Nesta Impact Investments

Annual Report

April 2016 to March 2017

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About Nesta Impact Investments (NII)

NII was established as a wholly owned FCA regulated entity by Nesta in 2012 to act as the manager of Nesta Impact Investments 1 LLP (NII1), a £17.6 million proof of concept fund. NIIF1 raised capital from Nesta, Big Society Capital and Omidyar Network and achieved final close in October 2012, becoming the third impact fund manager in the UK.

To find out more visit **www.nesta.org.uk/investments**

About Nesta

Nesta is a global innovation foundation. We back new ideas to tackle the big challenges of our time.

We use our knowledge, networks, funding and skills - working in partnership with others, including governments, businesses and charities. We are a UK charity but work all over the world, supported by a financial endowment.

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nesta Impact Investments

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Annual Report

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Introduction

Welcome to Nesta Impact Investments' (NII's) annual report for the year to 31 March 2017. This is our first publicly circulated annual report in five years of trading. It presents an exciting opportunity for us to reflect on our experience and is indicative of many changes in the business in the year to March 2017.

During the year we refined our business strategy, developed a new theory of change and initiated an overhaul of our systems and processes in order to support our goal of maximising the social impact that we deliver. It is the same motivation that has led us to open our approach to communication with external stakeholders. By sharing our experience with others we hope that they will observe, respond and help us improve, and where lessons can be drawn from our experience we hope others may be able to benefit equally.

The core of our business is the work we do with our investee companies. We are privileged to work with exceptional entrepreneurs who demonstrate vision, passion and commitment. This year we made five investments, four to support exciting growth in our existing portfolio and one new investment. In spite of our capital and the hard work of entrepreneurs, success is not guaranteed and the nature of innovation means facing challenges along the way. Sadly, Digital Assess,[1] went into administration in the year having failed to develop a viable business model. Digital Assess's technology was bought by a skills-training charity, giving extended life to the impact of its work.

By year end, now four years into the life of the fund, we had invested in 12 companies deploying almost 50 per cent of our fund. With more than five years remaining it is too early to tell what the final outcomes from NIIF1 fund will be, but we are confident that we will hit both the fund's target financial return and improved impact, and evidence of this impact in the majority of investees.

Our team is crucial to NII's success. In the year we built a team with almost 60 years' experience of successfully making equity investments in high-growth private companies. We embedded impact evaluation further into our operations, recognising the importance of applying rigorous analysis at every stage of our process. Our new Impact Director has equal seniority, responsibility and voice within our organisation with our investment leaders and has helped ensure that we have the knowledge and experience to make impact evaluation core to our everyday work.

As the team has evolved we have said goodbye to several old friends from executive and non-executive roles at Nesta Impact Investments, to retirement and to pastures new and we thank them for their significant contribution to building our business and wish them all well in their new roles in education, social accelerators, international development or just whilst on the golf course.

We believe that Nesta Impact Investments has now built a solid, scalable and impactful platform with clarity of strategy, capability of team, a growing track record, a unique ability to leverage Nesta's knowledge and networks to generate pipeline and the confidence of the backing of its endowment. We are excited to have the opportunity to take and develop this platform to change the lives of millions of people through our own work and by sharing our knowledge and experience with like-minded people and businesses who are passionate about making the world a better place.

The Nesta Impact Investments team

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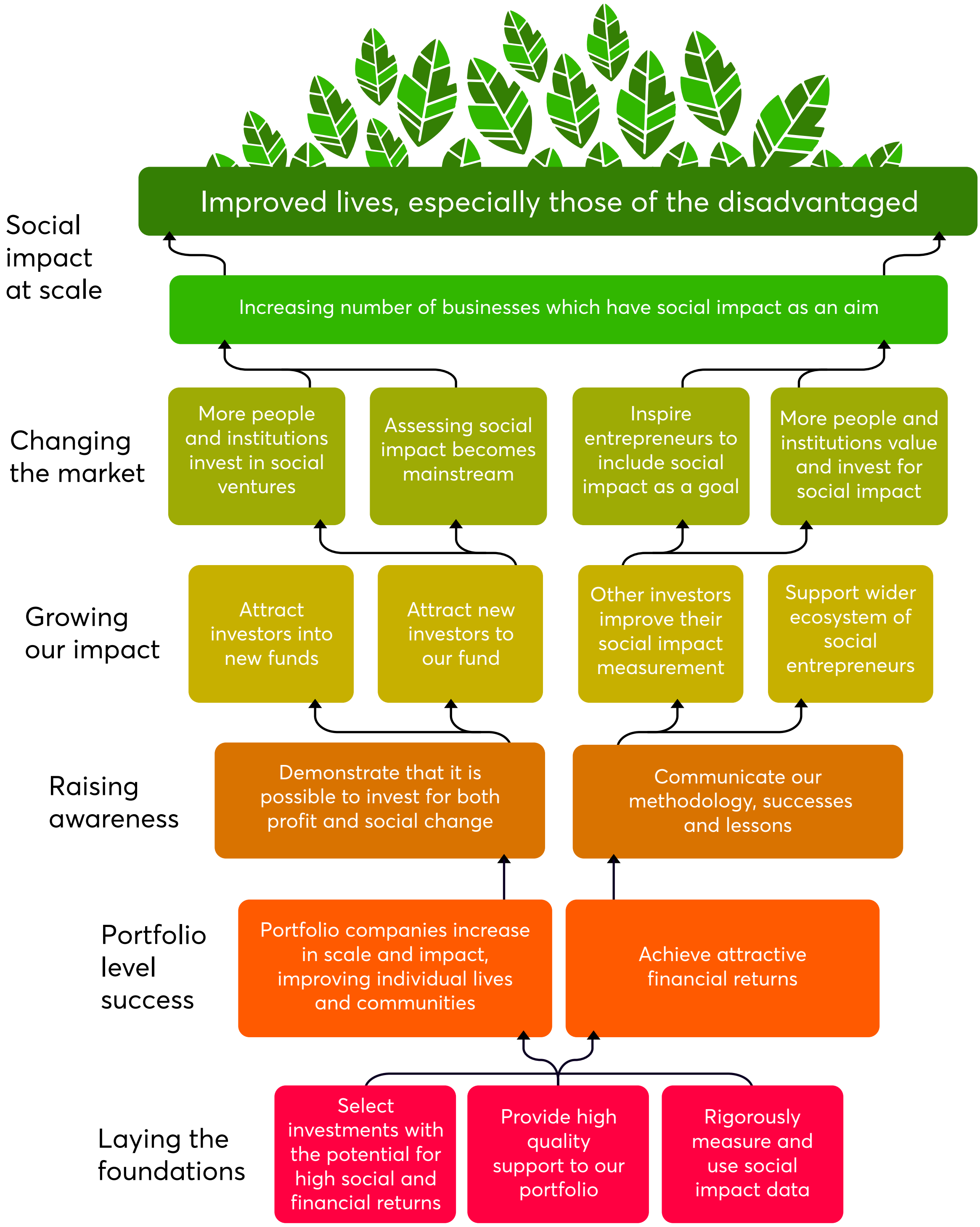
Changing finance for good

Our vision is one of social impact at scale, driven by a market that values and incentivises social impact. For us, **achieving the best financial and social returns is crucial** for achieving this vision. The foundation of our model is selecting and managing a world-class portfolio of enterprises that deliver both market rate financial returns and impressive social returns for our investors. By demonstrating that this is possible we hope to raise new funds, bringing new investors into the social investment market. By sharing our approach and experience we will help to strengthen the market through improved understanding of social impact measurement and support for social entrepreneurs at every stage of their business development.

The rest of this report reflects the different elements of our strategy or 'theory of change', showcasing the work we are doing and results we are achieving that we hope will play a role in changing financial markets for the better.

Third Space Learning

Nesta Impact Investments' theory of change



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Laying the foundations

The foundation of our work is in identifying investments with high potential for impact and financial return and then actively supporting our portfolio with both financial and non-financial resources.

During the year we have refreshed and deepened our approach to investment evaluation. This has improved our ability to identify impact return potential and risk. We have also surveyed investee companies through our newly implemented annual portfolio feedback survey. This will help us to understand our effectiveness in supporting investees.

3.1 Improving how we select for impact

2016-2017 saw us refresh our impact approach based on four years of practical experience of impact investing. Core to this new approach is a change in how we select investments with the greatest potential for impact.

In order to qualify for investment, companies must be able to demonstrate:

- **Alignment between commercial activities and social impact** such that increasing the social impact of a product or service is core to the commercial strategy of a business.
- **Commitment to social impact** through management processes, personal and corporate behaviour, governance and structure.
- **Inclusion of disadvantaged groups** through either tackling problems felt most intensely by the disadvantaged or that have a proportionate reach or higher for relevant disadvantaged groups.

We then take a structured approach to assessing potential investments by considering risks to social impact (impact risks) alongside the estimated impact on people's lives (impact returns) and then comparing the risk/return profile to our existing portfolio as a benchmark. More detail, and examples of how we apply this framework can be found in our recent report *Setting Our Sights: A strategy for maximising social impact*.*

While we have retained our emphasis on high quality evaluation, we have broadened our concept of impact risk to consider commitment to measuring impact, reliance on others, stability in relation to external events, capacity to deliver impact and ethical business management.

We break down impact returns into the number of people reached (scale) and the importance of this impact on their lives (depth). We give more weight to businesses achieving high depth, by reaching in-need populations or being highly effective, than we

*www.nesta.org.uk/publications/setting-our-sights-strategy-maximising-social-impact do those businesses having little impact at high scale. The challenge for a technology-dominated portfolio is to find those ideas that can dramatically change lives for those in need. In the next section we report on where our portfolio is in terms of returns, risk, depth and scale.

Taking a structured approach is crucial given the volume of deals we assess – we reviewed approximately 154 potential investments into new companies in the year 2016-2017, with just 11 being reviewed by the Investment Committee.

Synopsis Healthcare: Our first health tech investment

In December 2016, we invested in Synopsis Healthcare, a healthcare technology platform that facilitates seamless patient assessment and risk evaluation ahead of surgery and anaesthesia. The investment was made alongside GSTC Health Innovations Limited, part of the Guy's and St Thomas' Trust, and is being used to grow the customer experience and business development teams, to enable the company to scale up its reach and impact in the UK.

The impact case for the investment was driven by its potential for high reach for its target outcome to improve health outcomes after surgery. Each hospital that changes its pre-operative practices will affect millions of people.

One area that we particulary focused on has been to professionalise and upgrade the management team. Whilst Chairman Jake Arnold-Forster and COO Matt Gee joined the Board at completion of our initial investment, we have helped the team recruit Managing Director Ian Carr, who brings considerable healthcare industry expertise.

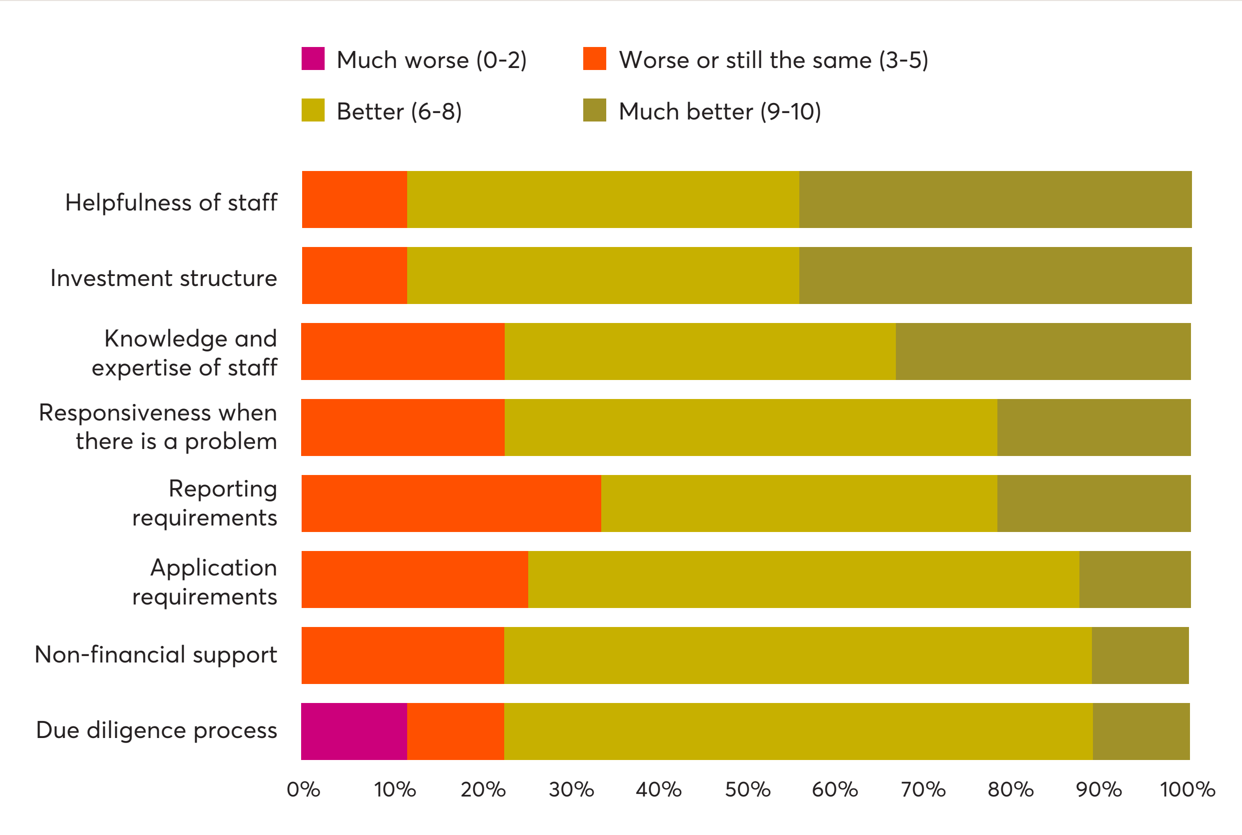
"Nesta's investment allows us to deliver remote assessments and further reduce the costs and risks of paper-based assessments that consume costly outpatient resources. The data collected will also enable important research and analysis to further improve outcomes at lower cost."

Jake Arnold-Forster, Chairman of Genera (now trading as Synopsis Healthcare)

3.2 Supporting our portfolio

For the first time this year we conducted an anonymous survey of our portfolio and asked for feedback on our processes, the support we provide and where we could improve.[2] Encouragingly, we perform well in comparison to other investors across all dimensions, particularly on helpfulness and knowledge of staff and investment structure (see Figure 1).

Figure 1: From your point of view, how does your experience with Nesta Impact Investments compare to your experience with other investors in each of the following areas? (0 = much worse, 10 = much better)



Our survey also showed our strength in the social impact aspects of our work. Our investees identified the most highly valued aspects of the support we offer as: helping preserve the mission of the business, improving alignment between social impact and business model and improving social impact assessment and reporting. On the other hand, investees identified that we have not improved access to Nesta's broader networks and markets to the extent that investees would have liked.

Based on the results of the survey, our priorities for improvement are: streamlining the due diligence process, increasing access to networks and partnerships in our portfolio and ensuring that impact reporting feeds into businesses' own learning and improving. At the same time, we will seek to maintain our support for the portfolio by focusing on impact, securing more investment, being responsive and minimising intrusive reporting requirements.

Arbor

Arbor Education: A case study for financial and social impact support

We first invested in Arbor, a company that helps schools to learn from their data in order to improve children's attendance and educational attainment, in a September 2015 seed round. We then participated in the company's Series A round, where they raised a total of £2.5 million, in May 2017. As a result of Arbor's strong performance in the intervening period, the value of our initial investment increased over 70 per cent.

The success of the company can be attributed primarily to the strong, well-balanced and resourceful team and the high quality products they have developed. We are privileged to have worked alongside them to design surveys to capture evidence of impact valued by schools and particularly during the intense period of raising their Series A round.

"With Nesta we know that we've found an investor who can help us scale both our impact and our business simultaneously. Through collaboration with the central team we've turned our impact reporting into a tool of competitive differentiation as well as informing product decisions. As investors, they've added huge value to our strategic thinking by lending their analytical skills to analyse market movement, pricing models and win/loss analysis. The combination of diverse skills in the team, ethical principles and deep market knowledge helps them really stand out as investors and add value to the companies they support. I can say for one that it's much appreciated!"

James Weatherill, CEO Arbor Education

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Portfolio level success and raising awareness

Selecting and supporting a high potential portfolio is the first step in achieving portfolio success. However, achieving this success is not straightforward and we often experience tensions when balancing a commercial and impact-led approach. Reporting success, failure and challenge in our portfolio is critical to building an understanding of how to manage these tensions and has required us, for the first time, to set a baseline for social impact against which we will assess ourselves in future years.

By sharing these results and our methodologies in this report we are hoping to raise awareness that it is possible to invest for both profit and social change and that others can learn from our experience.

4.1 Growing impact and financial value

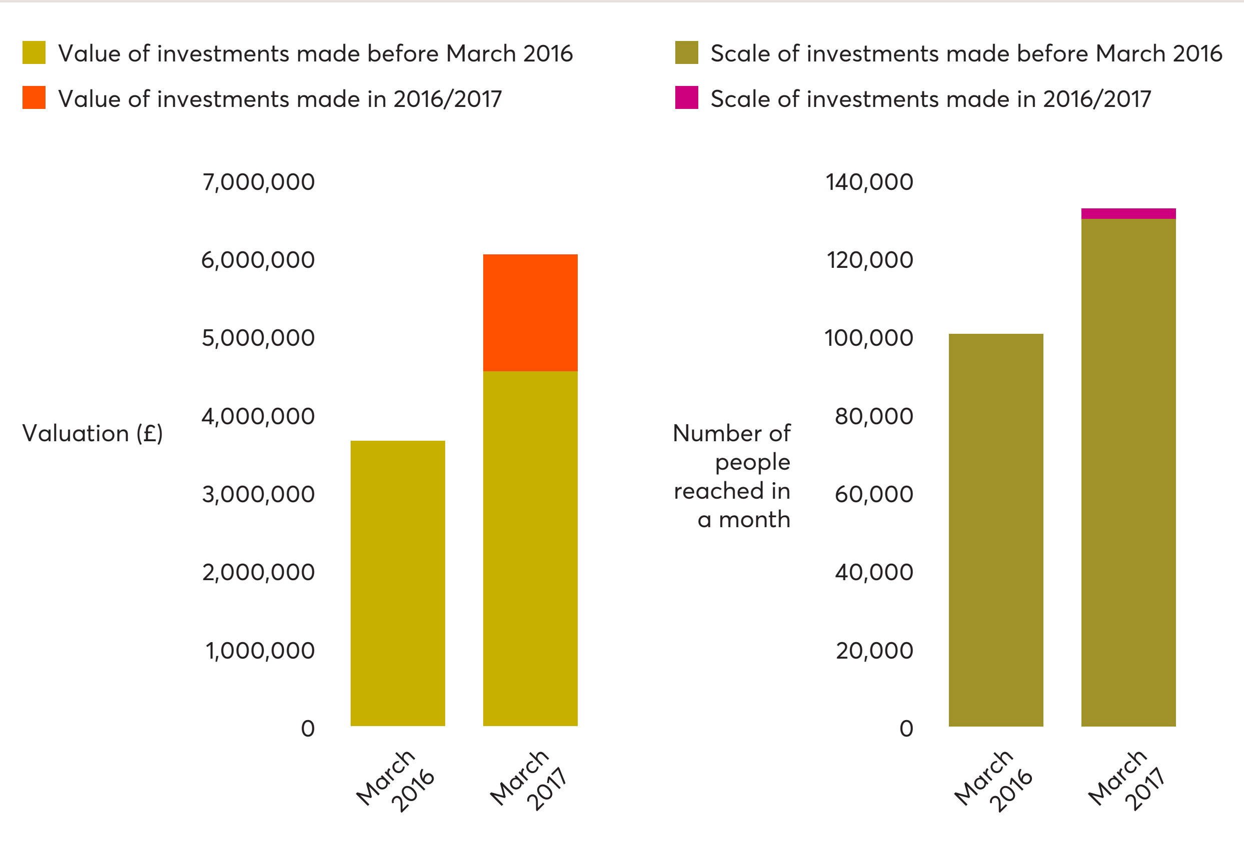
The last year has seen impressive growth in scale across our investments. Third Space Learning has gone from tutoring 3,520 students per term to over 8,000. Over 25,000 young people were using the careers advice provided by GetMyFirstJob in March 2017 compared to just 8,000 in the year before. Overall, the NIIF1 portfolio is now having an impact on more than 120,000 people per month.[3]

This increase in scale has translated into an increase in value for the portfolio during the year. At 31 March 2017, NII has made 12 initial investments and 13 follow-on investments. Whilst the NIIF1 portfolio is still immature, with an average holding period of just 29 months at year end, it shows positive signs of both social impact and financial return potential. NII does not seek premature exits that risk compromising potential long-term financial or impact returns and therefore expects exits in the later years of the fund. By the end of FY'17 the current portfolio of 12 included:

- Five companies that have successfully raised follow-on capital including two with material new independent investors permitting upward revaluation. NIIF1 made follow-on investments in all these rounds.
- One investment completed in the last 12 months held at cost.
- One realised at a small profit due to strategic change that resulted in the absence of any real impact strategy, leading to our decision to exit.
- Three investments have been written down in value reflecting underperformance.
- Two have been written off as a result of restructuring/administration.

Figure 2 shows how the value of the portfolio and the number of people reached grew over the financial year.

Figure 2: Growth in value and scale across the portfolio[4]



Case Study: Further investment into Oomph! Wellness Limited

During the year we made two separate investments into Oomph!, a provider of activity and wellbeing leadership training to care groups, local authorities and community support organisations, and provider of excursion services to care home groups with the aim of improving quality of life for older people. The investments enabled the business to test and launch a radical new excursion offering for older and vulnerable adults in care.

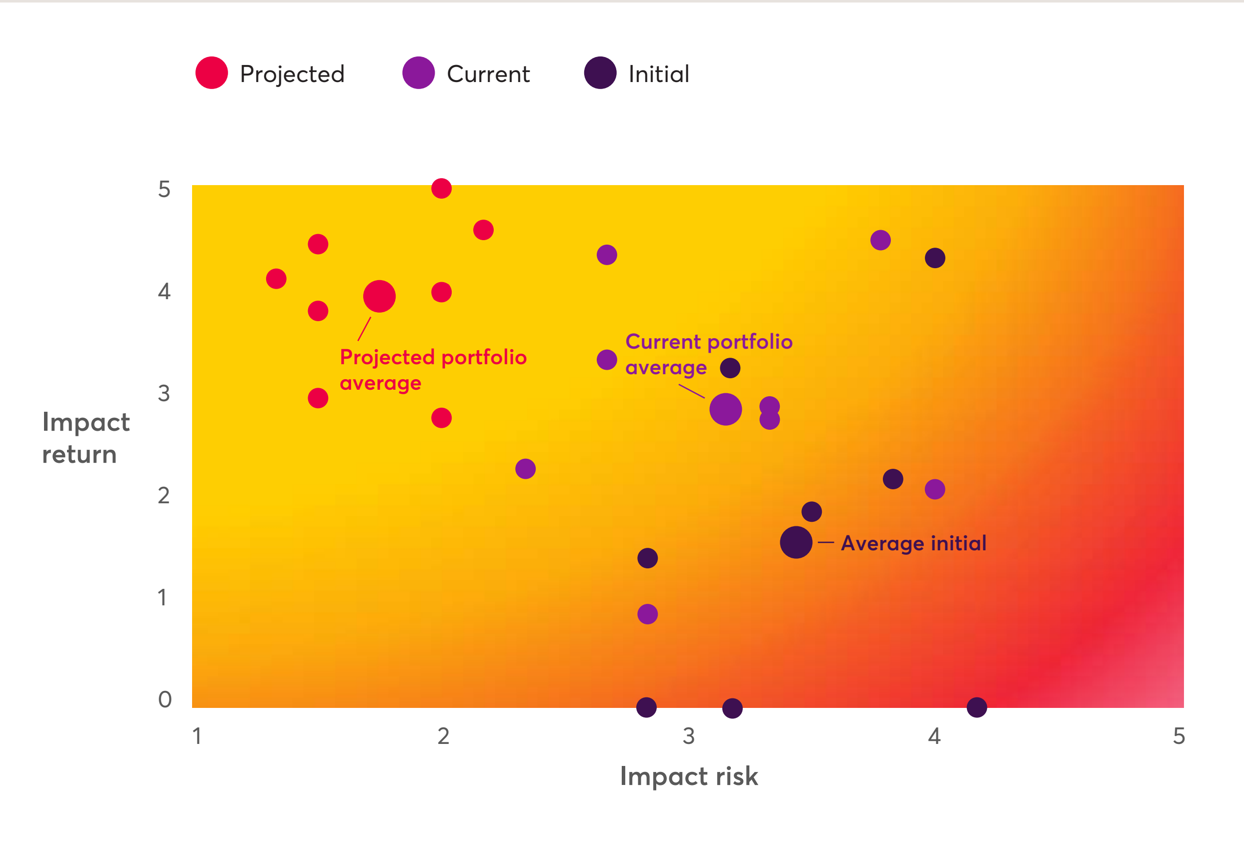
In May 2016 we invested £56k to fund a trial of the new service in Surrey. The business went on to refine its offering. We then invested £310,000 as part of a £1.5 million round, alongside The Care and Wellbeing Fund and Barchester founder Mike Parsons. The round led us to mark up our £566k total invested in the business to £1.33 million.

The investment has enabled Oomph! to test the new minibus service and scale its activity and exercise franchise. It has trained 1,598 staff, and delivers 59,575 sessions per annum. This approach has been shown to result in a 14 per cent improvement in quality of life using a clinical assessment tool.

4.2 Setting a baseline for impact

Growth and scale are just half the story of impact. We look to invest in businesses that are reaching those in need and creating meaningful change in their lives. These are investments we classify as 'high depth': for example, Reconnections is using volunteers to measurably reduce levels of loneliness in older people. Using our new impact framework this year we have set a baseline for the first time for our portfolio both in terms of impact returns and impact risk. Figure 3 shows where the portfolio was at point of investment, where it is now in terms of impact returns and impact risk and where we hope it will be at exit. Each year we will report on the portfolio's progress towards its end goal.[5]

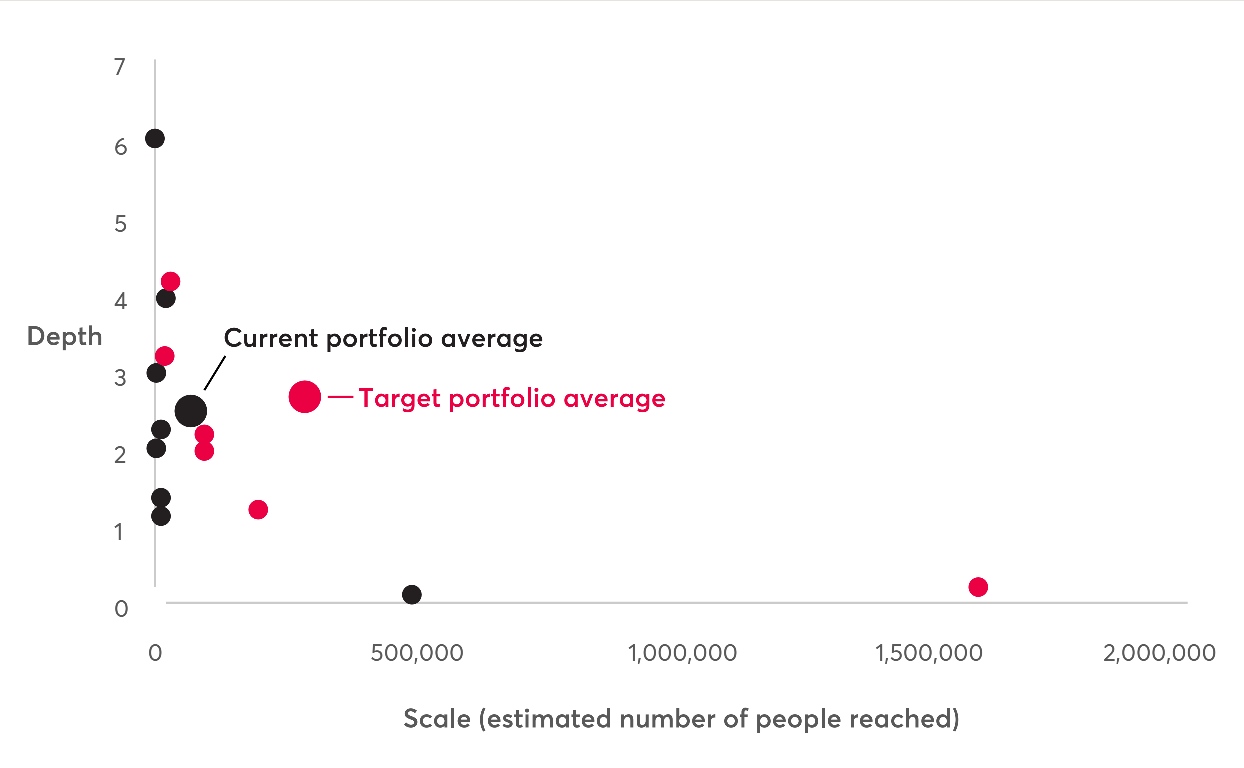
Figure 3: Portfolio risk and return*



*For more detail on the calculation of risk and return scores see: www.nesta.org.uk/publications/setting-our-sights-strategy-maximising-social-impact

Breaking down the estimate for impact return into its constituent measures, Figure 4 plots the exit projections and current estimates for our portfolio in terms of depth versus scale. Scale is the number of ultimate beneficiaries that an intervention is reaching, and depth is a function of the need of the target groups and the effectiveness of the intervention. We see that the relationship between depth and scale is highly non-linear: an increase in depth seems to be associated with a huge drop in scale. While Arbor reaches hundreds of schools with its software, its depth of impact on each of the 80,000 children in these schools is relatively light touch in comparison to the intensive relationship between the nearly 1,000 volunteers and isolated older people matched by Reconnections. The projections show that we expect to see large increases in scale before exit but less change in depth. In future years we will see how these metrics shift and whether there is opportunity to do more in terms of increasing depth.

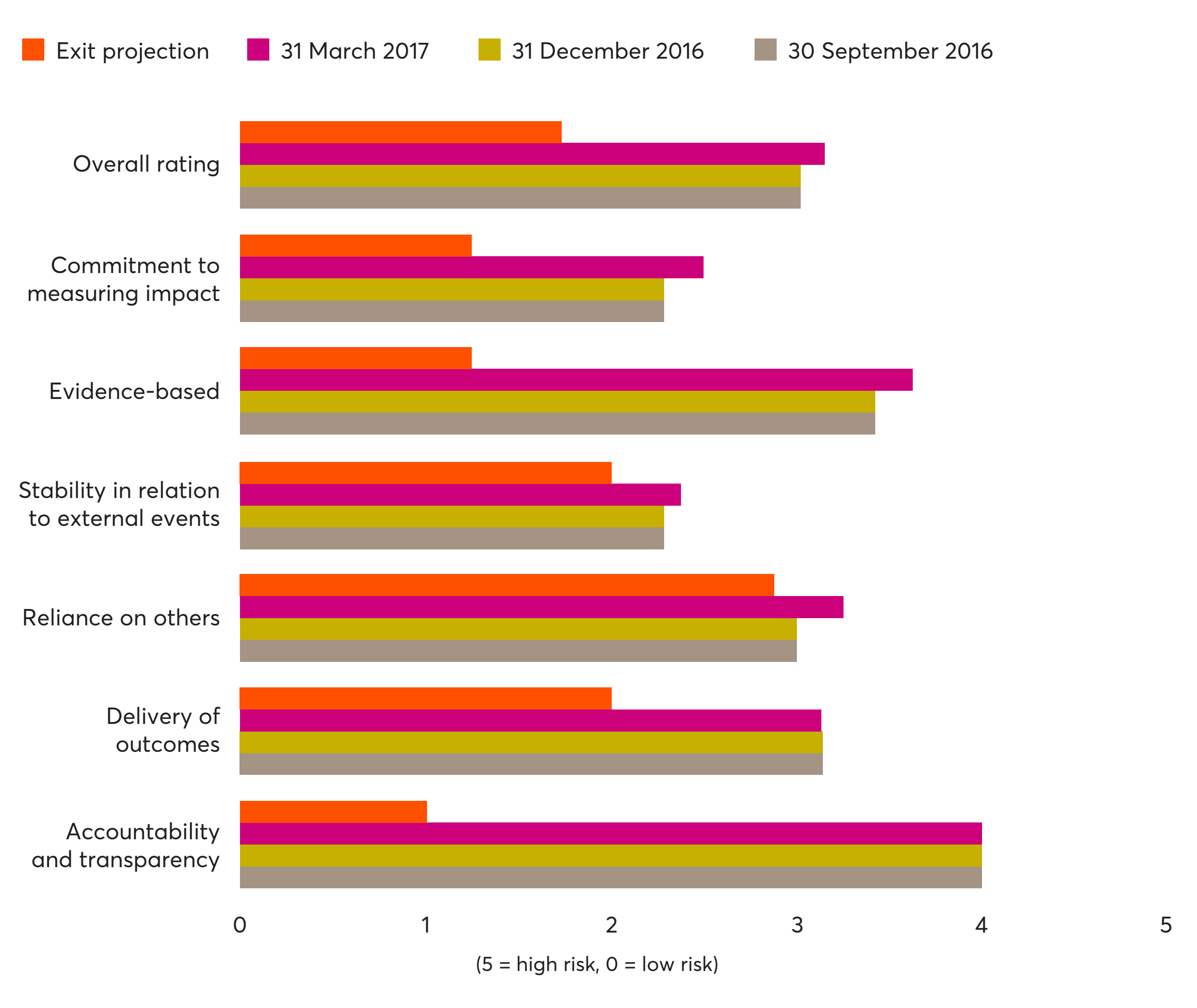
Figure 4: Impact depth versus scale (projected in red, current in black)*



The level of impact risk is benchmarked in Figure 5 alongside exit projections for the portfolio. Higher risk ratings are primarily driven by a limited evidence base and low participation in Ethical, Sustainability and Governance (ESG) certification schemes. This is not surprising given the financial and management costs of these combined with the early-stage nature of the portfolio and helps to define our risk mitigation strategy. Overall risk of the portfolio increased slightly over the year due to our new investment in Synopsis Healthcare, a very early-stage company.

*For more detail on how the depth score is calculated see: www.nesta.org.uk/publications/setting-our-sights-strategy-maximising-social-impact

Figure 5: Portfolio impact risks*



We have maintained our historic focus on improving the standard of evidence in the portfolio and two-thirds of the portfolio companies were on track with their measurement plans at year end. One of the biggest improvers in terms of evidence over the year was Third Space Learning. Having completed a randomised controlled trial and process evaluation in the course of the year, they have adapted their model based on lessons learnt. The company is now embedding student-level tracking of attainment into its routine monitoring and performance management of tutors.

In contrast ESG certification is a new consideration for the fund and we are at the beginning of a journey to understand how schemes such as B-Corps can help our portfolio and ourselves to have a positive impact on our wider society and environment. Going forward, engagement with a recognised ESG certification scheme will be a prerequisite for our new investments and we hope that more of our existing portfolio companies will also see benefit in taking this step.

*For more detail on how risk is scored see: www.nesta.org.uk/publications/setting-our-sights-strategy-maximising-social-impact

The challenge of staying focused on profit with purpose

Our goal is to invest where both impact and commercial ambition are clear and aligned. As a consequence, we operate alongside both pure profit-driven funds and impact funds to a greater or lesser extent focused on profit.

We have faced dilemmas when less commercially-focused funds invest without the same level of due diligence, legal protections or structuring rigour as mainstream venture investors. Whilst this 'easy money' may be attractive to stakeholders in the short term, the longer-term consequences can be significant. It is our responsibility to protect the interests of both our funds and our investee companies. We sometimes face a choice between (i) participating in the round on imperfect terms to help the business grow and scale impact or (ii) not participating, which leads to dilution and a loss of influence. In practice, we take the middle path: when we are not able to persuade the team to alter the terms of the deal, we manage our exposure by scaling back participation, and reserving capital for future rounds. At the same time, we continue to work with the businesses and investors to encourage more reflection in the business plan.

When investing with pure profit-focused funds, our portfolio companies risk mission drift away from their impact models. Recently, one of our portfolio companies attracted the interest of pure profit-focused funds in its Series A round. The intense scrutiny added welcome rigour to the business plan but we had to work hard to negotiate the retention of the impact provisions within the investment documentation. We have learned that impact is easier to retain where our capital is meaningful in the round. When we are unable to participate in follow-on rounds, maintaining the focus on impact will likely be more challenging. We will consider this question especially closely as we look for exit opportunities.

GetMyFirstJob

5

Future plans

We finish this annual report with a look at our plans for the coming year. Building on our success with the NIIF1 portfolio we are seeking to achieve impact on the higher levels of our theory of change, in particular through raising awareness and growing our impact. We also take the opportunity to highlight areas in our specialist sectors where we see exciting changes in the market towards increased impact.

5.1 Raising awareness and growing impact

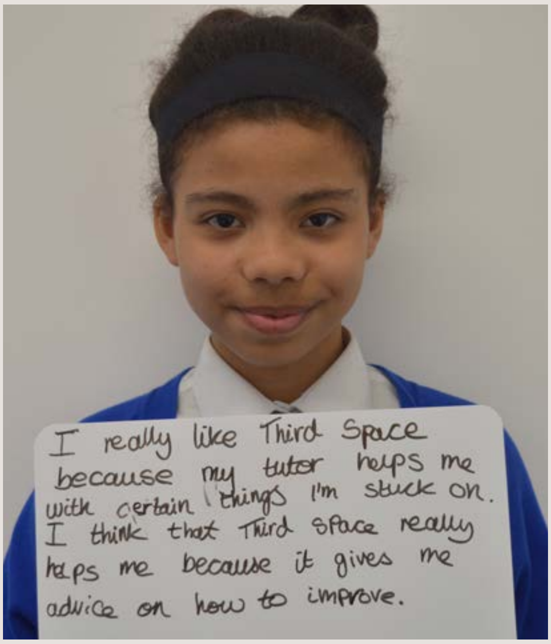
The 2016-2017 financial year was a successful one in terms of growing and supporting our portfolio and supporting the wider network of entrepreneurs (see below). We are using this strong foundation to raise awareness of impact investing as an attractive asset class. Here are just some of our plans for the year 2017-2018:

- Continue to develop our fund management activity.
- Publish our revised impact approach, based on lessons from four years of impact investing. This will give the market a practical example of how to take a structured approach to assessing the impact of potential investments and managing for impact after investment.
- Publish this, our first annual report, setting out how well we are doing against our theory of change and increasing the transparency of our business.
- We are delighted to be a contributing author to the Impact Management Project, a project to build consensus on how we talk about, measure and manage impact, bridging the perspectives of investment, grant-making, business, non-profits, social science, evaluation, wealth management, policy, standards bodies and accounting. Our contribution proposes norms around the use and production of evidence in impact investing.
- Commission an impact audit of the fund and aim to produce the first publicly available impact audit of an impact fund. By engaging an independent third party to examine our impact approach and practices we seek to increase our transparency and accountability as well as reflect on and improve our impact approach.

Our wider work with the sector

- **Manish Miglani**, our Healthcare investment lead, provides mentorship to companies in the NHS Innovation Accelerator (NIA) and Digital Health London. In addition, he also helps the NIA programme managers in judging and selecting the most exciting applicants for their programme, helping contribute to a better NHS.
- **Ishaan Chilkoti**, **Lucy Heady** and **Nathan Elstub** are active partners in the EDUCATE initiative run by UK Knowledge Labs aiming to create a 'golden triangle' between teachers and learners, Ed Tech companies and Ed Tech researchers to ensure that the UK produces products and services that have a genuine impact on learning. We have delivered workshops on gaining investment and embedding impact to the first EDUCATE cohort and will continue to deliver these and provide ongoing support to subsequent cohorts.
- During the year, several members of the team continued to play an active part supporting Bethnal Green Ventures, the tech for good accelerator, in selecting its cohort, acting as a sounding board to the teams on how to build solutions to social and environmental problems and helping them shape their investment pitches.
- **Helen Gironi** plus others in the team, worked alongside the founders of Applied, an early-stage technology platform aimed at removing bias in the recruitment market. We worked with them throughout the year mentoring the team, and helping them negotiate and prepare the business for spinning out of Behavioural Insight Ventures Limited. The business later went on to raise external funding from NIIF1 and others.
- **Nathan Elstub** is a member of the BVCA Impact Investment Advisory Group and sits on the investment committees of Nesta's Arts Impact Fund, the Shared Lives Incubator Fund and Bright Futures Fund (run by Social Finance), the Sporting Capital Investment Fund (run by Sporting Assets).
- NII is an active member of the EVPA and Toniic Impact Investment networks and is a financial supporter of B-Lab Europe.

Reconnections



Third Space Learning

5.2 Changing the market and social impact at scale

Impact investing is becoming big business. The Global Impact Investing Network estimates that over $22 billion was invested into nearly 8,000 impact investments in 2016 and predicts 17 per cent growth next year. While we do not yet have the data to understand how impact investment is changing lives on a national or international scale, we can highlight particular areas of the market where we see growing investment, pipeline and the potential to change lives.

Educational technology (Ed Tech)

Since our beginnings in 2012, we have seen significant increases in amount of institutional and venture capital money seeking Ed Tech opportunities in the UK. The country now has over 1,200 Ed Tech companies (the same as the number of financial technology companies in the UK) and they are expected to deliver total average growth over the next two years of c.30 per cent per year.

We see great potential for Ed Tech to improve learning but we also see a lot of hype with many innovations developed without input from schools, teachers and pupils. Many other innovations in the sector will not benefit those children that need help the most. Over the last year we have seen a gear change in the focus on evidencing the effectiveness of products. The squeeze in schools' budgets is focusing minds as schools seek better justification for their technology purchases. New initiatives are also having an impact, such as EDUCATE (see previous section) bringing together researchers, teachers and entrepreneurs to help ensure that schools are using technology that genuinely improves educational outcomes.

Communities

Since 2013, the level of social impact funding activity into sustainable communities has slowly increased. While overall funding in 2015 and 2016 did not increase, equity funding accounted for a greater proportion of the total in 2016, indicating the emergence of a stronger pipeline of high-growth private companies in the sector. This was certainly reflected in the businesses that came through our door with increasing numbers of rounds being raised in the charity tech, energy supplier comparison/switching, employability and circular economy sectors in particular. While not the right fit in terms of stage for our fund, we were excited by the disruptive models presented by the likes of Green Running (technology which enables households to save energy), Hubbub (improves the transparency of fundraising and donor engagement) and Neighbourly (reduces barriers to employment). In the coming year we expect this activity to convert into more opportunities at the right stage for the fund, stimulated by government legislation[6] and accelerators such as Fair By Design, funded by the Joseph Rowntree Foundation.

Health

Our health investment strategy spans the patient pathway: preventing disease, reducing escalation and improving treatment. Higher life expectancy is bringing with it more chronic disease and increasing lifestyle-led diseases. The need for innovation to address these challenges is high and we are seeing strong demand from both consumers and healthcare providers.

Two areas where we have seen increasing opportunities over the last year are in disruptive models of home care and harnessing the power of peer-to-peer support. New technologies mean that patients requiring home care can be matched and managed more quickly, effectively creating an exciting opportunity to both reduce costs and improve health outcomes. From chronic disease to mental health we are now seeing companies that are using the power of social networking sites to improve self-care by sharing experiences with peers and using behavioural 'nudges'.

5.3 We want to hear from you

We would like to close by thanking you for taking the time to read about our achievements this year. By publishing this, our first annual report, we wish to contribute to the transparency and accountability of the impact investing sector. We are also keen to learn and improve from the experiences of others as well as our own. If you have any feedback on this report, our new impact strategy or any other aspect of our work please get in touch and start the conversation. Email us, comment on our blogs or stop by for a coffee.

Oomph!

Reconnections

Endnotes

1. First invested in as Planet Sherston.
2. Anonymous survey delivered through SurveyMonkey in March 2017 to CEOs, impact leads and co-investors. Seventy-nine per cent response rate with at least one respondent from each portfolio company.
3. All scale figures in this report are based on data from multiple sources reported to us by portfolio companies.
4. Scale numbers include estimates based on average numbers of pupils per school and average numbers of older people per session. This is total scale and not adjusted for level of need.
5. More detail on the methodology for calculating these numbers can be found in ‘Setting Our Sights: A strategy for maximising social impact’.
6. For example, plans to prevent social landlords from letting any property with an energy efficiency rating of F or G.

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