

Impact Investment Products Responding to the Economic Impacts of COVID-19 in Emerging Markets

Understanding investor preference and informing fund design



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This report would not have been possible without the contributions of the 10 asset owners and 6 fund managers who participated in these workshops. Their willingness to engage in technical conversations about their own and others' fund structures is essential to building a more collaborative impact investing market and to driving more capital towards impact businesses—particularly those that are in critical need of capital in light of the economic impacts of COVID-19.

The Global Impact Investing Network

The Global Impact Investing Network (GIIN) is the global champion of impact investing, dedicated to increasing the scale and effectiveness of impact investing around the world. Impact investments are investments made with the intention to generate positive, measurable, social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets and target a range of returns from below market to market rate, depending upon investors' objectives. The GIIN builds critical infrastructure and supports activities, education, and research that help accelerate the development of a coherent impact investing industry. For more information, please visit www.thegiin.org.

Overview of Product Development Platform

The GIIN's Product Development Platform aims to accelerate the flow of capital to funds that seek to address the Sustainable Development Goals (SDGs). Through various activities, the Platform:

1. Supports diverse groups of asset owners¹ to articulate their interests in and needs related to investment products,
2. Provides a mechanism for fund managers to access that market intelligence, test and refine products, and ultimately raise capital, and
3. Enables those two groups to connect and work together.

As part of the Platform, the GIIN regularly hosts Product Structure Workshops, typically in-person, and typically focused on investment opportunities that align to an individual SDG or product type. In light of the economic impacts of the novel Coronavirus, COVID-19, we launched a series of workshops in late April 2020. These workshops were intended to shed light on investor requirements for products that *specifically* respond to COVID-19, and to provide the managers structuring those products with feedback. More information on how to be involved in the Platform can be found on the back of this report.

Methodology

What follows is a synthesis of three successive workshops, hosted in April, May, and July 2020, by the GIIN. Each workshop featured two fund managers, presenting in-development fund products in front of a panel of asset owners, representing diverse institutions and clients. The synthesis provided in this report is pulled from notes taken by GIIN staff, presentation materials provided by fund managers, and follow-up calls hosted with asset owner panelists and fund managers. These workshops are held under Chatham House Rule, and therefore all feedback on products has been anonymized, and the fund features discussed in this issue brief are not attributed to individual in-development funds.

¹ Throughout this report, asset owners are referred to interchangeably as 'asset owners' and 'investors'.



Investment Products Targeting Companies Impacted by COVID-19

The economic impacts of COVID-19 are immense. Economists predict this will be the largest macroeconomic shock in the last 100 years, and that the effect will be disproportionately felt in emerging markets. As of Q2 2020, the World Bank is predicting a 5.2% contraction in the global economy—2.5% in emerging markets.² If those projections play out, that contraction will be the greatest in the last 60 years. That macroeconomic shock has already been reflected in sizable shifts to emerging market investment allocations. In the first quarter of 2020 (before, even, the full impact of the crisis was felt), emerging economies saw the largest ever outflow of foreign investment capital on record—amounting to USD 68B for non-China emerging economies, or more than 2x the previous record set during the peak of the global financial crisis.³ On the demand side, roughly 42% of small and growing businesses in emerging markets face imminent risk of failure as a result of COVID-19 and the constraints it has placed on operating businesses.⁴

Despite these dire indicators of capital supply and demand, impact investors remain committed to their work, and are maintaining, and in some instances increasing allocations to emerging markets. In fact, 72% of respondents to the GIIN's 2020 Annual Impact Investor Survey noted that they plan to either maintain or increase their allocations to impact investing in light of COVID-19. 62% were either unlikely or very unlikely to change their region of investment allocation. Both are strong indicators of impact investors stepping up, despite uncertain economic times.

Each of the six products tested during these three workshops saw an opportunity in this data – to support their investees while building high-quality investment opportunities for their investor clients. All of the products tested were a direct response to the economic impacts of COVID-19, though several had begun the structuring process pre-COVID-19 and shifted their focus accordingly in light of the macro-environment. Collectively, they sought to raise between USD 495 million and USD 532.5 million for SMEs and Non-Banking Financial Companies (NBFCs) in emerging markets. The funds targeted several SDGs, particularly SDG #5: Gender Equality (three of the six funds targeted SDG #5) and #8: Decent Work and Economic Growth (all six funds targeted SDG #8), and three of the six funds planned to use IRIS+ metrics to measure impact performance.

More information about the workshops and methodology can be found on the previous page.

² <https://www.worldbank.org/en/news/feature/2020/06/08/the-global-economic-outlook-during-the-covid-19-pandemic-a-changed-world>

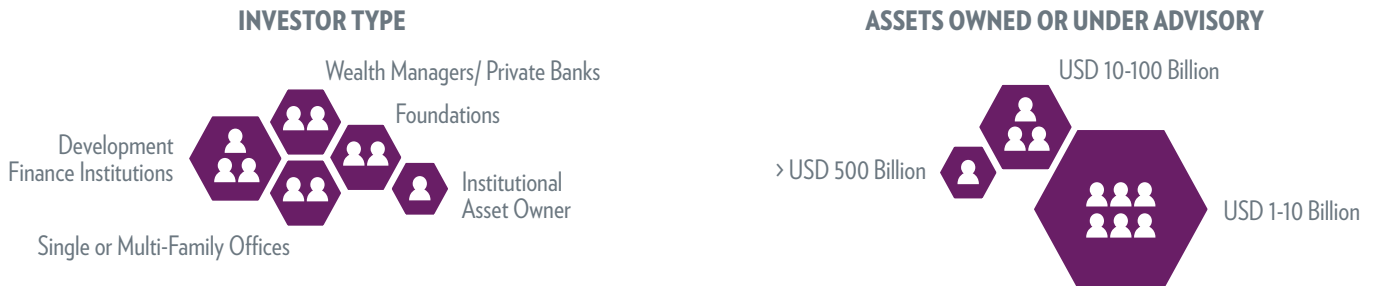
³ <https://www.iif.com/Research/Capital-Flows-and-Debt/Capital-Flows-to-Emerging-Markets-Report>

⁴ <https://www.andeglobal.org/blogpost/737893/348170/The-Small-and-Growing-Business-Sector-and-the-COVID-19-Crisis-Emerging-Evidence-on-Key-Risks-and-Needs>

Investor Panelist Profiles

A total of 10 asset owners (referred to in this document as ‘asset owners’ and ‘investors’ interchangeably) provided feedback on six fund products presented over three virtual workshops. The investors—including both GIIN member and non-member institutions—represented family offices, foundations, institutional investors, development finance institutions (DFIs), and private banks/wealth managers. Investors were all actively investing and seeking new deal flow, despite impacts from COVID-19.

Investor Attributes



Fund Profiles

During each of the workshops, two impact fund managers in the process of developing investment products specifically designed to respond to the economic impacts of COVID-19 presented their products to a panel of asset owners. The details of those funds can be found below.

Fund Attributes



⁵ Several funds had multiple investment geographies.

⁶ Returns figures are presented as net unlevered IRRs.

Investment Drivers and Constraints:

Investors noted three key drivers for their investment in debt products responding to the economic impacts of COVID-19. Notably, none of the investor respondents noted a strong financial driver for their investment into these funds. That may be in part because the funds, despite offering commercially-oriented investment opportunities via a tranching structure, were largely oriented toward providing below-market-rate debt to their investees to support them through periods of decreased revenues that resulted from COVID-19. Most investors, therefore, were skeptical of the dual narratives that (1) investees needed discounted debt, but (2) investors would receive a market rate of return. Consequently, investors' motivations for investing into COVID-19 related funds were related to the impacts those funds can generate or the characteristics of the funds themselves.

Supporting SMEs in emerging markets to sustain operations through the pandemic

Most investor participants noted that the primary driver for investing into products like those tested was to support SMEs in emerging markets through economic uncertainty caused by the pandemic. Many investors, however, do not have investment teams based in those markets, and rely on locally based fund managers to source investment opportunities and manage investments on their behalf. They were primarily attracted to these funds for that reason, though they noted that prior to COVID, that demand may have looked different (as it might as the economy hopefully begins to recover).

Some of the investor respondents were particularly drawn to funds that had exposure to their existing investees. One respondent commented that they have sought to invest in debt products with particular emphasis on providing bridge loans to the regions (and even specific companies) that they are invested into through their equity portfolio. Others simply saw concessionary debt or bridge loans as the most effective way to provide support to companies facing cash flow issues or insolvency as a result of COVID (rather than, say, providing technical assistance or grant capital).

Making and maintaining the financial case for emerging market impact investing

Several investors with long track records in emerging markets noted a desire to ensure the solvency of those markets and view their potential investment as a lifeline to get them through the pandemic. Investors with an impact-first mandate who had previously allocated to emerging market small businesses saw some of these products as a way of doubling down on the thesis that emerging markets can provide attractive returns. In order for that thesis to prove true, SMEs will need to not only survive this pandemic, but be in a position to grow once the recovery starts. Providing this incremental debt financing is a way of ensuring that happens.

The DFI respondents (who generally put emphasis on building economic systems) in particular noted that they fear that both the real risks and the perceived risks of investing into emerging markets will be exacerbated by COVID-19, and that by supplying additional capital to funds like those tested in these workshops, they are providing a lifeline to businesses that are the engines of that commercial opportunity. By doubling down to support those businesses, they will be protecting both their own existing investments and the business case that their organizations are premised on.

Drive toward less risky investments in 'risk-off' environment

As noted above, none of the investor respondents noted that they were driven to invest in these funds by a desire for competitive financial performance relative to the market rate of purely commercial opportunities. However, investors did note that they believed some of these funds offered returns in line with commercial peers, and with the added benefit of a social or environmental impact, they would be able or motivated to invest. In particular, many investors noted that debt funds like these, and particularly those with tranching structures or other blended finance elements that utilize catalytic capital to mitigate risk, are an attractive means of maintaining market exposure to impact funds and to emerging markets in this 'risk-off' environment brought on by the pandemic. Among wealth advisor and family office respondents in particular, where clients and families sought exposure to emerging markets (for social or economic reasons) or had target carveouts to impact, these debt funds were relatively attractive alternatives to riskier or more volatile securities like equities (public and private). Part of this is attributable to the risk profile of debt funds, generally, and another part is attributable to the first loss coverage or other blending that many of these blended funds offered.

Investors also identified constraints in further allocating to products seeking to respond to the economic impacts of COVID-19 products.

Risks associated with COVID-19 compound emerging market investment risk

Several of the risks associated with investing in emerging markets have been compounded by the economic and social impacts of COVID-19. In particular, investors cited increased volatility and a belief that currency markets would fluctuate significantly in light of the disparate monetary policies of emerging economies and the developed economies that account for the majority of their foreign investment. These are challenges that investors have always faced when deploying foreign investment into emerging markets, but they are compounded by the unpredictability of the COVID-19 virus and its economic impacts.

Further, while accessing comparable financial performance information from companies based in emerging markets has long been cited as a driver of risk, with much of the emerging world preparing for surges or experiencing lockdowns in urban areas, it is increasingly difficult for fund managers and their investors' alike to access sufficient information on the present and likely future state of the economy (and on the financial state of their companies) for screening and diligence.

Some structures differ from conventional counterparts

Each of the six products tested were blended finance vehicles, and therefore the structure was somewhat more complicated than a standard pooled fund and consequently, more difficult for some investors to understand. That the funds provide investment opportunities for commercially-oriented, market-rate seeking investors and catalytic investors alike in a single capital stack can often be a point of tension (e.g. commercial investors worry about whether their goals are aligned with catalytic investors, and vice-a-versa). While the complexity of the structure was a sticking point, several investors noted a greater openness to blended finance vehicles for the risk mitigation that the subordinate tranches and guarantees can provide to commercial investors. (More on the nuance of structuring a blended finance vehicle, below).

Key Fund Features Explored

Ahead of workshops, investors identified several key features on which to focus conversations. During the three sessions, investor panelists shared feedback on the attractiveness of those fund features. A synthesis of those opinions is below:

FEATURE(S) DESCRIPTION	INVESTOR REACTIONS
Tranches of Blended Finance vehicles should be structured to both mitigate risk and offer attractive investment opportunities for clients in light of the new economic circumstances created by COVID-19	Each of the six funds tested had at least one blended finance element, including junior debt, funded and unfunded guarantees, and first loss grant capital. Investor respondents had differing levels of experience with blended finance transactions, but all had invested in one or more. Structuring a blended finance fund during strong economic cycles can be difficult because it requires aligning the disparate interests of numerous investors in one capital stack. COVID-19 has, in some ways, provided opportunities to fund managers with experience in blended funds, and in others, has exacerbated those previous challenges. The economic uncertainty that COVID-19 has generated in emerging markets has made right-sizing blended finance tranches and structures especially difficult. Among investors providing risk-tolerant or concessionary capital within a blended structure, there has long been strong consensus that the amount of concessionary capital provided should be tied to a thesis about the amount of risk being mitigated. By providing too much below-market capital, those investors believe they could potentially distort the market and subsidize the returns of the commercial investors. By providing too little, they fear that the funds might appear too risky to crowd in commercial capital, or else might not sufficiently cover the risks associated with the funds' investments, thereby exposing commercial investors to too much risk and leading to longer-term reputational damage to the potential of blended finance. This already difficult exercise (of quantifying the risk of a portfolio of investments and comparing that to an identifiable benchmark), is exacerbated by the highly uncertain economic environment created by COVID-19. Both real and perceived uncertainty about the trajectory of the economy in emerging markets must be factored into decisions around how much catalytic capital to structure into a fund, and in what form. Simultaneously, the pool of catalytic capital that is able to be deployed has shrunk as foundations and donor agencies have either pulled back on allocations or else in some cases redirected allocations to direct relief.

In the context of COVID-19, many catalytic allocators advocated for a bottom up approach—starting with a quantitative assessment of the risk profile of each prospective portfolio of investments. From there, they encouraged managers to compare that risk profile to some broadly accepted index in the market in which they operate (over a time period including the volatility spikes induced by COVID-19), and adjust their blended elements accordingly. In short, concessionary investors were seeking a scientific and thesis-driven approach to determining the type and amount of catalytic capital provided. Managers almost uniformly expressed that such an analysis, in the context of COVID-19, was impossible. By the time the analysis was complete, and a structure determined, the market (and therefore the assumptions that underly the structure) may have moved enough to invalidate the structure entirely. Several managers used scenario analysis in order to mitigate this risk.

Commercially-oriented, market-rate-seeking investors (institutional and private) expressed a different perspective—that the amount of concessionary or risk-tolerant capital should be determined by market testing a fund with both themselves and catalytic capital providers. They felt that there was not sufficient data at the transaction level to be able to build out a bottom-up approach, and also have an understandable bias toward the supply-side perspective. Several catalytic capital providers took particular issue with this approach in the context of COVID-19, contending that in a world where precedent is less relevant than ever before, and where market volatility is off the charts, allowing commercial investors to inform the amount of catalytic capital a structure contains will lead to unnecessary subsidy.

Under the circumstances presented by COVID-19, Development Finance Institutions (DFIs) are a natural source of capital for many debt funds, but are also constrained by regulatory hurdles and stretched to support existing investees.

Of the six funds tested, four were explicitly seeking capital from Development Finance Institutions, and several had built tranches explicitly tailored to the needs of the DFI (typically a mezzanine or secondary senior tranche). In most cases, these offerings had relatively higher risk and return expectations and were subordinate to a more senior tranche targeting an institutional or private wealth investor set. Generally, DFIs were receptive to the offerings, but were conscious of the fact that large, quasi-governmental institutions like themselves are often not able to deploy capital in less than three months. Most of the funds tested were seeking to close on a tight timeline, in order to support their pipeline in a timely manner, and therefore concluded that DFIs may not be able to participate in these structures responding to the immediate impacts of COVID-19.

Some DFIs also noted that they prefer not to enter into blended finance transactions/capital stacks, because they worry about the perception of being ‘subsidized’ by catalytic capital providers. One DFI mentioned that they actively avoid these types of transactions, as their mandate prevents them from entering into any fund or vehicle that is not pure-play market rate. Managers (and other investors) expressed that, because of these limitations, DFIs may not be a natural partner for these types of funds going forward, which may limit the pool of capital available to these businesses.

Several of the DFI respondents did express that, given COVID-19, with so few investors able to direct capital to emerging markets, they are looking to be more flexible and agile in deploying, but that because of their role in managing mostly taxpayer money, they can’t change their mandates overnight, mid-crisis.

Simple structures are often advantageous in attracting investor interest.

Several investor respondents noted a strong preference for simple, not ‘over-structured’ vehicles. There is a natural tension between wanting to provide tranches that cleanly meet the mandates of a number of investor segments, and wanting to provide a simple structure that is easy to understand and manage. Particularly in the context of COVID-19, and the timeline on which managers were hoping to raise and deploy capital, investor respondents encouraged leaning toward the latter.

The desire for simple structures was driven, for most investors, by their own need to communicate about the structure to their own investment committee. Investing into emerging markets during COVID-19 is enough of a hurdle for an investment committee. Reviewing a structure that is inherently hard to understand presents yet an additional hurdle for investors to succinctly describe the opportunity at hand.

FEATURE(S) DESCRIPTION	INVESTOR REACTIONS
Manager compensation should reflect the economic impacts of COVID-19 and not create perverse incentives	Most investors noted a desire for fund manager compensation to reflect the urgent need for capital, by shifting from the typical return-incentivizing compensation models. The six funds tested during these workshops had compensation structures that fall into two categories: (1) Standard, market rate compensation structures, and (2) flat management fees (often 2.5-3%) without performance incentive. In general, investor respondents preferred the latter category (particularly among the subset providing catalytic capital), but there were mixed reviews on this front. For a few (more commercially-oriented) asset allocators, standard compensation structures (those with a flat fee on capital under management and a percentage of upside above a preset hurdle rate) were attractive because they mirrored more closely their purely commercial counterparts and were therefore easier to understand. Those commercial investors noted that, in addition to simplicity, they generally prefer to have their managers incentivized to perform well and that the traditional models with management fees and performance incentives tend to accomplish that task. Some commercial investors and most of the catalytic capital providers, however, noted that in uncertain economic environments, and working with a set of investees that are in tenuous situations because of the economic impacts of COVID-19, such an incentive could be adverse to the interests of the investees (and therefore, in the long term, adverse to the interests of the managers and their LPs). Many catalytic providers also noted that, in providing risk-mitigating capital to managers that they might not otherwise provide (in isolation of a pandemic), they expect the managers, too, to take haircuts in the form of performance incentives. All investors, however, acknowledged a desire to pay an adequate management fee and/or performance incentive to support their managers in operating effectively in emerging markets during unprecedented times. This led to a conversation about what type of performance the investors were seeking to incentivize. Of course, all investors sought good financial management and attractive returns. But most emphasized a desire for the funds to meet their impact potential as well—to provide necessary capital to support the solvency and eventual growth of small businesses in emerging markets. While no manager offered a compensation structure that was linked to the achievement of such goals (e.g. an incentive for those companies to meet certain solvency targets), investor respondents noted that they would be open to considering such structures.
Fund/vehicle life should reflect realistic expectations for recovery	Expected fund life should reflect the lack of clarity arising from the multiple plausible recovery scenarios The future state of emerging economies, in light of COVID-19 and the related impacts, is far from clear. These six funds each had a term of roughly 5 years. Managers noted that this was driven by a desire to deploy capital within the first 1-1.5 years and a belief that providing capital with flexible terms (including possible covenant-adjustment based on the solvency of the company) will be advantageous to these companies in the long-run. The loans disbursed will then have 1.5-3-year repayment timelines. Adding in 6 months or so as cushion, investors found 5 years to be the sweet spot, though several had built in possible 1-2 year extensions in their agreements with investors to ensure flexibility. While many investors noted a desire for short-term structures (particularly cited by commercially-oriented investors) to allow them to recycle capital back into other (possibly riskier and higher-return) investments as the economy recovers, others noted a desire to ensure that the fund terms were realistic about the chances of recovery, and were consequently comfortable with the 5-year term. Several of the catalytic capital providers did inquire about the ability to provide shorter-term investment opportunities, suggesting that it might be possible to structure an offering that allowed them interim liquidity (for funded mandates) after several years and after trajectory of the recovery became clearer. Those investors noted that they would recycle that capital into other, later-stage recovery vehicles.

FEATURE(S) DESCRIPTION	INVESTOR REACTIONS
Funds should have clear strategies for conducting due diligence during COVID-19	Investors noted a strong preference for managers with existing relationships with potential and pipeline investees. While not directly related to the structure of investment funds responding to COVID-19, every investor noted concern about managers' ability to effectively source and diligence companies in the midst of COVID-19 and the related shutdowns. Most managers, responding to this concern, plan to invest purely in existing or past portfolio companies so as to save time and energy and increase investor confidence in assurance practices. For one investor, this did create a philosophical concern: If it is true that capital in emerging markets is flowing only to companies that have previously received investment capital from impact investors and not to companies that have previously struggled to access capital, are we simply exacerbating the same power structures that have prevented access to capital in the past? In the case of these funds, managers contended that was not as much of a concern. While they, the managers, are providing loans only to existing investees, many of those investees are NBFCs or other financial institutions, who are, in turn, providing loans to micro-enterprises and workers in the informal economy. Many of those institutions are providing loans to new clients, despite lockdowns and other impacts of COVID-19.
Funds should be prepared to quickly deploy capital to investees	Most investors noted a desire to deploy capital quickly in order to best support investee companies. Particularly among the subset of investors driven by a desire to support SMEs in this period of lockdowns, the urgency to fundraise and deploy capital is significant. This meant that investors into funds were focused on two things (1) their own ability to diligence managers quickly and shift their own strategies for doing so away from in-person meetings and site visits, and (2) their managers' ability to line up pipeline and move quickly once the fund had been finalized and raised.

Get Involved in the GIIN's Product Development Platform:

The GIIN convenes workshops and working groups aimed at clarifying asset owner mandates and supporting fund managers to structure investment funds that meet those mandates. These conversations are open to GIIN members and external asset owners interested in learning more about in-development investment funds and contributing to the collective intelligence of the market. These conversations often take the form of product structure workshops, which bring together organizations dedicated to expanding a given SDG-aligned product segment. If you are interested in participating, please email productdevelopment@thegiin.org.

Disclosures

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Readers should be aware that the GIIN has had and will continue to have relationships with many of the organizations identified in this report, through some of which the GIIN has received and will continue to receive financial and other support.

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