

Catalytic Investment Decision Model

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Working with High Net Wealth individuals and Family Office investors, we have learned that it is often difficult to assess whether an investment proposition really deserves catalytic capital. If you are an impact investor who makes both market rate and catalytic impact investments, this framework is intended to help *you* decide whether an investment deserves your scarce catalytic capital. It does that by guiding you to balance the nature and quantity of the impact achievable due to a capital gap with the implied financial subsidy, defined as the difference between the financial terms you are considering and the terms at which an investor motivated only by financial returns (a “commercial” or “market rate” investor) would invest, as illustrated by Figure 1:

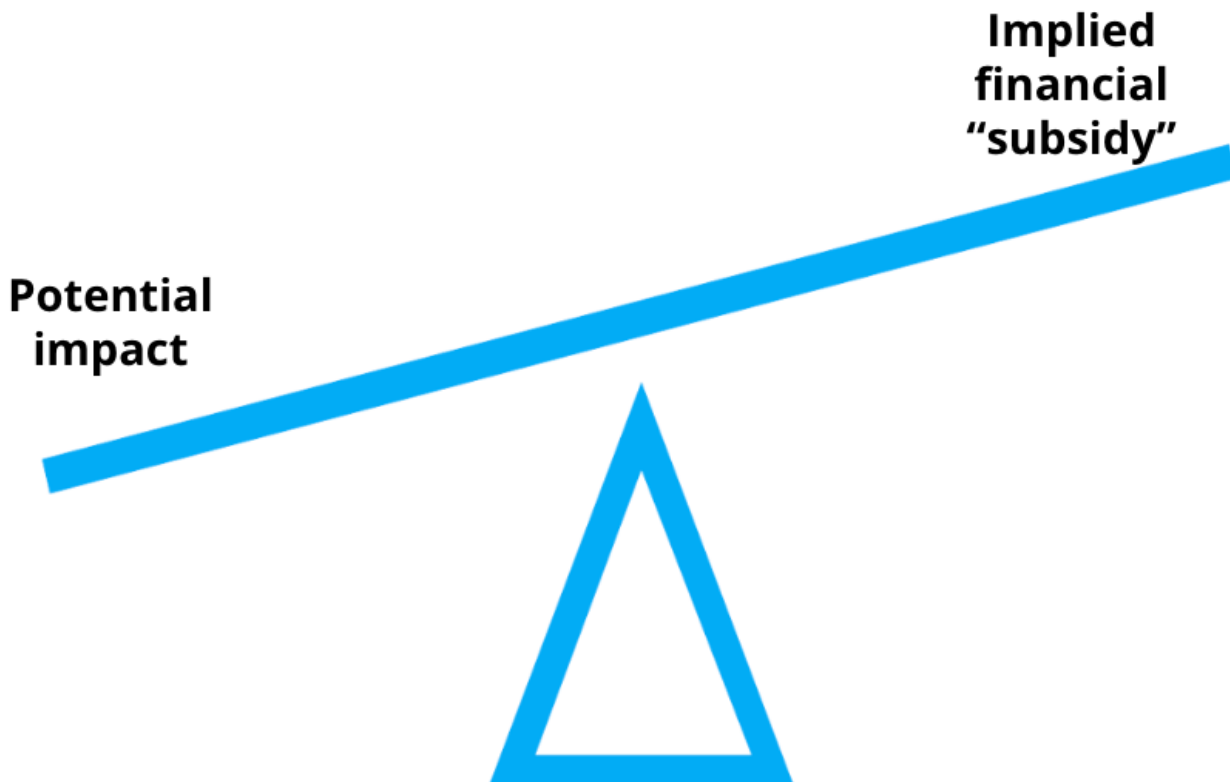


Figure 1

This model is designed to help you *evaluate the appropriateness of providing catalytic capital in a particular investment*. It does not replace the other aspects of investment decision making –appropriateness of ticket size for you, the fit of the investment in the portfolio, risk tolerance, your usual due diligence process, and so forth.



Figure 2

If your answer to all these questions is “yes,” the model is suggesting that providing catalytic capital is appropriate in this case.

If at any step the answer is “no”, the model is suggesting *not to* make the proposed investment.



DETAILED WALKTHROUGH

Step 1: Impact

Is the potential impact compelling enough to deserve scarce catalytic capital?

The potential for compelling impact is the fundamental analytical starting point, because if this investment cannot generate outsized impact, it does not deserve your catalytic capital (based on the [assumptions](#) listed at the end of this document).

That's a subjective question, informed by your areas of thematic focus, but you are looking for *significantly greater impact* than what you'd see in an investment that can attract commercial capital.

Direct v. Systemic Impact

Impact can be direct, systemic or both. Direct impacts are those experienced directly by stakeholders in the enterprise - the ways in which their lives are tangibly improved - which is a scope that generally makes measurement easier. An example is improving health outcomes for people by providing clean cookstoves.

Systemic impacts are indirect changes to a system created by investing in models that are disruptive or create new paradigms. Examples include proving out a new business model that can be replicated by other companies in other geographies, creating new financial vehicles, using investment terms that can draw in additional capital, building a market where one does not exist, or providing capital to historically marginalised entrepreneurs or managers to counter historical biases in order to inspire other investors to do the same. In each of these examples, the bulk of financial upside will be external to the original investor.

Each of the "capital gap" impacts listed above have some degree of both direct and systemic effect, but usually the focus is more on either direct or on systemic effects. It is useful to be clear up front on the dimensions of impact that matter most to you, which you will measure and track progress, and the degree to which the target for each is direct versus systemic.



Counterfactual Impact

In each case, you are seeking to assess “counterfactual impact” against baseline. In other words, what happens in a hypothetical world in which you don’t provide to the enterprise the catalytic capital it seeks?

Assessing Impact by Applying The Five Dimensions of Impact

To assess baseline and counterfactual impact, draw on the Five Dimensions of Impact from the Impact Management Project.

Doing this exercise for one potential investment will give you a semi-structured assessment of the impact of that enterprise. Doing it for multiple, similar enterprises will facilitate comparison of potential impact between enterprises. You can then (in a subsequent stage) see the depth of financial subsidy requested relative to the impact, and begin to make useful comparisons about the appropriateness of you providing catalytic capital for a given investment.

Step 2: Gap

Step Two is about whether this problem could be addressed with commercial capital. If so, the model assumes this investment should not get scarce catalytic capital.

If commercial capital is not flowing to enterprises seeking to have this impact, there is a “capital gap.”

There can be many reasons why commercial capital is not flowing to this type of investment.

The risk could be greater, or the returns lower, than commercial investors demand.

Sometimes it is about perception, not reality, as commercial investors follow received wisdom like “it’s too risky to invest in first-time fund managers,” which some catalytic investors may reject in some cases.

Catalytic investors might be seeking to:

- Reach underserved populations or geographies
- De-risk novel products, services, technical approaches or financing models
- Provide a track record or adequate scale for a new solution or a new team
- Support a business model that has greater capital needs or contemplates lower profitability than market rate, or an investment that requires more due diligence costs than what commercial investors would bear
- Address historical biases in capital allocation, like the marginalisation of BIPOC investees and communities in the United States or immigrants in Europe.

You may identify other capital gaps.



So the assessment at Step 2 is “Would the investment help fill a commercial capital gap?”

Step 3: Efficiency

Is it unlikely the impact could be achieved with lower financial subsidy?

Assuming in Step One you found the impact both sufficiently compelling, and due to a commercial capital gap, in this step you assess whether the financial subsidy sought is necessary to achieve the outcome.

The reason for this assessment derives from [Assumption #1](#) below that, all things being equal, as an investor you want to optimise the combination of financial and impact return, and [Assumption #3](#), that Catalytic Capital is scarce and should therefore be allocated to the highest impact opportunities.

Of course the investment pitch doesn't come with an “identified subsidy” - you have to estimate the difference between what you will receive and what a commercial investor would demand. That's the implied subsidy.

Then you evaluate whether the targeted impact could likely be achieved with a lower or no subsidy, or alternatively, whether more impact could be achieved at the same subsidy.

If there are other successful enterprises *backed by commercial capital* credibly promising similar or better impact, why would you provide Catalytic capital?

You might do so if you predict the pure commercial enterprises will ultimately fail or require subsidy themselves.

Or maybe you see commercially-funded enterprises making impact tradeoffs you don't like. Many impact business models have inherent tradeoffs between financial return and impact, such as a business model that charges middle-class customers more so they can charge poor customers less. You may wish to fund an enterprise that promises to make those tradeoffs with more emphasis on impact, recognizing that will hurt financial returns relative to commercial-capital backed enterprises.

But if you feel the financial subsidy sought is greater than what is needed or you are willing to make, you will likely decline to invest catalytic capital, or perhaps seek to renegotiate the terms to



see if the issuer is willing to accept a lower implied subsidy.

If this does not meet your criteria for catalytic capital, you may also consider a market rate investment (if no subsidy is needed) or grant capital (if the subsidy is too great).

Step 4: Distortions

Does the investment adequately avoid or mitigate market distortions?

Many well-meaning grants, subsidies and catalytic investments have caused long term distortions to markets that prevent or make more difficult the ultimate provision of goods or services at market rates.

This can be seen as a domino effect across the Spectrum of Capital, with grant-supported projects making catalytic supported ones more difficult, and catalytic ones making commercial ones more difficult or impossible, often due to setting unrealistic pricing expectations among consumers. Having anchored the expectation that a mosquito net should be free, consumers will be reluctant ever to buy one, even a subsidised one. Unless the donor plans to continue the granting/subsidy indefinitely, there will come a time where the market needs to be supported at commercial rates or the market will fail and the product or service will no longer be offered.

A way to phrase this question:

- *Are existing commercial players providing the same goods or services to the same client group? Is it possible that your catalytic investment may displace them?*

There are many tragic abandoned international development projects around the world that fell into disuse after the financial support of the donor decreased or disappeared. Sometimes these prevented the emergence of catalytic capital or even commercial rate approaches that otherwise may have been possible.

So if the targeted stage of the Catalytic Capital is Seeding or Scaling rather than Sustaining, one should examine the likely paths to a self-sustained enterprise (presumably at market rates) after the capital for Seeding or Scaling is withdrawn.

- *Can you define progress milestones that would enable you to withdraw your catalytic capital investment and enable a transition to a more commercial model after the early stages?*



Step 5: Realistic Path

Is there a realistic path to obtaining additional catalytic capital if the enterprise's need is greater or will last longer than what you would provide?

As outlined in the 2019 Tideline report "[Catalytic Capital: Unlocking More Investment and Impact](#)", there are three roles/stages for Catalytic Capital - Seeding, Scaling and Sustaining. If you are investing at the Seeding or Scaling stage, it is typically with the expectation that you are serving as a bridge to commercial capital at the Sustaining stage.

If you are investing at the Seeding or Scaling stage, the questions to assess at this step are:

1. Whether the enterprise will likely need catalytic capital at a subsequent stage, and if so
2. Are there realistic paths for the enterprise to obtain that capital?

Why should you care about this question? Shouldn't you just focus on the current stage of the business, for which you are considering providing catalytic capital, and leave the problem of raising money for subsequent stages to subsequent investors?

Not if, to achieve the impact you seek, the enterprise has to survive long term. Catalytic capital, while often necessary, is both scarce and potentially distorting. Some investors will *only* make catalytic investments at the Seeding or Scaling stage in order to help the enterprise "cross the desert to commercial funding." If, in their assessment, there is no realistic chance of the enterprise "graduating" to commercial funding, they pass on the deal.

Other investors make the choice to provide what, in effect, is an ongoing subsidy relative to the demands of commercial investors because they feel the enterprise is delivering valuable impacts in a commercial capital gap that cannot survive without that ongoing subsidy, and the alternative is to require outright grants for ongoing support. In that case, however, the investor should be clear at inception about their time horizon for exit. When the time for that exit comes, what are the possible ways the business can continue?

If the answer in either case is "I cannot foresee any realistic ways they will get the catalytic capital they will need in the long run", this model suggests to decline to invest catalytic capital in this deal.



Step 6: Comparison [optional for extra rigour]

How does this compare to similar investments?

This model can be used in two ways: evaluating potential deals one at a time, or comparing potential deals to one another.

Comparing multiple similar deals before investing is the more rigorous approach. As noted elsewhere, absolute measures of either financial subsidy or impact achievable are much more meaningful in comparison to similar opportunities.

As noted, it is easier to compare the degrees of requested subsidy between two or more deals than to compare financial subsidy to impact. Likewise, it is easier to compare impact sought across deals in the same sector and geography than to compare impact to subsidy.

By completing both an impact assessment and a financial subsidy assessment for two or more similar deals, intuitive comparisons of impact versus subsidy begin to emerge. Having two or more deals to compare before making an investment decision can be very helpful in assessing the appropriateness of deploying your catalytic capital.

In "real life," however, the nature of catalytic capital deals makes this challenging. Most such opportunities are highly innovative – there are usually not two additional organisations "in the wings" with an approach to achieving similar impact and a request for catalytic capital you can compare. So while Step Five brings the greatest rigour, it is often not possible to use.

LIMITATIONS AND ASSUMPTIONS OF THIS MODEL

This model meets the approach of many HNI, Family Office and Charitable Foundation investors in many thematic areas, but not all:

1. It assumes the investor would prefer to maximise the combination of financial and impact returns, because even if the investor is more focused on impact, more financial return can be recycled for more impact.
2. It assumes that a Catalytic investment must have the promise of high Investor Contribution (Additionality) for the investor to invest - that the investor is contributing to something happening that would not absent their investment.
3. It assumes that a single risk-adjusted market rate of return can be determined for each asset class. This is a vastly oversimplifying assumption that falls short when examined in detail. But it is useful at the high level of answering the question “would investors motivated only by financial return make this investment on these terms”?
4. It accepts market rate investments as the benchmark against which catalytic investments are compared, because Catalytic Capital is scarce and market rate capital more plentiful. This means it is more likely that market rate investments would be funded anyway by others, reducing Investor Contribution.
5. It assumes you can readily compare “financial subsidy” in a unit of currency to “impact achieved,” which is typically not resolvable to a unit of currency. Although in the abstract this comparison is fallacious, in practice it becomes useful when used to evaluate multiple similar deals. In that case, you can compare the degree of implied financial subsidy of multiple investments to one another, and likewise, compare the impact of multiple investments to one another, providing an intuitive sense of where the greatest impact can be achieved for the least subsidy, and even what constitutes “market rate” for that type of investment/sector. This works best in comparing investments seeking similar impacts in a single geography – it is less useful in comparing a climate change investment to a maternal health investment or an investment in Ghana to one in the same sector in Germany.
6. Application to 100% Catalytic Portfolios
Although in this model the degree of financial subsidy is measured against “market rate”, the model still works if the investor makes only catalytic investments, because the degree of subsidy relative to market rates is still a useful comparison even if the portfolio contains no market rate investments. Thus the model could still be useful even for investors who are not seeking market rate investments.