Submission to the Senate Standing Committee on Social Affairs, Science and Technology
Study on the creation of a Social Finance Fund

Note: The below text was prepared by Sarona for Global Affairs Canada but the suggestions and recommendations are equally useful in the discussions underway to create a social finance wholesaler for Canada.

How can Global Affairs Canada be catalytic to private capital?

The answer to the question turns, almost wholly, on the investor's perceived ***'risk-adjusted rate of return'***. To increase the flow of private capital to developing countries, GAC must enhance the risk-adjusted rate of return for private investors. They can do that by mitigating the risk and/or enhancing the return. (When I met with about a dozen of your GAC colleagues in 2013, as we were planning the investment in SFMF2, we said that GAC didn't need to do both 1st loss (risk mitigation) and profit give-up (return boosting). But we all agreed that, while no one knew what the actually catalysation rate would be, the more concessionary the GAC funding, the more it would catalyse.)

There are many ways that GAC's funding can be catalytic. In each of the four categories below, there are varying degrees of intensity that can be implemented:

1) **Junior equity:** This capital takes the first loss on either an investment-by investment basis (very strongly catalytic) or on a whole fund basis (less catalytic). Such a junior position significantly reduces the private investors' risk.
2) **Capped return:** In this scenario, GAC gives up all or a portion of profit that would otherwise be earned on its capital. The more the profit give-up, the more the catalytic effect. This does not affect risk, but pushes up the investors' expected returns.
3) **J-curve mitigation**: Paying for all of the fund's management fees and expenses for the first years of a fund's life. Institutional investors such as pension funds hate the J-curve trajectory of private equity funds because expenses are front-loaded and value creation is back loaded. These J-curves push down the institutional investors' total portfolio returns during this J-curve period. A lower intensity version of this would be to cover either just a portion of these costs, or to recover these costs at the back end.
4) **Early investment:** GAC could invest very early, well before a 1st close, so that the fund manager can begin to create a portfolio, thereby allowing private investors to invest into an existing portfolio rather than into a blind pool. Many private investors wait until a fund achieves a first close before engaging in due diligence. They don't want to spend time and money on DD, only to find that the fund never gets off the ground.

The halo effect of a public sector investor

During our conversations, I also referenced the fact that simply investing alongside private investors, on the same terms as the privates, is not catalytic. In fact, investors report that, on balance, the participation of a DFI on the same terms is a slight dis-incentive. In the attached report, you'll see on page 8 that most private investors are indifferent to DFI participation, but, on balance, feel negatively about DFI participation (when DFIs invest pari passu). There is still much room for DFIs to be a massive force for good, but the halo effect may not count for much. And neither does cajoling private investors to "do the right thing."

Building the sustainable infrastructure of capital flows

Finally, I'd like to point out that DFIs such as IFC, FMO and others, invest alongside private capital in emerging markets. But none of them catalyse private capital to cross the ocean.

On the other hand, Sarona and other firms like us, exist to be a bridge for private capital to flow from capital-surplus regions of the world (mostly North America and Europe) to capital-deficit regions (emerging markets). We are the infrastructure through which most such private capital must flow. Unlike

DFIs, the capital that crosses the ocean in our funds is almost all private. DFIs can not fund all of the needs of emerging markets. We need private capital to pick up that responsibility, and to do it with an SDG focus. If GAC considers whether it should support IFC or Sarona, the answer is pretty clear. One is a public-sector stop-gap solution that doesn't catalyse private capital. The other is a smaller, but growing bridge for the sustainable flow of private capital. Today there are few of us. In 15 years, there will be many Saronas in the world.