Double Bottom Line Investments: An Economic Development Tool

Hearing hosted by the Honorary Nora Campos, Member of the California Assembly

Thank you so much for the opportunity to address you today.

Pacific Community Ventures is a non-profit organization and a certified community development financial institution, a CDFI. PCV plays several roles in the impact investing ecosystem. And, I use the term impact investing to encompass socially responsible, double or triple bottom line investing, etc.

PCV is itself an impact investor. Both through small business loan fund as well as private equity funds, we invest in small businesses that have the potential to yield financial returns while also creating quality jobs for residents of lower income communities in California.

In addition to direct investing, **PCV builds the capacity of small businesses** in California—making them ready and able to deploy investment dollars for both financial and social return. In short, we build deal flow, for ourselves and for other impact investors.

Finally, **PCV is the acknowledged leader in researching, analyzing and sharing public policies that create an enabling environment for impact investing.** I would commend to you our report, ***Impact Investing: A Framework for Policy Design and Analysis,*** which has been embraced by the White House as a tool for moving forward in creating impact investing policy. I have brought each of you a copy of the executive summary. The full report—with 16 case studies from 14 countries that are working to encourage impact investing—can be found online.

The most important point to make about policy design in impact investing is that we must consider all elements of the investment equation. Most of the work being done around impact investing is around driving more capital to the space. Policies like the CDFI Fund program and the New Markets Tax Credit program have worked at the federal level to either supply directly or strongly incent the flow of capital to impact vehicles.

And the supply of available capital is important. But ensuring appropriate demand for capital—building quality deal flow where investment will yield both social and financial returns is equally critical. We need more high-potential impact enterprises for investors to deploy capital to.

Beyond supply and demand, helping the two to meet is not as easy as it might sound in the impact investing space. And there is a role for government to help here as well. Investing in underserved markets is generally more labor intensive and thus more expensive. It takes more time to find the deals, more time to underwrite them correctly, to structure the right kind of capital for the situation, ensure that the social return potential is there, and to work with the entrepreneur to make sure the capital is deployed properly so the business grows profitably and sustainably, thereby yielding both social and financial returns.

Thus, government can play a role in three areas of the impact investing ecosystem:

- Government can increase the supply of capital through direct investment or by providing strong incentives—such as tax credits—to investors. In this case, government can be thought of "goosing return" for the private investor. A tax credit makes it much easier for the investor to realize a risk-adjusted market rate of return, one that the underlying business investment would likely not yield absent the credit.
- Government can also play a role in building quality demand--deal flow--so that there are more small businesses with the potential for impact in the investment pipeline. These capacity-building efforts can also be thought of government helping to reduce the perceived risk inherent in impact investments. When entrepreneurs receive guidance, education, access to networks, and expert advice, their businesses are more likely to be on solid growth trajectories, making them better candidates for investment.
- Finally, government can play a role in "matchmaking"—more formally known as intermediation—making it easier for investors and investees to find each other and conclude deals, thus reducing transaction hurdles and costs.

Before I offer some concrete suggestions in each of these areas, I would like to make two overarching comments:

1. **The first has to do with the concept of "place."** Generally, public policies aimed at increasing investment in underserved markets focus on the physical place—usually low to moderate income census tracts. These policies aim to increase the flow of dollars invested in businesses, housing and/or facilities in these census tracts. And this is good—but it is too narrow and overlooks other ways that investments can benefit these same lower income communities. We need to enlarge our thinking from just "investing in" low income communities to "investing for the benefit of" low income communities.

To make this distinction more concrete, consider two possible investments.

- The first is an investment in a start-up technology company that is designing the newest, hippest software. The company employs 15 programmer types. Money is tight. They cannot afford the hip high tech space in SOMA but don't want to be too far away so they locate in the Tenderloin, a low income area. But all 15 employees leave the Tenderloin after work and go home to apartments on Potrero Hill or in Pacific

Heights. As a result, they spend almost no money in the Tenderloin. All 15 of these programmers have college degrees and are off to promising futures—outside of the Tenderloin.

- Now, contrast that investment with an investment in an artisan manufacturer located in the Dogpatch, which has become a higher income neighborhood over the past decade. This company also employs 15 people, most of whom either work in manufacturing, distribution or customer service. These jobs require some training, but not a college degree. Each one of these 15 people works in the Dogpatch, but lives in the Tenderloin. Their combined wages exceed $500,000, all of which goes home with them to the Tenderloin, where much of it is spent and cycles through the economy.

Which investment is having a greater positive impact on the low income Tenderloin? Using place and only place as a proxy for impact investment in underserved communities is convenient and easy—we just have to ask, "is the investment located in a low income census tract?"—but such a narrow definition leaves a lot of enterprises that could have tremendous positive impact in low income neighborhoods outside of acceptable deal flow. Again, we need to think more about investing "for the benefit of" low income communities, and less just about investing "in" these communities.

2. Second**, investors and investees who benefit from a government incentive such as a tax credit must be held accountable to show the impacts of their investments and projects.** When banks undergo a CRA examination, they have to show that their investments benefit low income communities. They have to provide data. Many bankers will tell you that the process is onerous, but over the years, they have figured out how to do it efficiently—just as they have figured out how to make money from CRA-qualified investments. We need to be able to demonstrate that any tax credit or other government expenditure is yielding social impact worthy of tax payer dollars. The process need not be complicated—it could be as simple as requiring investors or fund managers to collect employment numbers from investee companies once per year so we could track job creation. I will not go into excruciating detail here, but collecting impact data alongside basic financial data is the only way we will ever learn what works in impact investing and what doesn't or doesn't work as well. Investors will only provide data if they mandated to do so as a requirement of receiving the tax credit or other incentive.

Before I conclude, I'd like to offer a few thoughts on possible roles for the California state government in each of these three areas, supply, demand and intermediation. As part of these comments, I am going to address COIN, the California Organized Investment Network. I should insert here that I serve as Assembly Speaker Perez's appointee to the COIN Advisory Board.

- Supply development—The COIN program is in place and working, but could use some refinement. This is the first year that the COIN Tax Credit program has been truly competitive—there were applications for more tax credit than there is tax credit to allocate. This is good news—it means the word is finally getting out and it makes for more competition which will yield better applications for better projects. But we need greater clarity about how allocations should be prioritized. And, as I noted above, we need requirements on impact reporting. With clarity and accountability, we can better educate potential investees and investors—insurers, banks and others, at which point, the credit will incent more impactful investments. Ultimately, I would encourage you to consider extending and increasing the tax credit. It's a very effective way to drive capital to CDFIs whose clear mission is investment to benefit low income communities.

- Demand—We need more cost-effective and higher quality technical assistance programs. For the most part technical assistance exists for very, very small businesses, sole proprietors, but these businesses are not candidates for impact investments. They're too small. And, of course, once companies reach a certain critical mass, perhaps $5 million in revenues, they can start to afford some expertise—and they can start to attract the attention of potential impact investors whether with debt or equity, or some combination. But the companies in between tiny and small are often lost in the shuffle. Yet they are the impact investing deal flow of tomorrow. I know I don't have to tell you that half of all businesses fail in the first three years. New, small businesses account for both the majority of job creation—and the majority of job destruction. We have to develop cost-effective ways to reduce small business failures and increase the number that grow sustainably and profitably.

And even as we provide technical assistance and help to build more, better, stronger impact enterprises, we need to help match these enterprises with investment capital. This leads to the third area where the government could help build an impact investing ecosystem in California—intermediation, helping to make transactions happen.

- Intermediation. As some of you may know, Treasurer Bill Lockyer, along with several other western state treasurers and the Rockefeller Foundation, have been involved in creating the West Coast Infrastructure Exchange which enables cities and counties to put forth potential infrastructure projects for partnership with private sector investors. Now, clearly, infrastructure projects are much larger, and there are fewer of them, than impact enterprises, making the intermediary function less complicated. But there is a model here.

  There are programs already in place and under development to make more capital available for investment in California. Both CalPERS and CalSTRS have existing in-state programs and are making concerted efforts to develop programs that invest obviously and primarily for financial return, but also for impact in California. Let's think about how state government might augment those efforts by helping to build deal flow and make it known to PERS and STRS fund managers. Perhaps we need the **California Impact Exchange**.

Finally, to briefly recount my core points:

1. Think about the role of government in building the supply of capital, creating quality demand for capital and facilitating transactions.
2. Expand upon the concept of place. Remember that we are truly investing **<u>for the</u> <u>benefit</u>** of low income neighborhoods.
3. Insist on impact accountability. Impact investing is still relatively new. The only way we will learn about what works for BOTH financial and social return is if we track both.
4. Use existing structures in California. COIN is in place. Leverage it. CalPERS and CalSTRS are working hard to develop and implement investment programs that invest in California. Work with them.

Thank you very much.