EXECUTIVE SUMMARY

Advancing Practice in Catalytic Capital
Guidance Note 2 - The Scaling Role

NOVEMBER 2022
Impact investing is now part of the investing mainstream. Major financial services institutions have entered the field, and size estimates of the sector range from $715 billion\(^1\) to $2.3 trillion\(^2\). Yet while much has been achieved, 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 opportunities they represent, are where catalytic capital plays a critical role in ensuring that impact investing pushes farther, harder, and faster to help build a more equitable and sustainable future.

Taking up this important challenge is a growing community of catalytic capital\(^3\) investors that are striving to advance the practice. How can catalytic capital move more quickly and effectively into impactful opportunities? How can it best mobilize other capital in that process? How can it better meet the real needs of people and planet 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 the catalytic capital investing practice across the field.

The guidance note summarized here is the second 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 set out by Tideline (2019). This second guidance note specifically addresses challenges faced when deploying catalytic capital in the Scaling role.

All three guidance notes within the series are intended as a practical resource for catalytic capital investors, designed to help them reflect on and advance their practice to deploy such capital with effectiveness, efficiency, and integrity. The notes have a focus on indirect investment, but much of the discussion is also relevant for direct investment activity.

The guidance note has been developed based on invaluable input from and discussions with leading practitioners in the Scaling role of catalytic capital that participated in the C3 Scaling Learning Lab Series, a sequence of in-depth peer-learning discussions organized and led by Courageous Capital Advisors. In addition, investment managers provided vital input and perspective. The authors are deeply grateful to all who contributed.

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\(^1\) Global Impact Investing Network (2020) 2020 Annual Impact Investor Survey


\(^3\) For a definition of “catalytic capital” see, for example, Tideline’s report
Scaling: Closing the Transient Capital Gap and the “Multiplier Effects”

The Scaling role of catalytic capital comes into play after pioneering fund strategies and investment managers demonstrate early success. The **progressive closing of a transient capital gap** is a key expectation in the Scaling role. Over the course of what might be described as the “Scaling trajectory”, an impact vehicle would ideally transition from being nascent to being commercially viable.

Along the Scaling trajectory, vehicles will be able to raise increasingly greater volumes of private commercial capital, while gradually reducing their reliance on catalytic capital. It is a central thesis of Scaling that once commercial investors engage and become familiar with investment strategies, sectors and geographies, and once there is sufficient available track record and performance data to support their underwriting, funds active in these areas - or at least segments thereof - are expected to ultimately no longer need catalytic capital support. This progression is illustrated in Figure 1 below.

**FIGURE 1: PROGRESSIVE CLOSING OF THE TRANSIENT CAPITAL GAP**
Both the increasing Scaling trajectory and the decreasing catalytic capital trajectory unfold over time. The lack of smooth and predictable progressions highlights the need for catalytic capital beyond initial signs of success and viability and the importance for it to continue through the Scaling process. The need for such support should wane, though the slope of both trajectories varies from case to case.

Scaling vehicles aim for significant multiplier effects, in that catalytic capital is deployed with the clear intention to:

1. Replicate and scale enterprises and business models at investee level;
2. Replicate and scale (somewhat) tested investment strategies (e.g., follow-on funds);
3. Scale fund managers as they expand their existing or venture into adjusted or adjacent strategies (e.g., target geographies, target population segment, instruments used, etc.); and/or
4. Mobilize private commercial capital for the vehicle and an underlying strategy or sector.

These four multiplier effects are not mutually exclusive, and many Scaling vehicles combine elements of more than one. In particular, the fourth multiplier effect, capital mobilization, is a key enabler within many funds, often through blended finance structures.

The multiplier effects are the pathways to significantly amplify the magnitude and reach of impact solutions. Without the support of Scaling catalytic capital, many effective solutions are doomed to remain niche. They will not be able to generate the magnitude of positive impact ultimately needed to build a more inclusive and sustainable world for all.

Key Challenges Faced by Practitioners when Deploying Catalytic Capital in the Scaling Role

Our in-depth discussions with experienced catalytic capital investors have surfaced a number of key challenges deploying catalytic capital in the Scaling role. The challenges are summarized at a high level below, organized by specific investment process elements. These challenges are laid out in detail in the full guidance note, where suggestions for more effective approaches and behaviors, examples and ideas are discussed and presented.

A. STRATEGY

Objectives and their underpinning risk-return appetites and decision-making parameters, in particular including factors relating to the multiplier effects and blended financing structures familiar in Scaling vehicles, are often not clearly articulated by investors, either internally or with respect to transparent communication to the market. This can result in internal process frictions or external market confusion or both. In addition, many catalytic capital investors are searching for “new” strategies or propositions, and there is often diminished interest in follow-on investments that promise scale. And investors tend to operate in individual siloes, with limited strategic coordination and cooperation with other investors.

In summary, these challenges slow down individual deals, the development of emerging strategies and the general advancement of the catalytic capital community.

B. UNDERWRITING

For Scaling vehicles, there is already some data and track record with respect to previous, similar vehicles and to the relevant sector or market
related to the investment vehicle’s strategy - increasingly so as funds move along a Scaling trajectory. That said, such data remains limited when compared to more mature markets and is often in the hands of a few investors.

Also, underwriting processes can be long and convoluted. Lack of upfront and ongoing clarity is a recurring problem, as investors often offer only minimal guidance on their information needs, processes, timelines, and criteria. Without candid and timely feedback throughout the process, managers may have to guess at investors’ intentions.

When combined with the vehicles’ often-bespoke strategies and frequently complex blended structures, this can extend underwriting timelines, often spanning more than a year, leading to frustrations and ultimately delaying the arrival of funding.

C. CAPITAL-RAISING

For managers, capital-raising tends to be a time-consuming and expensive process. In Scaling deals, which often feature blended structures, it can be challenging to find the right investors for each capital structure component. There tend to be many unanswered questions in the market: who can play where? When can they come in? And at what amounts? The ways in which an investor’s capital can catalyze a transaction is often not sufficiently clear, making it difficult to find scarce funding and optimize its use in a structure. Furthermore, similar to the lack of cooperation on a strategic level mentioned above, investors often act in siloes at a deal level, with each running its own due diligence process and leading its own negotiation without leadership by or any meaningful coordination with other investors. This creates fraught processes whereby the manager spends a great deal of time and energy shepherding investors individually toward a closing.

For the manager, all this means a high burden of work and unnecessary negotiation loops, with often suboptimal results. For investors this means drawn-out processes and often a significant investment of time to close a deal.

D. STRUCTURE & TERMS

Negotiation of capital structures and terms, particularly in blended Scaling transactions, is often painful and long. With greater flexibility in terms and risk-return expectations comes greater ambiguity and complexity: if the different participants in a transaction are departing from conventional norms, there is a greater need to be explicit about each one’s priority terms and risk-return appetite. While there are precedents in Scaling transactions, vehicles still tend to be highly bespoke and hard to compare.

Prolongated discussions on structure and terms exacerbate the already familiar problem of wasted time and effort, but crucially it can also lead to wasteful use of scarce catalytic capital.

Ways to Advance Practice

The full guidance note includes a number of proposed approaches, including real-life examples, practical suggestions, modified behaviors and actionable ideas, for the field of catalytic capital investors that we believe have the power to advance the practice. Some of the key messages from the note include:

1. **1+1=3.** Constructive cooperation and transparent sharing of knowledge and data are key, especially as regards complex blended Scaling transactions, weaving together different investor types with diverging intentions, needs and experience. If we want to achieve meaningful change, investors, led by catalytic capital investors, must get better and smarter in working together, both on a strategic level and on a deal level.
a. **Deal level:** increased constructive collaboration on structuring, underwriting and term negotiation, following the examples set by syndicated loan deals, leads to shortened investment timelines. It helps avoid unnecessary loops and duplication of work. It further leads to improved outcomes, meaning (i) more efficient deal structures, where scarce catalytic capital is used wisely, and (ii) more catalytic and commercial capital crowded in. Both allow for the envisaged scale to be achieved. Our Learning Lab participants have planted ideas and provided tangible examples of ways to enhance collaboration in order to accelerate deal closings and capital flows.

b. **Strategic level:** only through collaboration - between investors and managers alike - can knowledge and learnings be shared and adopted, and relationships of trust be built. If the catalytic capital community seeks to enhance its efficiency and reach, it needs to build communities of practice that work together on sectoral, thematic and geographic focus areas, tapping both informal and structured ways of interacting. Throughout this Learning Lab series, investors have identified actionable ways to form such pockets of active engagement, which will enable the field to grow. There is appetite to build a dynamic community of practitioners that challenge and encourage one another to up their respective catalytic capital investing activities. The intention is to be an inclusive hub that grows its “members” and shares learnings with the wider impact investing universe.

2. **Sharpen the tools.** At the core of all catalytic capital deals is a capital gap. As a community of practice, we need to refine our analysis and understanding of these gaps - from underwriting to structuring - in order to leverage catalytic capital for Scaling transactions effectively. Such analysis cannot be limited to a quick comparison of past capital structures but must go deeper: it needs to identify the drivers behind the need for catalytic capital participation and generate data-driven analyses, including forward-looking market expectations and models, to assess the required capital ratio in any given vehicle.

3. **Hang in there.** To move an initial Seeding fund through the Scaling trajectory to scale - where no further catalytic capital is ultimately needed - stamina is crucial. Ongoing, patient and flexible catalytic capital support is immensely powerful, both through the capital provided and also by the signaling effect to the market, indicating confidence and trust. Together, these contributions accelerate capital-raising and increase the likelihood of attracting new investors. Scale is not achieved overnight through the use of a catapult; rather, it is often a long and strenuous process where investor confidence and familiarity and resulting participation are built over time.

4. **Make room to grow.** As important as stamina is the willingness to support tested and repeat deals. While the “new” is shiny and exciting, it will not change the world without growing to meaningful size and reach. Moreover, it is essential for investors to put their capital to work in response to market need. Underpinning an informed catalytic capital Scaling strategy is a holistic market view and the flexibility to adjust to dynamic and evolving markets.

We encourage the reader to look up and read the full guidance note, which shares much more detail. We hope that catalytic capital investors, both those already active and those aspiring to commence activity, will benefit from some of the messages outlined above and the detailed proposed approaches and behaviors described in the full guidance note. The insights and ideas presented in the full guidance note are intended to accelerate the deployment of catalytic capital in Scaling deals, allowing innovative notions to blossom into maturity, achieving the scale of impact that they seek - and that is needed to contribute to achieving the SDGs.
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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.

This work has been produced by Courageous Capital Advisors, who also designed and led the Learning Lab series.

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.

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Authors

CCA: Laurie Spengler, Leonie Arnoldi, Rizlane Baladi, Harvey Koh

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