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***Influence of public policy on private equity impact investing***

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A research project submitted to the Gordon Institute of Business Science,  
University of Pretoria, in partial fulfilment of the requirements for the degree of  
Master of Business Administration.

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## **ABSTRACT**

Commercial capital markets have started to recognise that the context of investment must be considered, this is seen via the widespread adoption of the United Nation's Principals for Responsible Investment. Impact Investing, has developed into a recognised mechanism for achieving a triple bottom line returns (financial returns, social returns, and environmental returns). Governments are recognising the benefits of this capital resource, by structuring policy to attract capital towards achieving impact. Private equity impact investing is a new alternative asset class that is regarded as a highly efficient instrument for allocating capital whilst achieving impact. This paper investigates the factors that are influencing Private Equity Impact Investing in South Africa, and it provides an exploratory investigation into the landscape of public policy that affects this asset class. This research is relevant through identifying trends and best practice for Private Equity Impact Investing in emerging markets, and evaluating their suitability for adoption in South Africa.

This study was a qualitative study using data collected via 16 semi-structured interviews. These interviews included 8 private equity fund managers, 4 investment intermediaries, and 4 policy makers. The data was processed with the use of a computer-assisted qualitative data analysis software. Thematic coded analysis was performed on the data, and relationships were defined in accordance with the categorisation of themes. Findings were triangulated to ensure validity.

The research found that whilst Broad Based Black Economic Empowerment provided an opportunity for targeted investment, it has the potential for expansion to incorporate additional impact areas. The poor implementation of policy by government agencies is resulting in failure to effectively feed soft capital into the investment spectrum, thereby creating a gap in the capital continuum. This has resulted in a shortfall in investment in SME and VC, thereby inhibiting the pipeline for Private Equity Impact Investment.

## **KEYWORDS**

Impact Investing; Private Equity; Public Policy

## DECLARATION

I declare that this research project is my own work. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration at the Gordon Institute of Business Science, University of Pretoria. It has not been submitted before for any degree or examination in any other University. I further declare that I have obtained the necessary authorisation and consent to carry out this research.

Signature:

Name: Hilton H. A. Fryer

Date: 2014-11-10

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## ACRONYMS AND TERMS

BBBEE	Broad Based Black Economic Empowerment
ESG	Environmental, Social and Governance
FDI	Foreign Direct Investment
GIIN	Global Impact Investment Network
GIIRS	Global Impact Investing Reporting System
IRIS	Impact Reporting and Investment Standards
NPO	Non-Profit Organisation
PE	Private Equity
PEII	Private Equity Impact Investing
SAVCA	South African Venture Capital Association
SiMODISA	A collaborative research, stakeholder engagement and policy design effort by key stakeholders from both the public and private sector in South Africa
SME	Small to Medium Enterprise
VCC	Venture Capital Company

## CHAPTER 1: INTRODUCTION TO THE RESEARCH PROBLEM

“Impact investments are investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return.” (Global Impact Investment Network, 2014)

Impact Investing has emerged as an effective mechanism to tap into commercial capital markets as a way to address social issues (Bannick & Goldman, 2012). This shift to a more inclusive business model, in which variables outside of those which are primarily financial are considered important, is a growing trend worldwide. In this way, there is no longer a need for business to choose between pursuing social or financial ends. Crifo & Forget (2012) present how private equity has proved itself successful in creating value in unlisted companies, through addressing environmental, social and governance issues, whilst Banerjee (2008) details the relevance of Private Equity in bolstering emerging markets’ capital markets as it provides an efficient mechanism to allocate capital.

Wilson & Post (2013) attribute this efficiency in Private Equity, to the incentive that profit creates for fund managers. Within the private equity model, there is a requirement for the “alignment of the mission and method with the venture’s capital and governance structure, and private ownership” (p.715). This thereby measures investment opportunities on the basis of the risk adjusted returns that they offer, and so avoids the distortion that is present in public capital markets.

Public policy provides the context within which investments are made, and it defines the profit potential for business opportunities that can be leveraged through investment into private companies. This research is focused on identifying the key policies that influence Private Equity Impact Investing (PEII) within South Africa, and evaluating the resultant enabling and inhibiting factors.

It is only in recent years that research and literature around impact investing has emerged. This research has been carried out by a number of parties, ranging from academics and authors, to foundations and corporations. Factors resulting in both the successes and failures of Impact Investing have been examined in published case studies. The increased attention has resulted in the evolution of impact investing’s practices, to the extent where it is now beginning to achieve recognition amongst the mainstream investing community (Del Bosco & Misani, 2011).

Few academic studies have engaged with how South African policy is influencing the adoption of impact investing. As a result, this research specifically focused on examining the influence of policy on private capital invested in private equity, for the purpose of creating a defined social impact. This was focussed on investments that aimed to simultaneously secure a market related financial return.

The objective of the research was to understand the various factors that shift the capital invested towards impact investing, compared to the other available financial instruments. Particular focus was given to the role of public policy, and how this brings into effect both social return and delivers risk adjusted financial returns, thus not sacrificing financial performance. This research examined the way that policy influences the factors inhibiting and enabling the development of impact investing within South Africa, specifically looking at the private equity investment model.

## **1.1 THE NEED FOR IMPACT**

Since the end of Apartheid in 1994, South Africa has been faced with the task of achieving transformation. This process involves the uplifting of those who were previously disadvantaged, and the balancing of the ownership of capital amongst its citizens in line with the principals of Broad Based Black Economic Empowerment (BBBEE). This is a necessary action, required to reduce social disparity within the country, and to create a stable social platform for equitable economic growth.

These shifts in focus in the country are marked, and for Morkel (2012) it is evident that, in South Africa since 1994, there has been a blurring of the boundaries between not-for-profit and for-profit business models. This blurring of boundaries is not, however, effective in creating a balanced and fair society. For example, Ballim (2013) recognises that South Africa's biggest social problem is poverty, and that to solve this problem we require real economic growth that exceeds the eroding effects of population growth by 3% per annum. It is evident that this economic growth is currently not being achieved. In order for economic growth to have the required transformative effect, it needs to manifest in job creation. For many, there is hope in the Small and Medium Enterprise (SME). However, job creation at the SME level requires entrepreneurs, and the more social entrepreneurs we have, the greater the potential for social impact.

## 1.2 CAPITAL MARKETS PROVIDE OPPORTUNITY

Socially Responsible Investing (SRI) is a term which aims to incorporate the triple bottom line return (financial return, social return, and environmental return) in the investment decision making process. Excessive greed and the lack of regulation of financial markets was attributed to creating the underlying environment in which the 2008 financial crisis occurred. This led to the general acceptance amongst the financial sector of the need for greater regulation, and resulted in the development of the Principals for Responsible Investment (PRI) in 2009.

An alternative asset class has emerged within the capital markets during the past decade, which aims to utilise investment activities as a way to achieve more than the targeted financial returns, and is known as Impact Investing. In an emerging market context, such as South Africa, there is a lot of scope for this form of capital allocation to bring about meaningful social change. This would feed into the requirement for companies to contribute towards creating a more equitable society. This potential opportunity is further heightened by South Africa's excellent infrastructure, mature private sector, and liquid Johannesburg Stock Exchange (JSE).

Job creation for the unemployed is regarded by the government as a critical social metric which must be addressed to alleviate poverty in South Africa and deliver essential services. It would be assumed that this priority would be supported in the private sector through the use of PEII. However, according to Saltuk, Idrissi, Bouri, Mudaliar, and Shiff (2014), 89% of total impact investing capital is invested in companies in 'post-venture-capital' stage. This spread of capital reflects the limited appetite of PE impact investing for higher risk Venture Capital investments. The fact that the available funds are invested at this late stage of a company's growth places organisations under pressure during the start-up phase. This is also the point where there would be the opportunity for long term job creation.

A key finding of the 2013 JP Morgan Social Finance survey, was that "respondents indicated that the most useful government support would be to implement policies that improve the risk/return profiles of investments, either through credit enhancement or tax credits or subsidies" (Saltuk et al., 2014, p. 6). Such policy implementation in South Africa could provide the ecosystem for attracting capital to the country and attracting PE fund managers, who would look to apply value adding activities to their portfolio companies. This introduction of best practice into a market will result in a 'spill over effect' whereby the basis for competition for competitors will increase, as a result of the new entrant. This will increase the total competitiveness of all participants in the market, which can be perceived as a mechanism for increasing the competitiveness of participants within South Africa on a global basis.

### **1.2.1 PRIVATE EQUITY EFFICIENCY**

Acharya, Gottschalg, Hahn, and Kehoe (2013) show how PE is efficient at allocating resources, and overcoming the agency problem, referred to as the conflict of interest when one party (management) is acting in another parties (investors) best interest.

Acharya et al. (2013), propose that private equity is better than other debt instruments, at achieving a greater return on capital. This potential can therefore maximise the return on the triple bottom line (financial returns, social returns, and the environmental returns). Public policy sets the economic landscape for business in a country, and is often created to attract Foreign Direct Investment (FDI). Given the opportunity to achieve triple bottom line returns from PEII, it would seem logical that public policy would encourage PEII. Furthermore it would be sensible for public policy to provide incentives to attract foreign capital into South Africa, particularly for the seed and venture stages of a project. However it does not appear as though this has been a priority in the South African policy landscape.

Given the profit orientation of PE, and dominance of corporate research within the domain of PEII, this research contributes to the academic body of knowledge by evaluating the influence that public policy is currently having on PEII in South Africa. Furthermore this research contributes by applying qualitative methodology to the research, by identifying trends and best practice for PEII in emerging markets, and evaluates their suitability for adoption in South Africa.

### **1.3 POLICY CAN INFLUENCE IMPACT**

There have been lessons learnt from policy within emerging markets that have attracted impact investment, an example being the foundational policy established in South Africa the created Business Partners, a private equity firm formed out of a private-public partnership (Clark, Emerson, & Thornley, 2013). South Africa needs to closely examine these case studies, in order to ensure that it is able to derive a policy that is efficient and based on working best practice examples. Where other emerging markets – who share similar social and economic structures and challenges – have experienced success, South African should seek to follow this example.

South Africa has developed its BBBEE framework, which defines a policy landscape according to which business must operate. This framework created a connection between business operations and social outcomes. For as long as the landscape provides ample opportunity for companies to make profit as a risk reward - which exceeds investment opportunities for allocations of capital - the engine of achieving social benefit via capitalist activities will work.

SiMODiSA is an industry association which is making policy recommendations to aid with the development and acceleration of SMEs and start-ups within South Africa. Such activities are regarded as key enablers for job creation and economic growth - which is a core component for the solution of numerous social problems that South Africa faces.

The year 2013 was significant in that it was when the impact investing community recognised that the policy environment was poorly studied, and two separate working groups were established to research it in more detail. Locally the SiMODiSA association was established under the guidance of the then South African Minister of Finance, Pravin Gordhan. The mandate was to make policy recommendations to the South African government on how to use policy to stimulate the venture capital, and SME start-up sector. Internationally, the G8, under the leadership of the United Kingdom's Prime Minister, David Cameron, established a working group to investigate best practises for the measurement of impact investing. Both working groups released their recommendations prior to the conclusion of this research report. This has allowed for the triangulation of data and the comparative analysis of findings to be studied in this thesis.

Traditional PE, refers to investment funds that invest in private companies for the purpose of generating profit, operating within the framework of public policy in the countries it operates in. Socially Responsible Investing (SRI), which considers factor beyond the financial return of an investment is, according to Cumming and Johan (2007), in the early phase of development of the impact investment asset class. As well as a lack of focus on policy, Crifo (2013) indicates that the majority of academic research on Social Responsible Investing (SRI), is directed towards public financial instruments. Speed (2012), highlights the need for research within the South African context when he explains: "there is a need for research that could assist in the development of public policy to promote impact investing. Such research could include a comparative survey of international best practices on impact investing" (2012, p. 94).

The 2010 changes to Regulation 28 of the South African Pension Funds Act, have allowed for pension fund managers to increase their investments in alternative asset classes (hedge funds and private equity) from 2.5% to 15%. Speed (2012) anticipates that this will unlock capital that could be allocated to impact investment. However in order for this to occur, there has to be an adoption of the investing category amongst institutional investors, and improved policy. If South Africa were to pioneer public policy that kept pace with the evolution of the global PEII industry, it could position itself as a preferred recipient for FDI into its social enterprises. Speed recognises the limited research performed within the area of impact investing, and states that "government

should consider what regulatory mechanisms it could put in place, and what support it could provide, to unleash the latent capacity of private capital to create social value” (2011, p. 67).

## 1.4 CONCLUSION

Impact investing is a shift away from the profit-only orientation of traditional capital markets, and fits firmly into the developing views that companies need to consider their social context. This view defined under the banner of SRI, requires investments must adopt sustainable practices that have gained acceptance, as defined internationally by PRI and within South Africa by Code for Responsible Investing in SA (CRISA).

South Africa has a significant requirement to address social needs within the country as well as to drive a transformation agenda in accordance with the principals of broad based economic transformation. This is a responsibility that sits with the corporate sector, but which it will be unable to effectively act upon in the absence of effective policy, which is driven by government. Policy is a powerful tool which defines the landscape upon which market forces play out. Specific outcomes can be designed by allowing PE to participate in the impact investment in South Africa.

This research was a qualitative exploratory investigation, which has identified and examined the influence that public policies have on the performance, and attractiveness, of PEII within South Africa. The scope has been limited to impact investing within emerging markets. This form of private equity investment is a component of the Investment Continuum (Harji, 2014), and aims to achieve profit-with-purpose in its investments.

Semi-structured interviews with South African PEII fund stakeholders were conducted, in order to evaluate current public policy influence on their value creation strategies. These interviews also highlighted the potential areas for change which practitioners sought. The development of public policy within global emerging markets was also evaluated, in accordance with its potential effect on capital markets in South Africa. In this way, this research has examined the broad policies and overarching factors that influence the PEII sector globally, as well as understanding the local and international responses to policy development in the PEII arena in South Africa.

This data and its findings are of value to stakeholders involved in public policy formulation. Intermediaries and fund managers will be able to evaluate the potential for investing in South Africa in the future. The research also provides insights into the availability of institutional capital, and how capital earmarked for PEII in South Africa may shift in accordance to changes in policy.



## CHAPTER 2: LITERATURE REVIEW

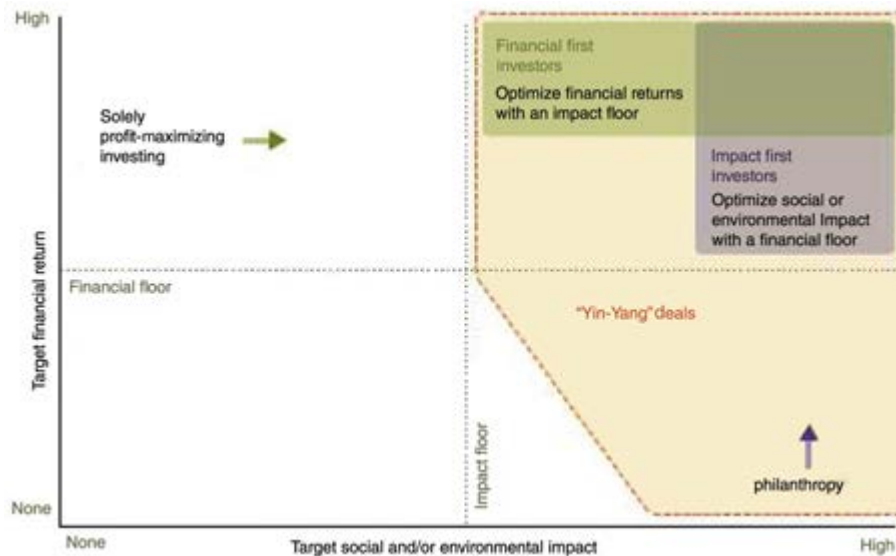
The term 'social entrepreneurship', according to Nicholls (2009), a leading proponent for contextualizing and defining social entrepreneurship, and has gained traction amongst the media, academia, and policy makers. The concept spans the areas of traditional business, and penetrates into the realm of social activism. Nicholls (2009) examines how the social component of the enterprise has required the exploration into "reporting practices [that] not only account for financial performance but also disclose more nuanced and contingent social and environmental impacts and outcomes" (2009, p.755). Research into social entrepreneurship has been complimented by an investigation into the forms of business, and the mechanisms for allocating capital within them. Emerson (2003) explores the intersection between the profit motivation of traditional business, with the social returns that defined the existence of Non-Profit Organizations (NPOs), and then proceeds to introduce the concept of a blended value proposition - which spans social and financial returns.

Chertok, Hamaoui, and Jamison (2008) discuss how the forms of organizations have changed to accommodate the purpose of the organization. These authors introduce the concept of the hybrid enterprise, which allows the organization to adopt two complimentary organizational designs, with compatible visions and missions and overlapping operating structures. While Chertok et al. (2008) model shows how the traditional NPO and profit-oriented organization can exist within the same entity, the recent thinking explained by Kuper (2014) is that if impact is fundamentally integrated into the organization, the resulting performance of the organization will increase, thereby increasing the financial performance. This perspective was portrayed by Saltuk et al. (2014) when the 2014 JPMorgan survey showed the addressing of ESG issues as being the greatest source for unlocking value within an impact investment business.

Beyond the motivation of the entrepreneur, and the structure of the business that they operate within, it is necessary to evaluate the form of capital that is utilized. Emerson (2003) examines forms of funding ranging from grants, to debt, to equity; and shows how investors would typically have different expectations for the returns. Those providing the capital would have specific interest in the returns gained from their investment. Frequently government and philanthropic grants do not expect the principal to be returned and would expect a different form of outcome or reward. Emerson (2003) lists these returns as being categorised as social, environmental and developmental. When capital is applied using an instrument which is expected to achieve a financial return, it traditionally factors risk against the prospects for

financial return. These market instruments can be portrayed in a linear sequence in accordance with their expected financial return. Lyons and Kickul (2013) have developed a model shown in Figure 1 which introduces an additional dimension for return, social and/or environmental. It then plots the orientation of ‘finance first’ investors against impact first investors.

Figure 1: Segments of impact investors (Lyons et al., 2013, p.153)



This additional dimension of return on an investment has now provided investors with the ability to target their risk adjusted financial return, via the available market instruments. They are simultaneously also able to select an instrument that delivers a desired social and/or environmental return, referred to as “impact”. This convergence of financial return with desired impact, within a financial instrument, is the area that is now termed impact investing.

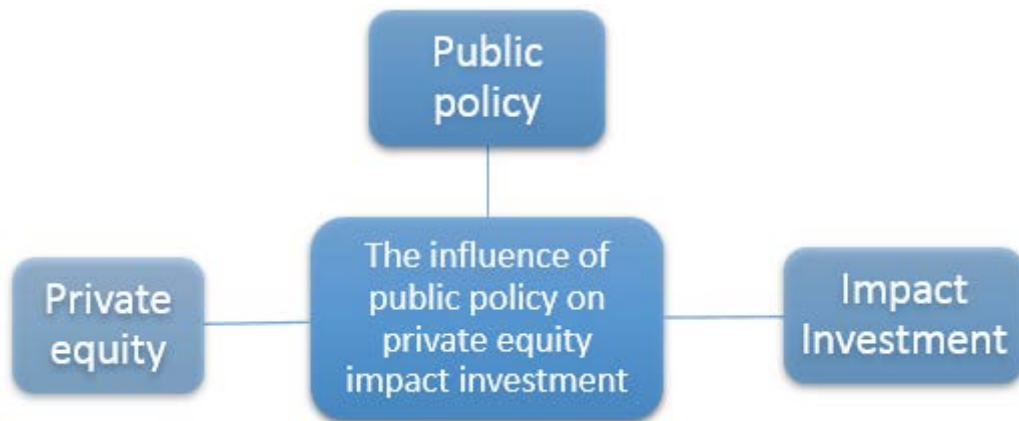
As with all investments, the policy within which the investment occurs needs to be considered, and this ranges from laws, to industry regulations, to tax regimes. A country's public policy will influence the manner in which investments can be made, and if a stakeholder wished to develop a particular area within a country, creating favourable policy would be the single most powerful lever which could be utilized to attract investment from both local and foreign capital (Thornley, Wood, Grace, & Sullivant, 2011).

This research report is comprised of three distinct academic areas which converge on a focus point for the research topic. The three areas are public policy, private equity and impact investing. Each topic has natural overlaps with the others, however when the three are combined within the context of a specific region, namely South Africa, it is possible to evaluate - through research - the precise situation for how each interacts with the other. Furthermore it is possible to determine how policy is influencing the impact investing space, and also to

evaluate the desirability of using private equity as an asset class to achieve financial and non-financial returns.

Figure 2 illustrates how these three academic disciplines connect around the topic of this research.

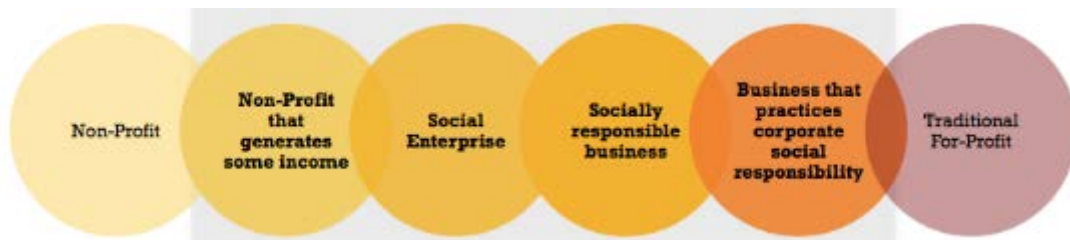
*Figure 2: Relationship between academic disciplines*



## 2.1 INVESTING SPECTRUM

The allocation of capital via investments will be determined by the impact effect required by the providers of capital. Certain capital is provided to an organization with the expectation of an operational outcome, and does not have expectations of recouping the capital. This is generally seen as grant funding, for traditional NPOs. NPOs are the vehicle for the allocation of capital, and typically do not have a mechanism to generate their own revenue. This model is not sustainable beyond the flow of grant funding – which is limited, and fluctuates. As one moved along the spectrum the balance between income generation and allocation of capital to non-income generating activities occurs. This relationship across the social investment spectrum is represented in Figure 3 where it portrays the linear financial sequence “from grants, to lending to charities, to investing equity in social enterprises, to Sustainable and Responsible Investing (SRI)” (RS Group, 2014, para.1).

*Figure 3: The Social Investment Spectrum (RS Group, 2014)*



The social investment spectrum incorporated different philosophies for investing with social and environmental factors, this can range from pure Responsible Investing (RI) which only considered the sustainability of the investment, to Socially Responsible Investing (SRI) required that the social context of the investment be considered, this continuum of progresses levels of environmental impact is described by Harji, Reynolds, Best, and Jeyaloganathan (2014), and represented in Figure 4 to portray the different levels that can be found under the term ‘social finance’ with the corresponding ESG factors that would be incorporated under each type.

Figure 4: Investment continuum (Harji, 2014, p.12)

IMPACT INVESTMENT					
Traditional	Responsible Investing (RI)	Socially Responsible Investing (SRI)	Thematic	Impact-first	Venture Philanthropy
Competitive Returns					
ESG Risk Management					
High Impact Solutions					
Limited or no focus on ESG factors of underlying investment analysis and execution.	ESG risks integrated into analysis of all holdings, as a component of financial risk management. Shareholder engagement is used to influence behaviour of holdings.	Negative and positive screening of ESG risks is used to align a portfolio to specific values. Shareholder engagement is used to influence behaviour of holdings.	Focus on one or more issue areas where social or environmental need creates commercial growth opportunity for market-rate returns.	Focus on one or more issue areas where social or environmental need may require some financial trade-off.	Social enterprise funding in a variety of forms, with a range of return possibilities. Investor involvement/support is common.

### 2.1.1 SOCIALLY RESPONSIBLE INVESTING

Socially Responsible Investment (SRI) is a process which considers social, environmental, and ethical factors within the investment decision making process (Dees & Anderson, 2013). Dees and Anderson (2013) discuss how SRI has been practised through religious institutions, in many forms, over centuries to generate social capital. Visser (2005) proceeds to provide local insight into SRI within the South African context showing how legislative reform can drive the adoption of sustainability reporting and SRI. This relates to how government and companies are using policy - and the allocation of capital to economic activities - as a way to address social issues. Within South Africa, the trend is towards adopting sustainability reporting and to being cognisant of Socially Responsible Investments.

In 2003 Dees and Anderson published their ‘sector bending’ model which describes how non-profit organizations (NPOs) imitate the business world by adopting their strategies and best

practices. They then explained how tools such as 'Porters Five Forces Strategy Model' and the 'Kaplan-Norton Balanced Scorecard' have been adopted within the non-profit organization. This is as a result of the 'interacting' and 'intermingling' of NPOs with traditional for-profit businesses. Such 'boundary blurring' has the advantage of increasing the financial strength and capacity of the social sector (Dees & Anderson, 2003). The results of this development of business models can be seen in the hybrid business structures defined by Chertok et al. (2008).

The term 'blended value', coined by Emerson (2003), was used to represent the convergence of traditional financial returns, with the desire to achieve an additional level of non-financial return. This blended value forms the basis for the ecosystem within which SRI exists. Blended value has developed as a term which incorporates the philosophy by which dual-returns can be delivered within a business, it spans the SRI spectrum and can be defined in relation to Harji 's (2014) six categories within the investment continuum: Traditional Investing, Responsible Investing, Socially Responsible Investing, Thematic Investing, **Impact Investing**, and Venture Philanthropy. The measurement of blended values involves evaluating the triple bottom line – measuring environmental, social, and financial returns (Meyskens & Carsrud, 2013), this research report focused exclusively on impact investing.

In 2011 Michael Porter and Mark Kramer published an article titled "Creating shared value" in the periodical Harvard Business Review. Although this article was received with great acclaim within the community, Crane, Palazzo, Spence, and Matten (2014) claim that it does not reflect original thought, and that it merely rebrands existing concepts within a new model. Crane et al. (2014) indicated that the paper only received recognition on the basis of the past accomplishments of the authors. Crane et al. (2014) proposed that Porter and Kramer have claimed ownership of the Creating Shared Value (CSV) model, without providing due consideration for the legacy and evolution which CSR has undergone, at the hand of countless academic efforts. Crane et al. however did acknowledge the significant steps made by Porter and Kramer in "understanding the role of government in the social initiatives on companies" (2014, p.133). A key area where Crane et al. highlight weaknesses in the CSV model is in how it "ignores the tension between social and economic goals" (2014, p.136) and how the interests of stakeholders are not necessarily easily aligned, which essentially is the result of an oversimplification of the complexity of relationships between economic interests within the social and policy landscape.

Wilson and Post (2013) examined the motivation for the design of social value creation, and synthesized the competing paradigms of hybrid forms of business by demonstrating that “social and economic value does not have to be seen as inconsistent and incompatible” (p.730).

### **2.1.2 RESPONSIBLE INVESTING**

Prompted by the 2008 global financial crisis, a partnership between the United Nations Environment Programme (UNEP) Financial Initiative and the United Nations (UN), Global Compact was developed, to define a set of Principles for Responsible Investment (PRI) (Biermans, Kemeling, & Van Lanschot, 2014). Biermans et al. define the fundamental basis for the PRI as an “approach to investing which explicitly acknowledges the relevance of ESG factors in investment decision-making, as well as the long-term health and stability of the financial market as a whole. Furthermore, it recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well-governed social, environmental and economic systems” (2014, p.8).

In June 2011 the partnership released the second edition of PRI, and many financial institutions under pressure to improve their corporate image and reputation have adopted the PRI. Private equity firm Kohlberg Kravis Roberts (KKR), measured the adoption of PRI in their 2013 report showing global investment firms’ rapid adoption of Environmental Social and Governance (ESG) issues (KKR, 2013).

### **2.1.3 CORPORATE SOCIAL RESPONSIBILITY AND STAKEHOLDER THEORY**

Corporate Social Responsibility (CSR) is an emerging mechanism for channelling corporate resources (e.g.: financial, human, material) toward social causes and activities (Visser, 2005). This is evident through the development of CSR public policy, which is entrenched within South African legislation. Whilst this has resulted in the successful adoption of CSR within South African corporations, it remains questionable if this is a programme that is adopted just to comply with legislation, whilst leveraging the mandated expenditure to achieve marketing and branding value. André (2012) argues that in order for companies to truly adopt CSR principals within their operations, mechanism such as the Benefit Corporation Legislation must be passed, as has been done the United States of America, so that management maintain their fiduciary duties whilst making decisions that are not always oriented toward maximising shareholder value.

According to Bishop (2013) the practice of using the profits of a capitalist system to support social causes, emerged in its modern form during 1997 when Ted Turner pledged \$1billion to the United Nations. The concept matured in 2006 when Warren Buffet asked the Bill and Melinda Gates Foundation to utilize his vast wealth for social benefit. Bishop coined the term

'Philanthrocapitalism' in 2006, to represent the practice of applying modern business practices to social causes, aiming to enhance their sustainability, whilst typically delivering 'high performance' impact. Scarlata and Alemany (2010) attributed the success of socially responsible investing, such as philanthropic venture capital investment, to companies playing their ethical roles in society, through the ability to establish economically sustainable enterprises.

Wilson and Post (2013) introduced stakeholder theory and examined the influence that this had on motivating public policy to deliver a social value proposition. In the context of stakeholder theory, policy makers would be external stakeholders that have an interest in the outcomes by which the corporation is managed. This philosophy of integrating a common agenda between social enterprise and capital allocation, as defined by public policy, will influence the process through which social business is designed and developed (Wilson & Post, 2013).

#### **2.1.4 SOCIAL ENTREPRENEURSHIP AND SOCIAL ENTERPRISE**

Lumpkin, Moss, Gras, Kato, and Amezcua (2013) define social entrepreneurship as "a social value creation process in which resources are combined in new ways to meet social needs, stimulate social change, or create new organizations" (2013, p.761). Lumpkin et al. (2013) then describe how such processes are conducted by individuals involved in entrepreneurial activities, to achieve outcomes that are not necessarily motivated by profit. Nicholls (2009) highlights job creation as a significant metric that is frequently measured when evaluating the impact of social entrepreneurs, and this is - as one would expect when considering the relationship - how new business established by entrepreneurs, forms a mechanism to address unemployment.

Shulman and George (2012) conducted a study looking to determine the performance of businesses that were run by social entrepreneurs, relative to traditional corporations, and they found the performance of social enterprises was significantly higher than the benchmark index of corporates. Shulman and George (2012), then concluded that entrepreneur-managed companies deliver higher job growth when compared to non-entrepreneur managed companies.

#### **2.1.5 IMPACT INVESTING**

Brest and Born (2013) question the ease with which investors can achieve "risk-adjusted market-rate returns on their investments and to have real social impact" (p.22), essentially questioning how often are investors able to deliver profit whilst making a difference. Brest et al. (2013) note that significant attention has been given to impact investing and they question the frequency within which investors actually achieve their desired outcome.

O'Donohoe, Leijonhufvud, Saltuk, Bugg-Levine, and Brandenburg published a seminal paper in 2010 titled "Impact Investing: An Emerging Asset Class". In this study, dimensions were identified to measure investment made with a mandate to deliver social benefits, while also generating economic profit. These core dimensions include finance preferences, market types, industry, and lifecycle of business. They found that the level of investment of capital into existing private companies varied considerably, depending on the desired social outcomes and the business sector involved.

In terms of the most recent JP Morgan social finance survey, Saltuk et al. (2014) identified some ambiguity around the definition of 'impact investing'. Within the finance community, this ambiguity was a dominant factor inhibiting the growth and adoption of impact investing, by institutional capital. However the ambiguity of this issue has improved, when compared to results of the 2009 JP Morgan Social Finance survey which shows there has been progress in contextualizing impact investment as a new alternative asset class (O'Donohoe et al., 2010). Bouri (2011) attributed this progress in awareness and understanding directly to the Clinton Global Initiative's formation of the Global Impact Investing Network (GIIN) in 2009. The GIIN was given the mandate to increase the "scale and effectiveness of the impact investing industry" (Bouri, 2011, p. 145).

The development of the GIIN, and the collaboration that has occurred between institutional investors and fund managers as a result of it, led to the development of significant corporate-driven research and publications. The academic community has contributed to the development of the impact investing concept, while corporate institutions have pioneered the consolidation of industry definitions and the development of standards - which is crucial for achieving scale, and for improved monitoring, within impact investing (Saltuk et al., 2014).

The 2013 JP Morgan Social Finance survey, the fourth consecutive annual survey of the impact investing industry, surveyed 125 impact investors, and found that "sixty-two percent of the total capital managed is invested through debt instruments (44% Private Debt, 9% Public Debt and 9% Equity-like Debt), and 24% is invested through Private Equity" (Saltuk et al., 2014, p. 7). This globally equates to \$3.4 billion of institutional capital surveyed, which is allocated to PEII. When examining the market types and stage of development, Saltuk et al. (2014), reported that the 2013 JP Morgan Social Finance survey found 70% of the total assets under allocation were invested in emerging markets, and of this 15% was invested in sub-Saharan Africa.



Crifo (2012) defined risk adjusted financial returns as the measuring of risk from an investment, and factoring it into the anticipated returns that would be expected, relative to alternative comparable market returns.

### 2.1.5.1 REPORTING

In his 2011 paper “How Standards Emerge”, Bouri compared the value that Impact Reporting and Investment Standards (IRIS) delivers to the impact investing sector, with the value delivered by the International Financial Reporting Standards (IFRS) to the global financial accounting community. In order for IRIS to realise the benefits of establishing itself as a global standard for measuring the triple bottom line return of impact investments, Bouri suggested that a “critical mass of early adopters” (p146, 2011) must leverage the standards’ value proposition to drive industry adoption. Figure 5 provides an example of the impact and financial IRIS indicators, this includes their standardized definitions

Figure 5: Example of IRIS Indicators (Bouri, 2011, p152)

	IRIS INDICATOR	DEFINITION*
PRODUCT IMPACT	Number of Clients (PI7094)*	The number of individual consumers served by the organization
	Jobs Created in Financed Enterprise (PI3687)	Net number of new FTE jobs at financed enterprise (including self-employed individuals and owners of businesses)
FINANCIAL PERFORMANCE	Direct Investment— Number of Investments (FP4359)	Number of debt and equity investments on balance sheet
	New Investment Capital (FP8293)	Value of cash flows from both loans and investments
	Contributed Revenue (FP3021)	Contributed revenue (operating grants and in-kind donations)
	Earned Revenue (FP5958)	Revenue resulting from all business activities
	Net Income (FP1301)	Net income from all business activities, including all contributed revenue.

Global Impact Investing Reporting Standards (GIIRS), a complementary standard to IRIS, is an analytical framework that provides the mechanism for evaluating the environmental and social return achieved by impact investments. GIIRS has “developed a survey that provides social enterprises and impact investment funds with an impact rating, similar to Morningstar or Moody’s in the mainstream financial markets” (Bouri , 2011, p. 157). This rating system supports investors in their ability to choose investments on the basis of their impact performance, whilst allowing them to compare impact investment opportunities, knowing that the definitions and calculation of metrics are comparable.

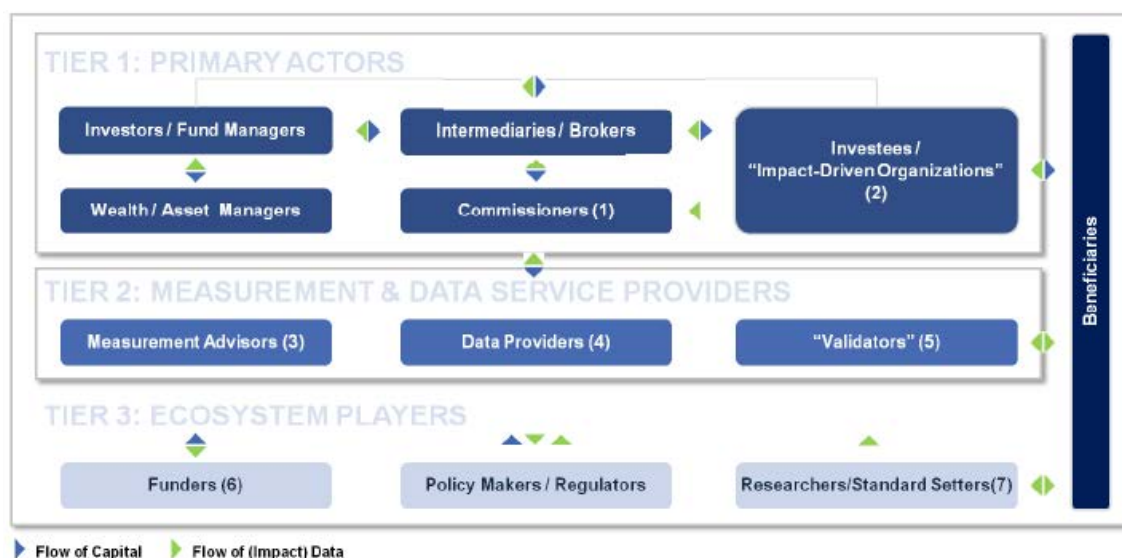
Despite the term ‘impact investor’ only emerging in the late 2000s, Bridges Ventures has been providing social impact capital, to companies in their development and growth stage, since 2002 (Palandjian, 2010). In the 2010 publication by Bridges Ventures titled “Case Studies Across Asset Classes”, Palandjian classified impact investing as two distinct groups: ‘Finance-first’, which identifies the priority of the fund as achieving financial returns as a principal mandate; and ‘Impact-first’ which aims to achieve social returns at the expense of financial performance. These groups mirror the principal intent behind the investment, and will typically influence the suitability of financial instruments for investment. PEII by definition, and based on its profit orientation, is always classified as ‘Finance-First’.

Richardson (2012) presented the background on how the Global Impact Investing Rating System (GIIRS) framework was established through collective participation of 25 funds over a one year collaborative period in 2011. This initiative for standardization of metrics quickly found traction, and as of October 2012 Richardson stated that 300 funds and 21 investors were utilizing GIIRS as their metric of preference via the ‘B Analytics’ Platform.

The B Lab 2013 press release “PULSE Merged Into ‘B Analytics’ Platform” indicates that the only other significant standard for measurement, a framework called PULSE, had been integrated into the ‘B Analytics’ Platform. This convergence of two competing systems under a common organization will support further convergence towards a single set of comparable metrics.

G8 Social Impact Investment Taskforce (2014) published a whitepaper titled “Measuring Impact” in 2014 which evaluated the current state of impact measurement, and identified the participants that exist in the impact investing and measurement ecosystem, this is shown in Figure 6. The whitepaper then proceeded to make guideline recommendations for the processes involved in measurement, and it then evaluated 4 cases where impact investment metrics have been successfully implemented. The three interviewee types that were engaged with for data for this research report, are represented in the ecosystem portrayed in Figure 6. They included fund managers and investment intermediaries - defined as ‘tier 1: primary players’, whilst policy makers are portrayed as ‘tier 3: ecosystem players’.

Figure 6: Illustrative Impact Investing and Measurement Ecosystem (G8 Social Impact Investment Taskforce, 2014, p.8)



### 2.1.5.2 OPPORTUNITIES AND RISK ADJUSTED RETURNS

Findings from Saltuk (2014) show that Sub-Saharan Africa achieved the largest growth in capital deployed (Saltuk et al., 2014). According to respondents identified in the 2012 JP Morgan Social Finance Survey, the top three contributors of risk to investment portfolios were: “business, model execution and management risk”; “country and currency risk”; “macroeconomic risks” (Saltuk et al., 2013, p. 15). It is important to note that the last two risks identified can be influenced directly by public policy. This again highlights the relevance of this proposed research to the impact investing sector.

## 2.2 PRIVATE EQUITY IMPACT INVESTING

Private equity is an alternative asset class which can provide investors with a mechanism to remove the information asymmetry between investors and management. This asymmetry is typical in listed companies, but in PE is removed by providing investors with access to the board (Haarmeyer, 2008). Haarmeyer (2008) further explains how PE shifts capital, labour and technology to drive growth, while the resultant concentration of ownership provides increased accountability and incentives to build value.

Crifo and Forget attributed pioneering work in conceptualizing PE impact investing to Cumming and Johan, who in 2007, considered the intersection between private equity and SRI and analysed “the factors that influence institutional investors to allocate capital to socially responsible private equity investments” (2013, p. 22). Cumming and Johan (2007) defined a

model for the interaction between PE and Corporate Social Investment (CSI), and presented the factors which motivated the allocation of institutional capital in PE funds with a social mandate. This in turn validates Wilson and Post's (2013) findings for the evolution of hybrid business models which converge social and economic value.

Kuper (2014) uses the term 'profit-with-purpose' to emphasise the orientation toward financial returns, whilst simultaneously delivering on a social mandate. Saltuk et al.'s (2014) findings from the 2013 JP Morgan Social Finance survey showed that the spread of impact investment per stage of business – i.e. start up, mature, expansion - reflects the risk profile of each stage. This in turn tracks the corresponding appetites for risk by PE investors. Saltuk et al.'s 2014 findings show the following asset allocation by stage of business:

“Most capital managed today – 89% – is invested in companies post-venture stage, with 35% allocated towards companies at the Growth Stage; 44% in Mature Private; and 10% in Mature Publicly-traded companies. Only 11% is committed to Seed/Start-up companies or Venture Stage businesses” (p.7).

Haarmeyer (2008) described how traditionally, 'PE Limited Partners' typically look for 'General Partners' to contribute a tangible portion of their net wealth in order to assure commitment to the funds' performance.

### **2.2.1 VALUE CREATION STRATEGIES**

Manigart and Wright (2013) discussed how the 2008 financial crisis triggered the re-evaluation of the relationships between PE investors and companies within their portfolio, to identify new value creation strategies. Haarmeyer (2008) defines these as being operational investment and sector specialisation. Financial engineering has gradually become less effective in creating value, and Crifo and Forget (2013) attributed growth as the principal value creation lever available to PE investors, since the 2008 global financial crisis. Acharya et al. (2013) were able to quantify the value creation resulting from PE through active ownership and governance in their 2009 quantitative study. Acharya et al. (2013) emphasised value creation that can be achieved through the development of sound management practices, as well as through structures which are optimised to create value while growing the portfolio company.

The governance, operational, and incentive levers studied by Acharya et al. (2013) validated the potential to add financial values to a portfolio company without the use of financial engineering. Bannick and Goldman (2013, p.5) produced a seminal paper entitled “priming the pump” which evaluates mechanisms to drive scale within impact investing, by focusing on the development

of entire impact industries. This thereby creates sector level value, and does not just focus on scale at the individual business level, but scale is achieved through the utilisation of “three policy levers: promoting competition, ensuring consumer protection, and promoting entrepreneurship” (p.5).

PEII has developed from modern portfolio theory and is now using specialist funds to provide increased value potential, through the development of synergies between portfolio companies (Bannick et al., 2012). This is done while developing industry expertise, in the form of in-house operational teams. In 2013 Manigart and Wright researched the extent to which PE firms can create value, by developing strategic synergies amongst companies within a PE fund’s portfolio. This is a strategy intended to increase the return on the triple bottom line. Other value creation strategies identified have shifted the emphasis to funds, drawing from the deployment of in-house operational expertise and the implementation of Environmental, Social and Governance best practices. Hemptinne and Hoflack use the term “in-house operation teams” (2009, p. 12) to describe specialists who can be deployed to portfolio companies, and discuss how they are “employed by the private equity firm, do not belong to a network of independent senior advisors, and are not hired on a consulting basis” (2009, p. 12). A more recent practice is to utilize operational teams separated from the funds’ operations, and which are structured to utilize separate grant funding (Kuper, 2014).

Potter (2013) describes how scale benefits will be achieved, once a second round of capital has been raised by the more established PE impact investing funds. Klein, Chapman, and Mondelli (2012) examine the mechanism whereby private equity alters the behaviour of managers to begin to behave like owners, this is achieved through the utilization of incentivisation strategies which connect the interests of the management team with that for the performance of their company.

Saltuk et al. (2014) discussed the various sectors into which investments are made, and showed the sector split as: 21% Microfinance, 21% Financial services (excluding microfinance), 18% Other, 11% Energy, 8% Housing, 8% Food & agriculture, 6% Healthcare, 3% Information and communication technologies, 3% Education, 1% Water & sanitation. Financial services such as micro-finance and micro-insurance have received significant attention recently. Roth described how the Leapfrog Investment Fund has specialized in the micro-insurance sector within emerging markets, and that the risk of currency fluctuations is mitigated by “strategically hedging the dynamic markets that are invested in” (2013, N.P.).

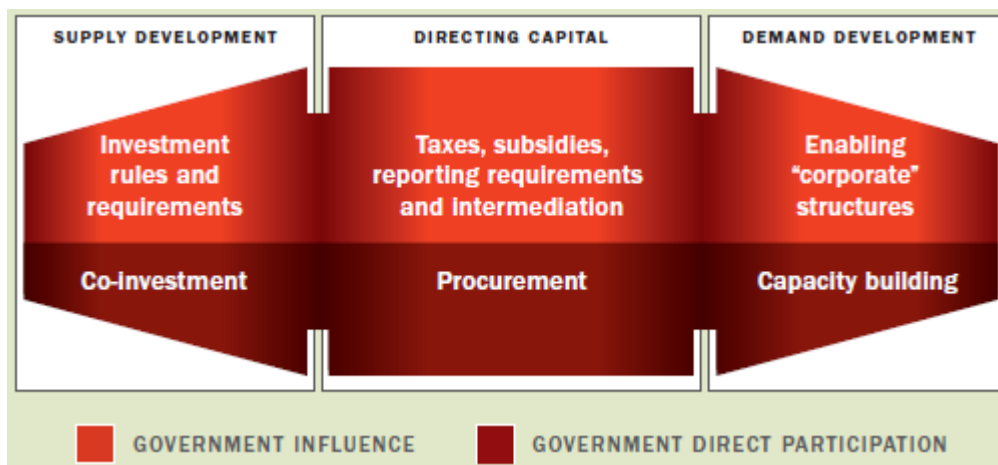
## 2.3 PUBLIC POLICY

Public policy is not a simple and homogenous concept. It is multifaceted and composed of various elements. As a result, the investigation of policy needs to consider various aspects. Thomas and Mohan (2007) listed the four levels involved in policy investigation:

1. Research concepts
2. Researching political context
3. Researching institutional capacity
4. Researching in the field of policy

Thornley, Wood, Grace, and Sullivant (2011) developed a framework which indicated ways that government can involve itself, either through policy or regulation, in the supply and demand of capital into impact investing. As a result, the state can influence the supply of capital through investing, or the establishment of a clear legislative environment. The state can assist in channelling the funds of others through ensuring that the sector is attractive in terms of the taxes and subsidies that organisations can attain through investing in the impact sector. And finally, the government can build the levels of demand for the sector through increased skills development and education in the sector. This framework is shown in Figure 7.

*Figure 7: Policy framework for impact investing (Thornley et al., 2011)*



### 2.3.1 POLICY FORMULATION PROCESS

Clark, Emerson, and Thornley, (2013) present five non-exclusive categories into which policy can be placed. Each category represents the nature of how the policy was formed and often reflects upon the participants who were involved. These categories are listed in Table 1..

Table 1: Policy symbiosis categories (Clark et al., 2013, p.15)

CATEGORY	DESCRIPTION
<b>FOUNDATIONAL</b>	The origins of the fund/firm are deeply rooted in a partnership with government, above and beyond the provision of any financial or other assistance.
<b>FINANCIAL</b>	Government entities are direct investors in the fund.
<b>REGULATORY</b>	Government regulations directly and heavily influence the structure, operations, or investments in/of the fund.
<b>ADVOCACY DRIVEN</b>	The fund works directly with government to influence the broader, systemic policy environment in which it and its investees operate.
<b>OPPORTUNISTIC</b>	The fund makes a dedicated effort to identify and leverage the discrete, non-systemic opportunities for government to support the success of portfolio companies – as do many traditional investors.

Different policy makers would be involved in the development of policy that falls into policy symbiosis categories presented by Clark et al. (2013). Barclay and Birkland (1998) highlight a policy maker who typically fill the gap in the policy making process and who are often overlooked in the process – namely the courts. The courts make rulings in accordance to the institutions with which they have direct control, and are able to substantiate the interpretation of policy where gaps reside. Consequently Barclay and Birkland state that courts have had relative success in participating in the process of altering the rules of law, and thereby the policy embedded within.

### **2.3.1.1 POLICY LANDSCAPE IN SOUTH AFRICA**

SiMODiSA is an industry association, pursuing collaborative research, policy design, and stakeholder engagement in order to catalyse entrepreneurship in South Africa. It represents key stakeholders from both the public and private sector, and focuses on strategies to address two core pillars of entrepreneurship. Firstly through research, advocacy and policy review to engage government and the private sector to gather industry insight. This insight and feedback aims to identify the key constraints to success, and develop practical solutions that will best overcome these. In this way it aims to support the creation of a more enabling environment and entrepreneurial ecosystem. Secondly, Entrepreneurial Amplification programmes seek to use effective programme mechanisms to bridge the gap between investors and entrepreneurs, and ensure that entrepreneurs are “investor-ready” through tools, training and networking forum events.” (Goldberg & Habberton, 2014, p.12)

A SiMODiSA working group evaluated the public policy requirement to accelerate the growth of SMEs in South Africa. Goldberg and Habberton (2014) present the conclusion from this working group, in four categories shown in Table 2. Each ecosystem has components which were investigated for significance in accelerating growth of VC and start-up businesses. Sub-categories presented represent the logical areas that should be evaluated for policy recommendations.

*Table 2: Categories of Entrepreneurial Ecosystem Components (Goldberg and Habberton, 2014, p.24)*

Regulatory Framework Conditions	Regulatory and compliance of start-up & running business
	Major Universities as catalysts
	South Africa's BBBEE Framework
	Access to infrastructure (telecoms, broadband, elect, water etc.)
	Educational system and infrastructure
	IP ownership & exportability
Resources	Funding & Incentives
	Exchange Control Loop limitations
	Human Capital
	Support System (mentors/advisors, professional services, networks etc.)
Market Access	Ease of trade & access to global supply-chains
Cultural Support & Entrepreneurial Spirit	Tolerance of risk & failure (e.g. bankruptcy laws)
	Positive image of entrepreneurship/self-employment as a preference
	Local heroes & role models
	Culture of research & innovation

Goldberg and Habberton (2014) make policy recommendations along six themes: Intellectual Property and Technology, Exchange Control, Pilot funding, Visa, Labour law, and Venture Capital Company (VCC). The policy recommendations proposed for VCC were incorporated into the South African 2014 budget speech, and were then adapted in amendments to the tax legislation. Key elements that determine the feasibility of the VCC model have been excluded, thereby undermining the business case for the initiative.

### **2.3.1.2 GLOBAL POLICY LANDSCAPE FOR IMPACT INVESTING**

In September 2014, the Social Impact Investment Taskforce, established under the UK's presidency of the G8, released a report titled 'Measuring Impact' that was intended to provide measurement guideline for adopting impact investing. Bannick and Goldman (2013) identified



the need to look at the returns continuum as a way to evaluate the appropriate financial instrument with which to use in accordance with the initiative. This can potentially range from grants, to risk-adjusted returns, to anything that may fall in the middle of the spectrum. Bannick and Goldman then proceeded to recognise that identifying the appropriate instrument for the context may be the optimal way to leverage opportunities to “priming the pump for sector-level change” (2013, p.6).

Bannick and Goldman (2013) discussed the gaps in the impact investing capital curve and identified the biggest gap existing in the area of “early-stage innovators” (p.12). However they identified the need to ensure that the process is carefully assessed, before funding is applied and allocated. Risks must necessarily be considered, as well as the relevance of the market that is targeted by the company. Bannick and Goldman (2013, p.16) state that;

“We applaud the exhortation to invest earlier in the innovation lifecycle. But we believe it is also important to conduct a thorough examination of the risks and benefits of subsidy in these situations. We would also point out that the appropriateness of subsidy is strongly influenced by the nature of the market being served: subsidies may be necessary to kick-start firms serving the very base of the economic pyramid, but are less essential—and potentially harmful—when directed at firms serving those with significant disposable income.”.

For Clark, Emerson, and Thornley (2013) ‘policy symbiosis’ model (Figure 1 ) creates clarity in the policy sector. These categories assisted in shaping the knowledge of the various methods and areas for investment, and for policy formation. It is important that policy, when created, is cognisant of these areas, and appropriate for each different stage.

Bendell, Miller, and Wortmann (2011, p.281) recommended that policy makers should utilize value inherent in private standards, and identified that “one cross-cutting area for the development of credible and certifiable MSI-developed standards is the fields of impact investing, responsible asset management, and responsible project finance”. Bendell et al. (2011, p.282) argued that

“Companies and investors may also recognise a strategic use for intergovernmental cooperation in this area, to provide consistency and predictability for government interventions in support of CSR standards. Conversely, as the public policy agenda on CSR continues to develop, the way a company or investor relates to this policy agenda,

through advocacy, lobbying, and political contributions, will become more central to an understanding of whether they are being responsible organisations”

### **2.3.2 PUBLIC POLICY INFLUENCE ON PRIVATE EQUITY IMPACT INVESTING IN SOUTH AFRICA**

Clark et al. (2013) clearly portray the relationship that exist between all policy makers in relation to impact investing when they describe policy symbiosis as:

“Impact investing is grounded in deep cross-sector partnerships, including with the public sector. Impact investing intersects with all levels of government, consistent with the public sector’s strong interest in maximizing social and environmental benefits to society, and the promise that impact investing can deliver these benefits at scale.” (Clark et al., 2013, p.13)

Furthermore, the ability for pension funds to invest in venture capital markets was the determining factor in the levels of capital made available in the seed and early growth sectors (Banerjee, 2008). Speed (2012) validated this sentiment, highlighting that South Africa’s recent changes to Regulation 28 of the Pension Funds Act, will afford greater scope for fund managers to invest in alternative investment instruments. Furthermore, South Africa’s World Economic Forum (WEF) Global Competitiveness Ranking South Africa’s private sector institutions are highly ranked, and thus are expected to attract PE investment into the country. According to the WEF, South Africa’s private sector institutions, are ranked first for ‘Regulation of Securities Exchanges, and Strength of Auditing and Reporting standards’; and second for ‘Accountability of Institutions, and Protection of Minority Shareholders interests’ (World Economic Forum, 2014).

It is important to understand what factors influence PEII. For Saltuk et al. (2014, p.5) the top three critical challenges to PEII were identified as a; “Lack of appropriate capital across the risk/return spectrum”, “Shortage of high quality investment opportunities with track record” and, “Difficulty exiting investments”. In a survey carried out by Saltuk et el. (2014), it was found that government policies can address these challenges. The South African Venture Capital and Private Equity Association (SAVCA) describes itself as “the industry body and public policy advocate for private equity and venture capital in South Africa” which currently represents R120bn in assets under management (SAVCA, 2014, para.1). Policy volatility, resulting from political instability, is a factor that can create a negative perception regarding the ability for PE impact investing to achieve its projected financial return on an investment (Manigart & Wright,

2013). Furthermore, policy instability and uncertainty raises concerns about the future condition for exit, determined by the funds' defined lifecycle (Manigart & Wright, 2013).

South Africa's Constitution, represents its core public policy and developmental agenda aims. The 1996 Bill of Rights, entrenched in the South African Constitution, sets a clear vision for the country and highlights the values and goals which all South African's should aspire to. In this, the need for SRI is indirectly highlighted. This is through the call to build a better, more equitable society, while entrenching the socio-economic rights of South Africa's citizens. Subsequent legislation provided the mechanisms for addressing social needs, which - according to Visser (2005) - is a significant motivator for companies to incorporate SRI practices within their business. The Broad-Based Black Economic Empowerment Act that was legislated in South Africa in 2003, has introduced a unique social agenda to the country. This BBEEE is similar to other Affirmative Action policies globally, but has been implemented in the South African context with much vigour. Visser (2005) identified this as a means to utilize economic activity as a catalyst to address social issues such as poverty alleviation, workplace empowerment, and affirmative action. The subsequent development of ESG standards within South Africa, such as the King III Code, has resulted in South Africa being recognised as a leading country for good governance (Visser, 2005). If this advantage is combined with appropriate policy to address the concerns of PEII, it could entrench South Africa as an attractive capital destination for emerging market PEII (Visser, 2005). It is thus of crucial importance that South Africa adopts the correct PE policy at an early stage, in order to capitalise on this advantage. With well-defined markets, and a history of effective investment management and good investment returns, the shift to a successful PEII market is within the reach of South Africa.

Ballim (2013) indicated that the levels of economic growth in South Africa required to achieve real impact in terms of poverty eradication, needs to exceed population growth by 3%. Yet South Africa does not have the capital to drive the required growth and so foreign investment is required, with PE being one of the most efficient ways to achieve this (Ballim, 2013).

Interestingly two studies, Crifo and Forget (2013), and Scarlata and Alemany (2010), concluded that ESG issues may be better achieved by PE than public investors. A reason for this presented by Visser (2005) could that PE investors consider the value creation potential resulting from the ethical and social dimension of an investment, instead of only using capital allocation metrics established by the public sector as conditions for access to capital. This is precisely what South Africa's legislation is hoping to achieve through the Bill of Rights and BBBEE. This simply reinforces the importance of capitalising on the growth in PEII.

### **2.3.2.1 PUBLIC POLICY AND VC**

The Venture Capital Company (VCC) model, introduced in South Africa in 2008 has been inherited from the Venture Capital Trust (VCT) model which was introduced successfully in England in 1995. Woolcock (1998) describes the failure that can result when a mechanism is applied to a new context without full evaluation of the political, economic, social and cultural context. This model failed in the South African context, as its nature shifted from that of a fund, to being a company model. Furthermore, where the VCT was exempt from paying capital gain tax, the VCC model does not have this advantage, and so is less attractive. In this way, what seemed to be a positive project – the identification of best practice from an international source – was corrupted as the elements of the case that were most positive and contributed to its international success were unduly omitted when implemented locally.

### **2.3.2.2 PUBLIC POLICY AND SOCIAL ENTERPRISE**

This is an area of great importance in this research. Due to the fact that PEII is focussed on the social good that can result from certain profit generating business activities. The social enterprise environment is an area in which the effects of policy formation can either drive or inhibit the sector's success.

In their resource-based analysis, Del Bosco and Misani (2011) investigated PE in the context of it being an emerging asset class that can also be classified as responsible investing. Del Bosco and Misani (2011) identified three types of resources that a responsible PE investor can provide to their portfolio companies, namely; financial resources knowledge and competencies; and relational resources. The net value that can be provided to a portfolio company, resulting from foreign impact investment funds, represents an increased flow of resources beyond that provided by FDI. Ballim (2013) identifies the need for public policy makers to recognise this benefit and build a supporting framework to attract more public-private participation. It is important to remain aware of the fact that not all FDI inflows are directed at impact investment. The majority of these FDI flows are in fact not aimed at achieving this. However this represents an opportunity to draw increased FDI into the PEII space.

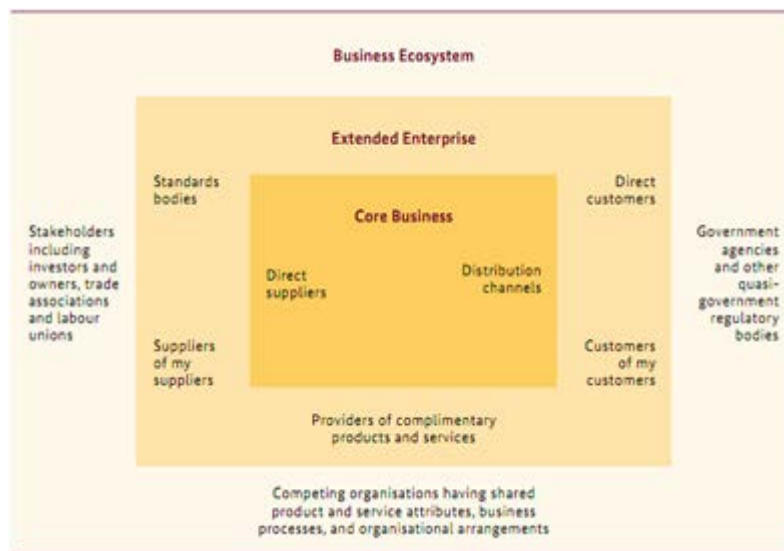
### **2.3.2.3 PUBLIC POLICY AND SOCIAL ENTREPRENEURSHIP**

Bugg-Levine and Emerson made recommendations on how individuals can influence the development of PEII, and specifically stated: "if you have influence over policy and regulation, clear the space that will allow social entrepreneurs and their investors to come out from where they are hiding" (2011, p. 40). This clearly highlights the need to develop a policy framework that is not cumbersome and bureaucratic, but creates the necessary stability in the sector.

#### 2.3.2.4 **BBBEE**

South Africa's BBBEE codes have been amended to promote enterprise development, within the supply chain, as the key driver of economic transformation. The original BBBEE codes emphasised ownership as the most important factor for achieving highly rated BBBEE credentials. This shift indicated an improved understanding towards the driver for investment within the capital markets, and how they interact with business within the business ecosystem. Moore (1996) presents a model that portrayed how business fits into its environment, immediately interacting with its Extended Enterprise, and ultimate residing within the Business Ecosystem. Moore's business ecosystem model provides a useful model for understanding the potential of the BBBEE enterprise development.

*Figure 8: Moore's business ecosystem (Moore, 1996, p.27)*



#### 2.3.3 **PUBLIC POLICY INFLUENCE ON PRIVATE EQUITY IMPACT INVESTING IN EMERGING MARKETS**

Speed (2012) questioned if the constraints of limited opportunities for PEII can be mitigated by public policy that supports and develops social enterprise. Trelstad and Katz (2011) indicated that the global policy community needs new solutions, and view initiatives such as the 'Impact Economy Initiative' as vital in meeting this goal. Through such initiatives, which explore the effects of public policy on the development of impact investing, the opportunity offered by PEII, will be connected to the growth of social enterprise due to supportive public policy. Thus public policy in areas that may not seem immediately related to the PEII space – such as social entrepreneurship regulation – has an impact on the opportunities available for PEII in South Africa. It is thus wise to take a broader view of policy implications and the various policy documents that shape the sector.

Trelstad and Katz (2008) stated that in the “social sector and public policy worlds, scale is ... defined by the organization’s scale relative to the problem being solved” (2008, p. 70). This can be interpreted as indicating that impact investors have a preference for maximising social and environmental returns, over pure profit. This is achieved by targeting high-impact opportunities, with the potential for achieving scale through rapid growth. That said, it should be recognised that global capital has ample resources allocated for impact investment. However according to Saltuk et al. the most significant factor inhibiting growth of impact investment globally, is the “shortage of high quality investment opportunities with track record” (2014, p. 5). Therefore there exists a dichotomy whereby the funds available for investment are available in the global economy. However due to the emergent nature of Impact Investment, there is little background information available for investors. This results in PEII not being considered as an appropriate vehicle for investment, and thus funding is diverted elsewhere.

Recent research by Saltuk et al. (2014) on public policy, and initiatives to encourage PEII has focused on developed markets, with a significant gap in policy research existing within emerging markets. Saltuk et al. (2014) discussed how these developed market policy initiatives are oriented towards establishing foundations, or public organizations, which can support social development. Alternatively these initiatives drive the adoption of regulation to classify and favour social funds (such as the European Social Entrepreneurship Fund). Saltuk et al. then described that the recent initiatives as:

*“The Social Impact Investment Forum launched three initiatives to support the development of the market: research commissioned from the **Organisation for Economic Co-operation and Development (OECD)** on global developments in the market, supported by a working group of impact investment experts; a **Global Learning Exchange** to develop and share best practice in public policy and more broadly amongst market actors; and a **Social Impact Investment Taskforce** aimed at building collaboration among the investor community”* (2014, p. 18, emphasis added).

Saltuk et al.’s analysis of their findings in the 2012 JP Morgan Social Finance survey identified and ranked government policies which influence impact investments. In order of importance they are; “technical assistance for investees”; “tax credits or subsidies”, “government backed guarantees”, “streamlined, clearly defined regulation for an investment offering”, “co-investment government agency”, and “procurement from investees” (Saltuk et al., 2013, p. 11). These factors all influence the sector and so should be central in policy development and analysis.

## 2.4 SUMMARY

The literature review aimed to examine contemporary thought around the role of business within society. It also aimed to understand the models that have been developed for optimising the functioning of profit oriented equity investment with the additional outcome of achieving impact. The convergence between social and economic interests is mature, whilst the study of public policy is relatively new. There is a critical need to understand the policy constructs that influence decision that investors make to participate in impact investing.

The social aspect is a core theme that has been investigated in this literature review. Social entrepreneurs are engaged in activities that deliver economic activity, whilst implementing social good. This portrays the existence of a social ecosystem as a core theme that connects into the activities business. This convergence is seen in Moore's (1998) 'business ecosystem' model that defined the business ecosystem, and described the scope of influence it has on stakeholders. Within the context of South Africa, enterprise development has become a key area required for growth, to power transformation at the grassroots level within the country.

Economic activity cannot be considered without regarding the source of finance. Capital is provided from a wide variety of sources, and the expectations for the allocation of capital have different outcomes. This is shown in the activities of investors along the investment spectrum.

Finally the evolution of social business, blended value, and shared value has emerged into a clearly defined context of "impact investing". This is understood by business, has tangible form, and can be adopted by businesses, investors and policy makers.

Private equity is a mechanism for how investors can participate in the private sector. This model lends itself to efficiencies, and investors can directly influence how the business is incentivised to achieve projected targets. As well as this, expertise can be introduced to the business to drive value creation. The profit incentive in private equity creates a highly efficient mechanism for capital efficiency, and when this gets applied to impact investing it defines an important area of convergence in the investment spectrum.

Thomas Friedman described that the world as flat, however not all markets are created equal, and the policy landscape creates one of the most tangible factors that can influence the ability and desirability of PEII participation. South Africa is a country that has a unique requirement to achieve transformation, and BBBEE is a policy framework that shows how impact can be achieved. This is through encouraging the participation of entrepreneurs and investors, to achieve profit whilst also delivering a measured impact.

Recently, the need to better understand policy influence towards impact investing has been highlighted, and policy has been attributed as the best mechanism to drive scale in impact investing at the sector level. There have only been limited investigations toward evaluating the role that policy has on impact investing, and none that are specifically oriented to evaluating PEII. Currently there are two working groups evaluating and making policy recommendations on how to measure impact investing. This is a clear indicator that the debate about the viability of impact investing has been concluded, and that policy makers are moving to determine how best to leverage the asset class to effect change within their environment.



## CHAPTER 3: RESEARCH QUESTIONS

The questions that are presented within this research report provide the basis upon which the methodology for data collection is designed. Data and findings relating to each question are presented in Chapter 5 and the discussion of the findings is presented in Chapter 6, with regards to how the analysis relates to the literature review of Chapter 2. These questions have shaped the research focus and ensured that the process of collecting the data was clear. These questions were developed in order to expose and provide clarity on specific areas that have been under-researched previously.

Appendix A presents a model that represents the integration of analysis and content, this is accompanied by a consistency matrix which links the individual research questions to the literature that is pertinent to it.

The following questions have been investigated in this research:

**RESEARCH QUESTION ONE: What factors constrain the development of private equity impact investing in South Africa?**

**RESEARCH QUESTION TWO: How is the policy landscape influencing the factors that are constraining the development of private equity impact investing in South Africa?**

**RESEARCH QUESTION THREE: What factors enable the development of private equity impact investing in South Africa?**

**RESEARCH QUESTION FOUR: How is the policy landscape influencing the factors that are enabling the development of private equity impact investing in South Africa?**

**RESEARCH QUESTION FIVE: What are the current policy initiatives and practices outside of South Africa that are enabling the development of scale of private equity impact investing within emerging markets?**

## CHAPTER 4: RESEARCH METHODOLOGY

The methodology designed for this research report considered the nature of the topic and the research questions that were been presented. The questions presented relate to an exploratory investigation into the nascent impact investing industry, with specific emphasis placed on the influence that public policy is having on PEII. Given that there is limited academic information relating to this topic, it was necessary to design a research tool that would support the collection of data from individuals who participate within this space.

The convergence of three distinct fields: public policy, private equity, and impact investing required a broad sampling of data from a universe that encompasses both, participants in this area, and those who had insights into alternative fields. These alternative fields included non-equity assets classes and non-impact oriented investment opportunities. However given the specific need to gather data relating to impact investing, interviewees needed to have actively participated in the impact investing debate, whilst it was not a requirement that they were actively investing in the PEII space. This is due to the fact that those with the potential to invest in the impact investment arena, but actively chose not to, had insight into the challenges and factors that prevented the PEII space from being an attractive investment portfolio.

The diversity of perspectives engaged with is important in order to ensure that a holistic approach to the research was taken. This is particularly important, as the development of the term ‘impact investing’ was through a consultative and inclusive approach. The below quote highlights the nature of stakeholders who have perspective on the influence of public policy on PEII.

“In 2007 The Rockefeller Foundation convened a group of investors, entrepreneurs, and philanthropists at its Bellagio Conference Centre in Italy. Participants were asked what would enable them and others to put more capital to work for social and environmental benefit. By the end of the meeting the term Impact investing had been coined” Rodin and Brandenburg (2014, N.P.)

### 4.1 RESEARCH DESIGN

A qualitative research design using semi-structured interviews was conducted to address the limited availability of qualitative data specifically on the influence of public policy on PEII. It sought to illuminate the subjective findings of those working in the field, providing a contextual richness and deeper exploration of the subject, which may provide direction for future study.

According to Rodin and Brandenburg (2014) there has been an increase in global collaboration between institutional capital and impact investors since the term impact investing was coined in 2007. This collaboration is evident in the recent participation of 125 impact investment funds, representing USD 10.6bn, in the 2014 annual survey conducted by JP Morgan Social Finance Research (Saltuk et al., 2014). This participation indicates there is an apparent desire amongst impact investors to collaborate in developing the nascent impact investing industry, so that it can achieve the scale and thereby develop market opportunities.

*Table 3: Comparison of JPMorgan survey participation*

<b>Year of Analysis</b>	<b>2012</b>	<b>2013</b>
<b>Survey Conducted</b>	2013	2014
<b>Number of funds participating in the survey</b>	99	125
<b>Repeat participation in survey</b>	n/a	67
<b>Assets under management in year of survey</b>	USD 8.0bn	USD 10.6bn
<b>Intended investment in future year</b>	USD 9.0bn	USD 12.7bn
<b>Minimum fund size for participation</b>	\$10mil USD	

This collaboration between diverse stakeholders, including foundation, investor, fund manager etc, in the research, as well as in the initial process of defining Impact Investing – as described above - proved beneficial in the data collection stages of this research. The research explored the nature and form of influence that public policy has on PEII. The majority of the participants in the research proved to be accommodating in volunteering time and information for this research, given that its intention was to create awareness amongst stakeholders in the industry.

In preparation for this research, 35 preparatory unstructured interviews were conducted with individuals who had expertise in the research area. Desktop research was also conducted to determine who the local participants to engage with were. This foundational research provided the author with contextual knowledge around the private equity industry, while at the same time evaluating the propensity for the asset class to engage in impact investing. A further area of preparatory research involved attending a range of private equity lectures and conference events. This served to provide excellent networking opportunities, to engage in further informal discussion with, and learnings from, stakeholders and interested parties. These events were hosted by various institutions which also gave insight into different perspectives held on the matter. The events that were attended were:

- Lecture: “PE in Africa” - SAVCA
- Two day conference: “Pension Fund investment in PE” - Bowman Gilfillan

- Three day course: “Master Class in PE” - SAVCA
- Four day course: “Strategy in Private Equity” - Gordon Institute of Business Science
- Half day conference: “Enterprise Development” - SAVCA
- Lecture: “European Markets” - SAVCA
- One day conference: “2014 Start-up” - SIMODISA

These activities and preliminary research were paramount in shaping the research, and understanding the factors involved in PE impact investment.

The 2012 research conducted by Speed, provided a recent evaluation of the main factors constraining and inhibiting the development of impact investing within South Africa. Building upon Speed’s 2012 findings and analysis, this research developed an understanding of how public policy within South Africa has influenced the sector, and how emerging best practices in the public policy sphere internationally can be applied to the South African context in the future.

Permission was granted from Speed to utilize his base data for the purpose of validation and triangulation. Triangulation is a method which promotes the engagement with multiple sources of data and information; and methodological triangulation, examines an issue with the use of many different methods (Maxwell, 2012). Triangulation is an important tool in reducing potential bias and in ensuring that multiple perspectives are gained and assessed. Speed’s data consisted of 18 interviews that were drawn from impact investors that participated in all asset classes. The relevance of this data, and the universe that it was drawn from, was considered appropriate given the PE policy landscape. This policy landscape also applies across the capital continuum, which sways the desirability of assets classes in accordance with the policy that encompasses it. This secondary data was collected during September and October 2011, and provided a dimension of time for analysis against this research’s primary data. This provides both a recent set of data which maintains its relevance, whilst also presenting a three year gap which could allow for comparison of findings over time. In this way, this study has elements of a longitudinal study, which allows for comparison, and which opens the potential for further comparison in the future.

Primary data was collected via 16 semi-structured interviews, these interviews comprised of the following stakeholder categories:

- Fund managers of private equity impact investment funds, with portfolio companies in South Africa. Eight were interviewed.
- Intermediaries who deal with PEII within South Africa. Four were interviewed.

- Public policy makers involved with policy relating to South African capital markets. Four were interviewed.

Initially it was expected that SAVCA would show an interest in participating in this research, and thereby assist with gaining access to interviewees. However upon engaging with SAVCA this support was not provided. SAVCA explained that it received numerous requests to participate in research and it did not want to harass their members, for the purpose of supporting individual external research. This ultimately did not prove a hindrance given that during the networking process that was undertaken (amongst fund managers, intermediaries, and policy makers), the referral of contacts was forthcoming and thereby access was established. The process followed and effort extended to develop access to interviewees was beneficial in deepening the author's insights into the nature of the research area. Deepened understanding of public policy influence was most useful to have attained prior to initiating the interview processes. The utilization of snowball sampling in this way further broadened the sample by including individuals who were not initially incorporated in the original list of interviewees.

#### **4.1.1 VALIDITY AND RELIABILITY**

Bowen (2005) highlighted the need to develop "trustworthiness" that addresses both validity and reliability of qualitative research by "providing checks and balances to maintain acceptable standards of scientific inquiry" (p7). Internal validity required that data collection processes are rigorous and that analytic methods be sound. Internal validity is key in that it ensures that the study measures what it set out to. In order to achieve internal validity, an approach of triangulation was used during the inductive analysis process. This involved interviewing a range of participants within the public policy and PEII fields, to ensure that a bias has not been introduced by the research design or the sampling technique.

Corbin and Strauss (2008) describe external validity as being the trade-off of generalizability with transferability, and present it as being the manner in which findings can be generalized across different research settings. Such generalizations within research design will result in a trade-off between internal and external validity. Two major tests for the validity problem are: are we using the right tool to get our answer, and if someone else followed the method would they achieve the same result?

External validity was achieved by using explicitly anonymous reference of all actual data which supports the linkage of findings to their original source. While using cases that are far from the norm increases the learnings and potential for new findings, this limits the generalizability of the

study. The number of interviews conducted, as well as the triangulation methods implemented, attempted to balance this trade-off.

Saunders and Lewis (2012) describe reliability as being the ability to produce consistent findings through the use of robust data collection methods and consistent analysis procedures. Therefore reliability depends on meticulous recording of processes and research execution, such that all stages of the research are audited and repeatable. This philosophy for research methodology was incorporated into the method design and was implemented successfully such that the results are considered reliable.

## 4.2 UNIVERSE

The universe for this research was independent PE impact investment funds that fit within the following criteria:

- The mandate of the PE fund is ‘profit-with-purpose’ invested in “finance-first” portfolio companies, that operate within emerging markets and deliver social impact that is actively measured.
- The mandate of the PE fund is not necessarily ‘profit-with-purpose’ yet the fund has the potential to invest in the PEII space. These funds operated in emerging markets and were not averse to investing in funds aiming to deliver social impact.
- PE funds must target emerging markets.
- PE funds must be established for a limited lifecycle, which typically indicates a period of 10 years.

### 4.2.1 SCOPE

South African private equity impact investment funds, targeting growth stage portfolio companies, formed the scope for interpreting the effect of South African public policy. Global impact investment funds - targeting growth stage portfolio companies in emerging markets - were the focus for identifying the design and effect of public policy that is currently positively influencing PEII in emerging markets.

Public policy that relates to the development of the country’s entrepreneurs is outside the scope of this research, due to it not being related to the capital market theory or impact investment theory. complexity and scale. The factors that define and shape entrepreneurship, and the challenges faced in the entrepreneurial sector are vastly different from the issues that lead to investment in the PEII space. As a result, there would be too many diverse aspects – skills, psychological dispensation, ability, finding, access and education – that would need to be

considered in this type of study. This would simply have diluted the focus of this study and led to the final report being very broad. Despite social entrepreneurship providing a pipeline for venture capital opportunities, the scope of the research is limited to policies directly influencing PEII.

Regarding research Questions One to Four the research scope was limited to the influence on private equity impact investment funds that are registered and operating in South Africa. The scope of Question Five incorporated key public policies that are currently influencing private equity impact investment in emerging markets.

#### **4.2.2 UNIT OF ANALYSIS**

The unit of analysis is public policy.

Due to the focus of this researching being the role that public policy plays in influencing the PEII sector, public policy has been identified as the unit of analysis. This concept, public policy, has been deconstructed into the various elements that influence public policy – as described by Thomas and Mohan (2007). Public policy is shaped by various factors, local and international. The role of a diverse group of stakeholders in shaping global public policy directions has been discussed, but the way in which this then impacts the local PEII environment is key.

#### **4.3 SAMPLING**

The sample was drawn from the sequential processing of several databases. The first source was drawn from the 2014 SAVCA directory of registered private equity funds, filtered to only include those funds that participate in impact investing. The GIIN's ActiveBase database was then analysed to identify funds with portfolio companies operating in South Africa. Finally Standard & Poor's Capital IQ source data was integrated into the list, to incorporate investment and portfolio company data. The resulting list of potential funds was specified according to the following dimensions:

- Is the fund actively engaged in impact investing and with managed metric?
- Does the fund indicate that it considers, and measures, social impact within its operations?
- Fund Structure – Is the fund closed cycle, open cycle, or a fund-of-funds.

Policy participants were selected by identifying who the key South African players were, and then soliciting referrals within the organization, for details of individuals who could be engaged. Frequently it was necessary to request a secondary referral to get the appropriate person in the

organization. Cold calling individuals was occasionally required, this was achieved using a template cover letter which was customized to the individual's context.

Networking regularly at conferences increased access to fund managers and lent a degree of authenticity to interview requests. Furthermore this provided background knowledge of the funds that were showcasing themselves as impact investors, as opposed to being deeply committed to achieving impact within their mandate. Snowball sampling was used where necessary, to get referrals to stakeholders who were not included in the original list, yet were considered important to the research. Furthermore this allowed access to those individuals who may not have been initially considered, but were thought by their industry peers to have a valuable contribution to make.

Given that the evolution of the data gathering process shifted according to the information gathered during the interviews, interviews were sequenced evenly across the stratified dimensions to avoid bias towards the stakeholders that were interviewed last. In this way, through grouping interview participants according to their industry role, it resulted in the data being more easily manageable and for those additional inputs to be easily integrated.

#### **4.3.1 SAMPLE SIZE**

The qualitative research process was concluded when saturation was reached. After 12 interviews a preliminary analysis exercise was undertaken to analyse the data, determine the level of saturation, and develop an initial version of the thematic codes. This was deemed necessary in order to interpret the data that had been collected, whilst also identifying areas of saturation, and gaps that required further data collection. The principal reason for the complexity in determining saturation, related to the three categories of interviewees, who were providing data from distinct perspectives.

Following this exercise to determine the level of saturation, a second round of interviews was conducted with a further 4 interviewees, bringing the total number of interviews to 16. This was to address remaining gaps in knowledge.. Following the additional interviews, no further information was presented and therefore saturation was deemed to have been achieved.

#### **4.4 DATA COLLECTION INSTRUMENT**

The interview format was based on the script used by Speed (2012) in his research on impact investing in South Africa. This may allow for potential comparison and lateral cross-analysis with Speed's 2012 data. The interview process was piloted with three individuals who are



knowledgeable in PEII, to trial and optimise the tool, whilst validating the output of the data analysis mechanism.

Prior to each interview the interviewee was thoroughly researched. This process was initiated several weeks before each interview, during the process of evaluating the individual's suitability for the research. The individual's company was studied and key aspects summarised, which proved necessary due to the large volume of desktop research that was performed. Funds were analysed and specified down to the level of key attributes, and portfolio companies that were publicly named were investigated. Research notes were split into two segments, the company / fund and the individual.

Before each interview the semi-structured script was adjusted to suit the specific context of the individual. A mind map was compiled on a single A4 page which would allow quick reference during the interview of the individual's background, and their current role within the fund. This desktop research was critical for a meaningful engagement with the individual immediately as the interview started. It further supported the development of authenticity when the individual realised that their time was being utilised for meaningful enquiry and not for content which was publically available.

One day before each interview the interviewee was emailed the research information sheet. The primary purpose of the information sheet was to provide the interview with formal content relating to the research in advance of the interview - which in some cases prevented unnecessary time being spent off topic during the interview. The second benefit was that it reminded the interviewee of the appointment the following day thereby reducing potential inconvenience caused by late cancellation on the day.

At the start of each interview, the context of the research was described by the interviewer, this was necessary as not all individuals had taken the time to fully read the research information sheet. A hard copy of the research information sheet was provided to the interviewee and they were requested to sign it. The interviewee was then asked if they were comfortable being recorded. The interviews were recorded using two recording devices. During the interview handwritten notes were made on the interview script. Immediately after concluding each interview, research notes were written up in a Microsoft OneNote research repository, while the information was still fresh.

It was recognised that the interviews conducted later in the data collection process would be more focused towards gaps and thereby may be perceived to hold greater values. The sequence

in which interviews were conducted was specifically structured so that key interviews were positioned at various stages of the interview process. Individuals who would provide broad data were targeted early whilst those considered experts in specialized areas, were targeted later. This strategy further provided the opportunity to prepare for technical interviews using preliminary preparation, desktop research, networking and interviews.

Research notes were maintained after each session of desktop research; all material and literature was converted into PDF and saved in a date stamped folder, marked up by the keywords relating to the unit of investigation. Research notes were captured within 24 hours of every engagement such that legitimacy of information could be ensured. Data that was collected outside of the semi-structured interview process formed a basis for informing the research into the topic and to allow the researcher to conduct the interview with authenticity. This was through being able to converse with the interviewee on topics that required technical knowledge, in order to explore the content in detail, and enquire into the specific influence that policy was having.

'In person' interviews were conducted where possible. The researcher made two journeys to Cape Town to interview candidates. Telephonic interviews were conducted with two interviewees, in both cases these interviews were shorter than the in person interviews, which was attributed to the ability to shortcut the preparatory conversation process and target key points more aggressively. The flow of the telephonic interviews was also more distinct and leant itself to conclusion earlier than the physical interviews. Consideration was made that the physical interviews did allow for peripheral issues to be raised during the summation of the interview, whilst the telephonic interview resolved to conclusion far more readily, owing to the ease with which the conversation ended.

Soft factors that could influence the validity of the telephonic interviews were considered, these include: impersonal rapport; less-formal structure; inability to interpret body language; insufficient time being made available for the interview; and office distractions being more prevalent. Despite these factors the telephonic interviews were considered to be highly effective as they proved to be more efficient with regards to time, and they were often more focused and had a rapid cadence which resulted in a fast progression through the interview script. This tempo of the conversation increased the focus on key topics, in contrast to in-person interviews where it was often necessary to allow an interviewee to digress from the specific focus area to maintain rapport within the interview. This required the interviewer to consciously lead the conversation back to the research script. This technical structure to interviewing required maintaining the

interview rapport during the in-person interviews, while simultaneously maintaining a passive interview style that was comfortable for the interviewer. During the telephonic interviews it was less acceptable to interrupt the interviewee to steer the topic back towards the core focus area.

#### 4.5 DATA ANALYSIS

After each interview the media files from the primary device were backed up to an external storage device, and then loaded into a computer audio editing software to be trimmed such that they included only the interview component of the recording. The processed media file was further optimised to reduce physical file size to aid electronic distribution via Dropbox. The file was also renamed according to an index which would remove the identity of the interviewee from the transcription service, then submitted to the transcription service. The transcription service QualQuarter typically returned the transcripts within 48 hours and the following steps were then taken:

- The transcript was copied to a local folder, transformed into a standardized template and saved as rich text format. The transcript was edited to add the interview index as document headings.
- The file name was edited to match the interviewee index.
- A spell check was applied to the document to validate obvious errors resulting during the transcription. Frequently colloquial terms, technical terms, and acronyms were incorrectly transcribed and these were corrected.
- The mark-up format of bold text for interviewer and plain text for interviewee was validated.
- The audio file was then listened to in full sequence to ensure that the content was correctly transcribed, edits were applied to the transcript where necessary.
  - During this process the additional research notes were developed and appended to the note that was created for the interviewee immediately after each interview had been conducted.
- Once validated the transcript was printed out as a hard copy and systematically processed. Key content was highlighted and notes were handwritten onto the document. Keywords were also written onto the document, and these formed the basis for the development of version one of the thematic set of codes.
- Once each transcript had been reviewed in hardcopy it was imported into a computer assisted qualitative data analysis software.

- The exercise of reviewing the data allowed for the development of a list of proposed codes.
- The hardcopy notes were reviewed end-to-end and all key content that had been identified was coded. Additional notes that might be relevant to the specific quote were captured as a comment associated with the quote.

Maxwell (2012) classified the analytic options recommended for use, into three groups; categorising strategies, memos, and connecting strategies. A thematic list for analysing coded interview data was developed to categorise the data according to factors that were policy inhibitors or contributors. Themes were defined during the interview process to support thematic analysis of the data. Through the process of the preparation for, and actual interview, as well as the review of transcripts and assessment of their accuracy, a great deal of familiarity with the content occurred, this information was captured as memos. This was then expanded upon through the process of working through the documents and adding additional comments. In this way, themes and gaps emerged naturally and it became evident where there was a need to delve deeper into the material. Whilst processing the data, connecting strategies were specified, with causal relations defined, and this supported visual network analysis and drill-down on the data.

#### **4.6 RESEARCH LIMITATIONS**

The exploratory nature of the study has resulted in the early exclusion of factors that are not relevant to public policies' influence on PEII. These factors have not fully been conceptualized within available literature, and therefore the research design developed in accordance with the data that was being presented.

South Africa was chosen as the area of study due to physical and practical limitation of access to individuals for research Questions One to Four. Research Question Five, which looks at global public policy in emerging markets and the influence it has on PEII, affords a larger universe, whilst only requiring a broad investigation into current best practices. These identified public policies have been conceptualized within a South African context and presented as recommendations for further empirical research.

Confidentiality and anonymity could be perceived to be a limitation to this research. Private equity is a competitive industry and protection of proprietary strategy and financial performance can be regarded as a necessary practise to protect a funds commercial interests.

## CHAPTER 5: RESULTS

The results of the data analysis that was conducted in order to answer each of the 5 research questions is discussed in this chapter. The results are presented and discussed, and the analysis is summarised below each research question.

### 5.1 SAMPLE DESCRIPTION

The sample comprised 8 fund managers, 4 intermediaries, and 4 policy makers. The data was collected over a 2 month period, two of the interviews were conducted telephonically, and the remainder were conducted in person.

The list of interviews in Table 4 shows the sequence in which the interviews were conducted. The sequence in which respondents were interviewed, was deliberately staggered. This was to ensure that respondents from the same group were not all interviewed sequentially. This approach was taken in order to ensure that the area of expertise of each interviewee was given even representation during the data collection process. As a result of the rotation of the area of expertise, the opportunity to query and probe the outcomes of a particular view, with experts from a different field, was possible.

*Table 4: Sequence of interviews*

<b>Interview Sequence</b>	<b>Interviewee</b>
<b>Interview 01</b>	Policy Maker A
<b>Interview 02</b>	Intermediary A
<b>Interview 03</b>	Policy Maker B
<b>Interview 04</b>	Fund Manager A
<b>Interview 05</b>	Fund Manager B
<b>Interview 06</b>	Fund Manager C
<b>Interview 07</b>	Policy Maker C
<b>Interview 08</b>	Intermediary B
<b>Interview 09</b>	Fund Manager D
<b>Interview 10</b>	Intermediary C
<b>Interview 11</b>	Fund Manager E
<b>Interview 12</b>	Fund Manager F
<b>Interview 13</b>	Fund Manager G
<b>Interview 14</b>	Fund Manager H
<b>Interview 15</b>	Policy Maker D
<b>Interview 16</b>	Intermediary D

## 5.2 DATA ANALYSIS

Thematic analysis was used to aggregate coded data into categories. Each code with its resultant theme and category was reviewed sequentially, within the context of each research question. Relevant quotes were flagged in accordance with the research question that it related to. A further cross-tabular analysis was then conducted to identify the relationship between codes that had defined causal relationships between each other. The convergence of analysis, relationships, and substantiating quotes were then grouped into logical sections for discussion under the heading of each question within Chapter 5.

## 5.3 RESEARCH RESULTS FOR RESEARCH QUESTION ONE

### **RESEARCH QUESTION ONE: What factors constrain the development of private equity impact investing in South Africa?**

When examining the main factors that constrain the development of PEII in South Africa, there were a number of perspectives that emerged from the interviews. These factors included a lack of knowledge about PEII, or a lack of clarity around the identification of PE impact investors. For example, according to Fund Manager D (2014):

“It is a curious thing in South Africa that private equity from where we sit has actually seemed relatively absent from the impact investing discussions. I think the individual private equity players that are looking for what you would call an impact investment... they aren’t participating in the same things that either in the rest of the continent you see a lot of that supported by development finance money, but in places like Kenya and places like Ghana there is impact investing as an umbrella term and people self-identify as impact investors” Fund Manager D.

This represents a distinct difference between the impact investing ecosystems in South Africa to other African emerging markets. Furthermore, it highlights the importance of building awareness around the term impact investing and gaining scale in South Africa.

A further challenge is the lack of knowledge of investment opportunities, and a lack of structure within which investors can operate. For example when speaking about new investment opportunities;

“That early stage high growth stuff, where there is no VC model, the impact investors are interested in, that are sitting overseas, but they can’t find the deals on the ground.

Or if they are on the ground they send some poor American over here for two to three years and then he leaves and his network goes with him” Intermediary B.

This further highlights that there is not a sustainable value chain being built, but rather that an ad hoc approach is being taken, and proper frameworks and institutions are not being developed to support and attract PEII.

A further constraint is that there is a lack of standardisation in the measurement, and poor understanding of the impact investment context, due to it being a relatively new field. For example, regarding impact investing:

“... most people like to claim they are doing it, but there are very few people who are specialized and understand it and are actually doing it properly. And who actually measures it. The difference is that most of the guys don’t have a baseline, pre-entry, so they don’t track the relative performance and sustainability which is the most obvious thing to do.” Fund Manager E.

### **5.3.1 GOVERNMENT INTERVENTION IN POLICY IMPLEMENTATION**

This research has indicated that government intervention decreases the efficiency of capital allocation, and increases the costs of operating within the market; “That is kind of acceptable. If you measure the cost structure of government doing the same thing guess what that cost is?” Policy Maker B. It has emerged that governments fulfil the role of policy formulation, and it should relinquish its involvement in policy implementation to the institutions which exist for that purpose. According to Policy Maker B, “governments have got in their mind that they drive growth which is a total misnomer. They get in the way of growth, they are the problem, not the solution”.

#### **5.3.1.1 TRUST**

The history of South Africa and the way that economic power is intertwined with political power creates a highly complex landscape for interaction and collaboration. This is particularly true given the multitude of participant’s agendas and interests.

“... you see there is a trust issue and if you come from a communist background, the private sector are evil and wicked and out to get you – and the problem is you then have to take best practice from elsewhere and you have to turn it because your mind set says you can’t trust the private sector to give you the outcomes you want.” Policy Maker B.

This trust deficit is evident in the way in which, currently, business and the private sector do not always communicate effectively. Furthermore, according to Fund Manager C, some business have been accused of withholding investment from the South African economy – sitting with large sums that are not being spent on anything productive as a way to mitigate perceived risk. This climate of mistrust will influence the nature of policy that is formed. In South Africa, this is compounded by an increasingly populist narrative, which will also impact policy direction.

#### **5.3.1.2 OWNERSHIP OF IMPLEMENTATION**

There is an issue for PE Impact investors of the challenge of bureaucracy. This has resulted in business facing numerous challenges and extended time frames to achieve success. An example of bureaucracy in the implementation of a fund can be seen in the Jobs Fund:

“... there is this holy trinity of National Treasury with all its Job’s Fund Committees. The Development Bank, DBSA and then consultants shadowing DBSA. They were with Genesis Analytics so to get anything done you have to sort of navigate your way through those three layers. As soon as anything goes wrong it is like starting again. It is not just a matter of changing something for the Committee that you are trying to get through now. If something changes it has to go back.” Fund Manager D.

Failure to harmonise the policy that is created across the government agencies that are tasked with policy formulation has been identified as a major source of failure in achieving the desired outcomes. This was explained by Policy Maker D:

“You have your institutions who are intended to implement policy, they are implementing agencies of government, this leads to a very interesting conundrum, they are so many bits and pieces out there. Who is pulling it all together in a way that it actually ultimately creates jobs?” Policy Maker D.

#### **5.3.2 GAP IN THE CAPITAL CONTINUUM**

There is a need for soft capital to be appropriately positioned to provide risk adjusted returns to attract private equity to participate:

“It uses the same kind of model but private equity isn’t as hands on as what VC or SME has to be. And it is also dealing with much higher risk, so that is why you have to de-risk it by putting in grant funding.” Policy Maker B.



This shows that South Africa has a shortage in angel investors, to allow for the continuum of capital to support development of start-ups which would ultimately grow into the pipeline for PE investments.

### **5.3.2.1 CAPITAL EFFICIENCY**

The capital continuum presents a risk adjusted rate of return which needs to be evaluated in accordance with the efficiency of capital allocation. There is a need to educate the investors about the importance of cost structures, to mitigate this effect. A common problem contributing to the poor sustainability of grant based impact enterprises is described by Policy Maker B:

“... the people who run those social impact type enterprises, **spend most of their time raising funding**, plus what they do is – and again this is very much if you are just impact orientated - you don’t worry about your cost structure, so they end up with massive cost structures.” Policy Maker B (Emphasis added).

A further problem with the capital efficiency is that public capital is not measuring the value and efficiency of the results from capital that is distributed. That would indicate that those who control the flow of public funding are generally measuring the wrong metrics. These incorrect metrics include elements such as “the number of patents awarded” (Policy Maker B). As discussed by Policy Maker B in relation to TIA, “so they had seven little entities that they gave this money to, and these guys who had no investment experience at all, they were all scientists, wandered off and gave money out”. This lack of structure and clarity indicates that the government does not have efficient channels to allocate the resources, or that – alternatively – should they decide to allocate resources, they should ensure that they do so with a clear mandate to achieve the right outcomes. This mandate should be based on a well-researched, and well thought-out and well-communicated policy and guidelines.

### **5.3.2.2 POOR EXIT POTENTIAL FOR THE VENTURE STAGE OF PRIVATE EQUITY**

A significant factor that exists in the South African small business context is the ability to develop scale economic benefits within the relatively small local market. Start-up business can be categorised as being survivalist versus being innovative. Survivalist business will fulfil the remuneration needs of the entrepreneur and the individuals that are employed by the business, however the business generally has limited potential to grow significantly. For the purposes of attending to the social impact of job creation, these survivalists business must be supported and assisted to grow and develop, in order to achieve the desired social benefits of job creation. However these types of companies do not present a suitable prospect for investment from the private equity funds.

South Africa does not have the culture of raising multiple rounds of finance, as has been seen in Silicon Valley. The reason for this can be attributed to a lack of market for growth potential, and the lack of ability to scale. In South Africa the decision to invest initially in PE is regarded as a way to secure a return on the basis of the investment value. In Silicon Valley early stage investment is a way to secure the rights to participate in subsequent capital raising events in businesses with perceived high growth businesses.

This presents a restraint on the desirability of South African businesses to private equity and venture capital, given that there is limited potential to exit the investment at the desired level of profitability. This therefore doesn't warrant the investment and there is limited potential to exit the business in the future owing to the poor market potential for scale.

### **5.3.2.3 PIPELINE FAILURE AT SEED STAGE LIMITS PRIVATE EQUITY DEAL FLOW**

Seed stage investment in research and technology development is a fundamental component that forms the intellectual property within a country which can be commercialized. The soft capital that is provided by government during the early seed stage, is not getting applied efficiently, and therefore creating a gap in the capital continuum. It is thus important to engage in dialogue with government players in order to reach consensus on the way forward, as it is important to ensure this seed funding is effectively used and not wasted.

“... it is such an early stage the failure rate is so high, the risks are infinitely high. You are never going to make your money back across that portfolio that is why there are no private sector players in that space. That is why we need government interventions like TIA, and it needs to work so that it can feed the pipeline of angels investing into businesses, and if TIA does not work, a lot of that deal flow is broken. TIA is critical factor in the tech transfer space” Policy Maker D.

Policy Maker D further indicated that "TIA is broken. It is still not working after 5 years. At least before TIA there were agencies that were funding stuff, getting things done, making some mistakes, but also having some successes.". This is a worrying fact and is the cause of major limitations in the sector.

### **5.3.3 ALTERNATIVE MARKETS**

Despite its world class regulation and business environment, as well as it's membership of the BRICS grouping, South Africa is not competitive as an investment destination amongst other emerging markets. The limited growth that the country is currently experiencing, as well as the downgrades from ratings agencies limits the attractiveness of the country. Furthermore, South

Africa has limited opportunities that offer the required returns for PE. Other emerging markets have more low hanging fruits with easy impact with strong growth prospects.

#### **5.3.4 LOCAL CONTEXT**

##### **5.3.4.1 SOUTH AFRICA IS TOO EMERGED**

Providers of capital into PEII are often looking to achieve impact within countries which are most in need of impact. Fund managers of PEII funds find themselves committing to impact metrics during their capital raising cycle. It can be perceived that South Africa's relatively strong position relative to other emerging markets, has the potential to diminish available potential for achieving the desired impact within particular sectors, which could dis-incentivise investment within South Africa.

##### **5.3.4.2 IMPACT INVESTING WINDOW DRESSING**

A further problem with achieving scale is the representation of social interests within the fund's brand, whilst not truly adopting them as the philosophy and mandate by which the fund operates and is measured for performance. The popularity of CSR has led companies to represent that they incorporate components of SRI into their public image and brand, even if they are not entirely legitimate in their actions.

“... use the example of Woolworths, it couldn't give a toss about sustainable farming and all those kinds of things, what has driven their whole approach to that is because it is a niche market solution for its customer base. That is what it is. There is no such thing as a caring organization. But they have established themselves as the type of organization where you can go to entrust the product, even though they are not as organic as they would like to be, but that is how we think of them; we think of them as responsible farming” Fund Manager B.

Opinions like this have negative implications for impact investing as an asset class as such behaviour may be perceived as being simply a means to access greater profit, and thus deter potential investors who are in favour of supporting an actual good cause, and contributing in a meaningful way to the development of society.

##### **5.3.4.3 INSUFFICIENT PIPELINE**

The debate around entrepreneurship is broad, and it borders on the topic of this study, in that the resultant businesses provides the pipeline for private equity deal flow. Clear parallels can be drawn between social entrepreneurs and social enterprises with impact investing.

A significant constraint in this area is that South Africa does not have an ecosystem that is generating sufficient quantity of quality opportunities for private equity impact investment:

“So we said it is too risky so there is no institutional funders, and because of that there are no VC fund managers, and half the reason why fundamentally those two don’t exist is because there isn’t a big enough market here in SA for new products, and we don’t have enough VC entrepreneurs – we just don’t have entrepreneurs.” Policy Maker B.

### 5.3.5 CONCLUSION

Government intervention in policy implementation is regarded as the most significant factor which creates market uncertainty and thereby introduces risk into the macro-economic environment. PE investors factor this risk into their expectations for financial return which inherently influences the desirability of PE in relation to other assets classes within emerging markets.

The key driver identified for government intervention in policy implementation is related to a lack of trust in agencies and institutions to appropriately represent government interests. The availability of quality opportunities for VC PE investment is poor, and this is attributed to the failure in the capital continuum. Specifically it has been expressed that insufficient soft capital is being allocated to start-ups, particularly those that have the potential to scale and thereby attract investment. PEII draws from a subset of this pool of potential investments opportunities.

Finally there appears to be a perception that the delivery of impact within the PE model will occur at the expense of financial returns. However, at the same time it is perceived that funds should not be regarded as neglecting the social context, this is seen in the wide spread adoption on PRI and SRI principals by funds. Therefore funds will opt to represent themselves as being “involved” in impact areas whilst not maintaining any tangible mandate for achieving or measuring impact as part of the funds design.

## 5.4 RESEARCH RESULTS FOR RESEARCH QUESTION TWO

**RESEARCH QUESTION TWO: How is the policy landscape influencing the factors that are constraining the development of private equity impact investing in South Africa?**

The policy landscape is complex in that it involves a multi-faceted layer of policy makers who rely upon the public and private sector. These players are, in turn, affected by the policy. Thus there is a constant interaction between those affected by, and attempting to shape policy.

#### **5.4.1 PUBLIC POLICY FORMULATION PROCESS**

Within South Africa the policy formulation process moves along a continuum starting from the recommendation for certain policy, to the finalisation of a white paper and in some cases entrenchment within legislature via the establishment of an act. This progression would be shaped by the involvement and ownership by the participants driving the initiative, and each participant would typically represent a defined agenda.

On the relationship between policy and regulation, Policy Maker A indicated that “regulations effectively become some form of policy because it stops certain things happening and it shapes the market in a certain way – which is what a policy is after all.”. Institutions that operate within a policy context find themselves intertwined with other policy makers, and need to be able to effectively operate in this environment. For example, “Policy is not an issue for us, the issue is working with government and stakeholders on a very collaborative basis, and forming close relationship and getting them to operate in network, not as silos. That is our challenge.” Intermediary B. It is therefore important to improve the levels of collaboration and conversation that occurs between the various stakeholders. This will result in better policy, improved regulations and a broader network within which those involved in impact investing could operate.

##### **5.4.1.1 POOR IMPLEMENTATION OF INHERITED MODEL**

A problem that has been experienced, is the poor suitability, orientated for the local South African purpose, of policy that is implemented when based on best practice policy from other countries. In this way, the policy is not stable in all areas of operation, and consequently, it is not necessarily suitable for the South African context.

The South African Venture Capital Company (VCC) model, a company structure with specific tax benefits, designed to facilitate increased investment in SME and start-up businesses; was inherited from England and was modified with South African tax incentives removed. In doing so this thereby removed the core feasibility of the model to work successfully. This speaks to the lack of trust between stakeholders and the perception is that policy makers do not want to concede profit to the private sector. As a result, a model that works successfully in attracting investment, due to the provision of tax benefits, is then flawed by removing the beneficial provisions.

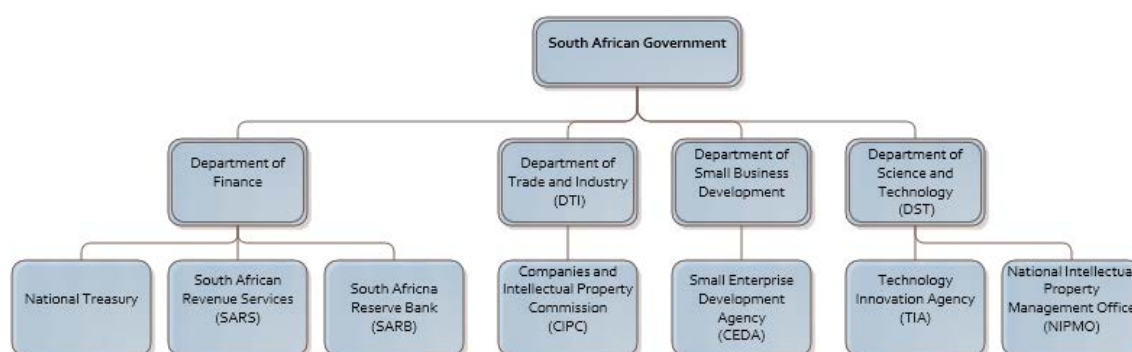
“The problem is that the Venture Capital doesn’t work in companies, it works in funds, but the (South African Government) don’t like funds because funds are in partnerships. So they want to get back into a company because they know how to deal with companies

and they can tax them. So they then turn it round and use the wrong vehicle. They give you a tax deduction if you put money in, but if it makes money you don't get a capital gains tax exemption" Policy Maker B.

#### 5.4.2 PUBLIC POLICY PARTICIPANTS

In terms of the players that influence the policy landscape, it is important to have the correct people controlling the allocation of capital. It is also necessary to determine who the players are, and to ensure that there is room for cooperation. The views expressed by Policy Maker B, stating that "... only entrepreneurs can fund entrepreneurs; government employees cannot fund entrepreneurs". The diagram in Figure 9 portrays the significant government departments and agencies which were identified as playing a role in the policy landscape that related to PEII.

*Figure 9: South African government participants in policy formulation*



The Department of Finance is a government ministry that influences policy that is relevant to this research, and the National Treasury is the agency where the policy is generally developed. The South African Revenue Services has involvement when taxation policy is developed, and the South African Reserve Bank as involvement when foreign exchange policy is developed.

The Department of Trade and Industry is involved in policy formulation relating to different sectors within the economy, whilst the Department of Science and Technology is a specialised sector department that is concerned with the development of sciences and technology within South Africa. The Technology Innovation Agency is involved in policy implementation, its mandate is to provide a channel for government funding to be invested into initiatives that will grow the science and technology sector.

The Department of Small Business Development is a new ministry that has been established to focus on the requirements for developing small business. The Small Enterprise Development Agency is involved in policy implementation, its mandate is to provide a channel for government funding to be invested into small businesses.

Table 5 lists organizations that were connected to the policy landscape that was being researched. DFIs deserve mention given that they are an important source of funding, however that were not included in the scope of the research given that they do not invest into closed-fund independent private equity partnerships. The Financial Services Board is the organization that regulates the financial services sector. SiMODiSA and SAVCA are associations that participate in the policy formulation process.

*Table 5: Other participants in policy formulation and implementation*

<b>Name</b>	<b>Role</b>
<b>Industrial Development Corporation (IDC)</b>	SA Government DFI
<b>Development Bank of South Africa (DBSA)</b>	SA Government DFI
<b>Public Investment Corporation (PIC)</b>	SA Government DFI
<b>Small Enterprise Finance Agency (SEFA)</b>	SA Government DFI
<b>Financial Services Board (FSB)</b>	Regulator
<b>South African Venture Capital Association (SAVCA)</b>	Industry Association
<b>SIMODISA</b>	Policy working group
<b>International Finance Corporation (IFC)</b>	International DFI

The policy makers listed in Figure 9 and Table 5 were presented within the data that has a significant influence on PEII. These participants are discussed independently below.

#### **5.4.2.1 GOVERNMENT AGENCY: TIA**

Despite the need to work together, it is vital for the government agencies and institutions to be professional and efficient. What has emerged is that the TIA has been more of an impediment than a motivating factor in driving the success of the sector. It was highlighted by Policy Maker C that “Failure within the Technology Innovation Agency (TIA). It has been a great disappointment. It has never really gotten off the ground.”.

In terms of equity investments, it has recently neglected to adopt the private equity model. This could however be a positive thing given that it cannot implement initiatives successfully and therefore would be best not getting involved in the equity model

This inefficiency on the part of government also serves as a hindrance to the development of the sector, and an impediment to smooth working relations with stakeholders. The Small Enterprise Development Agency (SEDA), although established to make a valuable contribution to the furthering of Small Enterprises in South Africa, has not had the results that it potentially could have. There are examples of the very inefficient allocation of capital, which limits both the productive outcomes of the investment, as well as rendering other – more valuable

opportunities null. As a result of this inefficient capital allocation, there has been the creation of the incorrect type of small enterprise. This is through the growth of survivalist SMEs – which rely on external funding in order to stay afloat, and not scalable business. Scalable businesses would be able to drive their own growth, ultimately contributing more to the South African economy, and having a larger impact. Thus, despite the emergence of more survivalist SME's which still meet a social outcome, there could be far more powerful results derived from SEDA activities.

### **5.4.3 POLICY VOLITILITY**

Policy volatility within the political context of a country, affects the environment with which investment decisions are made. This is true across all sectors. Investors require the knowledge and security that their investments will be secure and that the political and regulatory situation in a country is secure. Should there be doubts about the longevity of existing policy, or concerns regarding possible shifts in policy direction, investors will seek alternate opportunities. In a highly globalised and connected world, policy needs to be competitive in order to attract highly mobile capital.

Factors that typically influence investment decisions relate to specific policy areas. However the policy volatility in general will determine the risk exposure to investments for the typical private equity life cycle. This is due to the fact that the nature of the policy instability will affect the risk assessment of the investment in the sector. Furthermore, trends and perceptions in international markets about broad levels of policy instability, or perceived negative directions that policies take, will preclude certain markets from consideration when investment decisions are made.

### **5.4.4 POLICY AREA**

Due to the distinct social challenges that South Africa is faced with, there has been a strong emphasis and support for impact investing in particular areas as there is an opportunity cost involved with selecting a certain asset class, it should be prioritised to focus on areas where South Africa has the greatest need and competitive advantage. It is thus important to thoroughly assess and weigh the different options available for impact investing.

When considering the effect that public policy has had on PEII, it is necessary to categorise the policy into areas for analysis. The following sections represent these policy areas.

#### **5.4.4.1 BBEE**

South Africa has a unique position in that it has identified broad “transformation” as a significant social agenda mandate. This is further seen as a way to address key social impacts such as



poverty alleviation and the development of low income housing for previously disadvantaged people. The existing frameworks and policy documents regarding transformation and equity – such as BBBEE - can be built upon and modified for the impact investing field. In this way, the impact investing concept is not new to South Africa. Where there are already transformation agendas and organisations operating in this space, it indicates that there is a market for possible PEII. The need and desire of corporates to invest in social upliftment is well entrenched in society, and with increased awareness, PEII could become a primary method to achieve this transformation.

However a downside of this legislation is that it can result in the cost of doing business increasing. This limits the efficiency of the enterprise, which would affect the attractiveness of this to potential investors. Furthermore, this may result in premium contracts and legislation pushing manufacturing outside of the country.

However what is important is to ensure that PEII funds are focussed on actual delivery. There have been many cases in South Africa where the legislation designed to improve lives of the country's citizens is abused in order to deliver economic benefits to a minority. For example, as discussed by Policy Maker A;

“... you get dedicated BEE companies set up and then they import cheap products from somewhere and then just ship it on, because that person is buying from you, so they are complying with whatever. Meanwhile ultimately you are actually eroding the SA supply market, and we see that quite a lot, and it tells you a little bit about who is running the company and who is holding those executives to account and that stuff.”.

It is of great importance that impact investing does not act in a similar way to that described above. Face-value equity that does not meet a need, or go deeper to transform structural inequalities is misplaced, and any temptation to act in such a manner should be curtailed. This is an area in which policy should be firm and water tight, to prevent the mis-management and mis-representation of PEII.

PEII policy should harness the passion of people to turn their ability to make a positive difference into 'mission critical'. Should this be eroded, the trust in impact investing vehicles will be eroded and funds will flow elsewhere. There are many examples of where the opportunity to do good has not been used to fully drive transformation. As Fund Manager B states, below, the BBBEE regulations can be interpreted as either an exercise to generate more profit, through simple compliance. Alternatively, corporations can implement the legislation in a manner which

indicates that they believe in the importance of transformation and are implementing the policy due to a belief in the importance of social development.

“... because there are lots of corporate SA that actually do ‘okay, this is a license to do business, let me tick the boxes, let me get it through’. Okay? And others who have turned around and said ‘for us it is mission critical’ and there are reasons for it, it is mission critical as to why we need to work in a particular type of way.” Fund Manager B.

Utilization of the BBBEE codes within a PEII fund structure is complicated, Fund Manager E describes the requirement for compliance and why this is difficult to achieve:

“BEE and funds in South Africa are complicated and it’s still not 100% science either, there are guidelines to how funds and BEE works so we don’t qualify as a black fund, a black fund needs 3 things in South Africa, it needs 50+1% of the voting rights of the fund manager must be black owned, 50% of the profit, which is carried interest as well as fees must go into black hands, and you need to invest into more than 50% of your portfolio to make sure it is a minimum black empowered. Unless you check all those three things your equity does not count as black, it is difficult as a fund to do that, there are a few funds that are fully black compliant but then it is complicated by the fact that most of the capital comes from offshore” Fund Manager E.

#### **5.4.4.2 PENSION FUND ACT**

The changes to the regulation 28 of the Pension Fund Act of 2010 have sparked significant interest by institutional investors as to the potential for incentives in alternative assets. There is a lack of consistency given that the Government Employee Pension Fund (GEPF) is not governed under the regulation 28.

For Intermediary A “the Government Employee Pension Fund is managing three trillion assets under management at the moment, so they are large, and they are not forced to be part of regulation 28”. However when investing the pension funds of government employees, it is important that the vehicle is safe and secure, and that there is no doubt regarding the legitimacy of the interaction.

#### **5.4.4.3 COMPANIES ACT**

The introduction of the Companies Act No. 71 of 2008 has made it more difficult to do business. According to Intermediary D;

“When the companies act came out it was a hindrance in terms of how does one go about establishing a start-up. It was going to be harder. There are certain components from a VC perspectives. How easy or hard is it to get into a Joint Venture.”

#### **5.4.4.4 TALENT AND VISA**

Due to the emergent nature of impact investing in a South African context, there is a need to learn from those who have greater experience in the field. In this instance, these individuals are usually found outside South Africa’s borders. It is thus important to be able to get skills into the country. However as noted above, it is also important to manage this process so that when the individual returns to their country, they do not take their networks with them, leaving a void behind.

“We have had a lot of challenges at times with bringing people over on visas who are obviously highly skilled and will contribute a lot to the country, but creating room for skilled migration in the private equity space, and in the social enterprise and impact investment space would be very helpful indeed.” Fund Manager F.

As a result, this reluctance to assist foreign expertise to enter the country is slowing the pace of change in the sector. However it is necessary to have these skills in the country to ensure that the PEII sector is world class. Thus the South Africa regulations on skilled migrants should be modified, to encourage their entry.

#### **5.4.4.5 EXCHANGE CONTROLS**

The movement of capital in and out of South Africa is governed by exchange controls. This creates an obstacle for investment that has influenced the design of PEII funds domiciled in South Africa. “It’s unfortunate that most funds in South Africa, bar a few which target local institutions, will basically have a US Dollar component, whether it is Ethos or Brait or whatever, basically you always have a dollar component, ours is about 67% dollar based and about 33%, some of the international guys are invested in ZAR however unfortunately it’s just one of those things, there is not much you can do about it, that is where the capital comes from.” Fund Manager E.

#### **5.4.5 CONCLUSION**

The most tangible way that the policy landscape has influenced PEII in South Africa is via the process whereby policy is established. Government and its agents of policy creation have in some instances tried to develop policy using a cookie cutter approach, whilst simultaneously modifying key policy attributes thereby undermining the integrity of the proven policy model.

An example of this was the 2008 adoption of the VCC model, implemented as Section 12J in the Income Tax Act, amended in 2014 where capital gains exemption was excluded from the design. Roles played by policy makers have a tangible outcome on the policy landscape and two key factors have impacted this. The first is the lack of continuity over time resulting from turnover of policy makers and their support that that have within the ministries. The second is the failure of agencies to appropriately deliver on their mandate to implement policy – The TIA being the most noteworthy example. Inefficient outcomes can be seen in SEDA where funds are being allocated wastefully and are not delivering the required outcomes.

## 5.5 RESEARCH RESULTS FOR RESEARCH QUESTION THREE

### RESEARCH QUESTION THREE: What factors enable the development of private equity impact investing in South Africa?

The analysis of data into factors which are positively attractive to PEII, presents several key areas which are discussed as follows. These factors include the role of capital markets, the implementation of measurement standards, infrastructure and the role of institutions and the performance of funds.

#### 5.5.1 CAPITAL MARKET

Since SRI has become popular, many funds represent themselves as being involved in impact investing. Even though this can be split between two groups, firstly those who only brand themselves in a manner indicating SRI is a priority, whilst not adopting a specific mandate to achieve any impact. Secondly, there are those who are passionate about SRI and work hard to ensure that it is encompassed in every area of their business.

While this first type of representation may lead to growth in the market, it also dilutes the intent with which the market participants engage in impact investing. This thereby affects the perception of authenticity of impact investing, in that funds that are not *specifically* created to deliver impact are capturing some of the market. This is unlikely to be a positive thing for the sector. This is due to the fact that those investors seeking a truly authentic impact investment opportunity will look to new areas, should they perceive PEII to be an inauthentic area of investment.

#### 5.5.2 MEASUREMENT STANDARDS

The efforts of various participants has resulted in the consolidation of measurement standards and taxonomies, which now supports the comparison of performance and impact across funds. This acceptance of standards has increased the general comprehension of the metrics, and

supports the comparison of impact investment opportunities. GIIRS is an international standard and Fund Manager C explains how it is extended to accommodate South African measurement requirements:

“... we do use the GIIRS review as well, but on an ongoing basis our internal templates are more relevant and do encompass the factors incorporated into the GIIRS rating”  
Fund Manager C.

An interesting outcome of South Africa’s BBBEE codes is that companies are mandated to measure specified metrics and report on them as part of their BBBEE certification process. This framework presents an established set of transformation oriented metrics. In this way, it is evident how various policies interact to shape and influence a sector – reinforcing the need to examine a wide spectrum of policies.

### 5.5.3 PERFORMANCE

The performance of private equity funds are not released publicly, so specific metrics are not available for analysis. However the growth of the PEII industry can be examined to determine if the Limited Partners are achieving their desired returns, this will be seen in the success that existing fund managers have in raising new funds.

Fund Manager F described the progress that has been achieved on their first fund in meeting the target of providing financial service to 25 million previously unserved individuals:

“... we now provide insurance, savings, pensions, investment products – I mean our current numbers have reached 22.7 million people of whom 17.6 million are low income, and probably over 5 million of those get savings products etc, so it is actually quite a diverse set of people with getting diverse financial products – all unified by the notion of what we call emerging consumer, the person living on less than 10 dollars a day.” Fund Manager F.

Although the financial performance of Fund Manager F’s fund are not available, the mandate is to achieve strong financial returns. The success in delivering this can be seen in the closing of their capital raising for Fund Manager F’s second PEII fund USD 400mil which was three times more capital than the first fund. The raising of second round of finance, shows potential and belief in PEII by Limited Partners.

South Africa has a strong PE market and the market penetration is variable upon sector type and impact area. However it is interesting to note that the high touch approach, which involves close

operational involvement in the business by the fund manager, is proving the most successful model for VC portfolio companies. This value creation strategy is positioned at the incubator level, which is the reason why you see partnership between incubators and private equity firms.

When questions about the potential for using policy incentivisation to drive impact investing, Fund Manager F introduced the point that the most successful business that has the best potential for scale are businesses that can deliver impact profitably without the dependence upon subsidies or incentives.

“So there are all sorts of ways in which to encourage investors and businesses more generally to serve under-served populations, that aren’t about subsidy, they are about incentive; and I would much rather see that kind of route where avid capitalists can go in and have a reason to be good, and I think that has a lot of value, and I think it is very important that those incentives not be structured as some kind of tax, where people say ‘oh well we get to do it if we also do 10% of the lower income population’, which is often the case, rather mandated them out, and it is fine but **when you really get scale is when you can create actual incentives, to serve those populations such as they are served profitably.** And those are the most important and valuable incentives.” Fund Manager F (emphasis added).

#### 5.5.4 INFRASTRUCTURE AND INSTITUTION

South Africa was, until 2014, the largest economy in Africa and has been considered the gateway to Africa, for foreign countries and businesses. Although this position has changed recently, South Africa still has the dominant established economy, with mature and competent infrastructure and institutions. Although Nigeria’s rebasing of the economy meant that it’s GDP has exceeded that of South Africa, South Africa still represents the most sophisticated market on the continent.

South African companies have done well in other African countries, and this interconnectivity is set to expand further, thereby enhancing the gateway potential, and business networks. This simultaneously provides increased opportunities for PEII by South African fund managers outside of South African borders, and creates a network through which information regarding the activities in other African markets can filter back to South Africa. Even if the intended market for investment is not South Africa there is a need to have a local office established in the region. South Africa within its established infrastructure and institutions presents an advantage in the in that it can attract regional offices that service the sub-Saharan region. PEII fund manager need

to remain connected to their markets and portfolio companies, this is expressed by Fund Manager F:

“It is extremely important to have local representation, or to spend a great deal of time in market. So if people sign up to our firm, they sign up for one to two weeks a month in market - if they are an investment or value creation person.” Fund Manager F.

#### **5.5.5 CONCLUSION**

The development of established PEII funds with proven measurable records, is leading to the development of acceptance for PEII within capital markets. The emergence of measurement standards with which to compare the performance of investments, is enabling institutional investors to evaluate PEII as a potential alternative asset investment. The maturity of South African capital markets, supported by its infrastructure and institutions further enable the development of PEII in South Africa.

### **5.6 RESEARCH RESULTS FOR RESEARCH QUESTION FOUR**

**RESEARCH QUESTION FOUR: How is the policy landscape influencing the factors that are enabling the development of private equity impact investing in South Africa?**

The policy landscape within South Africa, and the perceptions of future political stability, has had an effect on the global investing community, this has influenced the availability of capital for FDI. It has also influenced the investment decisions of local investors, whilst simultaneously creating opportunities for Private Equity to invest in targeted impact areas, where information asymmetry exists.

#### **5.6.1 PUBLIC POLICY FORMULATION PROCESS**

The public policy formation process is important, as the government’s actions create positive impacts which can then create results in the private sector. Thus the inputs that influence the formulation process are important.

“So from a government perspective it supports what we are doing on a very high level when it comes to communication. They are our biggest supporters of what goes on in the Seed academy, as they are in the likes of the Raizcorps etc., because they are developing supply chain that is good for SME development and very good for the private sector” Fund Manager A.

This view is supported by Fund Manager E, who believes that the regulatory environment and policy formation is a critical issue in the sector. Those who have been involved in the industry

for a long period of time – since it first emerged as a category of operation – are impressed by the manner in which it has evolved.

“So we have experienced, since 2007 when the markets were very nascent and there were very few sort of solid policy, even the REEP program was a fragment of the imagination at that time, we could see the trends, we were confident that policies, that there would be enough legislation reform in our territory which is the SADC region to underpin both energy and environmental investment” ” Fund Manager E.

This is an important process, and the evolution of policy will continue. It is of great importance that this evolution remains positive and continues to enable the sector. Fund Manager E, continues to highlight that the evolution and development of policy is integral in the expansion of the sector.

“.. we have certainly seen a rapid policy and regulatory reform that is now supporting huge growth in both the environmental areas that we focus in as well as energy generation and we hope that it’s been largely led on the energy side which is seemingly quite highly regulated by public procurement programs.” Fund Manager E.

### **5.6.2 PUBLIC POLICY PARTICIPANTS**

The creation of SiMODiSA has been a highly effective initiative..... This organisation has resulted in the implementation of policy recommendations into the 2014 budget. This is a positive action as the group is able to present the views of numerous stakeholders, who have reached consensus on certain issues. However the effectiveness of their contribution to the budget, was lessened by the bastardization of the intent between what was initially announced in the budget speech, and the draft act that was subsequently released.

### **5.6.3 ESTABLISHED INSTITUTIONS, INFRASTRUCTURE**

The established institutions and infrastructure in South Africa, which – as noted – are effective and highly regarded internationally, play a significant role in the sector’s development. Fund Manager A indicated a view that “South Africans have got a huge amount of support, backed by this complex policy and the way it gets translated in the commercial economy. They have got plenty of support, it is solving SA community problems”. In this way, the policy and infrastructural environment are effective in delivering results. This is developed further, and ties into the Gateway theory discussed above, by Fund Manager F, stating that “... what is appealing about SA is that there is a relatively developed infrastructure in various ways, whether it is legal infrastructure -certainly compared to other African countries”. This is a definite area



of competitive advantage that South Africa has over its neighbouring African countries. Although other African countries have more 'low hanging fruit', the South African economy provides a wonderfully secure operating environment.

The low hanging fruit is contrasted by the "...many ways in which the ease of doing business in SA in those respects is greater", yet the South African market is not saturated and "there is also a large low income population to be addressed, so in a way you have got capacity, some more capacity and quality of infrastructure and still a large low income population to be addressed – and that creates real opportunity"(Fund Manager F). Fund Manager F continues to state that "... a lot of impact investors do very small investments, but if one is interested in scale and commerciality South Africa is very appealing." Fund Manager F.

The ability to scale up is perhaps slightly more limited in South Africa, due to the nature of the growth rate, and state of the economy more generally. However the support structures for scaling up are in existence and have a track record of success.

South Africa has good access to technical advisory skills in the following areas (legal, financial, banking). This provides a good starting point, as the knowledge and experience are local and thus appropriate for the context in which companies operate. This technical advisory knowledge does not have to be imported.

South Africa has progressive legislation and sound institutions –although there is a view that these may be lacking in capacity. It is widely known that the quality of the regulatory regime is a sector within South Africa, that has been found to contribute significantly towards improving the attractiveness of investing in South Africa. This is an area of competitiveness that must be preserved, entrenched and exploited.

The role of regulations and policy in attracting investment has been discussed, and the importance must be emphasised. For example, Fund Manager F, who operates in this space, stated that "... we have found that it is above all the clarity of rules and consistency of application that matters for investing, significantly beyond what any particular rule is". In this way it is important to provide stability for investments, as well as an attractive investment destination. This is as it has also been found that in terms of foreign investment, the "openness ... from regulators has been very helpful indeed, where we have been looking to invest - and the converse, where regulators have put up a lot of hurdles" (Fund Manager F). In the case of South Africa's regulation, which is complex and encompassing in its attempts to redress the past, these hurdles are an important factor. This affects investment decisions, as highlighted by Fund

Manager F, “It can be quite technical hurdles but nonetheless hurdles; it does disincentives investment. We do choose our countries partly on the basis of the quality of the regulatory regime”.

#### 5.6.4 CONCLUSION

Perception towards the South African policy landscape and future political stability is the biggest factor that influences the availability of capital for PEII. Perceptions suffer from information asymmetry, so opportunities can still result from a policy initiative that is generally perceived negatively. Individual policy initiatives that are attracting the attention of PEII indicate the desire between public and private to collaborate. This is true in the case of SiMODiSA, which is making policy recommendations, on how to optimize the policy landscape to create an ecosystem to accelerate VC and SME development.

### 5.7 RESEARCH RESULTS FOR RESEARCH QUESTION FIVE

**RESEARCH QUESTION FIVE: What are the current policy initiatives and practices outside of South Africa that are enabling the development of scale of private equity impact investing within emerging markets?**

Globally there has been significant progress towards developing the impact investing industry across the capital continuum, whilst research has been conducted within the sector to identify best practices to develop the sector whilst driving scale. Collaboration between industry players is evident and necessary for the purpose of building scale and the profile of the impact investing industry across all capital types.

The policy initiatives that shape the South African landscape emanate from various areas. Some policy directives are created in large, multilateral organisations. These assimilate practical experience but are largely directed by theory and attempts to reach desired developmental outcomes. For example;

“... there is some increasing evidence via the G8 and the global impact investing network, and the world economic forum, to try and bring a lot of this together. And obviously those are forums that really focus on public policy in a big way because a number of their constituents are major political leaders. And that can focus on the intersection between business and politics.” Fund Manager F.

However it is necessary to consider the importance of actual case studies and working examples from countries and regions. These may not be the result of large-scale networking events, but

the results delivered from on the ground experience are of great value. Fund Manager C provides the example of:

“Ugandan businesses ... being allocated land by the government, the same thing in Ethiopia, and they receive this land and typically it is allocated to existing businesses that have a track record – and those are the businesses we look at. I am not sure how accessible that land is to new entrepreneurs, but certainly we see this type of investment from the government let's say, or this type of policy impacting those businesses, giving them a leg up – which we don't typically see in SA investments.” Fund Manager C.

This is an important step in assisting businesses to scale, and assisting them to progress. In a South African context, this type of assistance would be welcome. However it would need to be highly regulated in order to ensure that assistance went to those companies that are truly worthy of assistance and not a politically or economically connected elite. However the success of a similar model in South Africa would have a great impact on employment levels in the country.

Policy Maker B described the success experienced in the initiative in Israel to develop the Private Equity industry by seeding it with capital and experienced fund managers: “The YOSMA Israeli model was where you bring in a whole lot of international fund managers to help get the industry off the ground”. Initiatives that have proved successful in achieving a desired outcome, can be adopted, however care must be taken to not incorrectly assume that a ‘cookie cutter’ approach, whereby the model is inherited exactly with due consideration for local context, is not incorrect used and thereby potentially setting up the initiative for failure. This example again reinforces the need to include or have access to internationally experienced executives, and the need to ensure that visas and emigration legislation is welcoming.

### **5.7.1 CAPITAL EFFICIENCY**

Capital efficiency relates to the ‘leakages’ that occur in terms of the cost incurred during the investment. The efficiency of capital allocation within the investment spectrum has proved to be a significant factor when determining the risk adjusted return expectation of different sources of capital. This is explained by Policy Maker B:

“... private equity charges 2% of funds under management per annum, the VC guys sort of charge 2% but if you are in the SME space you need more money to be more hands on to achieve the social impact, so it is like 5%. The IDC's VC guys, it is 25%. But if you

look at SEFA [Small Enterprise Finance Agency], the IDC that is handing out money for small businesses, it is like 40% or 50%, so it is exactly like the NGO model which had very high cost structures.” Policy Maker B.

Such findings clearly highlights the how PE has proved to be a highly efficient financial instrument that achieves capital efficiency based upon the profit incentive that it offers to the fund managers.

When these learnings are applied to an impact investment setting, they are equally valid. In contrast, grant funding of projects that desire a social outcome can quickly become unsustainable: “That kind of project [dependent on grant funding] will last for like a year or two and then ... and the people who run those social impact type enterprises, **spend most of their time raising funding**, plus what they do is – and again this is very much if you are just impact orientated, you don’t worry about your cost structure, so they end up with massive cost structures.” Policy Maker B (Emphasis added).

### 5.7.2 SECTOR SPECIALIZATION

Within the funds that were examined, it was found that sector specialization presented the most effective strategy for achieving a specific impact mandate. Correlating with the finding was that frequently such specialization made use of policy that supported and enabled such investments. Examples of this include the green energy sector and agriculture.

Vertical integration into Agri-Business is proving to be a sector specialization that is proving attractive for impact investors. This fits in well to the policy environment that is generally being established by emerging market countries at the current time. This is explained by Fund Manager C: “there are a number of very specific regulations environmental wise that primarily environmental agencies of the government have issued. And in terms of the social aspects I guess the primary policies to guide those would be the BEE codes, and the national agricultural development policy”.

Fund Manager C then shows the need to structure the portfolio of a vertically integrated fund so that risks can be managed within the sector: “We do invest into farming if it is part of a bag with vertical integration for the company but we limit that investment up to 15% of the entire investment into that company. So predominantly most of our portfolio companies are operating in the manufacturing space, food manufacturing – food processing let’s say – and you know thereby we limit the fluctuations in the agricultural industry impacts on portfolio”.

Renewable energy is a rapidly developing sector that is attracting investment of PEII. The policy environment has change significantly since 2007, this is described by Fund Manager E: “since 2007 when the markets were very nascent and there were very few sort of solid policy, even the REEP [Regional Environmental Education Programme] program was a fragment of the imagination at that time, we could see the trends, we were confident that policies, that there would be enough legislation reform in our territory which is the SADC region to underpin both energy and environmental investment but they have changed fundamentally for a whole bunch of reasons, it is mostly country specific and they generally are led by a combination of commitments to global greenhouse gas and climate change targets.”.

### 5.7.3 VALUE CREATION

When it comes to evaluating how change might be achieved within an emerging market it is necessary to consider how a critical mass can be achieved. Recognition has been given to how this can be developed on a regional basis centring on geographic regions.

“... government is convinced that government policy changes industries. When you have a look at it, governments don’t get economies off the ground, cities do. Cities generate growth and because they cluster lots of business people and entrepreneurs and make it easy for entrepreneurs to have access to market, and access to infrastructure.” Policy Maker B.

Increasingly there is the perception that value can be created through the adoption of legitimate sustainable business practices, and this can deliver increased value through existing and maintaining the values for the future equity investors:

“We also optimize job creation as far as possible and we run training and capacity building programs, which are all linked, those are all things that are not driven by policy they are largely driven by best practice, so its part compliance. So under the REEP program we will have certain socio-economic development obligations, part of it is compliance but we go beyond, way beyond compliance, at the end of the day that is what generates us a better price for us on our exit.” Fund Manager E.

PEII is generally concerned in building value, both through generating financial returns and delivering impact as a result of the business operating. A core lever that is utilized in supporting development and achieving growth is through the operational involvement in the portfolio business. PEII fund that have portfolio companies in multiple countries will need place specialists within the companies in order to implement operational practises. South Africa makes this

particular function difficult, which contrasts to other emerging markets, with is explained by Fund Manager F:

“We have had a lot of challenges at times with bringing people over on visas who are obviously highly skilled and will contribute a lot to the country, but creating room for skilled migration in the private equity space, and in the social enterprise and impact investment space would be very helpful indeed.” Fund Manager F.

#### **5.7.4 CONCLUSION**

Collaboration between international impact investors and associations is resulting in the establishment of generally accepted standards and practices. Case studies and research reports are being published which are developing the understanding around the effect of policy on PEII. Sector specialisation has been identified as a key strategy for achieving impact and PEII funds are using this strategy to penetrate into emerging markets. When this is supported by favourable policy the outcomes are positive.

## CHAPTER 6: DISCUSSION OF RESULTS

This chapter delivers an analysis of the data that was presented in chapter 5 whilst relating the discussion to the theory presented within chapter 2. In this way, the gaps in existing literature are merged with new research outcomes, in order to answer the research questions posed.

The five research questions that are covered in the chapter are:

RESEARCH QUESTION ONE: What factors constrain the development of private equity impact investing in South Africa?

RESEARCH QUESTION TWO: How is the policy landscape influencing the factors that are constraining the development of private equity impact investing in South Africa?

RESEARCH QUESTION THREE: What factors enable the development of private equity impact investing in South Africa?

RESEARCH QUESTION FOUR: How is the policy landscape influencing the factors that are enabling the development of private equity impact investing in South Africa?

RESEARCH QUESTION FIVE: What are the current policy initiatives and practices outside of South Africa that are enabling the development of scale of private equity impact investing within emerging markets?

### 6.1 RESEARCH QUESTION ONE

**RESEARCH QUESTION ONE: What factors constrain the development of private equity impact investing in South Africa?**

#### 6.1.1 GOVERNMENT INTERVENTION IN POLICY IMPLEMENTATION

Government intervention has been identified as a main factor constraining the investment landscape as it creates uncertainty around how policy is going to be implemented. This intervention creates uncertainty around the market effect and can introduce unpredictable outcomes thereby introducing risk which would need to be factored into the investment decision. This risk ultimately makes South Africa, as an investment location, less attractive.

Goldberg and Habberton (2014) discuss how the Venture Capital Company (VCC) regime introduced in 2008 was oriented towards SMEs and junior mining companies, to assist them

with getting access to equity finance. For Goldberg and Habberton (2014) the VCC regime was not implemented in a manner that attracted participation from the investor community, owing to failure in the design of the model.

The VCC model is not attractive for traditional institutional capital, since pension fund capital does not attract tax and international capital cannot benefit from the tax advantage. Therefore an alternative model should be used, that is more in line with the benefits sought by capital providers.

“No, it is coming mainly from high net worth individuals with high tax bases. Again, that can be a trust, a company or an individual. So those are the guys investing. Pension funds will not invest because they don’t really have the tax problem because it is a flow through type of structure. So it is sophisticated investors who are high tax payers who would like to invest in this new asset class.” Fund Manager G.

Goldberg and Habberton (2014) then describe how investors intend to utilize tax deductions, tax credits, and Capital Gains Tax exemptions to enhance the return that is achieved from the investment. The exclusion of Capital Gains Tax from the VCC model removed the tax incentive, whilst the dependence on the tax deduction benefit does not have any value for the pass through tax shield afforded to pension funds. Therefore the available investors that would be interested in the scheme is reduced significantly. This is an area of the existing policy that requires reassessment and careful consideration.

### **6.1.2 ALTERNATIVE MARKETS**

There are low hanging fruit in other emerging markets which are experiencing higher growth with more potential for scale. South Africa is losing its competitive advantage – it’s membership to the BRICS grouping notwithstanding. Relative to other African and emerging markets, South Africa is steadily losing ground, and so fund managers will have to work hard in order to sell South Africa as an investment destination.

As a result of this, it is of great importance that the policy frameworks in place are highly attractive to investors, in order to ensure that despite the emergence of new, higher growth competitive markets, South Africa remains a leader.

### **6.1.3 CONCLUSION**

There are numerous elements which impede the development of PEII in South Africa. Those that are primary are the role of the state and policy; the allocation of funding in the capital continuum and the increasing number of investment opportunities available in emerging markets.



These are all factors that can be remedied through the appropriate de-risking activities, largely centred on the correct policy formation and implementation. The only variable that is not under the influence of South African policy makers is that existence of alternate markets. As a strong continental player, however, South Africa has the capacity to ensure that it has developed superior frameworks and becomes entrenched as an attractive investment destination.

## 6.2 RESEARCH QUESTION TWO

**RESEARCH QUESTION TWO: How is the policy landscape influencing the factors that are constraining the development of private equity impact investing in South Africa?**

Research question two examines the policy landscape that exists within South Africa and identifies the nature of how the complex environment operates and evolves.

### 6.2.1 PUBLIC POLICY FORMULATION PROCESS

#### 6.2.1.1 GOVERNMENT INTERFERENCE WITH IMPLEMENTATION OF POLICY

The lack of understanding of the way in which the PEII sector operates is a key impediment to the development of the sector. The interference that has occurred in the establishment of TIA is impacting the existing functioning agencies with a new incorporated design, and the poor design of channels through which funds get allocated, has resulted in the wasteful allocation of significant resources. For example, Policy Maker B stated that, “So when I got there I found out that they had spent 2.4 billion rand on early seed capitals, early VC, so this was a mindblow for me.”. This funding was not effective and so was wasted, due to a lack of knowledge and understanding. Had this funding been directed in a purposeful and considered manner, the impact for the sector would have been significant.

Initiatives to establish a private equity model for the allocation of funds has been withdrawn, whilst the model for allocating funds through inefficient academic channels continues. This indicates a lack of trust and cooperation between the sectors. “2% of any innovation that actually ends up in the market, comes from government/universities – the rest comes from the private sector.” Policy Maker B. Should the funding held in the government sector be coupled with the skills and first-hand knowledge of the sector in the private sector, there would be the opportunity to have significant results. Currently, the appropriate people have not been utilized to allocate capital correctly. This is where lessons can be learnt from the private equity impact investment model, where the motivation is both impact and market related return. The view expressed by Policy Maker B, is that “only entrepreneurs can fund entrepreneurs; government employees cannot fund entrepreneurs.”. This is due to a lack of knowledge and experience in

the sector. Again, however, improved communication could assist in overcoming these barriers to achieve effective action.

#### **6.2.1.2 INACTIVITY IN FOUNDATIONAL COLLABORATION**

The policy categorization framework developed by Clark et al. (2012) recognizes benefits that can be achieved through foundational collaboration between private and public policy makers. Clark et al. (2012) present a case study on Business Partners in SA showing how development in Foundational Policy has allowed the establishment of one of the most successful impact investment institutions. Business Partners use a private equity instrument for its investments, however the capital base is not sourced from institutional investors and the fund does not operate on a closed cycle basis. This capital design can be regarded as affording Business Partners the ability to be patient in its investments, and not be forced to exit their position in a portfolio company under the pressure of a constrained time frame.

Unlike the foundational policy formulation that resulted from the formation of Business Partners in SA during the 1980s there has been limited activity on this level in recent years. Given the success that was achieved by Business Partners for over 30 years, it is remarkable that South Africa has not achieved success in further foundational level policy development. The poor design and implementation of the VCC policy lends itself to the conclusion that policy makers are neglecting the potential for implementing foundational private equity policy.

#### **6.2.2 POLICY VOLITILITY**

There are many examples in South Africa of the adverse effects that arise from policy instability. This instability leads to a freeze on investment decisions, and the withdrawing of capital – to the detriment of the economy and to development.

Fund Manager C indicated how agricultural investments have taken on a degree of uncertainty as farmers are limiting their capital investment to determine what the effect of the land claim extension that has been recently announced. This represents a policy instability which can introduce future risk and uncertainty. Furthermore, in terms of the mining and minerals, there has been an amendment to the Mineral and Petroleum Resources Development Act (MPRDA) which increases the extent to which government has a say in international firm's local operations. This uncertainty in terms of regulation has led to a number of large Multi-National Corporations suspending any operations or exploration in South Africa. It is thus vital that policy is both business friendly, clear, and enacted timeously in order to prevent protracted periods of uncertainty and instability.

It is thus of great importance that the policy environment is clear, stable and inviting. This is the area which investors consider when assessing their investment destinations. In a competitive economic environment discussed above, this is a key area to work on.

### 6.2.3 POLICY AREA

Thomas and Mohan (2007) explain how an investigation into policy requires an evaluation of the different points and levels of the policy process, they then discuss how policy is conceptualized as an iterative and dynamic process, and they emphasize it by saying: “policy is rarely written on a clean sheet” (p.42).

The new BBBEE codes that have been introduced within South Africa are effective from October 2014, Cunard (2014) posits that the design of the new codes created opportunities for black-owner private equity fund managers. Under the new codes portfolio companies are able to attribute full black ownership if particular criteria are met. Cunard (2014) shows how BBBEE criteria is now based upon voting control, composition of the management team, and the flow of profits; rather than the source of the capital that has been utilized in the fund. This has changed significantly from the previous codes and it creates opportunity to develop South African black fund management layer. In this way there is the opportunity to utilise all available capital sources, whilst still optimizing the fund structure to pass maximum BBBEE certification to the portfolio companies.

### 6.2.4 CONCLUSION

Government should concern itself with the formulation of policy, not the implementation of policy. If the strengths of the country can be judged on its institutions, given South Africa’s institutions, there should be no reason why our agencies are not able to effectively implement policy. It is the interference by government which is undermining, the successful application of policy within the market. Policy volatility is another area that is influencing PEII in that investors are not confident that their investment will be protected in future.

## 6.3 RESEARCH QUESTION THREE

**RESEARCH QUESTION THREE: What factors enable the development of private equity impact investing in South Africa?**

### 6.3.1 LOCAL CONTEXT

Having a local presence has been presented as being necessary for impact investment funds. This is not just in terms of maintaining successful investments, but also for being positioned to capitalize on opportunities as they arise by having an established local presence. This local

presence is not tied to an immediate geography, but indicates the need for fund managers to be in the region in which they are investing. This is important in order to understand and track the sentiment in the area, the policy shift and the movement of the economy.

In the South African context, the presence of these international players is a positive factor. This is due to the fact that the infrastructure in the country allows for impact investing fund managers to build their investment networks in other countries, from a South African base. As a result, this indicates that South African PEII funds are well positioned to take advantage of the local presence of international capital.

However it is also important for local PEII fund managers to make their products known, in order to capitalise on this advantage.

### **6.3.2 MEASUREMENT STANDARDS**

Saltuk et al. (2014) discuss the emergence of standardised measurement and recognises how it is allowing direct comparison of triple bottom-line performance. This ability to compare impact performance will assist with the liquidity of allocating capital based on Limited partners being able to evaluate the potential performance of fund managers. The need for South Africa to maintain its own measures – through King III for example - does diverge from the trend, however the GIIN does encourage partnership and the taxonomy of measurement standards can incorporate regionally bespoke metric.

Expectation for change in regulation can provide the opportunity to be first to market if you can get positioned to benefit in the market. However this needs to be a well-informed process, that considers the risks involved should the expected regulatory changes not occur. This change in the regulatory environment is also a potential drawback, should it be done in an inefficient manner, it may negatively affect the sector.

### **6.3.3 PERFORMANCE**

The view presented by Fund Manager F around the need to explore business PEII opportunities to achieve impact on the basis of profitability corresponds with the views presented by Klein et al. (2012) in that the motivation of the investors and the portfolio company's management team must be aligned towards the profitable orientation of the business, whilst the impact that is desired needs to be integrated with the business operations that both impact and financial performance be directly correlated.

An area which would be prime for achieving impact, using a private capital funding model, would be education. However there appears to be limited potential to implement this effectively owing

to the difficulty to establish a model that delivers the correct returns. According to Fund Manager A, “education here [in South Africa] is particularly weak and in that context you very seldom find impact investments that are going to drive the kinds of return that a for-profit fund is going to provide”.

The findings from the 2013 JP Morgan Social Finance Survey show that Sub-Saharan Africa is experiencing the largest growth in capital deployed (Saltuk et al., 2014). This cannot be directly compared to the data from this report, in that this research was oriented towards PEII funds with portfolio companies in South Africa. The outcomes from this analysis could be that the growth that is occurring in sub-Saharan Africa are going to other countries in the region, and not South Africa.

The allocation of Public funds into seed and start-up initiatives has shown that there is a strong alignment between social outcome and financial benefit: “No, it was giving fantastic social benefit but guess what, the people that had the most social benefit were the ones with the highest financial performance. The ones with the lowest performance gave the lowest social benefit.” Policy Maker B.

These positive findings relating to the success that PEII is having in achieving risk-adjusted market-rate returns whilst delivering on the impact relates back to the question raised by Brest et al. (2013). Whilst we do not have data that directly related to the ease with which the triple-bottom line can be achieved in PEII, relative to finance-only business, we can recognise that the desired intent can be achieved.

#### **6.3.4 INFRASTRUCTURE AND INSTITUTION**

Although findings from the research show that there is benefit to existing infrastructure and institutions within South Africa, there still remains an issue of scale within the country. This is regarding impact investing, and specifically with PEII. When Morkel (2012) reviewed the success of the NEXII, the South African Impact Exchange Platform, it held great prospects for scale. However its failure resulting from insufficient capital flowing through the exchange introduces questions around the critical scale that is required to sustain all required infrastructure on a regional level in South Africa.

#### **6.3.5 CONCLUSION**

The single most important factor that is enabling the development of PEII is the proven ability to achieve returns in the South African market. Establishment of measurement standards

enables this reporting on performance and the comparison of results between local funds and with the GIIRS and IRIS non-South African funds.

## 6.4 RESEARCH QUESTION FOUR

**RESEARCH QUESTION FOUR: How is the policy landscape influencing the factors that are enabling the development of private equity impact investing in South Africa?**

### 6.4.1 PUBLIC POLICY FORMULATION PROCESS

Whilst the findings show that there is a need within government to achieve social impact through the allocation of public funds, as described by Policy Maker A:

“So all Public Funds have a social element to them, if they are not returning socially, at least socially, then there is a problem with the way they kind of conceive it. And it can be direct or indirect but they need to have some social return as well”.

Clark et al. (2013) present the dichotomy that government is faced with when evaluating their role within capital markets. This examines the one perspective where government should safeguard the public good, which is contrasted with the other perspective where investors and entrepreneurs are trying to maximise their profitability. Traditionally these perspectives were mutually exclusive, however as seen with the acceptance of the role of the social entrepreneur, and the recognition of the value that can be achieved by integrating impact investing into the capital landscape, opportunity exists for government to participate in such a way that these perspectives can be integrated. The SiMODiSA initiative is a prime example of this happening. The initiative was requested by government, asking for recommendations to be made regarding how policy can enable an outcome that is desired by both the public and private sectors. Seeing this process occur through a working group that involved both public and private participation, highlights the opportunities for collaboration in the development of public policy.

Recommendations for policy amendments, from a trusted forum, in the form of the VCC, were implemented in the 2014 budgets. The precise design of the policy did suffer from changes later in the process, however these policy changes shows the development of trust which could - in the future - fast-track the development, creation and implementation of policy that suits the interests of both government and the private sector.

Government’s position on the type of impact that needs to be achieved is measured in accordance with the area that needs to be impacted. This can be shown by the perception that high-tech start-ups, although with potential to result in significant revenue for the country, do not generate significant jobs for those currently unemployed.

“one of the problems with these things is that they are not necessarily high priority because they don’t generally create jobs for unskilled individuals from previously disadvantaged areas and that kind of stuff. They are not creating a lot of jobs for those sorts of people” Policy Maker A.

Therefore, for the government – or for certain government departments –the question of jobs for whom is primary over the fact that there is job creation at all. This is a misguided and short-term view. The total overall economic benefits over time that could be created should not be discounted.

#### **6.4.1.1 THE WILL EXISTS TO DEVELOP AN EMERGING BLACK FUND MANAGEMENT LAYER**

Results were found to show that policy in South Africa is being established to encourage the development of small fund managers. This is an important initiative, yet, there are challenges in terms of delivering the numbers of black fund managers that are required. This process simultaneously needs to be organic, and to be driven by partners in the field. Therefore the policy that is created needs to create space for this to occur.

The increased number of black fund managers will then in turn contribute their ideas and experiences to the policy debate, and help to shape and evolve the policies in place.

#### **6.4.2 PUBLIC POLICY PARTICIPANTS**

Bannik et al. (2012) indicates that the key to achieving impact is to accelerate the development of an entire sector by enabling the factors to “spark, nurture, and scale new sectors for social change” (Bannik, 2012, p.5). In this instance, the ‘factors’ refer to the various stakeholders, including government, the private sector and fund managers, and lobby groups. Again it is evident that a key factor in limiting the PEII sector in South Africa is the lack of collaboration and discussion. This indicates that policy is lacking as the cooperation between interest groups is missing. This is an impediment to the accelerated development and scale that Bannik indicates is possible (2012).

SiMODISA’s active participation in making policy recommendations to the National Treasury is providing an opportunity for South Africa to quickly implement policy, which will facilitate the development of a policy landscape. This will, in turn, encourage the increased development of SMEs and the corresponding investment via VC.

#### **6.4.3 POLICY AREA**

Each business sector within South Africa is influenced by policy and regulation that has been developed over time to represent the total policy landscape. As was show in the findings, policy,

the form it develops into, and the manner in which it is implemented can result in a context that impairs economic development, and the impact that could result from growth within the particular sector. This is an example of where the policy formulation process fails to deliver the desired outcome of the policy makers. Thornley et al. (2011) however describes how, in contrast, government led policy initiatives can “catalyse industry-driven initiatives” (p.70), such as with the South African Financial-Services Charter. Here, industry participation was utilized as a mechanism to secure involvement in a broad policy development process that ultimately avoided excessive regulation of individual sectors.

#### **6.4.3.1 BBBEE FRAMEWORK**

In many regards, the BBBEE framework, and the new codes that have just come into effect are accepted by business in South Africa, and they form part of the policy landscape that needs to be considered. The potential for PEII to leverage this, exists with the new codes, given that the BBBEE certification for the fund can now be inherited from the black fund manager role within the fund. This is instead of it inheriting the BBBEE credential based on the source of the capital, which in many cases will not be black owned, especially if it is non-South African capital (Policy Maker B, 2014).

Thornley et al. (2011) describe how as a result of BBBEE, there are “opportunities for impact investors to invest in companies or products that meet societal goals increase with this policy. More importantly, the policy also fundamentally reshapes the landscape for all investors.” (p.71). This connects into the findings that show how the existing BBBEE can be further extended to provide explicit impact oriented policy that will encourage investors to participate in profit oriented opportunities and also serve social outcomes.

#### **6.4.3.2 IMPACT AREA**

Findings that many PEII funds are not collecting adequate pre-investment metrics, undermines the ability to report on the total impact orientation of the PEII within South Africa. Saltuk et al. (2014) show that the standardization of metrics for measuring impact investing has improved, and the recent integration of PULSE with GIIRS will further improve the comparability of data. Measurement of impact investment during all three stages, (pre-investment; investment; post-investment) needs to occur on globally comparable and locally contextual metrics. This will support the development of a history of performance data that can be used to represent performance to institutional investor and thereby attract investment from international sources.



The 2014 GIIN definition of Socially Responsible Investing segments specified by Saltuk et al. (2014) formed the basis for defining the impact investment segments, it is proposed that an additional dimension be added to cater for South Africa's black economic transformation agenda.

Therefore these categories (Saltuk et al, 2014, p.7) can be defined as:

- Microfinance
- Financial services (excluding microfinance)
- Other
- Energy
- Housing
- Food and agriculture
- Healthcare
- Information and communication technologies
- Education
- Water and sanitation
- **South Africa's black economic transformation**

The above categories highlight the varied nature of opportunities that exist in the PEII space, and would cater to South Africa's unique context. Given the open nature of the IRIS taxonomy (O'Donohoe, 2010) it is possible for South African policy makers to volunteer definitions for BBBEE and other transformation impact oriented measured into the IRIS metrics and thereby allow linkages to be drawn between local economic sectors, with other non-South African measures. In this way PEII within South Africa can be contextualized on an international investment platform which has the potential to increase PEII investment in the South African economy.

#### **6.4.4 CONCLUSION**

The policy formation process is affected by various players and inputs. These influence the way in which the policy is discussed, the way in which it is shaped, and ultimately the way in which it is created and the corresponding effect that it has on the sector. Thus a well formulated policy, created with the assistance and input of all affected players is a key factor in shaping the ability of policy to establish a positive and effective operational landscape.

Initiatives such as SiMODiSA are having a positive influence on the policy landscape. The success that is being achieved from the public-private collaboration in policy formation in developing a

much needed trust which will empower future effective collaboration. BBBEE has proved to be an enabler for PEII, in that it has defined the rules by which all businesses need to operate in South Africa. This is whilst participating in the mandated social and economic transformation.

## **6.5 RESEARCH QUESTION FIVE**

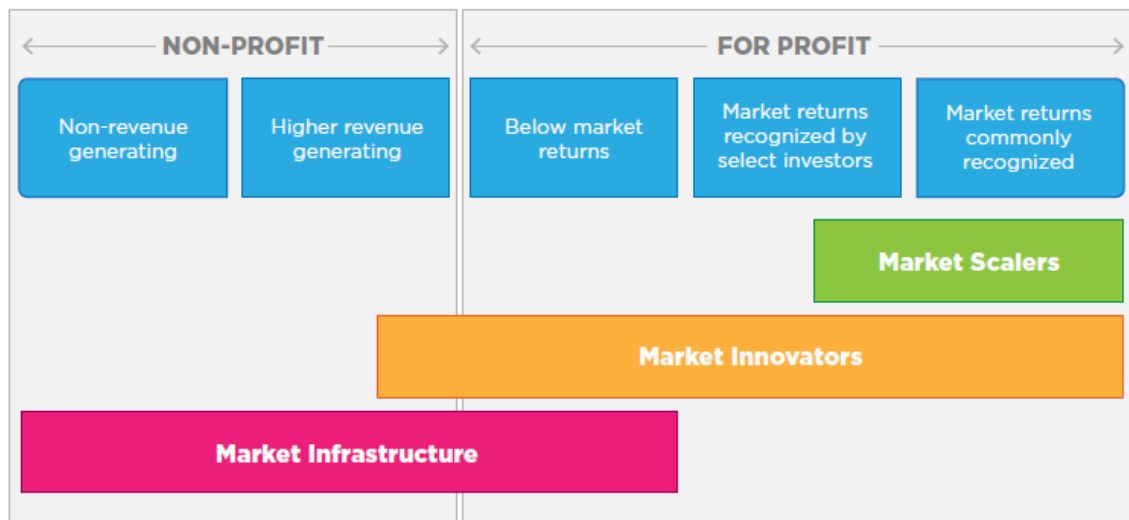
**RESEARCH QUESTION FIVE: What are the current policy initiatives and practices outside of South Africa that are enabling the development of scale of private equity impact investing within emerging markets?**

There are a variety of lessons to be learnt from the policy initiatives that are in practice in other emerging and developed markets. These lessons can be learnt from examples of good and poor practice in the sector. The extent to which the lessons are learnt will impact the success of the South African context.

### **6.5.1 CAPITAL EFFICIENCY**

The private equity model is consistently showing how market forces combined with profit motivation provides the most efficient way for allocating capital, this is clearly portrayed in this research's findings. Thornley et al. (2012) state that: "policies that direct existing capital change the perceived risk and return characteristics of impact investments by adjusting market prices and costs and improving transaction efficiency and market information". Whilst such policies can change the investment landscape, they do not influence the appropriate allocation of investment instruments, as per the investment continuum. Bannick et al. (2012) described how the risk-adjusted financial return of an investment opportunity will be matched with the appropriate capital type, with its underlying capital efficiency, on the basis of the expectation for return shown in Figure 10.

Figure 10: Investment profit orientation (Bannick et al., 2012, p.8)



### 6.5.2 SECTOR SPECIALIZATION

Bannick et al. (2012) look specifically at the potential of using a sector based approach in the formation of policy to stimulate impact investing, and thereby maximization the potential impact that can be achieved. They emphasise the need to consider the entire investment continuum, as this ecosystem for capital must operate effectively for true scale economy to develop. Findings from the research about a shortage in the supply of Angel Funding in the VC and SME space shows a fundamental failure the investment continuum which is causing a breakdown in the functioning of the South African impact investment ‘pump’.

### 6.5.3 VALUE CREATION

In the past, private equity may have developed a reputation for deriving value from the process of “creative destruction”, whereby value can be unlocked from the unbundling of an organization and selling it off in components. Generally this practice does not feature in the investment strategies of PEII. As such, the mechanism for generating value will remain oriented toward the benefits gained from financial engineering, access to capital and networking potential, resulting from partnership with new capital partners. Furthermore, the instilment of best practice and operational efficiency enabled though innovation and expertise delivered by the private equity partners is key. In some cases, the introduction of a strong profit orientation to the enterprise, such as what a PE partner provides to business, will drive performance and thereby increase value. PEII coupled with this model will link impact performance with the achievement of financial results, and will therefore increase the net value delivered.

Bendell et al. (2011, p.283) “A second broad theme of research could be on public policy innovations related to such CSR standards. This could be informed by a more comprehensive

and global mapping of public policy innovations for mainstreaming CSR standards. Then case studies of policy innovations could be conducted to develop criteria for assessing the impacts of policies, and when and why they work in certain contexts”

This mechanism for PEII creating value within a business is something that policy makers need to leverage, and they should engineer policy that channels the efforts of investors toward the areas that require impact within South Africa.

#### **6.5.4 CONCLUSION**

PE has proved itself as being the most efficient financial instrument for allocating capital to investment opportunities that are compatible with it within the investment spectrum. Therefore PEII would naturally also leverage this efficiency whilst delivering its targeted impact. Policy innovation that is enabling PEII within countries and sectors create opportunity for investors to enter new markets.

## **CHAPTER 7: CONCLUSION**

### **7.1 INTRODUCTION**

The policy landscape within South Africa exists as a mature yet developing platform upon which investment decisions relating to the country can be made. However recent policy volatility, in conjunction with poor economic performance, have impacted the desirability of South Africa as a target for investment, when compared to other emerging markets. In order to ensure that South Africa retains its appeal as an attractive investment destination, it is necessary to further understand the implications of this policy environment, particularly in terms of PEII

### **7.2 AIMS OF THE RESEARCH**

The research has sought to understand the interrelationships within the complex South African policy landscape. Furthermore, the research was able to identify the factors that influence the potential for achieving innovation in economic and social outcomes within capital markets. More specifically the nascent impact investing industry has been studied to determine the potential for leveraging the capital efficiency of private equity.

### **7.3 SUMMARY OF THE RESEARCH AND MAIN FINDINGS**

A lack of trust has been identified as being one of the largest factors hindering progress between the private and the public sector. The South African government has developed a policy landscape which attempts to drive social transformation within the country, whilst traditionally the owners of capital have looked only to maximise their profits. There is not a good history of capital providers using their position to serve the interests of society. However recently there has been the emergence of SRI practises, whereby individuals recognise that there is a need to participate in economic activities in a new format. As such, doing business in the social environment is expanding, and this needs to be developed in order to secure a stable ecosystem for continued equitable existence in South Africa.

Government acts in the policy creation and intervention space, which interfaces with business practices and market forces. In this way, government as a non-commercial entity, with unique priorities and aims, is critically involved with the development of the rules of engagement for the private, profit motivated, business sector. This introduces risk into the environment with PE investors being required to build into their expectation for a risk-adjusted financial return. Specifically, policy that has been developed around capital markets has progressively looked to erode profits that can be achieved by investors. This has inherently undermined the feasibility

of the investment landscape, in some cases to the degree when alternative markets are more favourable, the capital flows to those markets.

Bannick et al. (2012) indicates that government's role is to develop policy, while agencies and regulators should be empowered to effectively implement the policies. Government has limited capacity and resources at its disposal to apply to any given function. As well as the lack of capacity, there is often a lack of urgency and full understanding of the factors at play. The government in South Africa is also accountable to numerous stakeholders, such as unions, who impact the decisions made. As a result, if government attempts to be involved too deeply in policy implementation it undermines the proper functioning of the policy environment. This impacts the market participants given that they cannot rely on the existing institution to effectively moderate their markets, and it further drives uncertainty around the manner in which policy will be applied.

The private equity industry encompasses investment from the venture stage of a business, through the growth period into the mature stage and finally the buyout stage. Different private equity funds will specialise in various growth stages in accordance with the strategies that they implement in order to create value within their portfolio companies. The private equity industry in South Africa is governed by the opportunities that are available, and impact investment opportunities would exist as a subset of these. Impact investments in South Africa can be perceived to exist in two different forms, the first being existing businesses implementing models that have a direct impact on the environment and customers that they serve. The second are the innovative businesses that are pioneering new markets or disrupt existing markets. Both of these models fundamentally integrate impact into their business operations, in a manner that challenges the markets that they operate in. In this way, the lack of trust between government and private stakeholders is evident. This is due to the fact that a stable and clear regulatory framework would enable the private sector to do significantly more work in the impact investment space. In this way, the private sector would be driven to achieve results in the same area that is primary for the government – namely the improvement of the quality of life of its citizens.

When evaluating the PEII landscape, it is apparent that it suffers from many of the same challenges that traditional PE does. A gap in the capital continuum has been found within this research in the Angel Investment VC stage. This is further aggravated by the culture within South Africa whereby investors only provide a single round of finance, which is in contrast to Silicon Valley, where it is standard practice to secure multiple series of finance to support the growth

requirements of start-up companies. This shortfall in investment within South Africa limits the number of businesses that are able to explore opportunities, and thereby develop the pipeline for new business that would be considered by PE growth investment. This shortfall of soft capital provided in the face of high risk, inhibits exploration and innovation and the commercialization of opportunities that may exist.

While there is a significant amount of soft capital being applied in the South African market, the policy that exists and agents involved in the allocation of the capital, are targeting SME and start-up businesses that are involved in the survivalist business area. These survivalist businesses are the type of company that do not possess the potential to scale and therefore do not attract the interest of PE investors. When it comes to evaluating the potential to develop start-up business specifically involved in impact investing, this will frequently develop from the initiatives of social entrepreneurs. South Africa does have several incubators and accelerators that are generating successful results, however this again suffers from two draw backs. The first is the preference given to generating employment for the previously unemployed. This generally involves investing in individuals who are wanting to develop survivalist business. While this is directly delivering a social impact which is aligned to South Africans' need, through creating jobs and alleviating poverty, the model lends itself to grant finance given that the business is not sustainable in its own right. Soft capital is an important component in the finance continuum and it will traditionally be provided by government or philanthropist givers. However Bishop (2006) described how even the philanthropic model is shifting towards a more sustainable practice, where the funds made available for impact can be sustained. This is done through implementing business models where the principal fund does not get eroded. This entails using the allocation of capital according to the principal where impact can be achieved, whilst also achieving a financial return.

Success in the PEII space is attracting attention within the financial capital markets in that it is proving to be an instrument that fits the portfolio requirements of institutional investors. Social awareness and the use of a percentage of available capital in addressing social needs is a growing requirement for funds, and when even a small percentage of the pension fund is allocated to PEII capital, it forms a very significant total value within the industry. The desire exists within the investor community to invest in assets that can deliver social benefit, while either sustaining the principal or growing it in accordance with the investor mandate. PEII offers a mechanism to achieve market rate financial performance, which is exceptionally desirable to institutional capital, who have the need to incorporate a social investment component as part of their portfolio. The biggest challenge is the nascent state of the impact investment industry, in that

there are limited funds that have a proven record in successfully delivering results. As well as this, the sector itself is only just emerging as an established asset class with defined sectors and best practices.

South Africa has developed policy around several key areas that are having both a positive and negative influence on PEII. BBBEE is a most significant policy area in that it is applied to all business. The BBBEE Sector Charter allows for industries to have specific interpretations and factors to be applied to the certification process. These are generally in line with the need that has been identified within the sector to drive strategic targeted levels of transformation. A tangible outcome of BBBEE within the South African business environment - without considering the effect of BBBEE on individuals of various racial backgrounds in the country- is that it creates a defined set of rules by which business must operate. This framework is intended to achieve a desired level of social redistribution of wealth and opportunity. If the capital markets have confidence in the stability of BBBEE policy and foresee being able to operate in accordance with them while remaining profitable, it will attract the attention of investors. Private equity, as one of the available asset classes, will participate in accordance with these same views.

An opportunity exists to leverage the BBBEE codes in such a way that extended impact outcomes can be incorporated to the BBBEE metrics. This would provide further opportunity to target impact through investment decisions, and this would be best implemented via policy, if defined in accordance with the sectors. The most recent GIIN survey, 2014, shows that sub-Saharan Africa is experiencing the highest growth in impact investment. This growth is shown in the results spread across all asset classes. Such sectors that may be identified, requiring special policy within South Africa, include education and low income housing.

#### **7.4 THEORITICAL CONTRIBUTION OF THE RESEARCH FINDINGS**

The academic theory around impact investing has developed significantly over the past few years. This theory needs to transcend this arena and enter the debate between practitioners and those designing policy. However the increase in knowledge on the subject is positive for the industry, and indicates its growth and shift to a more entrenched investment asset class.

Efforts by notable academics, foundations, companies, philanthropists and research organizations have helped to develop impact investing as an industry and an asset class. This is to the mutual benefit of lending authenticity of the industry - which will help to attract traditional capital and also enhance the social change that can be achieved. In this way it is a positively reinforcing process.



The interest in the field of impact investing is gaining attention from both academic and commercial researchers. These take different forms, however the most notable research in the field is currently resulting from collaboration between the various stakeholders listed above. This is being released via commercial research reports. These include the efforts of the G8 Social Impact Investing Taskforce and the JPMorgan social finance study, which processes anonymous fund data collected by the GIIN.

Since the financial crisis in 2008, private equity has been forced to compete for available capital and has therefore needed to optimize its ability to create value in its portfolio companies. This has extended beyond financial engineering, and typically now incorporates strategies to use operational involvement to drive value. This includes the adoption of practices to attend to ESG issues, the most effective lever to create value.

Public good theory looks to maximise the benefits gained from the allocation of resources to the largest number of people. The South African Government is in a position where it needs to represent the interest of the people, while remaining attractive to business. This dichotomous role requires that policy sets a landscape that can attract capital for investment whilst ensuring that the people of the country receive equitable interest and a share of the economic reward.

## **7.5 RECOMMENDATIONS FOR FURTHER RESEARCH**

This research was specifically focused on the private equity model for capital allocation. It was restricted to the closed fund partnership, between limited partners and general partners. The reason for this was that other forms of equity investment, such as institutionally operated private equity; DFI funded private equity, or even public equity; operate with different contexts and mandates. It was considered important in the research to maintain the pure profit orientation. This was in order to study the efficiency of capital allocation driven by profit incentives, derived from the funds financial performance. There is a significant amount of capital that is available from public sources, and DFI sources which could be applied via a hybrid private equity model. This can be seen as the potential for hybrid forms of enterprise (Chertok et al., 2008) and as an indication that hybrid implementation for financial models should exist. Research is needed to understand how such hybrid models for equity investment have been established, and to determine their success in fulfilling the impact investment requirements of the available investors

Another area for further research would be examining the suitability of the existing measures for measuring impact investment, specifically in the South African context. This would be to

evaluate the ease with which measurement supports comparison of investment choices and outcomes between comparable sectors and asset classes. Numerous CSR standards have emerged in recent years and whilst they are not directly comparable to the existing impact investment metrics, there is the potential to investigating linking the two, on the basis of taxonomy and calculations. Bendell et al. (2011) identifies a need to research public policy innovation, related to such CSR standards, with the mind to get a more comprehensive understanding of these policy innovations. This would examine what has emerged in the policy space, the effectiveness of the policy, and the regional mapping of the policy according to markets classified as either emerging or developed. Such research could be presented as case studies of policy innovations.

## 7.6 CONCLUSION

Innovation in capital markets will occur, and it would be useful to expand future research to examine both public equity and hybrid equity models within the capital continuum which have equity-like incentives. This should also incorporate developing sources of capital beyond the traditional Limited Partner. DFI's are beginning to develop equity models for incentives in equity models, and there could be potential beyond the traditional Private Equity Capital source.

The fluid nature of the understanding of the private equity impact investing arena, coupled with its nascent nature, have resulted in the sector being under-researched. As a result, the factors that influence the effectiveness of PEII as an asset class, and the factors that influence the development of the asset class and the policy influencers, affect PEII in unknown ways. Due to this lack of clarity, this research focussed on gaining an improved perspective on these issues. As a result, the impacts of policy on the development of PEII have been analysed.

In the South African context, which is highly unequal and suffers from a historic legacy of inequality, the potential positive impacts of PEII are exponential. As a result, it is important to ensure that the policy framework is one which encourages investment – local and international, and which sets the South African PEII environment apart. This is necessary in order to attract investment and ensure that the positive developmental impacts accrue in South Africa. In this way, the various social goals that have been set by government – in terms of improving the lives of the majority of the country's citizens, are more readily attainable.

The need for private and public stakeholders to work together in seeking new public policy directions is of great importance, and the trust-deficit that is currently a feature of the landscape must be overcome. It is only in this way that there will be a set of clear objectives and a road

map to attain these through PEII. Lessons from other emerging markets should be learnt, and where others have stumbled, South Africa must ensure that its policy avoids these challenges. Furthermore the developed world offers an opportunity to learn from best practice. What needs to be avoided is the adaptation of policy that is then amended and results in the attractiveness to investors being minimised.

This emergent industry has the potential for great impact in the South African context, but it is important to establish the policy framework at an early stage in order to fully capitalise on the growth of the sector, as well as its ability to effect positive change.

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## APPENDICES

### APPENDIX 1: CONSISTENCY MATRIX

The following diagram represents the interconnectivity of analysis in accordance with how this research report is structured.

*Table 6: Consistency matrix*

<u>Research Proposition</u>	<u>Literature Review</u>	<u>Data Collection Tool</u>	<u>Analysis</u>
RESEARCH QUESTION ONE: What factors constrain the development of private equity impact investing in South Africa?	(Speed, 2012) (Saltuk, Idrissi, Bouri, Mudaliar, & Shiff, 2014) (Saltuk, Bouri, Mudaliar, & Pease, 2013) Clark et el. (2012) Thomas and Mohan (2007)	Interview Guide	Content Analysis Thematic Analysis Frequency Analysis
RESEARCH QUESTION TWO: How is the policy landscape influencing the factors that are constraining the development of private equity impact investing in South Africa?	(Cunard, 2014) (Speed, 2012) (Saltuk, Idrissi, Bouri, Mudaliar, & Shiff, 2014) (Saltuk, Bouri, Mudaliar, & Pease, 2013) (Goldberg & Habberton, 2014)	Interview Guide	Content Analysis Thematic Analysis Frequency Analysis
RESEARCH QUESTION THREE: What factors enable the development of private equity impact investing in South Africa?	(Klein et al., 2012) (Clark et el., 2012) (Speed, 2012) (Saltuk, Idrissi, Bouri, Mudaliar, & Shiff, 2014) (Saltuk, Bouri, Mudaliar, & Pease, 2013) (Brest et al., 2013)	Interview Guide	Content Analysis Thematic Analysis Frequency Analysis
RESEARCH QUESTION FOUR: How is the policy landscape influencing the factors that are enabling the development of private	(Goldberg & Habberton, 2014) (Clark et al., 2013) (Bendell et al., 2011) (Bannik, 2012) (Thornley et al., 2011)	Interview Guide	

equity impact investing in South Africa?			
RESEARCH QUESTION FIVE: What are the current policy initiatives and practices outside of South Africa that are enabling the development of scale of private equity impact investing within emerging markets?	(Thornley et al., 2011) (Bannik, 2012) (Bendell et al., 2011) (Goldberg & Habberton, 2014) (Bishop, 2006) (Chertok et al., 2008)	Interview Guide	

## APPENDIX 2: INTERVIEW GUIDE

### PRIVATE EQUITY FUND MANAGER - SEMI-STRUCTURED INTERVIEW QUESTIONS:

- Tell me about your company?
  - Do you actively engage in impact investing?
- What Private Equity investments has your fund made?
  - What is the target IRR for PE investments?
  - What is the strategy for adding value, active management and incentivisation of portfolio company management?
- What measures / standards do you use to measure social return / impact? (i.e.: IRIS; B-BEE)
- Policy
  - What policy is currently inhibiting PE investment in South Africa?
  - What policy is currently promoting PE investment in South Africa?
  - Do you know of any policy in emerging markets that is driving scale in private equity impact investment
  - What policy do you believe needs to be implemented to achieve scale of private equity impact investing in South Africa?
- Your experience of public policy
  - What **regulations and public policy** are significant to your investment landscape?
  - What **public policy** influences your investment landscape?
    - How does it affect PE
    - How does it affect Social PE
- Local Environment
  - How has **regulation in different sectors** influences decisions to invest?
  - How has regulation influenced the availability of suitable companies to invest in?
- Emerging Market Environment
  - Are you aware of any significant trends that is occurring w.r.t PE impact investing?
- Are you aware of any significant policy initiatives in emerging markets that is attracting the attention of PE Impact Investors?

## POLICY ADVOCATE - SEMI-STRUCTURED INTERVIEW QUESTIONS:

- Tell me about the <ORGANIATION> and how it approaches policy formulation
  - How is the effect of policy measured? OR does the amendment of policy fall back into the same cycle as policy formulation?
  - How does the <ORGANIATION> craft policy to utilize capital markets to participate in delivering social return?
- Tell me about <ORGANIATION>?
  - Who from <ORGANIATION> are involved with <POLICY INITIATIVE>?
  - What expectations does <ORGANIATION> have from <POLICY INITIATIVE>
  - Does <POLICY INITIATIVE> represent an innovation in collaboration between policy makers?
- Are there any other initiatives that you know of that is generating innovative policy that will attract private capital?
- Who are the policy makers within South Africa?
- Levels of policy formulation:
  - Foundational
  - Financial
  - Regulatory
  - Advocacy Driven
  - Opportunistic
- Regulation
  - How has **regulation in different sectors** influenced decisions to invest?
- Emerging Market Environment
  - Are you aware of any significant trends that is occurring w.r.t PE impact investing?
  - Are you aware of any significant policy initiatives in emerging markets that is attracting the attention of PE Impact Investors?
- Thank you, I have come to the end of my questions, do you have any further information to add, or recommendations for people that I should speak to?

## INTERMEDIARY - SEMI-STRUCTURED INTERVIEW QUESTIONS:

- Tell me about the <ORGANIATION> and how it was formed?
  - Is <ORGANIATION> involved in policy formulation?
    - How is the effect of policy measured?
- Pension funds and ESG
  - Given that <ORGANIATION> are developing a fit-for-purpose model for adopting ESG, have you identified a preference for SRI or Sustainability?
- GRI – Global Reporting Initiative
  - Has there been any collaboration between reporting standards such as: GRI & GIIN IRIS & SIMA (Chartered Institute of Management Accountant) Integrated Report?
- What is your views on the evolution of terms such as:
  - RI - Responsible Investing
    - CRISA - Code for Responsible Investment in South Africa
  - Sustainable Investing
  - RSOI - Social Return On Investing
  - Blended Value
  - CSR – Corporate Social Responsibility
- Are ESG and RI are presumed components of impact investing?
  - It seems that a combination of policy, initiatives, and best practices is shaping the landscape for impact investing
- Do you believe that the profit-with-purpose investing agenda has matured as a subset of sustainable investing?
- Is RI taking the form of allocation of capital towards PE investment that achieve market returns whilst delivering on a social agenda?
- What views do you have on the role that Private Equity has within the Responsible Investing space?
- How has Institutional Capital responded to the emergence of the UN PRI and CRISA?
  - What response have you seen in the alternative asset classes?
  - Has the shifting policy landscape within South Africa influenced the desirability of the available instruments?
- Do you have any insights into how the Public Policy process influences the private equity space?
- What are the routes towards entrenching sustainability into policy?

- Emerging Market Environment
  - Are you aware of any significant trends that is occurring w.r.t PE impact investing?
  - Are you aware of any significant policy initiatives in emerging markets that is attracting the attention of PE Impact Investors?
- Thanks you, I have come to the end of my questions, do you have any further information to add, or recommendations for people that I should speak to?