Bridging the Gap:

How Philanthropy Can Unlock Impact Investing

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Executive Summary

Impact investing holds great potential where philanthropy falls short—mobilizing the scale of financial resources needed to address the world's pressing problems. According to the Global Impact Investing Network (GIIN) total global impact investing assets in 2018 grew more than 50% from 2017. Yet, that growth is tiny relative to the overall investing marketplace—comprising only 4% of total socially responsible assets under management in the US, and only 1% of total US assets under management.[1]

Furthermore, there is evidence to suggest that assets committed for impact investment are largely sitting on the sidelines. For example, NatureVest's 2016 report—"The State of Private Investment in Conservation" —found that of the $8.2 billion committed to conservation, $3.1 billion was undeployed.[2] This is a real frustration considering what we know about the enormous need and urgency for those resources.

Building upon preliminary research presented by Namrita Kapur of Growald Family Fund during a September 2019 talk at Yale School of Management,[3] this report explores specific mechanisms and case studies to articulate and elevate potential roles for philanthropy to activate impact investing.

Drawing from interviews with key stakeholders and a literature review, the report outlines three primary avenues—financial tools, addressing structural gaps, and capacity building—through which philanthropy can serve to mitigate or resolve market failures that inhibit deployment of impact investing capital. In-depth cases on Root Capital and Encourage Capital illustrate how these strategies function in practice. It concludes with a series of recommendations for how efforts to leverage philanthropy to unlock impact investing could be scaled up: 1) actively foster communication; 2) broaden approach of endowments; 3) leverage philanthropy as risk capital; and 4) target resources for catalytic potential.

This report will be most helpful to organizations that seek to strategically deploy grant money that will create leverage in their impact investing portfolio. In fact, we believe a side benefit to this report may be facilitating stronger communication between grant makers and impact investors. It may also be of immediate relevance for conferences and networks that intend to unite both sides of the spectrum. The report's recommendations hold catalytic potential, but they will require communication and intentionality on behalf of these groups in order to rewrite the current status quo.

1 Mudaliar, Abhilash, Rachel Bass, and Hannah Dithrich. "2018 Annual Impact Investor Survey." Global Impact Investing Network. June 2018. https://thegiin.org/assets/2018_GIIN_Annual_Impact_Investor_Survey_webfile.pdf

2 JP Morgan Chase & Co., NatureVest, & The Nature Conservancy. "State of Private Investment in Conservation 2016: A Landscape Assessment of an Emerging Market." December 2016. https://www.nature.org/content/dam/tnc/nature/en/documents/state_of_private_ivestment_in_consrvation_2016.pdf

3 Kapur, Namrita. "Bridging the Gap from Philanthropy to Impact Investing." Presentation at Yale School of Management. 10 September 2019. https://cbey.yale.edu/event/bridging-the-gap-from-philanthropy-to-impact-investing

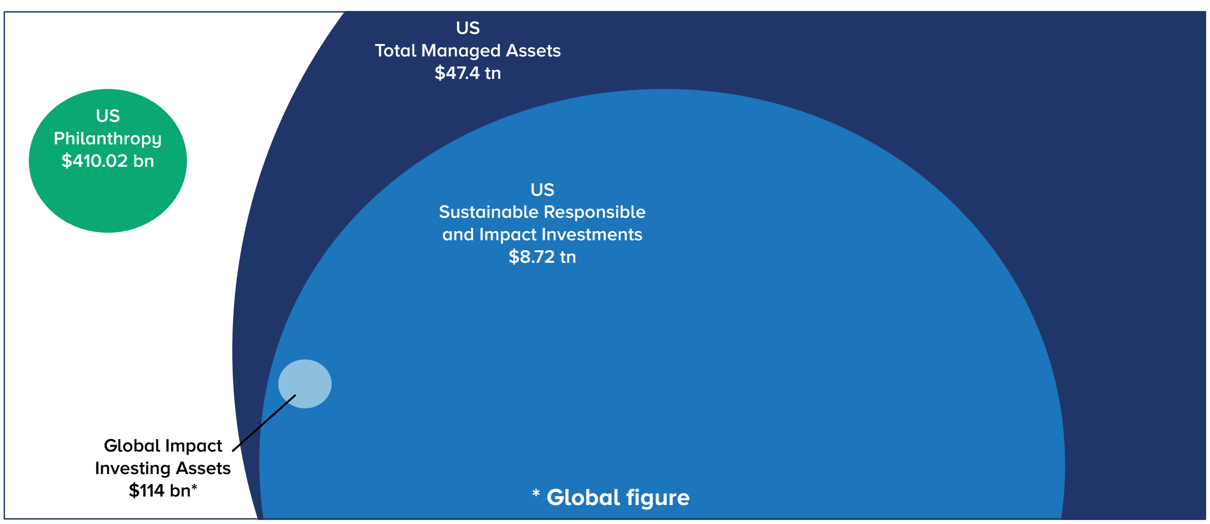
Identifying the Gap Between Impact Investing and Philanthropy

Philanthropic circles are buzzing about impact investing, which holds the potential to mobilize additional, high-impact resources to address the same issues that philanthropy targets. Yet, impact investing currently falls short of this promise. With rising urgency to deploy resources at the scale of society's problems, this report investigates if there is a role for philanthropy to accelerate the deployment of impact investing capital.

Impact investing is defined as investments made into companies and funds with the intention to generate a social and/or environmental impact alongside a financial return. The market covers a broad range of sectors, with the greatest share of impact investing capital allocated to financial services, energy, microfinance, housing, food & agriculture, infrastructure and healthcare. This report highlights environmentally-related examples, but its takeaways are pertinent across sectors.

According to the Global Impact Investing Network (GIIN), total global impact investing assets in 2018 grew more than 50% from 2017.[4] This 2018 growth is still tiny relative to the overall marketplace, representing only 4% of total socially responsible assets under management in the US and only 1% of total US assets under management.[5] By way of comparison, US philanthropy still dwarfs impact investing, with over $410 billion in assets in 2018, as compared to $114 billion in global impact investing assets.

Figure 1. Scaling Pools of Capital: Impact Investing and Philanthropy



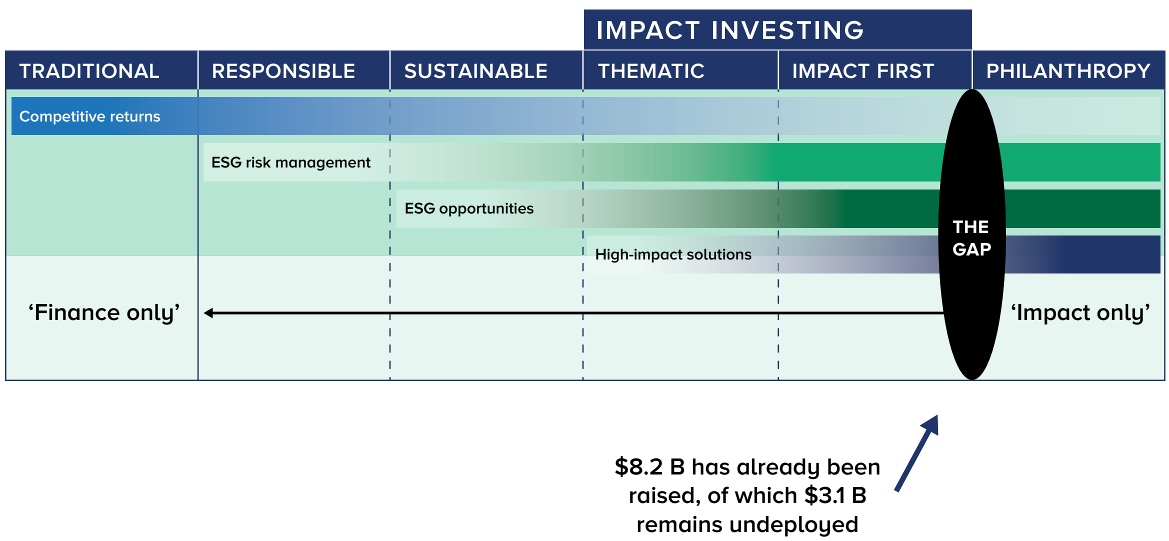
4 Mudaliar, Abhilash, Rachel Bass, and Hannah Dithrich. "2018 Annual Impact Investor Survey." Global Impact Investing Network. June 2018. https://thegiin.org/assets/2018_GIIN_Annual_Impact_Investor_Survey_webfile.pdf

5 Kelly, Jemima. "Global assets under management hit all-time high above $80 trillion." Reuters. 30 October 2017. https://www.reuters.com/article/us-global-funds-aum/global-assets-under-managment-hit-all-time-high-abve-80trillion-idUSKBN1CZ11B

Figure 2 lays out the spectrum of capital from traditional investments, focused on financial returns, to philanthropy, which is given away with the intention of yielding impact but no financial returns. Just beyond philanthropy are impact investments made with the intention to prioritize social and/or environmental impact while still achieving a financial return.

Focusing on the intersection of philanthropy and impact investing, some are concerned that not enough impact investing opportunities exist relative to the demand. As a result, money sits on the sidelines. For example, NatureVest's 2016 publication, "The State of Private Investment in Conservation," reported that of the $8.2 billion committed to conservation, $3.1 billion was undeployed.[6] This is a real frustration considering the enormous need and urgency for these resources. How do we address this gap?

Figure 2. The Spectrum of Capital from Traditional Investments to Philanthropy[7]



This gap between impact investing and philanthropy has traditionally been referred to as "venture philanthropy": an approach involving both financial and non-financial support with the goal of increasing societal impact. This means that venture philanthropy is interested in a longer time horizon for the organizations it supports and can offer more flexible forms of grant capital. It has the risk appetite and patience required to fund innovative business models and can offer hands-on non-financial support alongside grant capital. As a result of its longer time horizon, venture philanthropy is also open to providing seed funding for "proof of concept" and using its convening power to mobilize other funders.

Figure 3 contrasts key characteristics of impact investing and venture philanthropy. Unlike venture philanthropy, impact investing has a relatively lower tolerance for risk, expects financial returns on a shorter time horizon, is unlikely to provide non-financial support, and tends to support companies at a later stage of maturity.

6 JP Morgan Chase & Co., NatureVest, & The Nature Conservancy. "State of Private Investment in Conservation 2016: A Landscape Assessment of an Emerging Market." December 2016. https://www.nature.org/content/dam/tnc/nature/en/documents/state_of_private_ivestment_in_consrvation_2016.pdf

7 Adapted from Bridges Ventures. https://www.bridgesfundmanagement.com/us/

Figure 3. Key Characteristics of Impact Investing and Venture Philanthropy

	IMPACT INVESTING	VENTURE PHILANTHROPY
Expectation of Returns	Range of financial returns	No short-term expectation of financial return
Time Horizon	Typically shorter investment horizon	Interested in a longer-term horizon
Non-financial Support	Less hands on non-financial support	Can offer hands-on non-financial support alongside grant capital
Risk Tolerance	Lower tolerance for risky business models	Willing to fund innovative but potentially risky business models
Stage of Maturity	Greater stage of maturity	Can provide early stage seed funding for 'proof of concept'; uses convening power to mobilize other funders

RATIONALE AND OBJECTIVE OF THIS REPORT

This report considers 1) how philanthropy can be used to unlock resources already committed to impact investing; and 2) how to scale up use of philanthropic funds to realize the full potential of the impact investing movement. It builds upon preliminary research presented by Namrita Kapur of Growald Family Fund during a September 2019 talk at Yale School of Management.[8] It explores specific mechanisms and case studies to articulate and elevate potential roles for philanthropy to activate impact investing.

Research for this report was conducted by a two-student team affiliated with the Yale Center for Business and the Environment and supervised by Namrita Kapur. To assess current practices and move toward a solution, the student team conducted a literature review and interviewed a series of stakeholders to collect viewpoints on whether and how philanthropic grants have been catalytic in unlocking impact investing. The team also developed two detailed case studies illustrating specific mechanisms for how philanthropic funds can help to unlock impact investing in practice. The report concludes by raising recommendations for how to scale these current best practices to become less of an exception and more of the norm, with the intention of catalyzing deployment of impact investing funds.

8 Kapur, Namrita. "Bridging the Gap from Philanthropy to Impact Investing." Presentation at Yale School of Management. 10 September 2019. https://cbey.yale.edu/event/bridging-the-gap-from-philanthropy-to-impact-investing

This report will be most helpful to philanthropies and impact investors, as well as for facilitating communication between these two groups. It is particularly salient for those organizations that operate arms in both sectors, including foundations such as Ford, MacArthur, Packard, and Rockefeller, which are ideally positioned to begin moving the needle toward more intentional use of philanthropy to deploy impact investing funds. It will also be of immediate relevance for channels that are nodes for both philanthropy and impact investing, such as the Aspen Network of Development Entrepreneurs (ANDE), Skoll World Forum, and Social Capital Markets (SOCAP). The report's recommendations hold catalytic potential, but they will require communication and intentionality on behalf of philanthropy and impact investing groups in order to rewrite the current status quo.

Bridging the Gap: How Can Philanthropy Unlock Impact Investing?

Given that impact investing is designed to seek a return, why should philanthropy play a role in unlocking impact investing at all? We believe the answer centers on market failures, which are a recurring theme raised by those with experience at the intersection of philanthropy and impact investing.

Market failures result in an operating context where it is difficult for socially and environmentally-responsible businesses to generate a financial return. Examples of such market failures include minimal financial knowledge among business operators or clients due to limited public education resources, or a lack of regulatory structures to fully internalize environmental externalities, such as carbon pollution. Market failures erode the margins that investors might otherwise achieve and are thus a barrier for attracting impact investing capital. Philanthropy often focuses on addressing such barriers. We believe that impact investing will scale more quickly if philanthropy is more intentional about clearing away market failures that are directly linked to attracting private capital. Contributors stressed how sustainable business propositions generally aren't commercial or cost-competitive; how then can a proposition that has environmental value but doesn't yet pose a commercial return proposition be fixed?

Philanthropy, with its lack of expectations for financial returns and longer-term grant horizon, is ideally positioned to intervene when market failures make it difficult to invest return-seeking capital. The role of philanthropy can be both direct and indirect. For instance, philanthropic grants could directly fund capacity building to improve financial literacy, or fund NGO research and advocacy that indirectly influences policymakers to adopt legislation that properly prices externalities.

Drawing from the venture philanthropy model outlined above, we focus on three roles for philanthropy to mitigate or resolve market failures that we believe are most relevant to stimulating impact investing. In resonance with the collaboration between Toniic—a global angel investing impact investing network—and Shell Foundation, we divide our investigation into the following categories:[9]

- **Financial Tools:** Philanthropic donations can fund creative financial structures that mitigate risk for hesitant investors, thus paving the way to attract greater investment in impact funds.
- **Addressing Structural Gaps:** Conducting research, developing business plans, influencing regulations, and filling in gaps in basic science are all areas where foundations can support the infrastructure necessary to make loans work.
- **Capacity Building:** Donor-funded efforts to expand the skill sets and capacity of impact investing loan recipients can help to reduce the risk of defaults.

9 Toniic and Shell Foundation identify three categories of collaboration between venture philanthropists and impact investors: blended financing solutions, structural enhancement solutions, and ancillary solutions. The categories we identify largely map with these classifications. See Toniic Institute & Shell Foundation. "Venture Philanthropists & Impact Investors." June 2016. https://toniic.com/venture-philanthropists-and-impact-investors/

Below, we detail how each of these avenues functions in practice.

FINANCIAL TOOLS

Despite a willingness to forego financial returns in exchange for greater social and/or environmental impact, impact investors are still interested in mitigating financial risk. Enter the use of financial structures—like first-loss positions and guarantee facilities—which address these concerns These financial tools, which began receiving wider attention in impact investing about 20 years ago are a fairly tried and tested role for philanthropy to address risk and thus attract impact investment capital.

First-loss positions are an agreed-upon amount of capital earmarked to pay back first losses on a loan default. Grants are an ideal source of first-loss capital because they seek impact without a financial return. The longer the first-loss position is active, then the longer the grant is generating impact, as it is facilitating the deployment of an increasing amount of funding. Guarantee facilities are another financial tool that operates through a similar logic but a slightly different mechanism.

Philanthropy provides an ideal source for such catalytic capital because grant funds do not expect financial returns. Using grant funds to mitigate risk for investors can pose transformative results when a small grant enables deployment of a large-scale impact investment. One example of an organization attempting to scale such financial tools is the Nonprofit Finance Fund (NFF), which pre-raises philanthropic equity up front based on compelling strategic impact plans. Yet, at present, it is a relatively small universe of philanthropic actors who actively seek out opportunities to provide such structural financial solutions. Part of the reason for this low interest is the difficulty in measuring and articulating impact. Hence, more focus is needed in measuring and articulating the impact related to the results of the impact investing funds mobilized. Furthermore, smaller foundations don't necessarily have the in-house expertise to structure these financial tools. To address this, mechanisms such as collaborative guarantee pools would be helpful.

Case Example: Financial Tools	
DFID Department for International Development UK's Department for International Development (DFID) Impact Fund	DFID's Impact Fund provided a 20% first-loss reserve facility to private impact investors (investing as part of the Insistor Impact Asia Fund) that were investing in start-up social businesses working to improve the lives of low-income families in rural communities in Cambodia, Myanmar, India and Pakistan. By providing this investment applicable to potential losses, DFID was able to catalyze significant private sector capital and have a multiplier effect.

ADDRESSING STRUCTURAL GAPS

The structural gaps currently preventing philanthropy from unlocking further investment for their recipients include policy regulation, limited impact measurement metrics and capital availability among others.

Funder collaboratives are a promising approach among the solutions that have been researched to solve structural funding limitations, albeit with a few qualifying criteria. As per a study conducted by the Bridgespan Group, most funders and grantees report that the overall benefits from collaboratives are positive. For the grantees, however, these collaboratives sometimes fail to provide expected access to funders, long-term funding and bigger quanta of capital. Such obstacles can be overcome in collaboratives that streamline reporting requirements, actively promote the grantees and facilitate collaboration between funders and recipients.[10] When implemented well, collaboratives can drive powerful results, greater than those created by individual participants. Such successful implementation was found to center on a primary investment thesis, aimed at a specific organization, field or measurable target.[11]

Sector experts validated the importance of collaboration in interviews. Both Dan Crisafulli, the Managing Director at Potrero Impact Advisors and former Director of Investments at Skoll Foundation, and Vikas Mehta, Portfolio Director at Growald Family Fund, highlighted the lack of knowledge sharing that takes place between investing and grant-making. According to Dan, “Few foundations are able to bridge this gap and truly integrate the full set of tools available to create change and thus maximize resources deployed toward the foundation’s charitable purpose.” This lack of communication can also stem in part from inherent cultural biases against the private sector. There exists a notion of philanthropy needing to be separate from wealth creation.[12] However, the conflict in this idea stems from the fact that philanthropic giving, by definition, begins with wealth. This idea of addressing structural gaps is discussed in detail in our case study on Encourage Capital in the next section.

CAPACITY BUILDING

A third means by which grant funding can play a transformative role in unlocking impact investing is through capacity building. One example of capacity building to address a market failure is financial education and training for borrowers who lack basic business concepts. For instance, Root Capital, which invests in agricultural businesses across the developing world, provides financial education and training to its target populations, in addition to financial support. Root Capital found that many of its borrowers needed training on financial literacy to efficiently access capital to grow their businesses. Root Capital was able to make

10 Powell, Alison, and Susan Wolf Ditkoff. “Are Funder Collaboratives Valuable? A Research Study.” The Bridgespan Group. July 2019. https://www.bridgespan.org/insights/library/philanthropy/how-philanthropic-collaborations-succeed-nd-fail

11 Powell, Alison, Susan Wolf Ditkoff, and Fay Twersky. “How Philanthropic Collaborations Succeed, and Why They Fail.” Stanford Social Innovation Review. July 2019. https://ssir.org/articles/entry/how_philanthropic_collaborations_succeed_and_why_they_fail

12 Interview with Shilpa Patel, Climate Works, November 2019

an effective case to philanthropists on running a financial education training program—work that was happening anyway as part of the lending process and thus adding to the cost of providing a loan, limiting Root Capital's ability to cover its costs from interest earned.

This focus on capacity building has also been part of how microfinance evolved as a profitable impact investing area. Philanthropically-funded efforts in microfinance focusing on creating peer lending circles and financial literacy of stakeholder communities as well as other types of infrastructure played an important role in the financial success and exponential access to credit for stakeholder communities. With philanthropic resources addressing this public good issue, microfinancing institutions could efficiently address the market failure, attracting private investors and eventually some becoming publicly-traded entities. Although the transition of these microfinance institutions from non-profits to profit-seeking entities is considered by some to be controversial, it nevertheless demonstrates how capacity building can bolster growth, profitability and impact.

Case Examples: Capacity Building	
Compartamos	Compartamos was founded as a nonprofit in Mexico in 1990 with the aim of alleviating poverty through micro-loans to small businesses, especially women. Part of its strategy involved lending to groups of between 12 to 50 women. Leveraging lending circles enabled Compartamos to facilitate capacity building that helped borrowers to grow their businesses faster and better manage financial risk. The nonprofit became for-profit in 2001, and eventually, it made an initial-public offering in 2007, reaching a valuation of 1.5B.[13] Compartamos' IPO, which was facilitated by capacity building that provided ready access to capital for more borrowers, ultimately opened up a significantly more capital in the microfinance space.
SKS Microfinance	SKS[14] was founded in India in 1997 to provide financial services to the poor in order to help alleviate poverty among borrowers. Its lending arm, SKS Microfinance, adopted the Joint Liability Group (JLG) model, where group lending to five individuals at a time helped allow "social collateral" to plug market failures and for borrowers to receive capacity building and to learn from their fellow borrowers. SKS Microfinance became a for-profit entity in 2003, after which it subsequently began attracting equity investments from major venture capitalists such as Sequoia Capital and Sandstone Capital. SKS had an IPO in 2010,[15] providing similar benefits to Compartamos' IPO by generating a much larger scale of capital for microfinance in India.

13 Simon, Morgan. "Can Impact Investing Avoid the Failures of Microfinance?" Harvard Business Review. 8 June 2018. https://hbr.org/2018/06/can-impact-investing-avoid-the-failures-of-microfinance,

14 SKS contained four arms: SKS Foundation, SKS Education, SKS Microfinance, and SKS Technologies. SKS Microfinance has been renamed to Bharat Financial Inclusion since 2016.

15 Ibid.

Case Studies

A variety of literature attempts to characterize the nature of collaboration between venture philanthropy and impact investing. However, there are few detailed case studies that discuss key strategies for success and what challenges remain to scaling up best practices. We focused our research on fleshing out the details of two relevant cases: Root Capital and Encourage Capital. While these cases primarily map with two out of the three categories identified by which philanthropy can address market failures—financial tools and addressing structural gaps—both cases also yield broader takeaways for how philanthropy can help to address market failures that impede impact investment. They also shed insight on how to scale up the role of philanthropy in unlocking impact investing.

FINANCIAL TOOLS: ROOT CAPITAL

Root Capital was founded in 1999 with the mission of "investing in the growth of agricultural enterprises so they become engines of impact that transform rural communities." Root Capital focuses on the "missing middle" between microfinance and commercial lenders. Its lending targets agricultural businesses sourcing from small-scale farmers in sub-Saharan Africa, Latin America, and Southeast Asia.

Initial Challenge

Root Capital concentrates its lending in the most economically and environmentally vulnerable communities. Its loans to farmer cooperatives and other companies aim to connect anywhere from a handful to tens of thousands of farmers to export markets. Root Capital's portfolio holdings, therefore, require a high degree of balance to function properly, with a number of big loans evened out by a long tail of smaller loans to earlier-stage businesses with high potential but greater risk.

To maintain its focus on hyper-blended risk capital, an important growth driver for Root Capital's business model is its ability to attract investment capital into its funding pool. Root Capital leverages contributions from a range of public and private investors, as well as philanthropic sources. Investment capital plays a vital role in enabling Root Capital the resources to provide its loans, which generally range from around $200,000 to $2 million. In turn, the money coming from foundations and other philanthropic sources is indispensable for its function in enabling investors the financial risk mitigation assurance they require to be willing to invest capital in Root Capital.

Both pools of capital—investment and philanthropic—are difficult to raise for different reasons. On one hand, investors are hesitant to invest if there is a perception of high risk that they will not be able to get their capital repaid. On the flip side, very few philanthropies actively make grants for this purpose, such as funding first-loss positions or guarantee facilities. Few metrics exist to track the impact of these grants, which foundations often feel would be better placed directly toward funding programmatic work out in the field.

Solution

To resolve the above challenges, Root Capital has adopted two corresponding approaches: 1) leveraging philanthropic capital to guarantee repayments to investors; and 2) developing frameworks to measure the impact that philanthropic capital has in unlocking impact investing.

In terms of the former, one specific case is Starbucks, a corporate investor in Root Capital. Starbucks' investment aims to help coffee cooperatives access finance that they would otherwise find difficult to procure. Starbucks sees the value of its investment as helping to guarantee not only the sustainability but also the overall security and consistency of its supply chain, which is crucial for the company to grow its business. Part of this is a broader push by Starbucks to improve and grow its sustainability programs for coffee supply chain management. For example, it also issued the first U.S. corporate sustainability bond for $500 million in May 2016.[16]

Starbucks' willingness to invest was in large part made possible by philanthropy covering Starbucks' risk, should a default occur, through the use of a first-loss position. Root Capital fully intends to create a replicable operating model: Starbucks' investment and Root Capital's use of philanthropically-funded financing mechanisms have paved the way for other corporations to make similar investments in Root Capital.

It should be noted that philanthropy also helps to support Root Capital's operating costs. According to founder Willy Foote, "The debt capital we raise gives a very small return of 1–2%. It will return that not on a wing and a prayer, but rather we've never defaulted, ever, on our notes program over 20 years. But there's no question that we wouldn't exist without philanthropy, and that the full budget isn't covered by lending." According to Foote, portfolio yield covers a majority of lending costs, and then philanthropy covers the negative operating margin, or the "negative return sweet spot."

Root Capital has also developed a framework and tools to determine where philanthropy contributes the most to the impact objectives of the organization, its investors, and its donors. This technique, which was outlined by Root Capital's former Senior Director of Strategy and Impact, Mike McCreless, in a 2017 article in the *Stanford Social Innovation Review*,[17] takes traditional portfolio theory and adds in a third dimension of impact to create an "expected impact" rating for investments. The toolkit includes a method for rating the ex-ante financial, social and environmental (FSE) performance of Root Capital's loans.

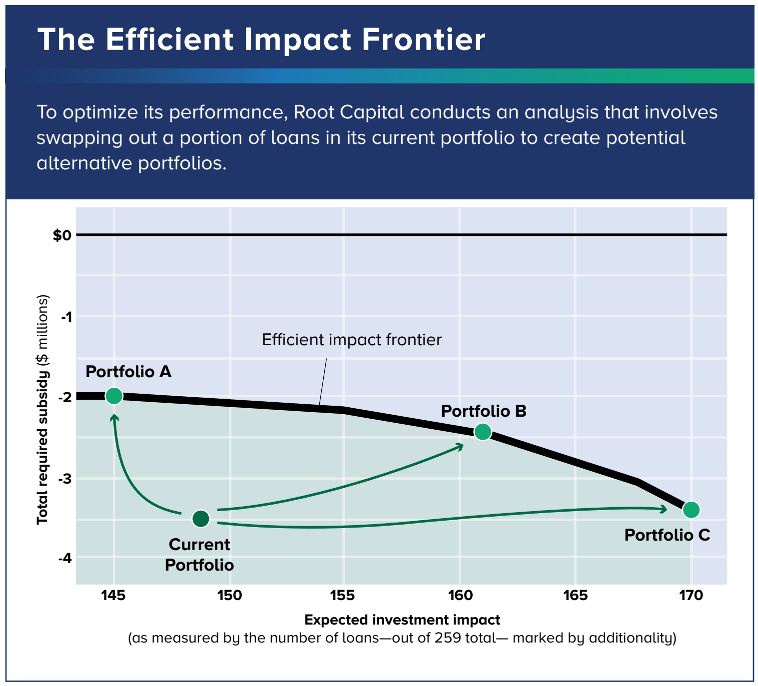
Root Capital also extends this impact-oriented variation on traditional portfolio theory to another financial concept: the efficient frontier. In the same article in the *Stanford Social Innovation Review*, McCreless describes how an investor might compare the expected impact relative to the expected risk-adjusted-return

16 Foote, Willy. "To Invest in the Future of Coffee, Starbucks Turns to the Capital Markets." Forbes. 23 May 2016. https://www.forbes.com/sites/willyfoote/2016/05/23/to-invest-in-the-future-of-coffe-starbucks-turns-to-the-capital-markets/#4ab677211740

17 McCreless, Michael. "Toward the Efficient Impact Frontier." Stanford Social Innovation Review. Winter 2017. https://ssir.org/articles/entry/toward_the_efficient_impact_frontier#

for a set of investment opportunities, resulting in an "efficient impact frontier." Illustrated below in Figure 4, the curve shows the efficient impact frontier where the highest level of overall impact is achieved relative to the cumulative financial return of those investments.

Figure 4. The Efficient Impact Frontier[18]



Based on this theory, if the rating on additionality as measured through FSE score is high, and Root Capital is the only investor, then Root Capital should be willing to consider a very low or negative contribution margin on that loan. The efficient impact frontier is one method that could be used to communicate with philanthropies about the impact their donations pose as a result of unlocking impact investing. While the framework certainly has room to improve, the tool has enabled Root Capital to put fewer philanthropic funds toward opportunities that could be served by commercial capital, while taking full advantage of opportunities to subsidize investments that would not otherwise occur.

Remaining Challenges to Scaling Up

Discussions with Foote and other impact investing stakeholders reveal a variety of remaining challenges to effectively scaling up Root Capital's method of leveraging philanthropic capital to insure loans through

18 Ibid.

first-loss positions and other similar tools. For one, capital from private investors or family offices that are willing to forgo higher returns on their investments "are not easy for us to raise but much easier than the philanthropy, especially first-loss philanthropy," according to Foote.

Impact investors are generally focused on preservation of capital if not some financial return, albeit modest. With this focus, first-loss capital or guarantee facilities are not an attractive way to deploy capital for most impact investors. Instead, the logic should shift: investors should realize that such catalytic capital unlocks more private funds and thus provides greater social and environmental value.

In addition, Foote describes some missteps along the way that perhaps resulted from Root Capital attempting to be too bold. In one instance, Root Capital was overly optimistic about the numbers they'd hit in their operating self-sufficiency (OSS). Rather than under-promising and over-delivering, Root Capital promised very specific metrics within the mid- to high- range of 80–90%. Among other issues, however, force majeure events such as a political meltdown and crop disease led to massive production losses for loan recipients, and thus Root Capital was unable to meet its projected targets. Foote believes that the donors who lost patience and pulled out investments may have had a different perspective if Root were more conservative with its OSS projections.

Another related challenge for Root Capital revolves around not overextending on where they can responsibly manage risk and maintaining their promises to investors. Foote refers to a certain period as Root Capital's great "juice cleanse," where Root Capital trimmed investments in a range of sectors after diversifying too broadly beyond coffee and cocoa into other crops, such as quinoa, chia, fresh fruits and vegetables. Foote believes it is better to be purposefully redundant rather than becoming a commodified trade finance shop, conceptualizing Root Capital's role as "an overperforming NGO, not an underperforming bank." One of the solutions to this challenge was to raise a reasonable amount of philanthropy to be stable and resilient and continue to be a leader, digging deeper into impact on a narrow universe of value chains.

Key Takeaways

Building on its illustration of how financial tools can unlock impact investing, the Root Capital case yields the following key takeaways:

- **Develop metrics to communicate philanthropic impact:** Impact investing funds similar to Root should look into Root Capital's "efficient impact frontier" model as one guide toward conceptualizing and communicating the catalytic role of philanthropic capital in unlocking impact by facilitating investments.
- **Re-conceptualize the role of an impact investing fund:** Impact investing funds should not necessarily position themselves as guaranteeing returns, but rather as maximizing impact that includes the most optimal balance of financial, social and environmental impact, à la the efficient impact frontier model.
- **Be purposefully redundant:** Impact investors should learn from what works and take pain not to overextend on where they can responsibly manage risk and maintain promises to investors. This will guarantee that their investments continue to be efficient for both investors and philanthropic donors alike.

ADDRESSING STRUCTURAL GAPS: ENCOURAGE CAPITAL

Encourage Capital LLC is a mission driven advisory and asset management firm focused on developing and executing impact investment strategies to solve critical social and environmental issues.[19] The company functions on the premise that it can simultaneously create economic, social and environmental returns for its investors. Encourage also intends to provide the institutions it supports with operational and strategic relationship-building support. It was set up in 2014, through the merger of two existing funds: the Wolfensohn Fund Management, LP and EKO Asset Management Partners, LLC.

Initial Challenge

One of Encourage's focus areas is clean energy financing. In building its investment portfolio, the company was looking to test the following hypothesis: investing in finance institutions that can develop and scale rooftop solar finance solutions for micro, small and medium enterprises (MSMEs) in India will catalyze a 15 GW market opportunity and generate financial returns for investors.[20]

In order to set up a fund to invest in solar energy financing in India, Encourage first wanted to conduct a research study to estimate the market size and to determine the most effective strategies to achieve its potential. Doing such a scoping study is not a common practice in the conventional investment space, but is normal for the company, per Encourage's Co-Managing Partner Adam Wolfensohn.

From Encourage Capital's perspective, such a study was a necessary precondition to launching an outcomes focused investment strategy because it was difficult to find investors willing to take the risk of funding a project with a narrow geographical and sectoral scope. Even if potential capital providers believed in the impact or viability of the idea, many were unwilling to support such a targeted approach without many avenues for diversification. In this scenario, a study of the kind described above could play a crucial role for Encourage by bringing investors to the table through the development of a more robust impact and investment thesis.

Solution

Encourage was thus already exploring how it could go about unlocking the solar market for MSMEs in India. It so happened that one of their contacts at Growald Family Fund[21] was also studying the same topic simultaneously—something discovered coincidentally at a catch-up meeting. From that point on, the idea for the study became collaborative, engaging three funders—the Growald Family Fund, the MacArthur

19 Encourage Capital. 2017. *Who we are*. Accessed January 17, 2020. http://encouragecapital.com/our-firm/who-we-are/.
20 Encourage Capital. 2017. *Who we are*. Accessed January 17, 2020. http://encouragecapital.com/our-firm/who-we-are/.
21 The Growald Family Fund is a high-impact venture philanthropy fund investing in the rapid transition to a clean energy future. Learn more at: https://growaldfamilyfund.org/

Foundation and ClimateWorks Foundation. The MacArthur Foundation[22] (who had previously worked with Encourage in the climate space) helped approach ClimateWorks Foundation[23] to jointly fund the research study.

From the perspective of both Growald and ClimateWorks Foundation, the study was not a typical project for either of the organizations. Growald and ClimateWorks Foundation approached the study as not just exploratory research but also as strategic plan development for the financial mechanism that could support the sustainability of the initiative, while the ClimateWorks and MacArthur Foundations supported the roll out of the study at the national level. The study confirmed the hypotheses surrounding gaps in the solar market in India; provided a systematic overview of the sector; and, added intricacy and detail to initial projections.

In Encourage's experience, the resulting study was found to be hugely helpful in raising the capital for the eventual fund. The study played a key role in convincing an anchor investor, KfW, which helped unlock further capital for the fund. Moreover, MacArthur chose to also invest in the fund itself, in addition to having supported the prior research study. Other investors in the fund included Capricorn Investment Group, the Jeremy and Hannelore Grantham Environment Trust and the Sant Foundation.[24] Ultimately, Encourage set up a new fund called Encourage Solar Finance LP, having raised a first round of $40M fund by April 2019. As of December 2019, the company had made its first investment from the fund to address clean energy financing gaps for MSMEs in India, and was also planning to raise another round of funding worth $35M.

Remaining Challenges to Scaling Up

Structurally, Mr. Wolfensohn feels that the philanthropic sector could make a key impact by rethinking how it approaches its asset base. According to him, it could do so not just by providing grant funding for certain activities, but also investing endowments in a mission-driven fashion. This, he felt, is both important and possible for philanthropic funders to do, especially in areas such as climate change, where there is robust interaction with capital markets.

From the funders' side, a major concern is the opportunity cost of providing support to such funding studies, since there are different ways that philanthropy can be catalytic. It could, for instance, invest in policy advocacy for clean energy subsidies, which is something Growald has done extensively in countries such as Indonesia and the Philippines.

22The John D. and Catherine T. MacArthur Foundation is a private foundation that supports creative people, effective institutions, and influential networks building a more just, verdant, and peaceful world.
Learn more at: https://www.macfound.org/

23 ClimateWorks is a non-governmental organization that works globally and collaborates with funders, regional and research partners, and other climate leaders to strengthen philanthropy's response to climate change. Learn more at: https://www.climateworks.org/

24 Cision. 2019. Encourage Capital to Bring Clean Energy Financing Solutions to Indian Entrepreneurs With USD $40 Million First Close of New Fund. June 27. Accessed January 17, 2020.
https://www.prnewswire.com/news-releases/encourage-capital-to-bring-clean-energy-financing-solutions-to-indian-entrepreneurs-with-usd-40-million-first-close-of-new-fund-300876137.html.

Alternatively, an innovative solution suggested by Shilpa Patel, Director of Mission Investing at ClimateWorks Foundation, is that projects focused on private sector engagement could be supported via alternative forms of financial support, as opposed to being grant-based. For instance, the terms of studies such as the one undertaken by Encourage could have been designed differently, wherein the money provided for the study would be refunded from the capital raised for the ensuing project—a structure paralleling an equity participation. Ms. Patel feels that in their current form, philanthropic funds are perhaps not being used to their full capacity. If instead there had been some kind of recoverability, for example, then Growald and ClimateWorks Foundation could have reinvested the money elsewhere. However, for such innovative solutions to be implemented, most funders interviewed agreed that current status quo and mindset need to be challenged. In other words, philanthropies would need to be more open to less conventional uses of their grant funds.

Key Takeaways

Apart from showing how Encourage Capital addressed structural gaps to unlock capital, this case yields the following additional key takeaways:

- **Connections are crucial:** Gaining access to capital can often be a function of an organization's network and its employees' personal contacts. In this case, for instance, Encourage's connection to ClimateWorks Foundation and its familiarity with Growald and the MacArthur Foundation were central to the proposed study obtaining the funding it needed. In such a scenario, enabling access between implementers and philanthropies—such as through conferences, meetings, and information sharing—can be key to catalyzing impactful ideas that may otherwise be lost.
- **Funder collaboratives can play a key role in unlocking capital:** Backing unconventional ideas can be perceived as risky by funders. They may, with good reason, be resistant to take on the risk of backing new ideas which may not succeed and be a drain on their limited resources. In these cases, funder collaboratives can be crucial to reducing individual risk. In the case above, ClimateWorks Foundation, MacArthur and Growald came together to support Encourage's unconventional proposal. Vikas Mehta from Growald in fact mentioned that being a sole supporter of the study may have been risky, and they hoped to find other partners to diversify associated risks.
- **Philanthropies should be open to alternative forms of financing:** While the philanthropic space is slowly opening up to alternative forms of investing, such as in the case of the Catalytic Impact Consortium being led by the Rockefeller Foundation, these initiatives are few and far between. With impactful work expanding beyond the scope of non-profits to include social enterprises and impact investing, philanthropies can also look to these new and alternative ways of delivering impact on the ground. With strong examples having already been set by some, others now have the opportunity to emulate and adapt their models and follow suit.

Recommendations: Scaling Up Philanthropic Mechanisms for Unlocking Impact Investing

How can we scale up successful examples of philanthropy unlocking impact investing? To answer this question, we sought insight from a range of stakeholders with extensive experience at the intersection of philanthropy and impact investing. Our recommendations are summarized in the chart below and discussed in detail in the following pages.

Figure 5. Recommendations

Recommendation	Challenges	Research Needs	Next Steps
Actively Foster Communication	• Philanthropy and impact investing work in silos with limited knowledge sharing and communication	• Research on potential impact of connecting different forms of capital	• Share knowledge • Test and pilot new models
Broaden Approach of Endowments	• Boards resistant to fund utilization outside of charitable giving • Would require structural re-thinking of investment strategy	• Research on legal frameworks and reporting norms surrounding shifts	• Generate awareness of existing success stories • Diversify organization skill-sets to include knowledge of investment management and financial tools and markets
Leverage Philanthropy as Risk Capital	• Philanthropies are concerned about maintaining the charitability of funding • Need to prove that charitable capital creates a public good	• Consolidate existing metrics for philanthropic impacts and develop new ones • Research different legal structures for charities	• Elevate metrics that communicate philanthropic impact • Create a collaborative guarantee pool to engage small foundations
Target Resources for Catalytic Potential	• Landscape of foundations is vast, and their missions vary widely • Philanthropy would need to re-evaluate strategy to unlock the potential of other pools of capital, such as government money, university capital, and international aid funding	• Identify organizations most equipped to implement strategies for unlocking impact investing • Quantify type and scope of pools of capital to identify synergies	• Develop a new type of role at foundations that focuses on catalyzing impact investing • Build a network among foundations with the scope and capacity to unlock impact investing

ACTIVELY FOSTER COMMUNICATION

Stakeholders highlighted lack of communication between actors in the philanthropic and impact investing communities as a major barrier to jointly strategizing new and unconventional ways for unlocking impact.

Challenges

Interviewees suggested multiple potential reasons for this lack of engagement with other actors. For one, both philanthropy and impact investing groups often work in silos. The dearth of communication between the two likely stems from the segregation of the different forms of impact capital. On the spectrum of financing, philanthropy and investment are seen as different modes of support, and are targeted toward organizations with distinct methodologies for change creation (such as non-profits versus social enterprises). This differentiation in turn lends itself to separation of these forms of financing into siloed and non-communicative wholes, working separately to meet very different goals. For instance, grant funding traditionally looks to measure its impact in the form of social output indicators, while impact investing seeks a mix of financial and social impact returns. Interestingly, the communication siloes seem to exist even within organizations that provide both forms of support.

Such differentiation, while sometimes helpful, also comes with its own set of constraints. By building separate groupings around financing tools such as ESG investing, impact investing, venture philanthropy, traditional philanthropy and so on, the sector limits its ability to cross-share learnings and utilize its resources effectively. In such situations, a shared and common goal can play a critical role in bringing about collaboration. Kimberly Dasher Tripp of Strategy for Scale described the situation succinctly when she said, “You need to name it, you need to make it a thing, and then you can start to build affinity groups around it.” This mindset could be applied to the concept of “philanthropy as unlocking impact investing” in order to foster communication between philanthropies and impact investors.

Research Needs

While existing research examines the usefulness of funder collaboratives, as described earlier, limited exploration has been conducted around the need to connect and bring together different forms of financing. Thus, building on this study and developing research around the potential for combined impact could play an important role in raising awareness towards the multiplier effect that can occur when stakeholders across the impact space collaborate.

Recommendations for Next Steps

Given the scattered but existing examples of bridging communication between philanthropic and impact capital, such as in the cases of Root and Encourage, the following steps could be taken to lend further support to our hypothesis:

- **Share knowledge:** First, thought leaders and conveners in the space can use existing platforms, such as conferences and closed-door meetings (e.g. ANDE, SOCAP and Skoll World Forum), to create frameworks for engagement that focus on sharing knowledge. Interviewees indicated that despite the existence of such platforms, collaboration rarely takes place due to the siloed functioning of different funders, especially when the financial tools (e.g. grants versus debt or equity) are varied. Such gatherings can be further optimized to build allies and partnerships across funding organizations looking to work across similar domain areas, so they too can begin adapting their existing models to meet the evolving needs of the sector.
- **Test and pilot new models:** A useful first step towards this endeavor would be to create a test case or pilot model, where organizations are able to try the proposed new methodology and tweak it before scaling up further. One of our interviewees described how they over-promised investors on their ability to manage both risk and return. Thus, in meeting interest payments and making support available to its target communities, the organization suffered a significant eroding of its own balance sheet, which proved to be a key learning and pivotal turning point in its internal strategy. Moreover, a key enabler here would be an enhanced funder appetite for risk. As evidenced in the example here, a tolerance for failure is critical to enable learning and course correction.

BROADEN APPROACH OF ENDOWMENTS

In order for donors to change their outlook towards the manner in which funds are utilized, interviewees suggested that the holders of endowments would need to broaden their horizons and re-evaluate their methodologies.

Challenges

Rethinking how endowments can pose social benefits is not an easy task. Endowments have functioned a certain way for decades and interviewees often noted that the boards of institutions can often be resistant to going outside their comfort zones. One contributor, for instance, suggested that endowments could be used not just to maximize capital, but also to support the organization's goals, possibly through mission investing. Bringing about a change in how the money is used and allocated would thus require awareness generation, followed by a structural re-thinking of strategy. This idea has been exemplified by Ellen Dorsey and the Wallace Global Fund. The Fund, through a multi-year transition process that began in 2009, is working towards moving 100% of its assets into mission-related investments that incorporate environmental, social and governance considerations into their endowment management.[25]

25 Wallace Global Fund. 2015. Mobilizing More for Mission. http://wgf.org/wp-content/uploads/mobilizing-more-for-mission.pdf.

Research Needs

Easing the process of helping donors reevaluate the use of assets would require research on the legal frameworks surrounding such a shift. This research, which may vary depending on the laws and legal norms of different states and countries, could be key to helping donors open up. Moreover, the reporting norms for different modes of financing are also different and would require additional knowledge for endowment teams. In such a situation, peer learning and joint research could go a long way toward efficiently utilizing limited resources, speeding up the process and building confidence.

Recommendations for Next Steps

- **Generate awareness:** As noted earlier, the first step towards enabling a shift in mindset is awareness generation toward the potential innovative uses of endowments by sharing existing success stories. The onus here would be on players who have already tested the impact of diversifying their capital utilization, such as the Growald Family Fund, Rockefeller Foundation and the MacArthur Foundation, among others. In doing so, they would play the crucial role of educating other donors on the different ways in which impact-focused capital can be channeled.
- **Diversify skill sets:** A potential constraint to this process highlighted in interviews was that most endowment teams do not include people who have experience around financial tools and markets. Thus, bringing on staff with investment backgrounds (impact-related or otherwise), who could act as “translators” and ease the transition, could be an effective way of overcoming this barrier.

LEVERAGE PHILANTHROPY AS RISK CAPITAL

Philanthropy can absorb risk that other types of capital cannot. Therefore, its impact should be reframed to be seen as highly catalytic—even without directly generating a financial return.

Challenges

In theory, foundations should be happy putting their money somewhere where capital isn’t necessarily preserved if it poses a net greater impact. Yet, philanthropies are often hesitant to make charitable grants to organizations, such as impact investors, who already possess a significant amount of capital. For philanthropy to be truly impactful when grants are made to impact investors or their borrowers, charitable funds need to address market failures and take on risk that other market players cannot absorb. In terms of specific challenges, philanthropies are generally concerned about the charitability of funding and protecting their tax-free status. Foundations need to find a way to prove that charitable capital creates a public good. This may be difficult when the means of influence are indirect. Climate change and other environmental impact metrics need a means of comparing across different categories—such as grants, debt, and equity—so that a baseline exists to measure impact regardless of capital type.

Research Needs

Two buckets of research can help to spearhead greater use of philanthropy in its unique role as risk capital. First, existing data and metrics should be consolidated and new metrics should be developed to measure philanthropic impact with regard to impact investing. Specifically, researchers should aim to translate indirect impact from grant money leading to large-scale effects. Second, research should look into different legal structures that enable philanthropic capital to be deployed in more non-traditional means of creating impact. Consider, for instance, donor-advised funds (DAFs).[26] Does such an incentive structure prevent philanthropy from realizing its full potential? Research should look at models that exist globally, and also develop recommendations for new structures.

Recommendations for Next Steps

- **Elevate metrics that communicate philanthropic impact:** Metrics such as Root Capital's "efficient impact frontier" model can help communicate the catalytic role of philanthropic capital in unlocking impact. More metrics should be developed, consolidated and elevated such that philanthropies and impact investors have a common language through which they can quantify the relationship between philanthropy and impact investing.
- **Create a collaborative guarantee pool to engage small foundations:** Smaller family offices and foundations might not necessarily have sufficient capital to play a role in risk mitigation. By pooling their capital, smaller foundations can be brought into the fold and more charitable capital will become available for the types of first-loss positions and guarantee facilities needed to private return-seeking capital.

TARGET RESOURCES FOR CATALYTIC POTENTIAL

Focusing on a subset of foundations with capacity and identifying synergies between impact investors and other pools of capital can help maximize the catalytic effects of philanthropy.

Challenges

The landscape of foundations is incredibly varied: based on data from the Foundation Center, in 2015, there were over 85,000 foundations in the U.S.[27] Therefore, who should focus their efforts on implementing the

26 According to Fidelity, "A donor-advised fund is like a charitable investment account, for the sole purpose of supporting charitable organizations you care about. When you contribute cash, securities or other assets to a donor-advised fund at a public charity, you are generally eligible to take an immediate tax deduction. Then those funds can be invested for tax-free growth and you can recommend grants to virtually any IRS-qualified public charity."
Source: https://www.fidelitycharitable.org/guidance/philanthropy/what-is-a-donor-advised-fund.html.

27 http://data.foundationcenter.org/

strategies outlined to help unlock impact investing? According to one interviewee, "We don't need everyone in the space to tip— we should really only care about maybe 500 of these foundations, those who have the kind of capital to really test these strategies."[28] In other words, only a small subset of foundations have missions and capacity that align with bridging the gap between philanthropy and impact investing.

In terms of prioritization, resources could initially be targeted at those organizations previously mentioned that possess both foundation and impact investing arms, such as Rockefeller, Packard, Ford and MacArthur. However, once the "usual suspects" have built up their capacity, best practices should also be replicated at smaller organizations.

The landscape of pools of capital should also be reconceptualized to see beyond philanthropy as capable of unlocking just impact investing. On one hand, the term "impact investing" is quite broad, and this study really only focuses on a small subset of it, namely, funds with environmentally-aligned missions. At the same time, government money, university capital, and international aid funding are all examples of other pools of capital that might see their potential impact transform, should philanthropy help to address certain market failures that inhibit effective lending and grantmaking. Intentionally targeting philanthropic resources for catalytic potential would thus do well to understand the nature of these different segments of capital, how they interact with each other, and where philanthropy can literally get the most "bang for its buck" by using grants to activate the greatest amount of overall capital.

Research Needs

Research in this area should first focus on identifying those organizations that are most suitable to begin adopting the strategies outlined in this report for intentionally leveraging philanthropy to unlock impact investing. Some reports have already conducted initial stakeholder mapping, such as Toniic and Shell Foundation's "Venture Philanthropists & Impact Investors." These scoping exercises should be updated and expanded. Secondly, research should quantify the types and scope of pools of capital that could be catalyzed through philanthropic efforts. Doing so would help to pursue synergies between impact investments and such areas as government funding and international aid funds.

Recommendations for Next Steps

- **Develop a new type of role at foundations to focus on bridging the gap:** Foundations should look into developing a specific type of program officer or other role that focuses on leveraging philanthropy to unlock impact investing. Once this type of role is developed, it can be replicated at different foundations. These individuals could develop a network

28 Interview with Kimberly Dasher Tripp

among themselves in order to address common challenges, learn from one another and facilitate communication within the space. In the words of one contributor, “Win the hearts and minds of a few and do it over and over and over again.”

- **Identify foundations with capacity and build a network.** Research should first identify those organizations with the resources necessary to participate in grantmaking that unlocks impact investing should be followed up with concerted efforts to build know-how at these organizations and foster communication between them surrounding the potential for philanthropic funding to catalyze impact investments.

Conclusion

We believe that philanthropy can play a key role in unlocking impact investing potential for organizations looking to solve the world’s foremost challenges. Through the lens of financial tools, structural gaps and capacity building, we have sought to exemplify how philanthropy can serve to mitigate or resolve recurring market failures and thereby further accelerate the scaling of impact investing. The in-depth cases of Root Capital and Encourage Capital illustrate existing success stories that we hope will inspire philanthropists and impact investors alike to communicate and jointly strategize unconventional ways of catalyzing impact. By collaborating to reduce risk, and rethinking how capital is distributed and used, we can move towards maximizing the catalytic effects of impact-focused capital.

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