

STATE OF THE MARKET

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STATE OF THE MARKET 2021

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Front cover photograph by Jeffrey Grospe

Impact investing: Start with a theory of change, then add capital

BY DAMIEN DWIN, FOUNDER AND CEO OF LAFAYETTE SQUARE

Impact investing is becoming the zeitgeist. Global asset managers are launching impact offerings, and greater numbers of both institutional and retail investors are asking how they can invest with meaning. It's becoming standard practice to question, 'How can I create social change without being concessionary?' Impact is becoming the next frontier for our industry, and that's positive.

Investing *should* confront the challenges we face as a society. Too many are burdened by unaffordable housing costs. Too many are unemployed or underemployed. Too few really participate in our highly financialised economy. The problems are numerous and easily identifiable, but real solutions are less clear. Change-making requires more than just capital. It requires an understanding of how change is actually created, or, phrased differently, a theory of change is needed.

On a personal level, I'm driven by a compulsion to improve the lives of the underprivileged. I grew up in a working-class neighbourhood; my father was a bus driver. Communities like mine have suffered this year. This is why I founded Lafayette Square (Lafayette) with the intention to become the leading provider of impact-driven capital. Lafayette is structured with two ideas in mind – *what* change do we want to affect, and *how* is that change made possible – everyone on our team has their own *why*.

While it's been challenging, 2020 has left significant space for new ideas and innovation. Despite being a fledgling firm, Lafayette is unconstrained by legacy and moulded to match the moment.

THE LAFAYETTE 'THEORY OF CHANGE'

Our theory of change boils down to a simple adage: *housing, jobs, and financial inclusion*. In each area, traditional thinking needs disruption, and traditional institutions are leaving large numbers underserved. To help, Lafayette provides capital and services – we think change requires both. Lafayette is not

just a dollar provider. We leverage our investment process to invest and serve companies, communities, and individuals.

HOUSING, JOBS, AND FINANCIAL INCLUSION

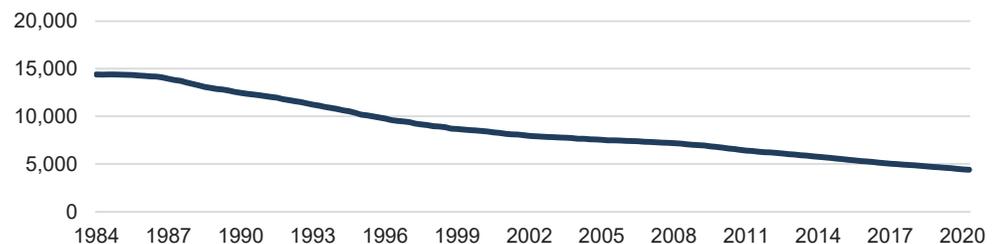
In *housing*, we face a new development 'barbell', with government-subsidised units on one end and high-end units on the other. For development in between those two extremes, in general capital is either not available or it is too expensive. This strains both ends of the market and forces people to live beyond their means. We see two factors driving this: (i) unsustainable return expectations; and (ii) fund vehicles with insufficient durations.

To address this, Lafayette partners with institutions which recognise that its residen-

ts' financial health is an underreported but fundamental contributor to risk-adjusted returns. In the long run, an asset is worth less if people can't afford to live there! We match with investors who share our belief in ever-green fund structures to bring fairly-priced, long-term capital to the development and preservation of sustainable housing.

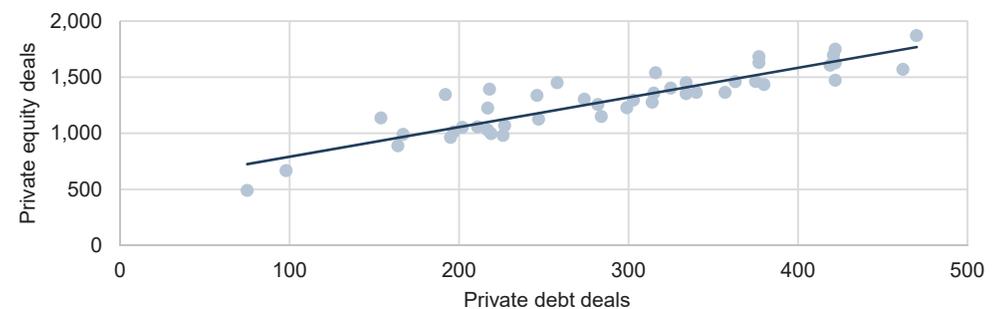
Alongside our investments, our housing funds pay a social services fee to enhance the lives of residents. This money could be used to provide internships, free WiFi, or after-school programmes. We argue that this spend is not philanthropic. Aligned residents likely have lower turnover and take better care of the property, which could enhance long-term returns.

Figure 1 – Commercial banks in the US



Source: Federal Reserve Economic Data, data accessed Q2 2020

Figure 2 – Private equity and debt deals in a given quarter



Source: Preqin, data accessed December 2020. Timeline shown is from 2010 to 2020

In *jobs*, for small and medium-sized businesses not owned by private equity sponsors, we're dealing with a capital markets crisis. The not-so-secret dirty secret is that few institutions want to lend to these businesses. Large banks have been regulated out. Regional banks have closed or consolidated. Non-bank private credit firms largely only lend to their counterparts in private equity. The data proves this out: Figures 1 and 2 show (i) there are almost 10,000 fewer banks than there were in 1984, and (ii) there's a suspicious correlation between private debt and private equity activity.

In response, Lafayette is building a credit platform that can lend to businesses up and down the EBITDA scale that will focus on firms owned by management teams and founders. Lafayette will originate and invest in opportunities regionally with targeted geographic deployment and a 'remote-first' investment team spread across the country. Similar to our housing funds, these funds will be structured as permanent capital to avoid the mismatch between a six-year fund and a perpetual-term company.

Again, Lafayette will seek to provide services with its capital. This could be giving financial and operational advice for a community development financial institutions (CDFI) investment, or providing financial coaching to portfolio company employees for a business development company (BDC) investment, in conjunction with partners and our own foundation.

In financial inclusion, despite automation and the increasing use of technology, finance remains deeply relationship-based, which is unlikely to change. And, the reality is, people are social beings prone to in-group behaviour. This creates a meaningful disadvantage for out-of-group individuals. In America, there are more than seventy trillion dollars of advisory assets; less than two percent are managed by female or diverse-owned firms.¹

Lafayette's response is to be generous. We plan to share our platform with female, diverse, and veteran managers as well as those that align with our theory of change. We'll do this through bespoke transactions that provide some shared economics without stifling the entrepreneurship (or the cashflows) of emerging GPs. Lafayette is purpose-built to increase participation. These managers frequently find themselves trapped in the vicious cycle of being subscale. They struggle to raise money because they're not big enough, and they're not big enough because they struggle to raise money. Lafayette provides out-of-the-box efficiencies of scale to managers on its platform.

Sticking to the same theme, Lafayette provides critical services to managers on our platform, including fundraising, back-office support, and mentorship.

PARTNERSHIPS FOR GREATER IMPACT

Many existing asset management firms and corporations make proclamations about impact but lack follow-through. My intention for Lafayette Square is to create a business that delivers on impact by design. However, the magnitude of the inequalities we face in housing, jobs, and financial inclusion is enormous, and we need partners.

Our first investment, Factory_OS (F_OS), demonstrates our partnership approach. Lafayette led a Series B round, backed by Autodesk, Citi, Facebook, Google, and Morgan Stanley, raising \$55 million for the housing innovator. F_OS uses cutting edge software technologies and lean manufacturing to create efficiencies in multi-unit housing construction, primarily for affordable housing development. F_OS produces modular multi-family homes, which are typically faster to produce and less expensive than onsite construction. In this case, our partners contributed capital and lent credibility as well-known innovators, positioning F_OS to deliver badly needed affordable housing at scale. We're not going to solve the affordable housing crisis in America in our lifetime, but, with investments like F_OS, we can preserve and increase the number of affordable housing units available and provide impactful services to residents.

TL;DR;

To drive change through investment, understand the what and how through a clear theory of change. Ask yourself how you can make the investment process impactful by partnering capital with services. Build partnerships to create leverage.

All the views and opinions expressed herein are those of Damien Dwin and not necessarily those of any other person or organisation.

1. *Bella Research Group / Knight Foundation*



Damien Dwin is a black American businessman, philanthropist, and credit impact investor. In November 2020, he founded Lafayette Square to use debt financing to materially impact under-realised housing, employment, and financial market inclusion opportunities. Prior to his current role as CEO of Lafayette Square, Damien served as co-Founder and co-CEO of Brightwood Capital Advisors from its founding in 2010 to October, 2020.

Mr Dwin began his finance career as a trader with Goldman Sachs, New York & London, there earning the Michael P. Mortata Award for Innovation. He further developed his finance expertise working for Credit Suisse, where he was the co-Founder and Head of the North American Special Opportunities business until 2010. At Credit Suisse, Mr Dwin also served on the Vice President Selection Committee and led the Fixed Income Division Credit Training Programme.

Mr Dwin is an active thought leader concerned about mass incarceration, unrealised potential of vulnerable communities, racial justice and representation, and the use of credit financing as a force for good. He has written for *Entrepreneur* and *Inc.com*. A committed philanthropist, Mr Dwin currently serves as Chair of the Board of Trustees for Vera Institute of Justice. He also serves on non-profit boards, including the Children's Hospital of Philadelphia, Studio Museum in Harlem, National Trust for Historic Preservation, Woodberry Forest School and Boys' Club of New York. Mr Dwin received a BSc/BA from Georgetown University, where he later served two terms on the Board of Regents.

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