NGOs and the challenge of impact investing: creating value and doing good

Improving outcomes and value for money

Several trends are disrupting the traditional funding sources relied upon by many non-governmental organizations (NGOs). Some government donor agencies that fund NGOs have threatened to sharply cut their budgets, as in the US, where 30 percent cuts have been proposed,[1] while the UK has signaled that it could start to impose tougher funding restrictions.[2] At the same time, liquid global capital markets and a greater risk appetite among financiers has expanded the landscape for private financing flows to include social and environmental programs — for example the growth of green bonds and SDG-linked equity funds. In relative terms, private foreign direct investment flows, remittances, and philanthropic giving far exceed the flow of official government aid to developing economies.

With this confluence of trends, many donors are thinking more like professional investors. "Private sector donors are becoming more sophisticated," says Trish Tweedley, Senior Director, KPMG Development and Exempt Organizations, US. "Many are seeking better value for money and returns on investment in terms of social outcomes, and expecting NGOs to be more accountable and transparent than ever." Similarly, public sector donors are looking for new ways to leverage their limited funding with blended (public-private) finance vehicles that augment declining public dollars with private funds.

The pivot

To adapt to a parsimonious and return-driven market for donor resources, many NGOs have taken a fresh look at their funding models. Some have seen this as an opportunity to add impact investing to their operations by pivoting towards activities that have social and environmental impact (doing good) while generating financial returns (creating value).

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>
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> Senior Director, KPMG Development and Exempt Organizations, US

The promise of an impact-investing approach for NGOs is to provide a new funding stream that diversifies them away from the problems of more traditional sources of finance — donations and grants for examples. Currently most NGOs live on the 'cliff-edge' as their financial resources are awarded for a fixed period and then drop off, leaving them with the perennial issue of finding new funding sources. They are also at the mercy of the changing tides of fashion as donors or philanthropists decide to shift strategies or just move on, leaving the recipient organization either underfunded or struggling to find new sources of finance. Impact investing offers the prospect of enabling NGOs to plan ahead with a more diversified pool of resources.

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[1] Source: Global Citizen website, Citizenship section, February 2018

[2] Source: DevEx website, News section, January 2018

However, the change in funding strategy also requires NGOs to provide greater transparency and accountability to their investor partners.

The cornerstone of impact investing is that it is driven by measureable results. Organizations have to think more intentionally about what they want to achieve and how they will achieve it. Dr Ruth Lawrence, Head of the KPMG Global Impact Investing Institute gives an example of the wide-reaching effects of social impact bonds, which are one kind of impact investment vehicle (see blue box below). In the case of a not-for-profit organization in Australia, the payment-by-results nature of social impact bonds "encouraged them to think much more clearly about how to define their program, the client group, and the cohort they wanted to work with," says Lawrence. "The not-for-profit organization had to think in the same way about the intervention, its inputs, achievements, how well it aligns with its mission, and how it would measure success."

The other side of the coin is that those who fund impact investments — whether public or private sector -- expect greater accountability. When NGOs can effectively demonstrate their success to others it can raise more funding. "It's good for branding and marketing," says Lawrence. "It makes it easier for NGOs to demonstrate to investors and the public what they are paying for and that the organization's mission is being achieved." Of course, those that do not deliver results may have the option to lift performance or face the risk of reduced funding.

Payment by results: how social impact bonds work

Social impact bonds, which ultimately are funded by an institution such as a government or international donor organization, are a popular model of payment-by-results impact investing.

An investor, which could be an individual, trust, foundation, bank, or community development institution, provides capital to a service provider to achieve an agreed social outcome. In many cases, the service provider is an NGO. The contract usually specifies a time limit and metrics for success. The service provider then delivers the program, and the more successful the delivery against measurable outcomes, the higher the return for the investor.

This means that organizations and investors that are often distant from the process can have greater certainty that their funds are providing a positive outcome. Two other parties are often involved in the process: an intermediary that structures and coordinates the relationship between the parties, and an independent third party that measures and validates the outcome.

Choosing a model, measuring results

Perhaps the greatest challenge for NGOs is how to modify their operations in order to foster financial value creation, while doing good. Fortunately, a variety of options are open:

Investor: NGOs may seek a seat at the investors table through the adoption of new business models. One NGO, with a history in providing financial services in developing countries, sought out business opportunities in under-served markets where its local knowledge and network could help establish a new, standalone operation that would complement its NGO activities. Others have created or co-funded investment vehicles like MicroVest,[3] which is partly owned by Mennonite Economic Development Associates, or Mercy Corps[4] which has a seed capital investment vehicle called the Social Venture Fund.

Co-creator: One NGO working in developing countries, for example, reviewed its own management and governance model and decided to update its board to include local beneficiaries. Now it can use its delivery capacity in the field to channel impact dollars with the added legitimacy that its work has direct oversight by beneficiaries. This ability to link demand with funding is an important role for NGOs, according to Martin Chrisney, Director at KPMG's IDAS Institute, "investors' greatest complaint is that there are too few good, investible deals." NGOs with on-the-ground experience can offer to screen opportunities and identify the implementation gaps that must be filled for programs to be successful.

Service provider: Another approach adopted by some is to identify new service provision roles in the budding impact investing ecosystem. For example, social impact bonds require a variety of actors to ensure their success (see blue box on the left). Funding parties like governments, multilateral banks and foundations often work with deal advisory partners to structure these pay-for-results models. While NGOs can provide the key implementation know-how, local knowledge is needed to deliver successfully. The Educate Girls program in Rajastan, India, was funded with a Development Impact Bond, and relies on investors like the UBS Optimus Foundation and the Children's Investment Fund Foundation, worked with a local NGO, Educate Girls, to expand learning opportunities and outcomes for girls with the pay-out based on actual results.[5]

Experimenter: Finally, NGOs have a unique advantage in being able to test and pilot new approaches in areas where impact investors are looking for double or triple bottom-line (social, environmental and financial) returns. Like venture capitalists, impact investors will have to use flexible models to find the right solutions, and often will fail several times before they succeed. NGOs can use these funds to pilot new models. Unlike traditional funding each experiment should be designed to contribute to the widening evidence base about what interventions are likely to work and why. The Australian government uses a 'test, try, and learn' approach that embeds

[3] Source: Microvest website, August 2018
[4] Source: Mercy Corps website, August 2018
[5] Source: Educate Girls website, August 2018

learning through data collection, monitoring, and a feedback loop. At an international scale, the Global Innovation Fund, with joint funding from USAID and DFID, seeks to fund pilot programs, test their results, and scale them up through the use of targeted grants and loans.[6] These efforts are part of a wider focus on creating an evidentiary base for future impact investment decisions.

Four questions to consider upfront

In the end, while the desire to consider impact investing is likely founded on its potential to harness new funding sources, there are critical questions that need to be considered at the outset. A careful and thoughtful response to these questions can help ground the discussions with an NGO's Board and Management and help determine which path to take.

Impact investing presents a range of distinct challenges to NGOs.

— First, the NGO must understand **what comparative skills and roles** it can play in the impact investing ecosystem. Whether as a facilitator in the deal origination process or a co-creator of new innovative pilot programs, the NGO should match the role with its existing capabilities or a future state.

— Second, there is the question of **what risk-reward trade off** is most suited to the NGO. Some may opt for a riskier strategy of making direct investments, while others prefer a more conservative role as a service provider. Each, however, entails changes in the underlying business model, issues of legal structure, consideration of financial solvency, and efforts to increase transparency and accountability — based upon verifiable results and implementation fidelity.

— Third, it is important to identity **who are the partners** that complement your skills and can fill gaps in the ecosystem that present barriers to successful project implementation.

— Finally, consideration should be given to **whether there is a willingness and capacity to restructure the organization** — operationally and/or legally, to be fit for purpose.

Final thought

When done correctly the promise of impact investing can create additional sources of revenue and greater opportunities to expand and scale impact. However, the shift from engaging solely with donors to engaging proactively with the impact investment ecosystem requires a clear strategy, strengthened delivery capabilities, and a solid grounding in data analytics in order to track and respond to outcome indicators. When NGOs meet these challenges and are equipped to succeed, they can scale the impact of their work and attract the long-term investment they need to grow and thrive.

[6] Source: Global Innovation Fund website, August 2018

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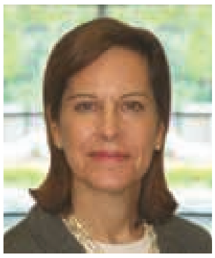

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