

# Deepening Impact through a Participatory Due Diligence Process

Peter O’Flynn,<sup>1</sup> Grace Lyn Higdon,<sup>2</sup> Daan Besamusca<sup>3</sup> and Anuradha Shetty<sup>4</sup>

**Summary** Impact investing can create a disconnect between the needs of the people that an investment means to serve and the intentions of the investor. Based on work carried out in partnership with the Impact Investment team at the Open Society Foundations, this Brief presents emergent lessons for investors conducting their due diligence on prospective deals (both equity and indirect investments) in a participatory manner. The focus is on incorporating the voice of those who impact investment seeks to serve – producers, employees, consumers and other stakeholders in the wider community – within due diligence. A process of structured engagement with these actors through the due diligence process can lead to deeper, more meaningful social impact on the ground.

## Introduction

In impact investing – placing capital with the intention of achieving social or environmental impact alongside financial returns – it is typically the owners of capital who define the impact sought. The lives of the people who impact investment aims to serve are significantly affected by decisions made about the allocation of investment capital, yet they generally lack any say in the investment process itself. Due diligence offers a promising entry point for widening participation because this stage sets the precedent for the investment’s intent, and it contains the initial outreach to all affected stakeholders. It affords some of the earliest opportunities to learn about community priorities from the perspective of the intended beneficiaries (henceforth target class)<sup>5</sup> themselves, and consequently to ensure these preferences are embedded throughout the rest of the impact investment process.

But why should impact investors be interested in participation, and how does including it in the investment process support greater impact? First, including wider stakeholders helps reduce the disconnect that too often exists between investors and the on-the-ground reality of the target class. Participation allows for the planning and design of an investment in a manner that will maximise social impact *as defined by the target class*.

Second, an investor can increase its chances of financial and social impact success by ensuring a product/service is a good fit with the target class in terms of quality, affordability and accessibility before making an investment. Third, incorporating participation can reduce risk and avoid harm in local communities that might otherwise not be understood without first directly consulting them. Understanding dynamics within a community is a prerequisite for mitigating the risk of perpetuating local forms of oppression and marginalisation. We believe that social impact can only be *real* when it is perceived this way by the affected community. Fourth, it helps ensure that social impact remains at the centre of such an investment throughout its tenure due to more clearly defined and robust social impact outcomes, engaged stakeholders and participatory monitoring practices. Finally, one can argue that impacting communities requires a shift of economic power and voice from capital-rich investors to the target class, and that ensuring the relevant voices are heard throughout this impact investment process is simply the right thing to do if an investor wants to align its values with its practices.

## Inquiry on participation in due diligence

How can the voice of target class stakeholders be better incorporated into the due diligence process? We identify three core principles for how

**Table 1 Opportunities for participation in due diligence**

Operationalising participation	The overall due diligence process	Tools used in the due diligence process		
		Due diligence questionnaire	Term sheet	Investment memo
<b>Understanding stakeholder relationships</b>	<p><b>Validate and verify</b> links between the fund managers/businesses and stakeholder groups.</p> <p>Schedule <b>field visits</b> to afford additional time to meet employees, beneficiaries, and representative groups advocating for the target class (e.g. civil society, unions).</p>	<p>Add <b>stakeholder mapping and a theory of change</b> as requirements to the due diligence questionnaire filled out by businesses.</p> <p><b>Validate the theory of change with the target class.</b></p>	<p><b>Enshrine roles pertaining to governance and impact measurement of the target class</b> from the start by including them within the term sheet.</p>	<p><b>Outline all outreach conducted with target class members</b> in an appendix and <b>check for representativeness.</b></p> <p><b>Present revised stakeholder mapping</b> based on due diligence questionnaire and field visits.</p> <p><b>Identify resource requirements</b> that may be necessary for some stakeholders to meaningfully participate (i.e. the most marginalised).</p>
<b>Incorporating target class voice in governance</b>	<p><b>Identify individuals to represent the target class</b> – either directly or indirectly through an intermediary such as an NGO.</p> <p><b>Identify areas where representation can occur;</b> examples include the board of directors, or an advisory committee. Where there are voting rights associated with a position, decide whether target class representation should have voting rights.</p>	<p><b>Incorporate questions directly relating to target class representation</b> in governance rights. Examples include representation through the presence of a technical assistance facility, representation on an advisory/expert board, or the role of community voice in affecting investment decisions.<sup>6</sup></p>	<p><b>Create legal provision and rights for incorporating target class voice</b> in the term sheets which are applied to the level of representation and rights associated.<sup>7</sup></p>	<p><b>Add a section on stakeholder voice within the investment memo,</b> outlining the likely individuals/organisations that could provide representation, and their core strengths and weaknesses.</p>
<b>Defining and measuring/monitoring social impact</b>	<p><b>Invite target class members to identify parameters for success of the investment.</b></p> <p><b>Identify feedback mechanisms for the target class</b> to directly inform the investor/fund manager on social impact progress.</p> <p><b>Invite target class to identify core challenges in the proposed theory of change.</b></p>	<p><b>Explicitly ask the business and/or fund manager how they perceive the social issue/social impact from a target class perspective.</b></p> <p><b>Include questions about how the business/fund manager will monitor impact.</b></p> <p><b>Include questions that collect information from the target class about how to monitor impact;</b> for example, target class members select the social impact indicators.</p>	<p><b>Create provision for feedback from the target class to be directed to the investee firm or fund manager.</b></p> <p><b>Create direct feedback channels from the target class to the investor.</b></p> <p><b>Enshrine rights for the actors who measure social impact, and create a budget for community reporting on a specified frequency.</b></p>	<p><b>Discuss the anticipated use of social impact measurement methodologies</b> which the fund will use.</p> <p><b>Discuss the level of representation</b> when a methodology incorporates target class voice.</p>

the due diligence process is operated as a whole, setting standards for identification of target class individuals, as well as how fieldwork is operated.

- 1 Understanding stakeholder relationships** offers opportunities to explore and clarify how various groups within the target class interact, and who has decision-making power. Often these relationships are not clear-cut or made explicit, thus an exercise such as stakeholder mapping as part of the due diligence process can be useful to uncover power dynamics between the different parties involved in or affected by the investment.
- 2 Incorporating target class voice in governance** explores ways to ensure the priorities of target class members are represented by including target class members themselves in the governing bodies of an investment. Examples of such representation include at the board level in an advisory capacity; through using an appropriate third party such as a non-governmental organisation (NGO) with relevant representation capabilities; or a 'target class champion' when the target class is a disparate group.

- 3 Defining and measuring/monitoring social impact** refers to the parameters and mission set for social impact. The due diligence procedure should recognise that different investments require different framings of social impact. Furthermore, investors should be aware that social impact measurement received *directly* from members of the target class (rather than filtered through the business or investee) can be unabridged and show exactly what is happening on the ground.

Our review of due diligence strategic and operational materials<sup>8</sup> identified three potential entry points for incorporating target class voice during due diligence:

- Participation prioritised in due diligence questionnaires and processes;
- Participation highlighted in internal investment memos to internal approval boards; and
- Participation in investment term sheets and agreements.

These principles and entry points are brought together and further developed in Table 1, presenting options for how they can be incorporated into investment decision-making for investors.

**Table 2 Additional considerations in incorporating participation**

Factors	Feasibility of incorporating participation	Reasoning
<b>Asset class</b>	High for direct investments; scope more limited for indirect investments	Indirect investments have fund managers whose immediate priorities may conflict with the values of participation in the investment.
<b>Ownership stake</b>	Increases with ownership stake	The higher the proportion owned by an investor, the greater the ability to influence a company and/or fund manager to take participation seriously.
<b>Number of co-investors</b>	Decreases with number of co-investors	Other co-investors may not be as aligned to the values of participation in the investment.
<b>Time horizon of investment</b>	Increases with a longer time horizon	The longer the time horizon, the greater the ability for strong links in the local community.
<b>Provision of technical assistance</b>	Increases with the provision of technical assistance	Technical assistance can provide a productive opportunity for bringing in the local community in identifying blockages to social impact. However, technical assistance is usually used not to deepen impact, but for commercial purposes.
<b>Available time from investor</b>	Increases with the amount of available time from the investor	Participation and incorporating the views of wider stakeholders can be a time-consuming process. However, it has been achieved: a notable example is the Buen Vivir Fund. <sup>9</sup> While participation may seem outside the scope of some investors, the benefits to social impact cannot be overstated.
<b>Availability of grant funding</b>	Increases with the availability of grant funds from foundations, development agencies, and associated actors	These funds can be used for transportation, child care, food and even honoraria to facilitate the participation of the most marginalised stakeholders.

### Feasibility and reasoning for incorporating participation

The scope and feasibility of incorporating target class participation into investments depends on investor appetite for such considerations as well as on their level of control. For example, there is a difference in the degree of control a single investor has when making direct versus indirect investments. Yet, a certain amount of power

still resides with these influential individuals to decide and define the circumstances under which an investment occurs. This power can be used to motivate the opening of more space for participation. Several considerations need to be made within the scope of the investment's ability to foster participation by an investor who advocates for participation.

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## Policy recommendations

Participation can support achievement of scale and the genuine social impact that investors seek to influence, yet insufficient attention has been given to engaging, consulting, involving and reflecting with the communities impacted by their investments. A number of entry points for incorporating participation have been explored and guidance for investors who champion social impact can be summarised as:


- 1 **Incorporate target class voices into impact investing:** Ensure the views and preferences of consumers, beneficiaries and wider communities are incorporated into the decision-making process of investments. This is not just for a value judgement, though that is important, but it helps ensure that social impact remains at the root of an investment thesis or theory of change. This will enrich a better, holistic, grounded, truer understanding of the risks and returns, as well as the intentional and unintentional impacts of an investment.
  - 2 **Amplify target class voice during the due diligence process:** Due diligence helps set the tone for the rest of the investment cycle. Better incorporation of target class voice during this stage, as well as incorporating structures to enshrine participation – such as in the governance arrangements and term sheets – helps facilitate participation throughout an investment's lifespan.
  - 3 **Be pragmatic in identifying and engaging opportunities for participation:** Opportunities to foster greater participation depend on having the right partners; for instance, identifying an intermediary such as a local NGO or community leader who can represent the target class at a governance level, or having the right co-investors that share values for participation. This is why identification of these opportunities is key during the due diligence phase, and incorporating policies that can correctly identify those opportunities (such as stakeholder mapping and incorporation of a theory of change) can be so influential.
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## Endnotes

- 1 Institute of Development Studies. Google Scholar ID:  
<https://scholar.google.com/citations?user=2wHLgfQAAAAJ&hl=en&oi=ao>
- 2 Institute of Development Studies.
- 3 Open Society Foundations.
- 4 Open Society Foundations.
- 5 The term 'target class' is a broad classification, which can be used to identify or target social impacts to a particular socioeconomic group.
- 6 For instance, for indirect investments: To what extent does the fund have provision to incorporate target class representation at any level of investor governance (i.e. at an advisory or board level)?
- 7 Rights such as the investment rights (whether binding or non-binding), impact measurement rights, or conflict resolution rights should the target class be adversely affected by the investment.
- 8 Due diligence questionnaires for both direct and indirect investments, investment memos, term sheets, technical assistance facility documentation and social impact reporting.
- 9 Higdon (2019).

## Further reading

- Apgar, M.; O'Flynn, P. and Higdon, G.L. (2018) *Participation for Effective Economic Advancement Programming*, IDS Eldis, [www.eldis.org/keyissues/participation-effective-economic-advancement-programming](http://www.eldis.org/keyissues/participation-effective-economic-advancement-programming) (accessed 13 June 2019)
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Institute of Development Studies, Brighton BN1 9RE UK  
 T +44 (0) 1273 606261 E [ids@ids.ac.uk](mailto:ids@ids.ac.uk) W [www.ids.ac.uk](http://www.ids.ac.uk)  
 W [www.eldis.org/collection/participation-economic-advancement](http://www.eldis.org/collection/participation-economic-advancement)  
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