Leveraging Impact with Catalytic First-Loss Capital

By Amit Bouri and Abhilash Mudaliar

The article below is excerpted and condensed from an issue brief on catalytic first-loss capital published by the Global Impact Investing Network.

In the nascent but growing impact investment market, some investment opportunities that have strong potential for social or environmental impact are perceived as having high financial risk. While some are seen as not producing sufficient financial returns for their level of risk, others suffer from a lack of information or track record given the opportunity's novelty. Innovative credit enhancement, which is a common feature of traditional financial markets, can encourage the flow of capital to these investment opportunities by improving their risk–return profiles and thus incenting more investors to coinvest.

AN INNOVATIVE TOOL TO REDUCE RISK AND CATALYZE IMPACT

Catalytic first-loss capital (CFLC) is one particular credit enhancement tool that has gained prominence of late. Impact investors are experimenting with CFLC in innovative ways to reduce risk, advance social and environmental objectives using commercial capital and stimulate investment activity in new markets.

CFLC, which can be incorporated into a capital structure via a range of instruments, including grants, equity, subordinated debt and guarantees, is best defined by two key features. First, it is catalytic: By improving the recipient's (see Figure 1 for a strict definition of roles) risk-return profile, CFLC catalyzes the participation of investors that otherwise would not have participated. Second, it is purpose-driven: CFLC aims to channel commercial capital toward the achievement of certain social or environmental outcomes. In addition, often – though not always – the purpose can be to demonstrate the commercial viability of investing into a particular market.

> "Philanthropy must do what it does best: peel back the first layer of risk, and experiment where other sectors cannot, making development and commercial investment dollars more productive and less risky."[1]
>
> —Dr. Judith Rodin, president
> The Rockefeller Foundation

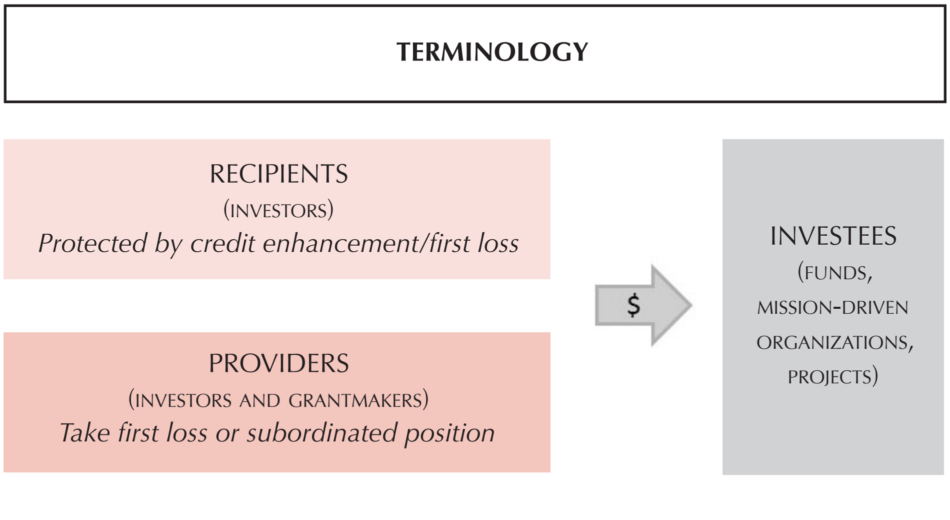
Providers are the chief protagonists of CFLC in impact investing: Their ability and willingness to offer protection to other investors are the most important factors in driving greater capital flows via such structures. Providers tend to be strongly aligned with the investee's social or environmental goals and theory of change. Additionally, they are willing to take on greater financial risk in return for driving toward target nonfinancial objectives. Given these characteristics, foundations are particularly well-positioned to play the role of CFLC provider.

BENEFITS FOR BOTH PROVIDERS AND RECIPIENTS

Providers and recipients both can benefit in various ways by participating in CFLC transactions.

The primary benefit for providers is that CFLC can enable them to leverage far greater volumes of capital to address target social or environmental challenges than they could mobilize on their own. To the extent that the opportunity is not seen to have potential to become commercially viable in the foreseeable future, continuous and ongoing credit enhancement will be required to maintain the inflow of commercial capital. In some cases, however, CFLC can help bridge information asymmetries and help develop new markets. Some investors, such as foundations and governments, often have considerable experience in certain sectors and regions where more risk-averse investors, such as banks or institutional investors, have limited experience. Investors unfamiliar with these markets may

FIGURE 1: RECIPIENTS AND PROVIDERS OF PROTECTION



believe investment risks to be greater than they actually are, and may thus be unwilling to invest.

A second benefit of CFLC, then, is to draw those investors into the market and demonstrate its financial viability: If the investment performance is sound, it can lead investors to alter their risk-return expectations and to subsequently reinvest in the same market with reduced, or potentially no, credit enhancement. By doing either or both of the above two – achieving leverage and demonstrating commercial viability – a third benefit for providers is that they can channel more of their own scarce capital toward other areas where the commercial case is less proven. Last, but not least, CFLC helps improve the terms at which investees can access capital.

For their part, recipients may benefit in a couple of ways. First, though they may be motivated by an investment's potential social or environmental impact, they may be subject to meeting specific risk–return bounds, including those imposed by fiduciary constraints. In the absence of credit enhancement, certain impact investment opportunities may fall outside these bounds. By reducing recipients' potential loss from an investment, CFLC improves the risk–return profile of an opportunity enough to incent or enable recipients to invest, thus expanding their universe of potential investment opportunities. Specific expertise that the provider may bring to the table – such as knowledge of the market or capabilities around impact measurement – can work to further reduce risk. Moreover, by investing with CFLC, recipients can gain first-mover knowledge of a new or nascent market, with the comfort of some downside protection.

It's important for providers to understand that it's often valuable, when trying to entice others to wade into uncharted waters, to present them with an opportunity to dip their toes first rather than requiring them to plunge right in. CFLC enables this in a very pragmatic way.

ADDRESSING CONCERNS PROACTIVELY

It should be noted that the term "first-loss capital" does carry some negative connotations. In some circles it is seen as "dumb money," i.e., money that is provided solely to improve a transaction's financial profile for other investors, without any discernible benefits for the provider. There also are moral hazard concerns: By providing first-loss am I encouraging potentially perverse risk-taking behavior? Finally, there is a concern that such subsidies might distort markets.

To proactively address these potential risks, providers should keep several important considerations in mind, both when structuring and then managing transactions that incorporate CFLC:

- **Clearly set expectations up front.** If the provider aims to catalyze or demonstrate a commercial market, it should communicate this and seek understanding that if the investment performs, the recipient will invest with less or potentially no loss protection in the future. Similarly, the provider should be prepared to make additional, though perhaps diminishing, commitments until the desired market development is achieved. By setting expectations up front, the provider can dissuade potential investors from predicating investment on CFLC support, as well as address the potential misperception that CFLC is necessary in the market, especially when no longer warranted.
- **Give careful consideration to structure.** Ideally, the amount of first-loss protection provided should be no greater than what is necessary to induce commercial capital to invest, i.e., the minimum sufficient to achieve desired goals. The objective is not to structure all the risk out of a particular investment. Ultimately, the level of CFLC protection in any given transaction will be a negotiated term derived from the natural tension between the provider's impact goals and budget and the recipient's risk-return objectives and mission-alignment. To the extent that parties are candid about their expectations and goals, a negotiated process will lead to determining the minimum amount of CFLC needed to complete the transaction. The current paucity of data on transactions incorporating CFLC in many sectors makes it difficult to create benchmarks, but more market data over time will certainly help to determine appropriate ranges in practice. The Global Impact Investing Network (GIIN) recently published a report on the use of CFLC in impact investing, which provides details on five varied transactions that incorporate CFLC in their structures.
- **Explore multi-layer investing.** Foundations are uniquely positioned to not just provide credit enhancement (using their PRI budgets) but also to invest in more senior positions through their endowment. By investing in multiple layers, a foundation can work to ensure alignment and balance (to the extent that they may diverge) among the incentives of different players in different layers.

All in all, CFLC presents as an attractive tool for foundations and commercial investors to partner to achieve financial and nonfinancial outcomes. ■

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Notes

1. Dr. Rodin's keynote address during the G8 Social Impact Investment Forum, held in London on June 6, 2013.

Investing to Protect the World's Climate

The following foundations have pledged to divest from fossil fuel companies and invest a portion of their assets in the clean energy economy under the Divest-Invest Philanthropy initiative:

Ben & Jerry's Foundation, Inc.

The Chorus Foundation

Compton Foundation

The Educational Foundation of America

Granary Foundation

Jessie Smith Noyes Foundation

The John Merck Fund

Joseph Rowntree Charitable Trust

KL Felicitas Foundation

Nia Community Foundation

Park Foundation, Inc.

The Russell Family Foundation

The Schmidt Family Foundation

The Sierra Club Foundation

Singing Field Foundation

Solidago Foundation

Wallace Global Fund

For more information, please visit http://www.divestinvest.org/philanthropy.