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Impact investing: an opportunity for Latin America

Summary

Impact investing, a type of responsible investing, is a new and growing market. Impact investors seek financial returns and a measurable, beneficial social or environmental impact. Currently, most such investments happen in developed countries. If Latin American countries attract more of these investments, they will be able to increase the capital available to address social and environmental issues while developing local entrepreneurs and fund managers.

Introduction

An increasing number of investors are concerned with the long-term effects of their actions on the environment and on society in general. Long-term investors, for instance, are concerned with the effects of climate change and of social issues – such as inequality, corruption and mass migration – on their investments. Responsible investing is the investment management industry's answer to these concerns. There are various ways to invest responsibly: exclusionary screening; environmental, social and governance (ESG) integration; and, most recently, impact investing. Each one springs from different motivations and investment goals, so each one has a different approach. Impact investing is now gaining momentum. It is a way to deploy more capital to social and environmental issues and reduce the government's burden in these areas. Impact investing can attract more investments to Latin America, and it can be an effective instrument of long-term development and social change.

The most traditional responsible investing approach is 'exclusionary screening'. In this case, the investor instructs the asset manager not to invest in certain companies. Typical exclusions are companies that produce tobacco or weapons, or companies that have been involved in human rights violations, corruption or environmental damage. Divestment strategies fall into this category, and investors have tried to use them as agents of change. A common example of this strategy was the divestment from South African stocks during the apartheid years and, now, divestment from fossil fuels. The effectiveness of divestment as an agent of change or as a way of solving environmental and social issues is, however, the subject of an ongoing debate.

As a sort of corollary to the exclusionary screening and divestment strategies, investors have found ways to consider the social and environmental performance of their investments. A prominent example is the United Nations Principles of Responsible Investment (UN PRI). By signing the UN PRI, institutional investors and asset managers commit to incorporate ESG factors in their investment decision and ownership practices. Approximately 1,400 asset owners, investment managers and service providers representing US$59tn in assets under management have signed the UN PRI. The principles are voluntary and aspirational and are designed for large, diversified institutional investors that operate within a traditional fiduciary framework.[1] This approach helps identify those investments that have a better performance in ESG and helps investors identify and address problems in those areas in the investments that they already own. Integrating ESG in the investment process, an investor may choose to invest in a company that manufactures a certain product in a way that pollutes less than its competitors, even if it may be less profitable in the short term. Impact investments take this approach one step further. These are investments made into companies, organisations and funds with the intention to generate social and environmental impact alongside a financial return.

Impact investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending upon the circumstances.[2] For an impact investment to be successful, the impact goal of the investment has to be achieved and be measurable. For example, if the impact goal is to reduce blindness in a given community by developing a cheaper and simpler way of doing eye surgery, the managers will have to be able to show the investors the reduction in blindness in that community and provide a profit to the investor.

Common investment themes in impact investing are conservation, climate change, renewable energy, resource efficiency, infrastructure, food and agriculture, healthcare, education, financial inclusion and housing. These types of investments can be done in different ways. Some examples include: investments in financial institutions that invest in organisations with social or environmental objectives; bonds that raise capital for social or conservation enterprises; and private investment funds that invest in social impact enterprises or in real assets for conservation, sustainable forestry or agriculture.

To determine which investments to make in order to have an impact, it is important to understand the characteristics and needs of the location where the investment will take place. The themes can vary depending on whether the investment is in a developed economy or in an emerging market, or in an urban or a rural community. One of the main benefits of these types of investments is that by developing a market solution to social and environmental problems, they can be more efficient and self-sustaining than solutions provided by governments or charities. In many cases, the solutions developed through impact investing may be scalable and useful in other places with similar needs.

The size of the impact investment market is difficult to measure because it is quite new and there is not yet a consensus on what should be included in the market. A 2015 study by J P Morgan and the Global Impact Investing Network (GIIN) estimates that currently US$60bn is invested in impact investments; 63 per cent of it is managed by fund managers and 18 per cent by developmental financial institutions. Almost all of the assets (90 per cent) are managed by asset managers based in developed countries; 40 per cent of the investments are in North America and only 11 per cent in Latin America and the Caribbean.[3] The Organisation for Economic Co-operation and Development (OECD) estimates that impact investing's potential can be significant due to the growing interest among foundations, mainstream investors and the younger generations of high net worth individuals who are expected to direct nearly US$6tn towards social issues over the next 50 years.[4] A study by the Aspen Network of Development Entrepreneurs, the Latin American Private Equity & Venture Capital Association and LGT Impact Ventures (Latam Impact Study), reports that US$1.3bn was invested in 522 impact investment deals in 2014 and 2015, mostly in Mexico, Colombia and Brazil. The Latam Impact Study indicates that the top sectors for investment in that same period were financial inclusion, agriculture and health.[5]

In Latin America, multilateral organisations like the Multilateral Investment Fund (MIF), an affiliate of the Inter-American Bank, have been active impact investors through their investments in local venture capital funds. The MIF mission is to support development led by the private sector to benefit poor and low-income populations and help them access tools to increase their income. It provides capital to local venture capital fund managers to invest in companies in markets such as health, education, renewable energy, agribusiness, housing, and Fintech. A study on the impact of venture capital in Latin America found that venture capital-backed companies incentivise formalisation of employment; promote economic mobility through incremental raises in average salaries; and tend to be proactive in terms of social and environmental responsibility.[6]

Many of the challenges of impact investment result purely from its early stage and are common to developed and emerging economies. There are few managers with track records and the deals are often small. Thus, there is a small pipeline of deals, and these deals consequently have relatively high transaction costs, which reduce rates of return. The work of foundations and institutions such as the MIF in this area is therefore of great importance for developing this area of investment, because it helps emerging managers to develop a track record while working with reputable organisations and allowing them to gain credibility to raise future funds to make larger investments.

In addition, it is critical for the

development of impact investments as a mainstream investment sector to develop an effective way to measure the environmental or social outcome. Currently, Impact Reporting and Investment Standards (IRIS), B Impact Assessment (BIA) and Global Impact Investment Rating System (GIIRS) are among the most popular ones. IRIS metrics are designed to measure the social, environmental and financial performance of an investment.[7] The BIA is a tool to assess a company's overall social and environmental performance. Companies and funds that use the BIA can be recognised for their performance by electing to become a certified B Corporation or GIIRS rated.[8] The Latam Impact Study reports that impact investors in Latin America found that the most common challenge of impact measurement was the high cost and the limited resources to implement metrics.[9]

Another important factor for the development of this sector is to have an economic and legal environment that enables the success of these investments. On this point, developed market-oriented economies have an advantage because they have sophisticated financial markets and legal frameworks that help entrepreneurs in general. Emerging markets generally lack those legal and financial frameworks, and have additional challenges. These relate to property rights, weak legal enforcement, and difficulties with exiting and liquidating companies that failed. All of these can further limit the development of the sector. Some of these issues can be managed, however, by structuring the investment funds in foreign jurisdictions that have a more developed investment management industry, or by structuring investments in the local companies as convertible debt or subordinated debt, rather than equity.

Investments that generate economic and social and environmental returns are attracting a growing number of investors globally. Latin American countries have been receiving a small number of these, and there is a growing opportunity. An increase of these types of investments in the region can increase the amount of capital available to address environmental and social issues, and help develop solutions tailored to local needs by local entrepreneurs.

Notes

1 See www.unpri.org, accessed on 1 November 2016.
2 See https://thegiin.org, accessed on 1 November 2016.
3 Y A Saltuk, A Idrissi, A Bouri, A Mudaliar and H Schiff (2015), 'Eyes on the Horizon: The Impact Investor Survey', *Global Social Finance*, J P Morgan and the Global Impact Investing Network, 5, 23.
4 OECD (2015), 'Social Impact Investment: Building the Evidence Base', Preliminary Version, 17.
5 Aspen Network of Development Entrepreneurs, Latin American Private Equity & Venture Capital Association and LGT Impact Ventures (2016), 'The Impact Investing Landscape in Latin America', 8.
6 O H Farfan, S Garcia-Robles, R Granda and C Landsberger (2012), 'Venture Capital: Driving Development in Latin America'.
7 See https://iris.thegiin.org, accessed on 14 January 2016.
8 See https://iris.thegiin.org/b-impact-assessment-metrics, accessed on 14 January 2016.
9 Aspen et al, 47.