

# Setting Portfolio Growth Strategy:

How WaterEquity Used Limited Information  
to Make Impact-Informed Decisions



## Summary

This case study describes how WaterEquity integrated impact and financial considerations to set a portfolio growth strategy. It is particularly relevant for investors considering how to integrate impact, risk, and return into portfolio construction despite imperfect data.

## Background

WaterEquity is the first asset manager exclusively focused on solving one of the most urgent issues of our time—the global water and sanitation crisis. WaterEquity invests in financial institutions and enterprises in emerging markets, delivering access to safe water and sanitation to low-income consumers, while offering an attractive financial risk-return profile to investors.

From WaterEquity's founding in 2017, the organization has been developing tools and systems to integrate impact management into every stage of the investment cycle. Investment decisions, portfolio management,

and targets have always integrated considerations related to risk, return, and impact.

WaterEquity formalized its impact-financial integration during participation in the inaugural Impact Frontiers cohort in 2019. As part of that collaboration, the organization developed an impact score and internal rate of return (IRR) calculator. These tools standardize the way WaterEquity evaluates each deal's projected financial returns and impact, and regional investment officers apply them at due diligence to help guide investment decisions.

## Integrated analysis to inform portfolio growth strategy

In 2018, after closing on its flagship fund, WaterCredit Investment Fund 3, WaterEquity began developing a strategy for growth and increased impact. This strategy focused exclusively on opportunities to expand access to water and sanitation in emerging markets and considered three potential areas for investment:

- 1) financial institutions that offer household and small and medium enterprises (“SME”) finance for water and sanitation,
- 2) SMEs and social enterprises that directly serve low-income consumers, and
- 3) municipal and state-level water and sanitation infrastructure.

At the time, WaterEquity had not yet developed standardized tools with which to quantify the impact and financial return considerations of each strategy. But the process was based on integrated thinking and concepts that formed the basis for the tools that WaterEquity later developed. Below is a simplified summary of some components of that analysis, and a qualitative visualization comparing returns and impact.

**Table 1: Return and Impact Expectations for Three Potential Areas for Investment**

		Financial Institutions	Direct-to-Consumer SMEs	Infrastructure
Return Expectations <sup>1</sup>		Microfinance investment vehicles with a hedged strategy averaged 6.5%-7.1% USD yield on debt investments from 2015-2017 <sup>2</sup>	SME funds have on average realized net returns of around 5- 6% in USD. This includes SME equity funds with larger ticket sizes, the net returns on funds focusing on WaterEquity's < \$2m segment being even lower. Debt-like mezzanine funds have shown returns between 0% and 8%	Average target return of infrastructure funds 10% in 2017; Relatively lower expected net returns in water supply and sanitation (8-10%) compared to some other infrastructure sectors
Impact Expectations	Percent low-income clients	High	High	Low
	Ability to reach scale	High	Low	High
	Strength of the evidence base	Medium	Low	High
	Ability to catalyze additional investment	Medium	Medium	High
	Quality of water and sanitation access	Medium	Medium	High

Based on the exercise, WaterEquity decided to move forward with the two investment strategies that better aligned with the organization’s impact goals and presented more attractive risk-return opportunities: financial institutions and infrastructure.

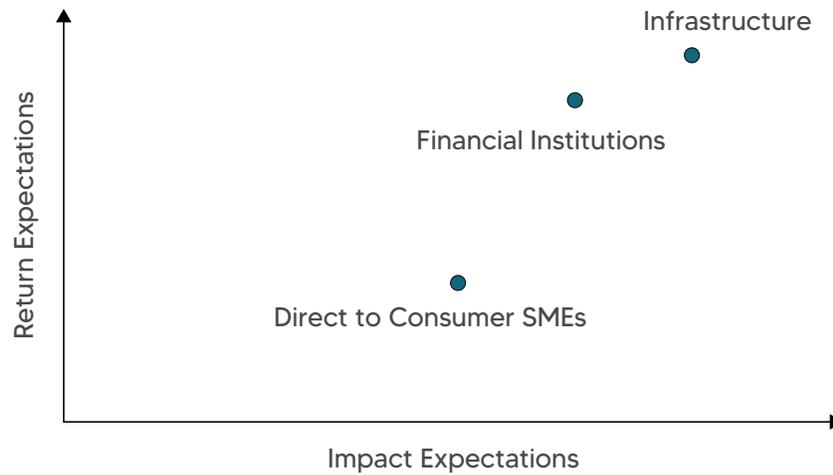
**Financial Institutions:** Expanding investments in financial institutions would provide focused outreach to low-income households at scale, but with relatively lower quality water and sanitation access.

**Infrastructure:** The potential for scale with infrastructure indicated to WaterEquity that even if each investment were to reach a smaller proportion of low-income households, the overall number of low-income households would be high. These investments would then provide those households with higher quality water and sanitation services.

<sup>1</sup>Past performance is not indicative of future results. There can be no guarantee that the potential areas for investment will achieve these expected returns.

<sup>2</sup>Source: 2018 Symbiotics MIV Survey Market Data & Peer Groups, [symbioticsgroup.com](http://symbioticsgroup.com).

Chart 1: Return and Impact Expectations for Three Potential Areas for Investment



## Integrated analysis to inform portfolio construction

### Starting the process

In 2019, WaterEquity prepared to expand the financial institutions investment portfolio. The organization expected to have a new pool of capital to invest across four regions (South Asia, East Asia Pacific, Latin America, and Africa), which would diversify WaterEquity’s reach from three countries to fifteen. WaterEquity determined markets to prioritize based on a screening process that considered factors such as water and sanitation need; poverty levels; regulatory considerations for foreign investors; and country risk.

To determine how to allocate this new pool of capital across countries, the investment team sought to reach a financial return target while simultaneously maximizing social impact within the universe of potential deals. Limited data was available to inform the initial analysis – particularly regarding impact. However, the team was able to adapt the integrated impact-financial approach as a planning tool.

## Pipeline building

WaterEquity’s pipeline building process began by sifting through a list of hundreds of companies to develop a short list of investment candidates that fell into the following criteria:

- 1) enabled access to water and sanitation for low-income households in the specified target market, and
- 2) aligned on loan pricing.

From this short list, each regional lead investment officer developed a plan to allocate a certain amount of capital and reach a target financial return. The question then became how to integrate impact into that portfolio construction process.

## Incorporating impact data into pipeline building

To incorporate initial impact data into the pipeline building process, WaterEquity looked at two key components that can support decision-making while using estimated or limited data:

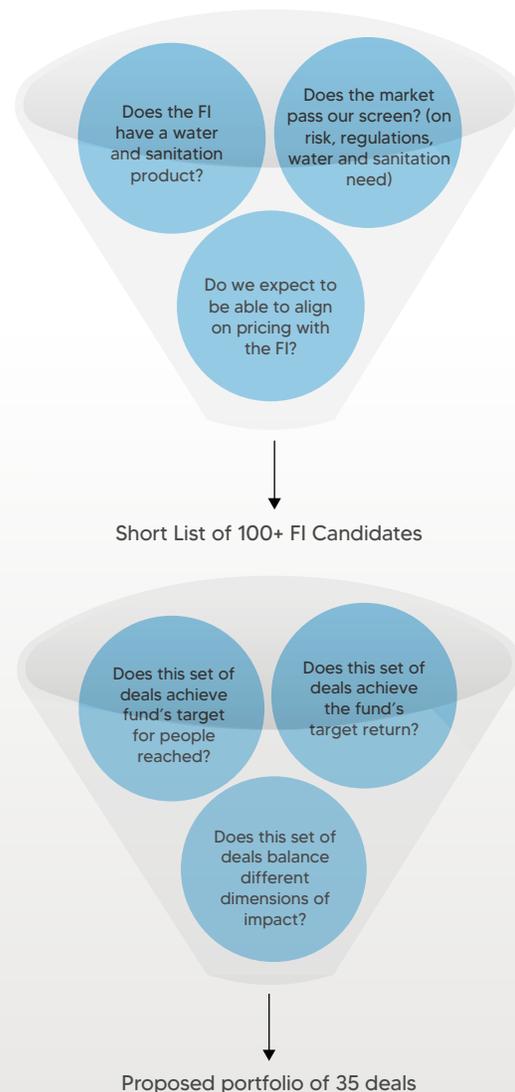
- 1) the topline key performance indicator (“KPI”), and
- 2) an initial estimated impact score across multiple dimensions of impact.

**Topline KPI:** To assess impact at the portfolio level and for each deal, WaterEquity considers a topline KPI of number of people reached with safe water or sanitation. Each WaterEquity-managed fund has a target for this KPI.

Even with limited information, the team was able to estimate the number of people that would likely be reached through each investment. WaterEquity projects the number of people that can be reached through each loan by using basic operational information such as historical microloan disbursement trends, average microloan size, and average household size. Regional leads were able to quickly estimate number of people reached through each investment.

**Impact Scoring:** By the time WaterEquity undertook this analysis in 2019, it had built a multidimensional impact scoring tool to assess impact at the portfolio level and for each investment. The impact score examines dimensions of impact including which types of clients are reached (i.e., low-income consumers, women), what type of benefits they experience, and for how long. The impact score is completed during due diligence after analyzing company data and conducting interviews with key company leadership and other stakeholders. During pipeline building, before initiating due diligence, regional leads relied only on general market knowledge and initial conversations with potential borrowers.

Chart 2: Pipeline Process Diagram



To adapt this social impact score for this situation of limited information, regional leads made estimated a categorical (low, medium, and high) score for each dimension of impact. For example, they might have known that one financial institution had very strong outreach to lower-income households but was relatively small compared to other players in the same country—that deal would score High on clients and Low on scale.

### Integrated decision-making

Each regional lead identified a list of potential deals, in order of priority, to reach their target portfolio size and financial return. The team then reviewed the proposed global portfolio simultaneously looking at the projected yield, impact, and country allocation. WaterEquity’s Chief Investment Officer and Director of Impact & ESG, as well as other team members, provided feedback and regional leads moved some deals from high priority to low and vice-versa to optimize the portfolio.

When considering impact, WaterEquity first focused on adjustments that would increase the “number of people reached” (i.e., scale). Initially, the proposed global portfolio fell short of the scale target, because until then regional leads had not been managing towards that target. Regional leads identified which borrowers had the most potential for scale and moved a few key borrowers up in priority list to ensure the fund’s target could be achieved.

At the same time, part of WaterEquity’s motivation in developing an impact score was to move away from impact decision-making that focused on scale alone. Borrowers that reach relatively few people

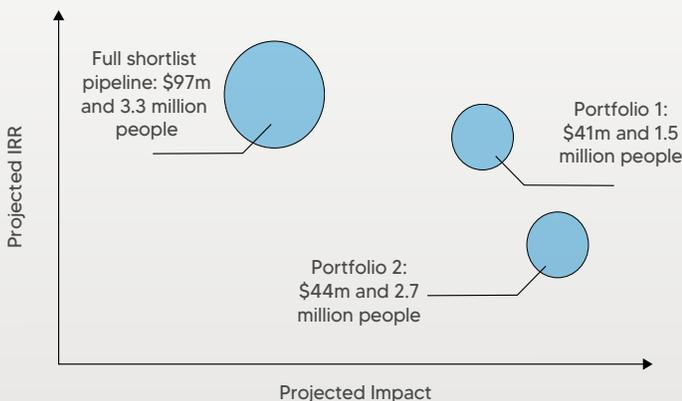
may have outsized impact in other ways. For example, they might reach more underserved communities, or provide access to higher quality or longer-term water and sanitation facilities. To incorporate these additional impact dimensions, the team re-considered their priority list with an eye to

- 1) balance the impact profile and
- 2) remove underperformers.

In balancing the overall impact profile of the portfolio, the team identified dimensions of impact for which the weighted average (subjective) score was low, looked for de-prioritized deals that were strong in those dimensions, and added those deals back into the portfolio.

As a result, the deals proposed in the final projected pipeline were expected to exceed the fund’s target number of people reached, achieve financial returns over the fund’s hurdle rate, and represent high overall expectations across multiple dimensions of impact.

Chart 3: Integrated Portfolio Construction, South Asia Example



From the full list of shortlist deals, when considering impact WaterEquity refined the potential portfolio to prioritize deals that would reach more people per dollar invested, and then to improve impact in under-performing dimensions. For example, in South Asia the regional lead initially proposed Portfolio 1, but subsequently shifted to Portfolio 2.

## Conclusion

Investors often point to the lack of data and analytical tools as a major barrier hindering the development of the impact investing industry. WaterEquity's approach to portfolio construction demonstrates that even without reliable, in-depth impact data it is possible to conduct right-sized analysis of integrated impact and financial returns. WaterEquity's team is committed to improving this process as they continue to accumulate market knowledge about impact and test initial assumptions throughout the investment lifecycle. This iterative approach highlights the importance of just getting started, and not letting perfect be the enemy of good.

WaterEquity is the first asset manager exclusively focused on solving one of the most urgent issues of our time - the global water and sanitation crisis. We invest in financial institutions and enterprises in emerging markets delivering access to safe water and sanitation to low-income consumers, while offering an attractive risk-return profile to investors.

Founded by award-winning entrepreneurs Gary White and Matt Damon of Water.org and led by Paul O'Connell, the success of WaterEquity is built on decades of experience investing in water and sanitation in emerging markets, delivering proven social and financial returns.

Learn more at [waterequity.org](http://waterequity.org).

Impact Frontiers is a peer learning and market-building collaboration, developed with and for asset managers, asset owners and industry associations. The initiative creates practical tools and peer-learning communities that support investors in building their capabilities for managing impact, and integrating impact with financial data, analysis, frameworks, and processes.

Impact Frontiers originated at Root Capital, migrated to the Impact Management Project in 2019 as a natural platform for industry collaboration, and is now continuing as an independent non-profit initiative of the Bridges group.

Learn more at [impactfrontiers.org](http://impactfrontiers.org).



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