Impact investing in Kenya: Practises and potential

Researchers Albert Lundberg and Carl Broomé recently returned from Nairobi, the capital of Kenya, where they spent the last couple of months assessing the country’s nascent impact investing sector. In this issue of Social Finance, they share some of their findings and conclusions. For more information we refer our readers to their comprehensive report 'Impact investing in Kenya: Practises and potential'.

Wanted dead or alive: Inclusive growth

Is capitalism inherently good or evil? Depending on whom you ask, you are bound to get different answers. Consensus will most likely never be reached. Can capitalistic methods, however, be used to fight poverty and facilitate social progress? This is what proponents of impact investing claim. While the ever on-going discussion on the morals of capitalism is likely to continue as long as man walks the earth, there is widespread consensus that aid and philanthropy will not solve the development challenges facing Africa, with Kenya being no exception. The challenges are in financial terms simply too big. Even if aid has an obvious and vital role to play in many situations it does not create resources. This limits its scope and scale, thus other instruments are needed.

Although many economies in sub-Saharan Africa have seen rapid economic growth since the dawn of the new millennium, extreme poverty remains widespread. Despite having more than quadrupled the size of its economy over the last fifteen years, 40% of Kenyans are stuck in extreme poverty, living on less than $1.75 a day. In fact, the share of Kenyans living in poverty remained virtually flat between 2006 and 2012, despite strong economic growth. Finding ways to facilitate continued economic development that benefits a larger share of the population should be of highest priority for anyone who wishes to improve the lives of ordinary Kenyans.

What then could be done, to not only sustain economic growth, but also make it more inclusive? Enter, the phenomenon of impact investing. First coined in 2007 at a conference held at the Rockefeller Foundation’s Bellagio Center, the term has gained momentum over the last half decade, spurring interest not only from philanthropic foundations but also from investment firms like JP Morgan, Credit Suisse and more recently Bain Capital. Impact investments are capital investments done with the explicit intention of creating both a financial return and a measureable positive social and/or environmental impact. The phenomenon aims to combine the practises of traditional investments with the goals of philanthropy. It is not confined geographically or to certain asset classes and impact can be delivered in various ways: Through jobs and higher income, better education, access to clean water, or through the spread of clean energy, to name a few.

The definition might seem similar to its perhaps better-known relative, SRI (Socially Responsible Investing).

Impact investing, however, goes further. SRI involves mainly negative screening, i.e. investors disregard certain businesses or even sectors since they are considered to have a

"Even if aid has an obvious and vital role to play in many situations it does not create resources. This limits its scope and scale, thus other instruments are needed."

"Impact investments are capital investments done with the explicit intention of creating both a financial return and a measureable positive social and/or environmental impact."
negative social or environmental impact. Impact investing, on the other hand, specifically targets investment objects that are considered to have a positive impact.

The case of Kenya

Kenya is not only East Africa’s largest economy; it is also emerging as an African financial services hub. Meanwhile, as noted above, it is also a country with immense needs for social progress. These two factors form the basis for successful impact investments. East Africa has been described as one of the centres of global impact investing, with Kenya in general and Nairobi in particular singled out as the regional hub. So far, approximately half of all impact capital disbursed in East Africa has targeted Kenya. Nonetheless, Kenya’s impact investing sector is still young and relatively unexplored. Existing research is, to say the least, limited.

Different countries offer different contexts, which means that different practises are suited. How is impact investing currently practised in Kenya, and what do the actors involved think about the prospects of the sector? These were some of the questions we intended to answer when we set out to investigate impact investing in Kenya. We interviewed 16 different actors, all in some way related to the Kenyan investing scene, to hear what they had to say on this new phenomenon. Some of the findings and conclusions from our resulting study Impact investing in Kenya: Practises and potential are presented here.

What’s impact investing all about?

The impact investors we surveyed in Kenya claim that they differ from their traditional commercial counterparts in mainly four regards:

- They are willing to do smaller investments
- They are willing to exercise greater patience
- They are willing to accept greater risks
- They are willing to explore and develop new markets and segments

In Kenya, as well as in many other countries, a recurring constraint on growth is often said to be ‘the missing middle’. A majority of the population is working for local ‘mom-and-pop’ businesses that still only provide a fraction of the country’s GDP. Large businesses and corporations that contribute a lot more to GDP employ a minority of the population. In between not much is found, hence ‘the missing middle’. A perceived lack of investments is considered by some to prevent small businesses from growing to become medium-sized. Impact investors in Kenya claim that they address this by providing capital for smaller businesses.

Impact investors also say that they are willing to be more patient with entrepreneurs than other investors. Since the companies they invest in are often small and barely even formal, more patience is needed. Since impact investors tend to target businesses that in some way are connected to the poorest Kenyans, the so called ‘bottom-of-the-pyramid’ (BoP) they claim that they often times open up new markets as well as new segments which creates opportunities also for other more commercial investors, spurring further growth. By investing in smaller less formal businesses and exercising more patience, impact investors mean that they are willing to accept risks other investors will not.

On a global level there is a discussion on how to categorise impact investors, depending on to what extent financial return and social
impact respectively is emphasised. In Kenya however, impact investors in general claim that they care about the two equally. The goal is always to maximise both. Some of the impact investors we surveyed do however, in certain situations, accept a below market-rate return on their investment.

While impact investors claim to care equally about impact and financial return, that does not necessarily imply that they compensate their employees in a way that gives them both equal weight. While some, or even most, impact funds have some kind of bonus tied to the financial performances of the companies they hold, none so far has a system in place where fund managers are incentivised based on social impact delivered. When questioned about this most representatives for impact funds point towards the fact that a system that gives a financial reward based on social impact would be very hard to design.

"...none [of the impact investors in Kenya] so far has a system in place where fund managers are incentivised based on social impact delivered.

Development finance institutions (DFIs) are closely related to impact investors and play an important role in Kenya’s investment market. DFIs are alternative financial institutions that provide credit in the form of higher risk loans, equity positions or risk guarantee instruments to private sector investments in developing countries. Several rich-world countries such as Germany, the Netherlands and Norway have set up such institutions and fund them by diverting a share of their aid budgets. The DFIs have an explicit mandate to invest in ways that promote social progress, much like impact investors. All of the countries listed above have local DFI offices in Nairobi. They invest both as direct investors in companies and by providing capital for other investment funds. When they invest in funds, whether they be impact or non-impact funds, they influence the funds to take other stakeholders into considerations and to look beyond purely financial results. This way DFIs help shape Kenya’s investing market.

Where does impact investing fit in?

As mentioned earlier, impact investing is closely related to SRI, which in turn could be viewed in relation to CSR (Corporate Social Responsibility). The common denominator here is the belief that other stakeholders besides shareholders deserve to be considered. The sometimes tense relationship between shareholders and other stakeholders is at the core of the Stakeholder theory. The shareholder view argues that only the shareholders, in their role as equity owners, are important to consider for the company’s board and its management. The stakeholder view on the other hand argues that this view is too narrow-minded. Several other stakeholders such as suppliers, employees, customers and local communities all have legitimate claims of interest. The argument goes that it lies in the long-term interest of a company to have good relations with the different stakeholders. While the shareholder view is likely sufficient to maximise short-term profit, it might be detrimental to long-term value. Over the long-term, and maybe especially in bad times, having good relationships with several stakeholders is likely to be beneficial.

Historically CSR has mainly been a side activity for companies to take some kind of societal responsibility. CSR activities that are not closely linked to the strategy or business model of a company does not only incur extra costs, they do not leverage the unique capabilities the company has in order to improve society. As a reaction to this, the view that CSR activities should be aligned to the company’s core business model is gaining traction. When a company aligns its CSR activities and its strategy it is practising ‘strategic CSR’. This means that the company incorporates the views and interests of other stakeholders into its core business model.

The companies that impact investors look for do not only consider the views and interests of stakeholders other than shareholders; they
give virtually equal weight to multiple stakeholders. Since this multiple-stakeholder view is incorporated from the get-go into the company's business model, it is not considered as a responsibility but rather as an opportunity. CSR in the traditional sense does not exist for these companies. This does not imply that impact investors do not expect to earn money from their investments; it simply means that short-term profits are not all they care about. While this might mean that they are, on some occasions, willing to bear reductions in short-term profits, it might also mean that they are better suited to create long-term value.

"Since this multiple-stakeholder view is incorporated from the get-go into the company’s business model, it is not considered as a responsibility but rather as an opportunity. CSR in the traditional sense does not exist for these companies."

In a sense impact investing is closing the circle regarding CSR. What started as a way to ‘clean up’ a damaged brand name or maybe develop a positive reputation, has slowly developed into leveraging core capabilities in ways that are mutually beneficial for company and society. Impact investors and their investees take this a step further. They adopt a social perspective from the get-go and use strategies and business models that benefit several stakeholders. This way the whole concept of CSR becomes obsolete, since there is no longer anything distinguishing CSR and business activities.

Authors: Carl Broomé Albert Lundberg