial objectives, and developmental funds, where the objective of generating financial return is either replaced or complemented by developmental return objectives. And it is useful to further distinguish between: investment funds, where investors appoint a fund manager to assume fiduciary responsibility for managing third party money; and donor programmes or budgets that are spent on a defined activity for which donors often contract a programme manager to carry out a set of tasks on behalf of their client (e.g. challenge funds or grant programmes for catalytic purposes that are managed by professional service firms).²⁵

24 Interview.

25 Lion’s Head Global Partners. *Low Carbon Study Fund 203134-101. Fund Management/Administrator Impacts on Investment and Challenge Funds’ Value for Money, Efficiency and Results*. Report, DfID, Research for Development, LHGP: London, 2015, p. 19.

Investment vehicles used for mobilising private capital for impact investment in developing countries differ depending on their funders objective, their risk-return-impact strategy, the capital structure and compensation structure (e.g. ‘waterfall’ structure or pooled investments), the financial instrument used to invest capital (venture equity, growth equity, debt, mezzanine, guarantees) as well as the investment strategy and target sector (infrastructure, SME, conservation finance).

In fact, the past five years have seen the creation of a diverse group of financing vehicles that involve a significant role for donors in leveraging private capital. The features of the 23 funds and vehicles examined for the present study illustrate this increasing range of choice: Eleven are domiciled in Europe (including six in Luxembourg), five in the UK, two in the US, as well as four in Africa and one in India. Only two of the funds focus on early-stage businesses; in contrast, more than 60% of impact investing assets are deployed in growth-stage SMEs. Three funds make investments of less than USD 1 million, 12 make investments of over USD 1 million but under USD 10 million, while just over one third make investments of more than USD 10 million. In terms of impact objectives, 12 of the funds invest in multiple sectors (including health, education, water and sanitation), four in climate change, and three in agriculture, among other sectors. More than 80% receive investment from publicly funded international development agencies, 70% benefit from investments by development finance institutions, 60% have attracted private sector capital from a diverse set of actors (including corporations, banks, insurance companies, high net-worth individuals and family offices), nine funds receive foundation financing, and four funds have mobilised pension-fund investments.

The following broad types of funds and vehicles were identified for the purposes of this study:²⁶

- *Pooled funds*: Pooled funds are those that pool together the capital of many investors and authorise a professional fund manager to invest the funds according to an agreed upon strategy and criteria. Pooled funds enable investors to share the risk, reduce transaction costs for themselves and benefit from the professional expertise of the fund manager (e.g. Voxtra Fund).
- *Structured funds*: Structured funds with a ‘waterfall’ structure offer opportunities for investors with different risk/return profiles. The overall risk is divided into tranches, each with different degrees of ‘seniority’ (e.g. order of repayment or return allocation in the event of losses, bankruptcy or sale). Examples include several structured funds by KfW e.g. the Green for Growth Fund or Sanad Fund.
- *Donor development funds*: Donor development funds adopt commercial fund approaches to channel concessional capital into investment opportunities with high developmental impact but also higher level of risks and potentially lower returns (e.g. DFID Impact Fund, African Enterprise Challenge Fund).

²⁶ While some of these funds are not impact investing funds in the narrow sense, as they do not make financial return or they are grant funded (e.g. in the case of challenge funds, or innovation funds), they are nonetheless included here in order to illustrate the wide spectrum of structures.

- *Result-based financing:* Result-based financing is used by developing country governments (national or local), state agencies, or donor agencies, in cooperation with the private sector, to incentivise the provision of goods or services, to create or expand markets, or to stimulate innovation (output-based aid, Advance Market Commitments, development impact bonds, Social Impact Incentives SIINC).
- *Guarantee funds:* A guarantee is a commitment that, if a negative event occurs, the guarantor will take action if the guaranteed party is unable or unwilling to do so. In impact investing and innovative finance, guarantees have been used in many ways. The establishment of guarantee funds (as opposed to guarantee programmes) allows donors to disburse DAC-recognised ODA funding and coordinate with other donors (African Guarantee Fund).
- *Sovereign thematic bonds:* Sovereign thematic bonds are fixed-income, liquid financial instruments issued by a national government or development organisations usually denominated in a foreign, stable currency such as US dollars.²⁷ They are used to raise funds dedicated to specific purposes, such as climate-mitigation, adaptation, and other environment-friendly projects, inclusive business, or infrastructure (e.g. Kenya infrastructure bond, World Bank green bonds, IFC inclusive business bond).
- *Project preparation facilities.* A variety of initiatives created to respond to challenges linked to the lack of market based finance to early stage projects, innovation and market infrastructure supporting project development and capacity building on the demand side, or providing patient, higher risk capital, or both (e.g. Global Innovation Fund).

Annex H provides a more detailed description and examples for each of these types of funds. (Annex D presents fact sheets for the 23 funds and vehicles reviewed for the present study, setting out the capital structures, risk mitigation measures and impact objectives for each.)

2.6 Impact investing and development goals

On the face of it, it appears that there are several ways in which impact investing and innovative finance can generate results that contribute to development as defined in the Sustainable Development Goals. At the level of sectors, the decision to mobilise and deploy capital in what some refer to as high-impact sectors (e.g. renewable energy, agriculture, etc.) offers the possibility of making a real difference on the ground. Impact studies often document general effects in regional economies. However, how such investments actually make an impact on the livelihoods and well-being of the ultra-poor, or even the Base of the Pyramid (BoP), is an empirical matter – and one that to date has not been well-researched.

27 Pareto, C. *Protect Your Foreign Investments From Currency Risk*. Investopedia, 02 January 2008.

In impact investing, results-vectors emanate from investee companies that have ‘baked in’ or embedded the intent and structures for social or environmental impact into their business models. Organic agricultural companies that buy products like shea butter at good prices from poor women small holders in Africa execute such business models, for example. Moreover, such social-mission businesses can also be scalable and thus multiply their benefits; notable cases here are Micel in Mexico (post-paid mobile services for the BoP), Jain Irrigation Systems (drip technology for irrigation) in India or D.Light (affordable solar lights). And yet rigorous studies, qualitative or quantitative, of the downstream impacts of these businesses and many others have not been carried out. Thus, systematic evidence beyond individual success stories remains outstanding. In one effort to address this gap, the OECD has taken the lead on an important project entitled ‘Building the Evidence Base’ for impact investing.²⁸

28 Wilson, K. *Social Impact Investment: Building the Evidence Base*. Technical Report. Organisation for Economic Cooperation and Development: Paris, 2015. <http://www.oecd.org/sti/ind/social-impact-investment.pdf>

3 Critical Issues: Impact and Financial Performance

3.1 Applying the theory of change

The use of logic models and theories of change is prevalent in the sampled funds. This can be explained by the fact that donor agencies and/or DFIs play key roles in these funds and they themselves are usually obliged by their own funders to use such tools. In terms of notable examples, the Private Infrastructure Investment Group uses a multi-level causality framework for its monitoring work, supported by a detailed handbook. AgDevCo also provides an explicit and detailed theory of change for its investment strategy, which moves from the identification of an investee farm and provision of business services, to stronger governance and contacts for the business and increased access to inputs and markets for smallholders, to the leveraging of additional investment and increasing of household incomes, to, ultimately, a reduction in the number of poor individuals and families.²⁹

Another elaborated theory of change is that developed by the DFID Impact Programme. This model begins with broader market-building efforts and the alleviation of certain market constraints. Within this context, then, impact investment is catalysed by the programme. In turn, such investments are expected to generate benefits to the livelihoods of poor and low income people in Sub-Saharan Africa and South Asia. This theory of change also sets out external factors and assumptions that influence or constrain the achievement of expected results, such as local regulatory environments or the programme's own efforts to support capacity building of fund managers and companies.³⁰

While such tools have been in use in the impact investing industry for some time, a closer look indicates that theories of change in that field have often taken a simplified and more rigid form. Such models have proven less capable of answering the 'how' and 'why' questions of a fund's performance rather than 'what' questions. Further, these theories of change have generally focused on investors and investees, downplaying or even ignoring the role of beneficiaries in the model. Leaders in impact investing and innovative finance would benefit from a more thoroughgoing analysis of the performance-assessment tools used in development, philanthropy and evaluation that engage complexity and volatility and also engage and hold all stakeholders to account.

29 AgDevCo Theory of Change, 2016,
Website: <http://www.agdevco.com/our-social-impact/theory-of-change.html>

30 The DFID Impact Programme: Theory of Change, DFID, London, 2015:
<https://prezi.com/xeyg0u7hbcf4/the-dfid-impact-programme-theory-of-change/>

3.2 Demonstrating additionality

Evidence of additionality

In constructing the study's sample, the study team intentionally sought to identify funds and vehicles in which development partners mobilise private sector investment to achieve social or development impact. Not surprisingly, then, a number of funds and their supporting development agencies and DFIs in the sample aim to focus their interventions where they are expected to be most additional, such as engagement in low income countries or support to business models that target the Base of the Pyramid. Some donors even embed support through a fund with a wider programme of market infrastructure-building (e.g. DFID Impact Fund).

Document review and interviews show, however, that there is little explicit evidence of such additionality. This is despite the fact that demonstrating additionality is – or at least should be – a fundamental requirement for any donor intervention in private sector development, in order to prevent market distortions and to ensure value for money. The lack of specific data on additionality is consistent with the findings of other reviews of publicly-supported private flows and public-private partnerships.³¹ The literature points to several potential explanations for this deficiency:

- First, systematic ex-ante additionality assessments are not necessary conditions for a project to go ahead, and ex-post evaluations of additionality have yet to become a common practice. For some funds it is simply too early for a comprehensive evaluation.
- Second, more detailed evaluations are not often released to the public, with DFIs arguing for confidentiality; this includes a 'publication bias' to report predominantly on successful figures.³²
- Third, the methodology applied to assess additionality is not sufficiently robust and 'is often based on qualitative descriptions, often lacking objective supportive evidence.'
- Finally, there is little practicable guidance available for staff of funding agencies to assess and evaluate additionality in planning or evaluating projects with private investors.^{33,34}

31 UKAN 2015, p. 18.

32 Campos, F. et al. *Learning from the experiments that never happened: Lessons from trying to conduct randomized evaluations of matching grant programs in Africa*, World Bank, 2012.

33 The DCED guide *Demonstrating Additionality in private Sector Development Initiatives*, published in 2014 (Heinrich, 2014), provides useful considerations and concepts; it focuses on support to private companies rather than the mobilization of private investors. The EBRD's DFI Guidance for Using Investment Concessional Finance in Private Sector Operations, developed in 2013, is intended as a framework for developing detailed internal guidance and regulations. Norfund is reported to be working with other EDFI members on developing a toolkit for DFIs on private investment (Norad 2015, p. 43).

34 UKAN 2015, p. 18. This included contributions to the design of projects but also policy dialogue, the effectiveness of demonstration effects, as well as whether donors really engaged in high impact, high risk areas or countries in order to pave the way for private investors.

Some reviews of DFI activities, though not specifically focusing on impact investing, are even more critical. An EU review on blended finance facilities found that ‘existing facilities tend to follow the market’ by focusing on areas that are already popular for investment by public and private entities.³⁵ It has also been argued that, in general, much of private sector investment by DFIs is allocated to infrastructure, extractive industries or financial services, and that these are sectors in developing countries in which investors, particularly foreign investors, are already very active.³⁶ Moreover, DFI private-sector activity has been concentrated in middle income countries and regional hubs such as India and Kenya.³⁷ And, as an IFC assessment concluded: ‘Most IFC investment projects generate satisfactory economic returns but do not provide evidence of identifiable opportunities for the poor.’³⁸

At the same time, though, there is no doubt that DFIs have been the key, and indeed often the only, investors in private sector development in emerging and developing countries for decades, thus contributing to much-needed infrastructure and financial services for SMEs, especially. In addition, they were also the first initiators of many of the funds in the present study’s sample. At the time of their establishment, the funds could have been considered high risk, as they used innovative financing structures or targeted new sectors or investees.

More recently, outside of their core institutional mandate, a number of DFIs have started to manage higher risk, higher impact projects on behalf of their governments. Some governments or DFIs have set ambitious quotas or revised their strategic priorities for their DFIs in order to increase their engagement in higher risk higher impact sectors and/or countries. For example, FMO aims to invest at least 70% in low and lower-middle income countries. The French DFI, Proparco, states in its 2014-2019 strategy that it will focus ‘30% of activity on projects that combat climate change, 25% to frontier markets (least advanced, low income, transition or post-crisis countries, increase the weight of equity and quasi equity and subordinated loans from 14-30%, devote 10% of our equity investment to early stage companies [...]’.³⁹

Measuring financial additionality

Measuring the financial leverage of a fund or vehicle – that is, the extent to which a public financial commitment resulted in mobilising some larger multiple of private capital for investment in a specific project or undertaking – is an important indicator of financial additionality as well as a core strategic metric in its own right.⁴⁰ OECD/WEF research on the financial leverage of blended finance vehicles found that private-to-public capital ratios varied between USD 0.29 and USD 20.40.⁴¹ A Norad evaluation report sought to improve its earlier estimates on Norad’s leverage by making stricter assump-

35 Eurodad, *A dangerous blend? The EU agenda to ‘blend’ public development finance with private finance*. European Network on Debt and Development. Brussels, Belgium, 2013, p. 22.

36 Open Capital Advisors and GIIN, 2015.

37 Open Capital Advisors and GIIN, 2015.

38 IEG, *Assessing IFC’s Poverty Focus and Results*, IEG World Bank, Washington, DC, 2011, p. xi.

39 Proparco, *Partnering with the South*. Profile, 2014.

40 Financial additionality refers to the capacity of a public sector instrument to mobilise additional (private) capital for higher development impact. (See Section 2.2).

41 OECD and WEF 2015b.

tions on its catalytic role and in consequence reduced the agency's leverage ratio from 1:9 to 1:3.⁴²

In general, there is a lack of consensus and clarity on various aspects of measuring financial leverage, including, in particular:

- whether the costs of publicly funded, catalytic pilot projects should be included;
- whether and how to count in public institutions' (most importantly, here, DFIs') money, which is actually redirected capital that would have otherwise been invested in other development projects;
- the specific methodology for measuring the leverage ratio itself; and
- how to identify the direction of the leveraging effect, i.e. was private capital leveraged by the public sector contribution, or, in fact, did the private sector lever the public sector's financing?

Beyond the financial leverage ratio, publicly available assessments of the financial additionality of public investment in the private sector show a mixed picture in terms of the percentage of projects that would not have happened without public sector contributions. Indeed, by one estimate, this percentage ranges from 30% to 63%, with more negative evaluations finding little or no additionality.⁴³ A Norfund study raised the question of to what extent financial incentives are, in fact, needed to effectively mobilise private sector investment. The experience of the Danish Climate Investment Fund suggests that high leverage can be achieved with relatively modest concessional finance by donors if the investment fund has a strong track record and significant investments.⁴⁴

Finally, a high leverage ratio does not automatically mean high donor additionality. In fact, an alternative interpretation could be that the investment did not really need the donor's contribution. A large number of other investors could also reduce the ability of the donor to influence the project design, investment strategy and implementation of the vehicle, all of which would otherwise constitute other forms of additionality.

3.3 Planning for impact

ESG and economic growth as impact strategies

There is now a greater choice of funds, vehicles, mechanisms and platforms whose aims are more explicitly focused on achieving social or environmental impact. For their part, most DFIs associated with the funds in the study's sample emphasise economic growth, private sector development, and job creation and integrate ESG standards as a priority in their strategies. Most have signed on to standards and guidelines used by their peers and international bodies, notably the IFC's Performance Standards on Environmental and Social Sustainability, as well as the Equator Principles, the UN Principles for Responsible Investment, ILO Conventions, OECD guidelines or the guidelines of industry associa-

42 Norad 2015, p. 40.

43 UK Aid Network 2015, p. 13.

44 Commons Consultants. *ODA for blended finance in private sector projects*. Presentation. 2015b, p. 6.

tions. Recent evaluations indicate that – through training, advisory services and regular reviews – DFIs and their funds have integrated such standards quite effectively in their private sector development activities.⁴⁵

In addition to the adoption of these standards, most of the funds in the study's sample (and their DFI investors) report on the number of firms or projects they invest in and the jobs created (directly or indirectly) and tax payments generated by their investments. This is consistent with recent research by OECD/WEF on 24 blended finance vehicles, which reported some 2,400 investee enterprises or projects and more than 440,000 jobs created since their inception.⁴⁶

Poverty orientation

Recent research studies and evaluations have critically noted an insufficient focus on direct poverty reduction in many development finance interventions. Instead, DFIs mostly seek to contribute to general economic development, employment creation or the reduction of GHG emissions. One critique of DFI performance in this area finds that 'impact and development objectives were systematically neglected in the selection of projects, partner institutions and investees or only broadly and vaguely covered.' Another study found that DFIs too rarely 'seek to influence project design in a number of areas that the literature suggests are important in shaping poverty outcomes.'⁴⁷

However, in recent years, this has been changing. Today, most multilateral development banks and development agencies have launched financing mechanisms that explicitly target investments in sustainable, inclusive and innovative businesses, social enterprise, eco-innovation and bio-diversity initiatives. While their strategies and structures differ, these newer mechanisms allow these agencies to target companies, sectors and financial institutions capable of creating greater impact and also engaging higher risk than the traditional core business of DFIs to date. One notable example in this regard among development banks is the Inclusive Business Initiative of the Asian Development Bank, which, along with investment capital, provides TA for project preparation, due diligence and impact assessments, while also promoting inclusive business accreditation and eco-system development. Other examples include a portfolio of 400 inclusive businesses of the International Finance Corporation, the Opportunities for the Majority programme of the Inter-American Development Bank, the ACP-Impact Financing Envelope of the European Investment Bank. Among DFIs, innovative programmes include Proparco's investment support fund for business in Africa⁴⁸ that targets regions that are more unstable or emerging from crisis, and OPIC's impact investment fund of funds, the Portfolio for Impact and its more recent programme window, Align Capital, for early-stage impact investments. (See Annex I for a list of MDB and IFI poverty oriented private sector investment programmes).

In the sample of funds and vehicles reviewed for the present study, 15 funds make specific reference to poverty, poverty reduction, the poor, and/or the BoP in their mission, objectives, policies or impact strategies. An interesting case is that of the DFID

45 Norad, 2015, p. 42; and Spratt, S. and L.R. Collins, *Development Finance Institutions and Infrastructure: A Systematic Review of Evidence for Development Additionality*. Report, IDS and PIDG: UK, 2012.

46 WEF/OECD 2015.

47 Spratt and Collins 2012, p. 44.

48 Proparco 2014.

Impact Fund, which is focused on investments in low-income and lower middle income countries in Sub-Saharan Africa and South Asia. This fund makes investments in funds and other vehicles that have a clear strategy of investing in businesses that achieve positive impact on the BoP population as well as the capacity to mobilise additional private and public capital. The programme also strengthens impact measurement. The size of this fund is GBP 75 million.

Gender

Almost a third of the funds in the sample reviewed here disaggregate impact data by gender, and report on it annually. And at least three of the funds place this issue among their most important metrics. One important example is again that of the DFID Impact Fund, which has established ‘total female beneficiaries’ as a key performance indicator to be tracked for all investments and for the Fund as a whole. Another fund in the sample that does the same is AgDevCo. It is worth noting that DFID, a strong proponent of gender equality, is an investor in that fund, as well. In addition, two environmental funds – the Althelia Climate Fund and the Danish Climate Investment Fund – explicitly aim to promote and report on gender equality within their broader ESG/CSR frameworks. In addition, among the other vehicles examined here, Aavishkaar reports on the number of women on the boards of directors of their investee firms.

A comprehensive approach to gender in the sampled funds is provided by the Private Infrastructure Development Group (PIDG). In 2012, after a decade of operating, and informed by a special study on the impact on women and girls of its projects, the Group and its donor members realised that ‘there is very limited coverage of gender issues across the project portfolio.’ Accordingly, they resolved that, from that point on, ‘every PIDG-supported project will report gender disaggregated results with regard to numbers of people with access to new improved infrastructure’ and ‘direct jobs created’, and that this information would be published on the fund’s website and updated quarterly. Further, for project planning, PIDG has adopted an IFC Excel tool for forecasting the number of women and girls that could benefit from new infrastructure.

In the broader impact investing field, a focus on the gender dimensions of social impact is increasing. Gender lens investing is defined as:⁴⁹

- Investments that increase *access to capital for women* entrepreneurs and businesses that have women in leadership positions.
- Investments that promote *gender equity in the workplace* by investing in private sector companies with leading gender policies that also extend across their supply chains.
- Investments that increase the number of *products and services that benefit women and girls* by directing capital to socially responsible businesses that develop and offer these products and services.

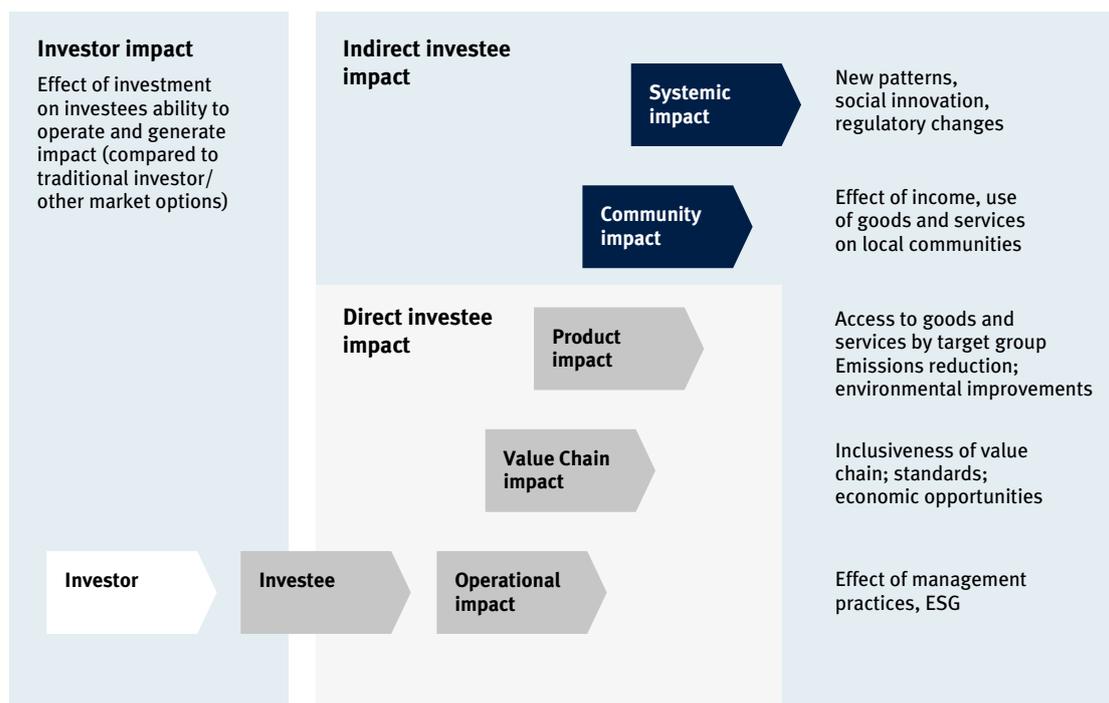
49 From the website of Criterion Institute, one of the leaders in the gender lens investing field, see <http://criterioninstitute.org/revaluegender/gender-lens-investing/>

One notable leader in assessing impacts through a gender lens is Root Capital, the US-based non-profit intermediary that lends to agricultural cooperatives and social enterprises in poor countries. By placing a gender lens over its entire portfolio, this impact investor can now track the number of gender inclusive clients it invests in, the amount it has disbursed to gender-inclusive clients, the number of female producers reached, and female producers as a percentage of all producers. Moreover, Root Capital has commissioned a series of special studies on the role of women in agricultural enterprises, and is planning research on the influence of women agro-dealers and lead farmers on agricultural value chains and farming practices. Such studies go beyond the ‘what’ and explore the ‘how’ and ‘why’ of the gender dimensions of Root’s portfolio performance.⁵⁰

System impact

In the impact investing field, a systemic or sector-wide perspective has become more common. This is also true to some degree in the field of development finance. More efforts are being made to capture indirect impacts on communities affected by the activities of investee companies as well as systemic changes – in addition to the direct impact on target group employees (Figure 4).

Figure 4: Investment impact chain with indirect impacts



Source: The Authors.

50 Kaplan, S. and J. VanderBrug. The Rise of Gender Capitalism. *Stanford Social Innovation Review*, Fall 2014.

The DFID Impact Programme, of which the DFID Impact Fund is a central component, aims to build impact investing markets by creating intermediaries and mobilising new capital sources as well as by building market structures. Another instructive example is that of the African Enterprise Challenge Fund, which aims at ‘making markets work for the poor’ in addition to achieving a direct impact on farmers in terms of employment and income. It has thus started to track the system changes of the companies and projects it has supported (see Box 1).

Box 1: Systemic change as tracked by the African Enterprise Challenge Fund (AECF)

The African Enterprise Challenge Fund supports market systems that are inclusive of rural communities and rural businesses (also known as Making Markets Work 4 the Poor). The fund manager therefore works to select business ideas with the greatest potential for market system impact. Five key types of systemic change are tracked within the AECF:

- copying of the business model by other businesses: replication of business model of AECF enterprise by other businesses or investors;
- ‘crowding in’: other businesses have entered the sector or value chain as a result of AECF supported enterprise;
- copying successful practices: households and organisations not involved in AECF copy behaviour and technology applied by AECF project;
- changes in regulatory environment: support to a new business model has resulted in regulatory changes;
- changes in factor markets: positive shifts in labour, land, capital and information market patterns as a result of AECF intervention.

Source: ACEF, 2014.

3.4 Impact assessment systems

Diversity of systems

Overall, much of the focus and experience of the funds sampled here with impact assessment would seem to be at the front-end of the investment process. That is, most funds have social and environmental criteria that are assessed at the investment scanning and due diligence stages; these are mostly output related (i.e. number of jobs to be created, farmers to be reached, and GHG emissions reduced, etc.). Further, most funds in the sample have highlighted the social and environmental results of their current and completed investments as a way of attracting additional investors and scaling their asset base. A few of the funds in the sample make considerable use of their impact assessment data to improve the social and environmental performance of their investees. The study team expects that more funds will make greater use of impact measurement for strategic and operational purposes during execution and also during exits.

While impact assessment therefore plays an important role in the sampled funds, there is much diversity across them with regard to the terms, methods and the number and type of indicators they employ in this work.

In research by Redesigning Development Finance Initiative (RDFI) of 24 blended finance investment vehicles, respondents indicated they track anywhere from one to 50 impact indicators, with the average fund manager tracking seven metrics.⁵¹ Only two fund managers in the RDFI study report using the IRIS system. In contrast, however, in a global sample of funds self-identifying as impact investors, some 60% report that they make use of the IRIS system, and a good number are also rated by GIIRS, the Global Impact Investing Rating System, which provides detailed, comparable ratings of a company's or a fund's social and environmental impact.⁵² In terms of efforts to create comparable, standardised terms and metrics, more funds in the study's sample have adopted other industry-wide standards, such as those of IFC or UNPRI.

At the same time, though, impact investment funds tend to use these metrics more intensively at the front-end of the investment process. Research on fund managers active in East Africa found that: 'The majority of fund managers interviewed do not specify a particular language or tool but rather report using flexible structures adapted to each new investment. Though many investors have rigorous and rigid impact guidelines to make an investment, they generally design and track metrics after the investment in an individualised manner to minimise the burden on portfolio companies.'⁵³ This appears to be broadly similar to the way impact assessment has been used, to date at least, by the funds sampled for the present study.

This diversity is explained in part by the variance across funds with respect to their investment theses and strategies, differences in the financial and human resources available to fund managers to measure impact, and, importantly, lack of standardisation in the practice impact assessment itself across the broad field of innovative finance. All of this, in turn, means that there is a general lack of comparability of social performance across funds, a situation which is not optimum either for scaling up the field or calculating its contributions to the Global Goals. It is worth noting, however, that there are challenges with standardised indicators, as well. One key challenge is that the enforcement of the definitions and indicators is difficult. And, when much data are the product of self-reporting, there may be validity and reliability problems. These and other challenges must be confronted in the years ahead.

Annex J provides a more detailed description of trends and directions in impact assessment.

Industry-wide terms and metrics

The IRIS taxonomy and catalogue of metrics, and the GIIRS fund and company rating systems, are products of efforts by the impact investing industry over nearly a decade to create a set of common terms and measures for that field. IRIS users are encouraged to create a metrics framework that includes both IRIS metrics and also customised metrics specific to each user's needs. Most IRIS metrics focus on the organisation level, such as energy capacity sold in KWhs, or number of hectares under sustainable management, by the social enterprise in question. In the case of GIIRS, funds and firms are rated on common metrics for their policies and practices with respect to governance, employees,

51 OECD and World Economic Forum 2015, p. 11.

52 Saltuk et al. 2015.

53 Harji, K. and E.T. Jackson. *Accelerating Impact: Achievements, Challenges and What's Next in Building the Impact Investing Industry*. Rockefeller Foundation, New York, 2012.

communities and the environment. Among self-identified impact investors, there has been increasing take-up of these systems, especially in the past five years, but most also use customised systems and tools at the same time. However, smaller funds and companies, and even some larger ones, have found both systems to be onerous, time consuming and overly detailed relative to their capacities and needs. There has been an effort by the proponents of IRIS and GIIRS to simplify their requirements.

Six funds in this study's sample use either IRIS or GIIRS or both. The African Agricultural Capital Fund uses both. This is perhaps not surprising, since the major investors in this particular fund – the Rockefeller, Gates and Gatsby foundations and JP Morgan – have been active members of the GIIN, which hosts IRIS. Indeed, the Rockefeller Foundation has been a key funder of IRIS and GIIRS. For its part, the DFID Impact Fund is also an IRIS user. At the same time, the DFID Fund has supported B Lab, the founding non-profit that created GIIRS, to further develop B Analytics, a platform that will allow subscribers to develop customised monitoring and benchmarking tools within the context of standardised terms and metrics. B Analytics itself is a blend of two earlier systems: B Impact Assessment, developed by B Lab, and Pulse, developed by Acumen. A third fund in the study's sample, the Essential Capital Consortium, is a GIIRS customer. Deutsche Bank, which leads this fund, is also a longstanding member of the GIIN. Finally, the Grassroots Business Fund uses the IRIS system, as well.

In addition, Aavishkaar's use of PRISM, which is IRIS-compliant, has been noted. Another good example in the sample is LeapFrog Investments, which utilises an in-house, proprietary framework known as FIIRM. At the same time, though, LeapFrog is a GIIRS-rated fund and an IRIS user, and is also a GIIN member. (LeapFrog Investments is an investee of major DFIs, most recently a USD 200 million commitment by OPIC, making it the first non-governmental impact fund focusing on Africa to reach USD 1 billion in funds raised.)

It is important to note that some funds in this study's sample adhere to other types of industry-wide frameworks. Nearly a third of the sampled funds make explicit reference to their intent to follow the IFC Performance Standards on Environmental and Social Sustainability. This framework sets performance standards with respect to environmental and social risk assessment, labour and working conditions, resource efficiency and pollution prevention, community health, safety and security, land acquisition and involuntary resettlement, biodiversity conservation and sustainable management, indigenous peoples and cultural heritage. Funds in this study's sample that have adopted these standards include AgDevCo, Althelia Climate Fund, Danish Climate Investment Fund, Dutch Good Growth Fund, Global Climate Partnership and Private Infrastructure Development Group.

Less explicit, but often underlying impact assessment frameworks and studies, are the OECD's Guidelines and Standards for evaluations. For example, the funds co-financed by KfW – such as the African Local Currency Bond Fund, EFSE, Global Climate Partnership Fund, Global Health Investment Fund, Green for Growth Fund, Regmifa, SANAD – are generally subject to that DFI's evaluation practices. KfW analyses projects on the basis of five evaluation criteria that have been agreed upon by the Development Assistance Committee of the OECD, including relevance, effectiveness, efficiency and overarching developmental impact. KfW uses a numerical scale to rate the performance of the fund being evaluated on each criterion and arrives at a total score that can be compared with those of other investee funds. To probe performance more deeply,

KfW sometimes commissions special ex-post, field-based evaluations, again informed by OECD guidelines.

Customised systems

Most of the funds in this study's sample use customised systems for monitoring and evaluating social and environmental results. Moreover, there is wide variation in the formality and comprehensiveness of these systems. Most track and report on the same core output indicators: numbers of investee companies, average size of investment, funds leveraged, jobs created, GHG emissions reduced. But there are variations even here. AgDevCo, for example, defines its jobs created as full-time equivalent jobs, and also reports on numbers of smallholders linked to markets as well as the additional earned income of engaged smallholders. Further, AgDevCo distinguishes in its system among inputs, outputs, outcomes and impacts in a manner more consistent with development evaluation practices and OECD standards.

Another fund in the study sample, Aavishkaar, provides a case of a well-developed, field-tested customised system. A Mumbai-based fund manager, Aavishkaar is an early stage impact investor in scalable South and Southeast Asian enterprises in key sectors – such as dairy, education, energy and water – and has benefited from financing from key DFIs and, recently, the Dutch Good Growth Fund. The group uses a made-in-India impact fund rating system called PRISM. The PRISM method assesses a given fund with respect to its sustainability and contribution to investee firms, the performance of its portfolio firms, the adjustment of these scores for conditions of local state development at the district level where its investments are located, and an aggregated, overall score. PRISM, which can also be used by investors to identify prospective investee social enterprises, is also IRIS-compliant. The system was conceptualised by Intellect, an India-based leader in the impact investing field, and the IFC, with support from GIZ.

While the approaches to impact assessment of the funds sampled here concentrate on core output indicators, a number of models are particularly comprehensive and track and report on macro-, meso- and micro-level results.⁵⁴ The approach of the Private Infrastructure Development Group (PIDG) is perhaps the most comprehensive, in that it sets out a multi-level causality framework for its monitoring system, including, among others, the overall context, PIDG strategy, PIDG portfolio, PIDG inputs, the set up and activities of individual facilities, facility outputs and outcomes, and wider outcomes. It also provides staff and partners with a detailed monitoring handbook with very granular definitions of a range of indicators to be reported.⁵⁵

Other comprehensive models are found in the cases of the DFID Impact Fund and AgDevCo. However, these examples represent a minority. Generally in the sample of funds, most impact assessment systems are much less developed or detailed. And this is similar to most impact assessment models and systems in the impact investment industry outside the sample. A good part of the reason for this is that the cost of developing and maintaining such comprehensive models is significant.

54 In terms of private sector development, for a very comprehensive approach, see Donor Committee for Enterprises Development (DCED). *Standards for Results Measurement*. DCED: Oxford, 2011.

55 Private Infrastructure Development Group. *Results Monitoring Handbook*. PIDG: Surrey, UK. 2013, p. 5.

Cost of impact measurement

Beyond the tracking and reporting of core output indicators and communication of select stories, the factor that constrains the further development and effectiveness of impact assessment inside and outside the study's sample is, quite simply, cost. For the smaller, commercially run funds especially, this is likely as much as they can pay for, and thus as much as they can do. And what they actually achieve is not trivial by any means.

One study has estimated that complex and stringent monitoring and evaluation as well as reporting can raise the operating costs of a fund and reduce its returns by as much as 2-3%, which, in turn, 'can tip the balance towards making a fund non-commercial for private investors.'⁵⁶

The examples of comprehensive evaluation and monitoring systems and tools from the sample suggest that donor agencies can, and already do, play an important role in addressing the cost issue. Either through grant-based subsidies or through the enabling of scaling of assets and operating margins, donors and DFIs can help address the cost of robust impact assessment at various levels: that of the individual investment, the fund, the programme and the eco-system at large.

At the same time, it is necessary to continue to mobilise technology and innovation to streamline and bring down the costs of impact assessment. Much of the interesting work along these lines is taking place in the impact investment space, though some is also be undertaken in other fields, notably in development evaluation.

Tracking and reporting progress on these core indicators is fundamental to the effective, scaled financing of sustainable development in the context of the Global Goals. In addition, successful impact investment fund managers argue that impact measurement and reporting is not a 'nice to have feature' to satisfy donors but an essential management and information tool at the core of day to day investment management. In that interpretation the separate parts of company performance – people, profit and planet – are being integrated into one system of design, planning, management, reporting and evaluation.⁵⁷ In fact, a study of 12 successful impact investment funds found that all of the funds analysed established a clearly embedded strategy and structure for achieving mission prior to investment, a form of 'mission lock' that determines the way the funds are managed and how it is reported.

56 LHGP 2015, p. 56.

57 Simon, M. 'Managing vs. Measuring Impact Investment: How a shift in mindset from impact measurement to impact management can lead to stronger social outcomes: a case study of Huntington Capital Fund III.' *Standard Social Innovation Review*, 20 March 2015.

3.5 Financial performance

Financial returns

Overall, the funds in the study's sample appear to achieve an acceptable level of financial performance that meets the diverse requirements of their various investors. This is difficult to ascertain with any precision because of confidentiality constraints. A number of studies were published in 2015 that assessed expected and where available realised financial performance.⁵⁸

At the high end, Regmifa has been found to yield 20% financial return to their debt investors. In its most recent annual report, Regmifa reports a median return on equity of 8.4%. And FMO government funds are found to achieve generally 'good financial results.'⁵⁹ In addition, for 2014, the current yield of the Grassroots Business Fund was 7.2% and, in 2013, the African Guarantee Fund posted returns of 2.3% and nearly 2.5% on its treasury accounts and bond portfolio, respectively.⁶⁰ For infrastructure projects, the PIDG fund sits in the mid-range, generating 6-10% annually. At the project level, an IRR of 6% is reported for a hydropower project in Vietnam.

This overall positive financial performance is generally consistent with findings from recent research on both impact investing and blended finance. The 2015 JP Morgan survey found that 55% of impact investors target 'competitive, market rate returns,' while 27% 'below market rate returns: closer to market rate.' Only 18% expect returns that are closer to capital preservation. The same study found that, on average, only 9% reported financial underperformance relative to their expectation.⁶¹

Likewise, a study on the financial performance of impact investment funds by GIIN and Cambridge Associates established that impact investment funds have outperformed funds in a comparative universe of conventional, private investment funds. The results also show that emerging market impact investment funds have returned 9.1% to investors (9.7% for those focused on Africa) versus 4.8% for developed market impact investment funds.⁶² For its part, a Wharton Social Impact Initiative study of 53 impact investing funds managing 557 individual investments found nearly identical performance of market-rate seeking impact funds with the relevant market index.⁶³

In the realm of blended finance, a Norfund-funded benchmarking study on investments made by Nordic governments in six blended funds and three DFIs in the fields of energy, energy-efficiency and climate and infrastructure sectors found that gross target portfolio returns were broadly similar (11.7% for blended facilities and 10.2% for DFIs' direct

58 Commons Consultants. *The Pitfalls of Innovative Private Sector Financing. Emerging Lessons From Benchmarking of Investment Funds Supported by Aid Agencies.* Summary Report, 25 August 2015a, Copenhagen; Saltuk et al. 2015; Cambridge Associates and the Global Impact Investing Network. *Introducing the Impact Investing Benchmark.* GIIN: New York, 2015.

59 Commons Consultants 2015a.

60 These data are drawn from the most recent annual reports of these funds.

61 Saltuk, Y. et al. *Spotlight on the Market: The Impact Investor Survey*, JP Morgan, the GIIN. 2014, p. 12.

62 Cambridge Associates and the GIIN 2015.

63 Gray, J., N. Ashburn, H. Douglas and J. Jeffers. *Great Expectations. Mission Preservation and Financial Performance in Impact Investing.* Wharton Social Impact Initiative. Philadelphia, PA. 2015, p. 16.

investments). However, the expected net returns of the development agency investing in a blended finance vehicle are significantly lower than for DFI investment (2.6% compared to 6.7% per annum). This is due to higher administrative and fund management costs, together with the grant incentive element used for risk mitigation or return enhancements. These costs are intentionally incurred by the development agency in return for expected additional private capital mobilisation and development impact, which was found to be uncertain, however (see Section 3.2).⁶⁴

The OECD/WEF found that debt and equity invested in blended finance can generate returns in line with market expectations. Survey respondents expected returns for debt between 4% and 7%, whereas, for equity, their expectations ranged greatly, from 1% to 22%. The average realised rate of return yielded by development funders was 5.4%, with returns ranging from 4% to 7%, while equity investments achieved an average return of 16.3%. Equity investments show a more significant variation in realised returns, fluctuating considerably between -2% to 61%.⁶⁵

Administrative costs and efficiency

The costs of setting up a structured fund may be substantial. These are costs that are usually borne by development agencies, the government or the lead DFI. Average fund manager costs range between 1.5% and 4% of fund volume per annum, depending on the type of fund and the fund's investment strategy; this may also include fundraising, pipeline development including competitions, due diligence, execution, management and technical support to investees or exit. Management fees for a private equity type fund range between 1.5% and 2.75%, while the operating costs of challenge funds are 3% to 4% per annum or more, depending on the scope of management responsibility and incentive structures.

The sample of funds for the present study yielded limited information on the full cost of setting up, administering and operating blended investment vehicles, data on the cost of the concessional element, or value-for-money studies that compare the chosen instrument with an alternative comparator. Such costs are rarely made public, however.

The Norfund-supported benchmarking study by Commons Consultants found, however, that the fund set up and administrative and operational costs in blended finance facilities were nearly three times higher than in DFI private sector funds. Over an investment cycle of seven years, DFIs had incurred costs in private funds corresponding to 10% of the investment (equivalent to 1.1% per annum). However, for blended vehicles, the projected fund costs were on average 27% of the capital committed by aid agencies (equivalent to 2.7% per annum). Considerations on costs have to be balanced with other considerations, such as availability of resources and the capacity of the DFI, as well as the desired level of autonomy from DFIs of a given fund.

64 Common Consultants. *ODA for blended finance in private sector projects*. Presentation, 2015b.

65 Due to confidentiality constraints, only a limited number of fund managers responded to these questions. These findings should be considered partial and preliminary.

3.6 Mission preservation

The studies by Wharton Social Impact Initiative and Cambridge Associates and GIIN study appear to support the argument that social impact and mission preservation in exit does not necessarily lead to tensions with a fund's financial performance – and that both impact and financial returns close to market rates are possible. There are other views, however.

According to the JP Morgan Impact Investing Survey, 'difficulty exiting investment' remains one of the top three challenges impact investors face given the nascent state of capital markets in most developing countries and the limited pool of suitable strategic buyers. One key concern has been that, in the drive for liquidity and financial returns and the lack of suitable impact oriented buyers, the exit process may actually render vulnerable or impair the impact mission of investee companies and projects. According to the JP Morgan Impact Investing Survey 2015, 61% of respondents attempt to mitigate the risk of mission drift. The rest either find it too difficult to do so (23%) or do not consider mitigating the risk of mission drift to be part of their mandate (16%). Most of the 61% impact investors seeking to mitigate the risk of mission drift according to the JP Morgan Survey stated however, that they do so by investing in companies for which impact was embedded, thus providing a 'natural protection' for the impact mission. Only 12 respondents, however, set specific targets with the acquirer ensuring continuity of the social mission.

The Social Impact Initiative of the Wharton Business School at the University of Pennsylvania concluded: 90% 'have investment or legal documents that explicitly allow fund managers to consider social and/or environmental issues and 70% go so far as to require them to do so' during the investment partnership. After exit most fund managers rely on the embedding of the mission in the DNA of the investee companies even though a much lower number of funds report having explicit statements in the realisation agreements. Interestingly, it also found that more than three-quarters of the surveyed impact funds were not able to control decisions regarding the terms of exit from investee firms.⁶⁶

In the present study's consultations with public sector agencies and investors, the study team found that some had not really thought much about this issue. In some cases, they anticipate a solution that defers the question of the preservation of the investee's social or environmental mission. 'Well, we would simply sell our shares to our co-investors who share our objectives,' said one fund manager, for example. And: 'We just assume the company that adopted our sustainability standards will continue using it. If someone less development oriented takes over our investment, there is little we can do about it.'⁶⁷ A large private institutional investor took the view that their responsibility was to exit in a way that generated the expected financial return on the investment, and that their fundamental obligation is to protect the financial interests of their shareholders or trustees in the exit process.⁶⁸

66 Gray et al. 2015.

67 Interview.

68 Interview.

3.7 A financial-impact trade-off?

In both the Wharton Social Impact and the Cambridge Associates/GIIN studies, the selection criteria for funds constitute a self-reported *intention* to generate social impact. It has been argued, therefore, that ‘to tell the whole story,’ funds should be benchmarked for impact or mission preservation in addition to their financial performance.⁶⁹

Indeed, the 2014 DFID Impact Investment Market Survey captured some of these diverging views on the ability and success of fully blending financial with impact returns and impact investment approaches that seek higher than or close-to market returns. Some argued that market-rate return targets are needed for the field to attract main-stream capital and achieve scale, and to maintain commercial discipline. Others, in contrast, raised concerns as to whether such investment strategies would inevitably lead to larger deal size, less risky investments and less of a poverty orientation.

‘The opportunity for commercial return with impact is overplayed. We get frustrated at the presumption that you can get commercial returns and get impact. It’s not always the case... Our organisation goes into the sector and works with the stage [of business] that delivers impact. Commercial investment cannot operate here unless first loss/blending of capital is used due to the early stage of the market, small ticket size, transaction cost and risk.’

‘We focus on the most un-serviced and high risk segments, markets in which typically 70%-90% of SMEs fail to reach the fifth year. Our businesses have an 80% success rate. We have learnt that you can only get a certain return. If you have no subsidy or support the IRR will never be high enough for finance first commercial investors.’⁷⁰

In other words, at the nexus of impact investing and blended finance, there may well be a trade-off between financial returns and impact. This seems to be especially the case for funds focusing on early-stage businesses and those making investments in high-risk sectors or regions.

69 Struwer, B. and R. Tews. Counterpoint: ‘Market-Rate’ Funds Should be Benchmarked to Impact, Too. ImpactAlpha, 26 October 2015.

70 The Impact Programme. *Survey of the Impact Investment Markets 2014: Challenges and Opportunities in Sub-Saharan Africa and South Asia*, UKAid, August 2015.

4 Critical Issues: Fund Design and Institutional Considerations

4.1 Choice of instruments

Limited variety of financial products and instruments

Despite the increasing capital flows to impact investments in developing countries, it remains a key challenge for companies in developing countries to access the appropriate type of capital at the appropriate stage in their growth process. This is due to the limited range of instruments available across the lifecycle and designed for specific market segments. In most developing countries, there is still a lack of high risk capital, working capital, and long-term debt finance. The Omidyar Network, a leading impact investor, states in their recent report on 'frontier markets': 'All investee companies need a lot of working capital, at the moment there is a real focus on private equity amongst investors, but it is not just PE; it is debt, it's mezzanine, it is the full spectrum of instruments that is needed.'⁷¹

Interventions in frontier markets require more innovative forms of financing and adjustment to the typical venture capital model. Some examples of pioneering experiments in this field identified by Omidyar Network include:

- *Longer time horizons:* The IGNIA Fund in Mexico is successfully investing in frontier markets, and has a 12-15 year fund lifecycle (as opposed to the usual 8-10). Aspada Investments created a holding company expressly to be able to hold on to investee companies for 15-20 years and be more flexible than VC and PE fund models: 'Between the regular cash flows and eventual exit we can get a good year-on-year return, which is difficult to obtain if we exit quickly.'⁷²
- *Venture debt:* IntelleGrow, launched in 2010 in India, replaces the collateral debt model with payments tied to cash flow. This model allows early stage businesses, generally without either collateral or established track record of profitability, to access debt more affordably. Loan guarantees by IFC, OPIC or USAID for private, local venture debt-providers could significantly reduce costs and accelerate the venture debt ecosystem.
- *Quasi equity:* Quasi-equity can offer investors a less risky form of liquidity, but pay-outs are still tied to the performance of the company. This leads to a stronger alignment of incentives between entrepreneur and investors than in the case of debt. For example, in an investment in MEDEEM, an early stage company that has developed an affordable and accessible land rights documentation process in Ghana, the Lundin Foundation provided subordinate, low interest loans with a sliding scale royalty, a percentage on the revenue and capped returns to the earlier achievement of its targeted IIR over 10 years.

71 Bannick, M., P. Goldman and M. Kubzansky. *Frontier Capital: Early Stage Investing for Financial Returns and Social Impact in Emerging Markets*. Omidyar Network, 2015, p. 27.

72 Bannick et al. 2015, p. 29.

Use of guarantees

Compared to concessional finance, guarantees are an underused instrument. Some commentators have claimed that their potential for mobilising resources and catalysing private sector capital have remained largely untapped.⁷³ In fact, only eight of 20 bilateral DFIs and agencies are issuing guarantees (with two more envisaging doing so soon). Recent OECD research of the guarantee portfolios of multilateral agencies found that:⁷⁴ First, most of the guarantees (85% in terms of value) backed capital that was mobilised in developed countries rather than making use of guarantees to develop domestic capital markets. Second, the bulk of surveyed guarantees (more than 70%) supported investments in the productive sector, financial services, infrastructure and industry. And, third, most development guarantees surveyed by the study covered risk in middle-income countries 'where conditions are well-suited for the use of market based instruments.'⁷⁵

There are several factors that may explain the limited use of guarantees to date. By their very nature, guarantees only lead to a registration in international statistical systems once a default occurs. In other words, basic international data on the prevalence and targeting of guarantees is incomplete. Consequently, detailed analysis on the costs and benefits and use of guarantees is still limited, compared with other financial instruments. Even more significant, perhaps, is the lack of eligibility of guarantees under the ODA system (see below). This constitutes a serious disincentive for governments seeking to increase their ODA contribution to meet the 0.7% target set by the UN. Furthermore, management of a guarantee portfolio is complex, even for conventional credit guarantees. Some smaller development partners may not have sufficient expertise both for originating a deal and for managing risks effectively. Finally, loan guarantees to individual companies, in particular, have also been criticised as requiring public sector institutions to be able to pick the winners, which is not simple in emerging and developing markets.

Incentive-based instruments

A contrary argument to the promotion of the guarantee mechanism has been advanced. This position argues that by emphasising downside risk mitigation, many of the donor-sponsored tiered funds send out a negative signal and in so doing, fail to meet the expectations of those investors they seek to mobilise.⁷⁶ It is true that developed market investors are often attracted to emerging markets in order to achieve above average market returns that are no longer possible in their traditional investment destinations. However, most developmentally oriented funds are established with the aim of assuring private investors that their downside risk is protected and that they can effectively achieve average returns similar to that which is achievable in established markets in developed countries. In fact, when respondents were asked about the importance of loss protection features in their impact investments, the 2015 JP Morgan survey found:

73 Mirabile, M., C. Sangaré and C. Schmerler. *Using financial instruments to mobilise private investment for development*. Development Co-operation Directorate, OECD, 2014.

74 Mirabile, M., J. Benn and C. Sangaré. 'Guarantees for Development,' *OECD Development Co-operation Working Papers, No. 11*. OECD Publishing: Paris, 2013.

75 Mirabile 2013.

76 LHGP 2015.

‘Only seven respondents (5%) chose “indispensable, wouldn’t invest without it” while 27% said it is necessary for certain transactions. A further 39% see it more has a “nice to have but not a must-have”, while 29% consider it irrelevant. Overall, 25% of Debt Investors indicated that they believe loss protection will become more important for them in future, while just 11% of Equity Investors did so.’⁷⁷

This is why it has been argued by some observers that increasing the share of co-investment by fund managers and development finance institutions may be a more effective way of mobilising the kinds of institutional private investors that are looking for outsized returns. Others, such as the Center for Global Development, have argued that mechanisms that reward the private sector for what it achieves and, at the same time, that tie the investors’ performance to social and financial performance (payment by results, as used in most result-based finance programmes), are better ways to stimulate private investment for development, compared with risk mitigation schemes that shield the private sector from risk and that minimise losses.⁷⁸

ODA eligibility

Questions remain around the eligibility of concessional finance, private investment and innovative financing instruments to Official Development Assistance (ODA) to meet the 0.7% of Gross National Income target recommended by the United Nations.⁷⁹ So far, ODA is recognised as official government flows and not flows from private financiers that are potentially leveraged with government ODA funding. On the other hand, much of the debt finance offered by DFIs is offered as development aid and therefore is characterised as concessional, although they are generally offered on market conditions. Some have argued that the use of ODA grants for leveraging public and private sector resources should be incentivised by recognising the public effort involved more consistently in ODA calculations and statistics. Others argue that blending and leveraging ODA diverts official assistance away from its core function of meeting the social needs of the poorest and forward providing subsidies to private investors in projects with limited poverty impact.⁸⁰ The debate on treatment of innovative financing for development is part of a general reform effort of the OECD/DAC system to arrive at a common understanding of concessionality in particular with regard to mobilisation of capital. One option is the introduction of an additional and broader measure of total official support for development (TOSSD), which would cover the totality of public resource flows to developing countries in support of sustainable development.⁸¹ Another option would be to group ODA with Private Development Assistance and non-concessional flows as a total of External Financing For Development (EFFD).⁸²

77 Saltuk et al. 2015.

78 For the work of the Center for Global Development on development impact bonds, see <http://www.cgdev.org/page/development-impact-bonds>

79 The share of ODA utilised for equity investments and public-private partnerships (PPPs) remains below two per cent: see OECD/DAC 2015.

80 DCF Republic of Korea High level Symposium. *Workshop in preparation for the Third International Conference on Financing for Development: the role of catalytic aid in financing sustainable development*. Location of Symposium: Republic of Korea, 8 April, 2015, p. 3.

81 OECD. *What is total official support for sustainable development (TOSSD)?* No date.

82 Morazan, P., F. Niewerth and A. Behrens. *Modernising ODA in the Framework of the Post MDG Agenda: Challenges and Opportunities*. A Study. European Parliament, Directorate General for External Policies, Policy Department: Belgium, 2014.

4.2 Fund governance and incentives

Most traditional funds are set up by an experienced team that develops an investment proposition and then looks for investors. Investors, in turn, delegate control over their capital to the investment manager. In contrast, in development finance, funds are often initiated by development agencies, which commonly opt for one of the following governance models:

- appointing external fund managers with the experience and skills required to manage the fund (or fund of funds) (e.g. KfW structured funds, challenge funds, AACF);
- appointing their Development Finance Institution (DFI) to run the fund (DFID Impact Fund, Danish Climate Investment Fund); or
- creating an autonomous organisation staffed with experts and hands-off oversight by investors and development partners (e.g. Global Innovation Fund).

Some interviewees for the present study see the comparative advantage of an external fund management model in accessing the required skills and experience of private sector professionals as well as ‘keeping politics out.’⁸³ Furthermore, depending on the specific design of the fund, internal rules and cultures, make a DFI-based fund-management model challenging.

Other observers, however, have pointed to high costs of external fund management and challenges in fund oversight, compared with an ‘internal’ solution. Furthermore, most DFIs have strengthened their own asset management competency and have demonstrated success in managing assets on behalf of their governments or third parties. Indeed, by their very mandate, they consider themselves well-positioned to marry development and financial objectives.

The common challenge for all governance models, though, is to allow the fund manager to apply their own expertise and act efficiently while ensuring development objectives are met. The choice of governance and incentive structures not only influences fund performance, but also has an important signalling effect for potential investors. In this regard, the interplay of the following factors is key: the role of the fund manager over the duration of the fund management agreement; the compensation of fund managers; investment decision-making bodies and processes; and oversight mechanism.

Role of the fund manager

Fund managers may be contractors, as in many funds with a strong development orientation (e.g. ACEF), or fiduciaries, and investors, as in many other donor supported investment funds (e.g. African Agricultural Capital Fund, Voxtra). The first model allows donors to exercise a high degree of control and oversight, but heightens the challenge to incentivise efficiency, prudence and the rapid deployment of capital. The second model is based on the traditional private-equity fund management approach, in which the compensation model seeks to ensure that fund managers have ‘skin in the game.’

83 Interview.

In turn, this drives profit generation. It also increases the challenge of designing compensation and governance structures that promote impact and nurturing of new markets.

The standard fund management agreement typically covers the entire life of the fund. Some fund management agreements provide for periodic renewal of the agreement and allow for the replacement of fund managers (e.g. Global Climate Partnership Fund and most challenge funds). However, the early replacement of fund managers by investors is uncommon.

Compensation model

Many investment fund compensation structures are based on the '2+20' *private equity compensation model*: They include some form of management fee (typically 2% of assets under management) as well as 'carried interest', a profit-sharing mechanism that enables the fund manager to receive a share of the money earned (typically 20%) in excess of the initial invested capital and after achieving a pre-agreed hurdle rate (often 6-8%). Some impact funds and debt funds (e.g. microfinance funds) have adapted the *mutual fund model*, only allowing the fund manager to charge a fixed annual fee on the basis of total assets under management. Other fund structures use a corporate model pioneered in investment banking. Here, investment professionals are remunerated through a 'salary plus discretionary bonus' compensation structure that is either pre-agreed or determined by the board or compensation committee (e.g. Global Health Investment Fund). In development donor funds, the remuneration of the agent is *cost plus profit* structure, based on an assessment of the workload rather than results; more recently, though, some funds have added incentives for performance elements (e.g. ACEF).

Many of the compensation models borrowed from the investment and private equity world have had to be modified in some way to fit to the impact investing and development market environment. An asset owner operating in Sub-Saharan Africa is quoted as saying:

'The two-and 20 model for investment is ridiculous in this space. The true cost is almost double given the high degree of support and high risk involved. It is not an argument many want to hear, but it is clear.'⁸⁴

Some funds have linked the financial compensation through carried interest or/and management to the fund managers' performance on impact. Carried interest from the financial performance of companies has been lowered or capped where 20% (requiring a 27%-28% project return) is considered unrealistic. In these cases, the fund manager can increase financial compensation by achieving or outperforming on impact targets. Investing in developing markets, early and growth stage companies and immature markets, with little market infrastructure and support mechanisms, all puts additional time and resource demands on fund managers. Management fees therefore tend to be set above the 2% of assets typically charged by traditional fund management in mature markets. In fact, in funds with a strong development orientation that operate in low capacity environments, there is a possibility that carried interest becomes a low probability option and that management fees become the principal component of fund-manager compensation. Some observers have warned that this may reduce the positive effects

84 LHGP 2015, p. 34.

of private-sector mechanisms, such as quick deployment of capital, efficiency and profits, and may create perverse incentives.

Because impact assessments can be complex and costly, stakeholders have sometimes established fund governance mechanisms to help prioritise investments with high social impact, instead of impact-based compensation structures. For example, some funds established a two-stage, front-end investment approval process screening: first, developmental impact and second, the financial prospective (e.g. Global Health Investment Fund, African Agricultural Capital Fund). However, not all found such separate screenings useful:

‘Initially, we assessed impact separately from financial prospects. We don’t do this anymore, as in the most promising investment opportunities we are unable to separate impact from the rest of the business model. They are one.’⁸⁵

Investment decision making bodies and processes

Many externally managed funds have independently managed investment committees. Separating fund management from investment decision making gives donors more oversight and relieves the fund manager of potential conflicts of interest. Some funds have chosen to include external professionals on the investment committee (e.g. Global Innovation Fund) or to add decision-making technical and developmental committees to an independently managed investment committee.

Auditing and reporting requirements are another way to exercise control and ensure delivery on donor objectives. Technical assistance facilities linked to the main fund have been set up with grant funding often covering in-depth studies, external evaluations and impact reports, to reduce the burden on the fund manager and ensure an impartial view. Many technical assistance facilities also support investees with time-consuming and costly capacity development that requires subsidy.

4.3 Transparency

One notable feature of the funds in this study’s sample is the unevenness of the public information they provide. Most funds provide extensive information on key areas, such as their investors, investment policies, and impact measurement. However, at the same time, there are important gaps in the information presented by funds in the sample. In particular, 15 funds do not disclose their leveraging ratios, 14 funds do not report their management fees, 10 funds do not specify their term or life-span, seven funds do not disclose the financial return they expect, and six funds do not report their impact measurement practices or results.

Outside the sample, broadly speaking, there is evidence that blended finance vehicles have under-performed to date in terms of transparency. Perhaps the sharpest critique has come from European civil society observers, who have strongly criticised the low level of transparency and accountability of EU-funded blended finance investment funds, stating

85 Interview.

recently: ‘Transparency and accountability levels are appalling[...] there is scandalously low transparency for the facilities, information is incomplete or out of data.’⁸⁶

A consulting study on ODA in blended finance found that the quality of impact data made available publicly is often low, but varies across donors and investment vehicles. For example, most KfW-supported funds have a professional website with detailed information on capital structure, key stakeholders, fund structure and annual reports. These websites appear to target potential investors and the wider public rather than sector stakeholders seeking detailed performance results and actionable lessons learned. Moreover, project-level appraisals are rarely made public. For the 20 structured funds initiated or invested in by KfW (and the German Ministry for Economic Cooperation and Development) over the past decade, there is only one publicly accessible, short project-level appraisal on the European Fund for South East Europe.⁸⁷ Other research, on a sample of eight blended finance facilities, found that no facility-specific review had been carried out since 2008. Similarly, the proponents of enterprise challenges funds have been criticised for their lack of systematic evaluations to date.⁸⁸

4.4 Local embedding

Of the 23 funds and vehicles reviewed for the present study, there is clearly very limited participation by investors or fund managers originating from developing countries. Eighteen of the funds are domiciled in the Global North. When they are fundraising, many development agencies, fund managers and lead investors still tap into their existing networks in their home regions rather than targeting potential investors with resources, knowledge and personal links to key investment destinations. This conforms to past patterns, where investment vehicles have mostly been driven by development agencies and managed by fund managers and staff headquartered in Europe or the United States. It is not surprising, then, that donor-supported blended finance facilities and impact investors alike have been criticised for poor local engagement and limited mobilisation of local resources.⁸⁹

However, there is evidence of a reverse trend in recent years both for development and impact investors. Many DFIs and investment funds have increased their local presence in destination countries and have delegated broader responsibilities to local staff and partners. Indeed, four of the funds in the study’s sample are domiciled in Africa, including three in Mauritius (African Guarantee Fund, African Local Currency Bond Fund and LeapFrog) and one in Uganda (African Agricultural Capital Fund). One Southern-based fund that is also in this study’s sample and is playing a leading role in the impact investing field is Aavishkaar, headquartered in India.⁹⁰

86 Eurodad, 2015. Website: <http://www.eurodad.org/>

87 In 2014 KfW had commissioned PwC to review these funds as part of a wider evaluation, but the consultants were not able to obtain the study.

88 Commons Consultants 2015b.

89 UKAN 2015.

90 Founded in 2001, the group’s name means ‘invention’ in Hindi. Deploying young investment managers and innovative technology, it invests in early-stage businesses of rural and low-income communities across India in such sectors as agriculture, dairy, energy, education, health and water, among others. Its international Aavishkaar Frontier Fund focuses on Indonesia, Sri Lanka and Bangladesh.

One of the interviewees, the representative of a development bank, reported considering local investors for the first time once the fund will be ready to start fundraising:

‘Indeed, we have been considering approaching investors from the region, which we have not done so far. Honestly, it has not occurred to us before as we always think of money coming from the Global North not from the partner countries we are supposed to support. While our fund manager does not have many connections to the region we as a bank could play a stronger role.’

The arguments for more locally embedded capital mobilisation and fund management strategy appear self-evident. Major economies in Africa, Asia, Latin America and Eastern Europe have accumulated an increasing quantum of wealth accompanied by the emergence of skilled professionals, including the return of diaspora community, with relevant expertise as well as local networks. Local leaders are behind some of the most pioneering approaches in the impact investing field (for example, the Tony Elumelu Foundation and Heirs Holdings in Nigeria, or Business Partners Limited or EdgeGrowth in South Africa). It is also important to note that developing country government agencies hold 80% of sovereign wealth funds globally that are currently heavily invested in the Global North.⁹¹ Often set up within a broad public interest framework, such funds are creating further opportunities for local capital mobilisation for long term investment in development.

4.5 Donor mandates

Development finance institutions have sometimes faced tensions between their institutional mandate and incentives on financial sustainability and profitability, on the one hand, with increased demand by their governments and other stakeholders for higher risk developmentally-oriented capital on the other. Indeed, some have made the case that DFIs go for ‘low hanging fruit’ rather than investing in more complex, riskier projects with high additionality.⁹² It is true that DFIs have incentives to engage in high-return, low-risk projects in order to remain self-financing and profitable as well as to maintain their credit rating as per their institutional mandate. Activities that are required to enhance developmental outcomes are often costly and time consuming constraining DFIs competitiveness relative to the private sector. And it has been argued that the professional background of staff in the private sector and investment banking further contributes to a commercially-driven culture in many DFIs.

In fact, the tension between the institutional mandate of development finance institutions, the institutional culture, and the capability of staff, on one hand, and the demand of governments, partners and the global development community to provide impact, on the other hand, has been increasingly acknowledged. In some cases, donor governments have allocated additional ODA funds to their DFIs to be managed off the latter’s balance sheet (e.g. FMO Government Funds; see Chapter 3). Some have set up specific blended finance units, which allow concessional finance under strictly defined conditions (e.g. IFC Blended Climate Finance Unit) or channelled funding to externally managed investment funds.

91 UNCTAD 2014, p. 158.

92 UKAN 2015, p. 18.

4.6 Capacity, learning and leadership

The lack of suitable and investment ready projects and companies has ranked amongst the top three items in most surveys amongst impact investors, asset managers and fund managers.⁹³ The DFID survey of the impact investment markets reports:⁹⁴

‘Nearly all interviewees spoke to a lack of skills and capacity as a major risk to investments. [...] Several areas of skill and capacity deficiencies were specifically cited in interviews including: lack of leadership, poor understanding of proof of concept and business models, low levels of human resource, distribution and supply chain management and management information systems know-how. [] There is lots of talent at CEO level but nothing in the business ‘engine’ room’ – middle management is lacking and this is a binding constraint.’

In the past, this constraint has mostly been seen on the demand side of the capital market, i.e. among entrepreneurs as the final investees. More recently, however, increasing attention is being paid to other players in this emerging eco-system, most notably the fund managers of capital. Indeed, markets generally lack fund managers that blend technical, financial expertise and also possess a good understanding of social and development issues, rather than relying on in-depth financial expertise alone. A study of 12 successful impact investment funds found that founders and leaders of successful funds often come from varied backgrounds, and have built ‘multilingual leadership’ skills, defined as the ability to move seamlessly among diverse stakeholders and audiences from the public, private and social sector.⁹⁵

Awareness raising and investor education have also moved up the agenda, as has the importance of dialogue with policy makers, public sector and donor officials. Indeed, government is more often regarded critical in its role as potential initiator, funder, investor, as well as regulator in impact investing markets.

Various mechanisms and arrangements have been used to enhance capacity at all these different levels. *Project preparation facilities* for example, targeting mostly infrastructure and other sectors, have been set up to intervene at different stages of the project development process. The scope of most facilities ranges from feasibility studies, technical assistance for policy reforms, as well as capacity building and training, to local partners (e.g. InfraCo, MSME facility).⁹⁶ Some donor supported investment funds benefit from access to a capacity building grant programme. Investment funds managed by FMO (e.g. MASSIF, Access to Energy), for example, all have access to the FMO capacity development grant programme that is deployed to strengthen internal operations, product development or governance.

93 For example, Saltuk et al. 2015.

94 The Impact Programme 2015.

95 Clark, C., J. Emerson and B. Thornley. *The Impact Investor: Lessons in Leadership and Strategy for Collaborative Capitalism*, San Francisco: Jossey-Bass, 2015.

96 Project preparation facilities (InfraCo MSME etc.). http://www.icafrica.org/fileadmin/documents/Knowledge/ICA_publications/ICA-PPF-Study%20Report-ENGLISH-VOL%20A.pdf

Most blended finance funds have a *technical assistance facility* linked directly to the fund that provides targeted business development and capacity building support to investees (i.e. fund managers and financial institutions in the case of funds with intermediary structures) and, in some cases, to other market players. Typically, technical assistance facilities also support impact analysis, audits, research and policy analysis. There is a trend towards separating out technical assistance in order to account for it and access separate funding. Indeed, in many other cases reviewed for this study, funding is provided through grants by development agencies or foundations. And, in a growing number of cases, beneficiary contributions that cover at least parts of the costs have become mandatory. With regard to some of KfW's structured funds, the board can decide to use a share of the fund's income on the technical assistance facility (Box 2).

Box 2: Technical Assistance Facilities under KfW structured funds

The Technical Assistance Facilities of KfW's structured funds (e.g. EFSE, Green for Growth Fund, SANAD etc.) generally follow a similar pattern. They are set up independently from the main fund as a trust fund under Luxembourg law. They are managed by the investment manager and investment advisor and overseen by the Technical Assistance Facility Committee (TAC) representing the initiators of the fund and the donors to the facility. The TAC approves all activities and supervises its management. The main activities entail capacity building and training of the fund's financial and non-financial partner institutions as well as audit and impact measurement and introduction of Environmental, Social, and Governance (ESG) standards. Other activities typically include awareness raising and research. The facility is funded by grants, beneficiary contributions (on average 30%) and, at the discretion of the GGF Board of Directors, a share of the fund's income. The aggregated project volume of the technical facility for the European Fund for South East Europe (EFSE) since 2006 is about EUR 12 million, and the fund's committed capital stands at EUR 2 billion in 2015.

Sources: Green for Growth Fund; European Fund for Southeast Europe; SANAD 2015.

Some donors have embedded their capital contribution in a holistic market-building programme aiming to strengthen market infrastructure. They do this by collecting much needed market data, increasing transparency, and strengthening the capacity of intermediaries and impact measurement systems. The DFID Impact Programme, for example, intentionally focuses on the supply side of the impact investment market, targeting investors, fund managers and impact investing market infrastructure (Box 3).

Box 3: DFID Impact Programme

A facility linked to investee funds launched in 2014 provides technical assistance to both managers of investee funds as well as their portfolio companies. Fund managers are empowered to deploy technical assistance to a set of interventions defined as ‘standard,’ based on meeting a set of criteria. Non-standard interventions (by size or nature) are to be approved or rejected by a Technical Assistance Committee.

In addition to support linked to the DFID impact fund, DFID supports global market building interventions, working with a range of different partners. This includes strengthening the global impact measurement system via support to IRIS, training of fund managers in cost effective impact measurement; strengthening the capacity of impact investment fund managers to implement cost effective impact measurements; support to B Analytics is a customisable web platform for measuring, benchmarking, and reporting on a portfolio’s social and environmental impact and the Global Impact Investing Reporting Standards (GIIRS). Other components are the Advanced Investment Management Skills (AIMS) which supports first time fund managers with training and mentorship on fundraising, ESG, impact measurement, and investment skills; the Base of the Pyramid (BoP) track to promote learning on BoP investing amongst GIIN members, as well as research such as landscaping studies and fund managers.

Source: DFID, 2015.

Impact investment firms that follow an active venture capital investment philosophy typically integrate capacity building with their investee companies in their investment approach. In addition to financial capital, they provide their portfolio with social capital, giving companies access to relevant networks, intellectual capital through management know how, mentorship and, if needed, targeted professional support through external consultants (e.g. Voxtra) or fellows.⁹⁷ LeapFrog, a ‘profit with purpose’ investment firm active in the financial and insurance services sectors in Africa, has a dedicated ‘Value Creation Group’ that works with portfolio companies on strategies, operations and product development. The in-house team of its Innovation Lab works on product development, pricing strategies of emerging consumer behaviour and analysis for the benefit all portfolio companies.⁹⁸

Peer to peer capacity building and community support mechanisms have become more common both in impact investing and donor-led private sector investment (as well as, indeed, in the broader global debate on capacity building in development).⁹⁹

97 LGT Venture Philanthropy is an impact investor and philanthropic advisory firm set up by Princely Family of Liechtenstein and the privately owned LGT Group. <http://www.lgtvp.com/Uber-uns/Uber-uns.aspx>

98 Both LeapFrog Financial Inclusion Funds I and II were able to attract investments from key development agencies, DFIs such as KfW, FMO, IFC as well as institutional private investors and major foundations. <http://www.leapfroginvest.com/investors/>

99 In the global development architecture, peer-to-peer learning is being established as a third column in addition to financial and technical assistance. See G20, Scaling Up Knowledge Sharing for Development: A Working Paper for the G-20 Development Working Group, Pillar 9, 2013, p. 4.

Outside the present study's sample, the Small Enterprise Assistance Funds' ¹⁰⁰ Centres for Entrepreneurship and Executive Development, for example, provide business-development training and assistance mostly through facilitated peer-to-peer learning and experience sharing programmes, mentorship and community support. Peer-to-peer learning has also been applied in *early stage incubation, acceleration and investment readiness* programmes. The Village Capital programme has borrowed elements of venture capital and the peer to peer approach used in group lending in microfinance. Village Capital established early stage, sector-based cohorts of 12 entrepreneurs with shared experience and peer-driven mentorship that, after going through an intensive training, give authority over pre-committed capital investments to entrepreneurs themselves.¹⁰¹

Incubator and accelerators typically provide business skills development, mentorship support as well as connections to networks prior to the first investment. They thus make an important contribution to building the pipeline for potential impact investors at the growth stage. They may be part of an international network (e.g. Impact Hub, UnLtd, Ashoka), launched by local founders (e.g. Dasra India or iHub Nairobi), launched by local organisations (e.g. Green Pioneer Ventures, a five month acceleration for ventures in the environmental field jointly set up by several accelerators and VC4Africa). Capria Accelerator is the first global business accelerator for impact fund managers. Capria invests in, supports and helps capitalise new fund managers backing early-stage start-ups, primarily in emerging markets including South Asia, Southeast Asia, Africa and Latin America. It has been founded by members of the United Venture Seed Fund in India.¹⁰²

Two recent studies on incubation and accelerator funding and operations in the impact investing field found that, while accelerators seek to diversify their revenue base, more than 70% of these accelerators are likely to remain reliant on grant funding provided mostly by philanthropic organisations.¹⁰³ Some bilateral and multilateral development agencies have started running acceleration development programmes that directly support social innovation, social enterprise investment readiness and inclusive businesses, often using thematic or sector based open competitions. This includes the IDB Opportunity for the Majority Programme, USAID Development Innovation Ventures as well as the Development Marketplace run by the World Bank Institute which is currently being revised. In addition, climate innovation centres (CIC) are a new initiative designed by the World Bank's infoDev programme, supported by DFID as well as the Danish, Australian, Dutch and Norwegian Governments. These CICs have been or are being set up in Kenya, Ghana, Ethiopia, South Africa as well as other countries in North Africa, and Asia. The centres provide not only business advisory, policy advocacy, and technical

100 Small Enterprise Assistance Fund (SEAF) is an international investment management group that provides growth capital and business assistance to small and medium enterprises in emerging and transition markets underserved by traditional sources of capital. It has set up the Centre for Entrepreneurship and Executive Development, born out of USAID grant funding in SME equity investments made by SEAF throughout the Balkans, and EBRD in Slovenia. <http://ceed-global.org/>

101 VilCap Inc. is a non-profit organisation that operates business development programs for early-stage entrepreneurs in agriculture, education, energy, financial inclusion, and health in the US and in India, East Africa, Brazil. VilCap Investments is a for-profit investment fund that invests seed funding (convertible debt) in the two top-ranked graduates from each program. See www.vilcap.com.

102 See the Capria website, 2015. <http://capria.vc>

103 Baird, R., L. Bowles and S. Lall. *Bridging the "Pioneer Gap": The Role of Accelerators in Launching High-Impact Enterprises*, The Aspen Institute, A report by the Aspen Network of Development Entrepreneurs and Village Capital, 2013.

assistance, but also seed financing to support entrepreneurship and SME development in the climate technology field.¹⁰⁴

4.7 Facilitating cooperation and co-investment

There is both cooperation and competition among impact investors, and also among blended-finance investors. Survey data from 2015 show that 58% of impact investors consider that there is some competition in their industry, and 10% believe there is a lot of competition. On the other hand, 87% of respondents believe that co-investors are important or critical in their work. And over 50% of respondents indicate that referrals from other investors are a highly effective means of sourcing deals.¹⁰⁵

There is also an increasing level of co-investment, sharing of platforms, project development and joint financing facilities among DFIs and between DFIs and other investors. Recent initiatives in the development finance field include:

- *The Redesigning Development Finance Initiative (RDFI) and Convergence*, an initiative led by WEF and the OECD, seeks to extend the reach and efficiency of official development assistance through the complementary deployment of philanthropy, impact and other private investment and the promotion of pioneering approaches to development finance.¹⁰⁶ Convergence, a new initiative to be launched in early 2016 under RDFI, is a platform designed to help connect private investors and public and philanthropic investors to blended finance opportunities in emerging and frontier markets.¹⁰⁷
- *GreenInvest* is a public-private dialogue and knowledge sharing platform, based in London, to promote development of new mechanisms to attract private capital for inclusive green growth, established under the Turkish G20 presidency in mid-2015.¹⁰⁸
- *The Sustainable Development Investment Partnership (SDIP)* is a technical assistance facility supported by donors, development finance institutions and the private sector to support developing countries in identifying and mitigating key investment risks, particularly in infrastructure. The SDIP aims to create investment opportunities and to mobilise USD 100 billion in private financing over five years, in water, sanitation, transport, green energy, agriculture, health, telecommunications and climate adaptation.

104 For more information on the CICs, see <http://infodev.org/climate>.

105 Saltuk et al. 2015, p. 18.

106 For the Redesigning Development Finance Initiative (RDFI) see <http://www.weforum.org/projects/redesigning-development-finance>.

107 Convergence, website, 2015. <http://www.convergence.finance/>

108 GreenInvest, website, 2015. <http://gggi.org/g20-launch-of-greeninvest-to-mobilize-private-capital-for-inclusive-green-investments/>

- *European Financing Partners SA* is a private limited liability company established by 14 DFI shareholders and is run by the secretariat of European Development Finance Institution (EDFI) in Brussels that was founded to pool funding and leverage private capital.¹⁰⁹
- *The Global Innovation Lab for Climate Finance* is an international initiative that supports the identification and piloting of cutting-edge climate finance instruments with the intention of driving private investment into climate change mitigation and adaptation projects in developing countries.
- *The Emerging Markets Sustainability Dialogues* are a group of platforms created by the G20 and led by GIZ, that engage representatives of Think Tanks, multinational corporations and the financial sector in joint research, consultation and dialogue on sustainable economic development in emerging economies.

In impact investing, several international players and platforms have enhanced coordination and information among impact investment funds, some of which are strengthening their emerging country focus and membership base. This includes, in particular:

- The *Global Impact Investing Network (GIIN)*, a membership-based organisation located in New York that houses IRIS, ImpactBase, a searchable, investor-facing online database of impact funds; as well as research and trainings.
- The *European Venture Philanthropy Association* and its regional sister organisation, the *Asian Philanthropy Association*, have become important platforms for foundations, fund managers and impact investors engaged in the whole spectrum of venture philanthropy and mission investing.
- The *Mission Investors Exchange* is a knowledge sharing network for US foundations on programme-related investments and mission-related investing in the American regulatory context.
- The *SDG Philanthropy Platform* facilitates learning about and engagement in the implantation of the Global Goals by philanthropic foundations and endowments. With a current programmatic focus on Ghana, Ethiopia, Indonesia and Colombia, the platform is supported by the Hilton and Ford foundations and UNDP, and is managed by Rockefeller Philanthropy Advisors in the United States.
- The *African Union* and *UNDP* have also launched a new initiative, supported by SDC and other donors, to promote impact investing across Africa. Its Pan-African action plan to establish an industry network, develop an advocacy programme, improve the preparation of impact investment opportunities, prepare appropriate policies and regulations, create an Africa impact investment fund or fund of funds, strengthen national eco-systems, and adopt impact measurement standards and well-defined monitoring and evaluation processes.¹¹⁰

109 European Development Finance Institution, website, 2015.

<http://www.edfi.be/about/efp-european-financing-partners.html>

110 UNDP. *Cape Town Declaration on Impact Investment in Africa*. Lord Charles Hotel, Cape Town, 26 November 2015.

- Industry bodies such as the *Emerging Markets Private Equity Association*, the *African Venture Capital and Private Equity Association*, and *Venture Capital for Africa (VC4A)* increasingly provide opportunities for information exchange at their annual meetings as well as participation in joint research initiatives. The *Social Impact Investment Task Force* set up under the G8 Presidency of the United Kingdom recently expanded its activities beyond G8 in welcoming national task forces members from India, Brazil and Mexico, as well as Portugal.
- In India, impact investment firm Aavishkaar, along with the Omidyar Network jointly set up the *Impact Investor Council*, a membership advocacy and match making organisation. It currently includes more than 30 local and international impact investors and partners including DFID and GIZ.¹¹¹ In South Africa, the *Southern Africa Impact Investing Network* was initiated by consulting firm Greater Capital in conjunction with investment group Cadiz Asset Management, and organises an annual conference for key industry players in South Africa and the surrounding region.

These and other platforms provide donors with a range of possibilities for learning and action.

111 Impact Investor Council, 2015, Website: <http://iiic.in/>

5 Conclusions and Options for Engagement

5.1 Identifying emerging lessons

The concepts, instruments and critical issues discussed in this report point to a number of trends, gaps and emerging lessons in innovative finance and impact investing in developing and emerging countries:

- *Market overview:* Impact investing is a small but rapidly growing field in the sustainable investment universe. The activities of impact investing funds and private innovative finance vehicles are concentrated in a limited number of countries. Some countries, such as Kenya, India and Brazil, have become regional hubs, while many others still have underdeveloped infrastructure and few players.
- *Role of governments:* An increasing number of governments around the world – such as the UK, the US and France, and also Ghana and South Africa – have taken steps to provide a conducive regulatory environment for impact investing and to mobilise private capital for the public good. Strategies have focused on: increasing the quantum of capital for investment (supply development); increasing the availability or strengthening the capacity of capital recipients (demand development); and adjusting terms of trade, market norms, or prices (directing capital).¹¹²
- *Investor profiles:* With increasing information being collected on investors' motivations, their impact, risk and return profiles investors are slowly being understood for their diversity rather than all being grouped together. Improved investor profiling would not only allow vehicles and instruments to be tailored to the needs and expectations of specific investor groups, but also would enable public sector interventions to be more targeted and help prevent distortion and wastage.
- *Impact investing and SDGs:* So far, the evidence of the extent to which impact investing contributes to achieving the SDGs is limited to impact reports by individual investors, case studies and anecdotal evidence. Efforts, however, are on-going to build the infrastructure to enable systematic comparative analysis across funds as well as country-level assessments.
- *Additionality:* Developing a common understanding among donors and then applying the concept of additionality are crucial tasks for donors in engaging with the private sector. While much progress has been made with regard to operationalising additionality in the context of donor cooperation with private sector companies, there is still limited *systematic* evidence of additionality, and measurement challenges remain.

112 Thornley, B. et al. 2011. See also the Impact Investing Policy Collaborative website for case studies from around the world www.iipcollaborative.org.

- *Higher risk, higher impact investing:* There are promising recent examples of high impact, high risk funds led by DFIs (often driven directly by government policies), including those that focus on post-conflict and volatile areas or target the Base of the Pyramid.
- *Impact assessment:* There is wide agreement by proponents of impact investing and innovative finance that impact measurement and evaluation are important. However, there is little consensus, beyond a few core indicators, on what to assess, and how. There is insufficient dialogue between the fields of impact assessment and development evaluation. Nor is there systematic knowledge and data sharing across industry-wide systems and standards, on the one hand, and customised systems, on the other.
- *Local markets:* In emerging economies, strong local actors have appeared in recent years, notably local foundations, investment groups and accelerators. In spite of this, both capital mobilisation and market development processes continue to be led from the capitals and financial centres of the Global North. And most local capital markets are still far from being able to offer impact investing and innovative finance products and services on a scaled, sustainable basis.
- *The investment pipeline:* In recent years especially, funds and programmes have demonstrated how quality investment deals can be generated and de-risked in the field. Strategies here have included: grant-based technical assistance, training and business advice; challenge funds; accelerators and incubators; deal preparation teams; and due-diligence tools, sometimes funded in part by fees from investees themselves.
- *Choice of vehicles, products and services:* Thanks to the efforts of donors, DFIs, foundations and a wide range of private investors, there is now greater choice in the models of funds and vehicles that are designed to meet the requirements of existing and new investors. Businesses in developing countries, however, still lack sufficient access to financial products such as venture capital, working capital and long-term debt finance, as well as technical assistance for investment readiness.
- *Non-financial instruments:* Technical assistance programmes and capacity building interventions as well as field building and policy dialogue play increasingly important roles. More information is needed on the experience of such non-financial instruments.
- *Collaborative impact:* Development organisations and new actors such as foundations, corporations, impact investors, international and local NGOs and associations are creating new vehicles for cross-sector coordination, based on the belief that individual interventions are insufficient to solve increasingly complex development challenges. Blended finance structured funds typify the recent wave of collaborative vehicles, as are development impact bonds (involving social organisations, the public sector and private investors), investor-investee matching platforms such as Convergence, and joint initiatives such as the Sustainable Development Investment Partnership.

5.2 Options for engagement

Mobilising private capital for sustainable development will remain a priority for the development community through the life cycle of the Global Goals, and no doubt, beyond. Donor agencies and their development partners can engage in this work in many ways, particularly through their roles as investors, market builders, commissioners of products and services, and advocates for quality standards.

The following options for engagement are worth noting:

- *Co-invest*: Through platforms, existing funds and vehicles, or their own countries' DFIs, donor agencies can become co-investors in innovative financing vehicles and impact investing funds that focus on the thematic issues (agriculture, education, water, etc.) and geographies of greatest priority to their governments. Co-investing with Southern investors can help promote local markets, capacity and impact. More generally, co-investing is an active mode of learning as well as of practical action.
- *Invest as lead*: Taking a lead role in setting up and directing a new fund or vehicle is also an option for engagement by donor agencies. After substantive learning and experience as a co-investor, development agencies are better positioned to play such a leadership role. This may entail becoming involved with a fund with a particular set of investors focused on a key sector, like renewable energy. The donor may then go on to catalyse the mobilisation and deployment of capital for a new fund with a similar mix of co-investors but in a new sector, such as sustainable agriculture.
- *Build internal capacity*: It is likely that development agencies will need to build their own internal capacity in innovative finance and impact investing. There are many ways of learning more about the various structures, players, issues and opportunities in impact investing and innovative finance in poor countries and regions. One is to join, participate in and contribute to networks and platforms that produce knowledge about and track experience in these fields. Donors can also support specific executive education opportunities, in-house training and special career tracks for their staff in innovative finance and impact investing. Beyond networks and skills, donor agencies need development professionals who are 'multilingual' in that they have proven that they are capable of working effectively across business, government, philanthropy and civil society.
- *Mobilise investors*: Donors are presented with an opportunity to engage more actively in mobilising potential investors, including local investors in partner countries. This might involve supporting, or speaking at, major industry events (e.g. the SOCAP conference, the Sankalp Forum). It also could involve hosting awareness raising events and connecting experienced investors with newcomers to the field. Furthermore, donors can expand access to skills development and education opportunities that targeting private investors and focus on developing country contexts. While on-site training facilitates peer-to-peer networking, e-learning opportunities – perhaps including webinars and even massive open online courses – also can be developed in order to reach a broader audience.

- *Identify and close market gaps:* Development agencies should consider taking a more strategic approach in identifying existing market gaps in countries, regions or sectors where their capital and support can be catalytic in reducing or closing such gaps. In particular, local capital markets in developing countries need to be strengthened to increase the availability of long-term capital, finance in local currencies and credit lines for renewable energy and inclusive business.
- *Strengthen impact assessment:* Development agencies can play a useful role by strengthening the strategies, tools and standards for impact assessment in innovative finance at multiple levels – fund, country, region and global – through action research and training. Facilitating a productive exchange between the development evaluation profession and impact measurement function in impact investing is especially important. So is animating integrated and efficient systems of industry-wide standards and both common and customised metrics.
- *Ensure additionality:* Development agencies can play an important role in ‘policing’ the issue of additionality in two ways. The first is by working with their peers, DFIs, foundations and other impact investors to ensure that systematic ex-ante and ex-post additionality assessments are carried out for funds and vehicles using public funds, as well as for their major individual investments. The second is by insisting on the transparency, including public reporting, of the arrangements made with private sector investors.
- *Deepen transparency and knowledge sharing:* While recognising legitimate confidentiality concerns in blended finance and innovative financing structures, donor agencies can and should do more to encourage impact investment funds and innovative financing vehicles that receive public support to disclose details on their capital structure, performance criteria and performance results to the public. Indeed, donors can also promote positive incentives for funds to increase transparency, through publicity, connections with new investors and opportunities, and other means. Moreover, development partners can do more to share best practices (and failures) as well as data collected and analysed. Funds supported by public contributions also should be evaluated regularly and these evaluations should be made public.
- *Fill the pipeline:* Using their field offices and contracted projects, TA units and accelerators, development agencies can work with impact investors, DFIs and others to not only identify bankable, higher impact businesses in which to invest, but also use business support and market development programmes to bring many more enterprises and projects, from a variety of sectors, to investment-ready status. If there are problems of insufficient or inaccurate information, engagement by donors with local business networks and sector experts can help address such challenges.

- *Support research:* Donors can commission research on issues critical to the growth and effectiveness of innovative finance and impact investing. Among an array of issues that deserve detailed study are: cross-fund comparative research on the set-up and operating costs of high-impact, scaled funds; cross-fund analysis of how much of an orientation to poverty, risk and complexity is possible when the private sector is involved in development financing; comparative experience in the use of different financial products across diverse geographies and sectors; needs assessment of the professional skills fund managers require to manage impact and return; what criteria are applied by different investor types to front-end and exit phase decisions; case studies aimed at understanding investee success or failure in high-impact sectors and communities; and field-based research examining the links between impact investments and development outcomes within the framework of the SDGs.
- *Make Africa the priority:* Finally, there is a strong case for development agencies making Sub-Saharan Africa the main priority in all of their efforts in helping to mobilise and deploy private capital for sustainable development. More and larger impact funds and vehicles based in the region, especially those that are locally owned, are essential to successful SDG implementation in Africa. So are more and larger locally owned *enterprises* with a social or green mission that are investment-ready. And national impact investing eco-systems – supporting asset owners, asset managers, investees and service providers – require capacity building through multi-year grant-funding and long-term accompaniment.

5.3 The task of field-building

The complex front-end work of structuring deals and mobilising capital, and then deploying that capital, takes place at the level of individual investments or investment funds. These tasks are challenging enough and require much expertise, resilience and effort. However, it is also essential to build strong eco-systems for impact investing at the national level. And creating an enabling policy environment is an important part of this work.

The field-building process in impact investing is neither simple nor easy in the developing world. Indeed, there are challenging North-South asymmetries not only of information but of power and influence among the key players. And, while dynamic and innovative, Southern impact investing eco-systems remain fragmented and under-developed. What is required, in fact, is long-term accompaniment. Building the impact investing industry is a long-term project, not a short-term one; it is a marathon, not a sprint. Multi-year grant funding for local networks, research and policy advocacy by foundations, governments and donor agencies has the capacity to provide this long-term accompaniment. Investment funds can contribute, but must devote the bulk of their resources to constructing and maintaining a successful portfolio.

Considering the cases of specific countries is useful. Two instructive examples are South Africa and Ghana. In South Africa, there appears to be the basis of an impact investing field that has some momentum and critical mass. However, the problems there include fragmentation, competition, and a weakly supported network. In Ghana, a fundamental challenge is lack of critical mass; the numbers of actors in the impact investing field in that country are relatively small, as are the funds themselves. In both countries, government is less connected to the industry than it could, or should, be.

Nonetheless, in both Ghana and South Africa, there are remarkable champions, dynamic funds, and innovative tools for deal structuring and impact assessment. There are committed service providers, such as consultants and universities. And, although both countries face a serious issue of income inequality, they also have wealthy elites and a solid middle class to fund solutions to this problem, through taxes, business growth and other means. In short, there is much to build on for donor agencies, foundations and other actors seeking to contribute to national field-building efforts. Annex K profiles field-building issues and opportunities in Ghana and South Africa.

5.4 Conclusion

Overall, from the literature examined here, the sample of funds and vehicles reviewed, and the experts consulted, it is clear that the nexus of impact investing and blended finance holds considerable promise for mobilising and deploying private capital for sustainable development and for contributing in significant ways toward the achievement of the Sustainable Development Goals. While there are limits and complexities at this convergence point, there are also innovations and early successes that demonstrate not just potential but real, tangible results. Donor agencies and their allies in sustainable development now have an opportunity to continue to scale these funds and vehicles, monitor and evaluate them systemically – expecting failure and surprises as well as ingenuity and success – and to accompany and animate this important work over the next 15 years.

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