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Unlocking capital for social impact across Africa

The State of Innovative Finance in South Africa

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Africa is in the last decade of delivering on the United Nations' 2030 Sustainable Development Goals (UN SDG) targets, and on course to miss or fall short of most of them. The continent needs an additional US$500 billion to US$1.2 trillion annually between now and 2030 to meet these targets. This is despite an annual total revenue mix of about US$650 billion, including US$500 billion in domestic revenue, US$50 billion in aid receipts, slightly less than US$50 billion in foreign direct investment (FDI), and US$60 billion in diaspora remittances.[1]

South Africa's SDG Index Score is 63.7 out of 100, ranking 108 out of 163 countries, and the country is only on track to achieve two SDGs (gender equality and responsible consumption and production) by 2030.[2] Meanwhile, South Africa faces significant social challenges, from rising youth unemployment and increased pressure on utility infrastructure (in sectors such as electricity and water) to unacceptable levels of stunting malnutrition – and traditional sources of social investment funding are rapidly disappearing.

Social investment funding, under which the SDGs fall, has traditionally been sourced from aid, government, and black economic empowerment (BEE)-related funding. Both aid and government funding are in decline, as evidenced by global aid cuts from the United Kingdom (UK) and United States (US) governments over the last five or so years, and under huge pressure, as seen by South Africa's growing public debt trajectory.[3] The loss of funding raises the question, "Where can South Africa source capital to sustainably finance its SDG/social investment needs?"

The private and financial capital markets are a viable source of funding. At about US$450 trillion globally, these markets dwarf the annual US$4.2 trillion required globally to finance the SDGs. The Johannesburg Stock Exchange (JSE) is the leading stock exchange in Africa by market capitalisation, with over US$1.4 billion traded daily (compared to, for example, US$44 million traded daily on the Egyptian Stock Exchange in Cairo).[4] "South Africa also ranks highly on other measures of financial market depth such as private credit as a percentage of GDP, demonstrating that consumers have access to a wider range of financial instruments relative to other African countries."[5]

Despite the availability of all this capital, there are still unacceptable levels of poverty and inequality in South Africa. Significant progress in addressing social challenges will be unlikely without an influx of private capital. Unfortunately, private capital players tend not to look at the social investment space as a potential source of an investable pipeline, mainly because this space is seen to be too risky. Increasingly, though, data tells us that profit and purpose are not mutually exclusive, i.e., that one can do well while also doing good. Mobilising more private capital into the impact space is both urgent and justifiable, if the country aims to meet the 2030 SDG targets.

For this to happen, investors will need to develop new competencies in innovative finance by leveraging the best of two worlds, i.e., the skills and capital of private capital players, and the risk appetite, on-the-ground knowledge and empathy of philanthropy. Innovative financial structures, such as blended finance and catalytic pooled funds, can mobilise flexibly packaged and deployed private capital into the impact space.

However, innovative finance-competent human capital in Africa is a scarce commodity, driven mainly by the lack of appropriate training institutions. Sadly, despite Africa being arguably the largest impact opportunity in the world, the continent has only one institution of learning, namely the University of Cape Town (UCT), that teaches the subject of impact and sustainable finance.

This unacceptable knowledge gap means that the application of innovative financing approaches in mobilising capital for impact in South Africa and the broader continent has gone untapped, leading to a scarcity of capital to meet the continent's social investment needs.

To address this challenge, the first step is understanding the current innovative financing space, including a baseline mapping of where innovative finance is being applied, where it's lacking, and why. These gaps reveal where proven interventions can be scaled, where bottlenecks need to be unlocked, and where additional research is required.

This study aims to provide an expert overview of innovative finance in South Africa's impact investing space. The findings of this mapping study and the recommendations herein should give way to programmatic interventions to open innovative financing opportunities in South Africa, enabling capital mobilisation and deployment at the required speed and scale for the greater good of South Africa's people. The diversity of challenges, the depth of financial markets, and the calibre of tertiary institutions in South Africa greatly position the country to not only become the leading impact economy in Africa, but also act as the global sandbox of innovative finance.

Thank you to the range of experts who contributed their knowledge and time to this study, the FirstRand Empowerment Fund for funding, and our research partner, Deloitte Africa, for conducting the research.

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Executive Summary

Background

In recent years, there has been increased optimism surrounding economic growth opportunities in Africa.[6] However, even though five African economies were identified as the world's five fastest-growing economies in 2019, knowledge and research on business operations on the continent are very limited.[7]

A related narrative concerns the potential of impact investment to contribute to African societal development and environmental sustainability.[8] Innovative finance through impact investment could play a unique role due to the broad range of socioeconomic circumstances and the potential for innovative solutions to address existing problems.[9] The Global Impact Investing Network (GIIN) specifically identifies South Africa, Kenya, Ghana, and Nigeria as ecosystems prime for impact investment, with South Africa being the leader on the continent.[10]

Objectives

The primary objective of this research is to explore the business case for innovative finance and assess the capacity status of innovative finance in South Africa.

This is disaggregated into the following sub-objectives:

- Identifying the state of impact investing and innovative finance in South Africa through desktop research, analysing various documents (including journal articles, reports, newspaper articles, and website pages)
- Interviewing leading stakeholders in the innovative finance sphere to determine the market view on the state of innovative finance and impact investing and extract the perceived challenges and opportunities in this environment
- Providing a benchmark analysis and identifying future areas of research on innovative finance in Africa.

Methodology and approach

Desktop research

A desktop review of the state of development finance and impact investing in South Africa is grounded in reviewing published documents (journal articles, reports, newspaper articles, and website pages), as well as Deloitte resources (such as research and industry insights).

Fieldwork

The case study approach, specifically the multiple case study approach, allows for a deep understanding of a specific phenomenon,[11] in this instance, mapping the key challenges and opportunities offered by the innovative finance environment in South Africa.

The unit of analysis in multiple case studies forms part of the essential research considerations:[12] in this study, leading industry experts in the impact investing and innovative finance space. The inclusion criteria were:

- Leading practitioners in innovative and sustainable finance in South Africa
- Individuals with expert knowledge of the impact investing and innovative finance space.

Primary data was collected via stakeholder interviews. Secondary data in the form of documents (journal articles, reports, newspaper articles, and website pages) supplemented any areas not fully developed or mapped out from the primary data.

Data analysis

A thematic analysis approach was adopted to analyse the data collected from the stakeholder interviews. Thematic analysis is a method used to identify, analyse, and report patterns within the data.[13] This approach is appropriate for extracting data from interviewees' views, opinions, or experiences and mapping out the state of innovative finance and impact investing in South Africa.

Findings

The high-level findings of the research may be summarised as follows:

- South Africa's retirement industry and the big five banks have significant capital and assets available, estimated to be more than ZAR10.4 trillion, 167% of South Africa's nominal GDP in 2021.
- Impact investing can achieve both returns and impact without necessarily forfeiting returns.
- Increasing awareness and education around impact investing are needed to attract more market participants and habituate traditional investors.
- A standardised impact measurement framework is necessary to identify and prevent future impact washing.
- Pressure must be placed on the government to create a favourable regulatory environment for impact investing to enable sustainable financing supporting SDG targets.
- Innovative finance solutions can be used to alter the risk-return profile of impact investments.
- Early-stage impact capital should be leveraged to scale projects, allowing commercial capital to be invested later.
- Challenges in the impact investing space include a lack of standardisation, capital flow, execution, and investor awareness, and a disabling regulatory and macroeconomic environment.

Recommendations

The research identified many areas of improvement and subsequent recommendations. In summary, these include:

- Investing in greater impact awareness and education
- Improved standardisation, impact measurement, and management practices
- A balance of regulatory involvement and market correction.

1. Introduction

Despite South Africa's natural wealth and powerful economy, and likely due to its unique societal and economic challenges, including loss of financial aid, the nation has failed to meet all but two UN SDGs. If the country is to rise to the challenge, funding must be found for social impact projects.

Fortunately, South Africa is prime for impact investment, an innovative financial solution that can draw on the vast private capital invested in the country to help with social transformation in a win-win relationship. Innovative financing can shift the risk of investments away from government and onto private capital providers to make more capital available for key service providers.[14]

Innovative financing approaches aim to generate additional funds by seeking out new sources of capital, enhancing financing efficiency by reducing delivery times, and introducing results-orientated financing methods, where the flow of funds depends on actual results. In essence, innovative financing seeks to raise and use new funds efficiently.[15]

Through primary and secondary research, this study aims to identify the state of impact investing and innovative finance in South Africa. The research includes both documentary analyses and interviews with leading stakeholders in the field, revealing hindrances and opportunities, providing a benchmark analysis, and identifying future areas of research on innovative finance in Africa.

This report is structured as follows:

- Section 2 reviews the literature on impact investing and innovative finance in South Africa.
- Section 3 explains the approach and methodology and describes the primary data collection and analysis that informed this study.
- Section 4 discusses the key findings.
- Sections 5 to 7 provide the conclusions, recommendations, and future research areas.

2. Innovative Finance and Impact Investing in Africa

2.1 Overview: Defining Impact Investing

The GIIN defines impact investments as "investments made into companies, organisations, and funds with the intention to generate social and environmental impact alongside a financial return."[16] The GIIN further defines the core characteristics of impact investing as follows:[17]

- **Intentionality:** Impact investments must intentionally contribute to social and environmental solutions.
- **Financial returns:** Impact investments generally seek a financial return ranging from below market rate to risk-adjusted market rate.
- **Range of asset classes:** Impact investments can be made across the different asset classes.
- **Impact measurement:** investor commits to measure and report the social and environmental performance of the investment.

General market confusion around the definitions of impact investing, sustainable investing, and the environmental, social, and governance (ESG) investment framework is rife. While the two are related, impact investing and ESG (sustainable investing) can be differentiated by the intentionality of the investment. ESG investment refers to a framework applied within the investment management process which specifies environmental, social, and governance criteria against which investors will assess the behaviour of companies to promote sustainable investing. Impact investing improves the ESG framework through intentionality in desired social outcomes, namely social impact. This is particularly the case in Africa, with its significant developmental challenges.[18]

2.1.1 The differences between impact investing and ESG

Table 1 illustrates the four main differences between impact investing and ESG, including the impact thesis, impact measurement, financial returns, and risk considerations.

Table 1: The differences between impact investing and ESG investing

	Impact investing	ESG/Sustainable investing
Impact thesis	An impact thesis states how an investment will lead to a set of pre-determined outcomes, resulting in the organisation achieving a clearly defined impact. The impact thesis acts as a guide to an organisation's decision making.	An impact thesis is not utilised in decision making by ESG investors.
Impact measurement	Impact investors try to measure the level of impact to see if the specified targets within the impact thesis have been met. Similarly, organisations receiving financing are required to report on the impact they achieve with these funds. This process allows for changes to be made, so that the desired impact is a more likely outcome.	ESG measurement is less formal and not a key phase within the investment management process. Furthermore, the social component of ESG generally focuses on internal issues (e.g., working conditions). Although relevant, ESG rarely focuses on the impact an investor or business makes at the community level.
Financial returns	Although some impact investors may be willing to accept reduced financial returns to make a greater impact, returns do not have to be sacrificed to make an impact.	ESG is generally included in an investment management process to ensure more sustainable and elevated financial returns.
Risk considerations	In addition to the risk of generating lower-than-expected financial returns, impact investors must consider the risk of not having the desired impact.	ESG is primarily a screening tool used to identify investment opportunities and manage risks.

Source: African Alliance & Tshikululu Social Investments, 2021

Although impact investing and sustainable investing are often used interchangeably, practitioners in the impact investing market argue that they differ. Impact Investing South Africa has therefore called for a shared terminology and classifications system to clearly distinguish between impact investing and ESG/sustainable investing.[19]

2.1.2 Available impact frameworks

Although there is no standardised approach to measuring and managing impact, a GIIN survey found 62% of respondents claiming to use the IRIS+ catalogue of metrics.[20] IRIS+ is an impact accounting system with a core set of regularly updated metrics that aims to achieve consistency in impact measurement and management. However, there are other available frameworks, including:

- The Sustainable Investment Framework
- Social Accounting and Audit
- Integrated Reporting Framework
- Big Society Capital Social Outcomes Matrix.

Impact Investing South Africa further identified the following four key components that are aligned with emerging good practice and present a robust impact measurement and management (IMM) framework:[21]

- **Design:** Intentionally target investments that positively address social or environmental challenge(s).
- **Measure:** Regularly examine and measure progress against defined impact goals.
- **Manage:** Ensure impact is factored into the decision-making process throughout the investment.
- **Report:** Regularly communicate progress towards impact goals to relevant stakeholders.

In addition to these key components, the GIIN recommends that when reporting, investors must be made aware of both the positive and negative impacts of an investment.[22] Also, the GIIN and Impact Investing South Africa have called for greater harmonisation of frameworks to reduce the confusion and lack of coordination surrounding impact measurement.[23]

2.1.3 Challenges to impact measurement and reporting

Impact measurement is typically conveyed through impact reports. The GIIN highlights a lack of transparency surrounding impact measurement and reporting as a critical challenge facing the impact investing market.[24] Other challenges include the inability to compare impact against a market benchmark, insufficient data collection, hindered analysis and interpretation of the data, as well as the costs associated with collecting data, and measuring and reporting on impact performance. Impact organisations spend an estimated 12% of their total available budget on IMM-related activities, with approximately 50% of these expenses associated with data collection and reporting.[25]

On the positive side, IMM practices generate additional business value for both investors and investees. Through IMM, organisations can identify opportunities for technical assistance and strengthen their marketing strategies. Given that impact is a crucial element of any impact investment, investors must understand the impact performance to compare the project's success against the organisation's set mission.[26]

2.2 The spectrum of capital and target returns of impact investments

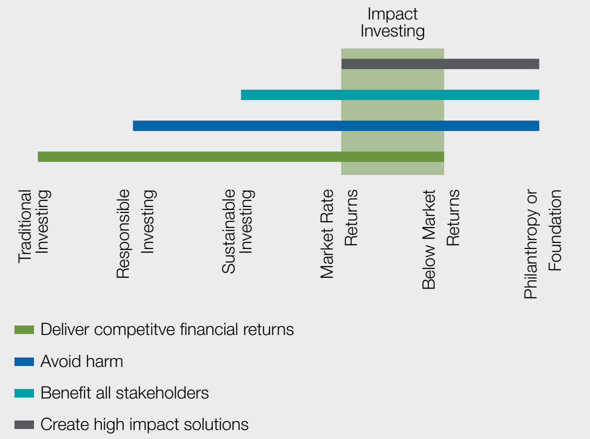
The second core component of impact investing, as defined by the GIIN, relates to financial returns. At one end of the spectrum of target returns, philanthropic or donor foundations address societal issues with little to no expectation of financial return. In contrast, traditional investing aims to maximise financial returns with little to no focus on ESG.

Impact, sustainable and responsible investment lie between the two. While responsible investment aims to maximise returns while avoiding harm, sustainable investment also focuses on benefitting all stakeholders by mitigating either ESG risk or the risk of financial loss.

Impact investments overlap with sustainable investments' aims, also seeking a positive rate of return from their investments.

This spectrum of capital and returns is illustrated in Figure 1.

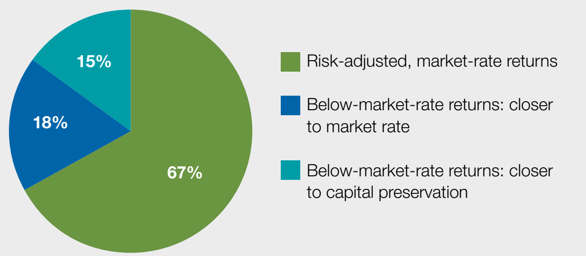
Figure 1: The spectrum of capital



Source: Impact Investing South Africa, 2020

However, different impact investors have different target rates of return, depending on their appetite for risk and their desire to make positive contributions to society through investment. Figure 2 highlights the spread of target returns sought by impact investors according to the Annual Impact Investor Survey conducted by the GIIN in 2020, ranging from below the market rate to the risk-adjusted market rate.[27]

Figure 2: Target financial returns primarily sought by impact investors



Source: GIIN, 2020

Most impact investors (67%) target market-rate returns on a risk-adjusted basis. In addition, according to the Annual Impact Investor Survey, only 6% of large investors[28] seek below-market-rate returns closer to capital preservation compared to 21% of small investors[29] and 13% of medium investors.[30] Therefore, smaller investors are more likely to sacrifice returns for impact. Furthermore, 81% of private equity (PE) focused investors and only 48% of debt-focused investors seek market-rate returns. This suggests that not only does the size of the investor influence the target rate of return for impact investors, but also the type of capital provided.[31]

2.3 The impact investment climate in Africa

The US$4.2 trillion financing required to achieve the 2030 SDGs target has stimulated unprecedented commitment from traditional investors in allocating capital towards these goals.[32] About 1.1% of the estimated US$430 trillion total assets held by banks and institutional asset owners is needed to fund the gap. Understanding the capital allocation to impact investing strategies over the next seven years is crucial as global markets enter a period where action is required.

Africa has witnessed declining levels of official development assistance and rising levels of public debt. This combination has limited African countries' available spending on the SDGs,[33] forcing them to borrow more to meet their financial needs. However, with 30 African countries already spending more on debt repayments than on healthcare, there is a real concern that these countries are accumulating unaffordable debt levels and that the SDGs may never be met.[34]

While it is important to understand the gaps which can be realistically filled by the private sector in years to come,[35] there is no single solution to get Africa back on track to meeting its SDGs: different countries' challenges require different types of financing. Still, all African countries require long-term patient capital, with more capital flowing to smaller projects.

2.3.1 Sizing the market

While the characteristics of impact investing are generally agreed on, investors disagree on the definition and identification of these investments as opposed to ESG, or sustainable investing, for instance.[36] This means that accurately sizing the local and global impact investing markets is complicated. A GIIN study estimates that 1,289 international organisations hold an average investment portfolio of US$485 million in impact assets under management (AUM). However, 34 large outlier organisations appeared to collectively manage US$343 billion in impact AUM, skewing the sample.[37]

In 2020, impact investing attracted an estimated US$65 billion in Sub-Saharan Africa (SSA). ESG, however, captured US$337 billion in SSA.[38] Within Southern Africa, South Africa is the largest market for impact investment, with an active set of domestic South African development finance institutions (DFIs) that fund South African enterprises.[39]

According to Riscura, South Africa accounts for 84% of impact investing assets in SSA;[40] GIIN notes that South African DFIs have disbursed more than US$14.4 billion across 6,800 transactions to South African companies.[41] Broad-Based Black Economic Empowerment (BBBEE) initiatives, aimed at achieving broader participation of previously disadvantaged, particularly black persons, in the South African economy, are closely linked to domestic DFI activity within South Africa. As the impact investing market matures, an accurate estimate of market size is pivotal in ensuring the relevance and significance of impact investing.[42]

2.3.2 The South African legal and policy framework

There are no clear policies specifically applicable to impact investing in South Africa. However, several relevant acts and regulations are applied within the impact investing environment, including the following:[43]

- The BBBEE Act aims to incentivise and facilitate investment in enterprises governed by or that benefit black South Africans, disabled South Africans, South African women, and South African youth.
- The Financial Services Conduct Authority (FSCA), which regulates insurers, pension funds, asset managers, investment schemes, and financial intermediaries, oversees how BBBEE should be considered within an ESG context when these financial parties allocate assets.

In addition, South Africa's National Treasury is currently working on the Sustainable Finance Initiative. The initiative will encourage long-term, sustainable investments, and not just financially reward those that reduce environmental pressure in the short term.[44] And, South Africa's National Development Plan aims to eliminate poverty and reduce inequality by 2030 and is closely aligned with the United Nation's SDGs.[45]

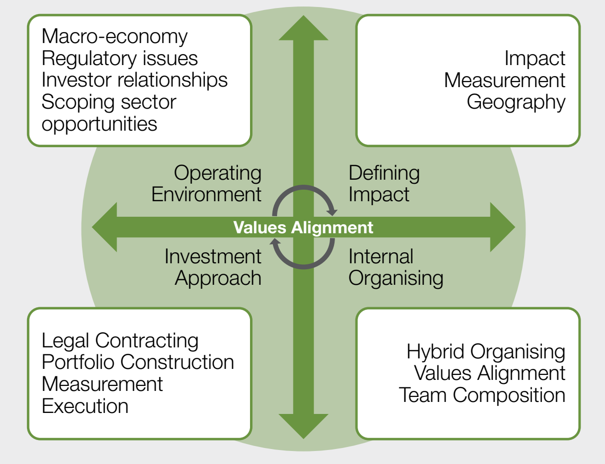
South Africa became the first African country to join the Global Steering Group for Impact Investing (GSG). The South African GSG representatives are decision makers within the public and private sectors working together to identify and address the gaps within the supply and demand sides of impact investing. However, South Africa's approach to policy has been criticised for being too focused on intent, with no clear-cut targets for measuring compliance and for holding anyone accountable in the event of failure.[46]

2.3.3 The challenges to impact investment

A study published in 2021, based on interviews with 15 impact investment leaders in South Africa, asked whether there are financial trade-offs between sustainable investments and financial returns.[47] The study found that of the 15 participants, eight believed there are real trade-offs between financial return and impact. In contrast, seven thought that trade-offs are unnecessary, and tensions are a matter of perception. The study identified three significant challenges that affect the stakeholders' impact investment portfolio: financial risk, impact challenges, and the risk associated with the internal investing team, coupled with the nature of the firms they invested in.

In a highly unequal country with a diverse range of socio-economic issues, the impact challenges of an investment are one of the major concerns for impact investment portfolios. The framework in Figure 3 on managing tensions in impact investment forms part of the study.

Figure 3: A framework for managing tensions in impact investment



Source: Mogapi et al., 2019

In addition, the GIIN has identified the following persistent challenges to impact investment in Africa:[48]

- insufficient investment-ready opportunities
- insufficient human capital
- limited financing in local currency
- limited electrical capacity.

The report[49] emphasises that solutions to these problems must be country-specific, given the unique country dynamics. Meanwhile, high-level solutions include leveraging technical assistance facilities to build a pre-investment pipeline, developing sector specialisation, expanding investment instruments, and establishing a local presence.

2.3.4 Areas of market growth

Two areas of market growth for impact investing are green bonds and corporate impact investing.

Since their inception in 2008, green bonds have become increasingly popular with private and public institutions. Green bonds are financial instruments in which the proceeds finance, or re-finance, green projects. Many are defined as impact investments due to their intentionality and measurement components.[50] However, not all green bonds qualify as impact investments – those which do not have intentionality and measurement at the core are considered responsible or sustainable investments.

In 2020, under the leadership of the National Treasury, the National Business Initiative (NBI) and Carbon Trust began developing a national Green Finance Taxonomy for green, social, and sustainable finance initiatives for the South Africa financial services industry.

The Climate Bonds Initiative argues that South Africa is the ideal candidate for the first coal-based economy in the south to successfully transition to a low-carbon economy.[51] This is due to the country's aging power stations, which cannot meet South Africa's electricity supply needs. Sustainable innovation is desperately required to meet the growing energy demand.

Another key market growth area is corporate impact investing. During the pandemic, global cash reserves held by corporations rose by nearly 32% from the previous year to US$2.15 trillion by end 2020.[52] In 2017, South African corporate cash reserves were estimated to be ZAR1.4 trillion.[53] In recent years, the shift towards productively investing cash reserves, amid stakeholder demands to address climate change and social inequality, has led to increased corporate impact investing. The scale of cash reserves and increasing societal focus to improve inequality is an attractive opportunity for the continued growth of impact investing.[54]

2.4 The need for innovative finance solutions

The body of research on the relative returns of impact investments is limited.[55] Some studies have shown that market-related returns in impact investment are possible; however, they may require de-risking strategies, such as better screening and growth-focused investing.[56] The United Nations Development Programme (UNDP) has found that most investment in the African continent can be seen as having some form of impact due to the substantive need for work opportunities and tax revenue.[57]

However, considering the severe challenges that climate change poses to Africa, the Bertha Centre for Social Innovation and Entrepreneurship[58] argues for increased innovation in financing mechanisms across the continent. Under traditional structures, the impact of investments is seen as an additional extra, rather than being the core on which the investment is built. Instead, the GIIN contends that there is strong demand for impact capital across Southern Africa because of the continent's challenges. At the same time, significant gaps in the provision of essential goods and services create opportunities for investments that meet the needs of disadvantaged populations while also realising financial returns.[59]

2.5 Capital providers

2.5.1 Retirement funds

Available capital

Over 5,100 retirement funds are registered with the FSCA, with an AUM of ZAR3.16 trillion.[60] In addition, the Government Employees Pension Fund (GEPF), which is not registered with the FSCA, and operates under its own law, has an AUM of ZAR1.61 trillion,[61] bringing the total AUM of South African retirement funds to an amount of over ZAR4.87 trillion.

Impact investing

Total investments of retirement funds in small and medium-sized enterprises (SMEs) and small and growing businesses (SGBs) cannot be accurately determined at an aggregate level. However, in 2017, total investments in PE funds accounted for 0.3% of total retirement fund assets, while total investments in other assets only accounted for 2% of total assets of retirement funds registered with the FSCA. This highlights how slowly retirement funds take up a regulatory framework that enables impact investing.[62]

On a positive note, some market participants have professed their support to impact investing as a way of addressing the constraints currently faced by micro, small, and medium-sized enterprises (MSMEs) in accessing capital and have expressed urgency in allocating assets to these sectors in response to the economic impacts of COVID-19. The GEPF has recently set aside 5% of its total assets towards local development, including SGBs, thereby unlocking capital of ZAR80.50 billion towards impact investing.[63]

Considerations

Regulation 28 of the Pension Funds Act aims to protect retirement fund member savings by limiting the extent to which funds may be exposed to a particular asset or class of assets, thereby reducing concentration risk.[64] The maximum investments retirement funds can make in debt instruments to entities not listed on an exchange are shown in Table 2.

Table 2: Regulation 28 limits

Type of debt	Per entity limit	All entities limit
Guaranteed by a South African bank	5%	25%
Issued by or guaranteed by an entity that has equity on an exchange, or debt instruments issued or guaranteed by a public entity	5%	25%
Other debt instruments	5%	15%

Source: South African Government, 2022

It should be noted that the maximum allocation allowed in PE assets in South Africa increased from 10% to 15% on 1 July 2022.[65] Given that most SMEs and SGBs are unlikely to be guaranteed by a local bank or listed company, the maximum allowance for pension funds investing in these organisations is expected to be 15% between all entities and 5% per investment.

A 2020 survey of 49 South African pension funds found that fund managers attempt to strike a balance between sustainability, diversification, and investment return.[66] Larger funds place a greater emphasis on portfolio sustainability than smaller funds. Furthermore, almost all respondents expect sustainable investing to increase in importance over the coming years.

2.5.2 Development Finance Institutions

The South African government has established several DFIs with directives focused on different areas of the local economy. Table 3 summarises the main DFIs in South Africa and their objectives.

Table 3: DFI objectives

DFI	Objective(s)
Industrial Development Corporation (IDC)	Promote economic growth and industrialisation
Development Bank of Southern Africa (DBSA)	Improve social and economic infrastructure Improve regional integration Promote sustainable use of scarce resources
National Empowerment Fund (NEF)	Drive black economic participation
Small Enterprise Finance Agency (sefa)	Foster the establishment, survival, and growth of MSMEs and cooperatives

Sources: UKaid, 2021; sefa, 2022[67]

While the IDC, NEF, and sefa directly support MSMEs, SMEs, and SGBs, developing and investing in MSMEs is not the DBSA's priority. Rather, the DBSA indirectly creates the enabling environment within which MSMEs operate.[68]

Available capital

The strategies of DFIs can be determined by assessing the total assets and the size and frequency of disbursements.[69] Table 4 compares the IDC, NEF, and sefa assets and disbursements.

Table 4: DFI assets and disbursements

DFI	Total assets	Total annual disbursements	Number of annual disbursements	Average annual disbursement
IDC	ZAR143.71bn	ZAR6.30bn	35	ZAR180m
NEF	ZAR7.32bn	ZAR1.05bn	203	ZAR5.17m
sefa	ZAR4.74bn	ZAR1.59bn	72,799	ZAR1.02m

Sources: IDC, 2021;[70] NEF, 2022;[71] sefa, 2021[72]

The IDC has significantly larger total assets, disbursements, and transaction sizes than both the NEF and sefa. However, the IDC owns sefa (a 100% subsidiary) and likely leaves sefa to focus on MSMEs.[73]

Impact investing

Table 5 summarises the different impact investments and plans for impact investing made by DFIs.

Table 5: DFI impact investing

DFI	Objective
IDC	In 2021, the IDC: • Established a small business financing unit to tailor and increase funding for small businesses • Created SME-Connect to leverage large businesses and projects to establish a growth environment for SMEs • Approved new funding of ZAR599m to women entrepreneurs and ZAR92m to youth entrepreneurs • Approved ZAR74m to support social and solidarity economic enterprises and initiatives • Approved ZAR1.4bn for black industrialists.
NEF	Between 2021 and 2022, the NEF has allocated: • ZAR142m to the NEF Women Empowerment Fund • ZAR200m to the COVID-19 Black Business Fund • ZAR150m to the SME Distressed Fund • ZAR150m to the Black Business Manufacturing Enhancement from the Department of Trade, Industry, and Competition (dtic) • ZAR1.135bn to the taxi industry via the Department of Transport and the dtic.
sefa	In 2021, sefa has allocated: • ZAR34.94m to finance over 5,400 MSMEs via the Township and Entrepreneurial Programme • ZAR1.4bn to black-owned enterprises • In total, over 73,000 MSMEs were funded • ZAR0.3bn to youth-owned enterprises • ZAR0.6bn to enterprises in villages and rural communities • ZAR0.6bn to women-owned enterprises • ZAR0.3bn to township-based enterprises • ZAR2.7m to enterprises owned by people with disabilities.

Sources: IDC, 2021; NEF, 2022; sefa, 2021

Considerations

DFIs are generally prepared to take on far higher risk levels than banks or PE. However, the latter strive for self-sustainability and, therefore, must ensure that their profitable investments offset unfavourable ones.[74]

2.5.3 Banks

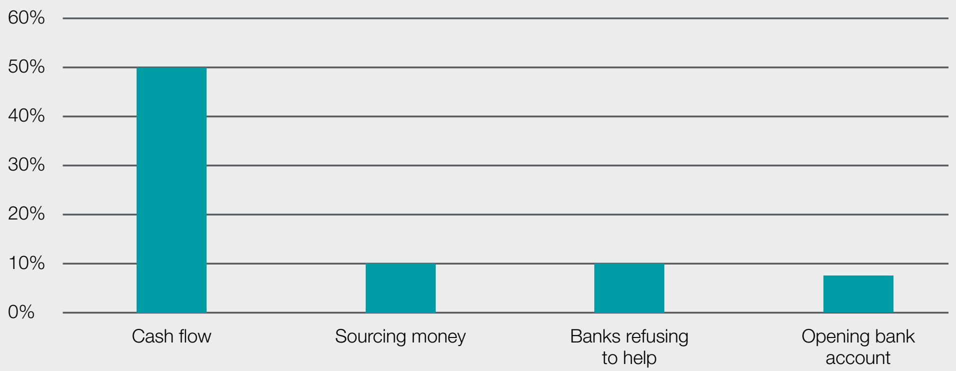
The International Finance Corporation (IFC) estimates the gap in South African MSME financing at approximately US$30 billion and the potential credit demand in the informal sector at US$24 billion (ZAR540 billion and ZAR432 billion, respectively).[75] Banks have the largest pool of capital in South Africa: 5% of South Africa's five largest banks' assets would be enough to fill the MSME financing gap.[76]

FinScope Small Business Survey

In 2020, FinScope conducted a survey of South African MSMEs, finding that 79.9% of MSME owners have access to banking products.[77] In comparison, only 46.9% were found to be banked in 2010 when the same survey was previously conducted, demonstrating a significant increase in the access to banking products for MSMEs in that decade.[78]

The survey also found that 70% of banked businesses utilise personal accounts. Of those businesses that are borrowing money, 35% use personal loans. Furthermore, about a third require financing to grow their businesses, and nearly 70% have experienced financing service problems when they either started or took over the business.[79]

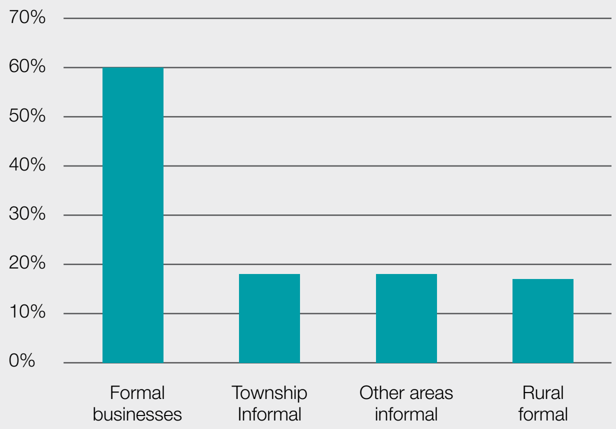
Figure 4: Financing service issues for MSMEs



Source: FinMark Trust, 2020

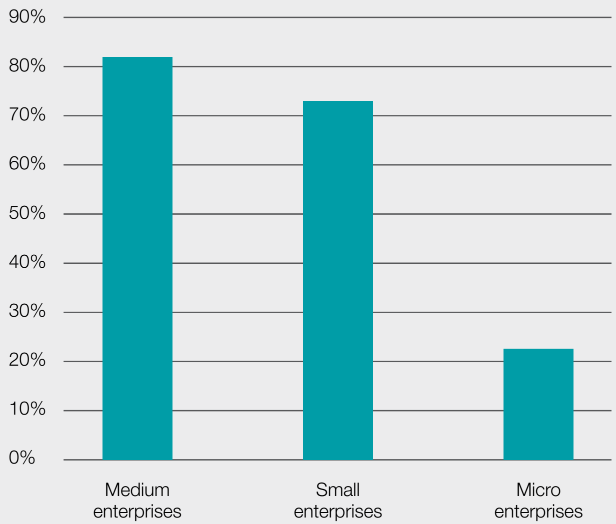
The same survey of small businesses also highlighted MSMEs' lack of access to bank credit, particularly micro enterprises and enterprises operating within the informal sector (Figures 5 and 6).

Figure 5: Access to credit by type



Source: FinMark Trust, 2020

Figure 6: Access to credit by size



Source: FinMark Trust, 2020

Problems with banks financing MSMEs

Banks are heavily regulated and are subject to strict capital and liquidity requirements to ensure the safety and security of depositors' funds and the stability of the entire financial system. Following the global financial crisis (GFC), capital requirements were increased, meaning an increase in the amount of capital banks have to hold and a restriction on the amount of capital that banks can invest.

Due to MSMEs having higher risk ratings than other bank assets, banks must hold more capital, often twice as much, to fund MSMEs.[80] This capital cannot be used to generate income from other assets, which means that banks would require extraordinarily higher returns from the financing of MSMEs to make up for the opportunity cost of not being able to use the additional capital needed to be held.

In addition to the excess capital required to finance MSMEs, the loans MSMEs need are generally far smaller than those sought by larger enterprises. However, the cost of risk assessments is largely fixed. This means that these smaller loans are typically less profitable for banks.[81]

South African banks face additional regulatory barriers, creating challenges when financing MSMEs, including:[82]

- Capping of interest rates under the National Credit Act (NCA), which applies to loans provided to sole proprietorships
- Customer due diligence requiring ID and proof of address that cannot be older than three months
- Know-your-customer restrictions on foreign nationals
- NCA requirement for three months' bank statements, restricting funding for start-ups
- Requirements for surety agreements to be signed in-person rather than digitally
- South African Reserve Bank (SARB) requirement of allocating a high default risk to customers with no credit history.

Impact investing

Banks have teamed up with DFIs to increase MSME financing, using guarantees and blended finance instruments to reduce the risk to banks and the cost associated with the financing arrangement.[83] Some examples of banks teaming up with DFIs include:[84]

- The South African government and local banks created a ZAR200 billion loan guarantee scheme to provide financial relief in response to COVID-19.
- sefa launched its wholesale lending division in 2018, offering banks and financial institutions guarantee schemes. In 2021, its guarantee facilities stood at ZAR395 million. Although banks have supported the government scheme, the level of bank balance sheet participation is still very low at ZAR100 million. In 2021, ZAR306.6 million was disbursed to SMEs through intermediaries and strategic partners.
- The IFC launched its SME Push programme in 2017, providing First National Bank (FNB) with an initial ZAR40 billion loan and a second ZAR1.2 billion facility, as well as incentives to reach women-owned businesses.
- Agence Française de Développement and its private sector financing arm, Proparco, opened up credit lines of EUR1.5 billion (ZAR26.3 billion) and put up EUR900 million (ZAR15.8 billion) as guarantees to support access to credit for MSMEs and start-ups in Africa.
- Banks have given MSMEs the tools to use credit properly by providing their clients with enterprise support or free accounting and invoicing software or other business resources.

2.5.4 Private Equity and Venture Capital

Private equity typically refers to investment funds that purchase and invest in businesses. Venture capital (VC) is a form of PE financing with significant risk involved. Venture funds invest in early-stage start-up companies, with the opportunity for maximum gains, albeit at the highest risk. Typically, 30% to 50% of investments in start-ups fail, between 30% and 50% break even, and between 10% and 20% produce significantly high returns.[85]

Available capital

Although the level of capital available for MSMEs from PE is increasing as the number of investment-ready small businesses increases, the market size remains smaller than other financing providers. In 2021, an estimated total of ZAR36 billion was available for investment in MSMEs, of which ZAR3.5 billion was available for VC.[86]

Constraints

Some of the deterrents to private capital investment in MSMEs include the following:[87]

- Many MSME business plans are poorly devised, with unrealistic business valuations.
- Due diligence may be expensive as a result of the following:
  - low financial literacy and business readiness
  - skills shortages within the MSME sector.
- Investors may be concerned about the owner's incentive to run the business, with many MSMEs being sole proprieties and unwilling to accept additional owners.
- There is a lack of fund managers specialising in MSME investments.

Impact investing

A 2022 survey by the South African Venture Capital and Private Equity Association (SAVCA) found that 94% of PE firms consider ESG factors when making investment decisions, and 82% of firms intend to escalate efforts to track companies' ESG performances within their portfolios. In addition, 75% of firms indicated that their fund managers' key performance criteria are linked to achieving goals beyond financial returns. Furthermore, although only 45% of firms currently have a specific impact investing mandate, 86% of firms without a current impact investing mandate believe that such a mandate will be considered within the next five years.[88]

Enterprise development funds

Enterprise development involves the investment of capital and time to assist with establishing, expanding, and improving businesses. The main goal of enterprise development is to improve economic growth through job creation by building sustainable businesses.[89]

Enterprise development funds have been set up by DFIs, including the NEF, which established a fund to aid MSMEs. In addition, private capital firms have set up enterprise development funds, such as the Nesa Enterprise Development Fund and the Inyosi Enterprise Development Fund.

Table 6: Examples of enterprise development funds

Fund	Nesa Enterprise Development Fund	Inyosi Enterprise Development Fund
Mechanics	Provides working, growth, and expansionary capital to MSMEs as unlisted debt on condition that they meet the outlined job creation, turnover, and black-owned requirements.	Provides working and growth capital as well as asset financing to MSMEs as unlisted loans, short-term borrowing, and other forms of debt on condition that they meet the outlined job creation, turnover, and black-owned requirements.
Highlights	• ZAR27.2m in assets under management • 14 MSMEs supported • 128 permanent jobs created • ZAR27.4m lent out • 14.9% return since inception.	• Provided over ZAR376m in loans to small black-owned businesses in 2021 • Funded 400 micro-enterprises with microfinancing totalling ZAR20m in 2021.

Sources: Nesa Capital, 2022;[90] Inyosi Empowerment, 2022[91]

2.5.5 Summary table

A summary of the different capital providers in South Africa, including retirement funds, DFIs, banks, PE, and VC, is provided in Table 7.

Table 7: Summary of capital providers

Providers of capital	Definition	Players
Retirement funds	The fund accumulates contributions from members and invests these proceeds on behalf of members to provide an income upon retirement. Retirement funds typically have large amounts of capital to invest.	• GEPF • Eskom Pension and Provident Fund (EPPF) • Umbrella funds, e.g., Sanlam, Old Mutual
DFIs	Specialised development banks or subsidiaries aim to provide financial support to the private sector by engaging in development finance activities. These institutions are typically owned by governments.	• DBSA • IDC • NEF • sefa
Banks	Retail and investment banks	• Retail banks • Investment banks
PE and VC	PE typically refers to investment funds that purchase and invest in businesses. VC is a form of PE financing with significant risk involved.	• Investment funds • Venture funds • Enterprise development funds

2.6 Innovative finance

"Innovative financing is an approach to funding enterprises and interventions that optimises positive social, environmental and financial impact. It uses all available financial and philanthropic tools to support the growth of these enterprises, interventions and entrepreneurs and, when the existing tools don't work, it creates new ones".[92]

With a growing number of people worldwide feeling that governments have not delivered their promises, social entrepreneurs have been encouraged to build businesses to address social issues. However, current financial instruments are inadequate to finance these social initiatives.[93]

Innovative finance has emerged as a way of accelerating the mobilisation of the private sector for development and social impact by providing an appropriate mechanism through which investors can simultaneously maximise social impact and financial returns.[94]

New innovative finance instruments differ from traditional grant, debt, and equity financing and include outcomes-based financing, quasi-equity, and innovation life cycle grants. These instruments are designed to treat impact as a core component of capital allocation by:[95]

- changing the cost of capital and return
- enabling outcomes to trigger payments
- allocating monetary value to outcomes.

2.6.1 Variations on debt financing

Impact organisations can access capital via variations of traditional loan terms, for example:[96]

- Adjustments to the payback periods and interest rates are possible, for instance, loans with longer payback periods and/or lower interest rates.
- Organisations (e.g., a local bank) can stand as guarantors for the borrower. This guarantee means the guarantor will repay the loan if the borrower cannot.
- Microfinance institutions (MFIs) offer loans to smaller businesses that struggle to get funding from more traditional institutions.
- Venture debt is a form of risk capital, generally an initial loan combined with equity warrants.

Credit guarantees are utilised in South Africa, including by sefa, which provides MSME financing directly and indirectly through wholesale lending to other institutions. Unfortunately, sefa has reported low repayment levels of MSME financing when clients realise that sefa is providing a credit guarantee: clients are less motivated to repay their loans, seeing the guarantee as a form of government grant rather than a loan. However, interviews with sefa reveal that credit guarantees, or risk assessment subsidies, remain the most effective means of capital allocation to these MSMEs, as they can be used to unlock the added value of private capital, compared to direct investment.[97]

MFIs, registered with the Development Microfinance Association (DMA), disbursed 56,287 loans to the value of ZAR1.1 billion in 2017. However, the microfinance industry faces several challenges, including:[98]

- Poor financial literacy of prospective borrowers
- Lack of identification of prospective borrowers (including birth certificates, identity documents, and proof of address)
- Loans being used for personal consumption rather than productive purposes
- A challenging regulatory environment, with MFIs being subject to the same set of regulations as banks
- A lack of patient capital and access to revolving facilities means that smaller MFIs cannot compete with larger, existing players. As a result, the sector has struggled to grow and has become more concentrated.

Venture debt, another possible avenue to access funding, provides the platform for start-ups to extend their early development, thereby allowing them to increase their valuations before reaching their further rounds of equity investment. This is generally achieved through a financing structure that follows a three-year loan, combined with warrants for company equity.[99]

2.6.2 Variations on equity financing

Equity financing includes all capital and resources provided to enterprises in exchange for a share of ownership. There are some variations on traditional equity financing, including quasi-equity and business incubators.[100]

Quasi-equity or revenue-participation agreements have characteristics of both debt and equity. The borrower receives a loan without giving up any ownership of the enterprise and agrees to pay back the loan on the company's performance.[101] The amount paid back is normally capped, either by a fixed amount or over a certain repayment period. The benefit of quasi-equity is that the borrower is not subject to a strict loan schedule in terms of timing and amount, which allows for easier cashflow operations.[102]

Business incubators assist and guide early-stage enterprises by providing financing, networking opportunities, business and technical assistance, and access to facilities. Young enterprises can survive their early years and develop into fully operational businesses in exchange for shared ownership of the business.[103]

2.6.3 Grant funding

Venture philanthropy is a long-term investment approach, financing organisations to help maximise their impact.[104] Venture philanthropy investors generally seek a return on only a small portion of their portfolio, often extensively using grants, or a combination of grants with equity or debt, to support their invested companies.[105]

These investors apply three core practices to assist impact organisations:[106]

- Choosing the most appropriate financial instrument(s) to support an organisation
- Providing non-financial support to maximise the social impact and improve the organisation's financial strength and sustainability
- Monitoring and evaluation of the impact created by the organisation.

Innovation lifecycle grants act as a midway between blended finance and venture philanthropy. Grant capital is used to fund an organisation while it scales from proof of concept to growth stages. This type of financing can be used to hasten expansion while providing incentives to move into harder-to-reach, high-impact areas.[107]

2.6.4 Catalytic capital

Catalytic capital is provided to an organisation at an early stage of its development. Catalytic capital providers accept higher levels of risk than conventional commercial investors to generate a positive impact. Catalytic capital aims to provide funding during a project's early, riskier phases. Leveraging this capital can grow and attract further commercial capital at later stages of the project.[108]

Catalytic capital can fill gaps for impact enterprises at various stages of their development. The three main roles of catalytic capital are:[109]

- **Seeding:** Provision of early-stage capital to fund operations
- **Scaling:** Providing capital to enterprises to multiply their impact, allowing them to realise economies of scale and reach new geographies and demographic groups
- **Sustaining:** Provision of support to enterprises that require ongoing investment.

2.6.5 Patient capital

Patient capital or long-term capital encourages investors to seek long-term returns instead of trying to make a "quick buck" by focusing on short-term returns. This capital is generally coupled with a willingness to forgo maximum financial returns while achieving maximum social impact.[110]

2.6.6 Blended finance

Blended finance combines public sector investment and private philanthropy, usually through concessionary loans or grants. Blended finance aims to remove some of the challenges capital seekers face by reducing investment risk, thereby directing more private and traditional capital providers to projects or areas that would otherwise be regarded as too risky. It simultaneously aims to achieve market-rate returns.[111]

2.6.7 Crowdfunding and digital assets

Crowdfunding is capital raising from a large population, usually via an online platform. The recent rise of blockchain technology and the promise of Web3 has created additional crowdfunding options, such as decentralised autonomous organisations (DAOs). A DAO is a "collectively-owned, blockchain-governed organisation working towards a shared mission."[112] DAOs are characterised by the lack of one central decision-making authority; instead, blockchain-based rules are embedded into the code, defining how the DAO operates, and funds are allocated.

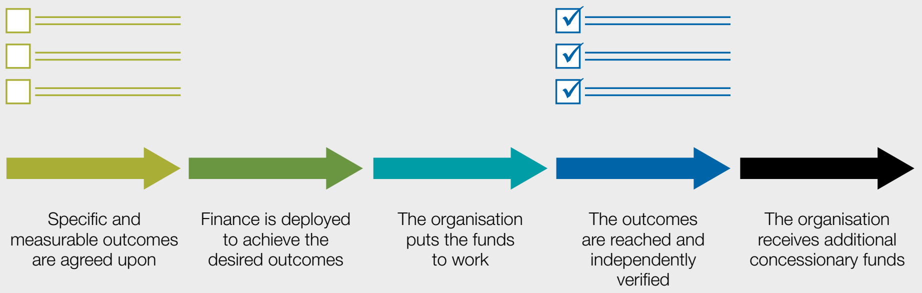
An investment DAO raises capital to invest in assets on behalf of its community.[113] Paralleling the development of DAOs is the rise of social impact awareness, with many leaders in the DAO space recognising the harmony between the two.[114] Investment DAOs allow like-minded individuals around the globe to pool their capital in certain investments, programming a specific investment ethos within the actual code of the organisation. Moreover, with blockchain technology acting as a public ledger, the investment activities are transparent and can be verified by each viewer.

2.6.8 Outcomes-based funding

Outcomes-based funding involves a mechanism through which an investor is willing to fund an enterprise that assumes responsibility for achieving a set of pre-defined outcomes. This process aims to link funding with outcomes rather than a business plan's inputs, processes, or prospects.[115]

Outcomes-based funding is not a new concept and comes in various forms, such as conditional cash transfers, results-based funding, performance prizes, and, more recently, impact bonds.[116] Figure 7 below displays how a typical outcomes-based funding mechanism is used.

Figure 7: Outcomes-based funding



Source: World Bank, n.d.

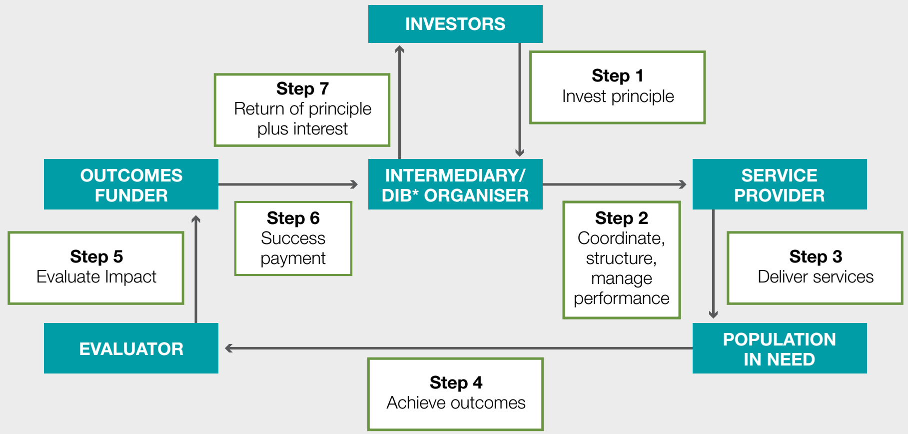
2.6.9 Impact bonds

Impact bonds are a form of outcomes-based funding where private investors cover the capital required in the early stages of business development, allowing the provider to deliver the product. The product is designed to achieve the commissioned, measurable outcomes. The original investor is repaid, provided that the outcomes are achieved.[117] There are two main types of impact bonds:[118]

- Social impact bonds: The outcome payer is generally a government organisation representing the target group.
- Development impact bonds: The outcome payer is an external or philanthropic organisation.

Figure 8 illustrates the impact bond funding process.

Figure 8: Impact bond funding



Source: Centre for Universal Education at Brookings, 2017[119]
*DIB: Development Impact Bond

2.6.10 Guarantees

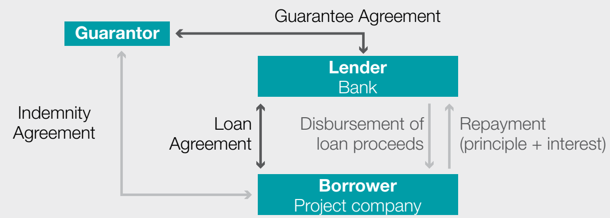
A financial guarantee is a contractual agreement that guarantees debt repayment to a lender from a third party if a borrower defaults on payment. A security deposit or collateral is a well-known form of guarantee that can be liquidated if the borrower defaults on their payments.

Financial guarantees act as insurance and have two main advantages:

- They enable better access to capital by creating a more affordable means of borrowing.
- They can put lenders at ease, making them more comfortable lending to higher-risk borrowers.

The guarantee process is explained in Figure 9.

Figure 9: Guarantee funding

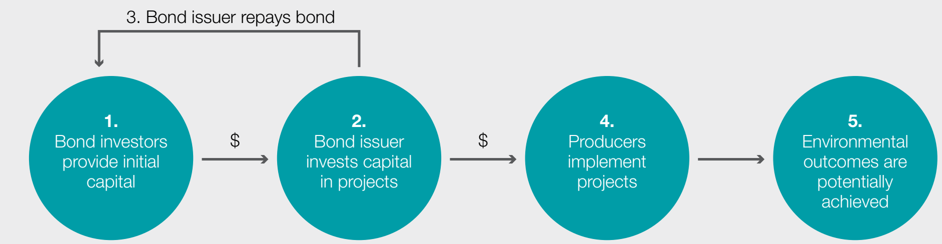


Source: African Development Bank, 2009[120]

2.6.11 Green bonds

Green bonds are financial instruments that raise money for climate-related and environmental projects. They may have additional tax incentives to enhance their attractiveness to investors. The term green bonds is used interchangeably with climate bonds or sustainable bonds. Figure 10 outlines the green bond mechanism.

Figure 10: Green bonds



Source: OECD, 2017[121]

2.6.12 Summary table

Table 8: Innovative finance summary

Innovative finance product	How it works	Advantages	Disadvantages
Variations on traditional debt financing methods			
Adjustments to the payback period and/or interest rates	Loans have extended payback periods or are offered at lower interest rates.	• Offer more flexible forms of repaying loans, making impact delivery more accessible.	• The risk potential of defaulting is higher.
Using credit guarantees	A third party stands as guarantor for the loan and will be required to repay the loan if the borrower defaults.	• Borrowers can borrow a higher amount with little or no credit history.	• Interest rates are high • Credit ratings of both the borrower and guarantor could be adversely affected in the event of default.
MFIs	MFIs receive funding from large institutions and offer micro loans to small businesses.	• Serve as a non-traditional financing mechanism to help distribute loans to borrowers who wouldn't qualify for a loan under traditional financing mechanisms.	• Usually have harsher repayment methods • Loans are usually smaller amounts • Interest rates are usually higher.
Venture debt	A form of risk capital combines an initial loan with warrants for equity.	• Helps companies to avoid dilution • Provides a cheaper source of funding • Helps avoid down rounds (useful for start-ups) • Offers quick and convenient access to capital.	• No flexibility is allowed in repayment • Can cause bankruptcy • Can act as a deterrent to company growth (paying off debt may crowd out growth).
Variations on traditional equity financing methods			
Quasi-equity	The borrower receives a loan without giving up ownership of the company. However, the loan repayment is dependent on the performance of the company. It is similar to traditional equity in that sense.	• Can be more attractive and offer higher returns for investors • Flexible repayment schedule provided for borrowers.	• Not suitable for short-term financing since debt is usually only repayable in the long term.

Innovative finance product	How it works	Advantages	Disadvantages
Patient capital	Patient capital encourages investors to invest long term and forgo the temptation to make a "quick buck." This capital is provided to businesses and is tied up within the business over an extended period, e.g., equity that can only be sold after an initial lock-up period.	• Supports mission-driven organisations with market-based strategies • Investors and companies align their values and intended impacts.	• Fewer patient capital funds are available • Still a developing field, and expected returns may not be clear.
Grant financing methods			
Venture philanthropy	Venture philanthropy takes techniques and approaches from VC. It applies these to ventures focussing on socially responsible investments that often meet the ESG criteria.	• Empowers beneficiaries to manage the grants given to them • More systematic and interactive than traditional grant-giving.	• Donors rely on the returns of their monetary investments • Start-up social ventures are sometimes preferred over established charitable institutions • May take away the concept of altruism and good motives to help others.
Innovation lifecycle grants	Multi-stage grant funding supports organisations in different stages, from concept to scaling.	• Allows businesses to scale during their initial phases • Provides incentives to move into impact areas.	• May be confused with pure grants.
Other forms of financing			
Blended finance	Strategic use of development finance to crowd-in commercial capital.	• Growing market: annual blended finance capital flows have averaged approximately US$9bn since 2015 • Funds represent the largest share of blended finance transactions • Sub-Saharan Africa is the most common destination for blended finance deals • Agribusiness and climate-smart agriculture have gained momentum.	• Lack of private sector mobilisation strategy and action plan • Low coordination between governments and domestic resources • Lack of transparency • Underdeveloped blended finance ecosystem.
Crowdfunding and digital assets	Based on raising capital on a peer-to-peer basis, occasionally using digital assets such as cryptocurrency.	• Low cost of capital • Flexible repayment terms.	• Long due diligence cycles • Funds can have narrow mandates in the types of companies they wish to invest in.
Outcomes-based funding	Provides funding based on the development outcomes achieved by service providers and governments.	• Stronger incentives to achieve outcomes • Lower cost for funders • Gives autonomy to service providers on how they accomplish a goal.	• It is difficult to align the objectives of outcomes-based funds with those of agencies requiring funds.
Green bonds	Fixed-income financial instruments that fund environmental improvements or similar projects. These bonds are asset-linked and backed by the issuing entity's balance sheet, so they carry the same credit rating as their issuers' other debt obligations.	• Increase in popularity due to their ability to generate revenues • Provide a tax incentive for investors.	• Not all green bonds qualify as impact investments despite their environmental focus. This is largely due to poor or no impact measurement by both issuers and investors.

Innovative finance product	How it works	Advantages	Disadvantages
Guarantees	A contractual agreement that guarantees debt repayment to a lender from a third party if a borrower defaults on payment.	• Borrowers can borrow a higher amount with little or no credit history.	• Interest rates are high.
Catalytic capital	Capital is provided to an organisation at an early stage of its development to generate a positive impact but carries higher risk levels than conventional commercial investments.	• Access to funding when there is the greatest need for capital • Can be leveraged to attract future growth • Can attract other investors in the future • Gives impact enterprises the ability to scale impact • Can be used to ensure the sustainability of an impact initiative.	• Investors are required to take on more risk at the beginning of the project • There is a risk that the capital is not managed effectively to attract other providers of capital in the future.

2.7 Section summary

The UN estimates that African countries will need an additional US$200 billion per year if they are to meet their SDG targets by 2030.[122] South Africa is currently achieving an SDG Index Score of 63.7 out of 100, which ranks 108 out of 163 countries.[123] Furthermore, South Africa is on track to complete only two SDGs (gender equality and responsible consumption and production), highlighting the need for significant action.[124]

To achieve SDGs, South Africa must make significant investments in many social and environmental causes. The responsibility for this largely falls upon government. However, the government has multiple competing objectives and mounting fiscal and debt challenges. Government expenditure and investments are hampered by the lack of GDP growth to drive meaningful increases in tax collection, the mismanagement of public finances, and an increase in the public servant salary bill.

Between 2019 and 2022, the South African economy has only grown by 0.3%.[125] As a result, the government has not been able to adequately invest in projects which aim to target SDGs. Thus, ensuring that SDGs are met, while simultaneously focusing on service delivery, is unlikely to become easier in the future.

Fortunately, South Africa's private sector has large amounts of capital which can be used to meet the SDGs. Innovative finance methods can be used to unlock some of this capital so that both the private and public sectors work towards achieving the SDGs. With both public and private capital, it may be possible to use collected tax more efficiently. The private market will need to absorb some of the risks typically taken by government. However, this risk can be accepted knowing that the returns are also available.

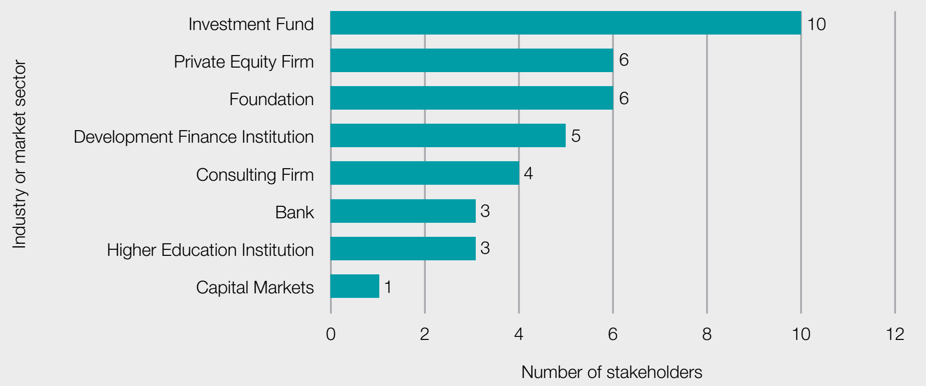
3. Methodology and Data Collection

A multiple case study approach was adopted to investigate the state of innovative finance and impact investing in South Africa.[126] Case study research is a valuable technique when the answers to a research problem are contained in multiple data sources and is commonly used in studies that attempt to explain the mechanisms of a phenomenon.[127] A multiple case study approach was thus appropriate to form a deep understanding of the South African innovative finance environment and to map the key challenges and opportunities. The unit of analysis in multiple case studies forms part of the essential research considerations.[128] In this study, the unit of analysis is leading industry experts in the impact investing and innovative finance space.

Thematic analysis was used to identify, analyse, and report patterns or themes within the data in the stakeholder interviews.[129] The method is appropriate as it aligns with this study's aim of extracting data from industry experts' views, opinions, or experiences.

To collect the data for this study, semi-structured interviews were conducted. A total of 39 stakeholders in the impact investing and innovative finance sphere were interviewed, with the majority being C-suite executives. Approximately 26% of interviewees represented investment fund companies, 15% of stakeholders represented foundations, and 15% PE firms.

Figure 11: Stakeholders interviewed per market sector



Source: Deloitte Africa research

4. Findings: The State of Innovative Finance in South Africa

4.1 Defining impact investing

The GIIN defines impact investments as investments made in any market that intend to create positive, measurable social and environmental returns alongside a financial return.[130] Interviewed stakeholders were asked to define what impact investing means to them. A resounding majority of interviewees agree with the GIIN's definition of impact investing, adding these particular characteristics. Impact investments are investments that:

- generate a positive impact (environmental, social, or both)
- generate positive financial returns
- are made with the intent of producing a specified impact which is defined at the outset
- can be measured and reported back on.

Although most respondents agree that impact investments make a positive impact and generate financial returns, stakeholders disagree over whether the impact or the return from an impact investment ranks more highly. Both views have their own merits. More impact-focused players may argue that impact should be the focus as it is the overall goal of the impact initiative. Other impact investors argue that financial returns are crucial to the project's long-term sustainability.

"Focus should be more on impact than on financial returns, but that does not mean there is no financial return, just that impact is the top priority." **– Consulting**

"Impact investors do not have to be impact first and financial last."
– Development Finance Institution

4.2 The trade-off between financial returns and impact

Stakeholder interviewees were asked if they believe there can be a trade-off between financial returns and impact. Feedback was divided, with half of the respondents indicating that there is indeed a trade-off and the other half stating that there is not.

4.2.1 No trade-off between financial returns and impact

Experienced investors with an eye for opportunity can make positive impacts without sacrificing investment returns. Traditional financial models do not consider all the relevant metrics when measuring financial returns, for example, opportunity costs arising from choosing a particular investment over another (e.g., foregoing an investment in a more sustainable opportunity). Impact investments could have higher returns if such metrics were evaluated in traditional investments. Future growth studies demonstrate that returns may have improved because of impact investing.

However, several respondents argue that investment returns and impact are not mutually exclusive. While this indicates that an investor can make returns and an impact simultaneously, it does not imply that an investor is foregoing financial returns to make an impact.

"Financial returns do not have to be compromised. Future growth studies show that returns have improved as a result of investing in impact." **– Consulting Firm**

"Financial returns of orthodox investments may be lower than what we think if the financial models accounted for all relevant metrics." **– Higher Education Institution**

4.2.2 Trade-off between financial returns and impact

Among the other half of stakeholders, a strong view is that there is always a trade-off between financial returns and impact; the trade-off size depends on the sector within which the impact investment is made. There are impact sectors in which there is not an existing trade-off, but there are very few. One example is that investors may be able to make a sizeable impact and return from renewable energy, but will find it challenging to do so in rural education. As a result, some impact investors only make investments within impact sectors that do not compromise financial returns or impact.

A less common view is that financial returns are compromised in all impact sectors. Impact investing functions differently from the traditional market, so impact investors should be willing to forego returns when an impact is being made. However, it may be disingenuous to try and attract capital into the impact investing space by claiming that there can be no trade-off between returns and impact.

"The number of sectors in which financial returns are not compromised is very small." **– Investment Fund**

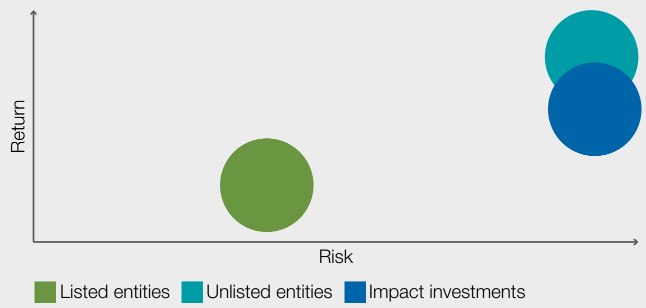
"Renewable energy is hot, but can impact investors make the same returns in rural education?" **– Higher Education Institution**

"To say there is no trade-off is probably disingenuous. There is some trade-off, but it does not mean that you cannot make financial returns." **– Development Finance Institution**

4.2.3 Further considerations

The positive relationship between investment risk and return is well known. Typically, investments with a higher expected return also come with a higher level of risk. Furthermore, impact investing is largely undertaken in the unlisted market, so returns from impact investing should be higher than those of an investment in the listed entity market but lower than those of PE.

Figure 12: Investment risk vs return



Source: Deloitte Africa research

Impact investments are typically expected to generate lower returns than traditional investments in unlisted entities (see Figure 12). However, investors are generally willing to accept a lower level of return if they believe that the impact made will outweigh the "lost" investment returns.

"Impact investing is supposed to yield returns higher than listed securities, but lower than private equity investments." **– Investment Fund**

However, impact investments do not necessarily yield a lower return than traditional investments in private markets: instead, lower returns on impact investments may always have been accepted because there are fewer high-return impact investment opportunities. Hence, when looking at impact sectors where it has been typically difficult to generate returns, it is not necessarily that a lower return needs to be the norm, but rather that there is a lack of investable projects with the potential to yield high returns.

This phenomenon is exaggerated when market players take up promising impact investments (i.e., those expected to generate good risk-adjusted returns) very quickly. This will likely change with the growing awareness of impact investing and the development of suitable financial instruments.

"Promising impact investments with good risk-return profiles are snapped up very quickly." **– Foundation**

Furthermore, impact investors argue that investments should not just be measured using a risk versus return framework, but using a risk-adjusted return versus impact framework, so that impact is an additional factor to consider when making investments. By creating an immediate impact, long-term returns are increased. There is also the argument that if impact investments are not made, the resulting social and environmental challenges can have devastating effects on the financial returns of all investments.

Instead, impact investment improves the population's standard of living by creating an environment for increased participation in the economy. In turn, through increased economic participation, companies and projects will have a wider pool of consumers for their products which will be positive for investments in general. Therefore, impact investing takes a long-term view. Although there may be a short-term trade-off between financial returns and impact, impact investors argue that there is potential for a positive relationship between impact and returns in the long run.

"Investors need to have a long-term view." **– Consulting Firm**

"Impact investments should be evaluated by assessing the risk, return and impact." **– Private Equity Firm**

4.3 Measuring impact performance

Impact investors expect businesses they fund to make an impact. They, therefore, need to report on the impact achieved and the financial and operational state of the business. There are several accepted methods of measuring the financial return of a business. However, when measuring impact, there are no set standards.

"When measuring impact, there are no set standards." **– Investment Fund**

4.3.1 The importance of measuring impact

The measurement of the impact made through any investment is crucial. Firstly, the impact needs to be measured so that it can be documented and used as proof to demonstrate to other stakeholders, including potential investors, that impact investing is tangible and that it is possible to make positive impacts and financial returns simultaneously. If organisations cannot demonstrate the impact made with the funds they have been given, there is a real risk of potential investors not believing that an actual impact was made, which may jeopardise the funded organisation's future financing aspirations. Secondly, regular measurement enables organisations to evaluate their performance regularly and make the necessary changes to their operation to meet the original, pre-set impact goals.

"You need people to believe you, and for that you need to quantify and report back on measurement." **– Consulting Firm**

"Organisations need to get the support from beneficiaries by measuring and reporting so that the business can scale." **– Consulting Firm**

4.3.2 Best practice when measuring impact

Each project should clearly define an impact thesis at the outset, integrating it into the key objectives of the investment. Furthermore, the impact thesis should be used to determine the appropriate metrics for measuring the impact. In addition to clearly defined targets within an impact thesis, an organisation should also derive a theory of change which describes how the impact will be made in practice and why the organisation expects it to play out as stated. The organisation's theory of change and impact thesis can be used as a benchmark in the future when the organisation sets out to measure the impact made.

Organisations must collect sufficient data to be used in impact measurement calculations. The reliability of the measurement will depend on the accuracy of the data collected. Therefore, organisations should follow sound practices when collecting and storing the data for measurement. Most impact investors tend to measure impact performance themselves. However, getting independent service providers to verify the calculated result gives investors faith in the authenticity of the results and confidence in the project for future funding.

"It is important to have an impact thesis and theory of change set at the outset of the project." **– Consulting Firm**

"There needs to be a clear objective at the outset which can be measured." **– Consulting Firm**

"Collection of appropriate data is key to measurement." **– Investment Fund**

4.3.3 The burden of impact measurement

However, measuring impact and independent verification of results can burden smaller organisations with demanding operational requirements and costs. Respondents note that a small organisation following a strict measurement and reporting regime is not the best use of time and resources.

There are also major concerns over how difficult it is to measure impact accurately and comparably across different sectors, for instance, comparing the impact of an investment in renewable energy to that of an investment in rural education. Therefore, a toned-down approach to measuring and reporting is more beneficial for smaller organisations.

"Impact measurement can be a burden on smaller players." **– Higher Education Institution**

"It is both difficult and time consuming for smaller businesses to gather the information required for impact performance measurement." **– Foundation**

"A lite approach to measurement is effective, especially for smaller participants." **– Foundation**

4.3.4 The challenges of measuring impact

Difficulties in measuring impact are directly associated with the sector in which the impact is measured. For example, while the reduction of carbon-dioxide emissions can be calculated with reasonable certainty in environmental impact, measuring social impact is a complicated process with no standardised model.

Measuring impact has other challenges as well. Impact investors disagree on what should be measured when demonstrating the impact achieved. For example, consider trying to measure the impact of an investment in a new hospital that aims to improve healthcare and quality of life in a specific community.

One approach is to measure the impact at an output level in terms of the number of patients treated over a specific period, which is relatively straightforward. However, when trying to quantify the improvement in healthcare and quality of life, there is no handy standard index to measure the increase in life expectancy or an improvement in overall community welfare. Furthermore, in the case of life expectancy, improvements only manifest over the medium to longer term.

Calculating the impact of an investment is further complicated by the issue of attribution. Continuing the example of measuring improvement in life expectancy, it is challenging to determine whether any improvement can be attributed to the investment made in the hospital or if the improvement is due to external factors (e.g., an improvement in the quality of water and sanitation). In addition, the time over which the impact is made needs to be considered during measurement.

There are further challenges in working with impact data. Firstly, impact data can be tricky to collect, with no clear understanding of what data is required to measure impact. Secondly, there are concerns over the quality of data collected from high-impact areas.

"Measuring social impact is extremely difficult, whereas measuring financial impact is very easy."
– Investment Fund

"It is very difficult to measure social impact meaningfully and to do it well is not only expensive, but also unrealistic." **– Development Finance Institution**

"The type of impact to be measured plays a major role in the difficulty of doing so."
– Consulting Firm

"The issue around attribution further complicates impact measurement." **– Investment Fund**

"Impact investors have struggled to become comfortable with impact data and there are further issues when considering the quality of the data in certain areas." **– Foundation**

4.3.5 Developing a framework for impact measurement

Although significant challenges and expenses are involved in demonstrating impact performance to key stakeholders, measuring impact remains crucial in any impact investment management process. Not only does it help to demonstrate to potential investors that impact and returns can co-exist within one investment, but it also assists the organisation in identifying any areas which require action, giving it the best possible chance of reaching the initial impact goals. As a result, much recent work concerns inventing frameworks and metrics to easily and effectively measure impact performances, ensuring increased transparency and comparability.

Given the extreme difficulties associated with measuring impact, especially in certain social sectors, and the burden this process places on smaller impact players, the question arises of whether there has been too much focus on developing a meaningful impact measurement framework. Market players are also concerned about the amount of time being spent on standardisation, particularly in areas such as South Africa, where there is an immediate need for impact investing.

For impact performance to be comparable worldwide, impact investors must adopt the same standard. A lack of clarity on impact performance measurement is also a barrier to future market players. However, given how long it took for other global frameworks, such as the Generally Accepted Accounting Principles, to be accepted, it may be argued that developing a set of standards is a priority.

"There is currently a lot of focus and momentum on standardisation."
– Development Finance Institution

"There is too much time being spent on standardisation, instead of actually making the impact."
– Foundation

"Look at how long it took for Generally Accepted Accounting Principles to be adopted."
– Private Equity Firm

4.4 Impact investing in South Africa

Most respondents indicated that impact investing in South Africa has become a focus since the 2020 coronavirus pandemic. While the market is growing and becoming more topical, the current environment remains largely underdeveloped. The findings highlighted respondents' concerns regarding the lack of graduates educated in impact investing and the broader lack of awareness of impact investing. However, a large body of research shows the growing potential of the market. Most stakeholders appear to have a positive outlook on the future of impact investing in South Africa.

South Africa's well-developed capital markets and diverse social issues make it a unique environment, prime for impact investing opportunities. According to stakeholders in philanthropic and donor organisations, investments are made for social return and in the form of grants. Some stakeholders note that a culture of grants is prevalent in South Africa's impact investing space, and greater execution of innovative finance instruments is required to develop the market.

Additionally, many stakeholders contend that impact investments in the South African market tend to focus on education, climate, and jobs, with less emphasis on other social impact areas.

When asked about the state of the regulatory environment in impact investing, most stakeholders feel that changes to Regulation 28 allow for a larger percentage of pension funds to be invested in infrastructure development, allowing for increased impact. While a few stakeholders argue that specific regulation on impact investing is still developing, other stakeholders suggest that National Treasury must produce clear frameworks for impact investing.

Overall, most stakeholders agree that the market is not yet developed enough for accurate benchmarking and measurement. However, there are many suitable areas for impact investing in the South African market, and both the demand and supply are growing.

"In South Africa, we are not at a stage where you could have benchmarks and measurements in a way that is accurate and well understood." **– Investment Fund**

"Impact investing has a long way to go in South Africa. But the positive is that two years ago there was not one head of sustainability at the banks and now they all have one. It's a step in the right direction." **– Consulting Firm**

"Impact investing is in its early days in South Africa. There are not a lot of players in the space but there are a few businesses or enterprises that are investment ready."
– Development Finance Institution

4.4.1 Investor risk appetite

Each investor has a different appetite for risk, which determines the level of risk the investor is willing to accept to generate a certain level of financial return. Impact investments are typically made in unlisted entities, which carry more risk than investments made in listed entities. Furthermore, impact investments are usually made with a long-term horizon, adding risk. As a result, impact investments are considered more risky than traditional investments.

"Impact investing happens in the unlisted space." **– Private Equity Firm**

Several stakeholders note an extraordinarily high level of conservatism in South Africa, with many investors unwilling to accept a high level of risk or take on new risks. Many investors are unwilling to invest in early-stage businesses because the risk of failure is higher.

Furthermore, these businesses require long-term capital, putting the investor at additional risk of being unable to recoup the investment for a long time, a problem in the event of an emergency need for liquidity. South African investors' conservative approach has meant allocating capital with a short-term view prioritising bottom-line returns. Consequently, risk-averse South African market players are unwilling to experiment with or develop innovative finance methods.

"There is a high level of conservatism in South Africa and the average South African has a very low risk appetite." **– Investment Fund**

"A large gap in the market exists due to investors being risk averse."
– Development Finance Institution

"Many allocators have a short-term view of things." **– Consulting Firm**

"The business market culture in South Africa has made it difficult to experiment with new instruments." **– Investment Fund**

Generally, impact investments' risk versus return profile requires additional financing for the traditionally risk-averse. Instead of traditional tools, new tools must be used to make impact investments more attractive to risk-averse market participants. One such tool is blended finance. Blended finance arrangements modify the risk versus return if used correctly. However, blended finance arrangements add complexity to investing, which deters participants unfamiliar with such agreements.

"Typically, impact investments require additional financing to make the risk-adjusted returns more attractive." **– Higher Education Institution**

"Blended finance can be used to modify the risk versus return profiles of investments to make it more attractive for other capital providers to come in." **– Foundation**

4.4.2 Challenges in the South African market

Interviews with key stakeholders revealed that the challenges of the South African environment discourage and/or hinder impact investing to some extent. While many challenges are specific to impact investing, general macroeconomic factors also play a role in discouraging such investments. Interviews revealed that the main challenges in the market are as follows:

- Lack of clarity in definition and framework
- Non-consensus between key market players
- Lack of capital flow and few current opportunities
- Lack of execution in the market
- Lack of impact investing education
- Impact washing and the potential for tick box exercises
- Disabling regulatory and macroeconomic environment.

The predominant challenge stakeholders identify is the lack of clarity between proposed definitions and frameworks of impact investing and what transpires in the market. Another key theme is the lack of consensus between PE players, donor and philanthropic organisations, and government. Many stakeholders also identified a lack of capital flow and opportunities in the space as primary challenges.

Lack of clarity in the definition and framework of impact investing

A general lack of clarity in the current environment results from unclear definitions and inconsistent measurement frameworks for impact investing. For a start, the current definition of impact investing is too broad and, therefore, difficult to regulate. While there appears to be hype around impact investing, stakeholders use different terms, such as developmental and social investing, as synonyms for impact investing, heightening confusion in the market.

"There is a disconnect between terminology and how impact is valued which creates discontent with asset managers – clear-cut definitions are needed." **– Private Equity Firm**

"I hope that there will not be a clear classification of impact investments and impact investors – it may create a tick box exercise." **– Investment Fund**

"We have to get to regulations eventually and we need hard definitions. The EU taxonomy Article 6, 8 and 9 is a good indication of the type of regulation needed. And further articles are needed on what kind of investor one claims to be." **– Development Finance Institution**

"Grey areas" in terms of definition and frameworks exist because of a lack of regulation. Thus, respondents urge National Treasury and the South African Revenue Service (SARS) to play a bigger role in producing clear impact investing frameworks. The grey areas hinder investment opportunities, as uncertainty makes investors risk-averse, creating a gap in the market.

On the other hand, the loose definition and lack of clear classification can be a benefit rather than a challenge: the openness allows for impact investing to develop authentically in the market without becoming a tick box exercise.

The consensus, however, is that a lack of clarity in the market is a clear challenge to impact investing in South Africa. Most stakeholders call for a clearer definition, a market consensus on what impact investing is, and structured frameworks to measure impact more precisely.

No consensus between key market players

Global and local stakeholders in the impact investment space, including PE and VC, philanthropic and donor organisations, and government, disagree on the role and definition of impact investment. These significant market players cannot align their impact investing goals, creating disagreement and confusion.

There is a need for better dialogue between all parties based on an agreed definition of impact investing. While some market players prioritise both the impact of and financial returns on their investments, others focus primarily on the impact and view any financial return as a bonus. A third group prioritises the financial return above the impact being made. Even though each of these three cases is vastly different, each party terms their actions as impact investing, which creates confusion and disagreement at the core. More conversations and open dialogue between stakeholders will help to develop and standardise what it means to execute impact investing.

"There is a need for more open dialogue between players to create the best environment for impact investing." **– Investment Fund**

Lack of capital and investment opportunities

The main concern raised by most stakeholders is the lack of capital flow into the impact investing space. More specifically, there is insufficient patient capital, and the focus is on short-term returns. This can be attributed to the nature of the investors in the space or to an underdeveloped pipeline. Since most impact investing finance instruments are a relatively new asset class, investors and capital providers are unfamiliar with them, making it difficult to crowd-in capital from investors and financial institutions.

Some investors and financial institutions are unwilling to learn, participate in the space, and prioritise the impact being made over financial returns. On the other hand, many stakeholders argue that the investors receive too much focus, with inadequate attention paid to the lack of innovation and creativity on the demand side. Investors are looking to allocate their capital to the impact investing space; however, stakeholders emphasise that current opportunities are not well-known, and there are not enough investable projects. The narrow pipeline results in most investors pooling their capital in the same few successful impact funds in the market.

Additionally, there are insufficient intermediaries in the impact investing space to connect the capital providers to impact investments that meet their requirements. Innovation and creativity are required in the pipeline, and more investable projects must be introduced to the impact investing market.

"It's difficult to find opportunities which give both social and financial returns." **– Bank**

"There are relatively new asset classes and so there is a lack of education in the space which makes it difficult for funds to get capital from investors." **– Investment Fund**

"From the supply-side there is enough money to get things going. The problem is investable projects and there needs to be a better way of reporting (this includes monitoring, verification and reporting on the impacts)." **– Consulting Firm**

Lack of execution

A predominant theme in the interviews was a lack of execution in the impact investing market and how it hinders future development. Some stakeholders argue that the methodology and framework for impact investing have already been adequately developed by the GIIN and that the challenge is implementation. National Treasury intends to issue policy guidelines for impact investing, but there is minimal implementation, monitoring, and enforcement. Due to the developmental nature of the impact investing environment, non-execution further hinders future development in the following three main ways:

- Key lessons and insights from trial and error cannot be drawn from the few developmental finance instruments currently being utilised.
- Necessary data collection and analysis cannot occur, which means no accurate mapping of the investors in the market, fund sizes, and potential benchmarks against which impact can be measured.
- Insufficient reporting and a lack of case studies create a dearth of information to educate and crowd-in investors.

As such, most stakeholders expressed a need for further execution and information sharing in the market to aid the development of impact investing.

"If we jump into IRIS+ it could lead to a tick box exercise. Even the industry is not aligned on this." **– Foundation**

"Smaller businesses should also focus on measurement and reporting, but it should not be a government compliance checklist type exercise." **– Investment Fund**

"20% appears to be window dressing in the South African market, and the rest appear to be intentional." **– Private Equity Firm**

Lack of impact investing education

There is still a general lack of awareness regarding what impact investing is. This often leads to impact investing being confused with ESG frameworks, and both terms are used interchangeably. The differences between the two are explained in Section 2.1, which explains impact investing as an improvement on ESG, particularly because of impact investing's intentionality and additionality. Impact investing's focus on sustainability is essential if South Africa is to face its many social and economic challenges and meet the defined SDGs.

This raises the urgent need for tertiary level qualifications and certifications specialising in impact investing and for more players to obtain impact investing qualifications. In addition, certification and education focusing on measuring impact investments' outcomes is a primary concern. Measuring impact is more complex than measuring financial returns; many respondents call for increased knowledge sharing and education on measuring and reporting these diverse impacts.

However, further education in impact investing is hampered by the fact there is only one higher education institution in South Africa with an impact investing programme, namely the Bertha Centre for Social Innovation and Entrepreneurship at the University of Cape Town (UCT) Graduate School of Business. In fact, UCT is the only university on the continent with an impact investing programme.

In the absence of formal education, some short-term benefits could be accrued by creating impact communities of practice to enhance peer-to-peer learning and knowledge transfer.

Impact washing and the potential for tick box exercises

Other predominant challenges to impact investing are the prevalence of impact washing in the market and the fear of impact investing becoming a tick box exercise. Few stakeholders mentioned impact washing, and most agree that there is a low percentage of impact washers in the market. Still, the risk of impact washing can be reduced by regulations like explanatory reporting and measurement standards.

However, there needs to be a fine balance between introducing useful impact investing classifications and having too many classifications that result in impact investing becoming a tick box or compliance exercise for investors. The latter is a challenge, and finding the right balance will require extensive stakeholder dialogue.

4.4.3 Financial instruments

Traditional loan and equity financing is inappropriate for many impact investing business cases. Using these traditional financing methods renders many impact investments unattractive to large institutional investors from a risk versus return perspective. New financial instruments, including impact bonds and blended finance structures, have been introduced in recent years; these modify the risk versus return profiles of investments, for example, by reducing the risk of the investment by providing more flexibility to the organisations seeking financing.

Up to now, grants have been typically used to provide impact investments. However, pure grant funding is unsustainable in the long run as the capital provided does not need to be paid back, leaving the investors (providers) with less capital for further investments. There is room for more creative and innovative solutions that are more sustainable for the lenders but also offer flexibility to the organisation receiving funding.

"There are many business cases where traditional financing methods are not appropriate."
– Investment Fund

"Generally, the risk versus return profile of impact investments requires additional financing for most traditional players to be interested." **– Higher Education Institution**

Early-stage projects need more risk-tolerant capital and the most flexibility over their repayments. Generally, there is not a shortage of capital, but rather a shortage of risk capital. There is, therefore, a need for increased catalytic capital, i.e., capital with a higher risk appetite in early-stage investments, which will lead to more impact pipeline for downstream commercial funding at later stages.

"Grants are a 100% loss." **– Investment Fund**

"Grants funding should be used almost exclusively for developing pipeline and not towards funding structures." **– Consulting Firm**

Different capital providers may be more suited to provide funding for an impact project depending on the life stage of the project. While there is a need for more catalytic capital in the development phases of a project, early-stage projects also require additional flexibility over repayments. Although the long-term sustainability of pure grant funding may be in question for the reasons outlined above, in many cases, grants are the most effective form of capital for early-stage impact projects that tend to have a higher risk profile.

Innovation lifecycle grants can provide flexible capital upfront while the impact project develops from the proof-of-concept stage to the growth stage. Once the project has developed and grown, and its risk has declined, other commercial players can provide funding.

However, new innovative instruments in South Africa have not been implemented effectively. Respondents list several reasons for the lack of development in this space, including the following:

- It has been difficult to erase the culture of grants.
- Copying and pasting these systems from advanced economies to Africa is inappropriate.
- Many asset managers are unfamiliar with innovative finance methods, deterring investors from utilising these instruments.
- Some instruments have a complex design, making them difficult to access.
- Grantmakers do not view themselves as catalytic investors.
- Entrepreneurs cannot fully leverage early funding to attract more capital at later stages.
- A deliberate lack of collaboration between players is caused by a siloed mentality among investors and the failure of grant makers and debt and equity investors to see themselves as part of the capital stack or continuum of capital (grants, debt, equity) that funds impact projects at different stages of the project's life cycle.

"It is difficult to remove the grant mentality." **– Investment Fund**

"Using the same systems from the West has not been suitable for Africa. There is room for creating instruments which are more culture sensitive." **– Investment Fund**

"Many of the asset managers are not familiar with the innovative finance methods which can deter them from investing." **– Higher Education Institution**

New innovative financing instruments are inherently more complex in their design than traditional financing methods, as they increase the flexibility available to financed organisations. Furthermore, keeping traditional financing methods as simple as possible may be preferable to traditional commercial investors. This can be done if these players are not involved in the early stages of any project, but instead are brought in to provide capital when the project is already at a stage where it may not need as much flexibility within the structure of its repayments.

"Blended finance adds complexity. In some cases, it is better to keep traditional capital as simple as possible." **– Higher Education Institution**

4.4.4 The regulatory environment

Government and regulation's role was greatly debated throughout the interview process. Some stakeholders argue for as little government intervention in the market as possible. In contrast, most stakeholders demand improved regulations and certainty from government to better guide and develop the impact investing environment.

The stakeholders who do not support government intervention in the market further argue that regulation slows the market down, stifling creativity and innovation and leading to compliance as tick box exercises. This lack of consensus between market players makes it difficult for government to introduce any regulation.

"Regulation has a tendency to slow things down." **– Investment Fund**

"Regulation can stifle creativity and innovation in the space." **– Foundation**

Another theme that emerged was the need for government regulation that clarifies the impact investing environment, especially in terms of tax. Philanthropic organisations and foundations report that once they make a profit, they lose their public benefit organisation (PBO) status; however, these profits are important to their sustainability, especially in the context of ever-growing needs, declining aid, and scarce grant capital. Clarity on tax regulation could enable more capital flow in the space. Changes to Regulation 28 are seen as enabling the impact investing environment.

5. Conclusion

South Africa is at risk of not achieving its SDGs if it cannot raise the investment necessary to address the country's growing social challenges. However, with mounting fiscal pressures and low real GDP growth, the government faces a tough challenge in bridging the SDG financing gap on its own. The private sector needs to step in and provide investment in certain areas. Fortunately, the private sector in South Africa, particularly banks and pension funds, has access to significant capital.

South Africa's retirement industry is estimated to have assets of more than ZAR4.6 trillion.[131] Furthermore, the big five banks account for over 90% of total banking assets, valued at approximately ZAR5.8 trillion, bringing the total amount of assets under pension funds and banks to ZAR10.4 trillion: this totals 167% of South Africa's nominal GDP in 2021 (ZAR6.21 trillion).[132] However, these private institutions have more stringent solvency requirements than government. In addition, they are constrained by regulations that restrict investment into certain asset classes. As a result, these institutions have a low appetite for risk and are only interested in projects which offer an inviting risk-return profile.

One possible solution is impact investing, which aims to achieve both financial returns and measurable social impact within a single investment. This approach to investing offers a sustainable approach to achieving the SDGs. Theoretically, investors can make a positive impact through investment and then use the returns to finance further positive impact.

However, even though impact investing can initiate a positive cycle of impact and profit, there is still a significant amount of financing and investment which needs to happen within the space for South Africa to reach its SDGs.

Although there is increased awareness of impact investing within both public and private markets, there has still been a lack of execution. The private market may be concerned that returns are forfeited when impact investing. However, it has been noted that returns do not have to be forfeited in each case and that the investor can still choose investments with an attractive risk-return profile. Furthermore, it has been argued that impact investing is a long-term approach and that while there may be a trade-off between returns and impact in the short run, over the long run, there may be a positive relationship between impact and return if the opportunity costs are considered of not attending to the social issues in South Africa.

Innovative finance solutions can be used to alter the risk-return profile of impact investments so that these projects are not only attractive to impact investors, but also to traditional commercial investors, who have a lower tolerance for risk. These methods offer more sustainable solutions than traditional grant impact investing, by ensuring that capital is utilised efficiently. Early-stage impact capital should be leveraged by entrepreneurs and used to scale, so that commercial capital can be provided by large market participants once the business has a more attractive risk-return profile. To this end, there is a need to build local catalytic capital, characterised by greater patience, risk tolerance, concessionality, and flexibility than conventional investing to support and grow the early-stage impact pipeline.

However, there are several challenges currently facing the impact investing space, including:

- Lack of standardisation surrounding impact measurement and reporting
- Lack of capital flow
- Few market participants
- Lack of execution in the market
- Lack of awareness of and education in impact investing among impact players and government
- Lack of an enabling regulatory and macroeconomic environment
- Lack of adequate risk capital
- The potential for impact washing.

Increased attention has been given to developing a suitable impact measurement and standardisation framework. Such standardisation may help to identify and prevent future impact washing. However, the remaining challenges may be difficult to overcome in the short term.

Increased awareness of and education on impact investing and innovative finance techniques will attract more market participants and help traditional investors to become comfortable with impact investing and innovative finance solutions. More people will share an understanding of how impact investing and innovative finance will be instrumental in achieving the SDGs in South Africa. In addition, as a growing portion of the population learns of the potential of impact investing to address South Africa's social challenges, more pressure will be placed on government to create a regulatory environment that supports impact investing.

Government will also benefit from this transition as the opportunity for social challenges to be addressed in partnership with the private sector reduces the pressure on stretched government resources. Furthermore, government has the opportunity to become the nation's biggest catalytic investor, helping to crowd-in more private capital into the social space, and leading the application of innovative finance tools on projects (e.g., testing outcome-based financing in tenders to ensure that the opportunity for corruption is reduced and project deliverables meet expected, pre-defined outcomes for the greater public good).

6. Recommendations

1. Greater impact awareness and education

A lack of clarity and consensus in the market regarding what constitutes impact investing appears to be fuelled by a lack of awareness and education. Greater consensus and agreement between the different market players is critical if the impact investing environment is to develop. The ambiguity in market-related definitions and terminology and the scarcity of market players specialising in impact investing create confusion and disagreement. Developing impact investing courses, specifically impact management, is a priority.

The following are key recommendations:

- More academic institutions should create and release suitable courses and qualifications on impact investing beyond the one currently offered by UCT.
- Impact investing funds and organisations need to share more case studies with the market to create better awareness around existing impact investments.
- The impact ecosystem needs to be built, including creating impact communities of practice to enhance peer-to-peer learning, break down investor silos, and develop greater collaboration among investors along the capital continuum (grants, debt, and equity).

2. Better standardisation and improved impact measurement and management practices

Impact measurement is a core challenge, and while frameworks and standards exist, there is no standardised impact reporting. Most stakeholders feel challenged by the difficulty in accurately measuring impact and express measurement and reporting fatigue. Better measurement practices will allow for more reliable data collection.

The following are key recommendations:

- Academic institutions, researchers, and experts must provide research, courses, and training on measuring impact.
- Market players should share their measurement experiences and key mitigating factors to reduce the difficulty of measuring impact and allow for better standardisation. There is an urgent need for more reports from leading market players.

3. A balance of regulatory involvement and market correction

While a few stakeholders contest regulatory involvement, most stakeholders call for a balanced approach to regulation to better enable the impact investing environment. Regulation can aid in the market's lack of clarity and consensus by enforcing restrictions on what can be considered impact investment and the tax implications thereof. However, too much regulation might create a tick box exercise, hindering potential impact. Therefore, market correction must play a role in the shift towards more standardised approaches.

The following are key recommendations:

- Better dialogue between impact investing market players and National Treasury to introduce balanced regulation is necessary.
- Clearer tax guidelines for public benefit organisations must be produced.
- Investigate regulatory regimes which create an enabling environment for impact investing and innovative finance.

4. Support the mobilisation and deployment of more catalytic pools of capital

There is generally more capital than there is investable impact pipeline. Catalytic capital is needed to fund early-stage or growth impact projects/MSMEs to get them to attain proof of concept, thus attracting more downstream commercial capital and building the next wave of sustainable and scalable impact enterprises and projects. These are important in addressing social challenges at levels and depths that government services cannot.

The following are key recommendations:

- Encourage the building of catalytic funds and players. Individual or pooled funds should be piloted and tested.
- Increased education and training on catalytic capital are vital.

7. Areas of Future Research

Additional areas of research that would be useful to further understand and enhance impact investing and innovative financing in South Africa include the following:

- Standardisation and customisation of impact frameworks in Africa
- Development of scalable investor readiness programmes for impact MSMEs and projects
- A review of standardised impact measurement frameworks
- How to embed social impact curriculums into tertiary educational programmes
- Benchmarking South African impact enabling regulations against those of other emerging and developing countries
- A review of South African regulation and policies to enhance impact investing.

8. Appendix

Stakeholders interviewed

AVPA and Deloitte Africa would like to thank the following stakeholders for participating in the interview process. The insights provided were vital to compiling this report, and we sincerely appreciate it.

Stakeholder name	Company	Title
Adam Boros	BII (British International Investment, Formerly CDC)	Manager (Formerly Tshikululu)
Adliya Van Niekerk	Innovation Edge	CFO
Albert Wimmers	DBSA	Senior Deal Originator
Aunnie Patton Power	Oxford, Impact Finance Pro	Associate Fellow, Co-founder and author
Barry Panulo	World Food Program	Innovative Financing Consultant, WFP Innovation Accelerator
Bridget Fury	Oppenheimer Generations	Former Head of Programmes
Bridgit Evans	SAB Foundation	Executive Director
Cathy Duff	Trialogue	Director
Cerin Maduray	WWF	Specialist
Chantal Ramcharan-Kotze	Partnering for Impact	Managing Director
Diana Njuguna	DFC	Advisor
Dipalesa Mpye	Tshikululu Social Investments	Head
Elias Masilela	SA NAB	Chairman
Heather Jackson	RBN Fund managers	CEO
Heather Sherwin	ELMA Philanthropies	Head of Impact Investing
Heleen Goussard	Riscura	Head of Alternative Investment Services
Jana Van Deventer	Intellidex	Manager/Researcher
Jayne Mammatt	Deloitte	Partner
Jonathan First	GFA Climate & Infrastructure	Managing Director
Julia Price	Linea Capital	Co-founder and Director

Stakeholder name	Company	Title
Khayalethu Makhubu	ELMA Philanthropies	Program officer: Impact investing, Gender and Social Justice
Konehali Gugushe	First Rand Foundation	Head of Social Investing
Lelemba Phiri	Africa Trust Group	Principal and Founder
Lerato Lehoko	Yellowwoods	Manager
Malik Fal	E Squared	CEO
Misha Morar Joshi	SA NAB (National Advisory Board for Impact investing) and UCT Bertha Centre	Head, SA NAB
Mmabatho Maboya	Cyril Ramaphosa Foundation	CEO
Mohan Vivekandan	DBSA	Group Executive: Origination & Client Coverage
Natasha Dinham	Roots Capital	Lead Advisory Manager
Ndabe Mkhize	Mavovo Capital	Managing Partner and Founder
Shameela Ebrahim	JSE	Chief Sustainability Officer
Shelley Lotz	SAVCA	CEO
Shiluba Mawela	Tshiamo Impact Partners	Managing Director
Sibonakaliso Mavuka	Tshikululu Social Investments	Head of Business Development and Special Projects
Sizwe Nxasana	Sifiso Learning Group	CEO and Founder
Susan de Witt	Frontier Finance	Director
Tanya Goncalves	Metier	Head of Investments and Impact
Xolisa Dhlamini	Sanlam	Head: Sustainability Operations and Impact
Zanele Twala	Standard Bank Tutuwa Community Foundation	CEO

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