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Impact Investment: A New Concept in SME Financing

Globally, innovative models are being explored to provide better funding alternatives to SMEs; one of them is Impact Investment. These investments are made into SME companies / organizations / funds with the purpose to produce quantifiable social and environmental impact alongside a financial return. The impact investors here target a range of returns - from well below the market up to market rate, depending upon the business model of the issuer. There are certain bodies and associations working for effective impact investing by building critical infrastructure and developing activities, education, and research that attract more investment capital to poverty alleviation and environmental solutions.

Importance of SMEs in Social sector

Social sector is an inseparable element of any economy. As per the Economic Survey of India for 2012-13, community, social and personal services contributed 14.3% to Indian GDP with CAGR of more than 7% for the last five years. Many NGOs, trusts,

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proprietorship firms and companies are present in the social sector, which are mainly dominated by SME segment. India is estimated to have had around 3.3 million NGOs in 2009, just over one NGO per 400 Indians, and many times the number of primary schools and primary health centers in India. These SME entities including NGOs also provide infrastructure services to rural areas, education and healthcare services. The main source of fund for these entities has been government assistance and PSUs.

Hitherto, non-tradable services including those in the government and social sectors are becoming domestically tradable. This really supports the new concept of impact investment as one of the new funding alternative for these SMEs.

Concept development

Social entrepreneurship and impact investing are rapidly growing fields, not only in Asia but also globally. Both are relatively new fields. In fact, "impact investing" is not a term

one would have heard 5 years ago. Part of the reason for the accelerated growth in these fields is a realization that, especially in these times of fiscal austerity in many parts of the world, there is simply not enough philanthropic and government spending to address the world's most pressing issues. At the same time, there is a growing realization that the best way to address certain development issues is to harness the power of the private sector.

The persistence of poverty and its related challenges, rising inequality and mounting environmental concerns, coupled with a willingness to try new tools to address these concerns is what led to the development of the impact investing sector.

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Bonds may be issued by for-profit Social Enterprises, which will pay interest and principal on the bonds from the profits generated in their businesses, as well as by not-for-profit Social Enterprises with income streams that provide a source for repayment of the bonds. Participating Social Enterprises can access a new source of capital to fund expansion, potentially at lower cost than other financing sources. Investors can expect to receive an economic return – through receipt of interest and eventual return of their principal – as well as social/environmental returns.



business, etc. Impact investors are generally seeking investments that create positive social and environmental impact beyond financial return. e.g. social VC funds, microfinance investment vehicles, pension funds, mutual fund managers, institutional fund managers, sovereign wealth funds, endowments/family foundations, etc. All the transactions are routed through this Impact Exchange.

Modes of investment

The impact investments can be in the form of private equity, loans, mezzanine finance etc. These investments can be made directly in the instrument or through funds or third party managers/advisors, etc.

Shares

For-profit, Social Enterprises can access equity capital through offerings of shares on Impact Exchange. Investors can expect to receive an economic return through dividends (and potentially capital appreciation),

as well as social returns, represented by the increased social impact generated by virtue of the investment.

Participating Social Enterprises will gain access to a source of equity capital to fund expansion at a valuation that should reflect both the economic and social/environmental values of their businesses.

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Building social capital infrastructure

In order to build an effective social capital infrastructure, the following four elements needs focus. The first element would be platforms that connect SEs in search of capital and impact investors in search of strong projects to fund i.e. an Impact Exchange. Secondly, it also includes creating the impact assessment tools that help SEs measure and communicate their social and environmental impact to investors. Thirdly, we need to build a database about the sector. Fourthly, a detailed regulatory framework should be in place to prevent misuse of invested capital.

Stock Exchange

An Impact Exchange has to be established with clear listing criteria to promote and reward the best social purpose businesses in an environment that ensures transparency and accountability for investors. Exchanges must have to utilize criteria typical of a traditional exchange – e.g. corporate governance, accounting standards, operating track record, and financial performance and add requirements to limit inclusion to companies with core social or environmental missions and ensure that listed Social Enterprises do deliver a double – (financial and social) or triple – (financial, social and environmental) bottom line return.

Impact Reporting and Investment Standards (IRIS)

IRIS is a set of metrics that can be used to describe an organization's social, environmental, and financial performance. IRIS is designed to address a major barrier to the growth of the impact investing industry - the lack of transparency, credibility, and consistency in how organizations and investors define, measure, and track their performance. The IRIS initiative has three main components: (1) developing and refining IRIS; (2) increasing accessibility of IRIS promoting IRIS use; and (3) encouraging voluntary contribution of self-reported, anonymous IRIS performance data to provide additional

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market intelligence.

By using IRIS to track social, environmental, and financial performance, a wide range of investors and organizations can communicate their social, environmental, and financial performance using the same terms and definitions. This consistency helps investors evaluate and compare performance for more accurate assessment and comparison, and helps portfolio organizations track and improve their business and social performance.



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Data

Impact Exchange need to offer a market data feed on Social Enterprises and players in the ecosystem to key news services, as well as to other interested parties and investors. This information will be vital to the Impact Investors, research firms, brokerage firms and others who will stimulate transactions on the exchange.

Global initiatives

Prof. Shahnaz is the founder of this concept and has actually implemented it in reality. After selling her business, she returned to Singapore from USA and began exploring the notion of creating a stock exchange for SEs that would eliminate many of the barriers to market opportunity that currently exist and help them scale to their full potential. While the idea was in its very early conception, the Rockefeller Foundation came across her writings on the topic and promptly became the first organization to support the creation of the first of its kind, Impact Investment Exchange Asia (IIX).

IIX's work is also supported by the

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Rockefeller Foundation, the Asian Development Bank (ADB) and the Economic Development Board of Singapore (EDB). Like a traditional stock exchange, Impact Exchange will provide liquidity to investors by supporting listing, trading, clearing and settlement of securities, issued by social enterprises. IIX anticipates launching Impact Exchange in second half of 2013. Once operational, Impact Exchange will allow investors to purchase and trade shares issued by for-profit Social Enterprises and bonds issued by either for-profit or not-for-profit Social Enterprises.

South Africa based advisory firm Nexii had been involved in creating Impact Exchange in that region and some regulatory material including development of IRIS. Recently, in a

collaborative move to strengthen and standardize the impact investing sector, Nexii announced transfer of its role in Impact Exchange to IIX. Also, with effect as from May 6 2013, IIX has taken over the cooperative management of Impact Exchange with the Stock Exchange of Mauritius (SEM). This Impact Exchange now aims at being a social stock exchange with significant global reach, from Africa to Asia, two regions in the most need of capital assistance for sustainable development.

Conclusion

Impact Exchange is a pioneering effort to use public markets for developing Social Enterprises through investment capital. As per an estimate by J.P. Morgan, there is an investment opportunity of approximately USD 400bn. to 1trillion over the next decade in housing, rural water delivery, maternal health, primary education, and financial services, where Impact Exchange can really make its impact. The initiative is good and efforts are really excellent as well as in the right direction. A speedy drive with regulatory support from various countries, including India, can boost one more source of finance for growing SMEs with impactful objective.

(D.R. Dogra, is MD & CEO, CARE Ratings)