

Advancing Practice in Catalytic Capital *Guidance Note 1—The Seeding Role*

MAY 2022

Guidance Note Series



SEEDING



SCALING



SUSTAINING

About FSG

FSG is a mission-driven consulting firm supporting leaders in creating large-scale, lasting social change. Through strategy, evaluation, and research, we help many types of actors—individually and collectively—make progress against the world’s toughest problems.

Our teams work across all sectors by partnering with leading foundations, businesses, nonprofits, and governments in every region of the globe. We seek to reimagine social change by identifying ways to maximize the impact of existing resources, amplifying the work of others to help advance knowledge and practice, and inspiring change agents around the world to achieve greater impact.

As part of our nonprofit mission, FSG also directly supports learning communities, such as the Collective Impact Forum, Shared Value Initiative, and Talent Rewire, to provide the tools and relationships that change agents need to be successful.

Learn more at www.fsg.org.

About Courageous Capital Advisors

Courageous Capital Advisors is an impact investing advisory firm. We believe that financial capital should be used to build a just, equitable, sustainable, and resilient society for all, our North Star. Recognizing that one size does not fit all, we tap a range of financial tools and instruments to combine different types of capital to achieve the impact objectives we seek in order to move us closer to our North Star.

Learn more at www.courageouscapitaladvisors.com.

This work has been commissioned and funded by the Catalytic Capital Consortium (C3), an investment, learning, and market development initiative to promote greater and more effective use of catalytic capital, in recognition of its essential role in realizing the full potential of the impact investing field and achieving the Sustainable Development Goals.



TABLE OF CONTENTS

2 Foreword

4 Introduction

7 The Seeding Role of Catalytic Capital

12 Strategy

19 Underwriting

26 Capital Raising

32 Structure & Terms

37 Conclusion



FOREWORD

The Catalytic Capital Consortium (C3) is excited to partner with the FSG and Courageous Capital Advisors teams on the development of this guidance note, which we hope will provide valuable information and insights to both new and experienced catalytic capital investors. C3 is an investment, learning, and market development initiative to promote greater and more effective use of catalytic capital, in recognition of its essential role in realizing the full potential of the impact investing field and achieving the Sustainable Development Goals. Together, the C3 Strategic Partners—[The Rockefeller Foundation](#), [Omidyar Network](#), and the [MacArthur Foundation](#)—are supporting field-building work through the [C3 Grantmaking Program](#), housed at and managed by the New Venture Fund.

C3 Grantmaking works to advance learning and market development related to catalytic capital and helps to answer critical questions about the scope of the need for catalytic capital, when and how catalytic capital can be most effective, and what tools and practices are needed. It does this through activities aimed at strengthening the evidence base, advancing the practice in the field, communicating and facilitating engagement among investors, and fostering solutions and infrastructure. [Learn more about the various C3 Grantmaking workstreams here.](#)

The first of a series of three publications, this guidance note emerged from a series of conversations with experienced catalytic capital providers (styled as “Learning Labs”) and fund managers, all of whom generously shared their insights, experiences, and expertise with us over several months. This document attempts to capture many learnings pulled out from conversations relating to creative approaches for navigating implementation challenges and crafting success strategies when deploying catalytic capital.

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Each publication will focus on one of the three “roles” catalytic capital can play when supporting an investee, as [delineated by Tideline in 2019](#): *Seeding*, *Scaling*, and *Sustaining*.

Although this first document focuses on the Seeding role, wherein catalytic capital is deployed to funds or other investment vehicles that have novel aspects of their pursued strategy, the proposed structure and investments are considered new, or they are managed by a new investment manager, we think it has implications for other use cases as well.

We hope this offering helps catalytic capital providers incorporate some of these practices into their own investment activities. We also aspire to drive greater awareness and understanding of catalytic capital in action and spur additional conversation in the field to surface other ways catalytic capital can be utilized more effectively, efficiently, and in service of deeper impact.

The other two guidance notes in this series, focusing on the Scaling and Sustaining roles, will be released later in 2022. They will be supplemented by other offerings from our various grant-funded activity streams, including research on past deployment of catalytic capital and contributions to infrastructure that will facilitate increased use of catalytic capital going forward. We are also looking forward to engaging with the catalytic capital community in different ways through the coming months. We are currently working to launch a LinkedIn community of practice where catalytic capital investors can come together to learn from each other and discuss critical questions. To stay in the loop as these additional resources are released and to learn about future opportunities to connect with C3, [please sign up to receive updates and announcements](#) through our newsletter. We are eager to build on this work and welcome dialogue and connections to unlock more catalytic capital and make real progress towards a more just, equitable, and resilient world.



Emily Duma
C3 Grantmaking Program Officer



INTRODUCTION

The impact investing sector has arrived in the mainstream. Major financial services institutions have entered the field, and size estimates of the sector range from \$715 billion¹ to \$2.3 trillion.² While much has been achieved so far, numerous opportunities to deliver impact still fail to attract investment.

Significant capital gaps remain, particularly for opportunities that are new and unproven, are sub-scale, or entail more challenging risk-return profiles—often targeting particularly poor and marginalized communities and geographies. Capital gaps such as these, and the underserved impact needs they signify, are where catalytic capital plays a critical role in advancing the frontiers of impact.

Catalytic capital, as defined by Tideline³, is capital that “accepts disproportionate risk and/or concessionary return to generate positive impact and enable third-party investment that otherwise would not be possible.” Catalytic capital is needed to ensure that impact investing pushes

farther, harder, and faster to reach the full range of solutions that can build a more equitable and sustainable future. Put another way, continuing to grow impact investing *without* catalytic capital runs the risk of leaving those who are most vulnerable

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behind, reinforcing societal inequities, and failing to deflect the current trajectory of catastrophic climate change.

1 Global Impact Investing Network (2020) [2020 Annual Impact Investor Survey](#)

2 International Finance Corporation (2021) [Investing for Impact: The Global Impact Investing Market 2020](#)

3 Tideline (2019) [Catalytic Capital: Unlocking More Investment and Impact](#)

Taking up this important challenge is a growing community of catalytic capital investors who are striving to advance the practice. How can catalytic capital move more quickly and effectively into the right opportunities? How can it best mobilize other capital in that process? How can it better accommodate the needs of the demand side, in pursuit of impact that could otherwise not be achieved? These are some of the questions we seek to address through this work, with the aim of strengthening and accelerating catalytic capital investing practice throughout the field.

About This Document

This guidance note is intended as a practical resource for catalytic capital investors, designed to help them reflect on and advance their practice in deploying catalytic capital.

It is the first of a series of three such notes, each of which focuses on one of the three roles of catalytic capital—Seeding, Scaling, and Sustaining—as defined by Tideline (2019) and explained further on in this document.

This series has a focus on indirect investment (i.e., investors deploying capital into funds and other indirect investment vehicles or platforms), but we hope that much of the discussion is also relevant and helpful for direct investment. Each note in the series seeks to unearth key challenges and barriers to the effective deployment of catalytic capital and lays out several practical responses, accompanied wherever possible by examples of approaches and tools used by experienced catalytic capital investors. These guidance notes are not primarily intended to make the case for catalytic capital, nor to describe the many ways in which it has been deployed in the past or could be deployed in the future.

The central focus of this work is to help catalytic capital investors to address and overcome some of the practical challenges faced with deploying such capital with effectiveness, efficiency, and integrity. The overarching objective is to increase the volume and accelerate the pace of catalytic capital investments.

This note has been developed based on invaluable input from and discussions with leading experienced practitioners in the Seeding role of catalytic capital. Specifically, the authors wish to acknowledge the significant contributions of the following individuals and organizations who participated in the C3 Seeding Learning Lab Series, a series of in-depth peer-learning discussions facilitated by Courageous Capital Advisors, in late 2021:

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- **Aner Ben-Ami**, Founding Partner, Candide
- **Anne-Marie Chidzero**, Chief Investment Officer, FSD Africa Investments
- **Christine Looney**, Deputy Director, Mission Investments, The Ford Foundation
- **Cynthia Muller**, Director, Mission Driven Investment, W.K. Kellogg Foundation
- **Daniel Wanjira**, Strategic Initiatives Analyst, Blue Haven Initiative
- **Debra Schwartz**, Managing Director, Impact Investments, John D. and Catherine T. MacArthur Foundation
- **Dia Martin**, Managing Director, Office of Development Credit, DFC
- **Emma Hawkins**, Investment Manager, Capital Solutions, British International Investment (formerly CDC Group)
- **Greg Neichin**, Managing Director, Ceniarth
- **Kanini Mutooni**, Managing Director, Draper Richards Kaplan, and Senior Executive Advisor, Oryx Impact
- **Margot Kane**, Chief Investment Officer, Spring Point Partners
- **Najada Kumbuli**, Head of Investments, Visa Foundation
- **Rebekah Saul Butler**, Co-Executive Director and Chief Investment Officer, The Grove Foundation

We also thank the following investment managers and related field-building partners for providing vital input into and perspective on this process:

- Amam Ventures
- Aruwa Capital Management
- Beacon Fund
- Collaborative for Frontier Finance
- Echoing Green
- FyreFem Fund Managers
- Global Partnerships
- Impact America Fund
- New Ventures Group
- Reinventure Capital
- Ruthless for Good Fund
- Sweef Capital
- The 22 Fund
- WIC Capital

We would note that the C3 Seeding Learning Lab Series adopted the theme of JEDI (Justice, Equity, Diversity, Inclusion) to provide a focal point for discussions, and readers will see this reflected to some extent in this guidance note. However, we believe that the transaction challenges and responses elucidated in the Learning Lab discussions, and in this guidance note, can be extrapolated beyond the JEDI theme.



THE SEEDING ROLE OF CATALYTIC CAPITAL

This guidance note addresses the *Seeding* role, one of the three roles of catalytic capital, as outlined in Tideline’s 2019 report, with a focus on indirect investments.

In the Seeding role, catalytic capital is deployed to funds or other investment vehicles with one or more of the following:

- ✓ Novel aspects to their pursued strategy
- ✓ Instruments, or a proposed structure, that are considered new
- ✓ An investment manager who is new (a “first-time fund manager”) or has a limited track record

Consequently, these vehicles typically lack performance data, comparables, and proof points with respect to the new aspect of the transaction. This data would usually be required to attract mainstream capital, including impact capital that is deployed with the risk-return expectations and norms conventional in their particular asset class in the mainstream investment market.

Seeding transactions hold the potential for closing capital gaps and achieving impact that otherwise could not be achieved. They also involve a high level of uncertainty (and therefore risk), which dissuades many investors, even when the promise is of market-rate returns or better. And yet, bridging this financing gap is key to proving and building new sectors, markets, and managers, thereby generating a future pipeline of investable impact opportunities, and resolving pressing challenges faced by people and planet. Catalytic capital helps break this impasse by accepting disproportionate risks in entering where others fear to tread, ultimately seeding a wider and deeper range of opportunities for the future.

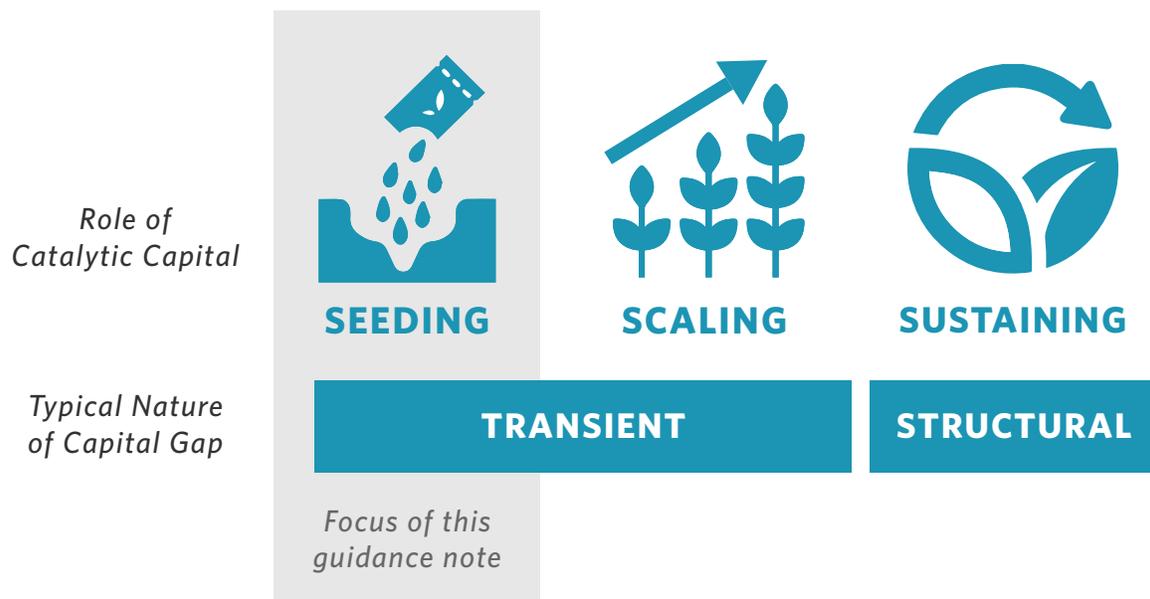
The *Scaling* role picks up where Seeding leaves off. Even after pioneering fund strategies and investment managers demonstrate early success, they can struggle to attract impact and commercial capital, as their track record might still be limited, their size still sub-scale, and the markets they play in relatively underdeveloped. In these cases, catalytic capital can step in to

help strategies and managers scale and expand their business to reach the necessary size and track record to generate broader support.

Meanwhile, the *Sustaining* role of catalytic capital responds to an ongoing (i.e., long-term or permanent) need for concessional returns to be accepted, or disproportionate risk to be absorbed, in order to maintain a focus on serving hard-to-reach beneficiaries or geographies, or otherwise operate a strategy that cannot achieve full commercial viability.

The Seeding and Scaling roles typically come with the implication (or at least an investment thesis) that the capital gap and need for catalytic capital is *transient*—that ultimate success is about closing the gap at the market level such that other impact or even fully commercial investors would be able to pursue similar opportunities down the line *without* needing the involvement of catalytic capital.⁴ In contrast, the Sustaining role typically assumes that the capital gap is *structural*, meaning that it is permanent or at least unlikely to change significantly over the long term.

FIGURE 1. CATALYTIC CAPITAL ROLES AND CAPITAL GAPS



4 The need to bridge these transient capital gaps in impact investing has been documented significantly over the past decade, including work by Monitor and Acumen on the [challenge of the pioneer gap](#), and by Omidyar Network on [priming the pump by taking a sector-based approach](#). More recently, Omidyar Network, FSG, and ImpactAlpha have curated perspectives from leading impact investors (including the Ford Foundation, Prudential Financial, Big Society Capital, and Blue Haven Initiative) articulating why and how they deploy flexible capital to bridge these gaps.

The Challenge of the New

As introduced above, Seeding situations present what one might call “the challenge of the new,” driven by impact-motivated innovation on the demand side of the market. “New” here includes new strategies—including, for example, a focus on unfamiliar demographic profiles, unproven business models and technologies, or underdeveloped markets (sectoral or geographic)—as well as new structures and instruments, or new managers. For example, BIPOC⁵ investment managers are overturning centuries of historical racial marginalization, bringing new understanding and focus to BIPOC communities’ needs and related investment opportunities not previously recognized by the mainstream. Open-end and evergreen vehicle structures are in some cases better at aligning investment time horizons with a realistic timeframe for sustainable growth and impact by enterprises on the ground.

Meanwhile, innovative strategies are pushing into these new areas because they are significantly underserved and therefore represent an opportunity to enable impact that otherwise would not be achieved. This could take the form of supporting new business models in South Asia to deliver high-quality affordable health care that fills the void between unreliable low-price options, on the one hand, and unaffordable premium health care, on the other. It could also take the form of backing new SME financing models to support agribusiness development in remote rural communities in sub-Saharan Africa.

Innovative strategies are pushing into new areas because they represent an opportunity to enable impact that otherwise would not be achieved.

Consider the examples of [Impact America Fund](#), [Reinventure Capital](#), and [The 22 Fund](#), three relatively new early-stage and growth VC investment managers in the United States that emphasize racial equity and target previously overlooked investment opportunities. Impact America Fund invests to increase the economic power of marginalized Black and Brown communities in the U.S.; Reinventure Capital backs BIPOC- and women-led companies across multiple sectors; and The 22 Fund looks to invest in women- and BIPOC-owned, tech-based, export-oriented manufacturing companies creating clean quality jobs of the future in underserved communities. Each includes Black and women professionals in their leadership, and all three are relatively new fund management companies (albeit ones that include experienced investment professionals). An additional layer of innovation can be seen in The 22 Fund’s inclusion of quasi-equity instruments in their investing toolkit to better adapt to the needs and requirements of their investees.

5 Black, Indigenous, people of color

All these new fund managers have faced strong headwinds as they have sought to raise capital. Key challenges reported by managers when speaking to potential LPs included a lack of understanding of their strategies, doubts about the viability of their investment pipelines, difficulty with small fund sizes, a general aversion to new fund managers, and, in at least one case, hesitation in backing a Black-woman-led team. While attention to the theme of investing for racial equity has reportedly improved following the George Floyd protests of 2020, these managers began raising funds several years beforehand—and, of course, the needs being addressed have been around for much, much longer. Moreover, the managers observed that despite this increased attention, relative percentage commitments raised for BIPOC and female managers or founders, vis-à-vis the wider VC community, have not clearly increased in recent years.

Getting Catalytic Capital Flowing

The situations described above—and many others—are prime opportunities for catalytic capital in the Seeding role. While there are many such opportunities and needs out there, what we are hearing from many investors and investment managers is that catalytic capital often moves too slowly and fails to seize opportunities with the urgency and decisiveness needed to address the pressing issues of our day.

From the managers' perspective, the market landscape for catalytic capital is often relatively opaque. It is therefore difficult and costly to navigate, especially for new managers and/or those proposing innovative strategies. Discussions, when entered into, can stretch out for long

periods without clear direction or conclusion, and investors' requirements with respect to the team or strategy track record can be unrealistic for Seeding opportunities, which typically involve newer managers and/or novel strategies.

Even where investor interest has been piqued, structuring, due diligence, and legal negotiations

can end up being long and convoluted processes because of challenges in effective coordination and aligning on terms between fellow investors. This arises particularly in blended finance structures where diverse investor types are participating across the different layers of a capital stack.

As a result, innovative managers face delays, exasperation, or even failure in getting their funds off the starting block. This results in limitations to the flow of capital to new opportunities that advance impact. There are also ramifications further afield: If it falls to catalytic capital investors to pave the way for other investors, these failures will also affect the wider impact investing market, creating blockages in the pipeline of new impact opportunities that the whole market can access. It is vital that the catalytic capital community address these challenges and work to get catalytic capital flowing as it should: effectively and efficiently.

Catalytic capital often moves too slowly and fails to seize opportunities with the urgency and decisiveness needed to address the pressing issues of our day.

In the next four sections, we will set out key challenges and suggested responses informed by our in-depth discussions with experienced catalytic capital investors as part of the C3 Advancing Practice Learning Lab focused on Seeding transactions. In addition, we have conducted interviews with a number of managers who have raised or are in the process of raising Seeding funds to benefit from their views on key challenges in investment processes. As such, these materials are grounded in the experience of practitioners and reflect a shared ambition to work better, faster, and smarter going forward.

The challenges and responses are grouped under the following headings, which we organized by key investment process elements:

A. STRATEGY: Determining strategic objectives for use of catalytic capital and building a community of practice

B. UNDERWRITING: Approaching underwriting effectively and efficiently for all

C. CAPITAL RAISING: Supporting the capital raising process toward a successful and timely conclusion

D. STRUCTURE & TERMS: Designing an efficient structure and enhancing terms negotiations



A STRATEGY

OVERALL CHALLENGE

The objectives and underlying parameters used for catalytic capital transactions are often not clearly articulated by investors, either for themselves or the market; they may have an element of “I know it when I see it.” This can produce internal process frictions or external market confusion—or both—which results in inefficiencies. In some cases, strategies are defined, but in too narrow a way, making it challenging to fit ever-evolving market demands and new investment strategies into institutional objectives. Moreover, there is a tendency to operate in individual silos without coordination or cooperation with other investors, or to cooperate in ways that are not transparent to the market.

All this results in challenges for catalytic investors, other investors, and managers as they navigate the market and seek to form and close deals. Here are some of the specific questions that came up as we engaged with this overall challenge, and various approaches and ideas to address them:

1. Clarity in strategic objectives and parameters

There is often a lack of clarity on the strategic objectives and parameters of investors for their catalytic capital investing. Such lack of clarity may exist *internally*, via definitions and articulations that provide an institution with direction across its specific teams, (e.g., investment team, risk team, impact team, and investment committee), and/or it may exist *externally*, if objectives and parameters are communicated to the market.

Where objectives are articulated, they can stay too general and lack the specificity that would make them easily applicable internally and to other market participants. If an investor is targeting specific capital gaps, what are they? If seeking to achieve additional or different impact from broader forms of impact investing, what is that? If willing to take more risk, how much more, what kinds of risks, and why? If able to tolerate a lower return or loss of capital, what are the thresholds?

APPROACHES

Effective deployment of catalytic capital begins with clear articulation of what it is seeking to achieve and how. Those objectives then need to flow through into investment parameters.

While *internal* clarity helps to foster alignment and smooth processes between different teams (including the investment committee), *external* clarity allows market participants, and managers in particular, to pursue a targeted outreach and have focused discussions with potential investors. Clear objectives and parameters make it easier for managers and fellow investors to assess the “fit” around specific opportunities when trying to design deals and find potential partners.

That said, some investors consciously exercise caution in communication with respect to specific deals, especially in situations where affixing the “catalytic capital” label to a transaction could negatively influence market perception and affect the investee’s ability to raise further capital. For example, this might lead other investors to conclude that the transaction is only seeking catalytic capital and/or not offering market rates of return, when in reality there could be the need for both catalytic and mainstream capital.

There are various ways to articulate one’s catalytic capital objectives and underlying parameters, and the preferred approach can differ depending on the investor type, size, overall impact strategy, or other factors.

Effective deployment of catalytic capital begins with clear articulation of what it is seeking to achieve and how.

One way to frame strategic catalytic capital objectives is to describe a particular *kind* or *level of impact* that is to be achieved. For example, at British International Investment (BII, the U.K.’s official development finance institution, formerly CDC Group), the Catalyst catalytic capital portfolio targets “Enhanced Development Impact,” defined as systemic change at scale. This is achieved by addressing the high risks associated with high uncertainty and first-mover disadvantage to address inclusion and climate sustainability issues (see example on page 15 for more detail). These objectives are then defined with greater specificity within individual strategies; for example, BII’s MedAccess strategy targets specific market failures that restrict patient access to life-changing medical supplies in Africa and South Asia.

Another approach is to target *capital gaps* driven by particular root causes. For example, Spring Point Partners sees its catalytic capital as being focused on addressing capital gaps driven by market inefficiencies, structural barriers, and injustices.

Catalytic strategic objectives may or may not be differentiated from other impact investing activities (either those pursued by the investor or the wider impact investing market). BII also provides an example of an institution differentiating its catalytic investing activities clearly from its other impact investing activities (in this case because BII needed to secure a distinct new

pool of funding from the U.K. government for its Catalyst catalytic capital portfolio). Clear lines have therefore been drawn with respect to impact and financial return expectations between the Catalyst portfolio and BII's mainstream Growth portfolio (see example on page 15 for more detail).

While some investors, like BII, explicitly allocate distinct pools of capital to their catalytic capital versus broader impact portfolios, many other investors do not allocate up front, preserving more flexibility to decide when and how to make catalytic capital investments as they consider opportunities. Meanwhile, some investors have specific allocations that are deployed as catalytic capital but may not be explicitly labeled as such. For example, the Program-Related Investments (PRIs) of U.S. foundations are intended to focus strongly on alignment with mission and are not made based on optimizing financial return or terms.⁶

In summary, **there is no one uniform or correct way** to articulate objectives for a catalytic capital strategy. It is important, though, to strive to be clear and as specific as possible, both internally and externally.

Specificity is also key when defining parameters and decision criteria that underpin strategic objectives. This helps to drive alignment between investment teams and investment committees, and to ensure efficient interactions with other actors in the market. However, we should be clear that specificity should not be confused with narrowness of parameters—parameters that are too narrow can cause problems for deployment of catalytic capital, particularly in the Seeding role.

Relevant investment parameters to define could include:

- ✓ financial parameters (e.g., risk profile, return expectations, loss tolerance),
- ✓ sector/thematic/geographic focus,
- ✓ requirements around impact additionality,
- ✓ what new aspects are to be supported (e.g., first-time fund managers), and
- ✓ preferred “role” in deals (e.g., investor, sponsor, or cocreator).

6 For foundations in the United States, Program-Related Investment (PRI) refers to mission-driven investments that meet a three-part test: a) The primary purpose of the investment must be to further one or more exempt purposes of the foundation, b) The production of income or the appreciation of property may not be a significant purpose of the investment, and c) No electioneering and only very limited lobbying purposes may be served by the investment. For more information on PRI and how it is to be distinguished from Mission-Related Investment (MRI), see [this resource](#) from the law firm Adler & Colvin, from which the above explanation is summarized.

DEFINING OBJECTIVES AND PARAMETERS: British International Investment (BII)

BII (formerly CDC Group) delineates its two investment portfolios, Catalyst and Growth, as follows:

Since 2014, we have operated two portfolios of investments: Growth and Catalyst. Growth is the core of our investment activity. Within the Growth portfolio, our teams look to inject patient, long-term capital into businesses that have the potential to achieve sustainable growth while making a positive environmental, social, and economic impact. Our Growth portfolio currently represents around 90 percent of our investment decisions by value.

The investment process within the Growth portfolio is focused on impact to the same extent as the process within the Catalyst portfolio, it is just that our Growth transactions do not have the same capacity to take on the higher level risk as our Catalyst investments do. We invest through our Catalyst Strategies to shape nascent markets and build more inclusive and sustainable economies. It's an innovative approach to impact we've been following for the last six years to build on British International Investment's 70-year history of investing in emerging markets. Given we're investing in markets where there are few precedents or benchmarks, we take a flexible approach to risk in exchange for pioneering impact.

Yasemin Saltuk Lamy, Deputy CIO of BII, further explains in [ImpactAlpha](#) that Catalyst strategies target opportunities “that can arise where emerging technologies are not yet valued, first-mover disadvantages burden pioneer companies, or collective action problems require coordinated investment across multiple actors before economies of scale can be reached.”

In line with this, BII has defined clear impact and risk-return guidelines and parameters for both Catalyst and Growth strategies for its investment teams. For example, the Catalyst portfolio's loss tolerance parameter is described at a high level in BII's 2022 – 2026 Investment Policy:

[BII] will continue to invest a portion of its capital in highly developmental investment opportunities with challenging risk-return profiles, pursuant to strategies that seek to unlock specific markets that can have significant development impact (the “Catalyst Portfolio”). While the specific parameters of the Catalyst Portfolio in terms of impact objectives and risk-return expectations will be set by the Board from time to time, [BII's] intent is for the loss tolerance of the overall Catalyst Portfolio to be set at 30% of its aggregate investment value over the next five years, 2022 – 2026, and for any losses in the Catalyst Portfolio to be fully funded over time by returns on [BII's] other investments. [BII's] aim is to grow the Catalyst Portfolio over the five-year period such that it reaches 10 – 15% of the NAV of [BII's] total portfolio.

UP-FRONT ANALYSIS:

Visa Foundation

Before committing to its catalytic capital strategy, Visa Foundation conducted a landscape analysis to validate its assumptions around density of opportunity, which would be needed to support its portfolio approach within the strategy. Backed by this, the Visa Foundation was able to proceed with confidence in announcing its strategy and making a specific allocation of catalytic capital to support it.

2. Alignment of strategy with the market

Investors' investment strategies are usually focused on certain target areas and seek to address a specific demand in the market. However, they might not account for all the market realities that shape how Seeding opportunities will present themselves, potentially leading to misalignment over time. For instance, too narrow a focus with respect to target sector, geographic remit, or other dimensions could result in some Seeding funds and managers (e.g., those straddling target and nontarget areas) struggling to fit their investment opportunity into investors' strategies.

These problems are particularly acute in the Seeding role because it relates to newer opportunity areas that are typically not well mapped or understood, and frames defined up front might turn out not to be in line with actual needs discovered in the market.

APPROACHES

Catalytic capital investors should seek to **align their strategies with market realities** and ensure they are fit for purpose up front, to the extent possible.

That said, while up-front market analysis can be helpful, there is likely also **a need for built-in flexibility** as investors progressively improve their visibility and understanding of the market landscape, and as market landscapes and needs evolve. This is particularly true in the Seeding role because of the novel nature of opportunities being addressed. As one investor described it, "It is hard to define the investment universe for new markets. Strategic fit needs to be an iterative process because we are trying to drive change in the markets and find the right partners that can be bold enough to take the steps required."

It is therefore important to ensure that strategies and parameters are **defined in a way that is sufficiently broad and adaptable**, such that they can accommodate a level of

unpredictability and diversity in the opportunities presented by the market without requiring a lengthy overhaul. For instance, foundation investors that are deploying catalytic capital within programmatic frameworks may wish to allow for a wider range of impact outcomes to be recognized, or more diverse ways for them to be achieved (per a Theory of Change or similar framework).

Another approach is to enable **time-efficient adjustments to strategic objectives and/or parameters**, allowing for a periodic reassessment of the market and demand. This should include building in learning loops from an investor's own engagement with the market, as well as market sensing, research, and analysis. For example, in recent years there has been an uptick in interest in gender as a key impact investment theme, as reflected in the strategies of some investors (e.g., Visa Foundation's Equitable Access Initiative, with a \$140 million allocation to investments) as well as in significant fieldwide developments, such as the 2X Challenge launched at the G7 Summit in 2018.

3. Community of practice

Investors can often act in isolation. As a result, market efficiencies and synergies that can flow from effective cooperation on a strategic level remain untapped. When investors do cooperate, it is often not clearly communicated to the market, which results in other players remaining unaware and consequently failing to leverage this opportunity.

APPROACHES

As has been described, catalytic capital investors in the Seeding role typically note that finding and sizing up opportunities takes more effort because of limited market information. One solution to this challenge is for investors to engage in **intentional formal forms of strategic cooperation**. These could include partnerships or platforms

BUILDING INTENTIONAL LEARNING LOOPS:

Ceniarth

Ceniarth is building an intentional learning loop into its catalytic capital strategy process. Together with the Tipping Point Impact Fund, Ceniarth is funding the 60 Decibels Financial Inclusion Index, which is evaluating the ultimate end impact on 25,000 customers of microfinance institutions (MFIs) in terms of access, resilience, management and understanding, household impact, and business impact. For Ceniarth, the primary objective of this study is to test the delineation of their thesis between concessional catalytic and market-rate impact portfolios to inform future strategy and allocations.

WORKING TOGETHER: The Climate Justice Investor Collective

The Climate Justice Investor Collective is a forum established to identify and collaborate on investment opportunities, with the dual purpose of addressing the climate crisis and increasing racial, gender, and/or economic equity. It is managed by Candide Group and includes among its members The Grove Foundation (a founding member), The Schmidt Foundation, and Ceniarth.

Members meet monthly to discuss pipeline and make collaborative decisions about which opportunities to move forward. Candide Group provides support in triaging opportunities and brings in external advisors to weigh in on the equity issues involved.

While each member makes its own investment decisions, the collective helps the members navigate the market effectively and efficiently. Further down the line, members might also cooperate in other ways if seeking to invest in the same opportunities—for instance, by sharing legal processes and costs. This approach also offers benefits to potential investees, which tend to have low capacity to respond to due diligence requests, by streamlining channels of communication with multiple potential investors.

for the development and sharing of pipeline (e.g., around certain sectors or themes), due diligence collaborations (including the use of joint due diligence lists, templates, or questionnaires), or other ways of joining forces in the use of resources and standardized templates and processes within an investment cycle. This cooperation can also help in better navigating otherwise opaque markets for new opportunities, reducing investment inefficiencies and accelerating deal processes for both investors and managers.

Even where investors do not engage in a structured form of cooperation, there are often **informal partnerships and relationships** based on repeated market interactions and participating together in past deals that can be leveraged. In our discussions, catalytic capital investors consistently highlighted the value of such relationships, as the familiarity, understanding, and trust that are engendered through them provide a significant boost to deal-making.

To further improve the value of these relationships for the market, it is helpful for investors to **communicate their typical co-investors**. Letting others in the market know those with whom you have a track record of co-investing enables efficiencies through simplifying the outreach process and identifying potential like-minded co-investors.

While there is scope for such cooperation to make things move faster, it is important to avoid falling into behaviors that effectively extend processes and create delays, such as when investors adopt concerns and challenges from other investors, adding them to their own existing criteria and preferences. This approach also **benefits from designated support resources**—either from one or more participating investors or an intermediary—that can help facilitate the activities central to the intended cooperation.

B UNDERWRITING

OVERALL CHALLENGE

Underwriting investments in the Seeding role means facing unique challenges, as conventional due diligence templates and information asks don't always apply to innovative situations. Too often, lack of flexibility in these requirements results in investors being unable to address the “new” within their existing frameworks.

Beyond the specific problem of underwriting the “new” element of a Seeding transaction, the general underwriting processes can also be long and convoluted. As mentioned above, lack of up-front clarity is a central problem, and often, critical asks are communicated late in the process, leading to unpleasant surprises. In addition, investors can often fail to provide candid and timely feedback throughout the process, leaving managers uncertain about status and having to guess what investors' intentions are.

All of this can result in frustrations and inefficiencies for investors and managers alike. First-time managers are particularly vulnerable here, as they typically lack the financial runway and working capital to sustain a prolonged fundraising process. Here are some of the specific questions that came up as we engaged with this overall challenge, and various approaches and ideas to address them.

1. Pragmatic solutions to address the “new”

Managers are often handed a list of due diligence asks based on standard templates and questionnaires. In Seeding, managers are typically new themselves and/or are pursuing novel strategies or structures. Consequently, they often struggle to produce some of the information that is typically requested for other, more mature deals. A rigid insistence on standard information asks can result in significant delays and costs for the manager, or even the potential failure to close a deal. Typically, any “new” element will require more up-front investor time and effort—and often creativity—to assess and to ultimately reach internal comfort.

APPROACHES

Investors need to pragmatically **adapt their standard due diligence asks** and be flexible where possible within their institutional constraints when it comes to “new” elements. In particular, investors should **be willing to consider proxies** for certain information typically provided by more established managers or for more established fund strategies.

For instance, demonstration of track record is a critical challenge for first-time managers. This is one area where investors can consider alternatives, engaging with the manager and evaluating:

- ✓ performance and deployment track record through relevant synthetic track record of individuals on the team, supplemented by the experience and capabilities contributed by their board and advisors, or the strength of their networks; and
- ✓ team track record through past collaborations between individual team members.

Our discussion with catalytic capital investors also pointed to the need to **prioritize the “lived experience” of managers** in engaging with the communities, issues, and opportunities that are the focus of their strategies, and the importance of making that an explicit value in the underwriting process. This is, at times, as important as the actual investment track record.

Another key challenge for first-time fund managers is in **addressing single-manager concerns and key-person risk**, which tend to be significantly more pronounced in these cases than for more established managers. Possible approaches to increase investor comfort in this regard could include (potentially in combination):

- ✓ extending considerations to the entire governance table (and potential strengthening thereof),
- ✓ taking out life insurance for the key person,
- ✓ engaging a “back-up manager,” and
- ✓ moving certain requirements around the strengthening of the team postclosing.

We acknowledge that there is no one solution that fits all. The key is to have constructive and pragmatic engagement seeking workable solutions.

There can also be **formalized cooperation on addressing due diligence challenges** so as to better serve opportunities beyond the established mainstream. One example from the BIPOC investment space is the Due Diligence 2.0 Commitment (see example on page 21 for more detail), which sets out nine specific practices that break the mold of structural biases built into conventional due diligence standards and expectations.

DUE DILIGENCE 2.0 COMMITMENT

The Due Diligence 2.0 Commitment recognizes that existing financial industry due diligence standards result in institutional assets being managed by the same white, male asset managers who control 98.7% of the market. The commitment has 62 signatories that have pledged to make changes in their due diligence processes around nine dimensions summarized below. Full details are accessible at the Due Diligence 2.0 Commitment website.⁷

- **Consider track record alternatives:** Instead of insisting on minimum track record, evaluate the team based on experience, investment sourcing capabilities, domain expertise, and prior track records in related or relevant work.
- **Expand what it means to work together:** Consider the time the team has worked together also in previous organizations as an indication of team stability.
- **Reassess assets under management as a risk metric:** Instead of considering assets under management as a proxy for a manager's financial stability, consider the manager's history of operating effectively with lower-than-standard budgets, ability to grow momentum, assets under management in previous positions, and provisions in place for underlying investments in the event of insolvency.
- **Respect BIPOC time:** Minimize requests for meeting time with managers and, if possible, convene group meetings to answer questions from multiple investors together. Help managers submit RFIs and RFPs.
- **Contextualize fees:** Compare fees to services provided by peer managers, considering the difficulties of reaching out to impacted communities, and tie future fee reductions to fundraising success.
- **Include historically unrecognized risks:** Consider risks resulting from BIPOC undercapitalization, such as the costs of social unrest, climate mitigation, sickness and productivity losses, and reduced government revenues.
- **Be willing to go first:** Consider being an anchor/seed investor or part of a first close, without asking for lower fees, to contribute to fundraising momentum.
- **Offer transparency about remaining hurdles:** If, after all the previous adjustments, there are still minimum thresholds or deal-breakers, communicate them clearly to managers so they can decide whether to focus on other capital-raising opportunities.
- **Provide detailed feedback:** If the decision is negative, provide clear, specific, and timely feedback regarding the reasons for rejection.

⁷ Source: [Due Diligence 2.0 Commitment](#)

Another helpful approach in overcoming due diligence barriers is exercising **flexibility in** delaying compliance with **certain asks** to the **postclosing period**—in particular, asks that require financial resources, such as the building of a team or developing certain procedures and systems. The possible risks of such a delay could be mitigated by the use of a milestone-based drawdown structure.

An investor could also go beyond their own underwriting information needs and widen their perspective to consider the entire investor table. On this front, an investor could actively sup-

An investor could go beyond their own underwriting information needs and widen their perspective to consider the entire investor table.

port the manager on improving the investment proposition and underwriting package with respect to the “new” factor in particular. This could involve guidance on the fine-tuning of an effective investor pitch and positioning, guidance with respect to procedures and policies, or the sharing of good templates (e.g., policy templates). Such support

can be very helpful in making future processes with other investors smoother.

Another approach to overcoming due diligence impediments for the wider investor table could be **providing pilot funding that allows a proof-of-concept phase**, enabling the manager to build a degree of track record (by confirming the existence of real demand and a viable pipeline, or by demonstrating the team’s ability to work together and find deals). This can take different forms and can be done via different structures (e.g., pre-first-closing funding, warehousing, managed account) and may include investment approval rights.

We acknowledge, however, that such pilots can be difficult for many investors to execute. As an (easier) alternative, catalytic capital investors could provide **for relatively smaller first closings**, enabling Seeding funds to get started on proving out the concept, while future drawdowns remain subject to achievement of certain milestones.

Last but not least, effective **engagement with other investors**, including the sharing of information, assessments, and internal approaches taken, can be invaluable to help unlock and accelerate processes.

2. Clarity on underwriting information needs

Underwriting information requirements are often unclear, and there is a “drip feed” of asks, with important queries sometimes coming late in the process. As a consequence, key issues are often unearthed only toward the end, leading to late process interruptions, and potentially to terminations. Early clarity in Seeding deals, particularly regarding key concerns and “new” factors, is especially important.

APPROACHES

An effective process for catalytic capital investors ideally begins with **internal clarity on their information needs**, with the caveat that certain questions might only come up in the process as the investors get to know more details of a transaction (e.g., with respect to specific risks). Investors should be rigorous in **identifying their must-haves** (i.e., threshold needs) and should differentiate them from their nice-to-haves. Where possible, investors should also distinguish what they need preclosing from what could be provided postclosing, as managers are often cash- and staff-constrained in Seeding situations.

Looking outward, it is helpful to **communicate key needs and asks early** in the process, especially where information gaps are foreseeable. Early communication provides time for such gaps and possible proxy solutions to be discussed and addressed. Importantly, this includes the early identification of insurmountable gaps, avoiding late process terminations. To the extent possible, due diligence should be confirmatory; that is, threshold issues should have already been cleared prior to the full due diligence process. In addition, investors' ability to explain the rationale for specific asks is likely to aid in a constructive and targeted search for feasible proxies and approaches.

We would encourage investors to engage conscientiously with managers as they gather the information needed for each decision step (e.g., pipeline inclusion, screening committee, investment committee), always seeking to be judicious with the manager's time and resources. In Seeding transactions, this awareness is particularly important in the case of young managers, where staffing is typically lean and financial resources limited. Some practical suggestions include the following:

- ✓ **Prepare the manager for the journey up front** by communicating the institution's decision pathway and information needs per decision step.

ENGAGING CLEARLY AND ACTIVELY:

MassMutual and Reinventure Capital

In engaging with Reinventure Capital, MassMutual clearly communicated its must-haves early on, and then actively engaged with the Reinventure team to solve open points and find substitute solutions. The investor ran a full due diligence process, as for any SEC-regulated company, but at the same time worked with the manager to overcome gaps identified through the process.

- ✓ **Be focused on conversations and information asks**, and make clear the rationale for specific asks. Where relevant, clearly differentiate general market intelligence discussions from information needed for the decision process.
- ✓ To avoid unnecessary loops, wherever possible, **provide templates, forms, and concise examples** to the manager, using common, standardized templates and forms shared by other investors.
- ✓ **Coordinate information asks with other investors** where appropriate and feasible.

3. Clarity on process, timely communication, and transparent feedback

Investors' underwriting and decision processes are often opaque from the outside, and changes over time are not effectively communicated to the manager, leading to uncertainty and frustrations. There can often be limited feedback provided along the way, and, as mentioned, important investor concerns are at times only unearthed late in the process. Hesitation on the part of investors to say "no" as clearly or as early as they could often leaves managers stuck in limbo.

In Seeding in particular, the absence of early and candid feedback often means that the manager progresses too slowly (or not at all) up the learning curve and is unable to make any needed improvements to the investment proposition and pitch.

APPROACHES

Beyond the information needs already discussed above, it is helpful if investors **give the manager clarity on the envisaged process** up front or as early as possible. Aspects of this could include:

- ✓ an outline of the internal decision-making process, milestones, and important time parameters;
- ✓ key people involved (including whether there is a continuous point of contact); and
- ✓ any capacity constraints.

As things progress over time, regular and transparent updates should be shared.

The importance of clarity similarly applies to sharing key concerns from the investor side and the internal challenges that they foresee. Throughout the process, it is helpful for investors to **provide transparent, thoughtful, and constructive feedback** to managers. Feedback should be specific and clear and, as feasible, should explain the rationale of the concern, as well as what

is needed to address it. This includes any need for substantive changes to the fund's investment proposition, such as modifications of the objectives or investment strategy. It also includes the communication of cocreation elements, where an investor seeks to participate more deeply in the design and shaping of a fund proposition.

Investors should **work through threshold questions early** and seek to **arrive at a yes/no decision as soon as possible**, at least in principle. To do this, investors need to make key needs and areas of concern clear to the manager as soon as is feasible and engage their respective investment or risk committees early in order to avoid late surprises. Once yes/no decisions have been made, there should be timely communication of these decisions and the supporting rationale to managers, taking steps to differentiate any reasons linked to manager status from those linked to the strategy being proposed.

Finally, throughout the process, investors should seek to **respond in a reasonable amount of time** to manager communications, even if it is only to manage expectations.

THE VALUE OF FEEDBACK: Cambridge Associates

The value of feedback, and the learning and progress it can enable, is underscored by the example of Cambridge Associates taking Impact America Fund II through its rigorous institutional due diligence process to prepare the firm for other institutional investors. Cambridge Associates went on to capitalize on this step by bringing in several clients to participate in the fund's first close.

CAPITAL RAISING

OVERALL CHALLENGE

For managers, capital raising can be a time-consuming and expensive process, which is particularly challenging for the newer and smaller managers who lack alternative income streams. Individual investors and their catalytic capital can help to move the process along in different ways, but they are not always clear and well understood by others around the table. Furthermore, investors often act in their own silos, with each investor running their own due diligence and negotiation without leadership or any meaningful coordination with other investors.

This results in fraught processes whereby the manager spends a great deal of time and energy shepherding investors individually to closing. For the manager, this means a high burden of work for (typically) relatively small deals, unnecessary negotiation loops, and an often sub-optimal result. That said, effective coordination and cooperation are easier said than done, and investors can just as easily trip over each other if this is attempted without clarity around roles (based on each investor's preferences and constraints) as well as processes.

Here are some of the specific questions that came up as we engaged with this overall challenge, and various approaches and ideas to address them.

1. Clarity on catalytic capital powers: terms, timing, and quantum

An investor's capital can catalyze deals through flexibility on *terms*, the ability to be a first mover and commit early to a deal (i.e., *timing*), or the capacity to provide a significant *quantum* of capital that changes transaction dynamics. One might think of these as the "catalytic capital powers" investors could possess and bring to bear on each specific investment. However, these powers are often unclear at the outset of a transaction, at least to the manager. Therefore, managers can at times misjudge the potential behind the capital, leading to suboptimal structures and delayed timelines.

APPROACHES

Clear and early communication of an investor’s catalytic capital powers helps all participants in a deal, but especially the manager. Knowing what an investor’s capital can provide (or cannot) by way of flexibility on terms, timing, or quantum allows the manager to structure the transaction and the capital-raising process more effectively by being able to use the capital to its full potential and, conversely, by being aware of the limits and constraints it has.

When talking about catalytic capital, discussions most commonly revolve around the catalytic use of **terms**; for instance, where catalytic capital investors provide subordinated capital (i.e., equity or junior debt) or guarantees into a capital stack. However, our discussions with investors have also pointed to additional catalytic levers that capital can have—**timing** (i.e., coming in early and allowing the manager to reference the early commitment) and **quantum** (i.e., providing substantial amounts that help managers reach certain thresholds needed to achieve the viability of the fund and a close, or to attract further investors). In Seeding transactions in particular, in addition to the flexibility on terms, the critical importance of these two powers should not be underestimated.

It is always helpful for investors to provide **clarity on their catalytic capital powers in each specific deal situation**. Some investors may also be able to provide such clarity on a strategic or portfolio basis (e.g., some investors can take a first-loss position while others cannot). In general, investors broadly sharing information on their own specific flexibility and constraints is helpful in facilitating targeted outreach and efficient deal structuring. This would mean providing answers to the following: What can one do? What can one not do? Are there certain conditions that allow a power to unfold?

TERMS, TIMING, AND QUANTUM

One example of how quantum can be used catalytically comes from the MacArthur Foundation and its support of Impact America Fund II. The Foundation decided to invest \$7.5 million, which helped total commitments surpass \$30 million, a key threshold for many prospective investors. By providing the fund’s largest single LP investment, MacArthur helped accelerate and unlock additional investment sources that had remained on the sidelines despite significant interest. Ultimately, Impact America Fund II closed with a \$55 million total capital pool.

Another example, showcasing the importance of terms and quantum, is the Global Partnerships Impact-First Development Fund, LLC (IFDF), a debt fund investing in growth-stage social enterprises serving people living below the poverty line, especially women and the rural poor. Global Partnerships contributed \$5 million in fund equity, sourcing \$4 million of that amount in the form of subordinated catalytic debt capital (terms) from Ceniath and the W.K. Kellogg Foundation and \$1 million from Global Partnerships itself, and then secured \$50 million in senior debt from the DFC (quantum).

BEING CONSCIOUS ABOUT INVESTOR CONTRIBUTION:

Candide

Recognizing the important contribution investors can make beyond capital alone, Candide, working with Transform Finance, added an “investor role” section to its impact framework, including in its scoring not only questions like “Did we set the terms?” but also “Did we enable other investors to come in?” and “Did we contribute to the impact approach?”

2. Bringing in more than money

Seeding transactions mostly relate to smaller funds, often run by newer managers that are typically small (sometimes just one person), are mostly less well established and connected, and commonly benefit less from diversified sources of income. Such managers tend to lack a large network and the necessary resources that can help in spurring an efficient and effective capital-raising process.

APPROACHES

In Seeding transactions, it is important that catalytic capital investors consider their ability to support a transaction and manager beyond providing the capital per se. **Support from investors in the form of their expertise and influence** is usually a highly beneficial contribution to a deal. Naturally, up-front clarity on what support an investor is—and is not—able and willing to provide helps with efficient use of such a valuable resource.

Areas of investor contribution that can help catalyze a transaction include the following:

- ✓ **Allowing the manager to use the investor’s name** (e.g., referencing the investor as an engaged first mover)
- ✓ **Reaching out to other prospective investors** and/or engaging directly with them
- ✓ **Sharing due diligence materials**, assessments, and analysis
- ✓ **Engaging in improving the investment proposition** (e.g., fundraising materials, such as the investor deck or financial model; operational setup and staffing discussions)
- ✓ **Providing grant funding to cover preclosing costs or support preclosing improvements** to the investment proposition

- ✓ **Engaging in cocreation** with the manager and other investors

Alongside these, a related point emphasized by experienced investors is **the importance of stamina** from the investor’s side, providing consistent backing of a manager throughout an investment process, and the inevitable challenges and setbacks that come with it.

3. Clarity on ‘leading’ and ‘following’ investor roles

Investors have different positions in a because of to the terms they can provide (including, in blended transactions, the capital layer to which they commit), the size of their investment, and the timing of their commitment. However, too often, regardless of such positions, investors tend to pursue an investment in isolation from others, including due diligence and negotiations.

APPROACHES

It is important that a catalytic capital investor be clear on its relative position in a deal (that is, with respect to terms, timing, and quantum, as described above). In addition, investors should be clear on their internal objectives, needs, restrictions, capabilities, and any potential capacity constraints.

Based on these, each investor should **consider what role it could helpfully play—leader or follower**—in a deal or in elements thereof (e.g., objectives, investment strategy, impact, terms negotiation, aspects of due diligence).

Channeling efforts through the appointment of deal “leaders” on specific transaction elements or topics can help drive efficiency and avoid the problem of simultaneous parallel discussions with multiple investors on the same topics. Furthermore, our discussions with investors highlighted

CONTRIBUTING BEYOND CATALYTIC INVESTMENT DOLLARS

Examples of catalytic capital investors contributing in ways that go beyond their investment dollars include the following:

Ceniarth, DFC, and Spring Point Partners have directly introduced managers to fellow catalytic capital providers (and potentially even share materials) to accelerate the capital raising process and increase the likelihood of success.

Surdna Foundation provided research grant funding to Impact America Fund I ahead of making its investment commitment.

FSD Africa Investments engaged in cocreation of an innovative vehicle, Nyala Venture, providing funding and capacity support to alternative local capital providers to increase financing to small and growing businesses in sub-Saharan Africa.

LEADING FROM SENIOR AND JUNIOR TRANCHES

While precise roles will vary according to the specific circumstances of each deal, our discussions with investors surfaced some key patterns. For example, while deal structure and key terms must be agreed upon by all investors, the largest senior tranche investor(s) can take the lead on detailed documentation and legal due diligence, as they tend to have the most conservative requirements. Meanwhile, for negotiations of strategic and impact objectives, the largest junior tranche investor(s) may seek to take a leading role, as the funding might be provided with strict programmatic requirements (e.g., by a U.S. foundation with PRI).

One catalytic capital investor described the dynamics as follows:

“The senior will lead on the structuring. Subordinated investors can negotiate all they want, but it will not go to a close if senior investors are not on board. But the seniors cannot be at the table without the catalytic capital. If we are delayed in our approval process, the seniors cannot go through their ICs because they need our approvals at hand. We need each other, so understanding that is key. We need to understand the different risk tolerances and objectives of the investors in the stack, and to recognize our own place in the stack.”

the value of acknowledging that different parties can lead on different topics, as opposed to the identification of a single anchor investor. Indeed, it may be wise to remove the term “anchoring” altogether from the catalytic capital lexicon. As one investor shared, “Anchoring implies that we know everything about the deal. It also signals undue control over the fund itself and the other investors, so I hesitate to use that word.”

Once roles are agreed on for any given transaction, they should be respected, and each investor should be consistent in behaving in accordance with its defined role. However, the role an investor takes can obviously change between deals, as circumstances, position, priorities, capacity, and investor combinations change.

4. Effective cooperation with fellow investors

Beyond the challenge of clarifying the roles of leaders and followers, general collaboration (or the lack thereof) is often a barrier to an efficient process. Investors in a deal often tend to focus on themselves without constructive cooperation with other investors, leading to inefficiencies and prolonged transaction cycles. Managers can be left to negotiate on all fronts, struggling to make progress as they try to square the circle with different (and often rigid) investor asks. Notably, this often arises in blended transactions, where different capital layers may pursue different interests.

APPROACHES

Catalytic capital investors looking at a specific investment opportunity could find it helpful to **engage early with potential co-investors** to try to find common ground and workable solutions around the investor table, driving toward an efficient closing of the transaction. They are encouraged to ensure their own requirements are kept to the bare minimum possible, so as to increase the chances of success.

It is important that such cooperation be constructive, seeking to drive to a close, and avoid behaviors where investors add each other's concerns and demands to their own lists, which could effectively increase the aggregate challenges faced by the manager. Investors should also avoid "me too" behavior in asking for certain terms that others have secured, especially where they do not really need them.

To drive efficiency, the manager should be included in investor discussions where feasible; where this is not feasible, the manager should be kept apprised of the discussions.

Where appropriate, investors could investigate setting up **joint processes** on specific topics of a deal, or even use **joint cooperation platforms** or intermediaries to help drive the process (see the example of the Climate Justice Investor Collective on page 18). In due diligence, cooperation could mean **standardized due diligence** questionnaires and information request lists, and/or the sharing of analysis and findings. For legal negotiations, beyond the appointment of distinct leaders discussed above, investors could consider the **appointment of a single lead counsel** for all investors (for each capital tranche in a blended deal) once headline terms are clear; this has the additional benefit of distributing legal costs among those investors.

5. Finding investors in a seamless way

Many managers that do not have multiple fundraising rounds under their belt struggle to find and access investors. In addition, often outreach emails from managers go unanswered.

APPROACHES

As described earlier, it is important that catalytic capital investors **communicate clearly to the market** about their strategic objectives and investment parameters so that there is adequate guidance about what deals they would and would not consider.

When outreach is received, investors should endeavor to **provide timely and clear responses**, whether it is a positive willingness to engage or a "no." If it is the latter, it is helpful for investors to share their rationale for the decision so the manager can develop their market intelligence, improve their search going forward, and potentially sharpen their pitch in future outreaches.

In addition, as discussed earlier, where a catalytic capital investor plays the first-mover role in a deal, it is highly catalytic to permit **the manager to reference them** in further fundraising conversations. Also, catalytic capital investors' **proactive outreach to their fellow investors** within their network to make introductions is usually very helpful, often helping managers to find suitable and aligned investors.

D STRUCTURE & TERMS

OVERALL CHALLENGE

As we noted earlier, one of the key catalytic capital powers is flexibility on terms. However, the negotiation of capital structures and terms, particularly in blended transactions with different capital layers, is often painful and long. With greater flexibility in terms and risk-return expectations comes greater ambiguity: If the different participants in a transaction are departing from conventional norms, there is a greater need to be explicit about each one's own priority terms and risk-return appetite. Where these are unclear between the manager and potential investors, and between each of the potential investors, discussions are likely to be less productive.

This awkward dance around terms and risk-return is all too familiar to catalytic capital players. This phenomenon compounds the already familiar problems of wasted time and effort, but crucially it can also lead to inefficient use of capital flexibility. Catalytic capital is relatively scarce, and it is therefore important that its use be carefully optimized. Of course, this is harder in practice than in theory, as Seeding situations generally lack the historical data required to objectively resolve these questions.

Here are some of the specific questions that came up as we engaged with this overall challenge, and various approaches and ideas to address them.

1. Clarity on risk-return appetite

As discussed earlier, finding the right investor or investors for any given deal is a major challenge. One aspect of the challenge is that the risk-return appetites of investors are often unclear, making it difficult for managers to assess up front the right fit of investors to the investment opportunity at hand. This challenge is especially pronounced with respect to blended transactions (and the search for scarce junior capital, in particular).

APPROACHES

To make the search for investors and the optimal transaction design as efficient as possible, it is helpful for investors to **provide clarity to the market on their institutional risk appetite and the parameters** they use when looking at the risk-return profile of deals, if available. Relevant detail includes information on investor constraints and areas of flexibility; for example, is the investor more interested in risk protection or returns? If possible, parameters should be differentiated according to categories such as asset class, geography, and manager type.

It is also helpful for investors to provide clarity on whether they are a **risk-mitigant “giver” or “taker,” or both**, in the context of any given blended deal, and potentially at the overall portfolio level.

2. Efficient capital structures and ratios

Designing capital structures and ratios in blended transactions is a challenging art. Negotiations tend to be long and bespoke. The outcome is often structures that are not entirely efficient, resulting in scarce risk-taking capital being overused.

APPROACHES

Risk-mitigating capital, such as catalytic capital, is relatively scarce, which means there’s a real need to optimize its use. To engage in efficient sizing and terms considerations, the manager and investors need to first **understand the drivers of demand for such capital** in a transaction, to the extent possible. Drivers typically include considerations with respect to the risks (real and/or perceived) embedded in the investment opportunity, but they can also include specific regulatory needs on the part of one or more investors with respect to risk protection and/or returns.

Based on clarity around specific drivers, a **transparent discussion on the sizing of the capital ratio** can be had, and each identified driver should feed into the sizing of an appropriate capital ratio.

In the case of specific risks, one should seek to quantify them based on available track record and data, and the running of appropriate scenario analyses. That said, Seeding transactions tend to lack information on the “new” elements, so certain assumptions and proxy data will often need to be used. There is an opportunity to delineate the risk analysis in the context of asset classes; for instance, one could recognize that all VC deals have a high degree of risk and uncertainty, while debt transactions could benefit more from analysis of proxies and adjacent data. Meanwhile, with regulatory needs, clarity should be sought on those needs and what is required to effectively address them.

These analyses should seek to **identify the minimum amount of risk-mitigating capital** needed to get the deal over the finish line. The capital ratio analysis should use any available track record (e.g., historic returns or default rates/losses), similar precedent transactions and benchmarks, and other relevant data (see also below on sharing of data).

That said, the process of right-sizing the risk-mitigating capital layer remains challenging, often bespoke, and as much an art—and a process of negotiation—as it is a science. Pragmatically, we acknowledge that managers may, at times, **choose to offer more than the minimum amount required**, as supported by their analysis, in order to offer “no-brainer deals” that can accelerate capital raising or get deals across the finish line, avoiding protracted discussions on capital ratio and risks.

Bridging risk perception differences between investors can be challenging, making **sharing of supporting data and analysis** important in this respect. Beyond underlying data, the sharing of financial models developed can help build better understanding and push for more informed decisions. To be clear, the work of reducing information gaps does not end with the sharing of information from one party; the receiving party needs to commit the time and energy to process the information received. As one investor explains, “a lot of perceived risk can be factually mitigated if investors are willing to take the time to dig into the data.”

Engagement by and with those investors that require risk mitigation in order to participate to establish the minimum baseline is particularly important, as they are the party effectively requesting the risk-mitigating capital to move ahead. Where possible, such investors could consider taking the following actions:

- ✓ **Invest in not only the senior but also the junior capital layer** (if only to a modest level) to align interests more closely with the junior capital providers.
- ✓ **Support the manager in making the case** of the need for risk-mitigating capital to the providers of that capital.
- ✓ **Set out a pathway toward reduction of credit enhancement needed** based on increasing data available or certain milestones (see example on page 35 for more detail).

3. Reducing use of catalytic capital over time

The capital gap in Seeding is typically transient, and the need for catalytic capital should reduce over time. However, there is a tendency for capital ratios to stay flat, as they get transferred over to the next deal, such that there is no progressive reduction in usage of scarce catalytic capital over time.

APPROACHES

From the outset, catalytic capital managers and investors should seek to **clarify the nature of the capital gap** that is being addressed: Is it **transient** (typically due to lack of experience, track record, and/or available data) or **structural** (e.g., originating from end-user economics driven by factors such as affordability)? This distinction is important because structural gaps need much more time and work to overcome (if they can even be overcome at all), whereas transient gaps offer a line of sight to a future where catalytic capital is no longer needed. This might be because a track record has been established for a new manager/strategy, or because a nascent market has become more developed.

Where the gap is understood to be transient, as would be expected in the Seeding role, it can be helpful if catalytic capital investors **engage early in discussion of a transition pathway** with the manager and co-investors, with a view to reducing and ultimately eliminating the catalytic capital need over time. This should clarify and align on what is to be expected, and over what timeframe, and what might be good indicators of progress toward this goal. While typically such considerations are made with respect to follow-on deals, one could also consider integrating a reduction of risk mitigating capital within the life of a fund, subject to performance or milestones reached.

That said, despite the desire for clarity in reduction pathways and the importance of developing such pathways early, in our discussions, catalytic capital investors also acknowledged the difficulty of precisely predicting up front how such reductions would actually unfold over time. Accordingly, as investments get made and a track record built, flexibility is called for in order to adapt the way forward based on what has been learned.

SIZING CAPITAL IN PRACTICE

One catalytic capital investor explains how right-sizing the risk-mitigating capital worked in practice on a deal:

"We asked [the risk-mitigation taker], what do you need to write a large check at that rate? It was not rocket science. After a bit of modeling, they set the leverage ratio that they wanted to get from a first-loss tranche. It was up to us to believe or not if that first-loss tranche would come back to us. We knew the manager's strong track record and their sophisticated approach to risk assessment on a loan-by-loan basis, so we could work with their data and model to decide that it was a good bet."

This investor goes on to explain that the need for risk-mitigating capital is not entirely rational, but hopes that will improve over time:

"The deals are structured thinking about catalyzing senior lender interest, but it can be challenging even with significant first-loss facilities. Perceived risks remain high even though if senior lenders did the math, they would see there is almost no way to lose money on some deals. Certain investments have decades-long track records, yet senior lenders are still overly cautious. Irrational levels of first-loss capital are often what senior lenders want to see, and can work to get them in. While this may not be optimal, it is a tool, and hopefully over time we can rationalize the market."

ALTERNATIVE INCENTIVE STRUCTURES FOR NEW MANAGERS:

Spring Point Partners

In seeking to back new managers with the JEDI (Justice, Equity, Diversity, Inclusion) theme, Spring Point Partners has had to be flexible and pragmatic in ways that go beyond conventional private equity standards. One example was the need to find alternatives to the typical 1% manager commitment that is customarily required in a private equity fund from the manager to align incentives with investors. Such a sizable contribution was not feasible for many of the new managers Spring Point wanted to support, so being inflexible on this point would have made them unable to pursue their JEDI focus.

In response, Spring Point encouraged new managers to develop alternative structures that align incentives without requiring a full 1% manager commitment and worked with their legal partners to create a general acceptance of alternative fee structures when negotiating first-time fund structures.

4. Landing a deal that works for all

Investors typically act in isolation as they seek the “best deal” for themselves, leading to extended negotiations. Moreover, the tendency of issues to arise at the last minute often impedes efficient deal timelines—in particular, in later stages when side letters are drawn up, unearthing new legal requirements and terms.

APPROACHES

Similar to the discussion on underwriting asks, investors need to be clear on what must-have terms they need to prioritize and where they have flexibility, and establish that clarity early on, both internally and vis-à-vis their transaction counterparties. Priority terms should be addressed early, rather than late in the process, and communicated to others with a clear rationale.

Beyond identified priority terms, investors should be flexible, seeking to make the deal—and the execution of the investment strategy—possible. Part of this entails **avoiding the adoption of a “me too” attitude** (i.e., seeking to adopt terms secured by others regardless of whether they are important to the investor itself) and **being willing to flex and compromise** in response to hearing what other investors list as their must-haves.

Also, investors should work with their legal counsel with an eye to **managing legal complexity and costs**. The aim should be to drive toward simplicity; make uniqueness the exception, used only where truly needed.

The bottom line is that there needs to be a shared priority to put together a deal that works for all—the investors and the manager—and ultimately achieves impact objectives for the investees and beneficiaries. This involves not only the negotiated terms per se, but also a timely closing of the deal and getting the money out the door efficiently.



CONCLUSION

The challenges and approaches described above are shared in the spirit of collegueship and common cause in advancing the frontiers of catalytic capital and impact. In laying these out, our intention has not been to deliver strict prescriptions, but, rather, to draw on the collective learning of the field in a way that encourages and supports all those deploying catalytic capital to do so as effectively and efficiently as possible.

Pulling up from the detail of the preceding pages, we see a number of key themes emerging that point the way to advancing catalytic capital practice.

- 1. It's time to break the mold; use new tools for new situations.** Conventional investing practices will continue to stymie new managers and novel strategies, so a more flexible and pragmatic approach is needed. This ranges from the use of appropriate proxies in due diligence to the thoughtful consideration of pre- and postclosing asks. Pilot funding, warehousing, and alternative fee structures are some of the innovative practices that can help to unblock progress, and initiatives like the Due Diligence 2.0 Commitment are galvanizing action across the investor community.
- 2. Clarity and transparency are golden.** In an opaque marketplace, investors being clear on their investment strategy and parameters, internally and externally, helps all actors navigate the market more efficiently. Discussions, once underway, benefit dramatically from clarity on process, information asks, and threshold requirements. Timely and detailed feedback is highly valuable, especially in Seeding situations where propositions and pitches have novel elements that need refinement. And yes/no decisions should be reached as quickly as possible so that managers, who are typically resource-constrained, can focus their time and attention effectively.
- 3. Investors contribute to getting deals done, through and beyond their capital.** While flexibility on terms is the most obvious area for capital to have catalytic “power,” other areas could also be key, such as being a first mover, and committing early to a deal, or providing a

significant quantum of capital that changes transaction dynamics. Investors can also bring their expertise and networks to support outreach to other likely investors and help managers refine their pitches, build their teams, and put policies in place. In some cases, investors could also engage more deeply in cocreating the opportunity with managers.

4. Investing is a "team sport." Working constructively with fellow investors always helps in getting deals done, and this is especially true in Seeding transactions. Sizing up opportunities with novel aspects can be challenging, so taking steps to share available data and models with others can help build a shared and more robust understanding of the opportunity. This can be done on an ad-hoc basis for individual transactions, or through an ongoing structured collaboration (as in the case of the Climate Justice Investor Collective). As deals move toward the finish line, investors around the table can work together intentionally, taking roles as followers or leaders on key aspects of the deal, ranging from impact objectives to legal due diligence.

We believe that the advancement of catalytic capital practice is imperative in a world where impact investing has yet to achieve its full potential, against a backdrop of great need, and where catalytic capital continues to be relatively scarce. While there are no silver bullets contained in this note, we hope to have shared the numerous ways that catalytic capital investors are working better and smarter—within their own institutions, with other investors, and with managers—so that available resources can go farther, and faster, than before.

The approaches described above were drawn from our discussions with seasoned Seeding catalytic capital investors—in particular, from our deeply valued group of C3 Learning Lab participants—as well as from the input of fund managers raising Seeding capital. They are, therefore, grounded in real experience across many deals and diverse contexts. Of course, that also means that this primarily reflects the experience and perspectives of this limited number of investors. It is necessarily a work in progress, a snapshot of the state of this art at one moment in time. We hope that other investors will contribute their own perspectives and suggested practices in response.

We look forward to building on this first guidance note with the next two in this series, and to hearing feedback from—and engaging in discussion with—others across the field. Along with other conversations, publications, and events, including those hosted by the Catalytic Capital Consortium, our hope is that this will stimulate a richer dialogue among catalytic capital practitioners about what it takes to do this well, and lay the foundations for a vibrant and sustained community of practice.

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