Zheng Partners LLC
IMPACT : EMERGING MARKETS
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RESPONSE TO FREQUENTLY ASKED QUESTIONS

PRICING IMPACT

Extending impact investing to price externalities and lower the cost of capital to impactful investments

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Since releasing the note “Pricing Impact” a month ago I have received a number of questions around common themes and I think it is worthwhile sharing these questions and my answers.

The four themes are:

- Can you summarize the key points of difference between the approach to impact investing developed in “Pricing Impact” and current approaches to impact investing.
- You make a big deal out of impact being created in what you label the commercial part of the impact opportunity space, but activity here lacks additionality and so will happen anyway. It is the parts of the impact opportunity space that you label ‘intent’ and ‘additionality’ on which we need to focus to create change.
- What part of the approach to impact described in “Pricing Impact” can an investor use now and how do they do this?
- If pricing externalities lowers the cost of capital for more impactful assets and makes activities undertaken at present by philanthropies and DFIs more commercially viable and scalable, does this imply a shrinking role for these groups?

In the answers which follow, charts and tables with numerical identifiers follow the numbering used in “Pricing Impact”: the number used here corresponds to the chart/table number in that document. Charts and tables with alphabetic identifiers are original to this Q&A.

(1) Can you summarize the key points of difference between the approach to impact investing developed in “Pricing Impact” and current approaches to impact investing.

The differences between the approach to impact investing outlined in “Pricing Impact” and current approaches to impact are both structural and conceptual.

The note itself focuses on structural issues – how can an approach to impact investing be developed which can be easily integrated with established portfolio management practice? I will confine my answer here to structural issues and cover conceptual issues in the response to the next question.

Table A summarizes the structural differences between the approach to impact investing described in “Pricing Impact” and current approaches to impact investing and describes the implications of these differences.

The implication of the differences between the approach to impact developed in “Pricing Impact” and current approaches to impact are that (i) current approaches to impact are not well aligned with established portfolio management practices, with the probable consequence that (ii) impact criteria are unlikely to be incorporated into the management of total assets under management and are likely to be confined to special buckets or carve-outs.

This in turn makes it unlikely that existing approaches to impact will be able to mobilize sufficient capital under impact-mandates to price externalities and lower the price of capital for more-impactful assets.

Table A Structural differences between the approach to impact investing developed in "Pricing Impact" and current approaches to impact

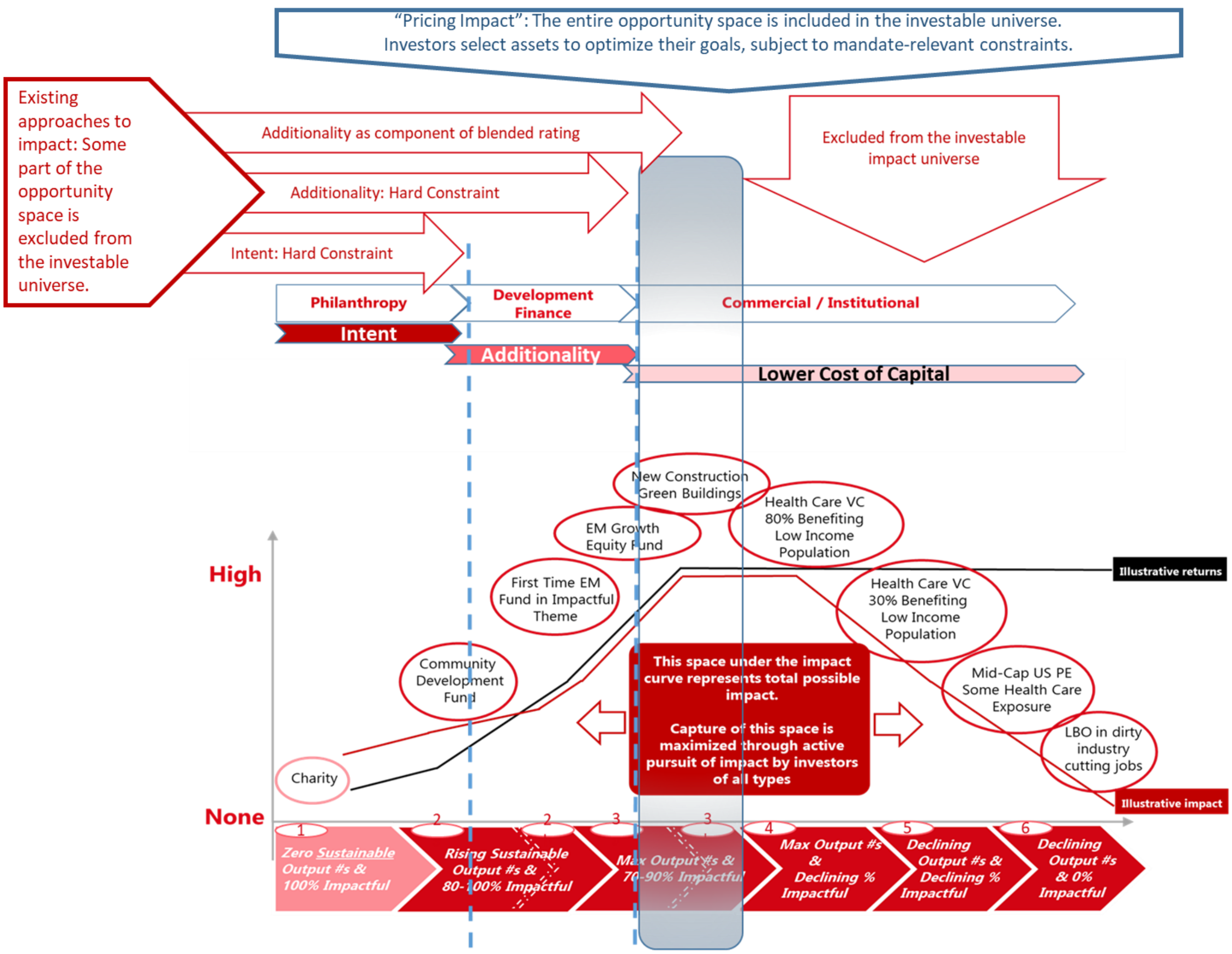
	"Pricing Impact"	Current Approach	Discussion
Emphasis placed on quantitative estimation of potential impact of assets	Total emphasis on quantity of impact at level of the General Theory. Significant emphasis at the level of individual assets.	Quantity of impact is 'in the mix' of factors used to rate the impact of assets.	A focus on quantity is required (i) if impact is to fit into a portfolio optimization framework and (ii) to develop a General Theory as qualitative factors cannot be applied to asset classes.
Emphasis placed on qualitative assessment of the potential impact of assets	Qualitative factors included in the assessment of the impact of individual assets, but excluded from the General Theory and assessment of the impact of asset classes.	Qualitative factors are a significant part of the rating of the impact potential of assets.	Qualitative assessment is important in judging the impact profile of individual assets. However qualitative assessment cannot be included in the assessment of asset classes as qualitative attributes are specific to individual assets.
Separation of quantitative predictors from mandate-related issues in rating potential impact of assets	Strict separation when assessing the impact potential of both individual assets and classes of assets.	Quantitative predictors and mandate-relevant factors blended in impact assessment.	Blending quantitative predictors and mandate-relevant factors into a single rating results in: (i) lack of correspondence between the rating and the quantity of impact created by an asset; (ii) inability to develop a General Theory; and (iii) exclusion of a large part of the impact opportunity space from consideration by investors.
Possible to develop a General Theory of impact	Yes. The strict focus on the quantity of impact and the separation of predictive and mandate factors enable the development of a General Theory.	No, due to blending of quantitative, qualitative and mandate-relevant factors in impact assessment.	Without the ability to develop a General Theory of impact it is not possible to rate the impact potential of asset classes.
Possible to rate both the potential impact of individual assets and classes of assets?	Yes, due to the ability to develop a General Theory.	No, due to inability to develop a General Theory.	Without the ability to rate the impact potential of classes of assets it is not possible to include impact alongside risk and return in portfolio optimization. This excludes impact from the initial stage of institutional portfolio design in which the major capital allocation decisions are made.

The structural differences between existing approaches to impact investing and the approach described in "Pricing Impact" result in significant differences in the degree to which investors are able to utilize all available opportunities to create impact. This is illustrated in Chart A.

The representation of the impact opportunity space in Chart A is derived from the general theory of impact developed in "Pricing Impact" and is described in pages 65-70. The impact opportunity space is very broad but divided into zones of activity particular to different types of investors (philanthropies, DFIs, institutional) by the mandate requirements of each type of investor.

As existing approaches to impact combine factors which predict the quantity of impact and mandate-relevant factors into a single rating, they exclude parts of the impact opportunity space from consideration by investors, reducing the ability of the market as a whole to maximize the total quantity of impact achieved.

Chart A   The investable impact universe: "Pricing Impact" compared to current approaches to impact investing



Looking at Chart A:

- A hard commitment to intent as a requirement for impact – for example a requirement for intent to exist at the level of the asset itself – will eliminate most of the impact opportunity space from consideration.
- A softer intent requirement (for example intent exists at the level of the investor) combined with a strict undiluted commitment to additionality (for example the type of additionality

requirement applied by the DFIs) will exclude assets beyond segment 3a of the impact opportunity space.

- A softer intent requirement combined with an impact rating methodology in which additionality is incorporated as one of several rated attributes will extend the investable universe beyond segment 3a. Exactly how far beyond segment 3a will depend on the weighting given to additionality in the methodology.
- Any impact methodology which incorporates mandate-relevant factors into its ratings to a greater or lesser degree, rather than maintaining separation between predictive factors and mandate-relevant factors, will eliminate some part of the impact opportunity space from consideration by investors.

The approach to impact developed in “Pricing Impact” suggests that a very large quantity, possibly the majority, of impactful outputs such as jobs, access to socially beneficial things such as education and healthcare and environmental effects are located in the part of the impact opportunity space which is most likely to be excluded from the consideration of investors by methodologies which embed mandate-relevant factors.

“Pricing Impact” also suggests that excluding such a large part of the impact opportunity space from consideration will prevent sufficient capital ever being managed under impact mandates to price externalities and lower the cost of capital for more impactful assets relative to less impactful assets.

2) You make a big deal out of impact being created in what you label the commercial part of the impact opportunity space, but activity here lacks additionality and so will happen anyway. It is the parts of the impact opportunity space that you label ‘intent’ and ‘additionality’ on which we need to focus to create change and achieve the SDGs.

This is the “So what?” response to my answer to question 1.

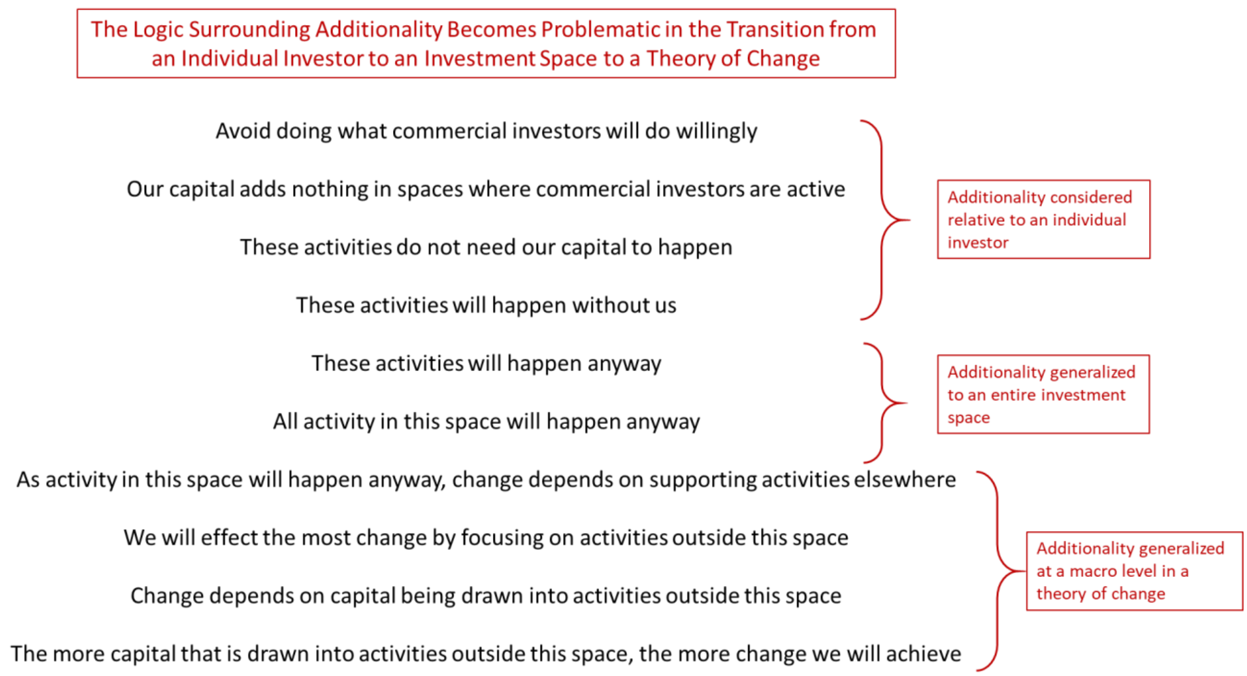
The perspective of this question is that excluding parts of the impact opportunity space from consideration by investors is desirable. Additionality is a desirable constraint for *all* investors in the context of impact as, to achieve the SDGs, we need to be doing things which otherwise would not happen. Investment activity in segments 3b to 6 of the impact opportunity space is fully commercially viable and will happen anyway. Therefore, to achieve the SDGs, we need to bring more investment activity into segments 2a to 3a.

My response to this line of thinking brings out the conceptual difference between the approach to impact investing in “Pricing Impact” and many current approaches to impact.

I think the question is incorrect in regarding investment activity in segments 3b to 6 of the impact opportunity space as pre-determined and beyond influence.

Chart B illustrates the transition of additionality from a concept applied to the activities of an individual investor, to a concept generalized to groups of assets, to a concept framing theories of change. As a concept which helps individual investors to remain true to their mandates, I think additionality has a role. However, as the application of the concept of additionality moves away from individuals to become a generalized way of framing an approach to entire groups of assets I think it becomes problematic as it is too narrow a frame of reference.

Chart B: Thinking around additionality can eventually create a barrier to maximizing the quantity of impactful outputs



A casual perusal of the history of investor preferences and capital allocation makes it clear that the allocation of capital within segments 3b to 6 is quite changeable and not at all pre-determined or immutable. Investors' allocation of capital within segments 3b to 6 changes in response to a multitude of factors including perceptions of the investment cycle, political risk, climate risk and enthusiasms for a changing cast of themes – biotech, dotcom, mortgage-backed securities etc.

Viewing investment activity in segments 3b to 6 as "going to happen anyway" and therefore "change depends on encouraging activity outside these segments" overlooks the possibility of influencing investors' allocation of capital within these segments of the impact opportunity space.

In particular it overlooks the possibility of shifting investor preferences toward more impactful assets and away from less impactful assets. Shifting investor preferences in this way would increase the allocation of capital within segments 3a to 6 to more impactful assets and reduce the allocation of capital to less impactful assets.

Further, given that the majority of global invested capital is located in segments 3b to 6, a reallocation of capital within these segments of the impact opportunity space has the potential to have enough scale to achieve the pricing of both positive and negative externalities and lower the cost of capital to more impactful assets. Lowering the cost of capital to more impactful assets will in turn increase the viability and scalability of impactful activities, attracting further capital to impactful activities and creating a cycle of positive re-enforcement for impact.

Creating this cycle is, in my view, our best chance of achieving the SDGs.

3) What part of the approach to impact described in "Pricing Impact" can an investor use now and how do they do this?

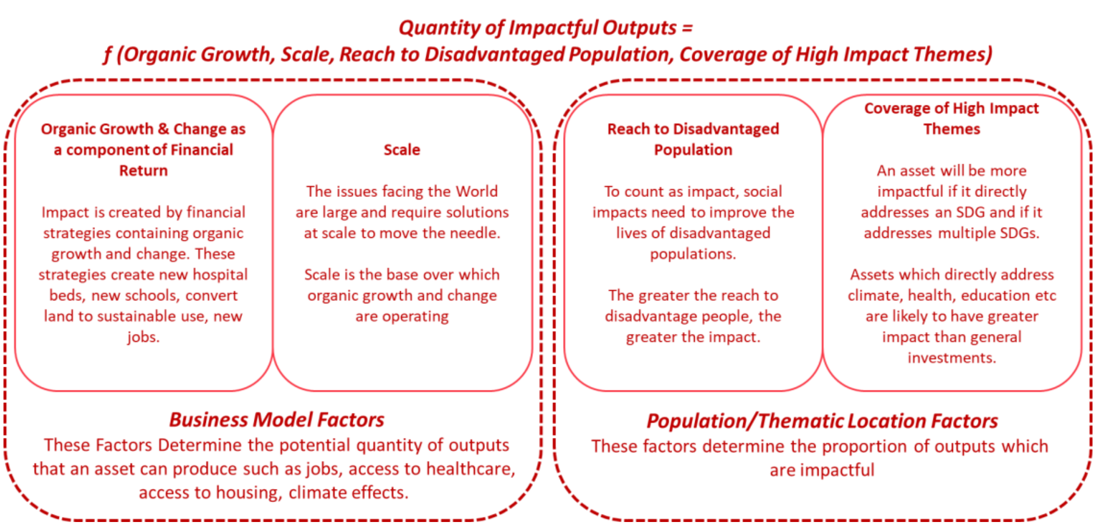
One of the major challenges to operationalizing an impact strategy is the lack of impact data. The approach to impact developed in "Pricing Impact" provides some help with the data issue by suggesting that we can begin to operationalize an impact strategy by using a general theory which has the least demanding data requirements of any approach to impact.

Chart 34 on page 93 of "Pricing Impact" suggests that the data required to begin to use the general theory of impact developed in "Pricing Impact" is the least complex level of data required in the impact space.

Chart 34 Layers of Complexity in Information for the Analytic Core of Impact

Chart 21 (page 49) describes the general theory of impact developed in "Pricing Impact".

Chart 21 The Determinants of an Asset's Ability to Create a Quantity of Impactful Outputs



The data required to operationalize the general theory of primary impact outlined in Chart 21 is described below. Larger institutional investors and advisors should be able to gather enough of this data from their records to create an initial scoring system and begin using the general theory as a guide to portfolio construction.

- *Contribution of organic growth to financial returns*. This can be obtained from the type of equity value creation waterfall analysis illustrated in Chart 20 (page 47 of "Pricing Impact"), which can be applied to the equity of any asset.
- *Scale*. A rating can be created for scale based on sales revenue at the time of investment.
- *Reach to low income population*. This can be based on the income distribution of the population in the geography in which the asset is located – where staff are hired and/or where sales are made.
- *Coverage of high impact themes.* Thematic exposure can be determined by the proportion of revenue generated by high impact themes.

The general theory can be used in a variety of ways:

- As a gating mechanism to create an initial sorting of more impactful from less impactful assets.
- As a way to identify lower-cost ways to get exposure to impact. This is illustrated in Chart C which maps impact scores and valuation multiples to identify the relative pricing of different types of impact.
- As an input to portfolio optimization to assist investors to create portfolios which meet their goals in terms of risk, return and impact. Such an exercise is illustrated in Chart 28 (page 77 of "Pricing Impact").

Chart C   Using the General Theory to Identify the Relative Pricing of Different Types of Impact

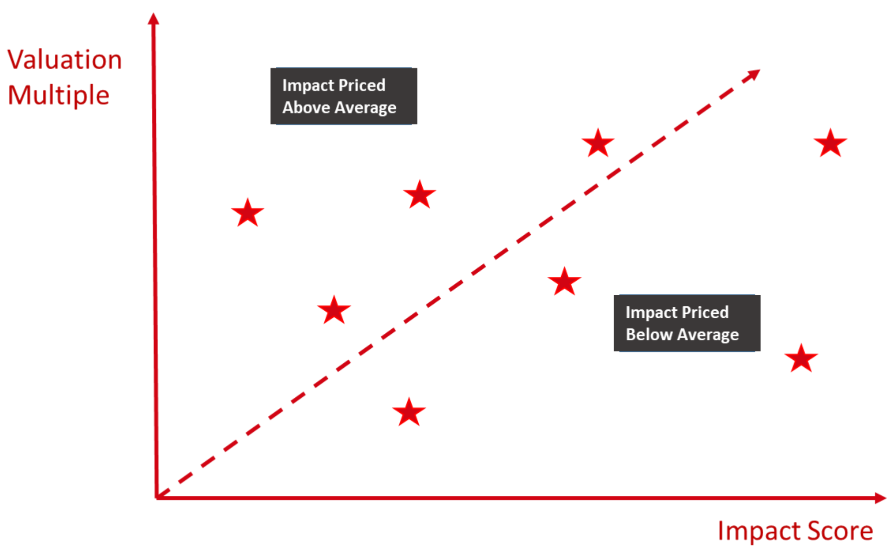
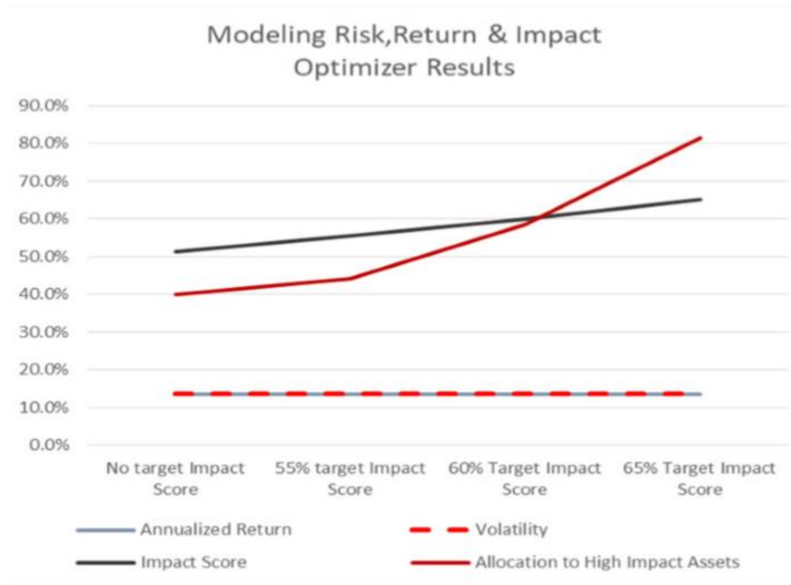


Chart 28   Increasing Portfolio Impact by Modelling in the Three Dimensions of Risk/Return/Impact



While larger institutional investors and advisors will be able to get enough data to begin to use the general theory, many other investors will not have access to enough data.

Even the larger institutional investors will lack sufficient data across all asset classes to create more than an initial approximate attempt. While this will be informative and enough with which to begin, more data across all segments of all asset classes would improve accuracy and focus.

The market does not need to wait for the creation of a public good version of the general theory based on pooling data from multiple sources to create a robust foundation before beginning individual initiatives to use the general theory. However, the creation of the general theory as a public good would help investors of all types.

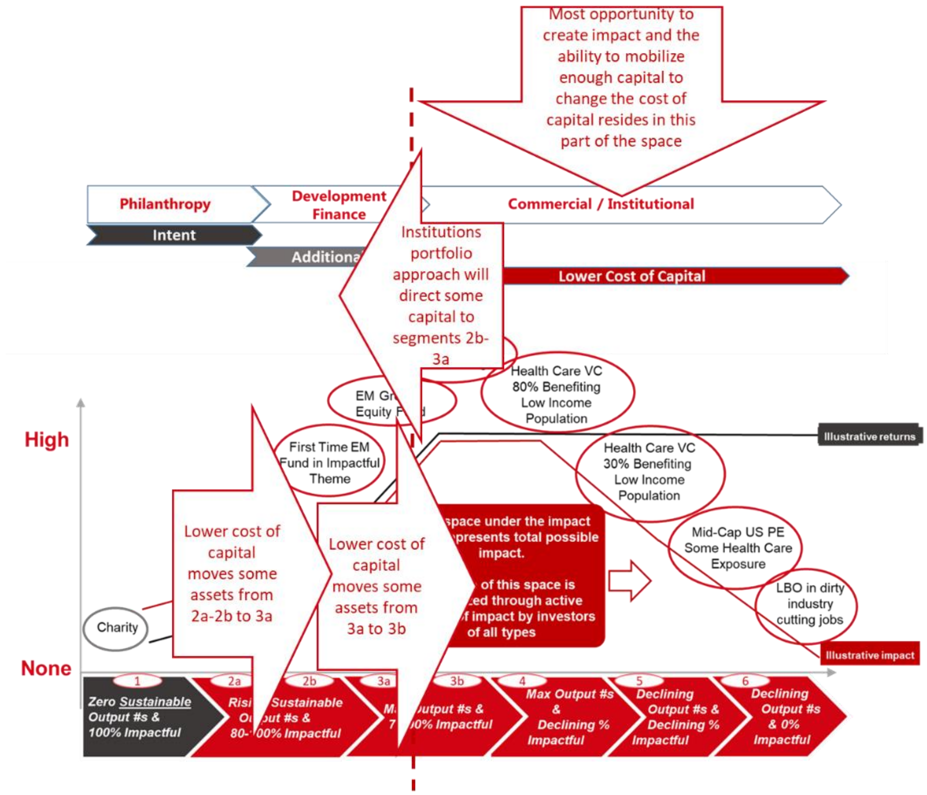
4) If pricing externalities lowers the cost of capital for more impactful assets and makes activities undertaken at present by philanthropies and DFIs more commercially viable and scalable, does this imply a shrinking role for these groups?

Chart 5 on page 10 of "Pricing Impact" suggests that lowering the cost of capital for more impactful assets will make some assets that are currently located in segments 2a-3a of the impact opportunity space more commercially viable and scalable. Chart 5 illustrates this as moving these assets into other segments of the opportunity space outside the mandates of philanthropies and DFIs.

Reflecting on this, I do not think Chart 5 provides the best illustration of what I believe will happen if the cost of capital for impactful assets is reduced.

The initial effect of lowering the cost of capital for more impactful assets will be to improve the environment in which philanthropies and DFIs operate by creating more opportunities to successfully scale activities on a sustainable basis.

Chart 5 The Logic of Capital Mobilization When Predictive and Mandate Factors are Kept Separate



In the short term these opportunities will remain in the segments of the opportunity space dominated by philanthropies and DFIs and will be acted upon by philanthropies and DFIs rather than commercial investors as, in the short term, they will continue to fit the deal screening criteria of these groups and not that of commercial investors.

This is likely to lead to a period of improved results for philanthropies and DFIs, enabling them to secure more support and expand their operations.

Down the road, this success will attract the attention of commercial investors whose interest in activities in segments 2a-3a will increase, attracting more commercial capital into these segments.

The open question is how the increasing amount of commercial capital engages with segments 2a-3a.

There are many options.

Commercial investors could establish their own vehicles through which to operate in these segments in direct competition with philanthropies and DFIs. Alternatively, rather than committing resources to create their own operations, commercial investors could see an advantage in working in these segments in partnership with philanthropies and DFIs. The outcome will likely be a blend of both approaches.

As long as philanthropies and DFIs are aware of the opportunities to partner with commercial investors and successfully position themselves to do this, I see no necessary reason why a lower cost of capital for impactful assets will reduce the role of these groups.