Poised for impact

Analysis of key drivers in the current impact investing space

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Key Takeaways

- Unlike philanthropic capital, impact investments are made with an express goal to achieve financial returns in addition positive social or environmental externalities. Impact investments are most commonly made through the familiar investment structure of closed-end private equity and venture capital funds, though impact fund managers are separated into two camps: funds who target market-rate returns, and those that accept concessionary returns in exchange for greater impact.

- Impact funds are typically smaller vehicles than generalist PE or VC funds, and fund managers tend to focus their strategies in emerging markets. In our sample of 270 impact funds, 86% of VC funds and 59% of PE funds are vehicles smaller than $100 million. Additionally, 59% of VC funds and 82% of PE vehicles target investments in emerging markets. Our data suggest that PE funds concentrate investments in Africa, while VC funds tend to focus more on South Asia.

- 2017 saw over $3.4 billion committed to PE and VC impact funds globally, though more than half of this volume is accounted for by TPG Growth's $2 billion Rise Fund. We expect that growing interest in impact assets will result in larger impact funds in the coming years, as more major alternative asset managers enter the space. These funds will likely focus more on investments in developed markets, which offer less economic and political volatility than emerging markets as well as a pipeline of investable opportunities in sectors like energy, agriculture, and transportation that are adopting sustainability practices.

Impact investing

Impact investing is a strategy of investing in enterprises, organizations, and funds that seek to create both financial returns and measurable social and/or environmental impact. Impact investments are most commonly made through the familiar investment structure of closed-end PE and VC funds.

Socially responsible investing (SRI)

SRI is an investment strategy whereby investors utilize screening and exclusion, divestment, positive reinvestment, and shareholder activism to achieve positive social or environmental outcomes. SRI is predominately used with public market securities and is relatively accessible to non-accredited investors.

Introduction

Investors tend to place for-profit investments and philanthropic capital in separate pockets. Impact investors, however, seek to prove that they can achieve both competitive financial returns and positive social and/or environmental externalities with one strategy.

Demand for socially responsible investing (SRI) has grown considerably in recent years. A 2017 survey conducted by Morgan Stanley reports that millennials are twice as likely to invest in environmentally friendly or socially conscious assets, while 84% of surveyed women indicated an interest in sustainable investments. The US Forum for Sustainable and Responsible Investment reports that socially responsible assets under management in the US grew to $8.7 trillion in 2016, thanks in part to major asset managers' provision of SRI products.

However, mainstream SRI strategies like negative screens or divestment may not bring about the specific outcomes some mission-driven investors desire. Impact investing, a strategy of for-profit, direct investing in companies or investment funds which actively measure the impact they create, is a potent way for investors to directly influence social and environmental trends while maintaining or appreciating their wealth.[1]

Initially, high-net-worth-individuals, foundations, and government institutions drove investment in the strategy, but pension funds, retirement funds, and insurance companies have joined the ranks of LPs committing to impact funds. With growing interest from clients, some alternative asset managers have integrated impact investment platforms to innovate their offerings and diversify their investment strategies. TPG Growth and Bain Capital have already launched impact funds, and Goldman Sachs, UBS, and US Bank have each added an impact investment platform to their asset management practices.

The impact investing ecosystem is still nascent, with developing strategies and emerging challenges. This note offers a holistic overview of the ecosystem to provide a framework to understand impact measurement, impact fund managers' investment strategies, and the current state of the market. For practitioners considering an impact investing allocation, this is a useful overview of the space.

1: The Global Impact Investing Network (GIIN)

Overview & differentiation

Investors who seek financial gains as well as either social or environmental returns refer to impact investing as the "double bottom line" (or triple bottom line for those targeting financial, social and environmental returns). Impact investments are most commonly made through the familiar investment structure of closed-end PE and VC funds, where LPs commit capital to impact funds—which deploy capital through active, direct investments in impactful portfolio companies—and at times co-invest alongside GPs[1].

Though impact investing is sometimes used synonymously with socially responsible investing (SRI) and environmental, social, and governance (ESG) criteria, these terms refer to different concepts. One example of an SRI strategy is the exclusion of "sin stocks," such as tobacco, firearms, and alcohol, from a portfolio of public equities. SRI is predominately used with public market securities and is relatively accessible to non-accredited investors.

ESG

ESG criteria are a set of measurements used to evaluate a company's environmental, social, and governance practices.

ESG criteria are a set of measurements used to evaluate a company's environmental, social, and governance practices. A sampling of the factors considered in an ESG score include impact on climate change, diversity and inclusion in employment, and management considerations such as executive compensation and audit committee structure. Both SRI and impact investors might find ESG data useful for analyzing potential investments.

Social enterprises

Social enterprises are companies that are both financially sustainable and bring about positive social and/ or environmental impact.

Impact investors target "social enterprises," companies that are both financially sustainable and bring about positive social and/ or environmental impact. Businesses often signal their orientation toward sustainability by sharing their ESG rating or attaining a B-Corp certification. Social enterprises can create positive externalities through the goods and services they offer, the populations they target, or the jobs they create, or a combination of these factors. Impact investors have exacting standards for their portfolio companies, and often require social enterprises to commit to sustainable business practices (fair labor practices, anti-harassment policies). In addition to the ethical rationale behind such requirements, sustainable business practices can also serve as a risk-mitigant, as they compel companies to put measures in place to ensure their operations last into longevity.

2: Additional impact investment strategies include investments in real estate, tangible assets, and private lending. In accordance with PitchBook's coverage areas, this report focuses on PE and VC strategies.

IMPACT INVESTING	SOCIALLY RESPONSIBLE INVESTING (SRI)	ENVIRONMENTAL, SOCIAL, GOVERNANCE (ESG) CRITERIA
• Investing in companies and funds that seek to create both financial returns and measurable social and/or environmental impact • Active investment management and impact measurement • Prominent in private markets investments	• Investors use screening and exclusion, divestment, positive reinvestment, and shareholder activism to achieve positive social or environmental outcomes • Most commonly used in public markets	• Rating of a company's environmental, social, and governance components • Used by SRI and impact investors for portfolio and investment analysis on public and private companies

What constitutes an "impactful" investment?

At a base level, investors agree an "impactful" investment is one which generates positive social or environmental outcomes, but this simple definition has its flaws. Impact can vary significantly across business sectors and geographical regions, and is informed in large part by the context of the stakeholders, enterprises, and the populations they serve. For example, an investment in a small business in an emerging market might be deemed impactful because of the resulting job and income creation. The same investment in the US, however, may simply be categorized as a small business loan.

Because of the subjectivity of "impact," investors actively track outcomes with metrics specific to their goals and target market, and typically require their portfolio companies to do the same.

Because of the subjectivity of "impact," investors actively track outcomes with metrics specific to their goals and target market, and typically require their portfolio companies to do the same. GPs and entrepreneurs may gather data explicitly required by their investors, create their own impact metrics, or utilize externally established performance-tracking frameworks. In addition to quantifying social/ environmental ROI, impact measurement data is useful for reporting, benchmarking, and mitigating risk.

Popular impact themes and sample metrics

The International Finance Corporation (IFC)—whose mission is to foster the development of private markets in emerging economies—requires its fund and enterprise investments to adhere to its "Environmental and Social Performance Standards." Investees use the standards as a guiding framework to track impact, identify and mitigate risk, and curate sustainable business activity. The IFC reports its framework has contributed to positive business and impact outcomes, with its high-scoring direct company investments financially outperforming the MSCI Emerging Market Index, and PE fund investments creating approximately 300,000 new jobs since 2007.

IMPACT THEME	SAMPLE METRIC
Access to essential services (financial services, healthcare, education)	• # of individuals with bank accounts • # of patients served • # of students enrolled
Quality jobs, income generation	• # of jobs created • Average income created • Employee demographic
Affordable housing, infrastructure development	• Units of developments completed • # of individuals housed
Women's empowerment	• % of portfolio companies or investment funds founded or operated by women
Environmental sustainability	• # of trees planted • Reduction in greenhouse gas from product or service

Source: IRIS catalog, Global Impact Investing Network

UN Sustainable Development Goals

The UN Sustainable Development Goals (SDGs), developed in 2015 by an assembly of 193 nations, consist of 17 global objectives to be achieved by 2030. The SDGs offer quantitative metrics to achieve each goal, such as reduced infant mortality rate for the third goal of "good health and wellbeing."

Unity around measurement

Developing metrics to quantify impact themes can be a difficult feat due to a general lack of best practices and the qualitative nature of some impact goals. Impact investors' lack of unity regarding how to quantify impact can propagate the risk of "impact washing," advertising about "impact" products that in actuality have with minimal social/environmental returns. Consequently, it is in the interest of impact investors to convene around common measurement frameworks. Some leading frameworks for impact investors include the United Nations Sustainable Development Goals, the IRIS catalog, and the GIIRS fund rating.

Recognized across institutions and geographic regions, the UN SDGs are a popular framework for benchmarking impact. In addition to clearly articulating standards for sustainable development, the SDGs offer guiding quantitative metrics to achieve each goal, such as reduced infant mortality rate for the third goal of "good health and wellbeing." Impact investors can replicate these metrics in their measurement, peg their proprietary metrics to one goal, or employ a combination of multiple SDGs.

Source: United Nations, Sustainable Development Knowledge Platform

Another popular measurement framework is the IRIS catalog, a method of performance tracking developed by the Global Impact Investing Network (GIIN), that is free to use. IRIS provides investors with quantitative and qualitative metrics to track the financial, operational, social/environmental, and product performance of their investees. These metrics can function as a stand-alone framework, or be combined with the Global Impact Investing Rating System (GIIRS), an impact fund rating developed by B-Analytics (the organization also known for its B-Corp designations), to gain a holistic analysis of impact funds and their underlying portfolio companies.

Investment strategies

Investors managing impact funds assert that financial returns do not necessarily need to be sacrificed to attain impact. The ecosystem consists of two dominant strategies: those targeting market-rate returns, and those who accept concessionary returns (i.e., below market-rate).

According to a 2016 survey conducted by the GIIN, market-rate funds account for more than half of the impact investing market. Impact funds that explicitly target market-rate returns are often structured as closed-end VC or PE funds, with traditional limited partnership agreements (LPAs) and fixed investment periods. The investment instruments utilized by these fund managers include equity stakes, leverage, and hybrid instruments, such as revenue-based financing or convertible notes. While impact is still a stated priority for these funds, some market-rate funds label themselves "finance first" to emphasize their financial goals to LPs.

On the other end of the spectrum are impact fund managers who accept concessionary returns and focus primarily on impact. These investors might also employ closed-end fund structures, but predominately use fixed income instruments to achieve financial returns, focusing on debt investments in riskier but highly impactful businesses. Concessionary funds might also focus on providing low-interest loans to populations with difficulty accessing credit, similar to models employed by community development finance institutions (CDFIs)[2] and microfinance institutions.[3]

3: The US Department of the Treasury defines CDFIs as institutions that provide access to financial products and services to residents and businesses in low-income communities.
4: MFIs provide low-interest micro-loans and other financial services to individuals and small enterprises, typically located in frontier and emerging markets.

Impact fund strategies

	CONCESSIONARY	MARKET-RATE
GP FINANCIAL GOAL	Capital Preservation, Impact-First	Capital Appreciation (targeting 10-15%+ net IRR)
INSTRUMENT	Fixed Income	PE, Hybrid Instruments
EXAMPLES	Microfinance, CDFIs, Impact Bonds	VC/PE Funds, Revenue-based Financing

Analysis

The PitchBook platform tracks data on over 270 VC and PE impact funds[4] that are managed by both impact-focused firms and mainstream firms overseeing discrete, dedicated impact funds. Funds are identified as “impact funds” if they: (i) aim to gain financial returns; (ii) create positive social or environmental impact; and (iii) actively measure impact (or self-identify as an impact fund). We highlight fund location and investment focus to shed light on where impact capital is concentrated and examine common strategies employed by impact investors.

Private equity

Amongst our sample of PE impact funds, we find a concentration of micro-funds focusing on growth capital investments in emerging markets.

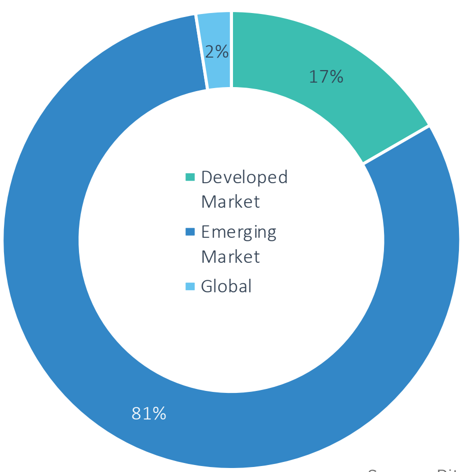
59% of PE impact funds are smaller than $100 million, and over two-thirds of these micro-funds are growth-equity vehicles. PitchBook’s data suggest that growth equity investors appear to be particularly prevalent amongst funds investing in emerging markets. In emerging markets, private investment ecosystems tend to be less developed and, as a result, it can be difficult for PE investors to secure debt for leveraged buyouts at reasonable prices. Growth equity might also be a common strategy because it can aid social enterprises in expanding their operations and reaching new markets, which may be the desired effect for impact investors whose goal is to encourage local entrepreneurship and catalyze economic development.

A large proportion of funds investing in emerging markets are operating out of developed countries, possibly a further reflection of some impact investors’ goals to spur economic and entrepreneurial development in these ecosystems. 68% of funds based in developed markets target investments in emerging markets, predominately Sub-Saharan Africa and Southeast Asia. Funds operated from Europe tend to target investments in Africa—this may be a product of geographical proximity. While most impact funds operate from financial hubs in developed markets, 35% of funds in the sample are headquartered in emerging and frontier markets, with a strong representation of African funds.

5: The PitchBook Platform tracks a total of 384 impact funds across all alternative asset strategies. This analysis focuses on VC and PE funds, as these are PitchBook’s prime areas of coverage, but readers can access the additional funds in this report’s corresponding dataset.

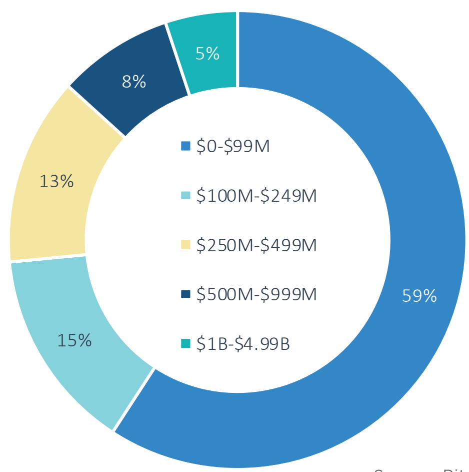
Of the 54 impact funds targeting investment in Africa, 38% are operated on the continent itself. This may be an advantage, as locally based fund managers are known to have greater access to quality deals and deeper understanding of local markets, and regulations. The data suggest that African impact investors are concentrated in West and Southern Africa. These regions have seen rapid economic growth and expanding consumer markets in the last 20 years, both of which contribute to opportunity for African enterprises. But amidst slowed GDP growth rates in 2017, the IMF reports that increased private investment is required to sustain regional development. This may explain why nearly every Africa-based impact fund has received LP commitments from one or more Development Finance Institutions (DFIs), given that impact funds are a direct way for DFIs to catalyze and sustain economic growth.

PE impact funds (#) by preferred investment regions



Source: PitchBook

PE impact funds (#) by fund size range



Source: PitchBook

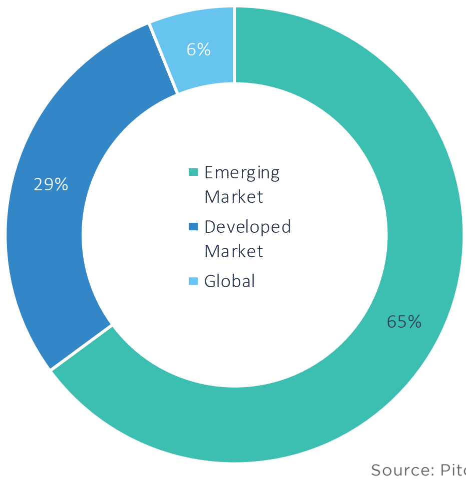
Venture capital

86% of VC impact funds are vehicles smaller than $100 million, with a few exceptions of larger funds operated by longtime impact managers or mainstream institutional investors investing in developed markets. Approximately 60% of VC impact funds focus on investments in emerging markets; of these funds, 35% target investments in India. The larger funds in this sample focus on investments in the US and Europe, investing in industries such as energy, transportation, and agriculture that have steadily been adopting sustainability practices.

India has become a hotbed for impact investing amidst strong economic growth and established entrepreneurial hubs. The World Bank Group estimates that India experienced 6.7% GDP growth in 2017, and projects future growth of over 7% for each of the next three years. A growing middle class has facilitated greater consumer spending, and 2017 saw additional infrastructure investment by the government, supporting increased access to the internet and technology. Bangalore has long been a hub for tech and entrepreneurship, and India is home to several established impact investment firms, including Aavishkaar, Lok Capital, and the Unitus Group. Impact funds in the region have tapped social enterprises that leverage technology to cater to underserved populations in areas of financial services, healthcare, and job creation. Although the Indian impact ecosystem has seen steady traction, it is still in early stages of development, as evidenced by small funds and financing rounds.

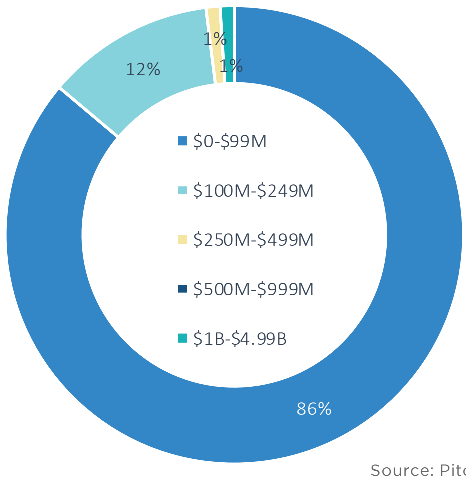
Funds investing in the US and Europe, on the other hand, represent a small proportion of mid-size and larger vehicles in our sample. Social enterprises in developed markets have taken root in sectors that have been shifting toward more sustainable business practices, including energy, agriculture, and transportation. DBL Partners, for example, is a notable US impact investor that raised a $403 million venture fund in 2015, and has made investments in cleantech companies like Tesla Motors and SolarCity.

VC impact funds' preferred investment regions



Source: PitchBook

VC impact funds by fund size range

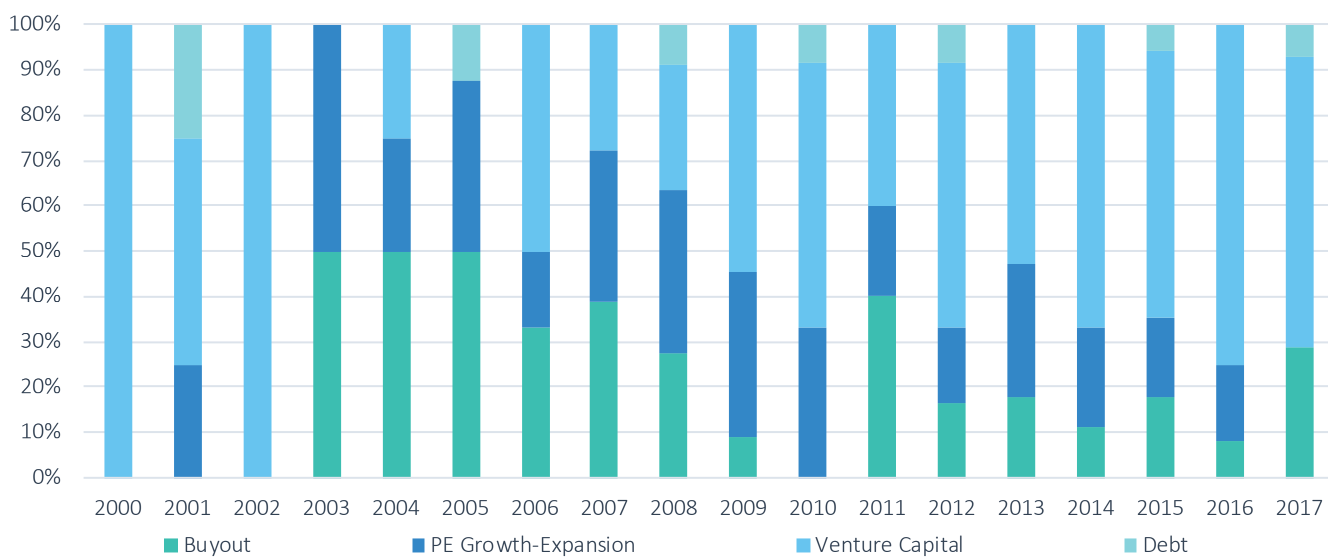


Source: PitchBook

Future outlook

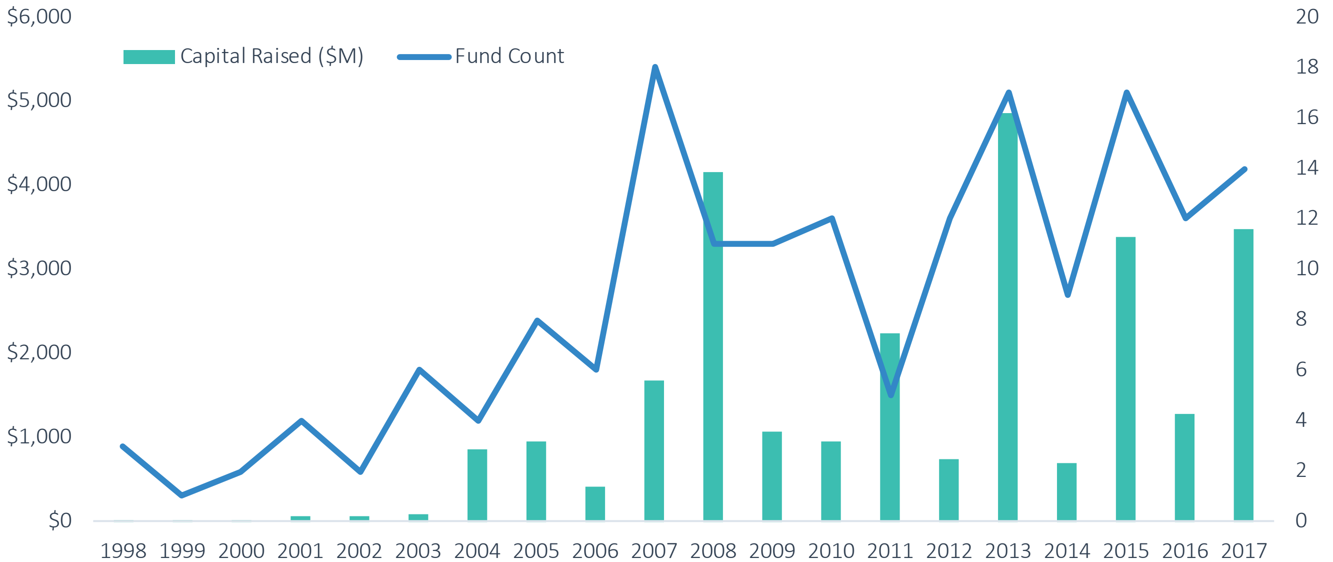
2017 saw over $3.4 billion invested in PE and VC impact funds globally, though more than half of this volume is accounted for by TPG Growth's $2 billion Rise Fund. Overall trends in impact fundraising are sporadic, with waves of activity. Although it is difficult to forecast what future fundraising will look like, impact investing commitments from notable LPs like the Ford Foundation and the Catholic Church have served to pique interest in the space. In terms of fund count, small venture funds have dominated impact fundraising in past years, though with the increasing participation of major alternative asset firms like TPG and Bain Capital, and a pipeline of over 20 open funds targeting funds sizes $100 million or greater, we expect to see larger VC and PE funds in years to come. Mainstream alternative investors, however, will likely focus more on investments in developed markets, which offer less economic and political volatility than emerging markets as well as a pipeline of investable opportunities in sectors like energy, agriculture, and transportation that are adopting sustainability practices. Developed market impact investments are an accessible entry point for mainstream firms exploring the space.

Impact funds (#) by type



Source: PitchBook

Impact fundraising activity



Source: PitchBook

What's next for impact investing?

As impact investing matures, the performance of pioneering impact funds will be a crucial factor for establishing credibility, solidifying best practices, and paving the way for future managers. The entrance of mainstream investment firms lends credibility and attention to impact investing, helping to attract a larger base of for-profit capital. While this is a welcome development, it has raised concerns about the prospect of firms offering "impact" products that may not be well-measured or deeply impactful.

Uniformity around common impact metrics will also aid the development of impact investing, helping to answer questions around definition and quantification of "impact." The integration of uniform impact metrics at the enterprise and fund levels will prove useful to investors comparing and benchmarking investment opportunities. The UN SDGs are a prominent and well-development measurement framework that a growing number of impact investors may adopt in years to come.

At a base level, impact investing is an innovation on philanthropic capital that socially-oriented investors can utilize to scale the reach of their allocation, while still enjoying financial returns. Impact investing has the potential to deliver market-rate returns to mainstream investors via market-rate funds, but whether this happens in the near term or down the road depends on the development of investable opportunities and performance of pioneer fund managers.