PitchBook

The Double Bottom Line: Private Market Impact Investment

Analyzing sustainable investment strategies and measurement frameworks

PitchBook is a Morningstar company. Comprehensive, accurate and hard-to-find data for professionals doing business in the private markets.

Credits & contact

Analyst

HILARY WIEK, CFA, CAIA Senior Analyst, Fund Strategies & Performance
hilary.wiek@pitchbook.com

Coverage picked up from
JOELLE SOSTHEIM

Research

reports@pitchbook.com

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Key takeaways

- Sitting beneath the sustainable investing umbrella,[1] impact investments are made with dual goals of achieving financial returns and positive social or environmental results. Impact investments are most commonly made through familiar LP structures such as closed-end PE and VC funds, though debt is a growing avenue for impact investors.

- While many may conflate impact with ESG, the first is seeking to make a measurable impact with the investments a fund manager buys while the latter is an approach to identifying non-financial risks that may have a material impact on an asset's value. ESG (environmental, social, and governance) factors are part of an investment assessment process, while impact is about the type of investments a manager is targeting.

- Impact funds are typically smaller vehicles than generalist PE or VC funds. The largest impact fund on our platform raised $2.1 billion, but there are many examples of general PE funds well over $10 billion. 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.

Introduction

Historically, the degree to which asset owners consider financial gains has separated capital decisions into two distinct categories: for-profit investments and philanthropic capital. However, over the last several decades, new sustainable investment products and strategies have been developed to help investors "do well while doing good." As sustainable investing has evolved from socially responsible investing (SRI) to ESG and impact investing, demand for sustainable investment strategies has grown considerably. A 2019 survey conducted by Morgan Stanley reported 95% of millennials (ages 18-37) are interested in sustainable investing, up nine percentage points from 2017. Across all individual investors, Morgan Stanley recorded a surprising 85% are interested in the topic, up from 75% two years prior. Interestingly, 65% of those surveyed cited a lack of available financial products as a barrier to including sustainable investing in their portfolios.[2]

1: "The Taxonomy of Sustainable Funds," Morningstar, Jon Hale, March 7, 2019.
2: "Sustainable Symbols: Individual Investor Interest Driven by Impact, Conviction and Choice," Morgan Stanley, 2019.

At the same time, investment products claiming some association with sustainable investing have proliferated, with $12 trillion in professionally managed assets in the US in 2018, a 38% increase since 2016.[3]

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While the data seems to suggest an ongoing boom in both supply of and demand for sustainable investing, those seeking investment products say they are not finding what they are looking for. This is in part because each investor has a different take on what it means to invest sustainably. While there may be a wide variety of strategies avoiding tobacco or carbon, there are fewer funds dedicated to social issues such as education or diversity, let alone funds to benefit a specific geography. Beyond strategy fit to investor mission, it is difficult for investors to uncover the appropriate funds, the track records are often short and difficult to assess, and there is always the hazard of "greenwashing,"[4] where self-identification does not match reality.[5]

In recent years, ESG as a term has popularly become synonymous with sustainable investment, but ESG is merely a framework for evaluating companies and not a standalone investment strategy in and of itself. However, impact investing—for-profit, direct investing in companies or investment funds that actively measure the impact they create—is a distinct strategy for those seeking to meld both competitive financial returns and positive social and/or environmental externalities into a single investment product. Going deeper on these dual-purpose funds, there are two camps—those who prioritize profit and impact equally and those who are willing to accept concessionary returns for greater effect.

High-net-worth individuals, foundations and government institutions initially drove investment into impact strategies, but pension funds, retirement funds and insurance companies have joined the ranks of LPs committing to the approach. With growing interest from clients, some asset managers have established impact investment platforms to evolve and diversify their investment offerings. TPG, KKR 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.

Because the impact investment ecosystem is still maturing, several aspects are still not universally accepted as standard by market participants. In particular, the methods to measure social or environmental aspects is still crystallizing. There is also bifurcation between fund managers developing new approaches with broad investor appeal or niche areas of focus. With that said, since we last published a note on this topic in March 2018, some interesting developments have occurred, particularly when it comes to measurement and reporting of ESG factor risks. This note offers a holistic overview of the ecosystem to provide a framework for understanding impact measurement, impact fund managers' investment strategies and the current state of the market.

3: "Report on US Sustainable, Responsible and Impact Investing Trends" US SIF Foundation, 2018.

4: "Greenwashing" is the practice of labeling or giving the impression that a fund has a mandate to invest with a sustainable lens, but closer examination reveals that the claim is only cursory.

5: Certain data providers such as Morningstar will add a layer of diligence before allowing a public markets fund to be given an ESG-related tag. PitchBook is in the process of curating its own private market roster of impact funds to help investors identify funds with a dedicated impact focus.

The sustainable investing ecosystem

SRI: the birth of sustainable investing

Terminology has taken a surprisingly long time to be ironed out in what we will call the "sustainable investment" space. This has led to some confusion and a slower uptake of the approach, particularly in the US. The earliest implementation of investment products considering such factors were SRI funds. These funds are generally public market strategies that utilize screening and exclusion to avoid what the investor feels are negative social or environmental exposures. A typical SRI strategy would exclude "sin stocks," such as companies producing tobacco, firearms or alcohol, from a portfolio of public equities. Many investors in the 1990s considered SRI strategies but decided that investing from a values perspective was not their mandate and so continued to construct portfolios the way they always had.

ESG: the sustainable investing framework

While SRI still exists today, the uptake was always limited, particularly outside the US. In the early 2000s, some began to espouse the merits of incorporating ESG factors into the investment process. Many thought it was basically a rebranding of SRI and did not look further to better understand the framework. This slowed the growth of the approach in the US, but Europe took up the cause of ESG risk factors in a big way before the global financial crisis (GFC). The GFC put any nascent efforts in the US to better understand and implement the ESG framework on a back burner.

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ESG has gained more attention in the US over the last decade as investors have come to recognize the materiality of risks that lie beyond the typical financial statement analysis. If a company is more profitable because it neglects to properly dispose of toxic waste, there is a legal risk associated with this negligent behavior. Improving margins by paying so poorly that workers must seek public assistance invokes social risks with potential consequences such as strikes or government interference. Companies with boardrooms filled with friends of the CEO run the risk of giving management the benefit of the doubt when critical feedback is needed, which violates the tenets of proper governance. When put into examples this plain, it seems obvious that an investment manager would be breaching its fiduciary duty by ignoring these risks, yet this framework is still a fairly new perspective for most US investors.

The Sustainable Accounting Standards Board (SASB) was established in 2011 to help standardize the ESG framework. Through work done with institutional investors, asset managers and companies, SASB released industry-specific frameworks in November 2018 for companies to report on the risks they face beyond traditional financial statements. Most importantly, SASB ensured that the metrics it included in each framework were financially material. The historical and point-in-time reporting found in financial statements does not adequately reflect potential future risks as these standards do. SASB provides some interesting language in each standard's introduction to describe their purpose:[6]

> *The SASB's use of the term "sustainability" refers to corporate activities that maintain or enhance the ability of the company to create value over the long term.*
>
> *SASB standards are designed to identify a minimum set of sustainability issues most likely to impact the operating performance or financial condition of the typical company in an industry, regardless of location.*

While public companies have been early adopters of ESG factor reporting, the framework offered by SASB is applicable to any company and institutional investors are beginning to ask private markets managers to provide reporting on the ESG risks faced by portfolio companies. Through the efforts of asset owners and organizations such as the PRI Association and SASB, the ESG lens is becoming a more common point of view for investors of all types.

Like SRI, the consideration of ESG factors began in the public equities milieu as investors sought a framework to consider risks to sustainability. There are several firms that provide ESG ratings on public stocks and bonds, allowing investors to get a sense of a company's and/or a portfolio's exposures to these risks.[7] However, the same elements are present in private market companies and we are hearing from GPs that LPs have increased their requests for reporting on this front. European regulators and the CFA Institute have named ESG risks as something that ought to be considered as part of a fund manager's fiduciary duty, views that will likely lead many more products to meet a voracious ESG appetite.

With trillions of dollars earmarked for sustainable investment products, fund managers are certainly incentivized to say they qualify—and many do. But saying you are an ESG fund can be problematic. The better way to express the adoption of ESG is to indicate that ESG factors are considered in your investment process. A portfolio can't be ESG, but the underlying companies can be evaluated within an ESG framework.

Impacting investing: sustainable investing for the private markets

This brings us to the ultimate topic of this note: the investment strategy called impact investing. This strategy is a potent way for investors to directly influence social and environmental causes while still accumulating wealth through investment returns. While impact strategies will likely consider ESG factors, impact investing is separate in that it is a strategy of investing in enterprises, organizations and funds with the dual goals of achieving financial returns and positive social and/or environmental impact. Investors who seek financial gains and impact refer to this as the "double bottom line," mimicking an accounting term to express how both aspects need to

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6: Quoted from one of the standards downloadable at SASB.org.

7: Disclosure: PitchBook Data is a wholly owned subsidiary of Morningstar. Morningstar announced April 21, 2020, that it would be fully acquiring Sustainalytics, one of the primary ESG ratings firms.

be measured and reported. While some public market portfolios might be considered impact, these strategies are most commonly made through private market limited partnership structures[8] such as PE and VC funds, though debt is a growing avenue for impact investors.

There are many different investments that a fund could make that would qualify it as an impact fund. Investors have many different views on what sort of impact they hope to make with their investment dollars, so a variety of funds exist to serve various subsectors of the impact world. For example, funds that target affordable housing, sustainable forestry, clean energy or economic development in disadvantaged economies all could qualify as impact funds. In all cases, the goal is both a profitable business and a measurable social impact. Some funds may have gotten into a business that fits into the impact space through purely profit motives, but many of these are moving to provide impact reporting in order to meet the demands of asset owners and other stakeholders.

Many deeply devoted impact investors have exacting standards for their portfolio companies, often requiring them to commit to sustainable business practices such as fair labor practices or 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 are positioned for longevity.

The sustainable investing ecosystem

Sustainable investing		
Socially responsible investing (SRI)	**Environmental, social, governance (ESG) factors**	**Impact investing**
• Investors use screening and exclusion, divestment, positive reinvestment and shareholder activism to achieve positive social or environmental outcomes • Most commonly used in public markets, easily accessed by all investors	• Metrics by which to measure a company's risks outside of a financial accounting framework • More public market funds are incorporating this framework, though private market participants are starting to, as well	• Investing in companies and funds with an eye toward both financial returns and measurable social and/or environmental impact • Prominent in private markets investments, limiting access for smaller investors

Source: PitchBook

What constitutes an "impactful" investment?

At a base level, an "impactful" investment is one that generates measurable positive social or environmental outcomes, but this simple definition requires more nuanced examination. What constitutes impact can vary significantly across business sectors and geographical regions and is largely informed by the context of the stakeholders, enterprises and 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. To be considered impactful in the US, however, that investment might need to target a disadvantaged segment of the population or otherwise it would be seen as a normal small business loan.

8: For more on how institutional investors access private markets, please reference this note.

Because what constitutes impact is situationally dependent, there is no universal definition. Instead, investors define and track outcomes with metrics specific to their own goals, typically requiring that their fund manager or portfolio companies 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 2018, the Global Impact Investing Network[9] (GIIN) released its Roadmap for the Future of Impact Investing. One of the action items was "to strengthen the identity of impact investing."[10] The two outputs addressing this were 1) developing the Core Characteristics of Impact Investing[11] and 2) the IRIS+ system, which "helps investors measure, manage, and optimize their impact."[12] This has led to some standardization among impact investors that was sorely lacking before, with common impact themes listed with ways investors could measure progress along a large number of potential metrics. An example of this work is shown in the accompanying table.

Select impact themes and sample metrics

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

Another standard setter is the International Finance Corporation (IFC), a sister organization of the World Bank, which has a purpose "to further economic development by encouraging the growth of productive private enterprise in member countries, particularly in the less developed areas, thus supplementing the activities of the International Bank for Reconstruction and Development."[13] The IFC lends directly to businesses for a market-rate investment return, an ability that is not available to the World Bank, which can only lend to governments of member countries. In addition, the IFC offers advisory services to support private sector development. In dealing with businesses, this group ensures the investments it supports in developing countries have impact by requiring all investment and advisory clients whose

9: The GIIN, which is a nonprofit 501c(3) organization, has a vision "of a world where financial markets serve all members of society and where finance plays a central role in solving the social and environmental challenges facing the global community." The organization has a board that includes leaders from Nuveen, the Nonprofit Finance Fund, the Ford Foundation and Swedfund. Supporting organizations include USAID, the Australian government, UKaid, the Ford Foundation, the Omidyar Network, Prudential and The Rockefeller Foundation.

10: "Roadmap for the Future of Impact Investing: Reshaping Financial Markets," Global Impact Investing Network, Amit Bouri, et al, March 20, 2018.

11: "Core Characteristics of Impact Investing," Global Impact Investing Network, n.d.

12: "IRIS+ System," Global Impact Investing Network, n.d.

13: "Article I - Purpose," International FInance Corporation, revised April 16, 2020.

projects go through IFC's initial credit review process to conform to the eight impact themes contained in its Environmental and Performance Standards.[14] Through the standards, the IFC has defined its clients' responsibilities for managing their environmental and social risks. The eight categories are

- Assessment and Management of Environmental and Social Risks and Impacts
- Labor and Working Conditions
- Resource Efficiency and Pollution Prevention
- Community Health, Safety, and Security
- Land Acquisition and Involuntary Resettlement
- Biodiversity Conservation and Sustainable Management of Living Natural Resources
- Indigenous Peoples
- Cultural Heritage

The performance standards guide companies on how to operate more sustainably. For example, the IFC summarizes that the Cultural Heritage standard "aims to guide companies in protecting cultural heritage from adverse impacts of project activities and supporting its preservation. It also promotes the equitable sharing of benefits from the use of cultural heritage."[15] Each of the performance standards has similar high-level language to instruct companies on how best to proceed from a sustainable perspective.

Select impact investment funds

Fund name	General partner	Area(s) of impact	Committed capital ($M)
The Rise Fund	TPG Growth	Education, energy, food & agriculture, financial services, healthcare, information & communication technology, industrial & infrastructure	$2,100.0
Macquarie SBI Infrastructure Fund	Macquarie Asset Management International Finance Corporate State Bank of India	Indian infrastructure	$1,170.0
Climate Change Capital Carbon Fund	Climate Change Capital	Clean energy and the low carbon economy	$1,000.0
Bain Capital Double Impact Fund	Bail Capital	Maximizing financial potential, scaling social and environmental impact	$390.0
Green Triangle Forest Trust	New Forests	Sustainable forest management	$332.1
Enterprise Housing Partners XXVI	Enterprise Community Partners	Low-income housing	$318.0
Turner-Agassi Charter Schools Facilities Fund II	Turner Impact Capital Agassi Ventures	Development of US schools in high-need areas	$296.3
TVM Healthcare MENA III	TVM Capital Healthcare Partners	Investments in healthcare companies focused on Southeast Asia and the MENA[16] region	$250.0

Source: PitchBook | **Geography**: Global

14: "Performance Standards," International Finance Corporation, 2012.
15: "Performance Standard 8: Cultural Heritage," International Finance Coroporation, 2012.
16: MENA refers to the Middle East and North Africa.

Unity around measurement

While there are a number of frameworks available for measuring impact, this variety poses a challenge as investors have not reached a consensus on best practices. For example, allocators may receive impact reports from multiple managers all in different formats. Impact investors' lack of unity regarding how to quantify impact can propagate the risk of "impact washing," advertising about "impact" products that have minimal relation to social or environmental returns. Consequently, impact investors stand to benefit from converging on common measurement frameworks. Some leading frameworks for impact investors include the United Nations Sustainable Development Goals, the IRIS catalog and the Global Impact Investing Rating System (GIIRS).

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, ranging from "decent work and economic growth" to gender equality.[17] Accepted by every country in the world, the SDGs are a popular framework for investors to measure impact. By clearly articulating standards for sustainable development, the SDGs offer guiding quantitative metrics to achieve each goal. This framework was conceived for the achievement of social goals, so in some cases the goals do not seem to obviously translate to opportunities for investment. Sometimes public policy or another solution is a better fit for making progress on a goal. However, there are areas where impact investors can utilize the metrics underlying each goal in their measurement by pegging their proprietary metrics to one goal or employing a combination of multiple SDGs.

Despite not specifically being designed for the investment community, the UN SDGs have seen widespread adoption.

Despite not specifically being designed for the investment community, the UN SDGs have seen widespread adoption. A 2019 GIIN survey of impact investment organizations indicated over 60% of respondents track their investment performance to the UN SDGs. In terms of where in the UN SDGs asset managers are finding opportunity, the specific areas most commonly cited were: decent work and economic growth (73%), no poverty (61%), reduced inequalities (59%) and good health and well-being (58%).[18] This preference for certain goals out of the 17 total SDGs illustrates investors are mostly finding opportunities in just a few areas.

Another popular measurement tool, free to use, is the IRIS catalog, a compendium of impact performance tracking ideas developed by GIIN.[19] 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 standalone framework or be combined with 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.

17: "Sustainable Development Goals," United Nations, 2015.
18: "2019 Annual Impact Investor Survey," Global Impact Investing Network, Abhilash Mudaliar et al., June 19, 2019.
19: "IRIS+ System," Global Impact Investing Network, n.d.

Investment strategies

Investors managing impact funds assert that financial returns do not necessarily need to be sacrificed to create impact. The ecosystem primarily consists of two approaches: those targeting market-rate results and those who accept concessionary returns (that is, below market-rate).

According to the 2019 GIIN survey, approximately two-thirds of the respondents target market-rate returns, with the remainder willing to pursue concessionary returns.[20] The focus often depended on the type of investor: Over 70% of foundations and non-profit fund managers pursued below-market returns while 79% of PE-focused investors[21] targeted market-rate returns.[22] Impact funds that explicitly target market-rate returns are often structured like generalist 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.

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On the other end of the spectrum, some impact fund managers 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. One example from the concessionary return world are low-income housing funds. While these would be managed similarly to a standard private real estate fund, making property improvements to justify significant rent increases (a usual path to profits for real estate funds), defeats the purpose of ensuring that low-income housing remains available where it is most needed. To serve the mission, investors are asked to accept less than market returns to keep rent increases from pricing low-income residents out of the building, thus maintaining the affordability of the property.

Impact fund types

	Concessionary	Market-rate
GP financial goal	Capital preservation, impact-first	Capital appreciation (targeting 10%-15%+ net IRR)
Instrument	Fixed income	Private equity, hybrid Instruments
Examples	Microfinance, CDFIs, impact bonds	VC/PE funds, revenue-based financing

Source: PitchBook

20: "Roadmap for the Future of Impact Investing: Reshaping Financial Markets," Global Impact Investing Network, Amit Bouri, et al., March 20, 2018.

21: In the survey, both LPs and GPs were surveyed. In this case, private equity investors were contrasted to private debt investors, though all were impact investors.

22: "Roadmap for the Future of Impact Investing: Reshaping Financial Markets," Global Impact Investing Network, Amit Bouri, et al., March 20, 2018.

What's next for private market sustainable investing?

As impact investing matures, the performance of pioneering impact funds has been 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 attract a larger base of for-profit capital. While this is a welcome development, we advise impact investors to take care to ensure these firms are offering products that are truly managing for the double bottom line.

We are seeing more alignment to the UN SDGs, which will also aid the development of impact investing, helping to answer questions around the 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. In addition, we are seeing more investment managers on the private side looking into ESG risk metrics and expect to see much more reporting on a sustainability level even outside the impact fund universe.

At a base level, impact investing is an innovation on philanthropic capital that investors seeking social or environmental change can utilize to scale the reach of their allocation while still enjoying financial returns. More products are coming to market to meet this need, improving the universe of investable opportunities.

Impact work forthcoming from PitchBook Data

PitchBook is in the process of more comprehensively identifying private market strategies investing with the goal of impact. We will not only identify which funds are truly impact funds but categorize them into the types of impact these funds hope to measure and report. LPs have had a difficult time finding impact funds that match their particular mission; we aim to fill that void with a comprehensive roster of who is active in the space. With improved methods of identifying impact funds, we will be providing industry-leading analytics on the market and regular reporting on how these funds are doing.

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We will also be conducting a survey in the summer of 2020 of asset owners, GPs and other industry participants to track sentiment on several ESG and impact issues, updating the work that we last did in 2016.