Report

Nesta Impact Investments

IMPACT STRATEGY AUDIT REPORT

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Results in development

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Statement of Independence

The views expressed in this report are the professional opinion of Itad. They do not represent those of Nesta Impact Investments or of any of the individuals and organisations referred to in the report.

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Acronyms

AGM	Annual General Meeting
ANDE	Aspen Network for Development Entrepreneurs
B2B	Business to Business
B2School	Business to School
EVPA	European Venture Philanthropy Association
GIIN	Global Impact Investing Network
GP	General Partner
IC	Investment Committee
ID	Investment Director
IM	Investment Management
IMM	Impact Measurement and Management
IMP	Impact Management Project
IVUK	Impact Ventures UK
KPI	Key Performance Indicator
LP	Limited Partner
NICE	National Institute for Health and Care Excellence
NII	Nesta Impact Investments (NII is the trading name of NIM LLP)
NIIF 1	Nesta Impact Investment Fund 1
NPC	New Philanthropy Capital
QLP	Quarterly portfolio-level Limited Partner (Report)
SIITF	Social Impact Investment Task Force
SPTF	Social Performance Task Force
SVI	Social Value International
SDG	Social Development Goals
SROI	Social Return on Investment
SVI	Social Value International
ToC	Theory of Change
UK	United Kingdom

Executive summary

Itad conducted an Impact Strategy Audit of Nesta Impact Investments (NII). This assessed their use of the strategy and compared it to best practice in the industry.

Nesta Impact Investments 1 Limited (NII1) is one of the UK's first impact investment funds. Established in 2012 with a focus on education, health and communities initiatives, the £17.6m fund invests in innovative, high-growth businesses to address social problems.

Itad undertook an audit of NII1's Impact Strategy to assess it's practical implementation, and compare it to good practice in the industry.

This report sets out a number of findings and recommendations for Nesta.

Since NII1's inception, NII has been committed to a rigorous understanding of the social impact of the Fund's investments.

NII refreshed this effort in 2016/17, developing a new strategy which set out their:

- guiding impact principles
- approach for selecting high impact investments
- approach for managing their portfolio for maximum impact
- reporting and transparency mechanisms

What is the Impact Strategy Audit?

The Impact Strategy Audit[1] explored the alignment between Impact Strategy and implementation and any resulting tensions and trade-offs. The primary objective of the Impact Strategy Audit is to assess NII's Impact Strategy in practice, and the secondary objective is to compare NII's Impact Strategy to good practice from industry Impact Measurement and Management (IMM) frameworks, and to those of other impact funds/fund managers.

The Impact Strategy Audit is expected to offer additional value to NII, Nesta and the wider investments management ecosystem in terms of improving IMM during NII1 and for any future funds and demonstrating the value of an impact audit process.

Itad carried out this Impact Strategy Audit during October 2017 to January 2018 utilising a lean design. We believe this is the first learning-focused Impact Strategy Audit of its kind in the UK.

Our approach

Itad conducted this Impact Strategy Audit using a rapid, learning-focused approach, engaging stakeholders and gaining feedback as work progressed.

Itad interviewed all NII staff, members of the Investment Committee (IC) and three investees; reviewed documentation including frameworks, tools and reports along with external reporting; observed key meetings and forums including IC meetings and an Annual General Meeting (AGM); conducted a literature review of selected recent industry IMM frameworks and industry practices; and facilitated an analysis workshop with NII and Nesta colleagues.

The scope and depth of the Impact Strategy Audit has been tailored to the available resources and short timeframe.

[1] *www.nesta.org.uk/report/setting-our-sights-a-strategy-for-maximising-social-impact*

Key findings

We found that in practice, NII has implemented the Impact Strategy well. In some key instances, practice standards exceed guidance and we have recommended updates to the Impact Strategy on:

- Good governance and management arrangements
- Aligning commercial performance
- Impact in Impact Strategy
- Due diligence

Acronyms and definitions

NII	Nesta Impact Investments'
IMM	Impact Measurement and Management
KPI's	Key Performance Indicators
B2B	Businesses which trade with other businesses, rather than direct to consumer
ToC	Theory of change
Carry scheme	A share of the profits of an investment

Findings about what worked well

Of particular strength is NII's partnership-oriented and iterative approach, which prioritised flexibility and practicality. NII shows a recognition that impact is difficult and most businesses – particularly those at early stage – fail to deliver impact.

NII also recognise that the process of identifying impactful businesses and managing towards impact needs constant attention and alignment with business strategy at all stages of the investment cycle.

1. Selecting High Impact Investments

NII's selection of high impact investments is the area most closely aligned to Impact Strategy. NII invests significant effort and resources into developing sector strategies to build an iterative understanding of 'what good looks like'. The due diligence process and new impact risk-return tools are overall fit-for-purpose practices that support this selection process.

The NII team use the tool to appraise impact investments resulting in a balanced discussion, rather than relying solely on it's algorithm.

2. Managing the Impact

In managing the investments' impact, NII focuses on quality of the businesses' implementation and not solely on outcomes. NII invests resource and time to develop well thought-out theories of change and KPIs with investees.

3. Reporting & Transparency

Finally, NII's commitment to openness and transparency in the industry is evident, including opening up discussions with other investors and stakeholders on the challenges and approaches required for investing for impact.

Key findings (continued)

Findings about what to improve and strengthen

We found some areas of mixed alignment between Impact Strategy and practice.

1. Selecting High Impact Investments

When selecting high impact business-to-business (B2B) investments, maintaining focus on the end beneficiary is more difficult.

The new risk-return tool, though comprehensive, does not fully consider impact risk to beneficiaries or externalities and perhaps uses language that not all stakeholders understand (e.g. IC, investees).

2. Managing the Impact

Impact Plans are updated opportunistically, which is realistic when working with early-stage businesses, but not effective for IMM in the medium and longer term if the process does not become more systematised.

Data collection has lagged as compared to Impact Plans, particularly for investments made prior to the new Impact Strategy, and mostly for investee operational reasons, as some struggling investees deprioritise impact reporting.

3. Reporting & Transparency

NII has continued to support companies that have not reported, under the expectation that this will improve as operations stabilise.

External reporting has often emphasised scale of impact rather than depth due to incomplete data, missing the nuance and complexity of impact.

Comparison with impact investing industry good practice in impact, measurement and management

Industry practice for IMM is emerging and we still know relatively little about best practice, and there is no industry standard against which an audit can be conducted. The Impact Management Project (IMP), started in 2017, represents the most recent industry consensus for 'what good looks like' and builds on previous IMM guidelines and frameworks including from the philanthropic and microfinance sectors.

NII's Strategy and practice are comparable with this measure of best practice overall, therefore positioning NII as an industry leader in IMM. Some examples that stand out in NII's Impact Strategy as compared to industry good practice include their use of

1) Comprehensive sector strategies and risk-return tools to select investments

2) ToC and KPIs integrated into impact plans, using a flexible approach and own resources to manage impact

3) A full disclosure approach to IMM, including comprehensive annual reports and this Impact Strategy Audit

4) A dedicated impact team working alongside the investment team and leadership to make impact a priority for good governance and management

NII's assessment of Impact could be deepened by integrating unintended outcomes and sector displacement effects into their definition of risk-return.

Recommendations

In support of NII's improvements under the new Impact Strategy, we recommend focussing on five IMM areas:

1. Continual improvement of frameworks, tools, and process

Refine the risk-return tool, data reliability, and decision-making process, working with the IC and investees to understand and improve utility and timeliness through

a) establishing variations of the tool for B2B models, and for strategic sector-wide investment models and impact definitions

b) reviewing and updating IMM tools for reporting and learning

c) integrating standardised metrics (e.g. IRIS) and the Sustainable Development Goals (SDGs) into the framework, where relevant.

2. Continued sector leadership on the business value of IMM

Continue to work with investees and investors on understanding and promoting the business value of IMM, and NII's expectations for IMM, at all stages of the investment cycle. This should have positive effects downstream on IMM and reporting, and on the ability of investees to articulate their impact case and commercial value.

3. Governance and management

Consider aligning impact performance incentives with a carry scheme and broaden IC membership to include more input from the philanthropic sector to improve impact oversight and decision making.

4. Responsible exit

Exits are often overlooked but if NII is to contribute to sustained impact it needs to more carefully consider responsible exits.

5. Transparency and industry learning

Commission a formalised peer review mechanism for NII, including establishing a formal audit panel with representation from investees and other fund managers; share and collaborate more actively with Nesta; and consider pooling financial resources with other investors or organisations for independent IMM verification studies.

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Part 1: Context and Introduction

1 Introduction

1.1 Context for the assignment

1.1.1 Background

Nesta Impact Investments 1 Limited Partnership (NII1) is a £17.6m venture capital fund managed by Nesta Impact Investments that invests in innovative, high-growth businesses seeking to address major social problems. NII has three focus areas: education, health and communities. NII is backed by Nesta, an innovation foundation working in the UK and globally. NII is committed to supporting social ventures to deliver on their mission.

NII1 was one of the UK's first impact investment funds, set up in 2012. Since its inception it has been committed to a rigorous understanding of the social impact of its investments: NII believes that measuring and communicating social impact with integrity is critical for building confidence in impact investing as a sector. Its approach has been to provide dedicated technical assistance to its portfolio to increase the capacity of investees to measure, report on and react to social impact measures.

After five years of investment experience, NII has refreshed its approach to IMM including in 2016/17 developing and subsequently publishing a new Impact Strategy. Based on lessons learned over the years, NII has expanded its approach to impact risk and built a more structured and consistent approach to assessing impact across the portfolio.

NII commissioned an 'Impact Strategy Audit' to further cement NII's commitment to rigour and transparency. NII's aims of the audit were as follows, to:[1]

- *give, investors, confidence that NII's approach will provide an accurate report of impact achieved and provide them with useful information.*
- *improve NII's practice and increase the social impact of NII1.*
- *share lessons with the sector on challenges and successes.*
- *encourage other impact investors to increase transparency and submit themselves to independent scrutiny.*

NII contracted Itad Ltd, an independent UK-based monitoring and evaluation specialist professional services company. The audit commenced October 2017 and was completed in January 2018 and was designed as a light-touch rapid process. As far as known to Itad, it is the first learning-focused Impact Strategy Audit in the UK.

1.1.2 Purpose

During start-up, the aims of the audit framed in the Invitation to Tender were further refined between Itad and NII. The primary purpose of the assignment is to audit NII's Impact Strategy in practice: *to what extent is the Strategy helping NII (and its investees) to measure and manage impact effectively, and how does this compare to how NII managed impact previously?*

The secondary objectives of the audit are to: *suggest additional best practice from industry frameworks, and compare the Impact Strategy to those of other impact funds/fund managers 'benchmarking' NII's Impact Strategy*.

The Impact Strategy Audit is expected to offer additional value to NII, Nesta and the wider ecosystem, namely:

[1] NII Impact Strategy Audit Invitation to Tender

- The results of this audit will help NII understand how to improve IMM during NII1 and any future funds.
- The audit process itself could be integrated into NII's IMM approach in future.
- Other teams in Nesta are aware of the audit and might participate in some audit activities. These teams are interested in the value an Impact Strategy Audit could also offer to them.
- Learning from the results and process of conducting an Impact Strategy Audit could be taken to other investors and funds. The results of the audit might demonstrate the benefits of NII's approach, and also generate learning on the alignment with, and tensions between, Impact Strategy and practice.

1.2 Approach and methodology

Here we provide a high-level summary of the overall approach and framing of the audit (approach), and the steps taken to deliver (methodology).

1.2.1 Approach

The audit assessed NII's Impact Strategy fidelity to practice at each step of the investment cycle against the strategy sections. We applied two lenses:

1. **Interrogation of the extent to which NII's Impact Strategy is put into practice** at each step of the investment cycle, comparing with industry best practice for IMM, primarily the most recent industry consensus in the IMP[2] and other frameworks.[3]
2. Understanding **the priorities, roles, engagement and experience of different actors at each step of the investment cycle** in order to unpack any alignment or tensions between Impact Strategy and practice, and how management choices potentially represent trade-offs. Some of these aspects of alignment and tension may relate to specific steps in the investment cycle, but many will apply to multiple steps.

The Itad audit team worked fully independently, while taking a learning approach to maximise utility to NII.

1.2.2 Methodology

Key steps to conduct the audit included:

- **October 2017:** Selection and interviews with three investees as a 'deep dive' exercise; Initial interviews with NII Investment Team, Investment Committee and Impact team.
- **November – December 2017:** Document review of internal and external-facing NII documents; Follow up interviews with NII Investment Directors and Impact Director; Impact Strategy observations of Investment Committee meeting, and Annual General Meeting (AGM); Analysis workshop with NII and Nesta.
- **December 2017 – January 2018:** impact investing sector practice literature review, comparison to NII Impact Strategy; Final analysis and reporting.

1.3 Report framework

This published report contains identical content to the report submitted to NII for their management response, with the exception that all references to specific interviews and individuals have been removed in order to protect the identity of those who contributed.

[2] http://www.impactmanagementproject.com/, see Annex Summary
[3] See Annex Summary

The report is organised in four Parts. Part 1: Context and framing of this assignment, Part 2: Impact Strategy Audit findings and recommendations, Part 3: Comparison of Impact Strategy to impact investing Industry IMM Practice and Frameworks, and Part 4: Overall conclusions and recommendations.

Part 1 (this part) provides a brief contextual framing for the assignment: a background to NII, NII1, NII's new Impact Strategy, and the Impact Strategy Audit Terms of Reference.

Part 2 is the Impact Strategy Audit Report. It is organised into five Sections, mapped directly against the NII Impact Strategy sections and subsections for ease of cross-reference and use by NII:

- Section 1: Our impact principles;
- Section 2: Selecting high impact investments;
- Section 3: Managing for impact;
- Section 4: Reporting and transparency.
- The fifth section is a new recommended Strategy section: Establishing Governance and Management Arrangements.

Within each Section of Part 2 we present the analysis of NII's Impact Strategy Implementation. We then summarise and provide recommendations for NII within each section. Specifically:

We present the overall finding on alignment between each section and subsection of the Impact Strategy and practice (coded as **GOOD ALIGNMENT**, **MIXED ALIGNMENT**, **POOR ALIGNMENT**), supporting examples of good practice, and reflections and recommendations for NII to strengthen the Strategy.[4] Where we have found that NII's practice actually exceeds, or is more advanced than the Strategy currently described, we have included additional recommended strategy sections, denoted by the text 'Proposed NEW STRATEGY SECTION' (for example Section 5, Establishing governance and management arrangements) and/or subsections within existing Sections of the Strategy that could be strengthened to more fully represent what NII is currently doing in practice, denoted by the text 'AREA TO UPDATE IN THE STRATEGY' (e.g. Section 3.2.3. Learning from failure/success).

We then summarise the alignment of Impact Strategy with recent practice and frameworks/guidance for IMM in the impact investing industry, and recommendations to strengthen NII's strategy and practice. The Annex presents in more detail the recent practice and frameworks/guidance for IMM in the impact investing industry, the relevance to NII and a comparison to the Strategy, and recommendations to strengthen NII's strategy and practice. IMM practice and frameworks are summarised from a wide range of sources, focusing mostly on impact investment in the global North, specifically North America and the UK. The examples, however, are not exhaustive, and should represent an initial review to which NII might continue to add.

Part 3 offers overall conclusions and recommendations emerging from the Impact Strategy Audit for NII to consider.

[4] Exceptions to this organising framework are: The overall findings for Strategy Principles in practice are referenced in Section 1, however the supporting evidence and reflections/recommendations are incorporated into the relevant detailed sections of the Strategy analysis; and Sections 2.3–2.5 – Assessing social impact returns, assessing social impact risks, and balancing impact risk and impact return are grouped together in one section in this report.

Part 2: Impact Strategy Audit findings and recommendations

1 Impact principles

Here we summarise the overall finding for implementation in practice of NII's Impact Principles governing the overall Impact Strategy and comparison to impact investing industry IMM practice. Further detail, including reflections and recommendations, is found in relevant later sections of this document, which are signposted.

In summary:

1. **Impact measurement must always link back to the ultimate beneficiary:** Overall Finding – MIXED ALIGNMENT. Innovative and fit-for-purpose tools are in place, e.g. Impact Risk-Return tool; however, challenges remain with disaggregation and with Business to Business (B2B) business models. [Refer Sections 2.3 – 2.5 for good practice, reflections, and recommendations]
2. **Impact measurement must create value for investors and portfolio companies:** Overall Finding – **GOOD ALIGNMENT**. There has been a shift and improvement from NII's earlier Impact Strategy. NII uses an iterative and learning-focused, rather than prescriptive approach. [Refer Section 3.1.1 for good practice, reflections, and recommendations]
3. **Impact measurement must be rigorous and transparent:** Overall Finding – **GOOD ALIGNMENT**. Innovative, fit-for-purpose tools and frameworks in place, and investees and investors have confidence in NII's IMM approach. [Refer Sections 2.3–2.5, 2.6, 3.1.1, 3.1.2, for good practice, reflections, and recommendations]
4. **Impact reporting must be accessible**: Overall Finding – **MIXED ALIGNMENT**. Investees understand the benefit of impact reporting and NII's external communications are clear. However, there have been challenges with investees' reporting [Reference Section 3.1.2, 4 for good practice, reflections, and recommendations]
5. **Our approach must be sustainable**: Overall Finding – **MIXED ALIGNMENT /TOO EARLY TO ASSESS**. NII intends to build IMM practice and approaches for responsible exit for the longer term. **However, no exits have yet occurred**, no detailed plans in place for responsible exit, nor yet plans for investees to measure impact beyond the life of the investment. [Reference Sections 3.3, 5, for good practice, reflections, and recommendations]

Impact Strategy principles – comparison with industry practice:

Overall Finding: NII's Impact Strategy Principles reflect notable industry guidance, though a direct comparison is not relevant since Principles will vary depending on the investment and impact thesis and/or **theory of change (**ToC**)** of the Fund.

Examples of good practice:

There is no 'right way' to define Principles for a Strategy, and NII's are based on their overall theory of change for the fund therefore right-fit for NII. The detail of the NII Strategy is overall aligned with 2 out of 7 (and partially two others) of the Social Value International principles.[5]

Reflections:

The NII Strategy Principles could be made more explicit to reflect the strengths of NII Impact Strategy reflected later.

[5] http://socialvalueint.org/our-work/principles-of-social-value/, see Annex 1

2 Selecting high impact investments

Here we provide analysis of NII's Implementation of Impact Strategy Section 2 Selecting high impact investments, and the associated subsections: 2.1 Sector-Led Approach; 2.2 Requirements; 2.3–2.5. Assessing social impact returns, risks, balancing risk and return. We also propose and provide the same analysis for two new strategy sections: 2.6. Alignment of commercial value and impact in overall investment strategy and approach; and 2.7 Due diligence. We also situate this section overall in the context of recent industry practice for IMM, and provide an overall assessment of alignment, reflections and recommendations for the Impact Strategy (where relevant).

2.1 Sector-led approach

Overall Finding: GOOD ALIGNMENT. Substantial market research is drawn upon to develop deal flow and ensure that investment is made into the opportunities with the highest commercial value and impact potential for the greatest need, in the context of scarce fund resources.

Examples of good practice:

Sectoral strategies have been produced for all three thematic sectors; Education, Health and Sustainable Communities and enable NII to select 'companies that do not fit the mould'. These draw on external industry-leading research sources (e.g. research by NICE) and identify new areas of need within each of those sectors. NII builds up iteratively an understanding of the sector and the evidence base through literature, journals, and talking to experts directly. NII engages experts particularly where a possible area of need is identified that NII is less familiar with or the evidence base is still emerging. NII lists under specific thematic priority areas examples of interventions that have been implemented by others. Each strategy paper concludes with suggestions of how impact could be measured in each sector and provides a strong sense of 'what good looks like'.

NII has also published papers mapping sub-sectors of the thematic areas it wishes to invest in. NII have produced subsector-wide reports under the three thematic investment areas. Examples include: community engagement, fuel poverty, urban planning and design, homelessness and others, e.g. *Remember me?* on the role of impact investing in funding innovations addressing issues related to dementia, including evidence and analysis of market opportunities.

NII team has achieved an increasing level of sector specialisation in education, health and 'communities' since 2016. NII views specialisation as being by nature an iterative process and as work in progress with room for improvement in team knowledge and capability. This sector specialisation has been easier in health and education, more than 'communities', the latter being a more complex ecosystem.

Reflections:

Sector strategies and details are not currently shared more widely within Nesta, though there is one example of Nesta's Research and Policy team reviewing impact data of an investee. Coordination between NII and Nesta is generally ad hoc. NII is aware of the value that the Nesta teams can add and of the fact that teams could find collaboration beneficial for their sector-specific work. However, this is work in progress from both NII and Nesta, citing day-to-day challenges relating to some internal silos. It has been a gradual evolution over time to build the awareness. More structured feedback loops could be very helpful to sector analysis and framing 'what good looks like'.

Recommendations:

While overall implementation is aligned with Impact Strategy, there are a few areas where we suggest NII consider further improvements:

1. Set up arrangements and share systematically strategies, learning or resources to broaden the range of value positions engaging in strategy development with Nesta teams.

2. Further formalise and improve IDs' sector knowledge and networks as part of the next phase of organisational development.

2.2 Requirements

Overall Finding: **GOOD ALIGNMENT**. Alignment between commercial value and social impact is demonstrated by investees before investment. Alignment of investment approach and social impact is at the core of the NII approach in practice.

Examples of good practice:

NII facilitates investees to participate in an open and robust discussion and to demonstrate their case for aligning impact with commercial value prior to investment decision making. For example, prospective investees present to and discuss the business impact case with the IC, and all recommendation papers to the IC include thorough impact cases for new investments.

Testing investee management commitment is a key part of NII's due diligence process: Commitment to Social focus is built into company articles, and post-investment presentations to the IC and management team include social impact at the centre of the business model.

Reflections:

There was limited explicit acknowledgement that there are tensions and there may be trade-offs in investment decision making relating to commercial value and impact alignment. Explicit discussion at investment stage helps frame necessary action plans for subsequent investment and impact management.

Recommendations:

While overall implementation is aligned with Impact Strategy, an area where we suggest NII consider further improvements is to emphasise more on the tensions and trade-offs (such as between short-term commercial gain vs longer-term and/or uncertain impact return), and be explicit on how these will be managed.

2.3 – 2.5. Assessing social impact returns, risks, balancing risk and return

Overall Finding: GOOD ALIGNMENT. The development and use (later in 2017) of the Impact Risk-Return tool represents good progress under the new Impact Strategy in terms of systemising assessment of impact return and risk, and is used in a pragmatic way to structure thinking and discussion.

Examples of good practice:

The comprehensive Impact Risk-Return tool is set up as described in the Impact Strategy to measure risk/return. The tool usefully discounts scale by weighting depth, which itself is a composite measure of need x effectiveness. This is a robust measurement lens for potential impact. Often impact is synonymised with number of people reached only. **Quality of service delivery is also included as an indicator**, which is an important component. The **impact value score is then calculated as depth^3 x scale x quality** and allowing the quality indicator to be a determinant of confidence in the ability to deliver returns consistently.

At investment stage, data is often lacking and this is to be expected. To account for this uncertainty the score for effectiveness is reduced accordingly, which is a practical approach. NII expects, at minimum, that investees commit to collecting relevant data. **NII puts effort into gathering the data and expert opinion that is available to support analysis.** This includes confirming with investee clients on service delivery quality, and evidence for reaching target beneficiaries using 'clues' or proxies where appropriate (e.g. % children on free school meals). Although this data collection is not systematically completed for all investments, the tool is designed to pull in data directly which improving efficiency of the process when conducted.

The Impact Risk-Return tool is used in a broadly standardised way for new investments and allows companies to be compared across the portfolio: this is an important and challenging task. **NII recognises that impact is**

difficult and complex and uses the tool to ensure that conversations within NII and recommendation papers to the IC about investment are well structured. The tool is used to bring different dimensions together, rather than a reductionist attempt to make impact decision making appear concise and objective, which is impossible in the context of uncertainty at investment stage, and within an overall dynamic system. A recent exercise has been completed to apply the tool to historical investments, prior to the new Strategy.

Reflections:

NII reflects openly on the extent to which the Impact Risk-Return tool is practical and valid and looks to continually adapt and improve the tool. Of note, recent examples included reflecting on: whether they have achieved a 'right-fit' with the weighting system (i.e. whether it balances depth and scale intuitively), if language used is appropriate, the ease of communicating its use and value to investees and the IC, and whether additionality is possibly conflated with making a difference.

For Business to Business (B2B)/B2School companies there potentially is a weaker focus, by design, on the ultimate beneficiary as compared to Business to Consumer business models. Since NII is one further step removed from the ultimate beneficiary, data might be harder to collect to make the impact case. For example, in the case of a recent B2B investment (currently at investment screening stage), the impact case (reducing fuel poverty) relied on an assumption that any money saved by using a device by beneficiaries would be used to increase spend on fuel. However, no relevant data was provided and the supporting evidence for this behaviour change was limited.

There is a gap in the impact risk assessment component in terms of assessing expected risk *created by* the investment (rather than the risk of impact not being realised), primarily this relates to risk created to beneficiaries when things do not go according to plan. **Possible negative and/or unintended externalities/outcomes resulting from individual investments are not considered systematically.** However, this is discussed informally at IC meetings – one investment was declined on the basis that the investment did not consider overall welfare in the system.

NII's strategy, by design, prioritises investing in businesses that have direct impacts on beneficiaries. However, in sectors where the wider system is weak or even breaking down, **there may be more impactful investments aimed at systemic change**. For example, NII is aware of potential investment opportunities in companies improving community engagement in urban planning, which could have an important systemic effect of improved urban design for the welfare of marginalised groups. However, these do not meet the current investment appraisal criteria. The NII team is aware of this and intends to reflect carefully on this for future funds.

It is not clear whether the IC understand the Impact Risk-Return tool comprehensively enough yet, or whether they receive impact recommendations early enough to be able to ask critical questions, add value to impact assessments and make informed investment decision endorsements (or otherwise). IC members effectively take the recommendation at face value at the final recommendation paper stage. It is also not made explicit on how investment recommendations and decisions are made when impact return is low and financial return is high, or vice versa.

Recommendations:

While overall implementation is aligned with Impact Strategy, there are a few areas where we suggest NII consider further improvements:

1. Consider risk differently, and apply more stringent impact data requirements/commitments to collect data for B2B models.
2. Continue to reflect on, test and update the Impact Risk-Return tool, in order to reflect explicit assessment of risk to beneficiaries created by investments and/or negative externalities.
3. Consider including a provision in the Impact and/or Investment Strategy for a new experimental pool of investments using a different risk-return model, in addition to the established systems and processes to

identify and appraise investees. For example, this would require a re-think of the depth prioritisation, since it is more difficult to measure depth for such investments, and would potentially require a wider/different range of data. Consider developing a variation of the risk-return tool to appraise these potential investments.

4. Review IC processes, thresholds and guidance for understanding of the risk-return tool to further refine and improve IC value-addition.

2.6 Alignment of commercial performance and impact in overall investment strategy and process (proposed NEW STRATEGY SECTION)

Here we recommend a new strategy section. We note that NII's strategy does not fully reflect the ways of working NII follows for its overall investment thesis, which is the foundation for strong IMM.

Overall Finding: GOOD PRACTICE. Alignment of investment approach and social impact is at the core of the NII investment thesis and approach in practice.

Examples of good practice:

NII plays an important seed capital role in early stage/high risk companies, and NII has made follow-on investments in a number of cases. These are important for the growth of the companies and for reducing transaction costs for a company seeking out new financing at a critical stage in their growth. NII shows flexibility to specific situations and needs faced by companies by providing bridging finance, and last-minute investment, e.g. in one situation when a co-investor pulled out of an investment.

NII works to its comparative advantage as a specialist in impact investment, co-investing alongside investors with niche expertise to offer the investee technology, commercial value/product development acumen etc. NII reports that co-investors trust the NII impact brand and invest alongside, trusting the role NII plays in working with the investee on IMM.

NII decided to not invest or reduce investment in response to co-investors' actions that NII perceived as representing a reduced impact alignment. In order to maintain overall alignment balance at the portfolio level, NII has adjusted investments. For example, when the mainstream lead co-investor was not prepared to accept primary social purpose into company articles; or believing lead investor's impact due diligence was not adequate which undermined the rigour of management and increased risk, NII reduced the investment size or withdrew.

Reflections:

Without the ability to make larger follow-on investments due to the small fund size (£17.2m) the flexibility of NII's strategy is limited. At times NII has not been able to continue to hold a significant investment in some investees for the term NII would have preferred, and/or their share in an investment opportunity has been diluted. Without NII, an impact-focused investor among the leading shareholder voices, advocating on impact focus in the longer term, the good work done on mainstreaming impact could be lost. **NII is planning for future funds to take learning from NII1 forward, and scale up the overall size of such fund in order that NII can invest in the same number of investees for a longer time period** without necessarily needing co-investors, or to facilitate LPs to invest directly in investment opportunities (as well as investing passively into the fund). Having access to additional capital available in future funds could allow NII to act as lead investor in more cases, and have more flexibility and control in decision making and execute the Impact Strategy more effectively.

Recommendations:

As part of an Investment Thesis for future funds, and to continue the mission to advocate in the industry for impactful and impact-oriented investment approaches, NII could:

1. Reject other co-investors who demonstrate behaviour that is not aligned to NII's Impact Strategy, while also ensuring the best interests of the company, and their capital requirements, are at the centre.
2. Encourage mainstream investors to get involved on terms that make sense for the investee, NII and the commercial investor.
3. Continue to work with existing investees so that they can communicate the commercial value of their Impact Strategy [also see 3.3 Impact after exit].

2.7 Due diligence process (proposed NEW STRATEGY SUBSECTION)

Here we recommend a new strategy subsection. NII's Impact Strategy Sections 2.3–2.5 focus mostly on the technical framework for assessing impact return and risk, and less on the operational process by which this assessment is completed with investees, which itself has an important influence over the extent to which NII mainstreams impact.

Overall Finding: NII recognises that Impact relates to its investment approach, operations and processes, not just impact assessment. Impact relates to management and the methodological framework of assessing risk and return and acknowledges that due diligence is a critical step in this overall process.

Examples of good practice:

Good relationships between investees and NII staff are prioritised at the due diligence stage of the investment cycle, and significant effort is dedicated to this which is a key strength of NII's approach compared to other investors, including flexible time spent at future investees' premises by investment directors. NII describes this process as iterative and views due diligence as a critical step to investing in the right business, therefore it is important to take adequate time to find answers. The initial engagement is intense (twice a week) then less frequent and steadier once sufficient confidence is established in the investee as per the risk-return tool requirements, with additional intense periods at relevant points later in the cycle, e.g. to prepare for follow-on investment/fund raising. This comes with a high transaction cost, particularly for larger investments, given the small size of the NII team compared to deal flow. Developing strong relationships allows for good communication and effective due diligence, which itself is critical for operationalising alignment between impact and commercial performance.

Reflections:

Issues such as delays in investment or requirement for management liability in contracts can have an opportunity cost on investees' time overall and are ultimately a potential disrupting influence on investee companies' ability to deliver impact. **Despite appreciating the longer-term benefit of relationship building, some investees feel that the due diligence process is suboptimal, in relation to managing their business,** and comes at a high opportunity cost, though still less-so than other investors. Some investees reported NII had a tendency to ask lots of questions which have a high opportunity cost to answer and do not appear immediately relevant/useful and can cause delays in investment. However, NII reflects that possibly more can be done to manage investees' expectations regarding the importance of due diligence, taking into consideration many investees may not have solicited commercial investment before, particularly for larger investments, and possibly underestimate the work involved by an investor to assess investment prospects. NII is aware of the need to review due diligence and acknowledges this is an issue to prioritise going forward.

Recommendations:

While overall implementation is positive, there are a few areas where we suggest NII consider further improvements:

1. Revisit the due diligence process and templates.
2. Focus more time during initial discussions with investees on explaining the due diligence process to manage expectations of investees and to allow them to allocate sufficient time and resources.

Selecting high impact investments: comparison with industry practice

Overall Finding: NII's Impact Strategy and Practice for selecting high impact investments is among the market leaders and most recent industry consensus for good IMM practice.

Examples of good practice:

NII Strategy and practice is broadly aligned with IMP[6], NPC[7] and EVPA[8]'s frameworks. NII is broadly in line with industry leaders, specifically: NII has coherent and iterative use of sector strategies and incorporates measurement of impact risk into the Impact Strategy, using a scorecard approach with minimum scores expected for an investment to proceed to IC, and applying weightings in scoring aligned to an investment thesis.

Reflections:

NII Strategy or practice currently does not explicitly reference indirect and/or unintended positive and negative outcomes, drop-off effects, nor displacement (though this is discussed informally),[9] however NII is transparent around assumptions.

Recommendations:

Areas NII might want to reflect on to strengthen the Strategy might include:

1. Being explicit on engaging different experts and stakeholders is important to broaden respective value positions and expectations (e.g. to start with, via broadening the links with Nesta).
2. NII could benefit from explicitly prioritising discussing at IC meetings trade-offs between the five dimensions of impact: what, how much, for who, contribution, and risk.

[6] http://www.impactmanagementproject.com/, see Annex Summary and Annex 2
[7] https://www.thinknpc.org/publications/investing-for-impact-practical-tools-lessons-and-results/, see Annex Summary and Annex 2
[8] https://evpa.eu.com/knowledge-centre/publications/measuring-and-managing-impact-a-practical-guide, see Annex Summary and Annex 2
[9] Impact Management Project, http://www.impactmanagementproject.com/. See Annex Summary and Annex 2

3 Managing for impact

Here we provide analysis of NII's Implementation of Impact Strategy Section 3 Managing for Impact, and the associated subsections: 3.1 Developing an impact plan: 3.1.1 Our data requirements, 3.1.2 Improving measurement; 3.2 Embedding Impact; 3.3 Impact after exit.

We also situate this section overall in the context recent industry practice for IMM,[10] and provide an overall assessment of alignment, reflections and recommendations for the Impact Strategy (where relevant).

3.1 Developing an impact plan

3.1.1 Our data requirements:

Overall Finding: **GOOD ALIGNMENT**. Since developing the new Impact Strategy, NII now works in close partnership with investees to develop Impact Plans aligned to investee needs and practical realities. NII uses a robust theory of change approach.

Examples of good practice:

Overall, investees report favourably on the process of developing the impact plan with NII as per the Impact Strategy. All investees under the new Strategy have used Theories of Change (ToCs) to inform respective Impact Plans , and these ToCs incorporate all the important components of a good ToC, organised and framed according to good ToC practice. The Impact Director invests significant time and effort using a participatory and flexible approach, learning from challenges under the previous Impact Strategy when a fixed template was used. This change has been more effective. The process of Impact Strategy development was considered strategically useful to business value by one investee. Investees report that ToCs have been important and useful to them and useful bases to engage with NII, and to understand which aspects of the business model are critical for delivering impact.

NII understands that a focus on service delivery quality is an important part of impact management, and 'Impact data is anything needed to manage towards impact', i.e. collecting data on quality of service delivery rather than simply and immediately focusing on business outcomes. **KPIs are carefully thought out in participation with investees** to understand drivers of impact, manage quality, and facilitate good measurement and management. One investee reflected that Impact KPIs are fully aligned with business KPIs and they have realised this is a more efficient way to manage the business; e.g. students using the service regularly and making progress has become the central learning metric, tracked as part of the overall theory of change towards educational outcomes.

Reflections:

There is some variability in ToCs regarding the consistency and terminology, as well as framing of assumptions that underpin them, specifically those ToCs for investees invested in prior to the new Impact Strategy. In one earlier investment, the Impact Plan designed post-investment was quite ambitious and required investees to collect data that was not helpful for informing their operational/business strategies. Once the issues were realised and flagged, NII worked collaboratively with the investee in question to address those issues through updating the Impact Plan. Additionally, for some investees, target setting is not completed at the outset. Target setting before knowing what is realistic for various KPIs is often difficult in the early stages of an investment, which is practical and realistic. However, **NII does not follow up systematically to update Impact Plans to redress this, and any other issues at a later date**. NII uses an opportunistic pragmatic approach, engaging with investees when a window of opportunity opens, e.g. when a new staff member joins at the investee. **NII now conducts six-monthly portfolio reviews during which it becomes clear which plans appear**

[10] See Annex Summary

out of date, and plans to follow up in a more coordinated and systematic way to update the plans going forward.

Recommendations:

While overall implementation is aligned with Strategy, we suggest NII consider improving on target setting and continue to work on consistency, and following up with investees systematically, and sensitising investees on doing this at Impact Plan development stage.

3.2 Improving measurement

Overall finding: **MIXED ALIGNMENT**. Data collection against Impact Plans generally lags behind plan, mostly companies are reporting on outreach and customer experience data rather than outcomes. Nesta's Standards of Evidence – NII team makes effort to help investees understand, and it is rigorously applied.

Examples of good practice:

As a general rule, investees have reported outcome-level and output-level data as identified in their ToCs and Impact Plans . Operational data provide insight on progress towards impact as well as business strategies, specifically: (i) ***scale and frequency*** (e.g. the total number of regular users), (ii) ***output purpose*** (e.g. use for a product), and (iii) ***output quality*** (users' satisfaction with the product/service). Investees report on depth as well as scale of investees' outcomes, specifically (iv) ***outcomes achieved*** (e.g. improved efficiency, communication and information management, improved service quality, improved confidence/reported progress among users, achieved savings, reduction in an undesired trend); (v) ***depth*** (e.g. number of users in most need of the intervention) and (vi) ***additionality*** (e.g. number of users that would not be served by traditional service providers). **Frequency with which investees are asked to report on impact is set out in their Impact Plans and** depends on the nature of their business, stage of investment as well as the kind of impact data they collect. Reporting frequency ranges from quarterly to annual reporting. **In general, collection of data on scale is more frequent than on impact quality and depth.** Both NII and the IC are aware that all current investees, with the exception of one investee, are currently lagging behind their Impact Plans , some significantly.

The Standards of Evidence Framework is part of the history of NII, and supports rigour, however it is no longer the primary driver of the reporting framework. **Good progress has been made with assessing and improving the reliability of data** from investees by developing a more robust approach to measuring reliability of data on service delivery quality based on the USAID reliability checklist. 2017 IC quarterly meetings were dedicated to monitoring portfolio investee performance, including robust discussion on social impact performance.

Reflections:

Three earlier investees have not reported any impact data for over a year due to commercial and management challenges in the company, NII appears to be taking a pragmatic and managed response to known issues facing the companies. The IC has been regularly informed about this, and efforts have been made to reengage with the companies to improve the situation. NII downgraded one investee's impact status as a result. These earlier investee examples illustrate the difficult balance between being responsive to the investees' commercial realities and constraints and pushing on impact management so that it remains a priority to the investee. However, these examples suggest the balance might not be quite right.

NII's intention is to move towards reporting on outcomes across all investees, however this is viewed as a staged process and at a rate of change that fits the needs and interest of companies rather than by pushing outcome- level reporting.

Recommendations:

While the principles and processes described in the Impact Strategy are being rolled out, progress on collecting data at the outcome level is work in progress, and there has been mixed experience across the portfolio with improving practice as described in the Strategy. Therefore, there are a few areas where we suggest NII consider further improvements:

1. NII's approach to reassessing investments periodically is good practice, however, it would make sense to systematise this reassessment process in the Impact Strategy and operational processes more explicitly, e.g. include a threshold below which an investee is no longer considered an impact business overall and integrate this into follow-on investment accordingly.
2. Prioritise continued focus on data reliability and continue to work with investees to build understanding.

3.3 Embedding impact

Overall Finding: **MIXED ALIGNMENT**. NII maintains the balance between flexibility to commercial realities while working with investees to prioritise continued focus on impact. NII takes learning seriously and engages with Investees to understand and advise. However, in some cases NII has continued to support companies that are not demonstrating delivery of/commitment to impact and have not yet demonstrated intent to report in future which represents a key risk to overall IMM.

Examples of good practice:

Working in Partnerships: NII invests effort into relationship building with new investees, and non-financial support of companies pre-and post-investment. NII invests internal time in building investees' capacity for IMM, and also some limited resource: one investee was provided with support to find researcher resource. Investees are generally positive about value added by NII, including NII opening other doors for investees, e.g. links to other information/organisations through 'Portfolio day'. NII engages with investees on impact management formally in board meetings, formally and informally outside, including on impact, e.g. building Genera's evidence base on impact of cancellations. Investees perceive NII as strongly contributing to preserving the social mission of investee businesses.

Promoting transparency: NII expects Investees' management to demonstrate passion and commitment for IMM at investment stage and uses due diligence to test this [Refer section 2.2].

Learning from failure/success: NII hold open and thoughtful discussions regarding meaningful impact of different companies, e.g. meetings on impact plan and alignment with Impact Director and Investment Director. The focus is on the Impact Plan within context of the business' operations, and meetings happen quarterly with the investee, or in some cases more often. For example, one investee and NII hold twice-monthly meetings, at which business and Impact Plans are discussed, and another is currently redefining their impact plan with NII after their business model has changed. Though not a systematised process, NII uses a rough heuristic that if an investee scores 4 or 5 on a couple of dimensions of impact risk in Quarterly Reports, this triggers a reassessment to confirm whether the investee still satisfies commitment to impact, alignment and inclusion, and continued investment.

Regular reporting [covered in Section 4]

Reflections:

Working in partnerships: Non-financial support with regards to market access and networking (not IMM) is less appreciated by investees. NII is aware of this, though reflects that possibly this support is not NII's comparative advantage compared to other investors who bring technical or product development expertise but not impact management understanding. Currently, NII is also thinking through how to better manage expectations with investees upon first contact and ongoing, which is a critical issue in effective partnering [see also Section 2.6.1].

Learning from failure/success: Some other (earlier) investees do not appear to have been held to account for not performing financially or not providing impact data since early 2016. For example, despite the substantial underperformance on both reporting obligations, NII are in process of providing two investees with bridge funding, citing confidence in the companies in the longer term and that they are expected to report once the business is back on track. This situation represents the complexity in managing alignment of commercial performance and impact, and deciding over what timeframe this is viewed and assessed. Additionally, the majority of investees did not perceive NII's social impact measurement and reporting requirements as being helpful to their own learning and improving, and the process of collating and synthesising qualitative impact data using the Impact Plan does not yet appear to result in highly effective learning and improvement processes, and investees do not always find all of the impact data they collect that useful.

Recommendations:

While overall implementation is progressing, to further ensure that investees are held accountable for IMM there are a few areas where we suggest NII consider further improvements:

1. Use the Impact Plan more as an Impact Management tool, as well as to frame impact data collection, and consider developing an updated reporting template for investees.
2. Focus on learning should be further prioritised with investees, including sensitising investees to the expectation for, and benefit of this at due diligence stage.

3.4 Impact after exit

Overall Finding – **MIXED ALIGNMENT/TOO EARLY TO ASSESS**: NII has tried to embed social purpose into the culture of investee businesses which is a step to facilitating responsible exit, but has been challenged by co-investors at times. Responsible exit features in principle in discussions, but not systematically. It is too early to tell if adequate practice is established since no exits have yet happened.

Examples of good practice:

There has only been one purposeful exit so far (i.e., excluding investees which went into administration). This exit was the repayment to NII of a loan with interest from the international parent company of an investee, rather than an investment exit, therefore this Strategy step is difficult to assess in practice.

Reflections:

IC members discuss responsible exit in principle, and exit routes at a high-level during IC meetings, however NII has not had meaningful conversations yet about the risks that exit creates for impact and how NII should manage the process. NII is considering how best to manage responsible exit, a difficult thing to work out and balance, given the complexity of multiple and varying incentives and issues. At the current time there are no detailed plans for this in place.

Recommendations:

Though it is too early to reflect on implementation of the Strategy, since no purposeful exits have been made yet, there are a few areas where we suggest NII consider further improvements:

1. At the juncture of setting up future funds, this is an opportune time to develop more detailed plans on responsible exit and for monitoring investees' progress and impact delivery post-exit.
2. NII could focus additional effort at exit, or nearing exit, to work with investees to communicate transparently the commercial value of their Impact Strategy to attract investors.

Managing for impact: comparison with industry practice

Overall Finding: NII's Impact Strategy and Practice for Managing for Impact is among the market leaders and most recent industry consensus for good IMM practice.

Examples of Good Practice:

NII's Impact Strategy and practice is broadly aligned with leading actors and best industry practice and guidance on Impact Management,[11] specifically: NII aligns financial and impact goals in the Impact Plan process using a ToC with clear assumptions and clear guidance on evidence using the Nesta Standards of Evidence framework, with clarity on gaps to fill and data collection plans. NII uses a participatory approach, with investees at the centre and driving the process, including supporting them with capacity building. KPI/target setting is done at the Impact Plan stage, if possible, and updated opportunistically with investees ensuring flexibility. NII prioritises collecting data on quality of service delivery including customer feedback, and requires outcome-level reporting and is working towards this in practice. NII contributes resources in kind from its own staff, Impact Director, to support capacity building, and funds studies and research from time to time.

Reflections:

Overall, NII's strategy does not create an expectation that NII will independently verify investee reporting, which is broadly aligned with industry practice. The IMP advocates for this to be integrated into IMM. However, NII reflects on whether a coalition of investors can pool funds to conduct a more comprehensive survey of portfolio companies. In line with the industry, NII expects investees to budget for and conduct almost all IMM, with the exception of NII funding a few ad hoc studies.

NII's quarterly monitoring cycle at the IC and team levels are reflected in good practice for learning, though NII, as reported in Part 2, could do more here in practice.

Recommendations:

NII's strategy and practice could further be updated to be more explicit in measuring negative outcomes and mitigation measures, and source funds for more in-depth portfolio-wide measurement and verification exercises.

[11] http://www.impactmanagementproject.com/, see Annex Summary and Annex 3

4 Reporting and transparency

Here we provide analysis of NII's Implementation of Impact Strategy Section 4 Selecting high impact investments, and the associated subsections 4.1 Regular Reporting; 4.2 Feedback from the market; 4.3 Independent Assessment. We also situate this section overall in the context of recent industry practice for IMM, and provide an overall assessment of alignment, reflections and recommendations for the Impact Strategy (where relevant).

4.1 Regular reporting

Overall Finding: MIXED ALIGNMENT. There appears to be significant evolution in the approach to reporting under the new Strategy resulting in a more coherent approach, though still at times with mixed clarity in presentation and utility for the IC for review and comment. External reporting publicly appears to accurately report some impact data reported by investees. However, reporting is often on scale, rather than depth; and reporting integrates proxies or market assessment exercises rather than data/evidence of impact. Impact risk is not reported, which would caveat and report uncertainty.

Examples of good practice:

The new IC report framework and presentation developed under the new Impact Strategy is fit-for-purpose and clear. There is a **clear traffic light system used in Quarterly LP reports and leads to integrated discussion on commercial value and impact.** Templates for reporting to the IC have been tightened to **align with risk/return and the methodology has become clearer, more robust and consistent so that IC has the information they need.** Sustainability in the system has been improved as a result of the new design and consistent application, the templates can be handed over to another staff member if necessary more easily.

The IC reports are used to feed into the reporting to LPs and at the AGM, indicating that a joined process is used. External communications (blogs, 2017 annual report) of investees'/NIIF1's impact supported by accurate impact data.

Reflections:

Quarterly portfolio-level Limited Partner (QLP) reporting on investee impact progress is sometimes inconsistent with regards to presentation of impact ratings as well as the amount of information on impact progress in various sections. The Portfolio Update sections of QLP reports summarise investees' operational issues, investments made by NII (new investments and tranches to existing investees), investee sales performance, their progress against business plan, and NII's support to investees. However, an update on investee impact progress is rarely made in the Portfolio Update section. QLP reports present progress on impact under the Summary Portfolio Position heading using the impact rating only. However, under the new Strategy (from 2017), reference to impact under the Portfolio Update section becomes more frequent.

In external reports, portfolio and investee-level impact is presented in terms of its scale, not depth. This possibly does not do justice or sufficiently communicate the nuance and qualitative data NII collects from investees. One investee that has not been performing strongly financially and has not reported impact data recently has been used by NII as examples of good practice. In this case, financial data reported is accurate, however is it slightly misleading to report on these investees as examples of good practice if they do not report impact data.

In blogs, one of the investments presented as demonstrating strongest alignment between commercial success and social impact demonstrates deep impact, but lacks evidence for strong financial performance. Impact data presented in blogs reflect findings from a market sizing exercise, reporting on the scale of envisaged impact.

Recommendations:

While there have been notable adjustments made to the process and frameworks for reporting, under the new Strategy, overall some challenges remain and to address these we suggest NII consider further improvements:

1. Prioritise a regular review of QLP reporting and continue to improve presentation and utility.
2. Prioritise writing more about the complexity of impacts and the methods and tools used for impact data collection and aggregation at portfolio level.
3. Design uniform impact reporting templates which can be aligned with Impact Plans of individual investees and serve as a tool (living document) for communicating progress on impact from investees to NII team.

4.2 Feedback from the market

Overall Finding: **GOOD ALIGNMENT**. NII actively seeks out feedback on their IMM approach from investees and the wider industry.

Examples of good practice:

NII is taking action on the positive and negative feedback received in the investee survey they issued early in 2017. NII also hosted an industry roundtable event in November 2017 with key stakeholders from the UK-based impact investing sector, at which the Impact Director and Chief Investment Officer hosted other prominent impact investors to discuss Impact Strategy approach, and presented the NII Impact Strategy. Discussion was facilitated in breakout groups on key industry themes in impact measurement and management.

Reflections:

NII has so far received helpful feedback directly from one stakeholder on the Impact Strategy following the roundtable, and has plans to integrate broader discussion points into the Impact Strategy, specifically on portfolio-level aggregation. However, soliciting useful feedback from stakeholders, often other fund managers and competitors, is challenging given busy workloads and agendas and can often require a more formalised and structured approach, which takes more planning and commitment – and possibly more resources.

Relating to challenges and opportunities to advance current practice highlighted in the Global Impact Investing Network (GIIN) Survey,[12] NII's strategy and practice demonstrates broad alignment with industry perspectives, and NII can proactively offer additional learning to the sector, namely on: (a) collecting quality data, and aggregating across the portfolio; (b) challenges in aligning incentives with investors relating to focus on impact, and additionally on expectations of investees for IMM; (c) Identifying and selecting KPIs and targets, and defining Impact Strategy and ensuring buy-in from investees.

Recommendations:

While overall implementation is aligned with Strategy, NII might consider:

1. Establishing a formal peer review panel for NII that meets under clear governance and management arrangements, and with fixed timeframes.
2. Convening further discussions for the sector around challenges with good IMM.

4.3 Independent assessment

[12] Reference: GIIN 2017, The State of Impact Measurement and Management Practice, First Edition, December: https://thegiin.org/research/publication/imm-survey, see Annex Summary

Overall Finding: GOOD ALIGNMENT. NII has commissioned this Impact Strategy Audit, and is interested in whether and how the process can be repeated in future.

Examples of good practice:

NII took the initial step of commissioning this Impact Strategy Audit, which as far as we know, is only the second of its kind in the UK, and the first learning-focused audit commissioned. The results of the other audit (IVUK) were not shared publicly. The audit methodology incorporated an analysis workshop, during which NII and broader Nesta colleagues had the opportunity to reflect on and validate emerging findings, which further supported the learning focus. The intent is for NII to share the results of this audit publicly, which should contribute to realising NII's mandate expressed in the ToC for raising awareness and ultimately changing the market.

Reflections:

In order for ongoing value to be realised, and continued trust in NII's IMM and overall impact investment approach maintained, it makes sense for NII to commission future audits, reflecting back on recommendations included herein and any progress towards continual improvement. The value of this audit was particularly focused reviewing NII's strategy, and **future audits might better be designed as a more rapid process and a more typical audit, focusing on validating results** achieved by NII under NII1, then future funds. Future audits could be designed incorporating a more formalised audit panel to review findings, possibly including external stakeholders and investees.

Recommendations:

While overall implementation is aligned with Impact Strategy, NII could integrate into governance of future funds by commissioning biennial learning-focused full disclosure Impact Strategy Audits, with a formalised audit panel.

Reporting and transparency: comparison with industry practice

Overall Finding: NII's Impact Strategy and Practice for Reporting and Transparency is among the market leaders and most recent industry consensus for good IMM practice.

Examples of good practice:

NII Strategy and practice is broadly aligned with industry excellence,[13] and adheres to the most comprehensive approach proposed by the IMP: full disclosure of the IMM approach. NII also publishes comprehensive external annual reports by sector. NII's strategy includes a reflection and interest to pool funds to conduct verification studies, and has commissioned this Impact Strategy Audit to review Strategy implementation, and set up an industry roundtable to reflect on the Impact Strategy and issues in IMM.

Reflections:

NII does not align with SDGs or other industry frameworks/metrics at this point in time.

Recommendations

1. Commission a formalised peer review mechanism for NII, for example biennial Impact Strategy Audits focusing on results. Establish a formal audit panel with representation from investees and other fund managers.

[13] See Annex Summary and Annex 4

2. Align reporting with the SDGs for longer-term industry IMM alignment.

4.5 Establishing governance and management arrangements (proposed NEW STRATEGY SECTION)

Here we recommend a new strategy section. We note that NII's strategy does not fully reflect their strengths in governance and management arrangements which facilitate strong IMM. We also situate this section overall in the context of recent industry practice for IMM, and provide an overall assessment of alignment, reflections and recommendations for the Impact Strategy (where relevant).

Overall Finding: GOOD PRACTICE. NII's team, governance and management arrangements are broadly set up for strong alignment of commercial performance and impact, and overall impact management.

Examples of good practice:

NII has hired and developed a motivated team, comprising Chief Investment Officer, three investment directors (IDs), one associate ID; alongside the impact team, impact director and impact associate. All IDs demonstrate commitment to impact and continual improvement and almost all having a commercial background (except the Impact Director). Impact and investment are not seen as separate in ways of working: investees report being able to speak openly to investment directors about impact at the same time as discussing financials. Systems to enable open and reflective team communication and discussion (with weekly meetings, a culture of openness), and key to building a practical understanding of impact and to develop good strategies to engage in what is recognised as a difficult process in order to identify the right investments and support investees to maximise their impact. The NII team meets once a week to discuss pipeline issues, which presents a space for conflict resolution and to work through the difficult issues of impact, alignment, and balance.

Reflections:

Most of the IC members are from commercial and investment backgrounds. There is one exception, who comes from a philanthropic/impact background and is the most actively engaged of the IC members with NII. **NII reflects that a gap in the Impact team is a staff member with practical and operational experience of impact management**, as opposed to design thinking. NII is currently working to improve processes and align incentives for future funds for continued improvement and sustainability – under NII1 **there is no carry scheme, or any other performance-based incentives for NII team, and salaries are paid by Nesta**. A process review to look at how to be more structured/documented is being conducted (KPI monitoring and minimum requirements, common issues across investments). **The process of IMM is resource intensive, and NII invests significant staff time into Investees. This is likely to have implications for NII's impact team and** the investee companies of any future funds, as these will likely be substantially larger than NII1, requiring even more time.

Recommendations:

While overall NII has established fit-for-purpose governance and management arrangements, there are a few areas where we suggest NII consider further improvements:

1. Consider broadening the IC composition to include one or two more members from a social sector background in the longer term
2. Align incentives in team with carry scheme, to make NII a market leader in this area

Establishing governance and management: comparison with industry practice

Overall Finding: NII's Impact Strategy and Practice for Governance and management is among the market leaders and most recent industry consensus for good IMM practice.

Reflections:

NII is broadly aligned with good practice in the industry practice and IMM frameworks, including having a dedicated and streamlined impact team alongside the investment team. NII's style of leadership appears to be well suited to taking risks and 'moving the needle' in the wider industry towards investing for impact.

Recommendations:

Consider linking social and financial performance to a carry scheme to align incentives more directly to delivery of impact.

Part 3: Overall conclusions and recommendations

Here we summarise the overall findings from the Impact Strategy Audit (Table 1), and comparison of NII's strategy (and practice) with IMM Frameworks and Practice (Table 2). We then conclude the audit and make five overall recommendations to further improve NII's Impact Strategy and practice.

Table 1: Overall findings: Impact Strategy Audit

1. Impact principles
1. **Impact measurement must always link back to the ultimate beneficiary**: **Overall Finding** – **MIXED ALIGNMENT**. Innovative and fit-for-purpose tools are in place, e.g. Impact Risk-Return tool; however, challenges remain with disaggregation and with Business to Business (B2B) business models.
2. **Impact measurement must create value for investors and portfolio companies**: **Overall Finding** – **GOOD ALIGNMENT**. There has been a shift and improvement from NII's earlier Impact Strategy. NII uses an iterative and learning-focused, rather than prescriptive approach.
3. **Impact measurement must be rigorous and transparent**: **Overall Finding – GOOD ALIGNMENT**. Innovative fit-for-purpose tools and frameworks in place, and investees and investors have confidence in NII's IMM approach.
4. **Impact reporting must be accessible. Overall** Finding – **MIXED ALIGNMENT**. Investees understand the benefit of impact reporting and NII's external communications are clear. However, there have been challenges with investees' reporting.
5. **Our approach must be sustainable: Overall Finding – MIXED ALIGNMENT /TOO EARLY TO ASSESS**. NII intends to build IMM practice and responsible exit that is embedded into organisations and NII for the longer term. However, no exits have yet occurred, no detailed plans in place for exit, and investees not measuring impact beyond life of the investment.
2. Selecting high impact investments
Sector-led approach, Overall Finding: GOOD ALIGNMENT. Substantial market research is drawn upon to develop deal flow and ensure that investment is made into the investments with the highest commercial and impact potential for the greatest need, in the context of scarce fund resources.
Requirements, Overall Finding: GOOD ALIGNMENT. Alignment between commercial and social impact is demonstrated by investees before investment. Alignment of investment approach and social impact is at the core of the NII approach in practice.
Assessing Social Impact Returns, Risks, Balancing Risk and Return, Overall Finding: GOOD ALIGNMENT. The development and use (later in 2017) of the Impact Risk-Return tool represents good progress under the new strategy in terms of systematising assessment of impact return and risk, and is used in a pragmatic way to structure thinking and discussion.
Alignment of commercial performance and impact in overall NII Investment Strategy/Approach (NEW), Overall Finding: Alignment of investment approach and social impact is at the core of the NII Investment Thesis and approach in practice.
Due Diligence, Overall Finding: NII recognises that Impact relates to their investment approach and operations and processes, not just impact assessment and management and the methodological framework to assess risk and return, and that due diligence is a critical step in this overall process.
3. Managing for impact
Developing an Impact Plan: Our Data Requirements, Overall Finding: GOOD ALIGNMENT. Since developing the new Impact Strategy, NII now works in close partnership with investees to develop Impact Plans aligned to investee needs and practical realities. NII uses a robust theory of change approach.

Developing an Impact Plan: Improving Measurement, Overall Finding: MIXED ALIGNMENT. Data collection against Impact Plans generally lags behind plan, mostly companies are reporting on outreach and customer experience data rather than outcomes. Nesta's Standards of Evidence – NII team make effort to help investees understand, and it is rigorously applied.
Embedding Impact, Overall Finding: MIXED ALIGNMENT. NII maintains the balance between flexibility to commercial realities and working with investees to prioritise continued focus on impact. NII takes learning seriously and engages with investees to understand and advise. However, in some cases NII has continued to support companies that are not demonstrating delivery of/ commitment to impact.
Impact After Exit, Overall Finding – MIXED ALIGNMENT/ TOO EARLY TO ASSESS: NII has tried to embed social purpose into the culture of investee businesses which is a step to facilitating responsible exit, but has been challenged by co-investors at times. Responsible exit features in principle in discussions but not systematically, however; and it is too early to tell if adequate practice is established since no exits have yet happened.
4. Reporting and transparency
Regular Reporting, Overall Finding: MIXED ALIGNMENT. There appears to be significant evolution in the approach under the new Strategy resulting in a more coherent approach, though still at times with mixed clarity in presentation and utility for the IC. External reporting publicly appears to accurately report some impact data reported by investees, however reporting is often on scale, rather than depth and use of proxies or market assessment exercises rather than data/evidence of impact, and impact risk is not reported to caveat and report uncertainty.
Feedback from the market, Overall Finding: GOOD ALIGNMENT. NII actively seeks out feedback on their IMM approach from investees and the wider industry.
Independent Assessment, Overall Finding: GOOD ALIGNMENT: NII has commissioned this Impact Strategy Audit, and is interested in whether and how the process can be repeated in future.
5. Establishing Governance and Management Arrangements (NEW)
Overall Finding: GOOD PRACTICE. NII's team, governance and management arrangements are broadly set up for strong alignment of commercial and impact, and overall impact management.

Table 2: Overall findings: comparison of NII strategy to IMM frameworks and practice

1. Impact Principles
Overall Finding: NII's Impact Strategy Principles reflect notable industry guidance, though a direct comparison is not relevant since Principles will vary depending on the investment and impact thesis and/or ToC of the Fund.
2. Selecting High Impact Investments
Overall Finding: NII's Impact Strategy and Practice for selecting high impact investments is among the market leaders and most recent industry consensus for good IMM practice.
3. Managing for Impact
Overall Finding: NII's Impact Strategy and Practice for Managing for Impact is among the market leaders and most recent industry consensus for good IMM practice.
4. Reporting and Transparency
Overall Finding: NII's Impact Strategy and Practice for Reporting and Transparency is among the market leaders and most recent industry consensus for good IMM practice.
5. Governance and Management Arrangements
Overall Finding: NII's Impact Strategy and Practice for Governance and management is among the market leaders and most recent industry consensus for good IMM practice.

Overall NII is implementing the Strategy well in practice. **In some cases, practice exceeds the framing of the Strategy**, such as good governance and management arrangements, due diligence, and we have captured this practice to recommend new strategy sections/subsections**. Of particular note is NII's partnership-oriented and iterative approach, prioritising flexibility and practicality**. NII recognises that impact is difficult and most businesses – particularly at early stage – fail to deliver impact, so the process of identifying impactful businesses and managing towards impact needs constant attention, and to be aligned with business strategy at all stages of the investment and business cycle.

Most closely aligned is NII's practice in selecting high impact investments: NII invests significant effort and resource into **developing sector strategies** to develop an iterative understanding of 'what good looks like'. The **due diligence process, and new impact risk-return tool is overall, fit-for-purpose. The NII team uses the tool to appraise impact investments using balanced discussion**, rather than relying solely on the algorithm of the tool. In Impact Management, **NII focuses on quality of implementation, not focusing solely on outcomes**. NII's commitment to openness and transparency is evident.

NII has made notable achievements and improvements in good IMM practice since the new Strategy was introduced, **particularly in selecting high impact investments, managing for impact, and reporting and transparency**. The risk-return tool has been pivotal to improving selecting high impact investments, as has the recruitment of the new investment and impact team, also integrating more established team members' knowledge and roles into the culture of openness and critical thinking. A more coherent approach to investment decision making and oversight/monitoring by NII and the IC has been developed with improved framework and templates. In impact management: a more flexible and participatory support is now provided to investees with developing ToC, KPIs and impact plan after investment.

Overall, NII's strategy and practice is aligned with the 'best in field' in the emerging impact investing sector and with recent consensus, guidelines and frameworks developed to support good IMM practice, and should continue to innovate, and prioritise their agenda for openness and transparency.

As mentioned, NII has innovated IMM Strategy and practice in the last 12-18 months, and continues to reflect and improve, again reflecting the strong organisational culture. **However, there are a few areas of mixed alignment between Strategy and practice**, most notably in reporting and transparency and managing for impact. Impact Plans are updated opportunistically, meaning not all have been updated in a timely manner. **Data collection is overall, behind against Impact Plans , particularly for investments prior to the new Strategy**, and mostly for commercial and operational reasons at the investee-level. **NII has continued to support companies that have not reported,** and expect reporting to improve once the businesses in question achieve relative stability. The focus on the end beneficiary is more difficult with B2B models, which NII is aware of but not yet risk-weighted sufficiently. The new risk-return tool, though comprehensive, does not fully consider risk to beneficiaries, or externalities and perhaps uses language that, as yet, not all understand (e.g. IC, investees). **External reporting has often been on scale only**, and at times not doing sufficient justice to the nuance and complexity NII captures and understands, however NII does balance this with stories about investees. As a continuation of NII's iterations and improvements under the new Strategy, we recommend five areas to focus on for the future:

1. **Frameworks, tools, and process continual improvement:** Continue to refine the risk-return tool, data reliability, and decision-making process (including explicit discussion around trade-offs), working with the IC and investees to understand and improve utility and timeliness. Consider establishing variations of the tool for B2B models, and experimental strategic sector-wide investments. Reposition the Impact Plan tool as an impact management tool as well as a reporting tool, and institutionalise learning with investees more strongly. Regularly review the QLP reporting tool and design a more uniform investee reporting template aligned with Impact Plan. Consider using standardised metrics and integrate the SDGs into the framework;
2. **Leadership on the business value of IMM:** Continue to invest more time sensitising, and working with investees and investors on the business value of IMM, and NII's expectations for IMM, at all stages of the investment cycle particularly at investment and impact plan stage. This should have downstream

knock on effects on impact management and reporting, and ability of investees to articulate their impact case and commercial value;

3. **Governance and Management:** Consider aligning incentives with a carry scheme, and broaden IC to include more balance with philanthropic sector to further institutionalise impact oversight and decision making;
4. **Responsible exit:** Develop more detailed plans for responsible exit to take forward to future funds; and
5. **Transparency and industry learning:** Commission a formalised peer review mechanism for NII, for example biennial Impact Strategy Audits focusing on results. Establish a formal audit panel with representation from investees and other fund managers. Share and collaborate more actively with Nesta. Pool funds with other investors or organisations (e.g. Nesta, other foundations) for independent verification studies.

Annexes: Comparison of NII Strategy to IMM Frameworks and Practice

In this set of Annexes[14], we first summarise the status, trends, opportunities and challenges for guidelines and practice in IMM in the impact investing industry, and provide some overall reflections and recommendations on NII's Impact Strategy and practice. In Annexes 1-5 we then review each Section of the NII Strategy: Sections 1-4, and proposed new section 5 – against specific industry practice and guidelines/frameworks and provide high-level reflections.

Summary of IMM in Impact Investing

Industry practice for IMM is very new and we still know relatively little about 'best practice'. Recent reports by the GIIN and ANDE are some of the few meta-surveys of IMM in the industry, but what we have seen so far in IMM is industry exemplars/more established impact fund managers, e.g. Acumen, Bridges (and NII) – that elevate their own perspectives without always having a clear 'comparable'. Most recent industry consensus has been generated by the IMP, 2017[15], and other most recent notable guidelines and frameworks include European Venture Philanthropy Association (EVPA) (2013, and updated regarding uptake 2015)[16], KL Felicitas Foundation and NPC – Investing For Impact (2015)[17]; and also the Social Impact Investment Task Force Impact Measurement Working Group (2014)[18], and Social Performance Task Force (2016, and updated as version 2 2017)[19]. At this stage of the early maturity of the Industry, we cannot really judge or compare like for like whose principles and strategy are better without sufficient data points on how they are applied, embraced, etc.

Nevertheless, we can still use these IMM frameworks mentioned, GIIN industry surveys and reports, and the publicly available practice on IMM to draw some comparisons and reflections.

Overall IMM trends among impact investors

The GIIN conducted their first global survey of IMM in 2017,[20] and drew on data from 169 impact investors. Nearly two-thirds of respondents were fund managers, and about half of respondents focus on emerging markets, with one-third focus on developed markets. Here we summarise notable findings from this survey, and reflect on NII's strategy and practice in comparison at the end of the section.

The survey reported that:

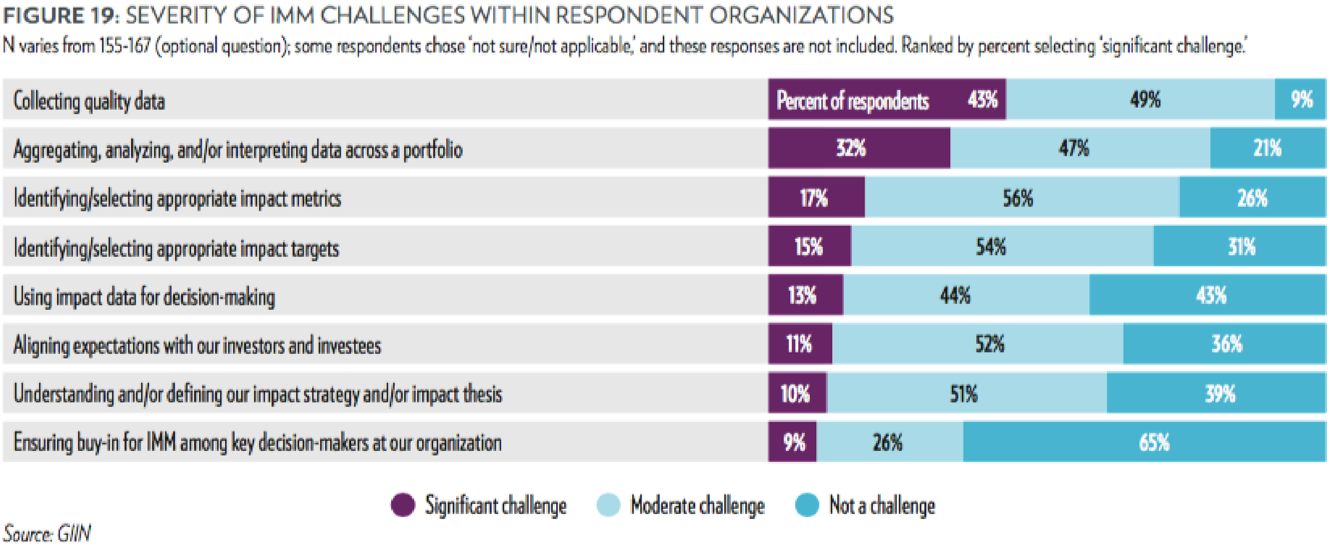
- **Motivations**: 83% agree IMM is very important for better understanding their impact, and 75% report that IMM is very important to managing or improving their impact. 78% feel IMM is very important for proactively reporting impact to key stakeholders, yet fewer than half (45%) find that requirements from investors or donors present a very important reason for IMM. Overall, the findings suggest that internal motivations for measuring and managing impact are much stronger than external ones.
- **Measures**: Most respondents report on outputs (91%) and outcomes (77%) of their investments. Roughly 40% of respondents each measure the breadth, additionality, or depth of their impact. About two-thirds of respondents only track the positive impact associated with their investments. The other third track negative and/or net impact, either exclusively or in addition to positive impact, for some (15% of respondents) or all (18%) investments.

[14] This review of industry practice in IMM was conducted in December 2017, so is current as at that date.
[15] http://www.impactmanagementproject.com/
[16] https://evpa.eu.com/knowledge-centre/publications/measuring-and-managing-impact-a-practical-guide
[17] https://www.thinknpc.org/publications/investing-for-impact-practical-tools-lessons-and-results/
[18] https://www.thinknpc.org/publications/impact-measurement-working-group-measuring-impact/
[19] https://sptf.info/images/usspm_impl_guide_english_20171003.pdf
[20] Reference: GIIN 2017, The State of Impact Measurement and Management Practice, First Edition, December: https://thegiin.org/research/publication/imm-survey.

- **Tools**: The most commonly used of which are IRIS metrics (62%). Others include the SDGs (42%), B Analytics (41%), and the Principles for Responsible Investment (26%). The most common approach is to use a combination of some standard portfolio-wide metrics and some metrics customised per investment (37%).
- **Incentives**: 59% of impact investors set targets to measure their progress on social and/or environmental indicators. Most (71% of those that set targets) note that their employees are intrinsically motivated to achieve these impact targets, and 56% note the same for their investees. Some further incentivise their employees by factoring the achievement of impact targets into employee performance evaluations (16%) or tying their compensation to the achievement of impact targets (13%). To incentivise investees, some investors require the achievement of impact targets to disburse follow-on capital (31%), to receive the initial investment (23%), or to meet loan covenants (23%).
- **Frequency**: Most commonly, respondents collect and report impact data quarterly (54% and 42%, respectively) or annually (52% and 66%, respectively).
- **Reporting**: 69% report their impact to donors or investors, and 56% include impact performance results in their standard financial reports. Additionally, 40% or more of respondents produce impact reports for management and staff, or produce impact reports available to the public, or share impact performance results on an ad hoc basis.
- **Challenges**: The two areas in which many respondents did indicate challenges concern measurement (rather than management), with 43% of respondents citing significant challenges in collecting quality data and 32% citing aggregating, analysing, and/or interpreting data across a portfolio.
- **Opportunities**: 76% of respondents felt that transparency in impact data and results is very important to advancing IMM practice, and over half of respondents cited common impact-based principles for investing, consideration of impact data in decision making with equal emphasis and rigour to financial risk and return, development of an impact benchmark, and integration of impact data into financial accounting standards and reports as very important.

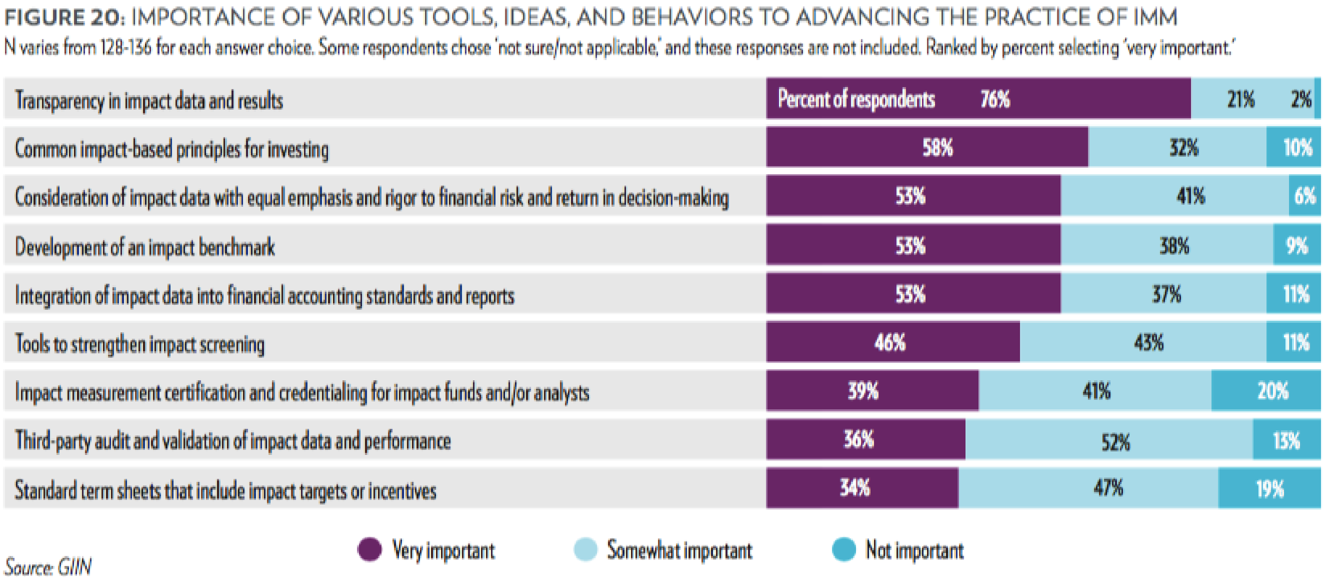
The report highlights survey results on significant areas of progress and challenges in IMM against key issues, namely illustrated in Figures 1 and 2:

Figure 1: Severity of IMM challenges within respondent organisations



Source: GIIN, 2017

Figure 2: Importance of various tools, ideas, and behaviours to advancing the practice of IMM



Source: GIIN, 2017

Reflections:

Compared to the GIIN industry survey responses, NII is positioned as a field leader, specifically: NII leads in motivating the impact investing and wider mainstream investment sector IMM, driven by a strong internal motivation. NII expects investees to report on outputs and outcomes, and prioritises reporting on depth as well as breadth, and additionality is integrated into the framework. NII sets KPIs and targets with investees in Impact Plans , however incentives to update and complete could be further refined and improved. For instance, NII does not align with standard metrics or the SDGs, and uses customised metrics per investee, aligned to impact plan. NII's investees report quarterly – most frequently; and NII reports to LPs and additionally externally on an annual basis. Relating to challenges and opportunities to advance current practice, NII's strategy and practice demonstrates broad alignment with industry perspectives, and where NII can proactively offer additional learning to the sector, namely: (a) Collecting quality data, and aggregating across the portfolio. NII's experience here could add significant value to the sector; (b) NII has experienced challenges in aligning incentives with investors relating to focus on impact, and additionally on expectations of investees for IMM, through experience and learning NII is moving into a leading position to advise on these issues; (c) NII demonstrates advanced understanding and practice of many of the other challenges cited, namely: identifying and selecting KPIs and targets (though refinement has been a challenge), and defining Impact Strategy and ensuring buy-in.

Recommendations:

Though NII is positioned as an industry leader, NII should additionally focus on integrating the SDGs into their framework. The SDGs are likely to increase in prominence as an overarching IMM framework in the industry (and for social and environmental development as a whole).

1 Impact principles

Overall Finding: NII's Impact Strategy Principles reflect notable industry guidance, though a direct comparison is not relevant since Principles will vary depending on the investment and impact thesis and/or ToC of the Fund.

Notable examples from the industry for overarching guiding principles for IMM come from **Social Value International (SVI)**. These are used since they broadly represent good practice: SVI is well known for broadly holistic market-based approaches. Specifically:

1. **Seven Principles of Value – SVI**:[21] These are a 'principle-based framework for accounting for, measuring and managing social value', and represent a holistic perspective on social value applicable to both market- and non-market interventions. The principles are:
   - **Involve stakeholders** – Inform what gets measured and how this is measured and valued in an account of social value by involving stakeholders.
   - **Understand what changes –** Articulate how change is created and evaluate this through evidence gathered, recognising positive and negative changes as well as those that are intended and unintended.
   - **Value the things that matter –** Making decisions about allocating resources between different options needs to recognise the values of stakeholders. Value refers to the relative importance of different outcomes. It is informed by stakeholders' preferences.
   - **Only include what is material –** Determine what information and evidence must be included in the accounts to give a true and fair picture, such that stakeholders can draw reasonable conclusions about impact.
   - **Do not overclaim –** Only claim the value that activities are responsible for creating.
   - **Be transparent –** Demonstrate the basis on which the analysis may be considered accurate and honest, and show that it will be reported to and discussed with stakeholders.
   - **Verify the result –** Ensure appropriate independent assurance.

The focus on stakeholder engagement and transparency are well understood, but the principles also emphasise materiality, valuation and verification – all of which are relatively undeveloped in IMM practice and frameworks. While they have been a cornerstone of SVI's (and previously SROI Network's) approach to Social Return on Investment (SROI), we do not yet have many examples to show how these principles translate effectively into practice, particularly around 'the boundaries around what is good enough' for different segments of impact investors/funds.

[21] http://socialvalueint.org/our-work/principles-of-social-value/, Annex 1

2 Selecting high impact investments

Overall Finding: NII's Impact Strategy and Practice for selecting high impact investments is among the market leaders and most recent industry consensus for good IMM practice.

2.1 Sector-led approach

Impact Management Project (IMP) consensus recommends:

- **When creating a new portfolio and setting goals from the very beginning**: **Identify challenge** (Step 1 of impact management cycle), and **analyse available data** about the cause of the challenge using the five dimensions of impact (who, what, how much, contribution, risk), e.g. which groups of people are not able to achieve which outcomes, what is the market/ecosystem currently doing to help those people to achieve those outcomes and can we contribute? Are there approaches with a strong track record of succeeding or do we need to take risks and try new models (risk?), then use this analysis to **set initial impact goals** across the five dimensions. **Combination of these initial impact goals with financial goals** should guide selection of portfolio investees.
- **General principles for defining impact:** Use enterprises' definitions of impact and in turn, those enterprises' intended beneficiaries' definitions of impact. **Define impact** in terms of overcoming challenges or achieving outcomes. Establish a clear foundational understanding of **which products, services or jobs** would be more effective than others in achieving the intended outcome or challenge overcome and the extent to which the beneficiaries are underserved in relation to defined outcomes and the extent to which the product, service or job is available elsewhere to the targeted group. Identify the extent to which the product, service or job is likely to generate the intended outcome or overcome the challenge. Take into account **other stakeholders** who might influence.
- **Defining impact around five impact dimensions**: **'What':** Incorporate preferences, expert opinion and/or public consensus as well as analysis of enterprise's material, direct and/or indirect effects on people and planet (including of its operations or its supply chain) into judging the extent to which the outcome is likely to be positive or negative; **'How Much'**: Determine the significance of the outcome, incorporating depth, breadth, duration, and timeframe within which we would expect to observe the effect; **'For Who'**: Take into account the extent to which the target beneficiaries are underserved; **'Contribution'**: Assess whether the effect is better or worse than would likely otherwise occur ('deadweight'), and compare it to the action of others ('contribution') based on whether the effect: (i) Leads to more or less important intended and unintended positive or negative outcomes and/or; (ii) Is more or less significant (in terms of depth or the number of people it occurs for or how long it lasts for or how long it takes to occur); and/or (iii) Occurs for people (or planet) who are more or less underserved than those currently experiencing it. Assess whether the outcomes are likely to decrease over time ('drop-off'). Assess whether the outcomes could have been delivered more efficiently or effectively by other means ('displacement'); **'Risk'**: Take into account likelihood of the outcome occurring/not occurring and link impact risk to business decisions, improving products and strategies so as to improve clients' conditions and reduce risks is essential to long-term success.

NPC advocates the following approach:

- **Identify and consult stakeholders:** include relevant stakeholders early and ensure that key viewpoints are reflected in the strategy, e.g. conduct **stakeholder interviews.**
- **Needs mapping:** Analyse needs data and assess future trends and consider impact of early intervention.
- **Role assessment:** Assess whether the focus will be on addressing needs, changing systems or changing behaviour.

- **Options appraisal:** Select criteria for assessing solutions, score potential options (e.g. using matrix) and prioritise.
- **Scenario planning:** Build on previous analysis, develop plausible scenarios and discuss implications for strategy.
- **Assessment of the external environment:** What is happening that might affect the strategy now and in the future? What are the points of leverage in the system? How can you influence others? This includes **analysis of market context** for potential products/services.

EVPA advocates:

- Define the overarching social problem
- **Identify stakeholders** expected to be affected and engage them in defining scope and impact objectives:
- **Confirm interest in activities among stakeholders** – establish their expectations and the logic behind those expectations

2.2–2.6. Requirements, assessing social impact returns, risks, balancing risk and return, due diligence

Impact risk remains a relatively unexplored area in impact investing. As more blended finance instruments emerge, the assumptions of positive impact will come under question, both in terms of intended and unintended outcomes. Few tools exist that bridge the gap between traditional social impact assessment (*ex ante*) and evaluation/IMM-driven outcome and impact assessment (ex post). Three fund manager examples are:

- Bridges Fund Management – initially with the RADAR, and subsequently through work with Bank of America and the Impact Management Project
- Investing for Good describes one fund's approach, which **rates opportunities on financial and social impact elements** – **breaks down the social impact rating** into four categories, which are **weighted** according to the Asset Manager's priorities. There is a **detailed minimum score** below which opportunities do not make it to the IC.
- Root Capital[22] uses a scorecard to conduct social and environmental due diligence, as well as to assess credit risk during the loan evaluation process.

There are several examples of due diligence frameworks, primarily geared at the investor level (to perform diligence on funds), relative to the fund level (to perform diligence on investees); of course, the former is still relevant for fund design. Notable examples include:

1. a comprehensive guide by the McConnell Foundation;
2. a template from the KL Felicitas to evaluate individual investments;
3. a guide from the GIIN to evaluate impact fund managers (including impact diligence);
4. a new initiative has recently been launched by Pacific Community Ventures to build a free impact due diligence toolkit.

Investing for Good reflect on due diligence analysis and recommendations presented to Investment Committees: Presentations vary in scope and content, from two-page summaries, to reports of up to 30 pages. Content includes: (1) a description of the social impact, (2) an assessment of the financial risk, (3) the suggested return, and details of the proposal and the governance of the organisation. Decision making at IC meetings is based on: trade-offs take place between the four key parameters of impact risk and generation, and financial

[22] Reference: Deep Dives on the use of Impact Data Throughout the Investment Process: https://thegiin.org/assets/GIIN_ImpactMeasurementReport_SUPPLEMENT.pdf, Root Capital, page 8

risk and return, but also potentially regarding portfolio composition, and alignment with the Asset Manager's approach.

3 Industry practice and IMM frameworks: managing for impact

Overall Finding: NII's Impact Strategy and Practice for Managing for Impact is among the market leaders and most recent industry consensus for good IMM practice.

3.1 Developing an impact plan

3.1.1 Our data requirements

Theory of Change is gaining traction as a tool for impact investors and impact funds. ToCs are often described at the sector level – see Omidyar series on Priming the Pump, and the recent GIIN Navigating Impact initiative. While many impact funds describe having a ToC, these are often simplistic, and more accurately described as an impact thesis. Vox Capital in Brazil conducts a ToC exercise with each shortlisted investee (even if they ultimately decide not to invest) in order to ensure that there is alignment with each other, and that investees are comfortable going through the ToC process and associated reporting expectations.

Identifying KPIs and data that will help ventures increase both their social and financial returns, is reflected on in the GIIN report 2016 on the Business Value of Impact Measurement: This report describes ways in which impact investors and investees use impact measurement practices to inform investment and management decisions to drive business value, defined as factors that are advantageous to the overall strength of an investor's or investee's organisation, including both direct economic value and strategic benefits that indirectly influence an organisation's long-term viability—and identifies five key drivers of business value as follows:

1. **Revenue growth:** helps businesses to segment customers more precisely, to develop effective marketing, to access new market segments, and develop and refine offerings.
2. **Operational effectiveness and efficiency:** a wide range of operational issues, from human resources management to accounting and finance procedures and others.
3. **Investment decisions:** data helps them to determine which sectors and particular deals are likely to provide the type of impact and financial performance they seek.
4. **Marketing and reputation building:** can help investees raise capital, smooth entry into new markets, and speed processes involving local authorities.
5. **Strategic alignment and risk mitigation:** can provide early insight into overall business performance, offering an opportunity to correct course and prevent losses (i.e., failure to achieve impact and/or financial returns).

The **IMP** consensus recommends:

- **Set goals explicitly linked to its Impact Strategy**, which is framed as the contribution the investor makes to the investee's impact goals. **Link impact and financial goals:** be explicit what financial performance we can forecast for the impact goals we want to achieve, or vice versa; and be **transparent** about assumptions made between interplay between financial and impact goals and what information those assumptions are based on, how we determine what information is more or less material (to both financial and impact performance), and the timeframe relevant for our understanding of materiality.
    - **Setting goals from scratch:** Use a **coherent logical process** using ToC thinking to link impact definition, **intentionality** and **constraints** to set goals for the Fund across the **five dimensions of impact** (What, How much, Who, Contribution, Risk).
    - Set goals to **reduce and/or mitigate negative outcomes**. Set goals based on an enterprise's **material effects on people and planet**, regardless of whether they are generated by its products/services, its distribution chain, its operations or its supply chain.

- **Information used to set goals:** Use information directly from people likely to be affected and draw on experience of those working at the frontline as well as publicly available information.
- **Indicators:** Use enterprises' own definitions of indicators of change → set indicators that describe the effect the investee has for all dimensions of the impact goals --> set indicators at the PF level.
- **Set targets:** Targets should be **explicit** about the level of performance expected against each indicator and set in partnership with investee businesses (particularly in unknown/frontier markets for NII). Use available information on **historical performance** of NII investee businesses or **comparable investment strategies**. For a **mixed portfolio**, within which there might be multiple impact goals, **retain flexibility** and include an **explicit description of this approach**.

EVPA[23] advocates:

- **Involve stakeholders:** Involve stakeholders in determining expected or actual outcomes (they might be also able to help identify ways of measuring outcomes).
- **Do not overclaim:** Consider the following: Business as Usual, contribution being made by other agents, and extent to which any outcomes that last beyond the end of the involvement in an activity, last at the same level.
- **Decide what to measure:** As the outcomes measured are not generally the same as the investee's goals, a decision will be required on which outcomes are material. Decide how far to go down the chain of outcomes, and how far to segment stakeholder into smaller groups experiencing different outcomes differently. Decide which outcomes to exclude as being not material. The principle is that outcomes could be relevant and or significant.
- **Value the things that matter:** Refine target outcomes and associated indicators and identify impacts with the highest social value.

NPC[24] recommends:

- Organise a workshop [with investees] to understand differing perspectives, and reach consensus on vision, mission, goals and values.
- Organise a **theory of change workshop** to map how the charity [investee] reaches its goals.
- **Activities mapping:** Exercise to map how the current /future activities with the ToC. **User journey mapping:** Engage with users and potential users to understand their journey through services. **Impact networks:** Exercise to map how [investee's] activities fit within a wider impact network and identifying maps.

3.1.2 Improving measurement

The **IMP** consensus recommends:

For designing a measurement framework:

- Incorporate all dimensions of impact into the **indicator and data collection framework**, include assessments to (i) verify impact claims made, and (ii) assess the value of impact claims.
- **Sample investees** according to representativeness or opportunity, and make these choices **explicit.**
- Use a f**ramework for standards of evidence**, which is fit-for-purpose, specifically at minimum: (i) **Relate to a ToC:** collect information that describes the chain of events that is intended to occur; (ii) Draw on **existing evidence base**, e.g. existing information about the material effects that

[23] Reference EVPA, 2017
[24] NPC, 2017

comparable approaches delivered in comparable contexts; (iii) Define **confidence of the data required** compared to impact claim made in the context and a counterfactual

- Use an **independent assessor** to at minimum validate and remove bias. Be aware of **context and influence** this has on ability to generalise externally.

Designing a data collection plan:

- Include clear data quality assessments into key steps in the impact management process --> Incorporate a **data collection cycle** mapped to the investment cycle and key junctures at which decision making happens, also re-setting impact goals.
- Budget for relevant and required data collection, expecting enterprises to budget for and collect data themselves on direct impact when possible. If enterprises are in early stage of growth, allocate **separate funding and/or technical assistance** for impact management/ data collection in such a way as to incentivise good practice, **manage risk** (e.g. improve products, services).
- **Define questions t**hat will benefit the field as a whole separately, and secure **external funding for data collection** to answer them.

Be **transparent** about the assumptions made over impact risk and data collection and therefore budget required to evidence claims in the data collection framework.

Collecting data on quality of service delivery: **Bridges Fund Management**[25] regularly tracks customer feedback and satisfaction, which contributes to commercial success and enables proactive management in response to any negative trends. For example, for its healthcare delivery investments, Bridges tracks patient and family feedback on the quality of care received.

Investing for Good's assessment of Asset managers found that:

- Once (investment) decision is made, Asset Manager develops indicators in collaboration (joint discussion) with the investee. **Best practice:** KPIs are ultimately mapped to the Fund's high-level outcome areas (investees still tackle social issues in their own ways, but are conceived as working towards the same end goals). E.g. One Asset Manager provides its investees with an actual menu of KPIs, 70% of which are IRIS matrices, and impact monitoring clauses are included in investment agreements.
- Information on outcomes is difficult to obtain: Asset managers mostly rely on **outputs** (better than no information). The level of impact reporting expected from grantees is proportional to their size, capacity and kind.
- One fund provided **SROI training** for investees, and no cases of independent Impact Strategy Audits were reported (except with Social Impact Bonds (SIBs)).
- **Collected data is reported in three formats:** (1) Narratives and case studies, (2) Assorted hard data, and (3) Systematised hard data (e.g. hard data is received from individual investments --> categorised --> accumulated at the sector/outcome level – this is made easier through supplied scorecards.)
- Equity investments tend to come with **more frequent reporting** and have **impact monitoring clause** in investment agreement. Asset managers are in **regular contact** with investees and frequently also have a **representative on the board**.

Costs of measurement: There is very little information available by investors or fund managers on the costs of doing IMM; one of the few data points comes from ANDE, which found that that ANDE investor members spent

[25] Reference: Deep Dives on the use of Impact Data Throughout the Investment Process: https://thegiin.org/assets/GIIN_ImpactMeasurementReport_SUPPLEMENT.pdf, Bridges Fund Management, page 3

an average of US $265,000 and a median of US $70,000, and that as a proportion of a total budget, amounted to a median of 2%.

3.2 Embedding impact

The **IMP** consensus recommends in respect to facilitating overall learning:

- Incorporate learning resulting from reviewing and analysing impact data and evidence, including on negative effects, into reassessing impact goals.
- Require investee enterprises to explain and account for any missed targets.
- Encourage and supported investee enterprises to find ways to improve delivering against their impact goals including adjusting products, services, jobs to improve social impact.

EVPA[26] advocates:

- **Verifying impact:** Did the impact happen in the way it was expected? E.g. desk research (looking at external research reports, databases, government statistics, to confirm the trends assumed), competitive analysis (comparing the investee's data with that of other comparable investees), **interviews/focus groups** (asking stakeholders about the results of the intervention).
- **Valuing** (measuring value created): was the impact important, i.e. valuable to the stakeholders? E.g. **qualitative methods** (storytelling, qualitative surveys, interviews, focus groups), **quantitative methods** (quantitative surveys, revealed preferences, monetisation etc.)
- **Only include what's material:** Whether an outcome is significant is judged by reference to the quantity, duration, value and causality of the outcomes and thresholds set by the organisation. Relative values and any trade-offs should be made **transparent.**
- **Stakeholders** should be involved in assessing whether the outcomes being measured represent all the outcomes they experience, positive or negative, as well as in understanding the relative importance of different outcomes they experience to inform decisions to improve design of products or services.

The judgements and assumptions made by investees about the data collection processes/actual impact data collected should be assured by an **independent process** that is acting on behalf of those affected: **Systemise data tracked** --> **analyse data to identify problems** --> **implement corrective actions.**

[26] Reference EVPA, 2017

4 Industry practice and IMM frameworks: reporting and transparency

Overall Finding: NII's Impact Strategy and Practice for Reporting and Transparency is among the market leaders and most recent industry consensus for good IMM practice.

The **Impact Management Project** consensus recommends:

- **External Reporting:** three options are possible listed from most comprehensive and detailed to aggregate reporting only:
  - Disclose the entire approach to Impact Management.
  - Disclose aggregated figures only at minimum through to full disclosure – the full set of information against metrics, qualitative and quantitative.
  - Use a format/software platform which easily enables benchmarking of the Fund and learning for external stakeholders.

Annual Impact Reporting: Impact fund managers typically provide annual reporting; one good example is Sarona's Annual Values Report, which uses thematic aggregation and comprehensive narrative, and references to cluster-based IRIS indicators.

Alignment with SDGs: There are several ongoing attempts to align impact measurement and reporting with the SDGs. Many of them are in early stages, but there will be more sophisticated tools and products in the next year. See the Toniic SDG Impact Theme Framework, and the efforts that are being undertaken by the UNDP SDG Impact Finance (UNSIF).

Knowledge Products to advance learning: Several impact fund managers have been active in sharing knowledge products with the broader field to advance learning on IMM, the most prominent of which include Acumen (Lean Data), Bridges Fund Management (Impact Management Project), and Root Capital, among others.

Investing for Good assessed Asset Managers' impact reporting, and found variations in content and methodological robustness from: **Case studies** of their investee organisations (individually listed and described), to more detailed **fund and sector level information,** giving an account of their **impact by sector and outcome area,** outlining their **analysis and methodologies**, and summarising **results from various impact matrices** across different investments. This consolidated information is followed by details of individual investments in **case study format** (including **impact data** for the funds where this is collated).

Investing for Good recommends establishing a **peer reviewing group of investors** to read and provide active feedback on each other's impact reports, and to bounce strategies off each other regarding impact accounting.

Developmental Evaluation: Humanity United, an Omidyar-backed impact fund focused on supply chain solutions, have initiated a two-year Developmental Evaluation. This will include work on the theory of change, Impact Due Diligence, Portfolio Mapping, and Knowledge Products.

5 Proposed NEW STRATEGY SECTION: Governance and management

Overall Finding: NII's Impact Strategy and Practice for Governance and management is among the market leaders and most recent industry consensus for good IMM practice.

The GIIN (2017) notes that responsibility of IMM falls mostly to the broader investment team (46%) or have both dedicated IMM staff and the broader team conduct IMM (42%); 15% contract IMM work out to external consultants, and 9% rely only on staff members who are solely responsible for IMM. Impact funds have traditionally decoupled realised impact from financial performance and compensation. In 2011, the GIIN issued a brief that profiled 3 impact funds with impact-based incentive structures, and explored:

- Should incentives address the short-term or long-term impact performance, or both?
- Should incentives penalise and/or reward General Partners (GP)s for which impact targets are met?
- What is the appropriate amount of compensation linked directly to social and environmental performance? What should be done with any monetary proceeds not distributed to GPs due to inability to meet targets?
- How and by whom are social performance metrics and targets defined?
- How can social and environmental performance be effectively monitored?

More recently, **other actors in the industry have advocated for tying GP financial compensation to both financial and social returns**, captured by Transform Finance's brief in 2016,[27] e.g. several other impact fund managers have tried to develop impact-linked compensation structures e.g. Vox Capital in Brazil ties half of its carry to its Global Impact Investing Ratings System rating.

Investing for Good reports that the Social Impact Accelerator (SIA) is currently piloting application of 'carried interest' to impact investing where carried interest is only received when financial targets (limited partners have received repayment of the original investment plus a defined hurdle rate) and social impact targets are met. SIA invests in Asset Managers and requires them to adopt this approach. Investing for Good reflect that best practice is when Asset Managers take a position on the board of investee organisations (this enables them to stay closer or how the KPIs are being used, and what the results are and mean). For example, an Asset Manager has created a board sub-committee for social performance (however, this is only useful when the investee organisation is sufficiently mature).

NPC advocates that **leadership needs to match ambition:** If a strategy requires taking risk, leadership style needs to support this. Leadership might need support or adapt to change.

[27] Reference: Transform Finance, 2016 Tying Fund Manager Compensation to Impact, http://transformfinance.org/blog/2016/9/21/tying-fund-manager-compensation-to-impact