Portfolio Company Selection in Latin America

Fabian Oppenheimer, 26 September 2013

A post on how Impact Investors select their portfolio companies in Latin America and what criteria are applied for screening and evaluating proposed investments in that region.

Impact Investing, a new approach in investing which seeks to generate financial returns and profit while achieving value for society and the environment at the same time, is attracting a growing amount of attention and an increasing volume of capital. The concept strives to optimise the balance between social impact and financial return; this dual objective is achieved by carefully identifying and selecting eligible ventures.

To date, the selection process – which is rigorous in view of the prevailing constraints – has not been investigated in depth, although practitioners and academics are already showing an increasing interest in Impact Investing. Thus there are no detailed insights on how deals are originated in Impact Investing in Latin America, or on which criteria are assessed during the selection process.

The overall findings obtained from the research done for the study indicate generally that Impact Investing in Latin America has adopted the social objectives of Philanthropy, while applying approaches, methods and procedures which stem from Venture Capital. Impact Investing follows Venture Capital's selection process model characterised by four main phases: namely deal origination; screening; evaluation; and deal structuring. Nonetheless, the influence of Philanthropy remains evident throughout the process, ensuring the balance between social objectives and financial return.

As regards deal origination, it should be realised that since the Impact Investing industry in Latin America is small in size and still developing, personal contacts and access to networks are of utmost importance. Within the various networks, deals originate passively or actively. Impact Investors may use passive deal origination sources, i.e. referrals which they receive. However, the opposite can also occur: Impact Investors are introduced to promising social ventures by their own contacts. The most promising deals are in fact those which Impact Investors find through their own network, which is why they prefer to proactively search for investment opportunities. Market players meet on a regular basis at conferences and other industry events for networking and to identify suitable investment opportunities. Parties without extensive contacts or access to the relevant circles turn to alternative networks, such as the Internet or external matchmaking platforms, or call in intermediaries. Impact Investors also occasionally resort to more unconventional methods for originating deals, such as calling for bids, business incubation, accelerator programs or actually setting up new social ventures.

After contact has been established with a social venture, Impact Investors require various documents to be submitted. However, since social ventures in Latin America are not necessarily in a position to draft complex proposals, Impact Investors there are rather more flexible and might merely ask for basic documentation from potential candidates. In some cases, Impact Investors even help to draw up complex documentation, e.g. business plans, if the company shows high potential for achieving the dual objectives being targeted.

The screening phase in Impact Investing is likewise similar to that encountered in traditional Venture Capital – the same criteria are assessed for aspects relating to e.g. portfolio structure or inherent risks. During the screening phase however, Impact Investors already expect evidence of the social venture's ability to also generate social impact on a wide scale.

In the evaluation phase, Impact Investors assessing social ventures consider various dimensions – i.e. entrepreneur and management; social venture; product; external factors; and deal features – whereby as is indicated below, the criteria of each one need to reflect the dual objectives being targeted.

Interestingly, Impact Investors considering an investment in Latin America seem to focus in particular on the first dimension: the individuals behind the company and their attitudes and personalities are deemed crucial if the dual objectives are to be achieved, if information asymmetry is to be avoided and if mission drift is to be prevented. Impact Investors highly appreciate moral values, whilst educational and business background – although important – is regarded as being secondary.

The social venture itself is expected to show the ability to generate revenues and be profitable. This is not necessarily self-evident, because Impact Investing has emerged as an alternative financing model for social entrepreneurship and incorporates the social objectives of Philanthropy. At the same time, in Impact Investing a social venture is expected to have a scalable business model, so that as the company grows, both its financial returns and its social impact will also increase.

Impact Investors expect the product to have some kind of positive effect on the individual consumer and on the wider community, by being affordable and providing a sustainable solution to a prevailing problem. The product must be of adequate quality and satisfy the customers' needs.

The external factors which Impact Investors especially consider are market size and market growth, in order to ensure prosperous development of the company: Impact Investors see market growth in relation to the scalability of the business, to which they attach special importance. Impact Investors prefer their social venture to achieve a competitive advantage on the market, but for the sake of benefitting the community and not merely for capital gain.

Impact Investors diversify their portfolios as regards the investments made and the sectors represented, paying heed not only to financial but also to social risks, whereby individual risk attitudes and the sectors focussed on are bound to vary. It is peculiar to Impact Investors that they do not seek to actually own the company, and even during the evaluation phase, exit is already an important criterion – not however solely with a view to making capital gains, as in Venture Capital, but also with regard to both the profitable continuation of the venture and the sustainability of its social impact.

Finally, it is common in Impact Investing for a proposal to be simply disregarded that does not meet the criteria applied during the selection process. Nonetheless, in cases where a venture has potential, the Impact Investor may either give non-financial support to help it meet the requirements or refer it to another fund in its network, both at no charge.

The Representative Office of the University of St.Gallen will be happy to provide you with the detailed outcome of the study conducted – please do not hesitate to contact us if you are interested.

The most frequently applied criteria in Impact Investing on the Latin American market identified by the study

Deal Origination

1. Conferences and industry events
2. Referrals within business network
3. Internet (web pages)
4. Funds' search for investments
5. Cold calls

Screening

1. Stage of financing
2. Investment size
3. Impact focus
4. Social relevance
5. Available core competencies

Evaluation

Required documents

1. Financial Statements
2. Budget forecast
3. Business Plan
4. Financial Projections
5. Competitive Analysis

Entrepreneur and Management Team

1. Integrity
2. Honesty
3. Social Values
4. Responsiveness
5. Long-term orientation

Social Venture

1. Ability to generate revenues
2. Profitability
3. Competitive advantage
4. Scalability of business model
5. Long-term business strategy

Product

1. Social Impact
2. Sustainable solution
3. Quality
4. Affordable price
5. Innovation

External Factors

1. Market growth potential
2. Market size
3. Competitive advantage achievable
4. Legal system
5. Market entry barriers

Deal Characteristics

1. Risk
2. Financial Instrument
3. Exit strategy – financial aspects
4. Social guidelines
5. Exit strategy – social aspects

Declined Proposals

1. Disregard proposal
2. Refer proposal to another fund
3. Provide non-financial support to make proposal meet criteria

For further information on the topic please contact the University of St.Gallen's Representative Office in São Paulo or the author **Fabian Oppenheimer** by e-mail (*fabian.oppenheimer@student.unisg.ch*) or by Skype (*fabian.oppenheimer*).