



Root Capital's Expected Impact Rating

*Companion piece to "Toward the Efficient Impact Frontier"
Stanford Social Innovation Review, Winter 2017*



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The purpose of this document is to provide more detail on the Expected Impact Rating that Root Capital developed to evaluate the expected impact of each loan relative to the net cost of that loan to Root Capital (i.e., subsidy required).

Our article "Efficient Impact Frontier" in the November 2016 Stanford Social Innovation Review provides an introduction to the Expected Impact Rating:

To measure expected impact, we developed a tool that we call the expected impact rating. This rating synthesizes various kinds of impact data that we collect on each borrower into a single number, thereby enabling us to compare the expected impact of disparate loans and to measure each loan's expected impact against its expected return. (Our purpose here is not to advocate for impact ratings in general or for our rating in particular. Instead, it is to describe one tool that has allowed us to develop the efficient impact frontier.)

Our use of this tool aligns with the framework set forth by Paul Brest and Kelly Born in a 2013 article in Stanford Social Innovation Review. Brest and Born distinguish between enterprise impact (that is, the impact that an enterprise has on its customers, its suppliers, or the environment) and investment impact (that is, the impact that a particular investment has on that enterprise). Another term for investment impact is "additionality." According to Brest and Born, additionality reflects the extent to which a given investment provides resources that add to what other investors would have provided in its absence.

The expected impact rating takes the form of a number from 0 to 10. To calculate that number, our team first sorts a loan into one of three categories of additionality. The lowest category (0 to 3.0) applies to cases in which a borrower likely could have received a similar loan from a commercial lender. The intermediate category (3.0 to 6.5) includes loans that a borrower likely could have obtained from some other mission-driven organization, but not from a commercial lender. And the highest category (6.5 to 10) applies to cases in which a borrower likely could not have received a similar loan on similar terms from any other source.

Then, within a given category of additionality, we assign to each loan a score for its expected enterprise impact. This score, which ranges from 0 to 3.5, is a composite of the baseline social and environmental need that a borrower aims to address (1 point), its expected performance in addressing that problem (2 points), and its operational scale (0.5 points). For this score, we give equal weight to social and environmental considerations. To quantify enterprise impact, we gather data on the following factors:

- *Poverty level in the regions where an enterprise operates*
- *Expected performance of an enterprise in addressing poverty*
- *Environmental vulnerability, as measured by water scarcity, soil degradation, threats to biodiversity, and exposure to climate change*
- *Expected performance of an enterprise in addressing environmental vulnerability*
- *Scale, as measured by the number of farmers and workers reached by an enterprise*

We elevate investment impact above enterprise impact because our aim is to subsidize only those loans that would not happen in a commercial market and because we have prescreened all of our borrowers for expected social and environmental impact. We understand that additionality is one of the most challenging aspects of our expected impact rating to evaluate: It requires our loan officers to make difficult judgments about the alternate lending options that an enterprise may or may not have. But we also understand that even if loan officers misjudge a certain portion of loans, they will make better lending decisions overall if we include additionality in our rating than if we do not. (To ensure that loan officers apply this metric consistently, we are now developing a training curriculum on this topic.)

We developed indicators for each of these components, and weighted them to get to ten points total.

Additionality has the greatest number of points – up to 6.5 – because we seek to prioritize the loans where our dollar is likeliest to make the difference for our clients. Social and environmental vulnerability receive 0.5 point each, and social and environmental performance receive one point each. Performance is weighted more than vulnerability because, while we want to work with businesses located in areas with the most need, we also want to prioritize businesses that are actively working to improve the situation. We give equal weighting to social and environmental components, because we see them as equally important to our mission. Finally, we give up to half a point for scale because all things equal, reaching more people is better.

Exhibit 1 illustrates how we combine and weight these components into the ten-point Expected Impact Rating. **Exhibit 2** shows the distribution of Expected Impact Ratings for Root Capital’s full 2015 portfolio.

While the tool is called the Expected Impact Rating, its components don’t truly measure impact – hence the term ‘expected impact.’ The indicators in the Rating are proxies for the types of impact we seek, and some are better proxies than others. For example, the Rating looks at whether a business is offering higher prices to farmers, whereas Root Capital’s ultimate goal is higher or more stable incomes for farmers, versus a counterfactual in which Root Capital did not offer the loan. The assumptions behind any expected impact rating need to be validated by ex-post impact evaluations (such as those we have undertaken, for instance, with [four enterprises in Guatemala](#)). Even if it is imperfect, we can use this Rating to guide our portfolio towards loans that generate higher impact relative to the cost incurred.

Exhibit 3 provides the detailed indicators, weights, data sources for the components of the Expected Impact Rating.

Our purpose is not to advocate for impact ratings, the particular method we chose for creating one, or for the variables we chose to include. We introduced the expected impact index simply because it was a necessary input for our efficient impact frontier.

Exhibit 1: Weighting Impact Components into a Ten-Point Expected Impact Rating

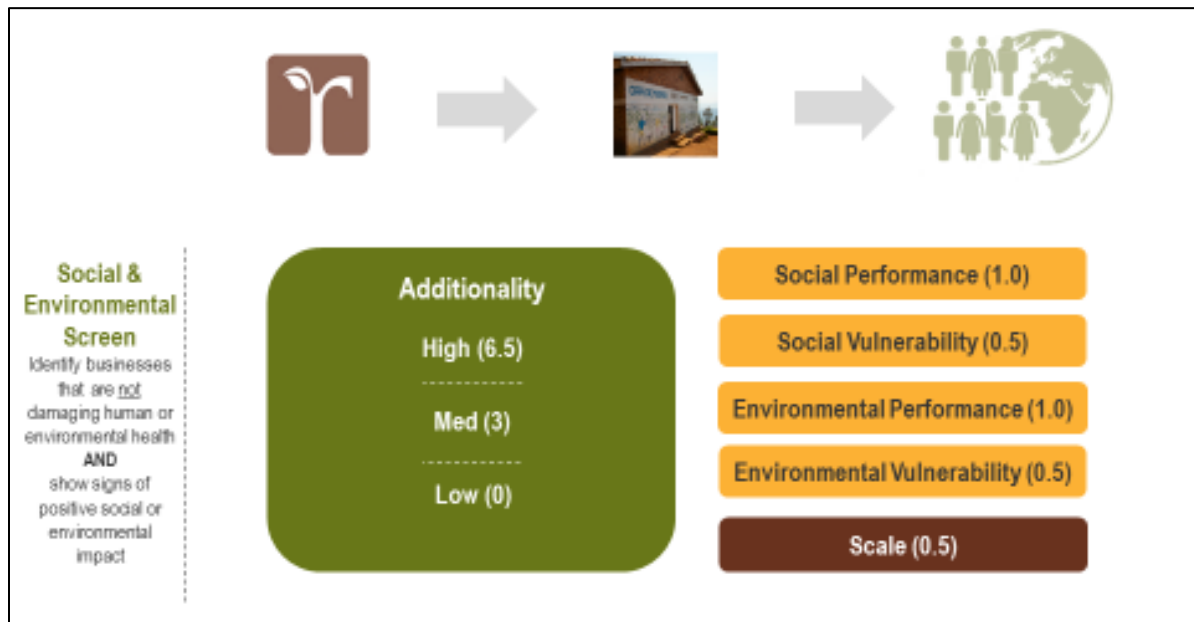


Exhibit 2: Distribution of Expected Impact Ratings, 2015 (486 loans)

