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# Impact Finance: Innovative Finance Solutions to Target Global Health Issues

Article By:

Ranajoy Basu

Carl J. Fleming

While the basic investment infrastructure needs to be developed, impact investment is becoming a stable and sustainable alternative for institutional investors and high-net-worth individuals. Private Equity funding is well suited as a powerful vehicle to address significant social and environmental issues.

As the economic impact of Coronavirus (COVID-19) continues to unfold, demand for healthcare remains a unifying global factor and provides an opportunity for innovative investment models to aid recovery and growth. Between 2020 and 2024, global health spending is expected to rise at a 3.9% compound annual growth rate, considerably faster than the 2.8% recorded in 2015–2019.

Those responsible for buying healthcare services (payors) commonly monitor population health metrics and the impact of changes to the healthcare landscape, such as clean water or vaccination programmes to assess need and allocate resources as part of their mandate.

Access to quality data can also allow potential investors to closely monitor market trends and anticipate demand. For example, there is currently a shift in the allocation of resources from the end of the healthcare value chain (treatment and aftercare) to the beginning, with an emphasis on preventative healthcare, such as social prescriptions, wellness, and early diagnosis. Investments in preventative health may result in quality of life improvements, fewer visits to doctors and hospitals, and lower claims costs for employers.

To complicate matters, there may be legal or regulatory barriers to extracting growth, depending on how healthcare is funded. In the United States, payors will be limited in the profits they can share with their stakeholders owing to a provision within the Patient Protection and Affordable Care Act. It is therefore to the payor's benefit to find alternative ways to invest the extra money, which is where social impact bonds come in.

## Social Impact Investments

Investing to both secure a financial return and effect social change has become increasingly popular.

The current trend of social impact investing challenges the view that philanthropic endeavours and the pursuit of financial returns are mutually exclusive.

Social impact investments can take a variety of forms.

**Loan Guarantees**

There are a number of international institutions that provide credit support for projects. The Bill and Melinda Gates Foundation, for example, now issues loan guarantees, rather than direct funds, to some of the enterprises it supports. Its first guarantee allowed a charter school in Houston to raise US$67 million in commercial debt at a low rate, saving the school and its donors almost US$10 million in interest payments.

**Quasi-Equity Debt Structures**

Some organisations have developed financial vehicles that combine the properties of equity and debt. A quasi-equity debt security is particularly useful for enterprises that are legally structured as non-profits and therefore cannot obtain equity capital. This security is technically a form of debt, but it has one important characteristic of an equity investment: its returns are indexed to the organisation's financial performance.

The security holder does not have a direct claim on the governance and ownership of the enterprise, but the terms and conditions of the loan are carefully designed to give management incentives to operate the organisation efficiently. Social investors purchase these securities, which perform the function of equity and enable social enterprises to offer banks and other profit-seeking lenders a competitive investment opportunity.

For example, the Bridges Social Entrepreneurs Fund recently committed £1 million for a social loan to HCT Group, which uses surpluses from its bus services to provide community transportation for people unable to use conventional public transportation. This social loan has a quasi-equity feature: the fund takes a percentage of revenues, thereby sharing some of the business risk and gains. Because the loan is tied to the top revenue line, it provides HCT with strong incentives to manage the business efficiently. Covenants on such loans are often added to avoid mission drift from the social goals.

**Pooling**

Techniques that involve pooling funds have also opened new financial doors to social enterprises, because the pooling institution can tailor its liabilities to the needs of different kinds of investors.

Switzerland-based social capital investor BlueOrchard, for example, assembles portfolios from many microlenders and bundles them into three tranches. The bottom tranche is BlueOrchard's equity, which offers high returns but takes the first loss. The next tranche offers a lower expected return but has less risk; it takes the second loss, after equity is wiped out, and is analogous to a convertible bond. The top tranche promises a low but relatively safe return; it is purchased by conventional debt investors.

The pooling model has spread globally, with innovators such as IFMR Trust, in Chennai, engaged in the securitisation and structured finance of microfinance loan portfolios in which they retain an investment share.

Another example of pooled funds can be seen in Gavi's COVAX Facility initiative. Gavi, a public–private global health partnership aiming to strengthen access to immunisation, leads in the development of COVAX, a mechanism through which demand and resources are pooled to support procurement of and equitable access to COVID-19 vaccines. Countries participating in COVAX would benefit by securing affordable access to vaccine supply and are offered a compelling return on investment delivering COVID-19 vaccines as quickly as possible.

## The Case For Impact Bonds in Healthcare

In 2015, UBS Optimus Foundation and Instiglio launched the first ever cross-border development impact bond (DIB), targeting education for children. Following the launch of the ground breaking Educate Girls DIB, UBS Optimus Foundation and Palladium launched the Utkrisht Impact Bond, which is one of the largest DIBs to date and targets maternal and child health.

The DIB, also known as a Social Impact Bond (SIB) is seen as a complementary source of development aid, rather than as a rival to traditional funding It can attract new sources of finance to bridge the huge demand for resources needed to achieve the UN's Sustainable Development Goals.

An SIB is a results-based financing instrument that enables investors to finance development programmes for the achievement of specific target outcomes. Private investors, donors, or governments that have agreed upon a shared development goal, provide initial funding to development programmes, where the eventual financial returns are linked to verifiable, pre-determined development goals. If these development goals are met, the outcome funder or funders make payment to the initial finance providers based upon pre-agreed payment criteria.

SIBs present an innovative way to fund development programmes and provide the opportunity for both private and public sector parties to work together to produce social outcomes that benefit the target country and its population. They offer a funding model that may be used to target development projects that might otherwise find it hard to attract initial funding, particularly in view of shrinking government aid budgets. For bilateral private donors, they are an attractive way to partner with private sector investors, and demonstrate that both types of capital can be deployed through these structures to effectively achieve their social outcomes.

Since SIBs focus on the actual "outcomes" rather than the underlying activities that are carried out to achieve such outcomes, they typically incorporate a series of mechanisms that measure results to provide transparency to the investors, outcome funders, and other stakeholders, to demonstrate the extent to which their funding is having a positive impact. This is a key differentiator from traditional approaches to development funding that may fail to deliver what was agreed on, or simply lack the means to measure it.

This key aspect of a SIB transaction also helps ensure cost efficiencies and effective implementation during the life of a project. For healthcare-related SIBs, impact can commonly be measured by accessing data sourced from payors or regulatory bodies as part of their regulatory licencing obligations.

There are four fundamental elements to an impact bond structure:

1. Meaningful and measureable outcomes
2. Reasonable time horizon to achieve outcomes

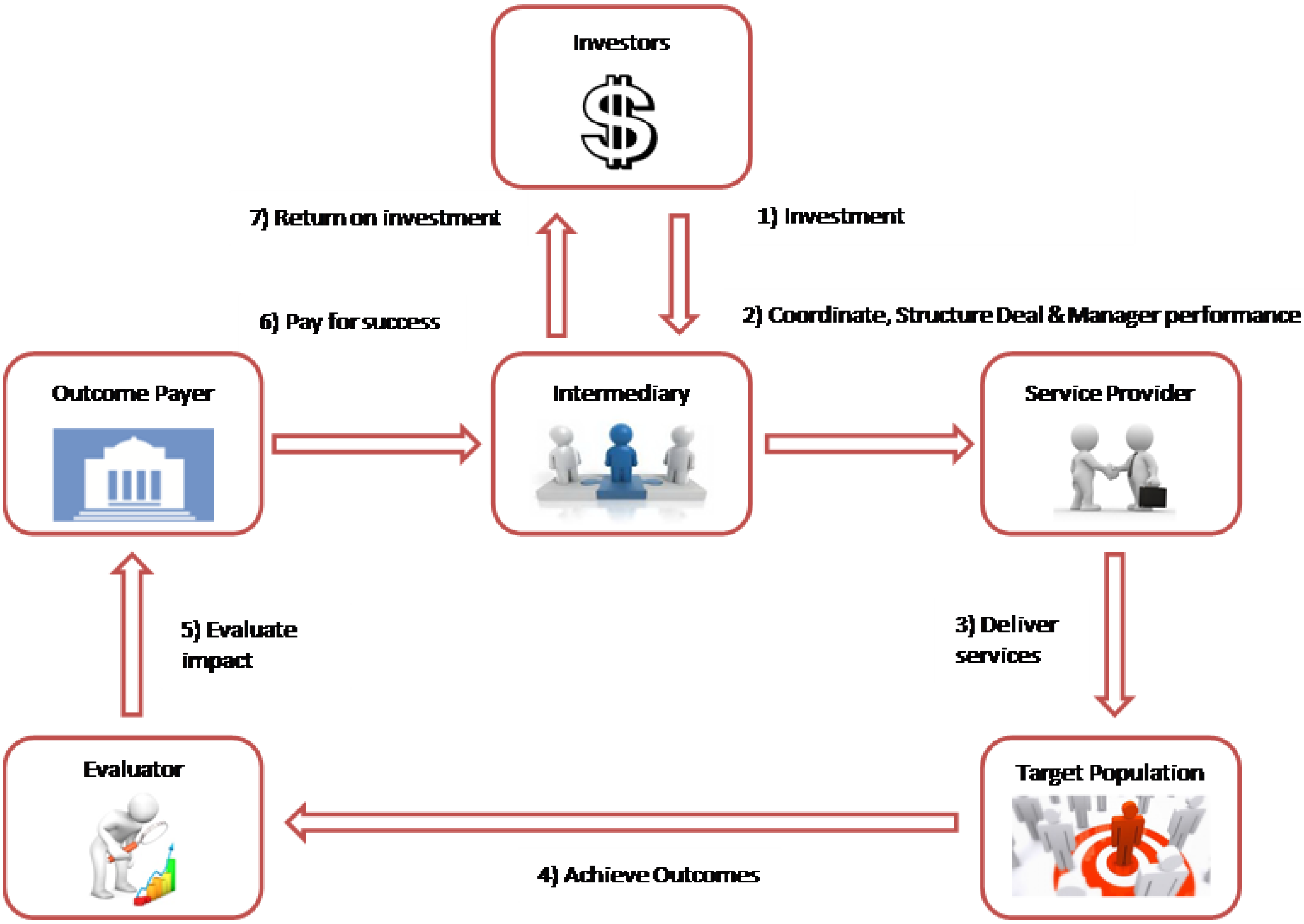
3. Evidence of success in achieving the outcome

4. Appropriate legal and political conditions.

The term “bonds” can be misleading when used to describe such transactions: these are performance-based contractual arrangements rather than capital market “securities”.

The role of the SIB delivery organisation includes brokering relationships between key stakeholders, sourcing capital, leading deal construction, and managing ongoing performance of the SIB programme. In some cases, the SIB delivery organisation or intermediary may identify and select service providers.

## Typical Social Impact Bond Structure




A typical SIB structure follows five key steps:

1. An outcomes contract is negotiated, under which the outcome payer agrees to pay for social outcomes.

2. Based on the outcomes contract, the SIB delivery organisation raises funds from investors, who provide upfront capital for the social or development service intervention.

3. The service providers, typically a hospital or community healthcare provider, agree to deliver

services and receive funds to address the issue for a target population.

4. Outcomes are evaluated or validated by an independent evaluator.

5. If the outcomes are achieved, the outcome payer repays the investors for the achieved outcomes (usually through the SIB delivery organisation). In most cases, the positive outcomes result in cost savings for the outcome payer and a portion of these savings is passed on to the investors as outcomes payments. These payments repay the investment amount, plus a financial return that depends on the degree to which the outcomes are achieved.

## Key Transaction Documents

The *framework agreement* provides the structure for the entire project and the other related transaction documents, and sets out the key contractual relationship and the governance structures during the life of the SIB.

The *grant and services agreement* documents the investor's commitment to advance amounts to the intermediary in order for the intermediary to distribute these to the service providers and to pay the costs and expenses of the SIB. The agreement also documents the intermediary's intention to use the grant to implement the interventions with a view to achieving the outcomes.

The *outcomes payment agreement* identifies the metrics for payment by the outcome payers on the basis of the outcomes.

The *evaluation agreement* documents the evaluation metrics (a critical part of the impact bond) and the related services to be provided by the independent evaluator.

There may well be other documents, such as several *memoranda of understandings* and *servicing agreements* relating to the underlying services to be provided for delivery of the outcomes.

## The Role of Private Equity in Impact Investing

Private equity (PE) funds have emerged as vital intermediaries for aggregating the capital of the typically smaller investors that have traditionally been the most active impact investors. Drawing on a framework developed by the Monitor Institute, PCV InSight divided the market for impact managers into three categories:

1. Impact first managers: those seeking social impact primarily and financial return secondarily

2. Financial first managers: those seeking financial return primarily and social impact secondarily

3. Double-bottom-line managers: those placing equal priority on financial returns and social impact.

PCV InSight estimated that

- Impact first managers managed US$400 million in assets dedicated to impact investing, with an investor base primarily comprised of governments, foundations, and individuals.

- Financial first managers managed US$2.1 billion in assets dedicated to impact investing, with an investor base primarily comprised of institutional fiduciaries and other “market-rate” investors and intermediaries.

- Double-bottom-line managers managed US$1.5 billion in assets dedicated to impact investing, with an investor base primarily comprised of foundations, banks, individuals and institutional fiduciaries.

An encouraging recent trend has been the entry into the impact investment market of large institutional PE managers. For example, the GIIN 2020 Annual Impact Investor survey notes the creation by both BlackRock Inc. and Bain Capital, LP of impact investing units in 2015. A March 2016 article in Law360 noted a move towards impact investing by PE giants KKR & Co. LP, Blackstone Group LP, and Apollo Global Management. These investors view impact investing as more than a branding gimmick or philanthropic endeavour. Henry Kravis and George Roberts, co-chairmen and co-CEOs of KKR, say impact investing “is also essential for smart investing. Our commitment to creating sustainable value has never been stronger.”

Since the term “impact investing” was first coined 10 years ago, the market for these investments has grown to about US$715 billion according to estimates in the 2020 GIIN Survey. And according to the Hauser Institute for Civil Society at Harvard University’s 2018 Global Philanthropy Report, the global assets of philanthropic foundations in 23 countries and Hong Kong are close to US$ 1.5 trillion, all of which could theoretically be directed into impact investments.

## Why Are Private Equity And Impact Investing Such a Good Fit?

It’s no coincidence that PE funds have played a central role in the development of impact investing. They are particularly well-suited to the needs of both impact investors and the social enterprises in which they invest.

### For Investors

PE funds are an attractive vehicle for investors to aggregate their capital to make impact investments. They offer investors the ability to leverage the expertise of a fund manager to invest at scale, drive higher returns, and access specific industries. In impact investing, where investable opportunities are relatively scarce, investee companies pursue double-bottom-line strategies that balance financial return with social impact, and models for measuring social impact are varied and often bespoke, an experienced fund manager is an even greater asset.

When asked their motivation for investing through impact funds, respondents to the GIIN survey identified the most important factor as “General Partner expertise in investment selection and management”.

PE funds also offer a powerful means of mitigating some economic challenges posed by impact investing, which is often characterised by small transactions that are more complex than their larger, traditional commercial counterparts. By aggregating the capital of several investors and paying a fund manager to deploy that capital, investments can be made more efficiently and common standards can be applied across investments, for example, with respect to measuring social return on investment. GIIN survey respondents identified “deploying capital efficiently/avoiding transaction costs associated with small investments” as a motivation for making impact investments through funds.

As Impact Assets noted in 2012, one of the most powerful reasons PE funds have proved to be such a popular vehicle for making impact investments is simply that “traditional, sophisticated investors are familiar with the private equity model and its basic structure”. The authors note that, “investors are drawn to a PE strategy because they are comforted by the maturity of the industry. It is a proven investment strategy that has repeatedly secured premium returns.” That’s not changed in the 10 years since the report: attracting investors at scale to an untested, novel or confusing investment model will always be a struggle. The familiarity of PE provides an excellent springboard for bringing new investors to the impact investing table.

**For Investees**

Just as PE provides an attractive model for investors looking to engage in impact investing, it also provides a model that fits well with the capital/resource needs and growth trajectory of many social enterprises seeking capital from impact investors. As ImpactAssets notes, “private equity investors identify and select companies with the intention of holding them for long periods of time to make strategic and operational improvements as well as adding capital.”

Growth-stage social enterprises that pursue double-bottom-line business models generally need ample time to generate attractive financial returns and achieve their social impact goals. Private equity, with its focus on close engagement with management to build lasting value, is well suited to meeting this need. PE funds are illiquid by nature and most have five-year investment periods with harvest periods of five-to-seven years, meaning investee companies have a built-in time period to grow.

PE funds can only accept capital from sophisticated investors that are able to bear the loss of their entire investment, so they are also well-suited to taking on the additional risks that can come with investing in young companies that may have inexperienced management teams or operate in countries with political instability or relatively undeveloped infrastructure. Accordingly, the risk appetite of an impact fund is often well aligned with the characteristics of the companies in which it invests.

In *Institutional Investor*, Susan Balloch, chief operating officer of GIIN, summarised the fit between private equity and impact investing as follows:

- Impact investing seeks long-lasting change
- Focusing on supporting profitable businesses is one of the best ways to create an enduring impact.

The private equity approach to nurturing and building businesses aligns with that ideal.

## Are PE Funds Appropriate Investors For SIBs And DIBs?

SIBs and DIBs have generally been financed by a single investor or a small syndicate of investors.

This is likely the result of their nascent nature and the high degree of planning and collaboration needed for their proper execution. There is insufficient deal flow to justify aggregating the capital of several investors into a single vehicle, and each deal requires a unique level of commitment and engagement that may be better suited to direct investment.

Nonetheless, as the impact investment market matures and investable opportunities become more available, there is likely to be an opportunity for investment managers with specific expertise to raise PE funds to invest in SIBs and DIBs. Fund managers could become efficient gatekeepers of investor capital, placing it into the most promising projects, developing standardised methods for measuring impact (working with intermediaries as necessary), and reporting that impact to investors.

While the basic investment infrastructure needs to be developed, social impact investment is becoming a stable and sustainable alternative for institutional investors and high-net-worth individuals. As the infrastructure builds further, and more funds across asset classes achieve market-rate performance, the impact investment sector stands poised to become a powerful vehicle to address significant social and environmental issues.



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