„Creating Impact for Impact Investing“
Summary of Findings, Feb 2016

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Ashoka and McKinsey&Company joined forces to provide an reality check on a market phenomenon that has captured not only the agenda of circles of power including the G8 and Davos but also the imagination of the financial industry: impact investing. Bringing a much needed fresh perspective and new vision ("hybrid finance") to the discussion, this report starts from insights into the reality of social entrepreneurs (the neglected demand side of the market) as well as rigorous analysis of the market failures still dominating the ecosystem - and draws a roadmap towards a €50bn collaborative market that works not only for investors but for the good of all.

1. The huge promise

It sounds compelling: Many social problems can be solved my market mechanisms. The social entrepreneurs behind such solutions have risen from obscurity to dominant trend in the citizen sector and philanthropy across Europe. Solving social problems at scale while using markets to create the necessary inputs not only sounds good, it has also proven to work in many cases. Whereas the field has enjoyed early support from leading individual „venture“ philanthropists, there is now a tide of support from governments across Europe competing around social innovation strategies. Even businesses are beginning to invest in social innovation as predictors of future markets (see this Harvard Business Manager article based on another Ashoka/McKinsey study).

With social entrepreneurship maturing quickly, the financial industry has started to take notice - especially in the face of an abundance of capital in the financial markets looking for returns beyond paltry interest rates. Predictions indicating that there could be a market as big as $60bn today or even $1trn by 2020 have spurred many reports and events by private banks, researchers, and former investors-turned-dogooders. What could be better than the promise of revenues, reputation and redemption at the same time?

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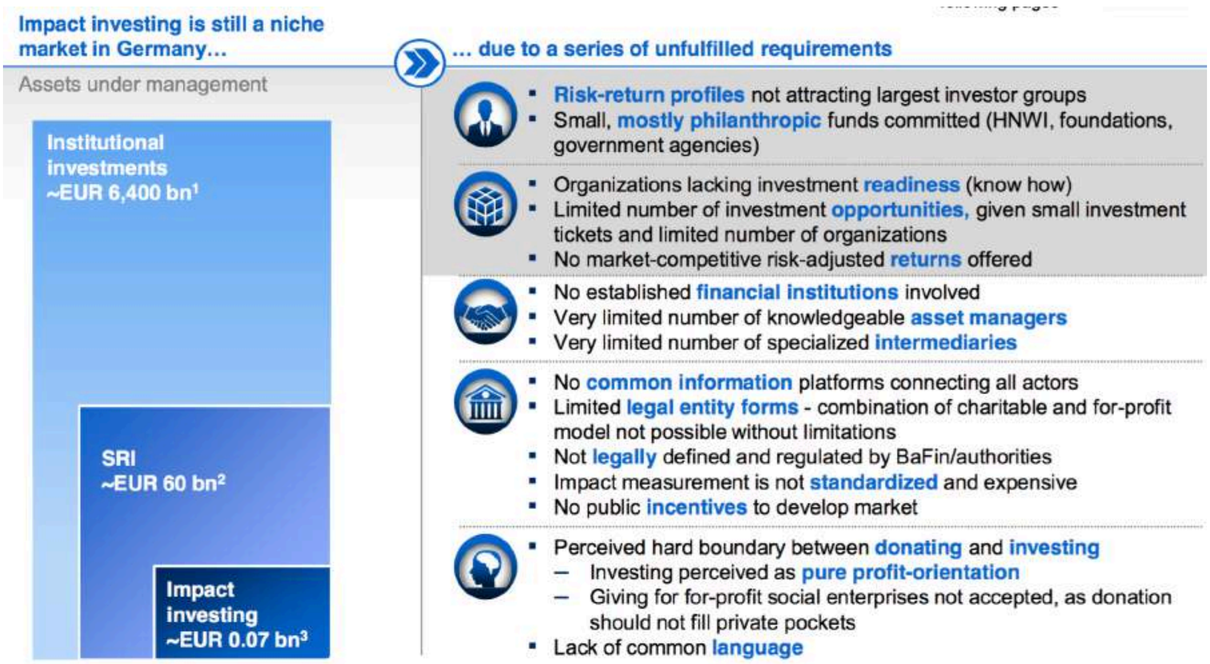
2. The sobering reality

The reality, though, is very different. A recent Bertelsmann Foundation study revealed the total assets invested in so-called impact investments to be only €70m in Germany. Even though the market is in an early stage, both size and trajectory are disappointing at one tenth of one percent of the socially responsible investment market, which in turn is only one percent of institutional investments.

Not more than €5m per year actually flow to social entrepreneurs. Compared to their other income flows, the promised new inflow of funding (unrestricted, in contrast to most government of foundation money) looks more like a drizzle.



1 Total financial assets of institutions in 2014, excluding intangible assets and short term assets (estimation by McKinsey Global Growth Cube)
2 Sustainable investments and mandates, AuM in 2014 (estimation by FNG Marktbericht Nachhaltige Geldanlage 2015)
3 German impact investing funds and deals primarily invested in Germany in 2015, foundations not registered (own estimation)

Social entrepreneurship experts now fear that the lack of good examples may cause investors to lose interest. In an even worse scenario, social entrepreneurs could change their existing business models to make themselves more attractive for impact investors, compromising on impact for their beneficiaries or even alienating existing philanthropic supporters in return - in the hope of tapping into impact investment funds that do not exist or are too expensive for them. In the worst scenario, opportunistic intermediaries could misuse the label "impact investing“ to repackage investments without any positive social impact.

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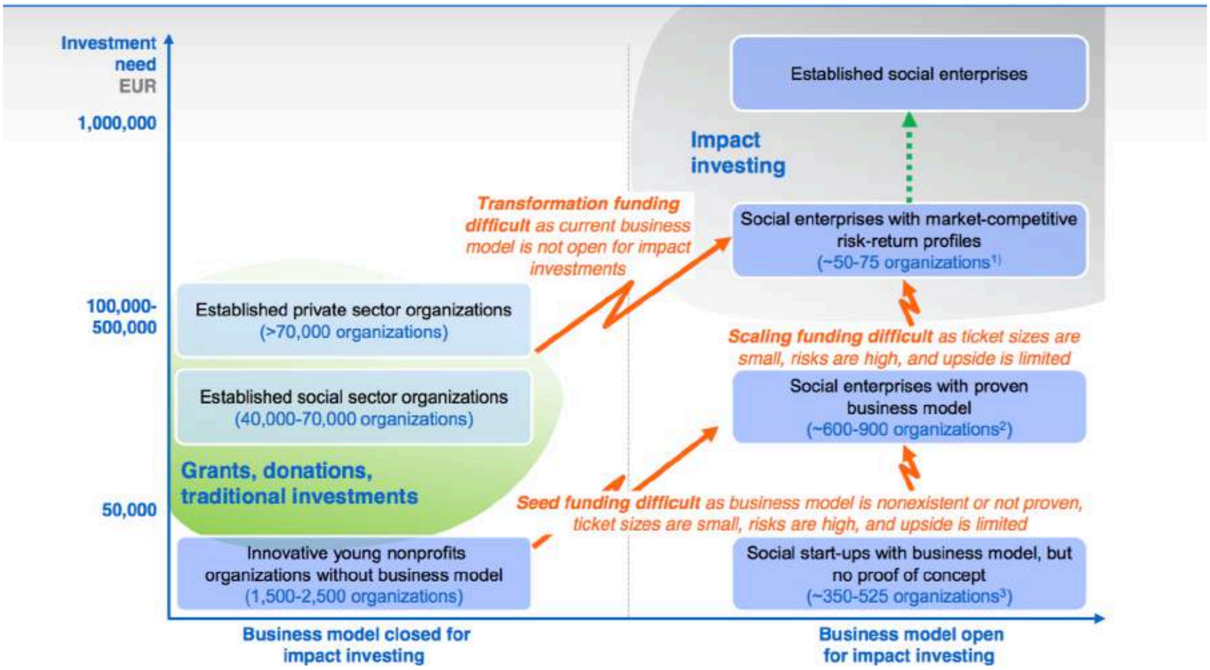
3. The broken pipeline

What is the reason for this market failure? An in-depth study of supply and demand undertaken by Ashoka and McKinsey&Company reveals a complex network of mostly broken market connections, or pipelines.

In a functioning market, financing options exist for every stage of the business life cycle. In social entrepreneurship financing, in contrast, many social purpose organisations with potential to break even or turn small profits face a broken pipeline (sometimes referred to as „valley of death“) early on in their growth. Funding above €100,000 and below €500,000 is very rarely available for them, resulting in stagnating development or worse as philanthropic funders prefer to fund only in pilot stages. Additional reasons for the lack of deals include a lack of investment readiness on the part of social entrepreneurs, and a scarcity of financial intermediaries bringing together different worlds.

In order for the market to grow exponentially, however, it will also have to look beyond social entrepreneurs, and build bridges for the far larger networks of welfare service delivery organisations, and help larger NGOs and charities in their quest to develop additional, sustainable funding sources.



1 ~5% of 1,000-1,500 revenue-based social enterprises (rough estimate) 2 ~60% of 1,000-1,500 revenue-based social enterprises (rough estimate)
3 ~35% of 1,000-1,500 revenue-based social enterprises (rough estimate)

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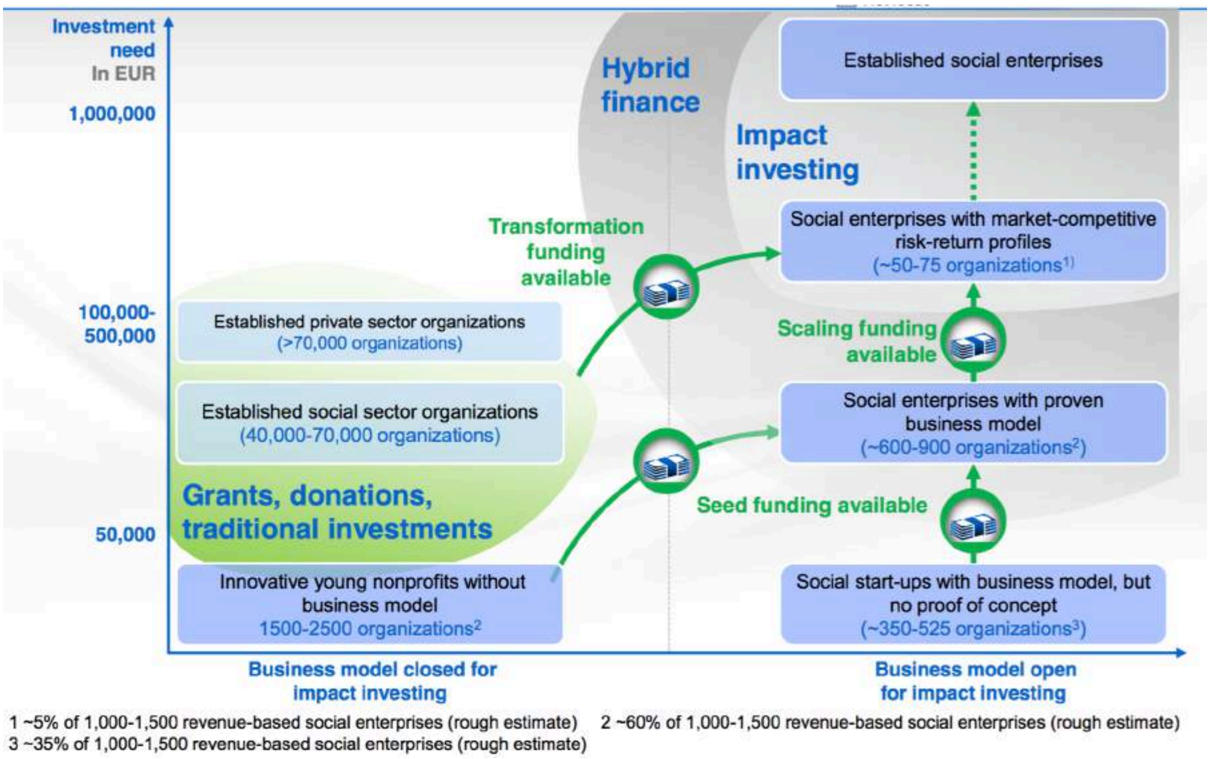
4. The hybrid market

If the challenge, then, is to fill the gaps between the dominating paradigms of grants and subsidies on the one end, and impact investing on the other, the solution is not one single new instrument or intermediary. The challenge lies in the fundamental assumptions of what used to be fields without any connection to each other: No investor wants to lose money, and no donor expects to see any of his money again. That space in between, however, is where many emerging social markets and transformational business models exist.

Most complex projects like, say, a new power plant, are not financed by one source of money but by puzzling together several sources of money with often quite different risk-return-profiles. A pension fund may be invested with a low risk and low return, a venture capitalist with a much higher return for his higher risk, while a public authority provides a guarantee and is happy to lose money for a different kind of benefit. This practice is called syndication, and it has been great business for banks and other intermediaries for more than a century.

And syndication is how to fix the broken pipelines that prevent the growth of many ideas with huge potential for market-based social solutions. By combining philanthropic (and government) funds with return-seeking investments, instruments could be tailored to the needs and abilities of organisation solving social problems, and help them grow to scale. According to the Ashoka/McKinsey research, this approach could actually deliver on the promise of multiplying the funding available AND invested.



5. The roadmap towards a €50bn market for the good of all

The key to fulfilling the promise of impact investing thus lies not with investors but with additional players in the market, first of all the most flexible ones: philanthropists. Foundations and individual donors now need to enter the game in their own, unique way, and think of investing as donating with a full or partial return. In effect, by using grants (and in some cases part of the endowment) as puzzle pieces that can be combined in creative ways, they could deploy a broad range of financial instruments covering the full spectrum of financial returns from -100% all the way up to positive returns - and bridge the „valley of death“ as well as other barriers of funding.

Doing so helps them solve three challenges: First, most grantees come back for the same money after funding ends. Using investments where possible can nudge them towards developing earned income streams and ultimately reduce financial dependency on grant makers. Secondly, foundations can spend (parts of) every Euro multiple times, and increase their portfolio even in times of low market returns. Thirdly, using both grant making and investing and everything in between replaces the one-to-one relationship of a foundation and its grantee with a more collaborative network of players that can also syndicate funding in later, far bigger rounds of investment.

The full set of roadmap recommendations goes beyond philanthropic players like foundations and individual donors. A functioning social financial market will require government financial intermediaries like the Financing Agency for Social Entrepreneurship (www.fa-se.eu) and many more. Together, they must not blindly follow the example of anglo-american markets with a completely different setup but implement a specifically German roadmap that for the first time includes only investors and investees but looks to gradually develop foundations, banks, government, intermediaries, and even the crowd as investors.

A fully functioning hybrid market, Ashoka and McKinsey estimate, would be worth at least €50bn in Germany by the time the roadmap is implemented. This vision may come with many „if“s but it will actually work not only for the good of investors but for the good of all.