

# EXECUTIVE SUMMARY

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

MAY 2022

### Guidance Note Series



SEEDING



SCALING



SUSTAINING



# EXECUTIVE SUMMARY

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 billion to \$2.3 trillion. 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 subscale, 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 ensuring that impact investing pushes farther, harder, and faster to reach the full range of solutions that can build a more equitable and sustainable future. [Catalytic capital](#), as defined by Tideline, 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.”

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 the process? How can it better accommodate the needs of the demand side, in pursuit of impact that could not otherwise 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.

The guidance note summarized here is intended as a practical resource for catalytic capital investors, designed to help them reflect on and advance their practice in deploying such capital with effectiveness, efficiency, and integrity. It is the first of a series of three such notes, each of which focuses on one of the three roles of catalytic capital as defined by Tideline (2019)—Seeding, Scaling, and Sustaining. The note 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.

This note has been developed based on invaluable Learning Lab discussions with leading experienced investors in the Seeding role of catalytic capital, along with input from a range of investment managers and related field-building partners. The authors are deeply grateful to all who contributed.

## The Challenge of the New

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

These vehicles typically lack the performance data and other proof points usually required to attract mainstream capital, including impact capital that is deployed with risk-return expectations and norms conventional in their particular asset class in the mainstream investment market. These are situations with high levels of uncertainty, which dissuades many investors, even when the promise is of market-rate returns or better. By accepting disproportionate risks in entering where others fear to tread, Seeding catalytic capital works to prove and build out new sectors, markets, and managers and to generate the future pipeline of investable impact opportunities.

But this is easier said than done. While there are many opportunities and needs out there, what investors and investment managers tell us is that catalytic capital often moves too slowly and fails to seize opportunities with the urgency and decisiveness necessary to address the pressing issues of our day.

## Key Challenges Faced by Practitioners

Discussions with experienced Seeding investors have illuminated specific challenges facing them as they seek to deploy capital in deals. These are summarized at a high level below, organized by key investment process elements.

### A. STRATEGY

Objectives and parameters for catalytic capital transactions are often not clearly articulated by investors, for either themselves or the market. This can produce internal process frictions or external market confusion—or both. In some cases, strategies are defined but in too narrow a way. There is also a tendency to operate in individual silos without coordination or cooperation. All this results in challenges for investors (catalytic and otherwise) and managers as they seek to navigate the market.

## **B. UNDERWRITING**

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 leaves investors unable to address the "new" within their existing frameworks. Underwriting processes can also be long and convoluted more generally. Often, investors are not clear up front about their needs and process and can fail to provide candid and timely feedback to managers. This results in frustrations and inefficiencies. First-time managers are particularly vulnerable here, as they typically lack the financial runway and working capital to sustain a prolonged fundraising process.

## **C. CAPITAL RAISING**

For managers, capital raising can be a time-consuming and expensive process, which is particularly challenging for 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 these ways 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 where the manager has to shepherd investors individually to closing, resulting in a high burden of work for (typically) small deals, unnecessary negotiation loops, and often suboptimal results.

## **D. STRUCTURE & TERMS**

The negotiation of capital structures, 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, there could be wasted time and effort, as well as inefficient use of scarce catalytic capital.

## Ways to Advance Practice

Our discussions with experienced investors about the key challenges above have also surfaced a number of powerful opportunities to advance practice in deploying catalytic capital.

- ✓ **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 incentive 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. It is also important to prioritize the “lived experience” of managers in engaging with the communities, issues, and opportunities that are the focus of their strategies; this helps break down some of the structural biases built into conventional due diligence standards.
- ✓ **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. 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.

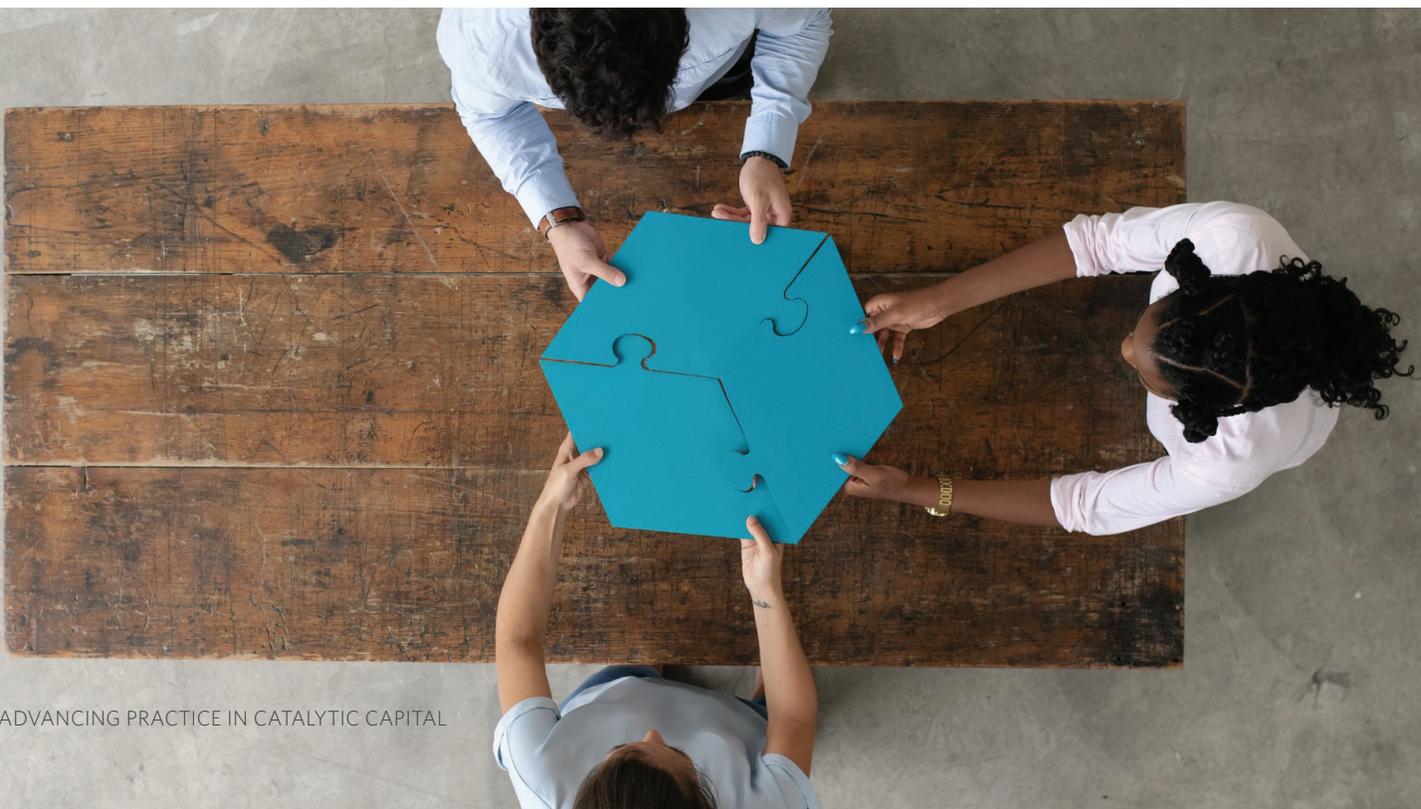
Managers and investors can work toward an efficient capital structure and ratios by understanding the drivers of demand for risk-mitigant capital and identifying the minimum amount of risk-mitigating capital needed to get the deal over the finish line. Discussions should also be had about how to reduce the need for catalytic capital over time, as the capital gap in the Seeding role is typically transient rather than structural.

- ✓ **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 by being a first mover and committing early to a deal, or by 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.

✓ **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).

Each investor could consider what role they 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), which could also be related to their position in the deal (e.g., junior or senior tranche in a blended transaction). As deals move toward the finish line, investors around the table can work together, taking roles as followers or leaders on key aspects of the deal, ranging from impact objectives to legal due diligence.

Grounded in the experience of leading catalytic capital investors, the full guidance note shares more detail, including examples and practical suggestions. We hope this encourages and supports all those deploying catalytic capital to do so as effectively and efficiently as possible, and we look forward to hearing from other investors about their own perspectives and practices as we work together to build the field.



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This work has been produced by FSG and Courageous Capital Advisors working in partnership.

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## 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](http://www.courageouscapitaladvisors.com).

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