Why impact investors should finance companies in disadvantaged urban areas



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Research shows that impact investing in disadvantaged urban areas generates financial and employment gains.

Two small French companies specializing in the installation of adhesive film and signage for retailers apply for a loan from a commercial bank. Both have 43 employees and were

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founded nearly two decades earlier; in recent years, they've performed roughly in line with the industry average, and are expected to continue to do so in the coming years.

The bank approves the loan for one of the companies, allowing it to expand and take on new employees. But the other is denied the loan — even though the fresh funds would result in a larger boost to financial performance and job creation than its competitor can expect to see.

Why? The companies are identical in every way except one: their address. One is headquartered in an affluent Parisian neighborhood, while the other is located in a working-class, strongly immigrant area of the French capital.

This exercise — a lab experiment in which almost identical companies were presented for loan approval — formed part of research on impact investing in disadvantaged urban areas by IESE's Romain Boulongne, together with Caroline Flammer of Columbia University and Rodolphe Durand of HEC Paris.

The group studied how small companies in France's low-income *banlieues* struggle to secure financing from traditional lenders and how impact investment, if secured, can have substantial positive repercussions for these same firms in terms of financial performance and job creation. In both financials and employment, investment in *banlieue* companies outperformed non-*banlieue* companies.

The research, published in the *Strategic Management Journal*, underscores the opportunity available to impact investors, who are looking to finance projects that are both economically viable and have positive social impact.

Location, location, location (or *emplacement*, *emplacement*, *emplacement*)

The advantages of firm location are well documented: setting up shop in an urban hotspot can make it easier for companies to attract talent, draw customers and gain access to capital.

But studies of the downsides of being located in a disadvantaged area — where there's greater need for jobs and the economic benefits that business activity brings with it — are thinner.

One of those downsides is reduced access to capital. Looking at small companies in both *banlieue* and non-*banlieue* neighborhoods, the researchers found that across all companies,

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self-financing (35%) and medium-term loans from traditional banks (33%) were the most common sources of financing.

But broken down by neighborhood, differences in financing patterns appeared. *Banlieue* companies were less likely to finance their investments through medium-term bank loans (28.7%) compared with non-*banlieue* firms (33.4%). Similarly, *banlieue* companies were less likely to rely on long-term bank loans (4.4% for *banlieue* ventures compared with 5.8% for non-*banlieue* ventures).

Conversely, self-financing was more pronounced among *banlieue* ventures compared with non-*banlieue* (40.3% vs. 34.5%). *Banlieue* companies have less access to traditional financing sources and rely more on their own money to finance their business.

The greater financing constraints faced by business ventures in disadvantaged urban areas have two direct implications. They limit companies' ability to grow and invest in key strategic resources — such as the hiring of qualified employees — that would contribute to value creation and help them achieve a sustainable competitive advantage. They also limit their ability to invest in promising projects, leaving them with little choice but to invest in smaller, less ambitious projects.

Better financial performance

What happens when *banlieue* companies do secure additional outside financing? To gauge the impact, the researchers identified nearly 6,000 companies that had received funding from a major public investment bank with a mandate to support entrepreneurship. Within that group, they then matched companies operating in the same industry and city but in different neighborhoods in order to compare post-loan outcomes.

When *banlieue* companies did get funds, they achieved a significantly higher increase in financial performance following loan issuance than their non-*banlieue* counterparts. Specifically, in the three years following the loan issuance, *banlieue* ventures reported a return on assets (ROA) that was 2.3–3.0 percentage points higher than that of similar non-*banlieue* ventures from the same city.

The reasons for this difference are many, but chief among them may be that the *banlieue* companies had greater unrealized potential, which the investment helped to unlock.

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Greater job creation

Beyond the financial performance, the funding translated into more jobs, which in turn has the potential to bolster consumption and ultimately support social inclusion in the economy. Compared with their non-*banlieue* competitors, *banlieue* ventures achieved higher employment growth by 6.5–9.2 percentage points in the three years following the loan issuance.

And the new jobs were high-quality positions, going to women as well as men. The researchers broke jobs down into four categories based on skill level: manual workers, clerical workers, intermediate workers and white-collar workers. While there was growth across all four categories, the biggest difference was in white-collar jobs — suggesting that *banlieue* ventures were understaffed in skilled workers before receiving the loan.

“In sum, such investments may lead to not only greater business venture success but also greater social impact when directed toward ventures that are located in (as opposed to outside) disadvantaged urban areas, thereby fostering the social inclusion of disadvantaged communities and the development of sustainable cities,” the authors conclude.

About the research

The research encompassed 5,871 companies with fewer than 250 employees and revenues between 750,000 euros and 50 million euros. The *banlieues* are 751 areas, in 490 different cities, that are officially classified as deprived urban zones — or *zones urbaines sensibles* (ZUS) — by the French government. A controlled lab experiment involving a fictional company specializing in signage for retailers was also conducted.

Boulongne has also researched how categorization processes for evaluating ambiguous offerings can be used for impact investing in disadvantaged urban areas.

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