



Gray Ghost Microfinance Fund

Building the Bridge to Impact Investors

OCTOBER 2015



This review was prepared by Paul DiLeo and Anna Kanze of Grassroots Capital Management with assistance from Francisca Lund and Alana Heath. The opinions expressed are theirs alone.

About the Report

This report presents detailed results and insights into asset allocation decisions taken at the Gray Ghost Microfinance Fund (GGMF) – an early private investor, promoter and operator of funds in the microfinance industry. The report that follows recounts and assesses GGMF’s experience and suggests some lessons of continued and general relevance with the objective of engaging impact investors and developing the impact investment industry. The report is divided into three key sections:

- › **Section I** — Foreword & Executive Summary
- › **Section II** — Detailed review and analysis of the performance of GGMF
- › **Section III** — Detailed review and analysis of the performance of GGMF’s investments

Please find Section 1 of the report online at:
www.grassrootscap.com/ggmf-report

About the Authors

Grassroots Capital Management Corp PBC (Grassroots) has been an active participant in the evolution of the global microfinance industry from philanthropic experiment to an industry with over 300 million clients, fully integrated into capital markets and many national financial systems.

Beginning with pioneering investments in BASIX and BRAC Bank in the late 1990s, Paul DiLeo launched and managed the Gray Ghost Microfinance Fund for most of the past 12 years, and created Grassroots Capital to launch and manage other impact funds. In the process, the Grassroots team has learned many lessons in how capital can be engaged to meet both financial and social objectives.

Going forward, Grassroots’ purpose is to help encourage individuals and institutions to regard their investment capital as one of the most powerful instruments at their disposal to affect the world and the future for better, and to provide vehicles to enable them to choose to constructively deploy this capital to build communities and eliminate poverty.

BY BOB PATTILLO / FOUNDER OF THE GRAY GHOST MICROFINANCE FUND & GRAY GHOST VENTURES

Gray Ghost Ventures' ultimate goal is to encourage impact investing as a core component coloring all aspects of the life of all investors: economic to family to spiritual.

While this journey is in its early stages, we are doing our best to illuminate the path. We count many more collaborators working towards that common purpose now in 2015 than was the case when we started. I can pick up my personal journey in the mid-1990s, after being fired from my family business by my older sister! Over the next nine years, I built Robert Pattillo Properties into the eighth largest industrial real estate developer in the United States. We'd gone toe to toe with some of the largest property development firms in the world, and won our share of tenants, plus a little. Even the old family business started using the strategies I'd proposed ten years before, so I had nothing left to prove to my family. At the same time I was professionally ready for work with a bit more purpose. I started searching, and found that purpose right under my nose.

In 1997, our charitable foundation had been introduced to microfinance. Led by David Weitnauer who headed our foundation, we began providing grants in support of the MIXMarket and Sanabel, the regional association of MFIs in the Mideast and North Africa. By 2001 I began imagining the possibility of microfinance as an investment, rather than strictly a philanthropic opportunity, and that tickled my vocational fancy.

The transformational power in the relationship between the microfinance loan officer and the client entrepreneur is rooted in the fact that it is a business relationship; the loan officer expects repayment. He/she is also dependent on the clients to know their business, to understand the customers on the street, to deep down know the needs of the community. But here is the big surprise: as a customer herself (of the MFI), the client earns the right to a fairly priced product, delivered in a timely basis, and in a quality fashion. She also expects the loan officer, the management team, even the shareholders to "know their stuff": to run the bank profitably so that another loan is forthcoming if she repays the first with success; to increase efficiency through training, scale, and technology so that her interest rates come down; to innovate and offer additional products like savings, life insurance, affordable home loans,

and education finance; and to treat her with respect. The best MFIs leverage the customer relationship by offering her other financial services, like savings, life insurance, maybe a home renovation loan, or even student loans to her kids. Here's a market dynamic with legs that philanthropy, government, the nonprofit world, even the church do not offer. The feedback loop of knowing what the local community truly needs is only available in a transaction with a meaningful exchange of value, a series of market-based transactions that define a business relationship.

So we decided to shift from philanthropy to investment, in the belief that microfinance offered an opportunity to align portfolio with purpose; values and personal growth; talent and joy. In 2003 I took what many (still!) consider the extraordinary decision to devote substantial financial resources and all my professional time to developing the private markets of microfinance.

Once that choice was made we needed a guide, a Sacajawea to our Lewis and Clark. David asked around the industry and came up with several names to help with what was intended to be a month-long research effort to survey the scene. We selected Paul DiLeo. Soon after the assignment commenced, we asked Paul to also take a look at a new fund that we'd been invited to invest in, MicroVest, and help us learn by doing. In the course

of that initial work, we were able to determine that Paul had more to contribute than thirty days of research.

We were on a conference call with Gil Crawford, promoter of MicroVest and one of the best and most resilient promoters of the industry. All of the sponsors had agreed on one thing: the fund must reach a critical mass of \$15 million to launch. Gil had worked like a Trojan to raise the money and he'd made progress, but prospects were slow to sign. Gil had asked for, and received, two extensions on the commitment deadline before being introduced to us and was fast approaching the third and final deadline, December 31. There was to be no more time given, and Gil had \$4 million left to raise of the \$15 million minimum. Paul worked patiently with Gil to find a way to get MicroVest launched culminating with a marathon phone call that began with Paul in his car to get cell reception, and ending at an outdoor pay phone in 17 degree weather after his battery ran out.

Paul's efforts with Gil dovetailed with my own experience and approach, and it's how Gray Ghost Ventures has continued to operate as it has moved beyond microfinance into other promising impact sectors: care about the fund manager, and through them, the company management team, and their clients. For an investment advisor, relationships are more important than deals: if you squeeze every nickel out of an investment, the

management teams will go out of their way to fund the next venture with somebody else; but if you listen first, show respect, help a manager solve problems together, show up at committee meetings prepared, and visit the field to “walk the walk”, the strength of the relationship will provide way more value, including financial, over the investment horizon.

For Gray Ghost Ventures, the “how” of investing is as important as the “who” or the “what”. Gaining the trust of the fund managers, and through them the CEOs of the impact enterprises, is vital to successful equity investment. Holding shares is like becoming a partner, in the strategy, the success, and the failures. CEOs and managers want to know the investor brings more than money. Substantial time is spent in the field, validating the leader and their decisions. When a time for pushback from shareholders comes, management clearly feels like all involved were putting one thing first: the enterprise. And by caring for the long-term interests first, sifting through those times when competing shareholder interests arose comes easier. Often investees vet us as thoroughly as we vet the prospective funds or their MFIs. They want to know the history of our past relationships before deciding to invite us into a new one, as they should. It is part of the reason we did debt deals in the early days, to establish our reputation. Nobody understood this better than Paul; and what began as a thirty day assignment developed into a long term working relationship.

With the benefit of those years of experience, much of which is shared in detail in this review of the Gray Ghost Microfinance Fund, our vision has crystallized: impact investment is a transformative experience for the investor, mending family relationships, offering purpose to our existence, stretching the development of our gifts. Gray Ghost and Gray Ventures’ success demonstrates that participants on both sides of the social investment relationship can benefit. Impact investors can add unique skills, resources, and perspective to the mix that supports the growth and evolution of microfinance and now other impact businesses globally, enhancing the impact and prospects for more clients. At the same time, impact investors themselves can benefit from an enhanced engagement with communities across the globe, a direct involvement in the responsible stewardship of their material abundance, and creation of a lasting legacy. Back in 2004, when we started Gray Ghost, we had this inkling:

“Finance is a means to a more fulfilling and rewarding life for ourselves, our families, and our communities. For Gray Ghost, the personal commitment and relationship implicit in a broad conception of social investment is central, ensuring that microfinance will remain merely the means to an end, and that the financial accomplishments and management achievements of microfinance will not obscure or replace the ultimate goal of enriching lives, both financially and spiritually, on both sides of the investment transaction.”

As it has become clear that many impact investments are financially profitable, perhaps extremely so, I have taken the next step of committing to recycle all the proceeds back into impact enterprises. I also have committed 96% of my net worth to impact. In part, this is in recognition and with respect that many other stakeholders have contributed money, time, expertise, relationships, or ideas over these years into these same enterprises without the notion that it would make a profit. Certainly they did so knowingly, and fully aware that Gray Ghost invested from a for-profit legal structure. But, Paul and I were motivated to generate profits mostly for sustainability, the demonstration effect, and by our own professional aspirations for extraordinary performance.

Gray Ventures' move into other impact sectors, including education, women's employment opportunities, and bottom of the pyramid technologies, is consistent with the approach taken by Gray Ghost and detailed in this report — taking the first mover risks, learning by trial and error, cultivating lasting relationships — and in this way building the bridges that enable other investors to follow.

I've learned that there are only three things you can do with money: you can spend it, you can give it away, or you can save it and invest it with the intent of spending it or giving it away at some future point. Historically, the idea was that *spending* brought personal happiness, and *giving* community happiness;

now with impact investment, investing, giving, and spending converge. The financial returns are demonstrable; over the last 10 years our microfinance investments have provided a nice return on capital, while our impact investments in education and mobile technology which have benefited from what we learned in Gray Ghost have done even better.

In this foreword I've shared my personal journey to impact investing and creating Gray Ghost Ventures; the review that accompanies is Paul's attempt to capture the part of that journey that is the Gray Ghost Microfinance Fund. I hope that one or both of these will encourage you to consider your own roles and purpose, take some inspiration from what we have done, and set out on your own journey. May this experience and these beliefs help you become a "Founder" yourself. May we travel on this investment journey together. May we encourage each other, share our new understandings, and teach one another's children. The future of our planet depends on it.

Impact investing has come of age.

Reports and surveys from sources including the Economist, JP Morgan, the Symbiotics Group, the GIIN², the World Economic Forum, and others have reported performance results from a wide set of funds and including comparisons with other investment alternatives, helping to raise the profile and orient actual and potential investors. But while the information and data available increases nearly every month, in many ways this is still early days. Data on financial performance, particularly for equity and other risk capital investors, is still thin. Metrics on social performance are emerging, but are still a work in progress. The relationship between social and financial objectives is still being understood and explored. And all these data and analyses are revealing just how varied and heterogeneous a category “impact investing” actually is.

The Gray Ghost Microfinance Fund (GGMF) was launched in late 2003 as a pioneering private fund of funds intended to promote the microfinance industry and in particular, private capital flows into the industry. At the time, it was the largest private investor in microfinance. It was conceived as an industry builder and path breaker, building the bridge between impact investing and private capital.

This report presents detailed results and insights into asset allocation decisions taken at GGMF. Starting in 2003, GGMF committed \$97 million across 23 funds, seeded 12 new impact managers and is on track to deliver a 5.4% annualized return to its investor from a portfolio combining debt and equity assets. The vast majority of managers with which GGMF invested have gone on to successfully raise new impact funds and become prominent actors in the impact space. Gray Ghost Ventures has expand-

¹ An initial assessment of GGMF was distributed in July 2013. This revised version has been updated to reflect portfolio performance as of June 30, 2015 and industry developments over the past two years.

² The Symbiotics group has prepared a well-regarded index of returns on microfinance debt funds for several years. In 2015, the Global Impact Investing Network (GIIN) and Cambridge Associates unveiled a benchmark for PE and VC impact funds which over time can be expected to become increasingly useful to impact equity investors. As of today, Grassroots believes that the first vintage of microfinance equity funds provides the most complete, reliable and broadly relevant data on the performance of early stage impact equity investment and how these returns .

ed and added education and health to its investment sectors, and GGMF's own manager – Grassroots Capital Management – has gone on to raise and advise 4 more funds with two more in process.

But why should the rest of us care to read about a fund that had largely completed its active investment phase more than five years ago? There are two important reasons. First, because of GGMF's role as an early private investor, promoter and operator of funds, it gained a unique perspective on what succeeded and what didn't, and indeed, a textured view of what "success" means in the context of impact investing. From GGMF's experience, achievements and shortcomings, several key observations stand out which can help clarify and guide impact investors as they form their own view of how they want to engage impact opportunities as the scale and scope of businesses pursuing a double or triple bottom line continues to grow and seek more investors and capital.

And there is a second reason to read about GGMF's performance. In recent years, discussion on performance measurement of impact investments have been dominated by the challenges of measuring social impact, leading to a mini-industry of social performance measurement, randomized control trials, and battling blogs. However, because of the presumed ease

of measuring financial performance, the absence of transparent and regular reporting of financial results – particularly of equity investment – has been overlooked. Selective reporting – "cherry-picking" – of results is rampant, gross and net (of expenses) results are often confused, and realized and unrealized returns combined, all making for great sound bites but failing to illuminate what an investor is likely to actually realize. We believe that for impact investing to 'come of age', the industry needs to win confidence of investors by improving

the quality and transparency of reporting both financial and social performance. Because GGMF was so engaged in the earliest vintage of microfinance equity funds, it can again lead the way in transparently reporting comprehensive financial results for microfinance equity, and the insights into how these returns were achieved.

Gray Ghost Ventures and Grassroots have collaborated to produce this report on the Gray Ghost Microfinance Fund in hopes that it will provide actual and prospective impact investors with insights and guide-

posts to their own activity. Nearly 15 years on, we believe that the capacity of impact investing to help address many of the world's more pressing challenges has been demonstrated. The task now is to encourage more of us to devote more of our financial resources to impact investments, and we hope this report can play a part in doing so.

In applying its resources to entice others into the impact investing market, Gray Ghost accomplished something that only a private investor could do. It was a much more important move than simply giving the money away. Gray Ghost is a wonderful example of intelligent and courageous use of money.

—*Elisabeth Rhyne,*
Managing Director of the Center for Financial Inclusion at Accion

Gray Ghost's active investment period ran from 2004 through 2008. At the start of this period there was virtually no private, non-philanthropic funding of microfinance, and Gray Ghost was the largest private microfinance investment fund.

By 2009, the microfinance landscape that prevails today was largely in place, with a multiplicity of private investors and vehicles spanning the full spectrum of the capital markets. The Gray Ghost Microfinance Fund was an active and influential participant in this transformation of the landscape during this formative period:

- GGMF committed \$97 million to 23 microfinance investment vehicles (MIVs) during 2003 – 2008; it created or co-founded eight of these and provided the critical capital to enable four others to launch.
- These MIVs raised \$760 million in total during this period – more than one quarter of average MIV assets under management (AUM) during these years.
- Of this amount raised, \$480 million was from private sources.
- GGMF assessed over half and invested in over a quarter of the 80 MIVs in existence as of 2008.
- During 2006–2008, GGMF accounted for 10–20% of all reported microfinance PE transactions, and a much higher proportion of secondary market purchases and sales.
- GGMF operationalized the integration of a social value model into its investment process in 2004.
- GGMF promoted roughly half of the local microfinance investment management teams that had emerged as of 2011.

Gray Ghost is a true impact investor that has made a major contribution to making microfinance equity a serious investment class for institutional investors around the world. Gray Ghost has been instrumental in the creation of Catalyst Microfinance Investors (CMI): it was the first investor to commit to what essentially was no more than an idea for a microfinance equity fund and the first to substantially increase its investment commitment, which in turn motivated other investors, including various major international pension funds, to commit large sums to CMI as well.

—Md. Shafiqul Haque Choudhury and Dirk Brouwer, Catalyst Microfinance Investors

Gray Ghost seeded many of today's leading MIVs and their managers – taking the lead when others were still deciding.

Capital Committed by Gray Ghost

2005
\$59 Million

2006
\$76 Million

2007
\$82 Million

2008
\$97 Million



Total Capital Committed to Gray Ghost Investees

2005
\$480 Million

2006
\$523 Million

2007
\$555 Million

2008
\$902 Million



Growth of the Total MIV Universe¹

2005
\$1,195 Million

2006
\$1,964 Million

2007
\$3,864 Million

2008
\$4,931 Million



¹ Source: MicroRate 2012 MIV Survey: total MIV AUM 2005-2008



Gray Ghost **leveraged its capital 8x**, increasing access to finance for millions



Our MIVs reached nearly **20 million people**



Our MIVs' investments reached over **1 million households**



And provide **employment for over 100,000 people**

Early on, Gray Ghost set five goals that would be the basis for its investment strategy and direction.

With over three quarters of its portfolio investments exited, this assessment will document that GGMF was largely successful in pursuing these goals and helping to shape the industry. Just as important, closely examining GGMF – a very active early investor – helps distinguish different types of impact investors with different appetites for risk, return and social impact and the different roles they play, with useful applications to the entire impact investing segment as it develops and matures.

- 1. Mobilizing Social Investors**
- 2. Generating Liquidity**
- 3. Creating a Financial Track Record**
- 4. Balancing Social and Financial Returns**
- 5. Promoting Local Management Capability**

1. Mobilizing Social Investors

GGMF was created to accelerate and deepen the engagement of private social investors in the microfinance industry, bringing their energy, perspective and capital to help move the industry to scale and maturity.

- Gray Ghost's \$97 million in commitments was matched with nearly \$500 million in commitments from other private investors, together representing well over half the total capitalization of the vehicles in which Gray Ghost invested.
- MIVs in the Gray Ghost portfolio had total assets under management (AUM) of \$900 million, representing a substantial proportion of the total during a period when total MIV AUM grew from \$1.2 to \$4.9 billion³.
- Gray Ghost leveraged its capital eight times, in most cases taking subordinated positions, and anchoring new investment vehicles which have since become industry models.
- Gray Ghost's industry-wide influence was substantial, providing and mobilizing critical support to fledgling and established players alike: Deutsche Bank Global Social Investment Funds, Calvert Foundation, Developing World Markets (DWM), Catalyst Microfinance Investors (CMI), Bolivian Investment Management, MicroVest, Caspian Impact Investment Advisor, and others.

As DWM struggled for almost a year to successfully launch in 2004 the first Collateralized Loan Obligation (CLO) in the microfinance space, there was one investor whose enthusiasm and degree of commitment to the deal sent a clear signal to the market and gave a huge boost to the team: Gray Ghost. With this critical help from Gray Ghost the deal helped stimulate, at an early stage, what has gone on to become a significant market in microfinance and impact investments in general. At DWM we will forever be grateful and recognize how much we are in the debt of fellow impact investing pioneers such as Bob, Paul and Gray Ghost.

*—Peter Johnson, Managing Partner at
Developing World Markets*

³ Source: MicroRate 2012 MIV Survey: total MIV AUM 2005–2008.

2. Generating Liquidity

Gray Ghost recognized that the perception of illiquidity and lack of financial track record were significant obstacles for private investors, and aggressively sought out opportunities to promote liquidity in micro-finance assets.

- Gray Ghost was responsible for a significant proportion of secondary market activity at both the MIV and MFI levels, promoting liquidity and generating price data when the absence of both was impeding further engagement with broader capital markets.
- Gray Ghost devoted significant resources to investor education and outreach, focused on the accumulating transactions and performance data and how to interpret them in the context of the double bottom line.

As one of the first large purely private investor in microfinance, Gray Ghost was a breath of fresh air to the industry. Devoting significant financial and other resources to tackle the lack of a secondary market for equities is an excellent example.

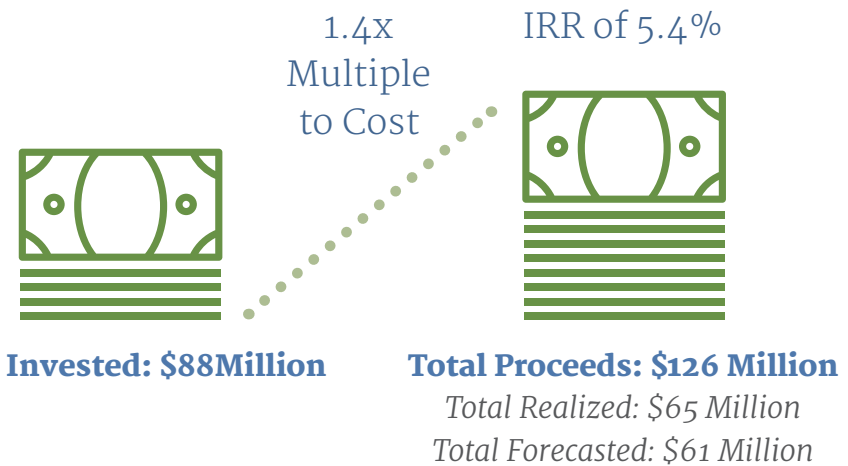
—Alex Silva, Founding Partner of Omtrix

3. Creating a Financial Track Record

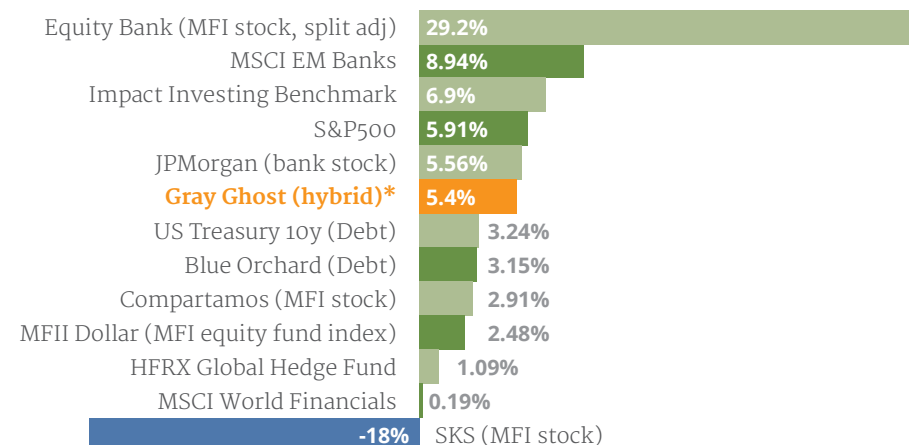
Gray Ghost's original financial objective was to preserve capital, subsequently revised to earn a moderate return, before expenses. For demonstration purposes, Gray Ghost endeavored to include investments in its portfolio that demonstrated the full range of possible outcomes with respect to financial returns and social value creation.

➤ The internal rate of return on the Gray Ghost portfolio of debt and equity funds (incorporating realized returns and projected returns on the outstanding assets) points to a final overall annualized return of 5.4%.

➤ While interpreting financial comparables in microfinance is not a straightforward exercise a review of a range of benchmarks and comparables that share some of GGMF's characteristics suggests that financial performance was in line with benchmarks.



Gray Ghost returns are solidly in the middle of alternative investments



*GG returns include conservative estimates of expected proceeds at exit for unrealized investments. Annualized returns for benchmarks are 5 – 12 year periods ending June 2015. For more detail see main report.

4. Balancing Social and Financial Returns

Gray Ghost was sensitive to the importance of confirming the double bottom line character of MFIs and undertook to carefully weigh the balance of social and financial value created in its investments and ensure that they maintained a core commitment to social innovation, outreach and impact.

- Gray Ghost succeeded in playing a catalytic role in the creation of a variety of different vehicles suited to various investor financial return requirements, risk appetites and social objectives and has illustrated the full range of risks, financial returns and social outputs available to investors in microfinance.
- Gray Ghost was a very active investor, with staff on Boards and Investment Committees of nearly all its investments (19 of 23), influencing the financial and social strategies and performance of a significant swath of the total industry.

With its investment, Gray Ghost became the largest and key investor, whose participation in Centurion attracted a number of international lenders to the company. When the company was faced with challenges, Gray Ghost played a significant role in saving the company and nurturing it to sustainability. As a result, Centurion Capital was the only wholesale company in Russia that survived the financial crises of 2008-2009, and not only became profitable and financially sustainable again, but grew beyond pre-crisis levels

—Irina Fedyaeva, General Director of Centurion Capital

5. Promoting Local Management Capability

Very early on, Gray Ghost concluded that building local investment management capacity in the target regions was the best way to both increase the flow of capital to where it was most needed in the micro-finance space and to increase access to investment opportunities for social investors.

- GGMF promoted roughly half of the local microfinance investment management teams that had emerged as of 2011, including successful management teams in India, Latin America, Russia, South Asia and Africa.
- As Gray Ghost had hoped, these locally based fund managers have promoted additional capacity, innovation and scale in a way that managers based in North America or Europe could not.

I write this on a day when India's Central Bank gave Banking Licenses to India's top ten MFIs, seven of them our Partners, and more importantly none of the seven existed in 2004! That was the year when Caspian and Gray Ghost conceptualised and established a catalytic fund to expand financial services in India – arguably one of the world's largest underserved market. This would not have been possible without the vision and single minded focus of Bob and Paul to broad base the Indian market by investing in extremely talented Indian entrepreneurs to engage in Indian microfinance, which at that time was dominated by poorly run government programs. This partnership flourishes even today. Trust, mutual respect and humility is the cornerstone of this relationship. It is only appropriate that a report of this nature should be brought out and given wider publicity, so that other stakeholders can learn from what Gray Ghost has achieved.

—Viswanatha Prasad, Managing Director of Caspian Impact Investment Advisers

Key Lessons for Impact Investing

Because Gray Ghost was so active, so early, and operated as a promoter and operator as well as an investor in funds, it had a unique perspective on what succeeded and what didn't, and indeed, a textured view of what "success" means in the context of impact investing.

From the Gray Ghost experience, achievements and shortcomings, several key observations stand out which can help clarify and guide impact investors as the scale and scope of businesses pursuing a double or triple bottom line continues to grow and seek more investors and capital.

1. Lead Investors

Impact sectors are highly dependent on "lead investors" like Gray Ghost, particularly as the business model is being stabilized and the track record of performance built. These early movers devote the time and incur the expense to find and develop relationships of trust and support with managers. Gray Ghost invested as much as five years to launch some management teams, and has remained engaged for ten years

and counting in others. While such lead investors play a crucial role, it is not one that can be justified on purely economic grounds as they are unable to capture much of the value they create.

2. Absorptive Capacity

While at a macro level the need for equity in microfinance appeared enormous, Gray Ghost and its MIVs found actually placing equity to be slow, suggesting that investors should be prepared to be patient without getting discouraged or moving prematurely to other sectors.

3. Local Management

The absence of local equity managers with experience and a solid track record capable of building pipelines of investible MFIs and creating social and financial value was a major impediment to the emergence of a solid, dynamic sector in most regions. Gray Ghost made a major commitment to developing local management teams, and in a number of cases these teams have now moved to support other impact sectors building on their microfinance foundation. But the intensified focus on microfinance "governance" in recent years, with major initiatives and studies in Africa, Latin America and India⁴ can be seen as confirmation that this remains a pressing need for microfinance and impact investing more generally. While

⁴ For example, the Africa Board Fellowship program; the Governance and Financial Inclusion program in Latin America; the "Governance Practices among Microfinance Institutions in India" study undertaken by MicroSave and SIDBI with support from UKAID and released in June 2015 and the AfriCap Governance Assessment undertaken by Grassroots and published by Calmeadow in March 2015.

one aspect of improved governance is cultivating the role of independent directors, a core feature remains engaged and informed nominee directors, which depends on robust local management capacity.

4. Impact Measurement

Gray Ghost's attempts to define and measure the social value of its investments dates back to 2004, when it incorporated a rudimentary social value model into its investment review process. Its experience showed both how difficult this is to do, and how critically essential it is if a coherent, cohesive financial and social strategy is to be implemented. Microfinance has learned, to its regret, that social value creation cannot be taken for granted: social objectives, even if modest, must be well articulated, operationalized and held to account if access to capital providers, and especially social investors, is to be preserved.

5. The Role Of Impact Equity

Until quite recently, there was scant information available on the performance of managed portfolios of microfinance equity. Instead, industry promoters touted selected results on individual transactions – or even unrealized values – to purportedly demonstrate financial performance.

There is ample evidence both from Gray Ghost and other

investors that investments in microfinance institutions can yield very competitive financial returns; well over half of the exits from Gray Ghost portfolio MFIs have yielded annualized returns in excess of 20%. This has helped engender strong interest from both impact and conventional investors in microfinance and other impact sectors.

However, results at the individual company level don't always translate into results at the portfolio level, where most investors face fee and expense leakage, as well as failed and underperforming investments. Gray Ghost and Grassroots' data, which largely avoids selection or survivor bias since it includes the entire early vintage of equity funds, suggests that investments in impact equity funds may not reliably offer returns significantly in excess of returns on portfolios of debt, at least in the initial vintages⁵.

Some investors have reacted to this emerging data by concluding that the solution is to invest directly, ignoring the fact that taking functions in-house may just obscure but not eliminate expense while resulting in less focused and less consistent management. Others have sought to reframe their investment goals to focus on impact sectors that target “superior” or “top quintile” returns.

We believe that the Gray Ghost experience demonstrates that equity is the instrument through which the social missions of microfinance and impact businesses are promoted and pre-

⁵ For a summary of Grassroots' data, see Microfinance Equity Exits: Data on Company and Fund Level Returns (www.grassrootscap.com/microfinance-equity-exits-data-on-company-and-fund-level-returns)

served: by absorbing higher costs; by accommodating the trade-offs that promote and confirm social objectives; and by innovating and absorbing the failures that will inevitably accompany efforts to address the intractable challenges of poverty, exclusion and economic justice.

Taken together, these observations point to a critical and idiosyncratic role for risk capital investors in impact businesses, particularly when new sectors begin the transition from philanthropic and donor support and approach the broader capital markets. These early risk capital investors build the essential bridge: finding the successful models and managers, largely through trial and error; stabilizing and safeguarding the balance between double and triple bottom line objectives; accommodating structures and timelines that may erode financial returns.

These are functions that were critical to the emergence of microfinance from a very narrow niche product to an investment accessible and appropriate to the wider capital markets and able to mobilize the billions of dollars that it now routinely raises each year. But they are also functions that, certainly in the early years, will not be financially remunerated: some first time managers will fail; some investor and management team will fragment; early funds are often sub-scale with disproportionately high fee and expense leakage; some business strategies will hit dead ends due to poor design or a shifting

regulatory, political or competitive environment; absorptive capacity may be out of synch with capital available resulting in overpricing or underleveraging. These are risks that are shared by many emerging industries, but compounded in all cases by adding an impact dimension.

The Gray Ghost experience suggests that there is a very particular and essential role to be played by those rare investors, like Bob Pattillo and Gray Ghost Ventures, who are willing to play the kind of transformative and bridge building role successfully played by Gray Ghost. More conventional, profit-maximizing investors play a very limited or even counterproductive role in the initial phases of proving social business models and scaling up, particularly those with low tolerance for trial and error and shorter timelines. And unlike the more conventional venture capital space, blockbuster returns in social investments targeting the poor, can have damaging repercussions⁶.

An important objective of this assessment of Gray Ghost is to highlight this role, and make the case to investors to devote at least a portion of their portfolio to supporting funds and managers that build nascent impact sectors, support innovation and outreach in existing sectors, and continuously push the boundaries of what impact investing can achieve in addressing the challenges of poverty, environmental degradation, and economic justice.

⁶ For example, many observers credit the SKS IPO, against a backdrop of reports of personal enrichment of MFI promoters, with creating the conditions for the Andhra Pradesh crisis of 2010.

Looking Forward

Overall, Gray Ghost has met its goals. But as usual, when you get to the top of one hill, it often gives you a better view of the peaks that lie ahead.

One thing that has become clear is that as impact investing has caught the attention and enthusiasm of many individual and institutional investors -- in large part due to the success of microfinance -- the need for investor education has grown more pressing. This cuts across several of the issues targeted in Gray Ghost's original objectives, including building a financial track record, articulating the social value proposition, and balancing the two. If anything, the accumulating experience and data with respect to both financial and social performance has made investor education more challenging, as the original overly-simplistic criteria (Is microfinance "investible"? Is average loan size holding steady?) have given way to more complex and varied criteria for evaluating performance. Gray Ghost's experience has greatly illuminated these performance issues, and helped fill the vacuum of information about what impact investors can and should reasonably expect. This data has, in turn, provided a solid basis for Grassroots' very active engagement in discussions of how to set and balance financial and social return objectives in recent years.

As impact sectors engage new investors, such careful and candid investor education is crucial to building stable and reliable relationships, even if this process slows the rate at which capital is engaged. At the same time, well-informed investors can bring more than money, enhancing the value proposition for investee partners. Among the questions and issues investors can consider as they embark on an impact investment program are:

- Have we thought through our expectations and rationale for profitability? What are our priorities in this investment? What is pursuit of social mission worth to us?
- Can we distinguish lower profitability associated with mission from inefficiency that erodes value to clients?
- Are our expectations with respect to mission well-defined and aligned with or at cross purposes with management and co-investors?
- Are we fully aware of the particular reputational and political risks that may be associated with impact investing, particularly when it focuses on poor and very poor clients?

- ▶ Are we prepared to commit the time and money required for active and engaged participation in governance, either directly or through others, and take the sometimes difficult decisions that may be required with respect to leadership development and succession, exits and other often contentious issues?
- ▶ How do our impact assets fit with the rest of our portfolio? What are our financial expectations or requirements?
- ▶ Are we prepared to be patient as impact business models build the capacity to productively absorb capital? Are we realistic about the likelihood of setbacks and outright failures as new models are subjected to trial and error and the inevitable growing pains?

A thorough and candid exploration of these and similar questions takes time, but lays a solid basis for investors to find a comfortable niche and position themselves to make a lasting positive contribution to building impact businesses.

Investors can play the critical role in moving a social initiative to scale and sustainability⁷, building in many cases, including microfinance, on the models and innovations pioneered and refined with support from donors and philanthropies. Investors strengthen promising models through business discipline,

provide solid governance and demand accountability for results. A subset of these investors will also take on the bridge building role played by Gray Ghost. It is hoped that this assessment will encourage the emergence of more such investors and support the proliferation of impact businesses to address the most pressing challenges and enrich lives.

Ultimately, Gray Ghost's goal was to make impact investing a more accessible component of everyone's financial and spiritual lives. While this is far from being achieved, the path to get there has been greatly illuminated by Gray Ghost's efforts.

"Impact investing" is increasingly assumed to be an important component of any investor's portfolio, even as its definition remains fluid. Gray Ghost Ventures and Grassroots are enormously gratified by the partners and collaborators that have helped us achieve our goals and make such progress towards that common purpose. We look forward to continuing to work with these and new partners as we continue this challenging and rewarding work.

⁷ Discouragingly, some observers still overlook the role investors, as distinct from donors, play: see Karlan, SSIR, Nov 2014.