Catalytic Capital Consortium

COURAGEOUS CAPITAL ADVISORS

EXECUTIVE SUMMARY

Advancing Practice in Catalytic Capital

Guidance Note 3 - The Sustaining Role

December 2022

Guidance Note Series

SEEDING

SCALING

SUSTAINING

EXECUTIVE SUMMARY

Impact investing is now part of the investing mainstream. Major financial services institutions have entered the field, and size estimates of the sector range from $1.2 trillion[1] to $2.3 trillion[2]. Yet while much has been achieved, numerous opportunities to deliver impact still fail to attract investment. Significant capital gaps remain, particularly for opportunities that are new and unproven, are sub-scale, or entail more challenging risk-return profiles - often targeting particularly poor and marginalized communities and geographies.

Capital gaps such as these, and the underserved impact opportunities they represent, are where catalytic capital plays a critical role in ensuring that impact investing pushes farther, harder, and faster to help build a more equitable and sustainable future.

Taking up this important challenge is a growing community of catalytic capital investors that are striving to advance the practice. How can catalytic capital move more quickly and effectively into impactful opportunities? How can it best mobilize other capital in that process? How can it better meet the real needs of people and planet in pursuit of impact that could not otherwise be achieved? These are some of the questions we seek to address through this work, with the aim of strengthening and accelerating the catalytic capital investing practice across the field.

The guidance note summarized here is the last of a series of three such notes, each of which focuses on one of the three roles of catalytic capital - Seeding, Scaling, and Sustaining - as set out by Tideline (2019). This third guidance note specifically addresses challenges faced when deploying catalytic capital in the Sustaining role.

All three guidance notes within the series are intended as a practical resource for catalytic capital investors, designed to help them reflect on and advance their practice to deploy such capital with effectiveness, efficiency, and integrity. The notes have a focus on indirect investment, but much of the discussion is also relevant for direct investment activity.

The guidance note has been developed based on invaluable input from and discussions with leading practitioners in the Sustaining role of catalytic capital that participated in the C3 Scaling Learning Lab Series, a sequence of in-depth peer-learning discussions organized and led by Courageous Capital Advisors. In addition, investment managers provided vital input and perspective. The authors are deeply grateful to all who contributed.

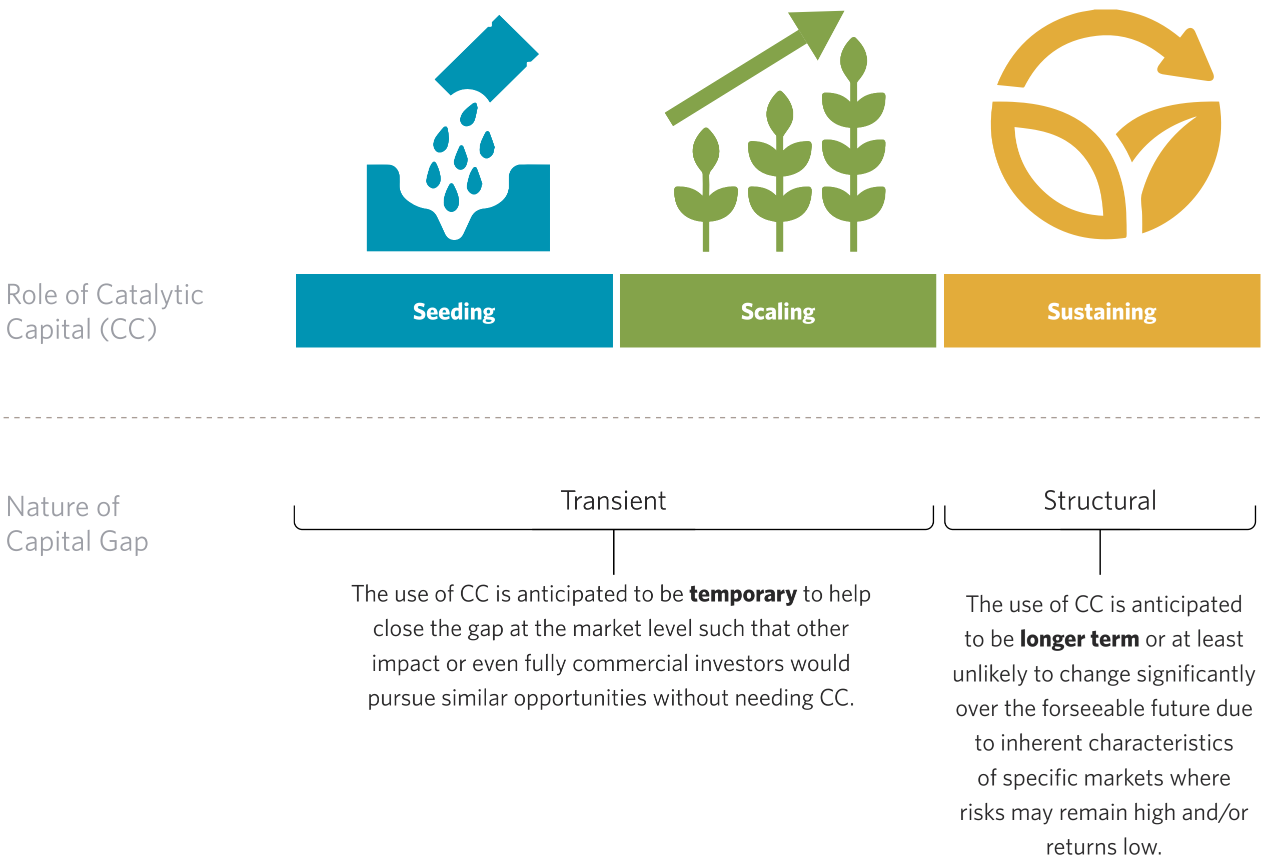
1 Global Impact Investing Network (2020) Press release

2 International Finance Corporation (2021) Investing for Impact: The Global Impact Investing Market 2020

Sustaining: The Challenge of Structural Capital Gaps

The Seeding and Scaling catalytic capital roles, which are discussed in detail in the first two guidance notes, typically come with the implication (or at least an investment thesis) that the capital gap and need for catalytic capital is transient (i.e., that ultimate success is about closing the gap at the market level such that mainstream impact or even fully commercial investors would be able to pursue similar opportunities down the line without needing the involvement of catalytic capital). By contrast, the Sustaining role, which is the subject of the third guidance note, typically assumes that the capital gap is structural, meaning that it is anticipated to persist for an uncertain period generally understood to be over a longer term, as explained in Figure 1 below.

FIGURE 1: CATALYTIC CAPITAL ROLES AND CAPITAL GAPS



The Sustaining role of catalytic capital is perhaps the most difficult because it addresses the most challenging capital gaps. This role seeks to extend capital - and deliver impact - to people and places that are the hardest to reach. Sustaining capital focuses on sectors (or sub-sectors), business models, population segments or geographies that are typically sidelined when it comes to investing, as they entail persistent high risks and/or low returns. Sustaining vehicles and strategies cannot achieve full commercial viability in the foreseeable future without catalytic capital to absorb ongoing (i.e., long-term) disproportionate risk and/or accept concessional returns.

1. **Risk:** there are many risks that, when significant, can lead to a long-term structural capital gap. While transient risks typically include those that can be reduced over time—such as perceived risks that are addressed through increased data and track record, and also some real risks that can be addressed through market maturation (e.g., business models becoming increasingly tested and refined; sectors gaining maturity through gradual maturation and sophistication of operating enterprises)—structural risks are (even) more difficult to address and reduce. They are typically anticipated to remain over the longer term and carry a high degree of uncertainty as to when or whether they will be fully resolved. Structural risks can include one or more of the following:

- ✓ high and persistent risks related to a targeted *geography*;
- ✓ high and persistent risks that are inherent to *investees* in a *targeted sector* (or sub-sector) or pursuing a certain *business model;* and/or
- ✓ high and persistent risks that stem from the nature of the *end-users* or *clients* of the investees or their targeted *population segment.*

2. **Return:** similarly, there can be structural return challenges, where no short- or medium-term growth trajectory will allow for the underlying enterprises, strategy or vehicle to scale out of initially sub-commercial returns. Structural return challenges can apply in sectors or strategies that are "tried-and-tested", i.e., with a track record, but also in combination with untested, sidelined markets that bear uncertainty and high risks. Return challenges, leading to a vehicle needing to offer sub-market returns to investors, usually occur with respect to:

- ✓ sub-market investor-level returns reflecting *moderate investee-level returns*: e.g., due to structurally sub-commercial unit economics or pricing constraints linked to the target market; and/or
- ✓ sub-market investor-level returns reflecting *high fund-level costs*: e.g., due to small fund size leading to relatively high operating costs; high transaction costs due to small investment amounts; or high management fees due to small investment amounts and/or high-touch investee support.

The risk and return factors shown above are not mutually exclusive. Risk and return are two sides of the same coin and, usually, more than one of the factors apply to a Sustaining vehicle. The difficulty often lies in understanding the nature of the capital gap, resulting in a realistic assessment of what results can be reasonably and credibly targeted.

Unlike the Seeding and Scaling roles of catalytic capital, Sustaining vehicles are typically not regarded as "shiny and exciting". Indeed, they are often considered boring as they may lack the excitement of new players, innovative models and novel strategies, and newsworthy levels of commercial capital mobilization. That said, they are critically important. They tackle the hard-to-reach households and communities in the places forgotten or in the shadows.

While structural risk-return gaps are persistent (i.e., with no anticipation of a short- or medium-term transition out of the gap and consequent reduction of the need for catalytic capital), investors in these strategies nevertheless often have a long-term view on change beyond the deal-level impact. Many investors aim to advance market- or systems-level change – which is particularly relevant in Sustaining transactions, where long-term routes towards reducing tenacious structural capital gaps are often the explicit drive for deploying catalytic capital.

Key Challenges Faced by Practitioners when Deploying Catalytic Capital in the Sustaining Role

Our in-depth discussions with experienced catalytic capital investors have surfaced a number of key challenges deploying catalytic capital in the Sustaining role. The challenges are summarized at a high level below, organized by specific investment process elements. These challenges are laid out in detail in the full guidance note, where suggestions for more effective approaches and behaviors, examples and ideas are discussed and presented.

A. STRATEGY

Catalytic capital investors are often confronted with a lack of internal and/or external clarity on their catalytic capital's objectives and investment parameters, including risk-return parameters. Clarity is particularly important in Sustaining transactions as they require the willingness to go the extra mile, both with respect to effort and flexibility of the capital. If there is no clear intentionality internally, including an articulation of objectives and additional flexibility on the parameters, such transactions are likely to stay unaddressed.

Externally, a lack of clarity increases the degree of difficulty for managers to put together and execute already challenging deals. While in Scaling vehicles the blended structure puzzle is tough to solve, it is often even trickier for Sustaining vehicles. In Sustaining deals some pieces of the puzzle need enhanced willingness, capacity and ability to put in effort to get the deal over the finish line and to accept disproportionate risk-return propositions.

Also, particularly in Sustaining investments, close collaboration - including the sharing of data and analyses, the discussion of multiple viewpoints and brainstorming of ideas, and effective cooperation on initiatives and deals - is needed to chip away at structural issues and, over time, achieve change.

In summary, if there is no clear strategic intentionality to the effective deployment of catalytic capital, the Sustaining capital gaps and their underlying market failures and challenges are likely to remain unaddressed.

B. UNDERWRITING

Sustaining (and also Seeding and Scaling) transactions often face significant underwriting challenges, including delays and unnecessary loops due to unclear asks and obscure processes and the inefficiencies that stem from a lack of sharing of materials, analyses and knowledge.

In addition, specific challenges arise in Sustaining deals because of the often-opaque nature of the structural capital gaps and the need for bespoke and tailored responses, as well as the struggle to internally justify the use of subsidies.

Underwriting Sustaining deals often requires additional effort, leading to particularly long and convoluted processes and delays, preventing the capital from reaching its destination in a timely manner - or at all.

C. CAPITAL-RAISING

Capital-raising, from start (finding investors) to finish (transaction signing and closing) takes a long time. The reasons for this are myriad. They include challenges around topics such as bespoke blended structures (leading to an intricate "investor puzzle" that needs solving), siloed investor processes and lack of cooperation, from underwriting to legal documentation and negotiation.

For Sustaining vehicles, these significant challenges become even more pronounced. In addition to the underwriting challenges discussed before and the structuring challenges to be discussed in the next section, fundraising is particularly challenging as not many – even catalytic capital – investors focus on Sustaining transactions, and the ones that do at times do not have large amounts of capital they can invest in Sustaining deals. Catalytic capital investors active in Sustaining propositions need to be willing to roll up their sleeves, stick with it and continue to be flexible along the path, if they want to truly achieve change over time.

D. STRUCTURE & TERMS

Many catalytic capital transactions, including Sustaining deals (perhaps even more so), have complex and blended structures, entailing long and convoluted negotiation processes and legal documentation. Sustaining transactions typically require more catalytic capital flexibility on terms and risk-return appetite, given the nature of the structural capital gaps.

The risk and return challenges prevalent in many Sustaining transactions, and the often-limited underlying data and bespoke nature of the challenges at hand, can make these vehicles challenging to structure.

Ways to Advance Practice

The full guidance note includes a number of proposed approaches, including real-life examples, practical suggestions, modified behaviors and actionable ideas, for the field of catalytic capital investors that we believe have the power to advance the practice by responding to the identified challenges. Some of the key messages from the note include:

1. **Play the long game.** Sustaining strategies require tenacity. To reflect the importance of that feature in catalytic capital in the case of Sustaining investments, we added tenacity to the capital "superpowers". By itself, one investment will not fill the structural capital gap and even less chip away at it. Therefore, catalytic capital investors that take up the challenge to tackle structural gaps should have a realistic long-term perspective when they develop their strategies, objectives and investment parameters, construct their portfolios, and assess a single deal.

2. **Build the racetrack.** In Sustaining deals one needs both investors with a deal-level perspective, engaging to fill a structural gap in the market, and investors with a longer-term market- or even systems-change perspective, that choose their investments with a view to, step-by-step, shift a dysfunctional (or at times build a non-existent) market and thereby create long-term indirect impact beyond the immediate direct impact of the investment itself.

3. **Purposeful outreach.** Even more than Seeding and Scaling catalytic capital, Sustaining requires close cooperation, on both a strategic and deal level, between investors and beyond. As discussed in this note, Sustaining deals are difficult to pull off, all the way from underwriting to structuring and negotiation. Further, as per above, Sustaining investors often seek to look beyond the deal level to the market or system level. In all scenarios, building relationships, sharing data, embarking on joint initiatives and co-investing are important to unlock deals and create new - maybe even more relevant - vehicles.

4. **You are not alone.** The pursuit of Sustaining strategies is often an uphill battle - both outside an institution, where one may be the only investor (or just one of few) tackling a

structural gap, but also inside an institution, where Sustaining propositions, or pushing the envelope on them, are often pursued by single champions or new teams that still need to do substantial internal convincing to get the broader institution on board. That said, as our Learning Labs proved, there are peers out there that share both willingness to engage and a similar vision - who are happy to exchange experiences, approaches and work together.

We encourage the reader to read the full guidance note, which provides much more detail including several actionable ideas that may galvanize more catalytic capital investing. We hope that catalytic capital investors, both those already active and those aspiring to commence activity, will benefit from some of the messages outlined above and the detailed proposed approaches and behaviors described in the full guidance note. With the insights and ideas presented in the Sustaining guidance note we hope to make the effort to get Sustaining vehicles across the finish line a little easier, the timelines of such deals a little shorter and shifts to structural gaps and markets a little more likely.

Reflecting on the three guidance notes and the investor input that contributed to them, it is our vision that catalytic capital investors will continue to roll up their sleeves individually and collaboratively across investor types and across the catalytic capital roles of Seeding, Scaling and Sustaining to advance the practice of catalytic capital in pursuit of positive impact.

Acknowledgments

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This work has been commissioned and funded by the Catalytic Capital Consortium (C3), an investment, learning, and market development initiative to promote greater and more effective use of catalytic capital, in recognition of its essential role in realizing the full potential of the impact investing field and achieving the Sustainable Development Goals. Together, the C3 Strategic Partners - The Rockefeller Foundation, Omidyar Network, and the MacArthur Foundation - are supporting field-building work through the C3 Grantmaking Program, housed at and managed by the New Venture Fund.

C3 Grantmaking works to advance learning and market development related to catalytic capital and helps to answer critical questions about the scope of the need for catalytic capital, when and how catalytic capital can be most effective, and what tools and practices are needed. It does this through activities aimed at strengthening the evidence base, advancing the practice in the field, communicating and facilitating engagement among investors and fostering solutions and infrastructure.

This work has been produced by Courageous Capital Advisors, which also designed and led the Learning Lab series.

About Courageous Capital Advisors

Courageous Capital Advisors is an impact investing advisory firm. We believe that financial capital should be used to build a just, equitable, sustainable, and resilient society for all, our North Star. Recognizing that one size does not fit all, we tap a range of financial tools and instruments to combine different types of capital to achieve the impact objectives we seek in order to move us closer to our North Star.

Learn more at www.courageouscapitaladvisors.com.

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