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Impact Investing in Developing Markets: The Importance of Enhanced Liquidity

The impact investing sector has grown rapidly over the past five years, with a 14% CAGR in assets allocated to impact investments[1]. However, despite this progress, the scaling of the impact investing market is impeded by various constraints. A key concern for investors is the limited liquidity associated with impact investments. This relative illiquidity hampers sustainable investment flows into regions that need them the most. Long-term capital commitments are essential for the success of impact projects, yet investors often hesitate due to the lack of exit options.

Liquidity, defined as the ease with which an asset can be converted into cash without negatively impacting its price, is a key factor in investment decisions. Impact investments in developing and frontier markets are often considered less liquid due to two key factors. First, many investees are private companies that rarely offer exit opportunities through IPOs or M&As[2]. Second, these markets typically exhibit lower levels of financial activity, as reflected in modest trading volumes and turnover velocity on local exchanges[3]. This limited activity suggests lower liquidity in private markets as well, when compared to more mature financial ecosystems.

The Global Impact Investing Network's 2024 *State of the Market* report confirms that the lack of suitable exit options is a significant challenge for impact investors, with 20% of the polled investors considering it a "significant challenge", 20% a "moderate challenge", and 21% a "slight challenge"[4].

To enhance liquidity and support the growth of impact investing, two types of solutions are essential:

1. Financial Innovation

Innovative financial instruments can increase liquidity by providing more exit opportunities. For example, traditional equity investments can be structured with equity redemption rights, allowing investors to sell shares back to the company using a pre-agreed formula[5]. Additionally, open-ended funds and holding company structures can offer more flexible exit terms to investors[6], creating a more investor-friendly environment. We also see the strong emergence of "GP-led" secondaries, where a GP of a fund sets up a continuation vehicle that allows existing and new investors to continue being exposed to investments when other investors decide to exit. Addressing the exit of existing portfolio is critically needed to address liquidity; however that liquidity solutions must be designed and implemented structurally so that more private investors can be crowded-in to invest into impact funds. Such new investors are willing to have liquidity as build-in initial feature of their investment.

2. Market Infrastructure and Policy Support

Governments, regulators, and stock exchanges in developing markets can significantly enhance liquidity by strengthening market infrastructure. This includes promoting impact investing to a broader investor base, issuing new financial instruments, and cultivating a more enabling policy environment[7]. Stock exchanges can facilitate liquid impact investments by building robust trading platforms and developing innovative listed fund structures. Policies that support the issuance of green bonds and other sustainable financial instruments help deepen capital markets and provide more liquidity options. Furthermore, the development of instruments such as social and sustainability-linked bonds can support a broader and more resilient sustainable finance ecosystem[8]. Liquidity facilities can also play a vital role, offering exit options while preserving long-term commitments. For instance, the Mobilist initiative which aims at leveraging on listing impact vehicle to mobilise private capital at scale.

Importantly, collaboration between financial institutions, regulators, stock exchanges, and governments is key to building primary and secondary markets that provide the depth and diversity needed by various types of impact investors. In turn, enhanced liquidity will accelerate the sector's growth, unlocking capital and creating a virtuous cycle of impact.

Food for Thought:

- How can impact investing structures offer more liquidity to investors?
- How can stock exchanges contribute to the creation of new secondary markets catering to the liquidity preferences of varied impact investors?
- Could DFIs and MDBs make a difference by investing more in secondary opportunities?

Thank you to our guest editor:

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The SDG Impact Finance Initiative invites you to engage with us and the broader community on our LinkedIn page!

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