Impact Investing

March 2023

DeMarche

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Points of Discussion

Abstract

Impact investing takes many forms. In this paper we will briefly define the term and discuss some ways to make an impact with your investible dollars. In addition to investment opportunities that are designed exclusively for making an impact, this paper will highlight asset classes such as social infrastructure and sustainable agriculture, which can garner investors a meaningful return while also positively changing our world for the better.

Making an Impact

Over the last two decades, impact investing has grown to mean many things to many different institutions. While there are many perspectives on how to best define impact investing, the most common thread ties the concept to the utilization of an investment approach that aims to contribute to the achievement of positive social and environmental impacts.

While no industry-wide definition has reached acceptance yet, DeMarche is accustomed to contributing to the research, education, and debate as advances are made in areas such as asset allocation, performance analysis, and risk management - to illustrate a few other major advances from the 1970s-2020s. To us, impact investing's definition must include something measurable, that is a policy implementation action, which was entered into with purpose, where that purpose is aligned with one or many mission-centric objectives of the investor or institution.

Today impact investing can come in many forms, ranging from Environmental, Social and Governance focused approaches in the public markets, to investment opportunities in private equity and debt that support the measurable advancement of specific climate, diversity or social objectives. The need for liquidity of funds should be taken into account as some strategies are much less liquid than others.

This paper will focus on highlighting three ways institutions can make an impact through the private markets by investing in Community Development Financial Institutions, infrastructure, and sustainable agriculture.

Community Development Financial Institutions

One way to make an impact in an underserved community is through investing in a Community Development Financial Institution (CDFI). CDFIs have been around for decades and provide critical lending and financial services to under-served communities. CDFIs can be organized as banks, credit unions, loan funds, or venture capital funds. CDFIs are critical sources of capital, helping to fund small businesses, affordable housing, and other community development initiatives. To improve diversification, an investor can invest in a fund that will allocate dollars to multiple CDFIs.[1] Typically, the interest rate earned is below market, but the coupon is fixed and does not fluctuate. An investor's commitment to a CDFI is not insured, and the investor bears the risk of loss.

[1] *Community Development Financial Institutions Fund*. Home | Community Development Financial Institutions Fund. (n.d.). Retrieved July 27, 2022, from https://www.cdfifund.gov/

CDFI funds often attract institutional capital from foundations, but most of the investor base is made up of individuals.[2] CDFIs are predominantly illiquid and often yield lower returns than an investor would get in comparable investments, but they also offer a significant social impact as the dollars invested go directly into the communities where the need is greatest. Historically, CDFI related investments have served as one of the most direct ways to create a measurable social impact, but also provide one of the least secure investment outcomes given the nature of the loans (higher credit risks at lower yields than market).

Infrastructure Investing

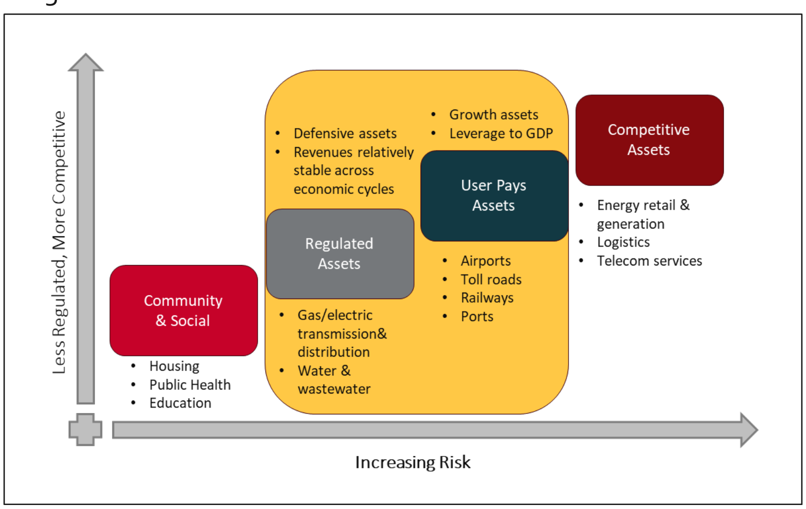
Let's first broadly define infrastructure for use in this paper and then narrow our focus. Infrastructure comprises large-scale systems that are essential for communities, governments and businesses to operate in an orderly capacity. Such systems are often categorized as Transportation, Utilities, Communications and Social. Most institutions access infrastructure investments through private funds that acquire or develop infrastructure assets. Infrastructure assets tend to be highly correlated to inflation, have long useful lives, and pay out "rents" to investors. Within the public markets, the investor can purchase listed equities of companies that provide infrastructure services. For example, companies that make concrete, building equipment, solar panels, wind turbines and such could be candidates for purchase by an infrastructure investor. In this case, we call these companies "listed infrastructure." These companies are traded publicly and will bear market risk, thereby providing less diversification benefit to an investment portfolio than private infrastructure assets.

The table below provides some examples of infrastructure assets:

1. Transportation	2. Utility & Energy	3 Communications	4. Social
• Toll roads	• Power generation	• Transmission towers	• Hospitals
• Bridges	• Electricity and gas networks	• Cable networks	• Schools
• Tunnels	• Fuel storage facilities	• Select satellite systems	• Community and sports facilities
• Airports	• Water treatment		
• Ports			
• Rail and mass transit			

Social Sectors

Figure 1



While infrastructure is widely viewed as providing a benefit to society, investors wishing to have a greater impact may target funds focused on social infrastructure, which provides a more measurable impact on society.

For example, social infrastructure could take the form of a diversified pool of real assets with an emphasis on social sectors such as hospitals, education, water, and renewable power systems.

One of the fastest growing segments of social infrastructure and infrastructure, in general, are Public Private Partnerships or P3 for short. There is a mismatch in the need for infrastructure and the amount of capital spent on

[2] *Opportunity Finance Network*. OFN. (2022, July 6). Retrieved July 27, 2022, from https://www.ofn.org/

infrastructure. With some governments facing aging infrastructure, there is an opportunity for private investment to fill some of the gap. In these situations, private investment funds will work with local municipalities to structure an investment that provides a stabilized income stream (usually in the form of lengthy contracted lease/rent agreements) for the investor, while reducing the financial burden on municipalities for capital-intensive infrastructure projects. In terms of social infrastructure, there is an outsized need for medical, senior housing and education investment to support changing demographics in the U.S. Additionally, as major economies around the globe work to reduce their carbon footprint, considerable investment is needed to upgrade electrical grids and build renewable energy systems such as wind, solar and hydroelectric. Investors in social infrastructure funds or dedicated renewable energy funds are expected to comprise a meaningful portion of the financing of these projects.

In addition to financing new infrastructure projects, social infrastructure funds also make an impact through building improvements and improved management of existing assets. As an example, this can take the form of improving the energy efficiency of student housing at universities and senior living centers. Additionally, hospitals and other healthcare infrastructure managed by these funds may receive improved electrical systems and physical plants to ensure that resiliency and redundancy to these systems are maintained and the quality/value of the asset is improved.

Social infrastructure investors ultimately receive their return in the form of rents from the operator of the physical assets. In addition, there could be some capital appreciation on the assets, but the primary return driver are payments made to the investors by the operator. Such projects are long-dated contracts that provide resilient cash flows to investors and have low correlation to other asset classes such as public fixed income or equities. Investors can typically access social infrastructure through open-end or closed-end funds that can generate high single-digit returns over a market cycle. Liquidity is limited, and even open-end vehicles will have a "lock-up" period where an investor cannot access liquidity. After the lock-up period is over, quarterly redemptions are typically allowed. Fees will vary but tend to range from 1.0% to 1.5% depending on the amount invested and the types of underlying assets in the fund vehicle. An example of what a social infrastructure fund's portfolio might include is provided in Table I.

Table I

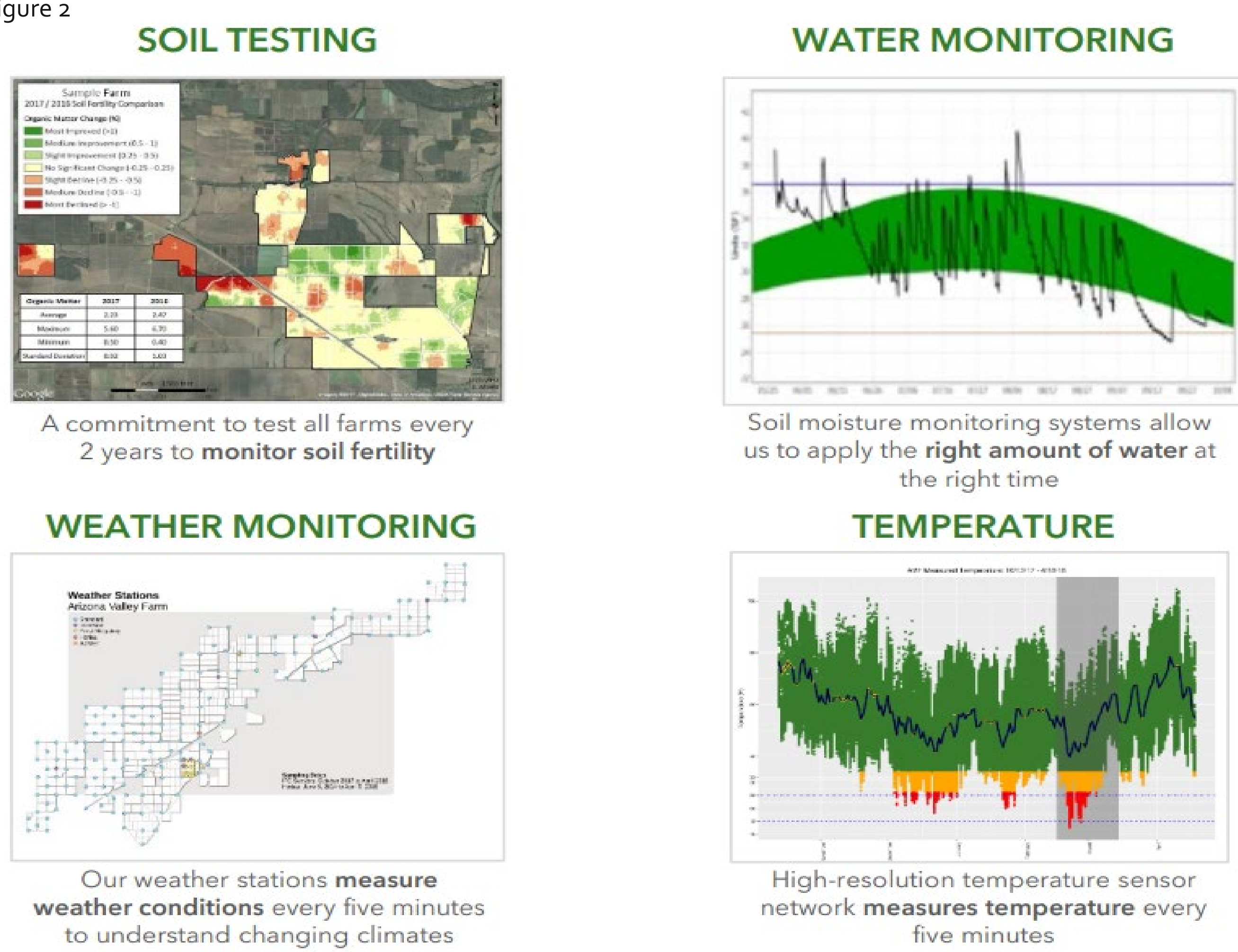
IN SCOPE			OUT OF SCOPE	
SOCIAL 40% - 50%	UTILITIES 45% - 55%	TRANSPORT <5%	EXTRACTION	MANUFACTURING
• Residence Halls	• Power	• Rail	• Oil & Gas	• Petroleum refining
• Innovation Districts	• Electricity T&D	• Roads	• Other extraction (coal, metals, minerals)	• Chemical
• Academic Buildings	• Renewables	• Airports		• Heavy Metals
• Civic Buildings	• Water	• Ports		
• Hospitals	• Telecoms/Data	• EV Infrastructure		

Source: Harrison Street

Sustainable Agriculture

Another way to make an "impact" is through sustainable agriculture. Agriculture is changing and becoming more institutional in nature as investors have greater access to invest in farmland. Institutional investors own the land, but generally do not own the means of production (tractors, combines, etc.) or the commodity (crop) itself. Therefore, investing in farmland allows farmers to farm more acres more efficiently as capital intensive farm equipment is better utilized over larger parcels of land. Agriculture investors receive their return in the form of rents from the farmers. Farmers earn their return from the sale of crops. Farmers are also often held to sustainable farming benchmarks such as water monitoring, soil health and carbon emission targets. The following graphic illustrates the sophistication of tools utilized by farmers and investors to maintain good soil and water health.

Figure 2



Source: International Farming Corporation

Good farming protocols are put in place by third-party industry groups that monitor water and soil. It is in the best interest of farm owners and farmers to follow these protocols. In addition to these protocols, agriculture funds often invest in improving the land to improve yields. These improvements include advanced irrigation systems, tile drainage (reduces soil loss and fertilizer runoff), and soil improvement. The sustainable practices implemented by institutional managers make farmland more efficient and productive, thereby providing investors with a potential higher rate of return from rental premiums and crop yields, while also ensuring the long-term viability and quality of agriculture in the U.S. and globally. Agriculture Investment vehicles for institutions are typically structured as closed-end funds that will require a long-term investment with 8 to 12 year lives. Open-end funds do exist, but lock-up periods can be anywhere from one to five years with an annual notice of withdrawal.

Conclusion

Impact investing can take many forms within an asset allocation and within a portfolio strategy. Investors can impact their communities by utilizing the public and private markets. We discussed only a few ways to make an impact within this paper and welcome the opportunity to further the conversation with institutions considering how to implement impact investments within their mission-oriented portfolios. There is a significant need within this space to put funds to work to improve infrastructure systems and the well-being of society in both the U.S. and around the globe.

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Sources Utilized:

- *Community Development Financial Institutions Fund – cdfifund.gov*
- *Opportunity Finance Network – ofn.org*
- *BlackRock*
- *ClearBridge Investments*
- *Grosvenor Capital Management*
- *Harrison Street*
- *International Farming Corporation*