IMPACTASSETS ISSUE BRIEF **#10**

FROM GRANTS TO GROUNDBREAKING:

Unlocking Impact Investments

An ImpactAssets issue brief exploring critical concepts in impact investing

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PRÉCIS

Philanthropy and the practice of grantmaking have traditionally been very separate from investing in both culture and approach, but the emerging field of impact investing invites a productive collaboration between these two disciplines. Impact investing deals generate both financial and social returns and often require different types of capital, including grants, below-market and market rate capital. This Issue Brief explores the potential for greater coordination between impact investments and grants, with a focus on how grants may be structured to attract investment capital. To illustrate how grantmakers and investors can cooperate, this Brief profiles several ways that family foundations, philanthropic institutions, and public funders can use their grants to unlock dollars from the growing impact investment field.

INTRODUCTION

In recent years, the term "impact investing" has gained real traction and no small amount of attention from actors within both traditional philanthropy and mainstream investing.[1] At its core, impact investing is simply the deployment of capital with the intent of generating financial return together with measurable social and environmental impacts. Impact investors, operating at the intersection of capital and extra-financial motivation, have the potential to create social and environmental returns that neither traditional capital markets nor traditional grantmaking organizations can achieve alone. However, the relatively recent proliferation of new socially driven business models makes it challenging to identify opportunities that are ready for investment or that have enough of a track record to provide confidence in the return that impact investors seek.

[1] For a complete introduction to the topic, please see Impact Investing: Transforming How We Make Money While Making a Difference, Bugg-Levine/Emerson, 2011.

Supporting these business models can be accomplished by combining impact investment funds, which seek both financial and social return, with flexible grant funds, which seek a social return but do not require a financial return. Coordinated grants may not only decrease the risk of transactions but also prepare and support socially driven financing models, thereby enabling impact investment opportunities that might otherwise not be possible. Grants can reduce transaction risk for impact investors in several ways; two examples include through participating in capital stacking and by serving as loan loss reserves. Using grants to pay for demand studies and deal structuring are examples of how grants can lay the groundwork for socially driven financing models.

Living Cities: Coordination of Grants and Investments in the U.S.

Living Cities was established twenty years ago and is comprised of 22 of the world's largest foundations and financial institutions that pool their capital to work on behalf of low-income individuals in US cities. Living Cities deploys a variety of different types of capital—grants, below-market rate flexible debt pooled from member foundations through the Catalyst Fund, and commercial debt from bank and insurance company members. Living Cities capital has been leveraged nearly 30 times, resulting in over $16B of financing that has helped build schools, affordable housing, clinics, childcare and job training facilities, among other community institutions and services for low-income communities.

Over the past five years, Living Cities has experimented with several ways to coordinate different types of risk capital into investments which meet community, philanthropy and investor requirements. One lesson from this experience has been how difficult it is to originate and close deals that deliver social impact, even with flexible, below-market rate debt. Some potential borrowers are nonprofits that have historically raised grant funding but do not have the expertise to structure and close a loan. Other borrowers have limited track records lending to low-income communities and require grants to protect lenders against potential losses. And still others are simply not ready for debt because they require grants to support business planning or other predevelopment activities.

Living Cities, like many fund managers in the impact investing arena, believes risk capital in the form of impact investments alone is not enough to address the enormous social and environmental challenges facing our communities today. Extensive work has been done on the topic of using philanthropy as a strategic bridge to impact investments, primarily in a developing world context; those articles should be explored as well.[2] The intention of this Brief is to provide specific models of domestic collaboration and illustrate how grants may be thoughtfully structured to support social and environmental impact while also attracting additional investment capital.

[2] The most recent example of work in this area is the report From Blueprint to Scale, produced by Monitor Group and Acumen Fund (http://www.mim.monitor.com/blueprinttoscale.html). Other examples may also be found through a brief literature review.

MODELS FOR COLLABORATION

There are many models for how grants may help unlock transactions for a growing impact investment field. We offer two scenarios in which grants can help tap debt capital from impact investors:

- When transactions are perceived by investors as too risky; and
- When transactions or borrowers are not ready for debt.

In other models, grants may be combined with equity investments or used to provide technical assistance and capacity building to small businesses.

Transaction is Too Risky

As highlighted in Issue Brief #2, *Risk, Return and Impact: Understanding Diversification and Performance Within an Impact Investing Portfolio*, impact investors make decisions based not only on traditional investment metrics that balance risk and return, but also based on the desired social impact of any given investment. This section will explore how impact investors can use grants to appeal to different investor risk-return preferences.

Impact investors, such as the Living Cities Catalyst Fund and high net worth individuals, have some flexibility in how they balance perceived risk and projected return with the attainment of social impact. When these investors are driven first by impact, they are often willing to accept lower financial returns for such impact. The balance between risk, return and impact is somewhat idiosyncratic, however, and depends upon the values of each investor. There is currently no industry standard for valuing social and environmental impact or trading it off against financial returns, and the field has not yet moved to a "blended value"[3] view of economic, social and environmental benefit to clarify investment opportunities. In the absence of such a framework or tool, segregating risk and return for different investors is critical to being able to attract and pool together multiple sources of funds.

This leads to a core question:

How can transactions be structured to appeal to the different risk-return preferences of investors?

One answer is called capital stacking — building a "layered capital stack" — with grants or subsidies at the bottom of the stack and capital seeking more market-oriented terms at the top.

The following section explains how capital can be layered within a fund structure.

Structured Fund with a Layered Capital Stack

What is a structured fund with a layered capital stack? It is a dedicated pool of capital with defined investment parameters that has been created from different layers of grants and investments. Structured funds

[3] For information on the concept and applications of Blended Value, please see www.blendedvalue.org.

generally require commitments to fund a blind pool rather than a particular set of project investments. As a result, investors are backing a strategy and/or a set of parameters, but not a set of specific investments.

In order to attract investors with different risk and return parameters, the fund is organized in layers, with each layer reflecting a different risk/return profile. The investors in the top layer of the stack get priority for repayment (called seniority). If there are losses, the most senior lender is repaid first, making the levels at the bottom least likely to receive repayment in full.

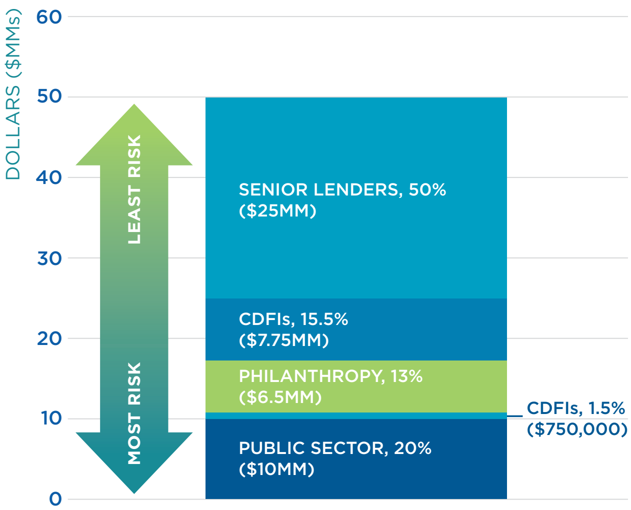
Layered capital stacks are commonly used in project finance. Structured funds with layered capital stacks are less common in the impact investment field. Creating these funds has been difficult and time consuming to create given the highly tailored nature of impact transactions and the individual financial and programmatic requirements of impact investors.

We will use an example of an investment that the Living Cities Catalyst Fund made into the Bay Area Transit Oriented Affordable Housing Fund[4] (TOAH) to illustrate the impact of a layered capital stack.

In March 2011, the Catalyst Fund lent $3MM to the TOAH, sponsored by the Great Communities Collaborative, a 24-member collective of Bay Area nonprofits, national organizations and regional philanthropic entities. The $50 million TOAH provides early-stage financing primarily for affordable housing with some mixed-use developments in mixed-income, transit-oriented development communities. The Low Income Investment Fund is the TOAH fund manager. Six community development financial institutions[5] (CDFIs) serve as the originating lenders for the TOAH.

The TOAH pools four different types of impact investors, with each impact investor accepting a different level of risk. The priority of each investor level is shown on the graph and listed on the following page from least risk to most risk.

BA TOAH FUND CAPITALIZATION



[4] For more details, please see the following website: http://bayareatod.com

[5] Definition from the CDFI Fund Website: a certified Community Development Financial Institution (CDFI) is a specialized financial institution that works in market niches that are underserved by traditional financial institutions. CDFIs provide a unique range of financial products and services in economically distressed target markets, such as mortgage financing for low-income and first-time homebuyers and not-for-profit developers, flexible underwriting and risk capital for needed community facilities, and technical assistance, commercial loans and investments to small start-up or expanding businesses in low-income areas. For more information, please visit the CDFI Fund's website: http://www.cdfifund.gov/what_we_do/programs_id.asp?programid=9

- Class A, Senior Lenders: 50% of Fund ($25MM) from financial institutions
- Class B, Originating CDFIs: 15.5% of Fund ($7.75MM) from originating CDFIs[6]
- Class C, Philanthropic Lenders: 13% of Fund ($6.5MM) from Living Cities and other philanthropic lenders
- Class D, Originating CDFIs: 1.5% of Fund ($750,000) from originating CDFIs
- Class E, Public Sector: 20% of Fund ($10MM).

In this model, the public sector has provided $10 million of subsidy (essentially through a grant). These funds take the most risk, thereby decreasing the overall risk of the transaction for each of the other participants in the fund. In effect, this funding serves as the base or critical capital for this entire fund — without this subsidy, the CDFIs would not lend, without the subsidy and the CDFIs, the philanthropic lenders would not lend, and without the subsidy, CDFIs and philanthropic lenders, the senior lenders would not lend.

And that is the goal of the layered capital stack strategy: the creation of a larger pool of capital mobilized in pursuit of social impact.

Had the public sector decided to invest alone, rather than coordinate its efforts with impact investors, then the Bay Area would only have had $10MM to support affordable housing near transit instead of $50MM. The pooling of different sources of capital into a fund also allows developers of affordable housing to more efficiently access the capital they need rather than having to cobble together multiple sources of capital on a deal by deal basis. As this subsidy is being lent out as loan dollars rather than expended as one-time grants, there is also an opportunity for these funds to remain in the community as an ongoing subsidy source if the transactions repay as anticipated.

In addition, the participation of the public sector with an interest-free subsidy and philanthropy willing to take more risk results in the fund being able to offer lower-rate financing at more flexible terms and amounts than the developers would have otherwise been able to access from the financial institutions directly. The TOAH is currently able to lend at rates between 4-5% while the CDFIs typically lend at rates between 6-7.5%.

Co-Investment into an Organization

In the prior section, we discussed how different types of capital can be layered into a fund structure. This section provides an example of how grants can be combined with loans to an organization to decrease risk.

[6] The originating CDFIs are both Class B and D lenders. In order to align the CDFIs' incentives with the philanthropic lenders (who are taking more risk than the Class B level), the originating CDFIs agreed to put a small portion of their lending dollars at risk before the philanthropic lenders in the Class D level.

Because grants do not require repayment or a rate of return, they can be used more flexibly in transactions. Grants can be used to provide guarantees, fund a loan loss reserve or serve as flexible lending capital (as discussed in the prior section).

When blending grants with loans, philanthropy should coordinate with impact investors to determine the best use of the grant capital. If a lender is lending to a weak borrower, an aligned grant can be helpful in serving as a buffer, or loss reserve, for the loan. But a grant to support programming and capacity building to the same organization, while important, probably would not enable the lender to make its loan.

In 2011, the Living Cities Catalyst Fund made a $700,000 loan to the Neighborhood Development Center ("NDC") as part of the Living Cities Integration Initiative[7] in Minnesota. NDC is a Twin Cities non-profit CDFI[8] established in 1993 that offers training, technical assistance and loans to local small businesses. The loan from Living Cities enables NDC to provide working capital, equipment and real estate loans to locally-owned small businesses located along a light rail transit corridor that is currently under construction. These loans are intended not only to help these businesses survive during construction but also to enable them to expand and grow to capitalize on increasing land values and foot traffic post-construction.

As NDC is a relatively small CDFI that historically used grant funding to make loans to high risk borrowers, this loan was initially too risky for the Catalyst Fund. However, Living Cities was able to provide a $200,000 aligned grant to NDC to mitigate any losses that the Catalyst Fund loan might incur. In this case, the grant funding was the critical capital. Without the buffer for loss, the Catalyst Fund would not have been able to provide a $700,000 loan.

It is important to point out that the use of the $200,000 in grant funding to support loan losses was a more compelling use of capital than simply making a grant to the organization to cover general operating costs or specific programming. The grant enabled NDC to secure the loan from the Catalyst Fund, which is helping the organization build a track record and credit history that will enable it to potentially access larger and more conventional forms of capital in the future. NDC is able to earn interest income on the loans it makes, thereby helping the organization decrease its overall reliance on grants. In addition, any of the $200,000 that is not used to cover loan losses becomes a general operating grant for NDC once the Catalyst loan is repaid, which helps to align incentives and encourage the organization to take appropriate risks. In an increasingly subsidy-constrained environment, we believe that all of these factors are critical for the health of CDFIs like NDC.

[7] Please see Living Cities website for more details: http://www.livingcities.org/integration/

[8] Community Development Financial Institution

In today's fiscally constrained world, philanthropic grants and government subsidies are in short supply, while the need is growing. Making the best use of every grant dollar is particularly important. Aligned grants can be critical to unlocking impact investment capital, thereby stretching the dollars going into the communities and issues we care about.

Transaction/Borrower is Not Ready for Debt

In the previous section, we explored how grants could decrease the overall risk profile of transactions for impact investors. In both of these cases, there was a transaction that was fundable - i.e., there was a clear source of repayment, the borrower/borrowing entity was well-established, the participants had a track record to support the proposed lending, and the risks were identified — but there was a need to entice investors to participate by addressing their tolerance for the risk profile of the transaction. However, in other cases, transactions or borrowers are not ready for capital that is seeking a rate of return. They may lack a credible business plan or may have socially driven business models that are not well-tested or proven.

In this section, we will explore how grants can be used in such cases to develop "investable" transactions. We believe grant funds could serve as more effective seed capital to unlock capital from later stage impact investors if the grants are made with the explicit cooperation of impact investors and evaluation metrics and performance requirements are effectively incorporated to satisfy the needs of impact investors.

Grant funds can be used to support new ideas that are not mature enough to generate investor returns, build capacity and scale social ventures. Unfortunately many grants intended for this purpose have not led to the hoped for follow-on funding by impact investors. Some social ventures are not suited to develop into businesses that can service debt or generate a return on equity, and some have simply not invested in the evaluation and metrics that can validate their model to investors. Grantmakers can involve impact investors early-on in their grant due diligence process to help them identify and support organizations that have a higher potential of developing into investable business models. In addition, they can work with impact investors to structure their grants in ways that can attract future investment.

In traditional capital markets, there are clear roles that different investors play in the sequence of financing for organizations as they move from seed stage to later stage. However, in the impact investing field the role and needs of investors at different stages are not as clearly defined. This provides an opportunity to be creative with financing and include a variety of stakeholders, but it also requires increased transparency and communication from investees, funds, and intermediaries to accommodate different risk and impact profiles.

During the last two years, Living Cities made over 15 grants to support emerging energy efficiency programs in cities throughout the United States.[9] The initial grants were awarded based on four criteria, one of which was that the grantee was developing an approach toward energy efficiency lending that could scale. These models were in the development phase and it was Living Cities intent that the initial grants to support these programs as they moved from inception to early stage pilots would lead to subsequent loan opportunities for the Living Cities Catalyst Fund.

However, the initial portfolio of grants only led to one loan opportunity for Living Cities. This can partially be explained by the overall challenges of developing energy efficiency financing models; however, another contributing factor was the way the grants were made. These grants served as planning and capacity grants to help catalyze energy efficiency programs. However, the grants had a variety of objectives, and the structure, management and evaluation of the grants were not specifically focused on developing energy efficiency lending models.

The core lessons learned by Living Cities about using grants to facilitate debt financing may be summarized as follows:

- Grants need to be made with clear, prioritized objectives. Too many objectives may muddle the opportunity for later stage impact investment.
- If grants are to seed later stage investment from impact investors, they should be structured with milestones and benchmarks identified as requirements from impact investors.
- Grant-making should not be siloed from lending in organizations such as Living Cities that have the capacity to provide both. Rather, grant making and lending should be constantly collaborating and working across a shared agenda and theory of change.

The intentional sequencing of grants and debt is a promising but developing area for the impact investing field. Based on these lessons learned, Living Cities is in the process of examining its own governance structure and policies to better understand how the organization can shift to better support impact investing through its grant making. Living Cities is also exploring the array of activities that grants can fund (e.g., feasibility studies, demand studies, start-up costs) to enable impact investments. The organization will continue to dedicate time and resources to learn from its experiences regarding the optimal conditions and circumstances for sequencing grants with debt and looks forward to disseminating lessons learned with others in the field of impact investing.

[9] Energy efficiency is the practice of reducing energy consumption. Living Cities made grants to energy efficiency programs that were focused on scaling energy efficiency in buildings, particularly affordable multifamily buildings. Developing a model for energy efficiency lending that uses external capital is believed to be important for the growth of the energy efficiency sector and these programs because many building owners do not have the upfront capital to pay for energy efficiency improvements.

CONCLUSION

In an increasingly resource-constrained environment, the ability to drive more impact investments into the communities and issues we care most about is imperative. This Issue Brief highlights specific examples of how grants can serve as the critical capital to unlock impact investments for transactions that are either too risky or not ready for investors seeking financial returns.

What has not been addressed in this Brief are the entrenched historical and cultural differences between grantmaking and impact investment institutions which will need to be bridged. Some of these differences include differing views on the best use of capital (to address the highest need or to finance scalable solutions that only address part of the need), different processes and metrics for evaluating opportunities, different relationships with borrowers and grantees, and hesitation by both camps to cooperate.

Driving increased coordination between grantors and impact investors will require additional work to bridge these two cultures. Part of the solution is cross-training individuals from grant and investment disciplines, as well as shifting organizational cultures toward permeability and collaboration among staff of different disciplines. It is our hope that this Issue Brief can serve as an introduction to some of the challenges to and opportunities for fulfilling the promise of mobilizing even more capital — whether philanthropic or market rate — in the years to come.

This Issue Brief is jointly authored by Jed Emerson, Chief Impact Strategist, ImpactAssets and Amy Chung, Senior Investment Officer, Living Cities. As part of ImpactAssets' role as a nonprofit financial services group, Issue Briefs are produced to provide investors, asset owners and advisors with concise, engaging overviews of critical concepts and topics within the field of impact investing. These Briefs will be produced by various ImpactAssets staff as well as collaborators and should be considered working papers—your feedback on the ideas presented and topics addressed in IA Issue Briefs are critical to our development of effective information resources for the field. Please feel free to offer your thoughts on this Issue Brief, as well as suggestions for future topics, to Jed Emerson at **JEmerson@impactassets.org***. Additional information resources from the field of impact investing may be found at the IA website:* **www.ImpactAssets.org***. We encourage you to make use of them.*