Executive summary

Itad conducted an Impact Strategy Audit of Nesta Impact Investments (NII). This assessed their use of the strategy and provided guidance on improvements based on good industry practice.

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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