British International Investment

Framework

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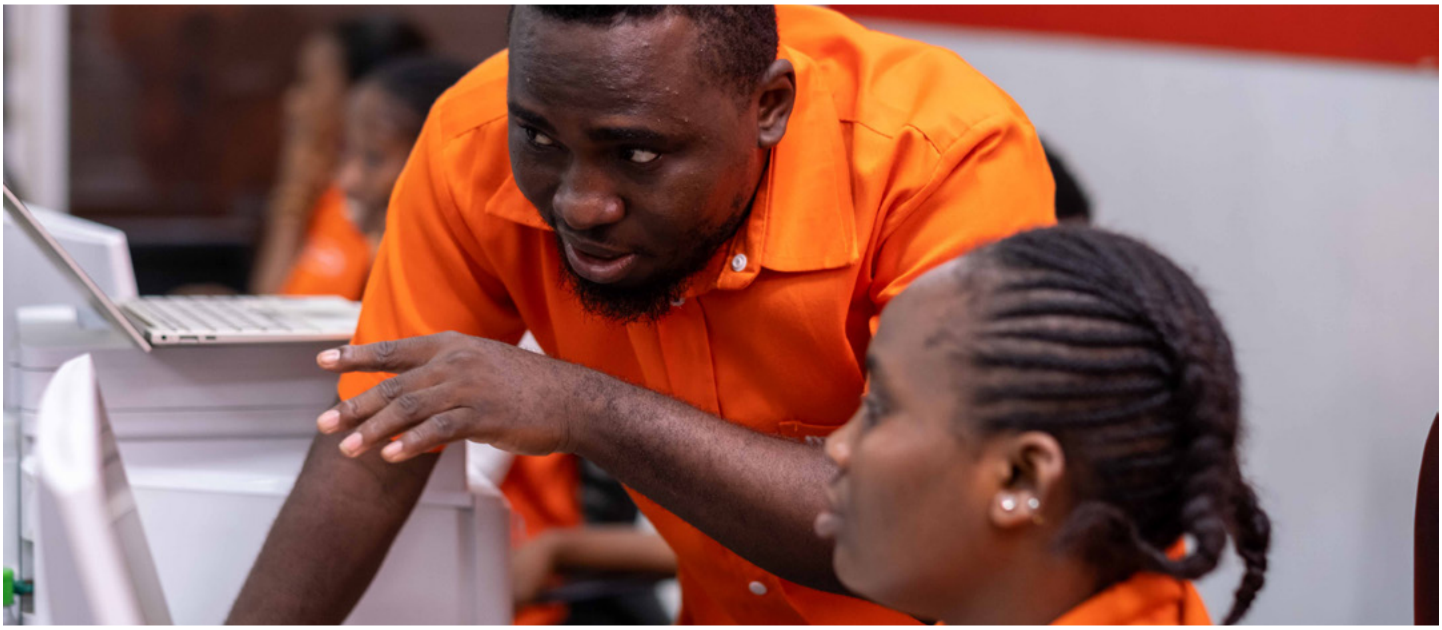
Our approach to enhanced development impact



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Introduction

We invest through two portfolios: Catalyst Strategies and Growth. Through our Growth portfolio, we inject patient, long-term capital into businesses that have the potential to achieve sustainable growth while making a positive environmental, social and economic impact. Through our Catalyst Strategies portfolio, we help shape nascent markets and contribute to more inclusive and sustainable economies.

When making a Catalyst investment, we are able be more flexible on the level of risk we take on, compared with our Growth portfolio, in exchange for enhanced development impact. That means Catalyst investments and strategies require a higher impact hurdle.

But what exactly do we mean by 'enhanced development impact'? This article explains our approach as well as how we think we can unlock more impact by catalysing markets.

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What do we mean by enhanced development impact?

We exist to help solve the biggest global development challenges by investing patient, flexible capital to support private sector growth and innovation. That means our investments seek to make a lasting difference to people's lives and to play a role in tackling climate change. We pursue this mandate across all our investments, seeking productive, sustainable and inclusive development in everything we do. However, when we use more flexible pools of capital, like our Catalyst Strategies, we do so with an expectation and understanding that the greater risks that we accept are outweighed by an even greater quality of impact. This does not mean that more commercially interesting investments cannot deliver the same impact. Rather, it is an expectation that our Catalyst Strategies have a higher minimum threshold of impact in exchange for flexibility on risk-return.

We have defined this threshold – or "enhanced development impact" – along two key themes: first, promoting inclusion and second, climate action (Figure 1).

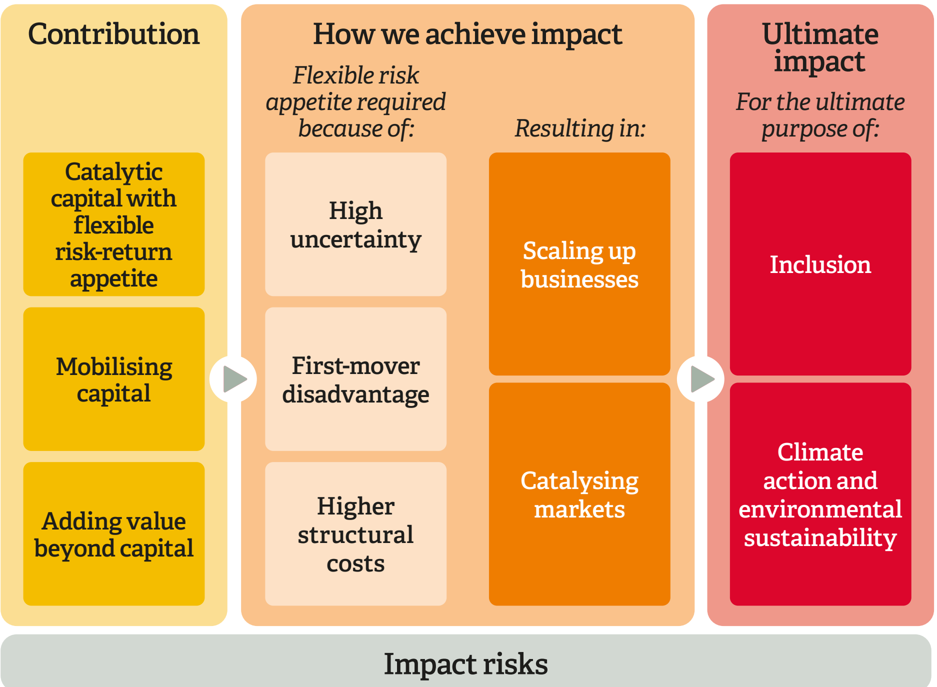

Figure 1: BII's enhanced development impact framework

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What are our ultimate impact goals?

3.1 Inclusion

Our first impact goal is inclusion, so that we can improve the lives of those most in need – namely the poorest and most excluded. We define inclusion as intention and potential to meet the needs and raise the incomes of our target population, so that they experience meaningful positive outcomes.

Inclusion is an important objective across our whole portfolio: it is one of our three strategic impact objectives under our current five-year strategy. We apply our Impact Framework, which uses the Impact Management Project's dimensions of impact, across all our investments. An essential dimension of that framework is to consider *who* is affected by our investments. In our approach to enhanced development impact, we have set a higher bar in terms of the groups we intend to positively impact with our investments.

We recognise that sometimes reaching lower-income groups can be more challenging, for example it may mean incurring higher costs or testing new innovative solutions. This means these investments may not always be appropriate for our Growth portfolio, where there is a more conservative risk-return profile.

Under our definition of enhanced development impact, we are particularly focused on having a positive impact on the lives of low-income people. We define our target population as the bottom 40 per cent (as per Sustainable Development Goal 10, 'Reduced Inequalities') or people living below $5.5/day, a well-recognised poverty line.

As much as possible, we also want to prioritise people living in extreme poverty (SDG 1, 'No Poverty'). Learning from our previous investments, we recognise that limiting ourselves to that segment of the population in turn limits the number of sustainable and commercially viable opportunities we can invest in. Instead, we've learnt that business models with a broader target market like the one we've mentioned above, can reach this segment in a more viable and sustainable way.

3.2 Climate action

Our second impact goal relates to climate action and environmental impact. We chose this goal, first, because climate change is a unique global challenge in scale, urgency, magnitude and complexity of action. Second, we've identified challenges in addressing this theme (see section 4.4), which we think a more flexible form of capital can help to address.

The climate emergency requires a fundamental shift in how economies and sectors work, Without it, we will exceed a 1.5˚C increase in global warming as early as 2030. Similarly, if we do not significantly step up efforts to build resilience to acute and physical climate risks, we risk undermining any development gains of the past and in the future. Therefore, the enhanced climate impact framework is focused on transforming economies so they are net zero, just, climate resilient and deliver on people's needs for prosperity and improved living standards.

There are certain climate technologies and business models that have become increasingly proven, mature and more viable for commercial forms of investment. Therefore, we decided we could have the most transformational impact by focusing on those investments that materially accelerate the *pace*, *scale* or *depth* of change required to deliver on climate and development objectives.

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How we achieve impact

At British International Investment, we believe we can achieve impact in several ways. The most obvious and straightforward is by investing in a business with the aim of increasing the impact that it already achieves. For example, when we invest in a company that provides jobs and increases the income of otherwise unskilled and low-income women, our aim is to improve women's livelihoods. We can also generate impact indirectly, for example by increasing access to power or to finance, which businesses need to grow and succeed, and which in turn creates jobs and improves people's quality of life.

However, we think we can achieve the most transformative and large-scale impact when our investments change other business and investor behaviour, so that the impact is multiplied and more far reaching. We describe this as "catalysing markets".

4.1 What do we mean by catalysing markets?

Most importantly, for us, catalysing markets is a means to an end. That's why we first defined our ultimate impact goals, before establishing how we could achieve them.

Because the observable change in the market is harder to both measure and link back to our investment, having a clear understanding of the theory behind how an investment can lead to changes in outcomes becomes of even greater importance.

To guide us through this exercise we have created two tools. First, we identify the market failure (see section 4.2). Once we have correctly diagnosed the problem, we assess and consider how we can shape the market to improve the way it works (see section 4.5).

4.2 Identifying market failures

For every investment or new strategy, we ask ourselves a series of questions.

First, we ask: "*Is this market one we want to scale and what is the ultimate purpose we want to achieve?*"

Once we have assessed this, we ask: "*What is the market failure stopping businesses and investors participating in this market?*" While the common assumption is that lack of capital is the market failure, in fact it is merely a symptom – if the market were successful, commercial and scalable, capital would be flowing. We need to identify the underlying causes that are stopping the market from succeeding so we can assess whether or not we can address these causes.

We have identified three common failures:

1. **High uncertainty.** We deliberately used the term uncertainty rather than risk here. These are instances where often the risk level is not known and so assumed to be high. This uncertainty may be due to the country context, or an unproven business model.
2. **First-mover disadvantage.** This materialises when there are significant costs involved in doing something for the first time, and where others may reap the benefits.
3. **Higher structural cost.** These arise when pursuing certain outcomes means incurring additional costs. For example, social enterprises facing higher costs and/or lower margins in trying to reach more excluded population segments, such as affordable primary health care delivery in rural and less-served regions.

4.3 Identifying market failures in achieving inclusion

First, there is the uncertainty of returns. Penetrating these underserved markets often requires innovative and untested business models. And while these greater risks can pay off, many investors are simply unwilling to tolerate or experiment with these higher risks.

Second, particularly when considering more nascent markets, many businesses have to take on important initial costs. These include research and development, building basic infrastructure, or investing in skills and human capital. Often these initial costs are not easily defendable by the first mover, and get captured by others who replicate the model. While from a developmental perspective, this is positive and indeed desirable, it does not make for a compelling investment argument.

Finally, more inclusive business models will often need to make trade-offs between financial returns and development impact. Deciding to keep prices affordable, or to expand to more rural locations, typically comes at some cost. This does not mean these businesses cannot be commercially sustainable or indeed successful. But often commercial capital is unwilling to take any compromise on financial returns in order to maximise impact.

4.4 Identifying market failures in achieving climate action

As with achieving inclusion, piloting a more nascent business model, early stage company or technology to meaningfully impact on climate mitigation or adaptation brings uncertainty of financial returns. Examples include energy-storage solutions to accelerate the integration of renewables, and green hydrogen to facilitate the decarbonisation of transport.

Transferring a relatively traditional renewable energy model, company or technology to a new market or context where it does not exist, or exist at scale, is another way of achieving this impact on climate. However, given the first-mover disadvantages associated with this model, catalytic capital is needed.

Finally, businesses providing solutions to climate adaptation and resilience needs are often small-scale, which can mean that they face high structural costs. Examples include solar-powered, water-efficient irrigation systems and climate-modelling and weather-forecasting data providers.

4.5 How can our investments shape nascent markets?

This brings us to our last and possibly most difficult question: "*What can we do to address these market failures?*" Can our investments address some of the root causes of the market failure, so that it will influence the behaviours of other market players? Or are we only helping individual businesses address the symptom of the problem by providing them with capital, which is otherwise unavailable? For example, one of the issues we face in addressing climate change is that markets do not price the negative externalities generated by carbon emissions. This is a regulatory problem that we can't solve through our investments. However, we can still make a difference by finding segments of the market that are viable and scalable, such as energy service companies, to reduce the energy consumption of other businesses. We cannot claim to be solving a market failure, but it does help move forward the market in a sustainable way.

True market impact only happens where these failures are solved in such a way that other investors and businesses start behaving differently. We have identified five ways we believe investments may change how markets players operate.

1. **Encourage competition.** This is possibly one of the strongest pathways to market change. It is often the result of innovation that allows a new entrant to lower prices or improve quality, leading other market players to respond. For example, we invested in a generic drug manufacturer. Our impact thesis is based on the hypothesis that our investment in the company will lead to a response from other pharmaceutical players and a decrease in prices of essential medicines as a result of the increased competition.
2. **Replication and 3. Demonstration.** These two pathways are variations on the same theme. The first – replication – is about proving that a business model works, which leads to others replicating it. A typical example is an investment in a new or high-risk market, such as the first fund manager in a fragile or conflict-affected country. The first mover will often incur higher costs and uncertainty to prove the model works in the first place, but if successful others may use those lessons and start investing too. The second – demonstration – is what happens after other people have proven something. Replication is more powerful because the effect is strongest when backing a first mover, which others then replicate. Nonetheless, demonstration is still important because we know that continuous proof of success is required for a market to truly mature.
4. **Develop skills and capacity.** This pathway recognises the importance of human capital in allowing markets to function and deepen. A textbook example is the Bangladesh garment market. Foreign players initially entered the market, but it was local businesses, most of which were founded by the early employees, which really allowed this market and ecosystem to take off.
5. **Improve the enabling environment.** While it is rarer for us, as investors, to act on this pathway, we recognise the importance of regulation and other mechanisms to affect market behaviours. One way we contribute is by proving elements of regulation work, for example when we invest in the first public-private partnership in a country or sector.

Contact us:

We are committed to learning and adapting to market needs so that we maximise our impact on both people's lives and the planet. These tools and frameworks help us achieve high standards of development impact and as we use them in practice, we will undoubtedly need to refine our thresholds and processes to reflect what we learn in practice.

We hope you find this approach useful. If you have any questions or are interested in sharing your own experiences in investing to achieve development impact, please contact: Zahra Khan (**zkhan@bii.co.uk**) and Martina Castro (**mcastro@bii.co.uk**).

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