

# Profit and purpose?

*The social motivations that typically drive impact investing might seem at odds with the financial imperatives that underpin private equity. But there's no reason why they have to be mutually exclusive, writes James Taylor*



**Rottenberg:** time for social enterprise to move on

It's a clear June morning in London's Canary Wharf, and *PEI* is watching two private equity types grill an entrepreneur about his business model. Not exactly an uncommon sight in Europe's financial capital – except that on this occasion, there's something other than money on the table.

The event is an 'International Selection Panel' for Endeavor Global, a not-for-profit organisation that looks to identify and support 'high-impact' entrepreneurs in emerging markets. As co-founder and CEO Linda Rottenberg puts it, it's 'venture capital without the capital' or 'mentor capitalism': Endeavor seeks out entrepreneurs capable of building fast-growing businesses, and then it provides them with the support networks and introductions they need to make it happen. In places with a developed enterprise ecosystem – like Silicon

Valley or London – budding entrepreneurs often have easy access to these (formal and informal) networks. Endeavor wants their emerging market counterparts to have the same advantages – because it believes that the resulting companies can be genuinely transformational to the economies in which they operate.

"You cannot have healthy self-sustaining societies and economies without robust private sector development," Rottenberg tells *PEI*. "And high-impact entrepreneurs are the ones that do that." She cites a Stanford Business School study of almost 400,000 companies, which found that the top five percent generated two-thirds of the jobs and nearly three-quarters of the revenues. "Without these motors of economic growth, you're not going to get anywhere." »

**“The way to drive social change is to invest in solid commercial businesses that provide affordable products and services**

» The potential ‘motor’ under the spotlight today is Diego Saez-Gil, the 28-year-old founder and CEO of WeHostels. His company offers online budget travel booking with a mobile/social media twist: as backpackers move around, they can share their experiences of particular hostels, and arrange to meet up with like-minded people at their next destination. Saez-Gil is an impressive character: born in a small town in Argentina with an enterprising streak and an insatiable wanderlust, he managed to win a scholarship to an MBA course in Barcelona – during which he spent most of

his spare time backpacking around Europe. He then moved to New York and started a business, which failed; but undaunted, he adjusted his model and started WeHostels (formerly known as Inbed.me – the name was changed because people kept getting the wrong idea about exactly what the site was promoting...).

On the other side of the table are Mustafa Abdel-Wadood, the CEO of Abraaj Capital (one of Endeavor’s main strategic partners), and Matt Harris, who runs Bain Capital’s venture business in New York; it’s their job to assess whether Saez-Gil would

be a good fit for the programme. That’s partly about the quality of his business and his strategic vision, but it goes beyond that: they’re also asked to consider how he might act as a future champion both for Endeavor and enterprise more generally. “We’re looking for businesses where the entrepreneur has the right sort of capacity in terms of execution and vision to create a business that will ultimately be scaleable in a reasonable period of time,” explains Abdel-Wadood. “And we also want an entrepreneur who can inspire future Endeavor entrepreneurs.”

The two professional investors do have some reservations about the WeHostels model; Harris isn’t sure why Saez-Gil has restricted its remit so explicitly to hostels, while Abdel-Wadood worries that he’s spreading himself too thinly. They tell him that he needs to think about ways to retain his customers for longer (or across more verticals). But they obviously think that there’s the germ of a good idea there – and someone as eloquent, charismatic and compelling as Saez-Gil will clearly make a great ambassador for the organisation. At the selection meeting later that day, he is officially selected as an Endeavor entrepreneur, with all the support, introductions and advice that entails.

**THE ENDEAVOR CATALYST FUND**

Endeavor has always steered clear of providing capital to its entrepreneurs directly. But this is changing (sort of) with the launch of Catalyst, its new fund.

The idea is that Endeavor will start co-investing in any \$5 million-plus financing rounds completed by its companies (it will take 10 percent, up to a maximum of \$2 million). Eighty percent of the proceeds will be set aside for direct investment in Endeavour companies, while the rest will be used to fund its operations – thus (hopefully) making the organisation financially self-sufficient for the first time. When you’ve spent the last 15 years knocking on doors trying to solicit donations, as co-founder Linda Rottenberg has, that has an obvious appeal.

But is there a danger that by changing Endeavor’s risk/reward profile, Catalyst might change the way the organisation behaves – and potentially damage the entrepreneur relationships that have always been its overriding priority?

Endeavor is trying to avoid some of the more obvious potential conflicts by adopting a passive approach: it won’t negotiate (instead going in on the same terms as the VC or PE firm involved), and it won’t take a board seat. But challenges will remain,

notably in terms of what happens when a relationship doesn’t work out. “We’ve worked out a way to enter these deals neutrally; now we need to figure out how to exit them neutrally,” Rottenberg admits.

So why is a fund like this appropriate now, when it wasn’t before? Rottenberg highlights two significant factors: the growth of local angel networks (some of whom are Endeavor alumni), and the increasingly global outlook of Silicon Valley VCs. The fact that there’s more capital available to these companies means that it’s much easier for Endeavour to come in as a minority passive investor, she says.

Donors seem to like the idea: Endeavor has already raised \$10 million for Catalyst (eBay founder Pierre Omidyar’s foundation is the anchor investor) and hopes to eventually raise as much as \$40 million. And it’s easy to see why: Endeavor reckons the historical return on cash invested in Endeavor entrepreneurs’ large funding rounds has been around 2.9x. Even if Catalyst’s return is a bit lower, it will still amplify that donated capital into much larger sums.

Hopefully this will turn out to be another instance where social impact and financial returns very much go hand-in-hand. ■

**MUTUAL ADVANTAGE**

On the face of it, this may appear to have little to do with private equity. Endeavor’s goals are ostensibly social and philanthropic, not financial (although it has just launched a new co-investment fund that is explicitly chasing a financial return; see box-out).

But organisations like Endeavor can clearly benefit from the input of private equity people – notably in terms of talent-spotting, strategic insight and introduction-making (plus access to capital, of course).

Less obviously, the same thing is also true in reverse, according to Abdel-Wadood. “You go there on the premise that you’re



*WeHostels: a future \$1bn company?*

dispensing your wisdom to them, but it ends up being very much a two-way process – because the energy and the ideas and the capabilities you see in some of these businesses are truly phenomenal,” he says. “In our industry that’s very helpful; it keeps you fresh and current.”

But there’s a bigger picture here too, which he touches on when he talks about Abraaj’s rationale for getting involved with Endeavor. “As part of our stakeholder engagement in the communities we invest in, we do a lot of work around the area of entrepreneurship. It’s a great enabler as far as our reach in emerging markets is concerned.”

By creating this support network – which often includes the wealthiest families and business leaders in that particular country – organisations like Endeavour help to build companies of scale where they didn’t exist before. As they grow, these companies will attract greater financial infrastructure around them and accelerate the development of talent. So the result is a commercial environment that is far more conducive to private equity: there are more deals around, more financing options, more managers to

run companies, and more exit routes when the time comes to sell.

As such, the example of Endeavor has something important to say about the relationship between private equity and impact investing.

**GROWING IMPACT**

Impact investing is the umbrella term for any kind of investment strategy that seeks some kind of positive social impact as well as (or in some cases instead of) a financial return.

It’s a broad church. At one end is strategic philanthropy – donors who prioritise social goals above all else. They aren’t too concerned about the financial returns; they just want to give their money away more effectively. In the middle, there are those investors who are willing to sacrifice some financial upside to achieve a greater social impact. And at the other end of the spectrum are those who believe that social impact and financial returns can actually be complementary.

It’s an area that’s growing, rapidly. In a recent survey, JPMorgan recorded some 2,200 transactions globally in 2011, worth

a combined \$4 billion; it has predicted that impact investing could be worth as much as \$1 trillion by 2020.

Some of this growth is being driven by governments. In an era where public money is in short supply, politicians are looking at new ways to tackle intractable social problems with the help of private capital. Take Big Society Capital in the UK, a state-sponsored £600 million social investment vehicle that is pioneering the concept of ‘social impact bonds.’ This involves raising money from investors to finance a prisoner rehabilitation programme, and giving these investors a payout if their programme turns out to perform better than the national average.

Notably, BSC is chaired by former private equity grandee Sir Ronald Cohen, who since retiring from Apax Partners (the firm he co-founded) has become a tireless advocate for social investment. He previously also managed to persuade the government to seed the debut fund of his firm Bridges Ventures, which focuses on investment opportunities in deprived or under-served areas in the UK (an idea that the US government is now trying to replicate).

Developments in philanthropy have also been significant. Wealthy donors – like the ones signing up to the Bill Gates/ Warren Buffett Giving Pledge in the US – are no longer satisfied just to give their money away. They want to do it more efficiently, and in a measurable way.

But there’s another reason why impact investing is likely to grow in popularity: some firms are starting to prove that it is possible to deliver a positive social impact and market-beating returns at the same time. And in the long run, that’s probably the best way to attract more institutional capital into the area.

**NO TRADE-OFF REQUIRED**

Consider the insurance market. The dominant global players in the West are all facing the same problem: saturated home »

» markets that, in many cases, face years of feeble growth. Although the obvious answer is to look to emerging markets, the trouble is that the pool of potential customers tends to be pretty small. But what if there was a way to tap into an extra billion customers? That would be good for insurers, because they'd sell more policies. And it would also be good for the people concerned, because they'd suddenly have a safety net to protect them if the worst happens.

This is effectively the thesis behind Leapfrog Investments, a firm set up by Andy Kuper and Jim Roth to invest in companies that insure under-served people in Africa and Asia. Leapfrog launched its debut fund-raising in the week after Lehman Brothers collapsed – but despite this inauspicious timing, it collected \$135 million, well above its \$100 million target. Leapfrog believes there are as many as 3 billion people around the globe who can afford insurance but can't get at it; with its debut fund, it aims to hit 25 million of these, including 15 million women and children.

A good example of the Leapfrog approach is AllLife, a South African company that provides insurance to people with HIV (and now diabetes too). In the past, these people were considered uninsurable – and since you need life insurance for things like bank accounts and mortgages, that meant they were effectively excluded from the real economy. The AllLife policy is based around an adherence programme; so the *quid pro quo* is that policyholders sign up to regular testing and anti-retroviral medicines. The company says those who join

the programme typically see a 15 percent improvement in the relevant HIV markers – even if they're not taking the drugs. AllLife plans to sign up as many as 50,000 people in the next few years.

Leapfrog makes no bones about its commercial aspirations. “We're quite different from lots of impact investment funds in that some are willing to accept sub-par returns; there's a trade-off between the commercial and the social,” says Roth. “We decided not to do that. We decided that if we wanted to access the big pools of capital in New York and London, and fundamentally open up the gates of the capital markets, we had to offer returns in the top quartile of private equity.”

Kuper likes to describe Leapfrog's approach as ‘profit with purpose’. “Our particular proposition is that profit plus purpose equals performance. These are complementary things; each can amplify the other rather than it being a trade-off. We focus on areas where you can optimise financial returns by achieving certain social outcomes, and you can optimise social returns by achieving certain financial outcomes.”

Nadia Sood, co-founder and partner at Impact Investment Partners, a new firm that is raising an Indian healthcare fund, argues that it boils down to scale. “Philanthropy is important; donations can often be catalytic and attract commercial capital into a nascent sector or space. But achieving social change at scale requires large investments, so donations alone are not the answer. For example, not-for-profits which do a lot of social good are constrained by their structure – they can't take on debt or equity. That makes it harder for them to attract talent and to scale. The way to drive social change is to invest in solid commercial businesses that provide affordable products and services that people need.”

Kuper suggests this approach creates three key areas of competitive advantage. The first is to do with the scale of the



Shriram: part of a \$12bn business

opportunity it opens up, particularly in emerging markets as it helps low-income people rise into the middle class.

The second is innovation. “When you look at the creative stuff these purpose-driven companies do to keep costs down and invent interesting products, there are all kinds of powerful knock-on effects,” he says.

And the third area of advantage is talent. “The highest quality people are looking for meaning and money combined. When we advertise for an associate position we get 250-plus applicants, a third of which might be real superstars.” This allows the likes of Leapfrog to build a higher-quality team – which makes the proposition far more attractive to potential investors.

“Lots of these [impact] funds are founded by people from a development background,” adds Roth. “If you look at our team, we've focused on getting people

**“The next step is to get the capital markets and private equity excited about these up-and-coming companies”**





who have run large commercial businesses – but were willing to take a hit on salary, and make returns over the long-term via carry, to do more meaningful work. That’s very reassuring to LPs.”

This highlights an important point. Do institutional investors *get* impact investing yet?

“Some of the best LPs do,” Kuper insists. “There’s a growing awareness. I wouldn’t say it was widespread yet, but it exists in certain forward-looking LPs. And it’s clearly increasingly on the agenda.”

It’s still early days. But Sood argues that as the area develops, it is rapidly attracting greater institutional interest. “We are seeing different investors and pools of capital moving into the impact space – everything from family offices to hedge funds and other institutional investors. There are also now a whole range of funds available to investors.”

One potential issue is where impact investing sits in an institutional portfolio. For firms that target private equity-style returns, it’s more straightforward. But for firms that place greater priority on social impact, there may not be an obvious home for it; after all, it’s not quite philanthropy, but it’s not comparable with a normal equity or bond portfolio either. This could be a practical constraint on growth.

Then there’s the question of impact measurement, a huge topic in itself. Financial returns are relatively easy to measure, but social outcomes are less so – which makes it harder for LPs to compare like with like. An awful lot of work has gone into developing standard metrics – notably through the IRIS (Impact Reporting and Investment Standards) framework. But ultimately there will always be a degree of interpretation involved.

**THINKING BIG**

The links between the likes of Leapfrog and IIP and the ‘standard’ private equity model are clear. Both are using similar operating approaches to target similar sorts of returns; the only difference is that the impact investors see social purpose as an essential part of their investment thesis.

Nonetheless, Kuper still believes that investments like those made by his firm are seen by the industry as somehow being in a different bracket. “People are used to thinking of anything social as small. There needs to be a mindset switch. We need to get beyond the stage of thinking about the small scale heroic entrepreneur; there are really remarkable substantial businesses out there that are purpose-driven and have generated fairly legendary returns.”

He cites the example of Shriram, an Indian business in which Leapfrog has invested \$15 million. Its parent company is a \$12 billion conglomerate, built up over 40 years to deliver financial services products to low-income people; buyout firm TPG

invested in its vehicle financing business and reportedly sold out for an 8x return. “Private equity has a very significant opportunity now to pursue returns in interesting places and in replicable ways – where there were previously fewer incentives and less openness from LPs to do so,” he insists.

But it’s not just this end of the impact investing spectrum that benefits private equity. The entire ecosystem is important. Philanthropy channels capital to areas in which it makes no commercial sense to invest, helping them to grow.

Equally, Endeavor may be not-for-profit – but it sees its role as facilitating the kind of environment that will ultimately make companies more attractive to private equity. “We started out trying to bridge the gap between microfinance and private equity in emerging markets; to create jobs and the aspiration to think big,” says Rottenberg. “We’ve managed to capture the imagination in those countries; angel investors are starting to bubble up locally, VCs are starting to take a look ... But the next step is to get private equity and the capital markets excited about these up-and-coming companies that have real potential to get to the next level, to the \$1 billion-mark.”

Rottenberg believes the social enterprise movement should be doing its bit to break down the distinction between social and financial. “People call me a social entrepreneur ... I’m very proud of the movement but I also feel like we have to go beyond it. I’m motivated by sustainability, scalability and impact; that’s where the whole field needs to go.”

Maybe one day Saez-Gil – with Endeavor’s help – will be running a \$1 billion travel company. If so, he’ll not only have created jobs and wealth in emerging economies; he’ll also have delivered a very healthy return to his backers, and created a business that most private equity funds would love to buy. That’s why it’s in everyone’s interests for impact investing to flourish. ■