Discussion paper series on investor impact mechanisms

Mechanism #4: provide non-financial support

2° Investing Initiative

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Mechanism #4: provide non-financial support

Presenting the mechanism

According to Heeb and Kölbel (2020), the mechanism implies to "*provide resources beyond capital that enhance the growth of impactful companies (e.g., know-how, reputation, network)*".

Non-financial support (also called capacity-building support or technical assistance) strengthens an investee's operations, strategy, or impact. Such support may be provided either pre- or post-investment and either directly by the investor or by a third party.

Non-financial support is a heterogeneous, widely applicable tool that has the potential to offer direct benefits to both investors and investees. It addresses a range of investee needs, including general management issues, impact measurement and management as well as technical and/or specialized support.

There is no single way to structure and deliver non-financial support. Instead, impact investors generally use highly customized methods to design projects tailored to the needs and requirements of their investees.

Typical forms of support include training, mentoring and connecting investees with other stakeholders.

Examples of products

In this section, we present a list of products that, by nature, could lever the mechanism.

Non-financial support in VC/PE

As put by Heeb and Kölbel (2020), "enhancing the growth of portfolio companies by providing nonfinancial support is a key value proposition for many traditional venture capital and private equity firms".

It is common that VC and PE funds help their investees to professionalize and strengthen their practices.

Whereas the motivation of providing non-financial support in conventional VC/PE is targeted at maximizing investment return or reducing investment risk, motivations of impact-motivated venture capital or private equity are multiple (social, organizational, financial) and reflect their hybrid nature.

While both impact and conventional investors use non-financial support to strengthen the underlying businesses of investee companies, impact-motivated venture capital or private equity funds also use it to enhance and extend their impact beyond profits.

The wisdom of crowds in crowdfunding

Another example of financial products that can embed non-financial support are investments through crowdfunding platforms. Crowdfunding can act as a conduit for the crowd of individual investors to provide feedback to the entrepreneurs[1]. For example, crowds can provide ideas on the development of a product during and after the crowdfunding campaign and generate valuable information on the future demand for the new product. In a way, crowdfunding permits crowdsourcing of ideas[2].

And the feedback offered by a multitude of individuals may turn to be very valuable due to the concept of “wisdom of crowds”. The principle of the wisdom-of-crowd states that, under some conditions at least, the crowd displays more wisdom than an individual (even an expert) when solving problems or making decisions. As the crowd can offer direct feedback on the product, it can potentially be more valuable to the firm than professional investors’ guidance on business development. Indeed, the crowd of individual investors possesses a variety of experiences and backgrounds, thus ensuring a unique forecasting mechanism that is superior to that of any single individual, even an expert[3].

Various studies[4] show that entrepreneurs approach crowdfunding strategically to obtain additional benefits – other than funding – through crowd engagement, such as improved market knowledge, enhanced promotional capabilities, and connections with key stakeholders.

Questioning the impact narrative

Dual objectives

The GIIN used semi-structured interviews with practitioners at 31 impact-oriented organizations to question the delivery and effectiveness of non-financial support[5].

They obtain that most interviewees perceived some financial benefits from their provision of non-financial support, including revenue generation, operational improvements, risk reduction, and long-term strategic planning. The interviewees’ responses also revealed that the type of support depended on the financial instrument used for investment. Impact investors primarily investing through debt tend to provide capacity-building support that mitigates the risks of the businesses in which they invest and enhances cash-flow management. Impact investors primarily making equity investments tend to provide support that enhances their portfolio companies’ ability to scale their businesses through market expansion, refinement of product and service offerings, or other means.

Non-financial support can also be a useful tool in expanding or enhancing impact, according to interviewees. Impact investors often find their impact to be embedded within investees’ products or services, in which case strengthening those offerings or pricing and marketing strategies generates greater impact. In other instances, investors worked to bolster internal staff capacity, operations, and strategy to deliver, measure and monitor impact. Many impact investors also use such support to improve companies’ environmental, social, and governance (ESG) compliance and adherence to other international and regulatory standards.

Lastly, some impact investors offer capacity-building support to companies outside of their portfolios, including to potential investees and others. Some view such support as an opportunity to strengthen the markets in which they invest so as to create better business environments in general. This approach can strengthen longer-term investment pipelines or create more favorable operating environments for portfolio companies.

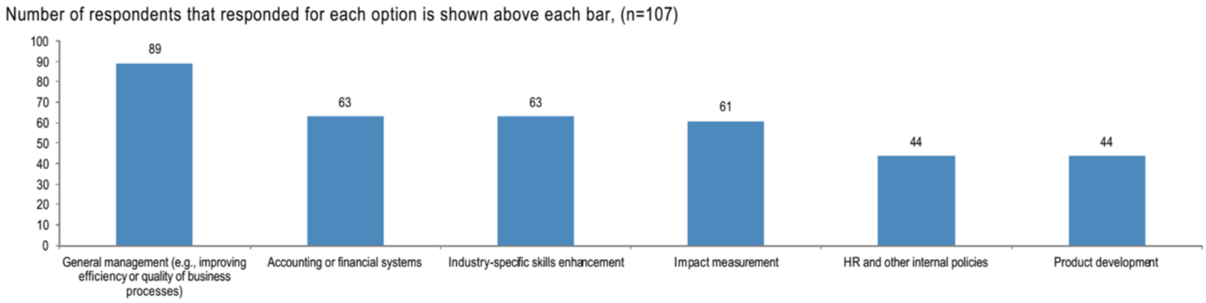
[1] Belleflamme et al. (2014)
[2] Schwienbacher and Larralde (2012)
[3] Walthoff-Borm et al. (2018)
[4] Wald et al. (2019)
[5] GIIN (2017)

When applied well, non-financial support can improve investor competitiveness, enhance business performance of investees, expand impact for beneficiaries, and strengthens markets and sectors.

A frequent contribution among impact investors

Non-financial support appears to be a common practice by impact investors. Another study conducted for the GIIN[6] reveals that seventy-three percent of surveyed impact investors provide technical assistance to investees, either in-house and/or through third parties. The most common use of technical assistance is general management support, followed by assistance with accounting and financial systems and industry-specific skills enhancement. Impact measurement is also a common focus area for technical assistance

Figure 1: types of technical assistance provided by impact investor



Source: GIIN, J.P. Morgan.

The general needs of young companies

The type of non-financial support entrepreneurs receive is very diverse and should match investees' needs. The stage of business of investees is an important factor affecting the type of support needed[7]. Seed- and early-stage companies tend to need support to refine their business models and impact theses, including improving product and service offerings; exploring their fit in the market; understanding the needs, wants, and behaviors of beneficiaries; building staff talent; and generally defining strategy. Growth-stage companies need support to ensure they have the infrastructure to scale their business and their impact effectively, including refining and scaling technology systems, improving governance at the senior management and board levels, strengthening the capacity of middle management, and developing consistent and targeted sales and marketing strategies.

A crucial identification of needs

In an analysis of the growing field of venture philanthropy (which overlaps with concessional impact investing), several researchers have asserted[8] that the first key challenge in offering non-financial support is making sure that investors are offering what social entrepreneurs need.

Impact investors use various methods to identify investee needs that can be addressed through non-financial support. The investor may identify these needs, in some cases, or the investee may request support.

Impact investors may identify the non-financial needs of their investees throughout the investment cycle. They may identify needs before investment through the due-diligence process conducted by the deal team, or use in-house diagnostic tools for all new investments to identify capacity-building needs. They can finally identify needs after investment, during routine investment management interactions with investees

[6] JP Morgan (2015)
[7] Ibid
[8] Cantino et al. (2016)

The capabilities of impact investors to deliver support

The capability of impact investors to deliver non-financial support depend on several factors, especially available personnel and funding.

Regarding personnel, some impact investors provide capacity-building support through their own staff. Appointed staff may be members of the deal or investment management teams, or they may operate within a dedicated technical assistance facility (TAF), a pool of resources devoted specifically to non-financial projects that support the investor's portfolio. By building a TAF or other dedicated in-house team, investors cultivate in-house expertise in capacity-building support and position themselves to aggregate and evaluate lessons learned from previous projects. Most impact investors that provide capacity-building support also contract external consultants to structure or deliver specific projects. Some investors also described a role for mentors and executive education programs in the context of their broader capacity-building work. Mentors' roles and responsibilities may closely resemble those of a consultant, or they may include longer-term, informal engagement with an investee. Mentors are typically selected based on their experience in the sector, the investee's stage of business, their relationship with the investors, and their ability to support the investee on a pro-bono or low-bono basis[9].

Funding is another important determinant of the capacity to provide non-financial support. Usually, impact investors finance their non-financial support via external aid (from government agencies, development finance institutions, or foundations), whole or partial cost-share arrangements with the investees receiving non-financial support or via internal resources. A survey showed that the majority of investors who provide technical assistance reported that the financing comes from their own internal resources as part of their investment (76%) rather than from third parties such as foundations, governments, or aid agencies[10].

The observed outcomes

Few attempts to evaluate effectiveness

If it is clear to quantify how much money impact investors invest have invested in projects, there is less precision in terms of the value they provide through non-financial support, more specifically relating its cost to the impact on investees.

Nevertheless, many impact investors try to assess the effectiveness of capacity-building projects via their ongoing or routine measurement of impact and, additionally tailor performance targets to each capacity-building project, selecting metrics and targets that match the project's scope, scale, and objectives.

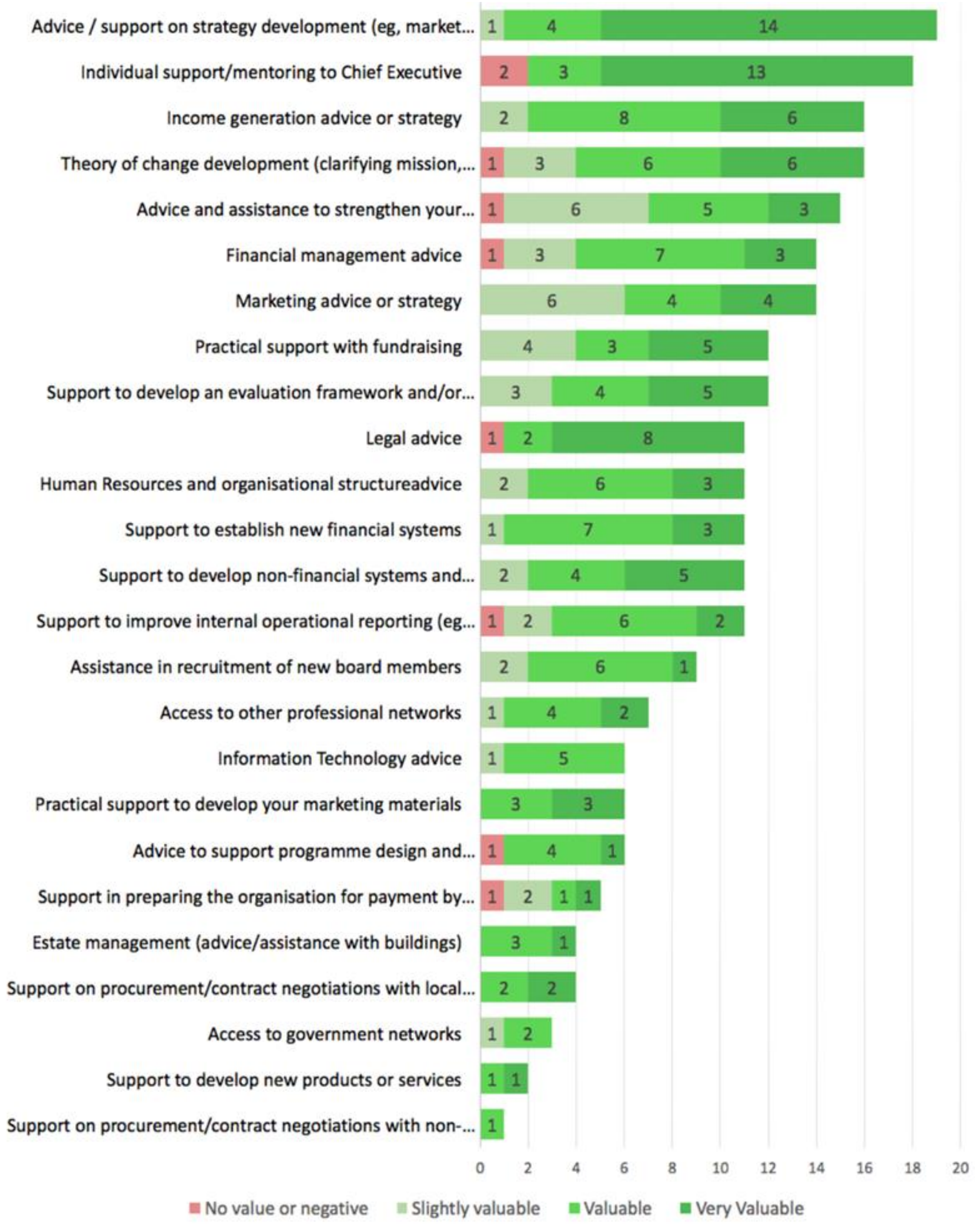
As for financial support, the real-world effects often only materialize much later after the delivery of a capacity-building project. Due to that limitation, investors that evaluate their non-financial support often restrict the evaluation to direct and immediate outputs of their support.

To the best of our knowledge, very few academic studies have tried to assess the effectiveness of non-financial support. Heeb and Kölbel (2020) stated that "several empirical studies looking at private equity or venture capital funds show that non-financial support by fund managers can affect the performance of investee companies. However, there is a relatively high level of variation among the results of these studies. A set of qualitative studies shows that both investors and entrepreneurs attribute considerable importance to nonfinancial support". For instance, Isserman (2013, 2018) studied the added value created by non-financial service provided by a venture philanthropy

[9] GIIN (2017)
[10] JP Morgan (2015)

organization: the Impetus Trust Fund. He obtained that the average Impetus-supported SPO manager reported receiving 10.5 different types of nonfinancial services through its engagement. Of these, 5.8 were supplied by Impetus Trust staff and 4.7 were supplied by external consultants or experts, whether pro bono or (infrequently) paid by Impetus Trust. He discovered that a high majority of investees interviewed valued very positively the non-financial support provided.

Figure 2: evaluation of technical assistance provided by Impetus Trust according to managers of supported organizations

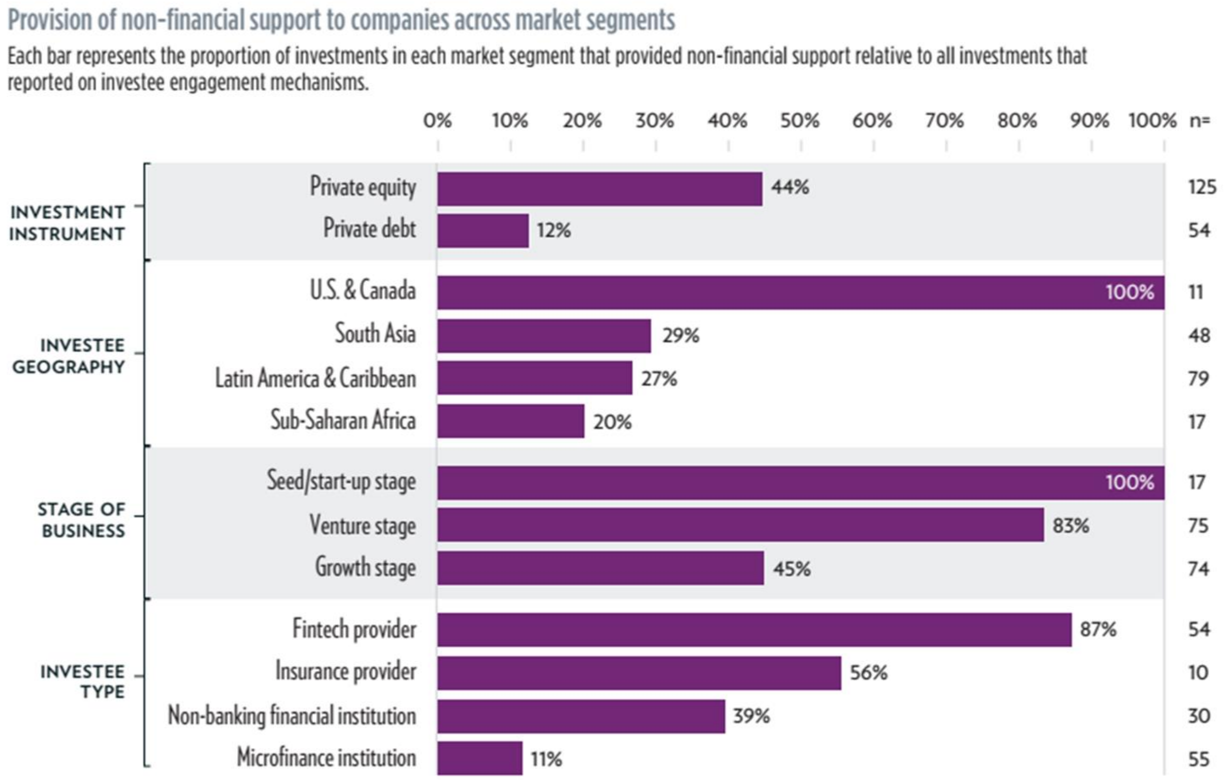


Source: Isserman (2018)

The example of financial inclusion

A brief by the GIIN (2022) explores investment-level, annualized impact performance data contributed by investors to the IRIS+ Financial Inclusion Impact Performance Benchmark and connects it to the provision of non-financial support. Data pertain to direct impact investments in financial inclusion. Findings presented in the brief show that just under a quarter of investments that reported on engagement mechanisms offered non-financial support to companies, with variation across investment strategies and investee features. Non-financial support was more commonly provided through private equity investments (44% of private equity investments compared to just 12% of private debt ones), perhaps given these investors' more active ownership role or the prevalence of private equity investments among earlier stage companies.

Figure 3: percentage of impact investors offering technical assistance - Financial Inclusion



Source: GIIN (2022)

They also point to a positive effect of non-financial support. Investments in the sample that offered non-financial support were associated with greater average impact results across three key performance indicators for the topic of financial inclusion: (1) Clients actively using responsible financial services, (2) Micro-, small-, and medium-sized enterprises (MSMEs) responsibly financed, and (3) Decent jobs supported at or above a living wage. Additionally, investments with a non-financial component saw stronger year-on-year increases in active clients and decent jobs supported as compared to investments without non-financial support.

The outcomes of crowdfunding

Several studies have highlighted a greater business success of SMEs using crowdfunding to get financed compared to other SMEs not using crowdfunding and connect such a performance to the non-financial benefits permitted by crowdfunding.
Positive effects have been found on:

- **Growth:** Eldridge et al. (2021) obtained that equity crowdfunding (ECF) acts as a catalyst for growth, confirming the impact of the wisdom-of-crowd effect.
- **Innovation:** Walthoff-Borm et al. (2018) showed that the firms that relied on equity crowdfunding had 3.4 times more patent applications than matched non-ECF firms. This confirms ideas from Paschen (2017) and Stanko and Henard (2016) who posited that crowdfunding leads to an increase in innovation, through increased idea generation and feedback from backers.
- **Internationalization:** using an inductive qualitative research design based on multiple case studies of Italian SMEs, Troise et al. (2022) show that equity crowdfunding (ECF) and reward-

based crowdfunding (RCF) help SMEs in acquiring the financial resources needed to internationalize and, at the same time, offer significant added value to their internationalization. ECF and RCF play a key role in helping companies to overcome their resource limitations in regard to internationalization, not only in terms of the provision of financial resources but, above all, by compensating for any lack of knowledge on aspects relevant to the internationalization process.

The moderators

When does provision of non-financial support lead to the expected impact? We have identified a list of success moderators:

- **The identification of investees' needs:** to maximize its impact, the impact investor should propose services that match investees' needs and, for that purpose, build on a structured elicitation mechanism
- **The personnel allocated to non-financial support:** the impact investor should also have (internal or external) expert staff to allocate to the support of investees
- **The financial resources dedicated to non-financial support:** the impact investor should have adequate financial resources to allocate to the support projects though internal or external financing
- **The systematicity of non-financial support:** to maximize impact, the impact investor should propose tailored non-financial support to all investees and not restrict it to a few of them (e.g., those asking for support), for instance through the use of Technical Assistance Facility.

Conclusion

The specific needs by young, fast-growing companies of non-financial support from their stakeholders is well documented. And investors with a relevant expertise are in a good position to offer it.

There are consistent reports from different sectors to highlight that such a support is highly valued by beneficiaries and a bit of empirical evidence that it accelerates their growth and development.

In a sense, the provision of non-financial support might be interpreted as the non-monetary equivalent of providing flexible capital as the associated costs of the technical assistance mechanically reduce the financial returns for investors.

Consequently, additional research would be welcome to i) price the market value of the technical assistance provided by investors and ii) compare the implied cost of capital for companies that do or do not benefit from the technical assistance.

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