

# Why Impact Investing in Frontier & Emerging Markets?

## Summary

The Bill Working Group “Frontier and Emerging Markets” [WG FEM] aims to shed light on the compelling reasons to invest in FEM. We discuss why and how impact investing in FEM represents a promising way to simultaneously generate market-adequate financial returns and impact. We turn our attention to the vast potential involved, while also covering the specific risks.

Forming strategic collaborations with local entities and leveraging local knowledge, utilizing innovative and de-risking financing mechanisms, as well as employing tailored risk management approaches and diversification are key. In this way, investors can adequately navigate the FEM-specific intricacies and investment risks such as currency, market, country, political, regulatory, and other risks.

**Impact investing** differs from conventional SRI or ESG approaches and should meet essential characteristics. They involve investing to generate financial, social, and/or environmental returns, i.e., measurable positive effects in the real world [impact]. The success of impact investments in FEM is measured not only by financial returns but also by tangible social and environmental outcomes.

Our definition of impact investing is informed by the Bill Position Paper #1, “Impact Investing,” which builds on acknowledged actors in the field, such as the Global Impact Investing Network [GIIN], Impact Management Platform [IMP], and academic research. This paper is essential to Bill’s work, and we recommend it for a better understanding of the terms and concepts used.

The sector offers diverse impact-risk-return profiles, from structured microfinance initiatives to groundbreaking investments, tackling concrete social and/or environmental challenges such as biodiversity decline and gender disparities. Furthermore, larger institutional investors are increasingly supported by fund managers and advisors with market- and sector-specific expertise.

Sharing the insights of Bill and WG FEM — a consortium of seasoned experts with a proven track record and deep market knowledge — this paper endeavors to initiate a comprehensive discourse among the investment community regarding the transformative potential of impact investing in FEM.

*No matter whether or not you are already investing in FEM, contact us to discuss, join, and enlarge your network!*

**Frontier and emerging markets** refer to the economic and investment status of countries and their market development, openness, and size. Frontier markets are countries with smaller, less accessible, and less developed financial markets than those with emerging markets. They are in an earlier stage of economic development and may need more market depth, liquidity, and regulatory oversight. Emerging markets fall between developed and frontier markets regarding market development. They have more significant market capitalization, deeper financial systems, and greater accessibility for foreign investors than frontier markets, but they still lack the maturity and stability of developed markets.

# DUAL RETURN POTENTIAL OF IMPACT INVESTING IN FRONTIER & EMERGING MARKETS

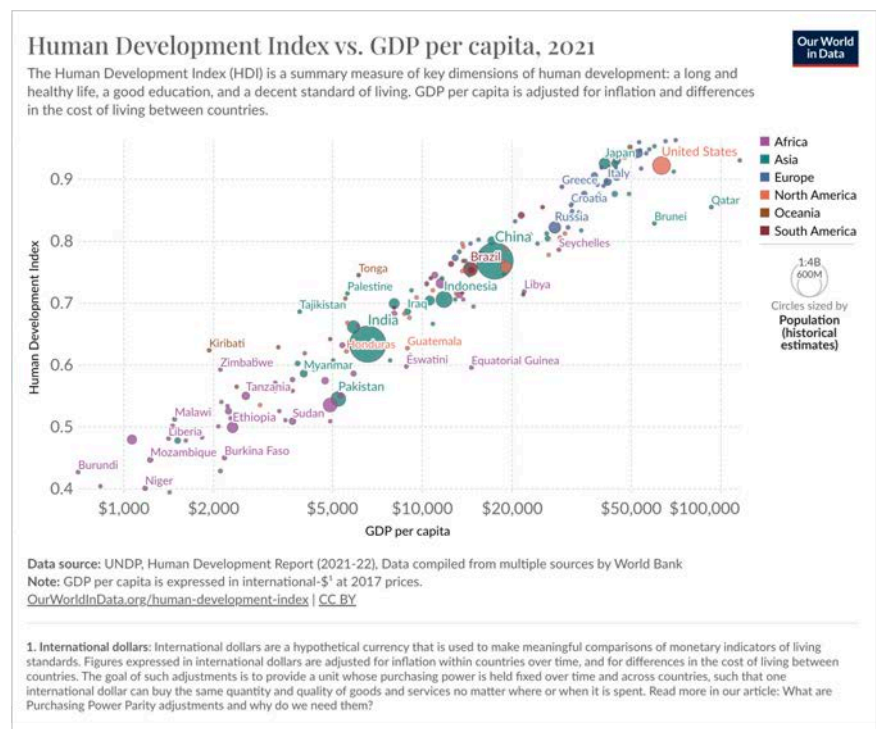
Impact investing leverages the strong correlation of positive socio-economic results with business and market growth in FEM. Its potential to generate financial and impact returns is high, and it unfolds on several levels, as we will outline in the following sections.

## 1. Solving global problems in a connected world — where entrepreneurship, impact and investment capital meet

**Frontier and emerging markets exhibit on average higher levels of poverty, inequality, and less stringent environmental regulations than developed countries.**

This becomes evident from composite indicators included in the Sustainable Development Goals [“the SDGs”] or the Human Development Index [“HDI,” see section Sources & References]. The HDI graph [see graph] visually correlates income levels with human development indicators: In addition to economic metrics like GNI or GDP, which are often seen as a measure of success, the HDI includes environmental and social indicators crucial for human development and well-being. On average, they indicate lower or even alarming levels in FEM [see graph], underlining the urgency for targeted impact investments.

Investing one single euro has the potential to generate a more significant positive impact due to greater needs and lower baselines. To illustrate the potential for impactful entrepreneurship in FEM, consider the case of Kenya’s renewable energy sector, where investment in solar microgrids has not only provided returns but also empowered rural communities with reliable electricity. However, most of the SDGs still need to be on track to



Human Development Index vs. GDP per Capita, 2021 – Source: <https://ourworldindata.org/>

be achieved by 2030. Some have not progressed or even deteriorated [GSDR, 2023], partially because of severe underinvestment. The SDG investment gap has widened to over USD 4 trillion annually [OECD, 2023 and UNCTAD, 2023]. Although this figure may seem huge compared to the 2022 Official Development Assistance [ODA] of USD 0.2 trillion [OECD, 2023], it is not when considering the global sustainable finance market size of USD 5.8 trillion in 2022 [UNCTAD, 2023], or even the international capital market, where several sources<sup>1</sup> have estimated annual investments to be more than USD 200 trillion. Therefore, a massive scale-up of private finance is not only possible and urgently needed — it is also imperative to not miss out on the significant impact and investment opportunities in FEM.

1. For example, the Rockefeller Foundation provided a striking illustration of the funding gap, philanthropic and public development finance, and the global capital market in 2020: <https://www.rockefellerfoundation.org/wp-content/uploads/2020/03/Annual-SDG-Funding-Gap-3.png>; accessed on October 28, 2023.

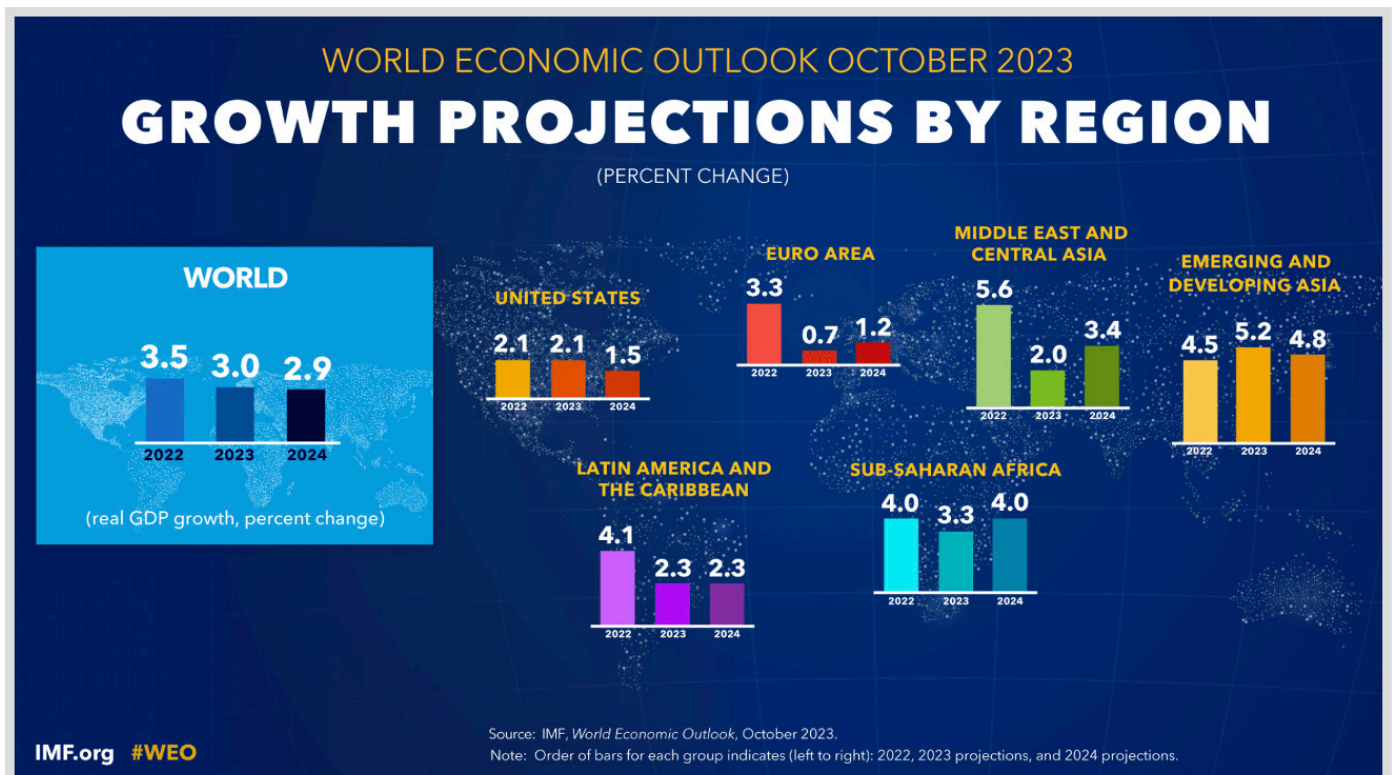
## 2. Challenging the trade-off between impact and financial returns — impact and business can grow together

**Contrary to the common notion that impact investing involves the trade-off between impact and financial returns, we argue that strong risk-adjusted financial returns can be achieved in FEM.**

Experiences from subject-matter experts among WG FEM or development finance institutions [DFIs] support this view: FEM show more investable impact, that is, impact where profitability and impact generation go hand-in-hand. There also exists a growing literature on the financial performance of impact investments. According to the Global Impact Investing Network, “impact investors seeking market-rate returns can achieve them [...], and top quartile funds seeking market-rate returns perform at similar levels to peers in conventional markets” [GIIN, 2017]. In a FEM study, the majority [87%] of investors surveyed [seeking risk-adjusted market returns] found their

“investments meeting or exceeding financial performance expectations” [GIIN, 2019]. However, there are still research constraints and limitations in this relatively young market segment [regardless of FEM]. Small sample sizes, the lack of available and comparable data, and the heterogeneity [different approaches to “impact,” risk appetite, focus on public or private markets, etc.] are yet to be taken into account [Jeffers et al., 2023].

From an academic and macroeconomic perspective, FEM are characterized by a lack of capital combined with structurally higher growth rates [see graph], underscoring the opportunities for investors to capitalize on them. Apart from tapping into this potential for economic development and innovation, providers of the scarce resource of “capital” are more likely to be rewarded than in advanced economies — not in every single investment, but by the law of big figures.



Growth Projections by Region – Source: IMF, *World Economic Outlook*, Update January 2022.

### 3. Focusing on solutions — products & sectors driving sustainable development

**Impact investors provide financing to enterprises and entities that have also been selected through an impact lens. They promote sustainable development in FEM through targeting direct positive effects on several levels:**

**Economic development:** Impact investments can foster economic development by supporting the creation and growth of financially viable businesses (including SMEs) that adhere to sound environmental and social practices. Impact investors often pursue sustainable growth by targeting highly relevant sectors, such as energy (including renewable energy), sustainable agriculture, financial services, and infrastructure. By providing non-financial support, such as technical and managerial expertise beyond the capital [Heeb & Kölbl, 2020], impact investors can further promote sustainability, productivity, and overall economic prosperity.

**Social development & local empowerment:** Most impact investors directly address social issues in FEM. They target enterprises that prioritize social welfare and inclusion and provide, for example, affordable healthcare, education, and financial services, especially to underserved communities. Through improved access to basic services and social well-being, impact investors can reduce poverty and inequalities (e.g., regarding gender) since they are more likely to invest in disadvantaged areas [Cole et al., 2022].

In addition, impact investments that empower local communities through the involvement of local stakeholders can foster local ownership, entrepreneurship, capacity building, and social cohesion, as economic development benefits are distributed more equitably.

Impact investors support establishing and growing enterprises (including SMEs) that provide formal employment and decent work to generate a fair and regular income<sup>2</sup> This is a significant driver of economic and societal transformation in many parts of the world. FEM countries have relatively high self-employment rates due to the lack of diversified economic structures and a considerable informal sector. Many FEM exhibit high population growth rates and rural-to-urban migration. This will increase the natural demand for basic needs such as sustainable food production, adequate healthcare services, education, infrastructure, energy — and jobs.

**Environmental sustainability:** Impact investors can play a vital role in promoting environmental sustainability in FEM. Portfolio companies' investment and impact management will support enterprises and entities that adopt sustainable practices, reduce carbon emissions, or address environmental degradation. Thus, impact investors contribute to mitigating climate change, preserving and restoring natural resources in FEM and globally.

### 4. Capitalizing on current trends — how being the first-mover creates additional opportunities

**Bridging the financing gap as a basis for business growth:** Investing creates an impact by providing funding and financing in underdeveloped financial markets. The lack of consistent access to capital — both in volume and type — is one of the significant obstacles for businesses of all sizes in FEM, and especially for SMEs which play a pivotal role in local development. Enterprises need help accessing even traditional forms of financing, such as bank loans or equity investments, which makes impact investing a desirable option.

**Paving the way for additional investments:** Impact investing acts as a catalyst for attracting further investments in FEM. Once impact-oriented investors and enterprises demonstrate their ability to generate both financial returns and positive social and/or environmental impact, their markets also become attractive to mainstream investors. This increased interest can mobilize additional capital, spurring further economic and social development in these markets and thereby increasing the liquidity of this asset class, making it even more attractive for investor engagement.

2. The International Labour Organization [ILO] defines decent work as “productive work for women and men in conditions of freedom, equity, security and human dignity,” highlighting key aspects such as employment creation, a fair income, social protection, and labor rights.



**Future-proofing businesses by integrating sustainability and regulatory requirements:** The shift in investor sentiment towards integrating more ESG aspects and SRI/ESG investing strategies creates additional opportunities for impact investing. Many Bill members have observed that investees express heightened interest in a collaboration, seeking competent support in implementing sustainability- and impact-related policies and processes.

Apart from purpose or market expectations, rapidly evolving regulatory requirements have mainly driven this new relevance. Comprehensive ESG regulations worldwide aim to direct capital flows towards a sustainable transformation. They strengthen the case for impact investments even further.

## WALKING THE LINE BETWEEN GREAT OPPORTUNITIES AND REAL RISKS

Although impact investing in FEM opens significant prospects for attractive risk-return profiles across various asset classes, it also presents challenges. Investors are well-advised to be very risk conscious though not risk averse. In order to capitalize on the vast opportunities, investment risks — including currency risks, market risks, country risks, political situation, and regulatory and other risks — should be appropriately assessed and balanced. The required expertise and methods for risk management tailored to specific needs already exist and are evolving rapidly, for example:

- Tailored due diligence processes and loan structures, and strategic partnerships with key industry stakeholders to address specific risks in microfinance [such as the risk of default and over-indebtedness in case of a high concentration of borrowers with limited credit history or collateral];
- Access to local business ecosystems and multi-stakeholder networks with well-versed and experienced fund managers to navigate uncertain business and regulatory environments, as leveraged by venture capital [VC] investments;
- Effective use of existing and innovative financial instruments, such as credit enhancement mechanisms in debt markets, structured products/funds, hedging or blending mechanisms, also by DFIs, which are intentionally designed to mitigate risks [de-risk] for private investors.
- First time investors are especially advised to explore strategic partnerships. A network of organizations with a proven track record and deep market knowledge in FEM, as well as experienced experts, can be found at WG FEM and through the more comprehensive Bill network.

## CONCLUSION

Impact investing in frontier and emerging markets [FEM] offers vast potential for creating positive impact at several levels and with attractive risk-return profiles. This applies across various asset classes ranging from tradable, structured microfinance funds to pioneering, impact-linked investments into frontier market start-ups, tackling concrete challenges such as biodiversity, gender, and other critical environmental and social issues. Contrary to common belief, investors can achieve risk-adjusted market-rate returns.

Investors can effectively navigate the intricate complexities by forging partnerships with well-versed stakeholders and local networks, leveraging existing and innovative financing mechanisms.

Through tailored investment and risk management processes, they can effectively manage and diversify FEM-specific investment risks such as currency, country, or regulatory risks.

Bill and WG FEM provide a network of organizations and experienced experts with a proven track record and deep market knowledge in FEM. We look forward to kicking off a broader discussion among investors, turning the attention to the significant opportunities for investors and FEM alike.

If you are already investing in FEM or considering it, reach out to us to talk, connect, and expand your network!

## SOURCES & REFERENCES

The following is a selection of free and open resources which we find useful to encourage data-based discussions in the FEM context:

**The Sustainable Development Goals [SDGs]** are a universal framework adopted by the United Nations in 2015. They define 17 global goals and sub-targets to end poverty, protect the planet, and ensure that all people have the opportunity to live a healthy and prosperous life by 2030. There are many resources on the SDG implementation status. Official sources include [for example] the data and information provided by the United Nations Statistics Division through the SDG Indicators Database [<https://unstats.un.org/sdgs/dataportal>], the user-friendly UN Data Commons for the SDGs platform [<https://unstats.un.org/UNSDWebsite/undatacommons/sdg>], or the Global Sustainable Development Report, produced every 4 years by an independent group of scientists [see references].

**The Human Development Index [HDI]** measures average progress in key dimensions of human development, including composite indicators concerning a long and healthy life, access to knowledge and education, and a decent standard of living. The United Nations Development Programme [UNDP] publishes the HDI, which provides corresponding data and information by region or country: <https://hdr.undp.org/en/content/human-development-index-hdi>.

**The World Bank Group [WB]** is an international financial institution providing financial and technical assistance to developing countries to reduce poverty and promote sustainable development. WB Open Data publishes comprehensive data on development indicators: <https://data.worldbank.org/>

**Gapminder** is a non-profit organization that uses data visualization tools on global trends and patterns, including social and environmental indicators, to promote a fact-based worldview and to combat misunderstandings about international development: <https://www.gapminder.org/>

**Our World in Data** is an online publication that uses data and evidence to provide insights into the world's most pressing environmental and social problems: <https://ourworldindata.org/>

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