



PRIVATE EQUITY WIRE

EXPECTING MORE

THE EVOLVING DEMAND FOR ESG AND IMPACT INVESTING

EXECUTIVE SUMMARY

In this month's Private Equity Wire Insights report we hear from private equity impact fund investors and direct lenders to get a sense of the challenges and opportunities that arise when finance and ESG considerations intersect.

Macroeconomic challenges continue to inform most conversations in the world of investment – fundraising in the impact space is increasingly challenging and investors are keener than ever to see proof of the widely acknowledged value-add that ESG brings to portfolios. Add to this a wave of regulatory shifts, which signal the world of impact investing is at a crossroads of sorts.

But there is hope the coin will land right side up – demand for and optimism about impact investing is high and climbing, according to our survey data and wider market research. There are also a number of deployment opportunities, particularly in emerging markets, that could produce significant returns if approached correctly.

And the overall rise in demand for private credit as an investment strategy could spell opportunity for impact fund managers, provided they can improve their measurement strategies to demonstrate both financial and impact value. The lower risk-profile of impact investment could combine with the same perception around credit as an investment strategy to win over nervous investors.

At any rate, impact funds have been weathering the macroeconomic storm with equal if not more success than traditional buyout and venture funds – demonstrating the resilience that many have long ascribed it.

KATHERINE STEINER-DICKS
REPORT AUTHOR

CONTENTS

KEY FINDINGS	3
SECTION 1	4
PERFORMANCE PRESSURE	
SECTION 2	12
FUNDRAISING SPOTLIGHT	
SECTION 3	19
CREDIT AND IMPACT	

METHODOLOGY

This Private Equity Wire research is based on survey responses from nearly 70 GPs across Europe (30), North America (19) and Asia Pacific (13), among other regions. Around 30% of respondents specifically manage impact/ ESG/sustainability funds, while the rest are spread across buyout and venture capital, among other strategies. Survey findings are supplemented with qualitative interviews with named and unnamed sources, as well as third-party data and intel in this report.

KEY FINDINGS

1

Impact still on the priority list

In an economic landscape where fundraising remains a challenge, the same number of GPs that have raised impact funds in the past four years plan to do so in the next 12 months. Investors as well as lenders see impact investing as lower risk compared with traditional assets, and there is a willingness to plug the funding gaps in emerging markets.

2

Investors seek performance

The days of laissez faire in the impact space appear to be behind us – though funding in this space is expected to continually rise, investors are voicing concerns about returns on these funds. GPs are under pressure to improve their measurement strategies – for performance across impact as well as financial metrics.

3

More tech potential to explore

Despite the growing focus on impact and financial measurement, only 27% of GPs report that the adoption of ESG due diligence and compliance software has helped compare investment opportunities. The high ratio of 'intangibles' in the world of impact might be one explanation, though there is an opportunity for GPs and tech providers to capture new efficiencies.

4

Credit could provide impact boost

Though impact credit funds occupy only 13% of the global impact investing pool, growing investor interest in the attractive risk-return ratios in private credit in general might make it an attractive strategy for GPs. Measurement improvements will be crucial to drive this shift, but the pool of direct lenders in the impact space is expanding and diversifying worldwide.

WATCHFUL ENTHUSIASM

Investor interest in impact funds remains robust, though their financial performance is under scrutiny for a number of reasons

If the uncertainty of high interest rates, the Fed debt ceiling crisis and US-China trade tensions were not enough, ESG-aligned and impact fund sponsors might have to take a few awkward calls from LPs following a new report from PitchBook. The research found the estimated 2000 funds signed up to the UN's Principles for Responsible Investment were not performing better than non-signatory funds.

The data is at odds with the widespread belief that investing with ESG principles can improve long-term fund performance by eliminating material risks, such as Co2 emissions, or high employee turnover. But if, as the data suggests, signatories commit to applying ESG to just 50% of their Assets Under Management (AUM), how meaningful are the findings? Arguments in support of impact investing

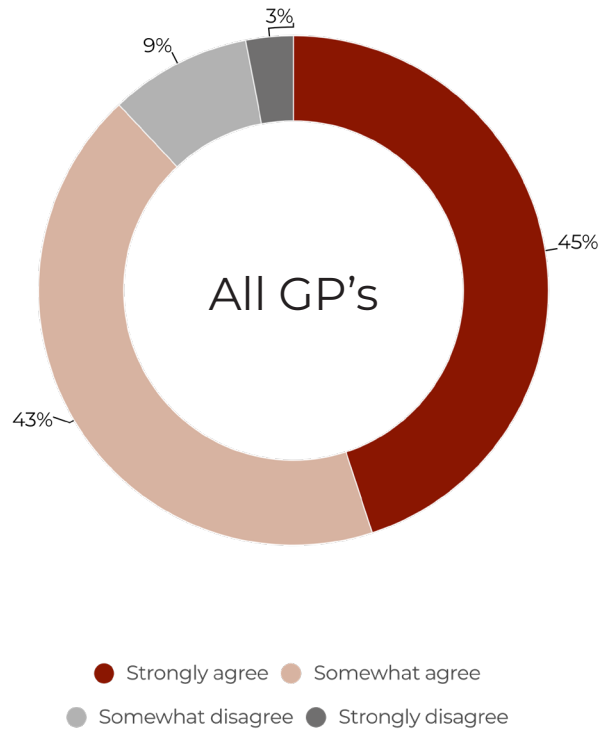
remain strong. "From 2016 onwards, impact funds have generated good returns, with some recording higher IRRs than ESG funds," says Sumit Chhabra, Managing Director, Global Head of Private Equity & Consulting Services at Permira-owned Acuity Knowledge Partners.

"We strongly feel, based on our conversations with our clients and what we are seeing in the market, that impact funds are here to stay. Their importance will only continue to grow over time."

Dörte Höppner, Chief Sustainability Officer and Managing Director at midmarket investor The Riverside Company, says continuing ESG due diligence and portfolio integration – even when the global economy is struggling – just makes good business sense.



Figure 1.1 Expectation around impact investing's growing profile in private equity



Analyst note: Respondents were asked, "To what extent do you agree that impact investing will become a bigger part of the private equity market in the next 2 years based on LP demand?"

Source: Private Equity Wire Readers survey

"Why should a fund give up on creating value in its portfolio through tools like ESG just because interest rates have gone up? If there's a good angle to add value with even one environmental initiative – such as putting solar panels on the roof to be less dependent on high energy prices – businesses would want to do that now," says Höppner.

EMERGING OPTIMISM

Suboptimal economic conditions and protracted deal closings in mature venture and private equity markets will have undoubtedly caused a few restless nights, though some fund managers are sleeping better than others. One example is Tim Crijns, Fund Manager of Triodos's Microfinance Fund, who puts his extra winks down to the optimistic outlook for emerging markets – his team's bread and butter – which he says is looking better than advanced economies.

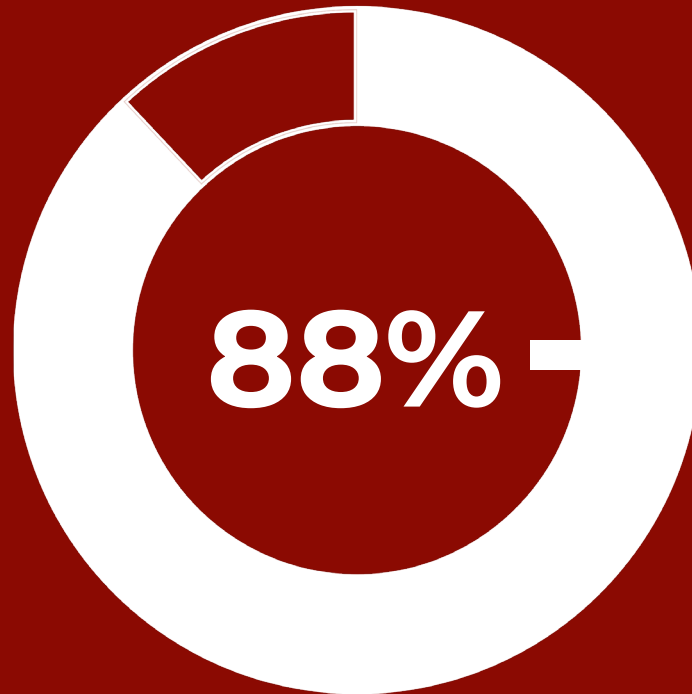
Triodos's Microfinance Fund's open-ended structure provides private equity, debt and subordinated debt to local financial institutions that serve the traditionally excluded in emerging markets. The equity investments, however, come later in the relationship after an initial loan, when financial inclusion goals have been met, transparency is proven, and an institution is prime for scaling up.

Jonathan Harrison, CEO and Founder of private equity emerging market investment firm Frontier-Invest, says he and his co-investors are looking at opportunities in Africa that will likely generate IRRs towards the upper end

KEY FINDINGS

Impact investing will continue to grow in profile

Share of GPs who agree that impact investing will become a bigger part of the private equity market in the next two years



“

we would never back a company that we didn't think was a good employer

of the 20-30% bracket. The numbers might encourage a greater focus on the emerging world – currently on the margins of private market impact activity (See Fig. 1.2).

Harrison has invested with co-investors in retail businesses such as Quality Foods Africa, which is launching franchise brands such as Krispy Kreme and Dodo Pizza in Nigeria and across other African countries. Their fund has also co-invested in renewable energy companies including Arc Power, a solar-powered grid company operating in Sub-Saharan Africa. Frontier-Invest is not an impact investor by default, but many of the companies they invest in are creating jobs and entrepreneurial opportunities across Africa, particularly for women.

“Stimulating economic activity creates employment opportunities and generates

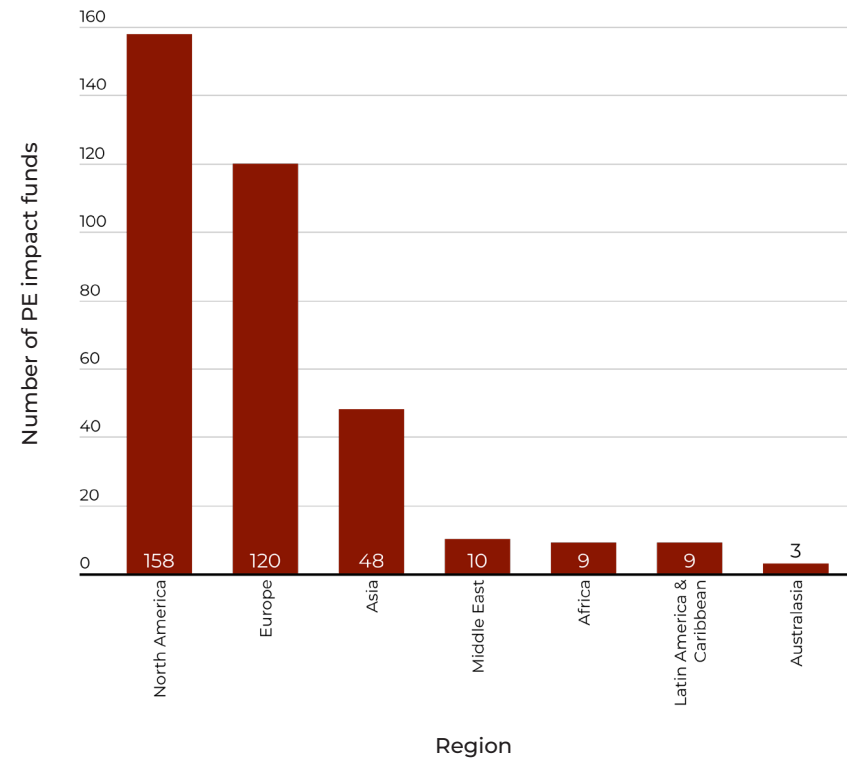
income for families, many of whom are in need. However, we would never back a company that we didn't think was a good employer – that is absolutely part and parcel of being a good business. That aside, we don't have tick-box requirements as such,” says Harrison.

IN STEADY DEMAND

Most GPs surveyed by Private Equity Wire for this report expect demand for impact investment to persist – indeed, 88% could see private equity claiming a much larger stake in global impact investing by 2025 (See Fig. 1.1).

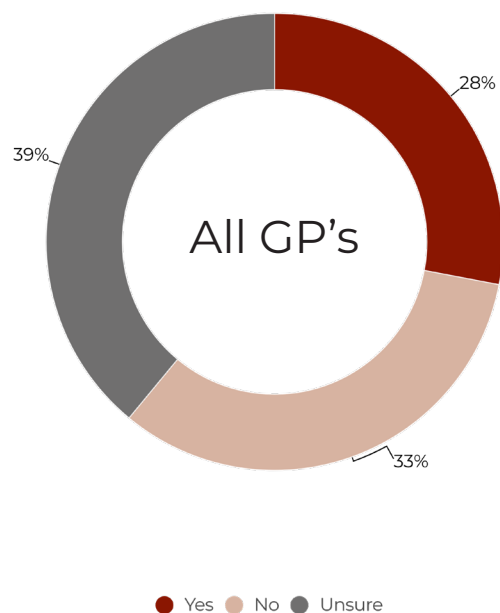
Crijns says private micro finance has been providing stable track records for decades, compared to perhaps higher-performing but less stable counterparts. Fellow Triodos fund manager Florian Bankeman says financial institutions in emerging markets are much

Figure 1.2 Regional distribution of current private equity impact funds



Analyst note: Interest might shift to emerging markets due to high return potential

Source: Preqin

Figure 1.3 LP concerns over impact fund returns in a downturn

Analyst note: Respondents were asked, 'Are LPs voicing concerns of doubt over whether impact fund returns will meet expectations in a downturn?'

Source: Private Equity Wire readers survey

Valuing the intangibles

After working through the financial crisis and witnessing how much money the financial industry earned in the rebuild, Tim Crijns, Fund Manager of Triodos's Microfinance Fund said his priorities shifted.

"It made me think: What are we doing here? What social benefits are we providing?" The answers have become clearer for him since working in impact investing, feeling a sense of purpose that comes with effecting positive change.

The same is true for Triodos Fund Manager Florian Bankeman, who recalls one memorable experience

where he helped secure a \$200 loan for a female client in Latin America when no one else would because her business was "too small." That small business owner would go on to double the number of kiosks she owned after paying back the first loan. The impact was two-fold as it levered a generational shift – providing her family with healthcare for the first time and securing higher education for her daughter.

Bankeman recalls the gratitude expressed by the client: "This is why we are doing this job. This is what helps us sleep better at night."

“

Those impact investments more focused on key industries, such as energy and infrastructure, have been enjoying solid financial performance

more focused on the “real economy,” which can be more stable, unaffected by equity market performance, and truly “driven by impact.”

In 2022, Triodos invested €800m in emerging markets to help financial institutions provide capital to small businesses, rebuilding not only after the COVID-19 lockdown but in some cases other devastating events, such as the floods in Pakistan and the invasion of Ukraine.

“Businesses were able to put loans to good use immediately after lockdown, with many repaying them within six to 12 months. People in emerging markets are very resilient to crisis – they need microfinance to rebuild their businesses,” says Crijns.

He believes success stories like these are creating equity exit opportunities for microfinance funds in emerging markets. Regional private equity funds in particular are targeting financial institutions with management teams that have strong financial and impact track records, and are familiar with institutional level finance and impact due diligence processes.

THE INTANGIBLES PREMIUM

There are indicators that some LPs are voicing concerns about fund returns when it comes to their impact investments (See Fig. 1.3), as might be the case with all private equity strategies.

Hugh Simpson, who oversees ESG services for private market funds at Petra Funds

Group, says portfolio companies in more discretionary goods and services as well as in tech are having a “more challenging time with their growth strategy due to macroeconomic headwinds.”

“Those impact investments more focused on key industries, such as energy and infrastructure, have been enjoying solid financial performance. However, even they are facing challenges to balance their ambitions and growth.”

Some anonymised benchmark platforms, such as the ESG Data Convergence Initiative, can be useful to compare the impact performance of portfolio companies. There are mixed views on the use of tech for performance measurement – 50% of our survey respondents said the adoption of ESG due diligence and compliance software has not helped them compare investment opportunities, while 27% say such software has been adopted and is proving to be valuable (See Fig. 1.4).

Danielle Pepin, who Heads ESG, Portfolio Monitoring and Valuation at Dynamo Software, says just as with other types of private assets, impact fund valuations are “negatively affected by the contraction of comparable multiples.”

“There’s always a lag, and due to the less liquid nature, there’s usually some expectation of rebound factored into the returns forecast. That’s baked into the illiquidity premium.” The difference with impact funds, she says, is that there is an additional premium for intangibles, which naturally correlates less with the markets.

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People in emerging markets are
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their businesses

Tim Crijns
Fund Manager, Triodos Financial Inclusion Funds

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I do think impact is hard to measure, but most GPs have not bothered to collect the data to do so

However, some impact specialists such as Claire Veuthey, a Principal at Rizoma Ventures, do not believe performance is contingent on the impact characteristics of portfolio companies, but rather how rate-sensitive their business models are. She says the focus has shifted away from growth at all costs to profitability, but she does not see the impact side as being totally intangible.

“I do think impact is hard to measure, but most GPs have not bothered to collect the data to do so,” she says, though there are signs of change. “LPs are starting to ask for some evidence of impact after years of very light oversight/expectations of what impact actually consisted of in GP’s investment strategies.”

Simpson says the valuation of ESG assets and impact has been affected by fluctuations – owing to the link to growth and momentum

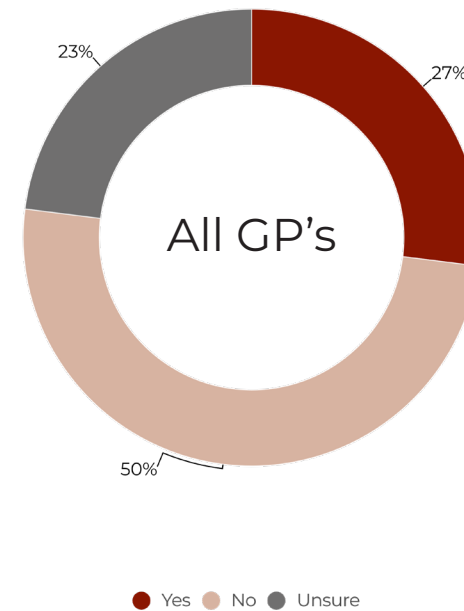
factors that historically have scored well against ESG criteria but have been impacted significantly by macroeconomic conditions.

“While this gives rise to certain challenges, we are expecting a shift in the future. As corporate ESG legislation such as CSRD and SEC rules, among others, are being rolled out, we envision a far closer link between impact and external factors.” ■

KEY TAKEAWAY

The financial and impact performance of private equity impact funds has been resilient despite a range of challenges that have affected this \$1.2 trillion market over the past 12 months.

Figure 1.4 The role of software in impact investing



Analyst note: Respondents were asked, 'Has the adoption of ESG due diligence and compliance software helped compare investment opportunities?'

Source: Private Equity Wire readers survey

RAISING CHALLENGES

Regulatory complexity and political headwinds are making fundraising tricky for impact funds – some investment strategies are proving far more popular than others

Private equity and private debt sponsors believe they will see their market share in the impact space increase significantly in the next two years, according to our survey (See Fig. 1.1), despite the economic climate and the rise of anti-ESG sentiment in certain markets.

Appetite for impact investment has not waned – 39% of respondents said they have plans to raise an impact fund in the next 12 months, with an additional 25% considering it. Around a third (36%) said they would not be raising an impact fund in this time frame (See Fig. 2.1). Though demand looks promising, fundraising

has not been easy as sponsors try to convince even existing LPs about strategies and deals that would deliver returns above public market benchmarks. Certain strategies have proved more effective at weathering the economic storm than others, according to Claire Veuthey, Principal at Rizoma Ventures, who says climate-focused funds have been especially resilient.

This is in line with our research, which revealed that those fundraising are largely leading with environmental (60%) and cleantech (47%) strategies (See Fig. 2.2). Market conditions

could also be shifting more power into the hands of investors, according to Veuthey, after “years of ‘free money’ for ‘hot deals’.”

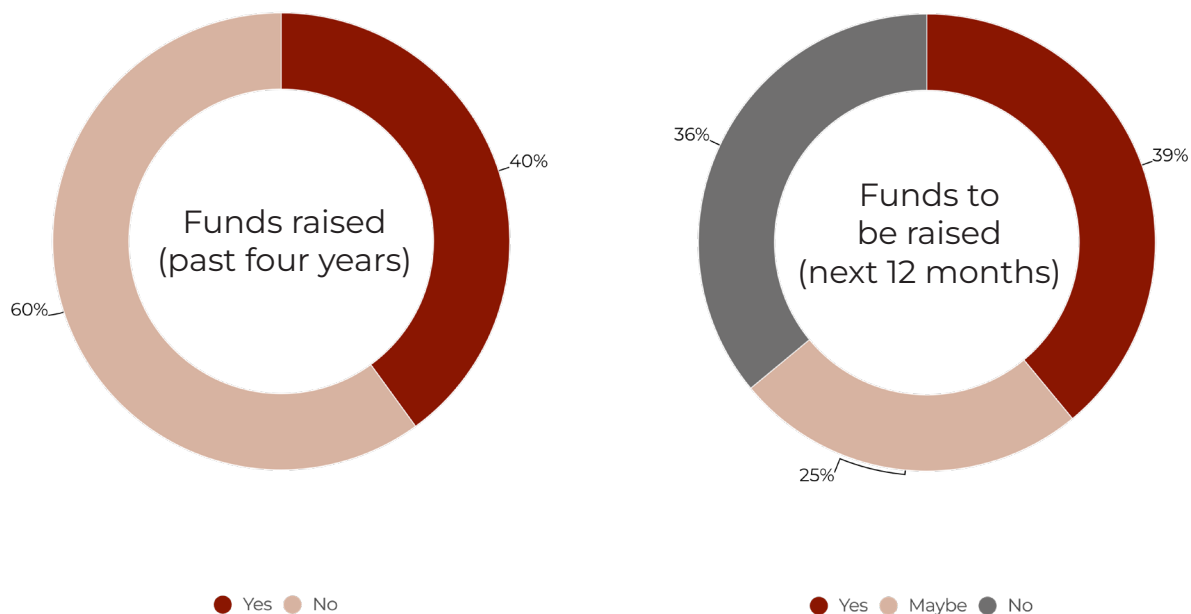
This begs the question of whether GPs and their limited partners are still confident about raising and allocating capital to impact funds in the current economic climate. Hugh Simpson, Petra Funds Group’s ESG Director, says “there are headwinds that, though significant, look to be surmountable and temporary.”

Whether it is the uncertainty shadowing US corporate mindsets or regulatory scrutiny over compliance proposals, support for environmental and social activism dropped at the 2023 annual meetings of US companies, the Financial Times has reported. Big corporates that can influence shareholder and market ESG sentiment, such as Amazon, ExxonMobile and even the United Parcel Service have shown “waning enthusiasm” about ESG matters, the report states.

Simpson says: “LPs have often made sustainability commitments. As the macro-economic environment and, consequently, their asset allocation have changed, the focus on assets that can make the greatest contribution is more important than ever.” He is of the opinion that private markets are best placed for this allocation owing to the stewardship levers they can pull and the impact this can have.

“There has been a certain amount of hesitation within the GP impact community as they struggle with investment under a series of regulations such as SFDR, EU Taxonomy, SEC

Figure 2.1 Appetite for impact investing isn’t hindered by the economic climate



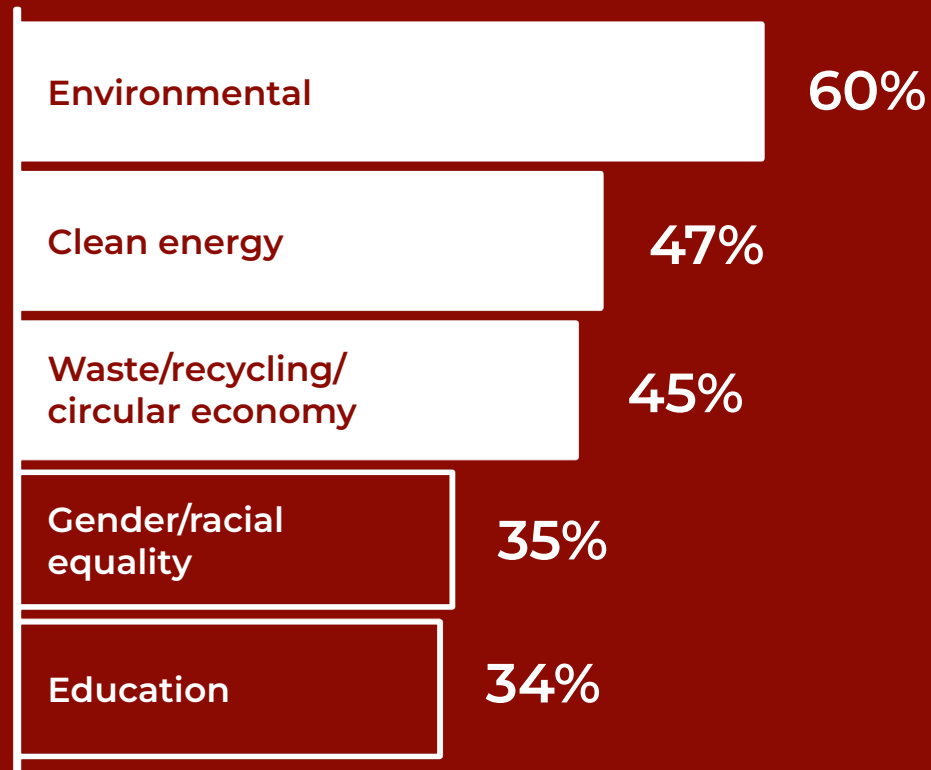
Analyst note: Respondents were asked, ‘Have you or a client raised an impact fund in the past 4 years?’ and ‘Will you/your client be raising one in the next 12 months?’

Source: Private Equity Wire readers survey

KEY FINDINGS

Environmental sustainability considerations dominate the impact investing agenda

Top five benefits in focus in impact investing



Debt diversity

With impact investing being the fastest growing asset class, it looks like it will be a natural progression for sponsors to target private debt aimed at impact deals.

“There are many impact funds across the spectrum of private debt, but it is still a challenge to look at secondary and mezzanine debt”, says Petra Funds Group’s ESG Director, Hugh Simpson.

“In this context, direct lending is the most typical way of investing for impact,” he says.

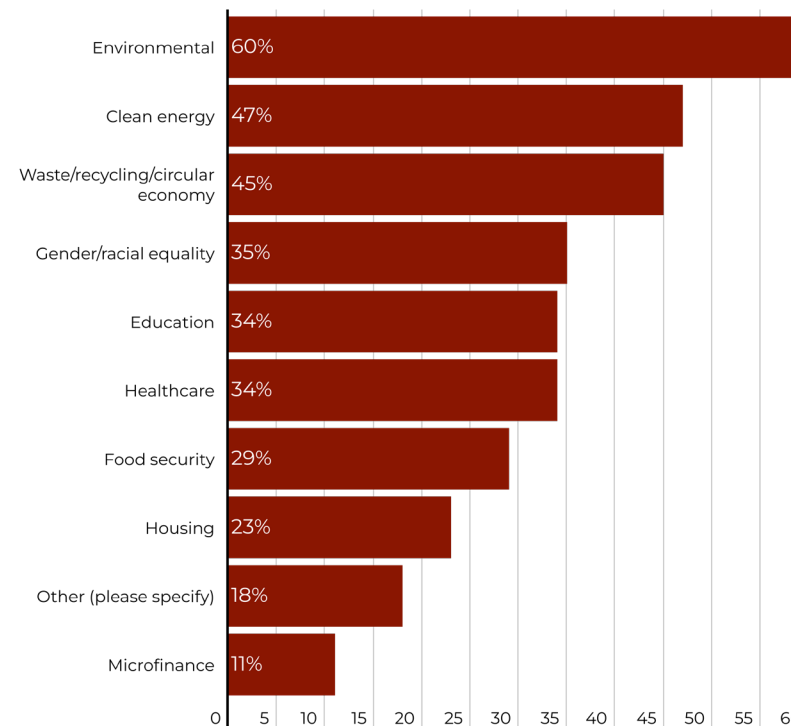
Investors are using several tools to identify and invest, such as Sustainability-Linked Loan (SSL) principles and margin ratchets to tie financing to specific outcomes. To facilitate this, Simpson explains a number of players will become

involved, including sponsors, investors, ratings agencies, loan administrators and legal teams.

The use of SLL criteria also means enhanced activity from the ESG teams that will be involved in investment and through the hold to monitor against goals and their associated margin ratchets.

Asset class-wise, real assets remain the most active, followed by private equity, says Simpson. “Those investors who are most interested are pension funds, insurance companies, foundations, and endowments. They are looking for fixed-income products to meet their cash flow, liability, and fiduciary requirements that don’t correlate with the market and can help them reach their impact goals.”

Figure 2.2 Benefits in focus for impact investing



Analyst note: Respondents were asked, ‘Which social and/or environmental impact benefit(s) is your fund/client’s fund targeting?’ (Please select all that apply)

Source: Private Equity Wire readers survey

and LP restrictions, among others. Those that are succeeding are building these factors into the investment process,” says Simpson.

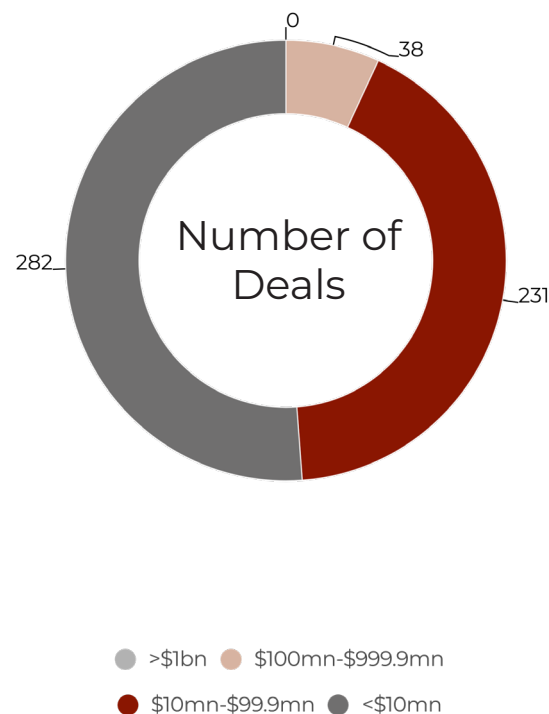
Regulators are flexing their muscles to eliminate greenwashing propagated by woolly ESG reporting and conflict of interest between credit rating agencies and funds. Credit agencies providing ESG consultancy or insurance to businesses they rate could receive fines of up to 10% of their annual turnover if conflicts of interest are found, according to an upcoming rule proposed by the EU financial regulator. The rules will be applied to agencies inside and out of the EU bloc, reports The Financial Times.

DIRECTION OF DEPLOYMENT

There are 357 impact private equity funds and counting across the globe, with the US dominating the market for number of funds raised to date, followed by Europe and Asia (See Fig. 1.2.).

According to Preqin data, venture capital funds are the most active impact investors – accounting for 607 deals completed worldwide between January 2022 and May 2023 – compared to 78 in the private equity space. Most VC opportunities seem to arise in the sub-\$100mn zone (See Fig. 2.3). However, with impact funds now raising in excess of \$3bn – TPG Rise Climate, Clean Technology Fund and Beyond NetZero, to name a few – we can expect the \$1bn impact fund to become more commonplace over the next couple of years. Even inaugural funds such as Just Climate’s

Figure 2.3 Distribution of VC deals by deal size



Analyst note: Total number of deals = 551

Source: Preqin

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There are headwinds that, though significant, look to be surmountable and temporary

Hugh Simpson
ESG Director, Petra Funds Group

Climate Assets Fund I closed at \$1.5bn, exceeding its \$1bn target. The involvement of high-profile founding investors such as Microsoft's Climate Innovation Fund makes it easier for managers to sell their strategies to other investors such as CalSTRS and AP4, for instance.

For now, Preqin data suggests that buyout and growth deals will likely dominate mega funds much like they always have. Our own survey data reveals sponsors will be looking to Europe predominantly for the most attractive opportunities, followed by the US and Asia (See Fig. 2.4).

Bridgespan's Chris Addy, Partner and Head of Market Impact Southeast Asia, Singapore, says impact funds in Southeast Asia have not been affected by high interest rates, mainly because they are backed by government and sovereign wealth funds and, increasingly, family offices – the latter are taking a hands-on approach to impact investing, which is not the case in markets such as the US.

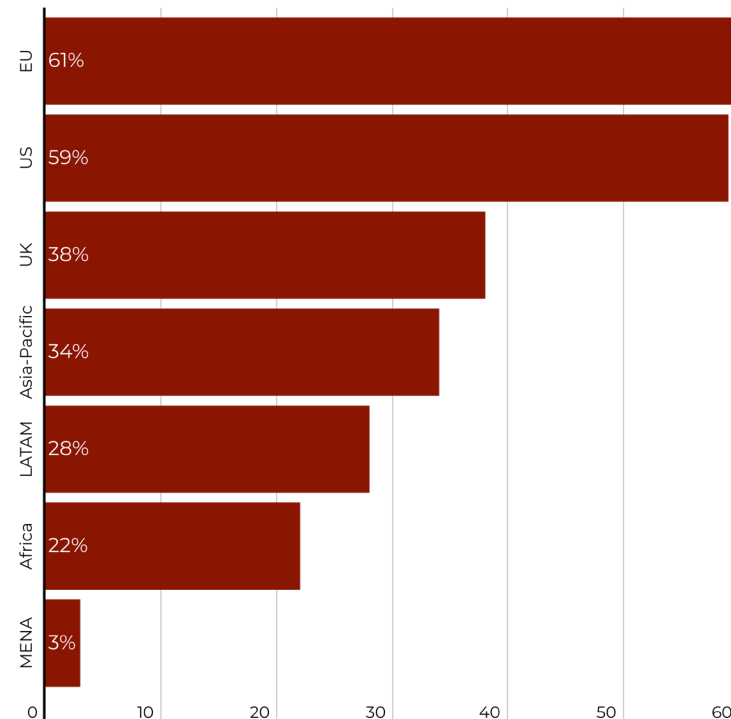
Addy says impact investing in the region is not dissimilar to what it was like in the US a decade ago – with lots of discussion on how to create ESG frameworks and networks so local funds eventually emerge.

The lack of impact funds in Asia poses an opportunity for international and regional players alike. However, unlike the autonomy they enjoy in their home markets, they will learn to expect a closer relationship with governments, monetary authorities and family offices in markets such as Singapore, Malaysia and Indonesia, all of which are ripe for impact investment. ■

KEY TAKEAWAY

Demand for impact investments is set to grow across venture, private equity and debt over the next two years, though growing regulatory scrutiny over ESG ratings and strategy transparency will make fundraising a challenge.

Figure 2.4 Geographic focus for impact investors



Analyst note: Respondents were asked, 'Which three geographic markets do you rate as having the most attractive impact investment opportunities?'

Source: Private Equity Wire readers survey



LENDING FOR CHANGE

Growing investor interest and favourable market conditions could expand the currently limited role that private credit plays in the world of impact investing

Private credit funds occupy only 13% of the global impact fund pool (See Fig.3.1), lagging behind private equity impact investments in every region (See Fig. 3.2), according to Phenix Capital data from early this year. This is despite climbing investor interest in both impact investing and private debt as a whole – the latter owing to skyrocketing rates of return in the current economic landscape.

GPs seem to be missing a trick – in a challenging fundraising landscape, impact and ESG assets appear a popular choice among debt allocators. “Article 8 and Article 9 funds are perceived as lower risk, which makes them an attractive prospect. In particular assets that can demonstrate their impact in line with institutional environmental and social development covenants can minimise risk exposure,” says Martin Bang-Löwgren, Head of Sustainability at Polaris.

PwC Luxembourg data reveals 71.6% of private debt-focused LPs globally position ESG reporting as an important GP selection criteria, but notes a widespread perception that lending comes with less responsibility to drive change than ownership as a reason for slow GP uptake in this space.

There are signs of progress – Amy Wang, Managing Director and Head of Credit Strategies at Blue Earth Capital notes that while the impact private credit market remains fragmented, it’s diversified and growing with large capital inflows. “There are a range of players in this space, from large global funds that have adjusted their strategies to incorporate an ESG lens to emerging specialist impact funds like ourselves.”

“Specialist funds can broadly be categorised into two types: global funds mostly focused on

certain key sectors in either climate or financial services/fintech, or smaller regional players that may be multi-sector in their purview. In emerging markets, we're seeing a lot of activity from Developmental Finance Institutions.”

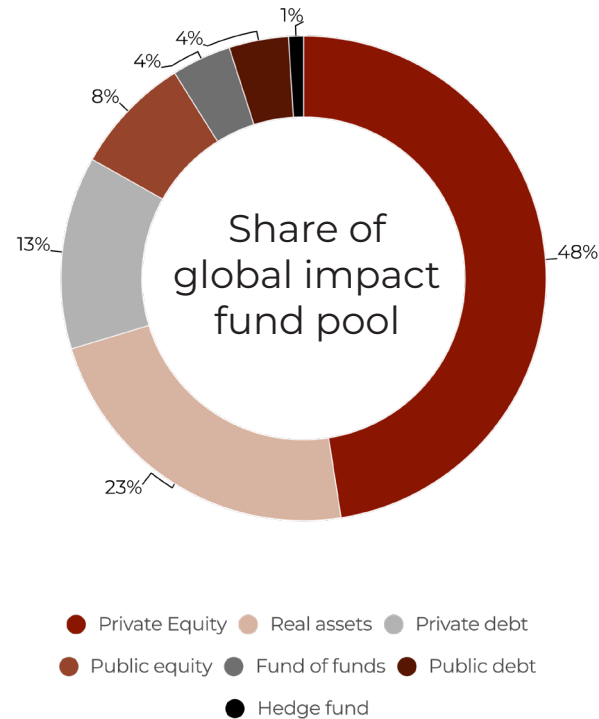
Wang notes the focus areas for impact credit are sectors that are essential to human development outcomes such as quality of health, jobs and homes – businesses in all of these areas will remain in high demand even through recessionary conditions.

DEBT CALIBRE

But despite growing LP appetite, a long-standing challenge for private credit fund managers as they take on a bigger impact portfolio is to reconcile impact performance with commercial gains, while also balancing the level of liquidity sought by allocators. From a commercial perspective, impact credit mirrors the general risk benefits of credit as an asset class – more visibility and certainty on returns relative to equity, downside protection and lower capital charges, among others.

Credit also has significant ESG impact potential. Ricardo Cavilliotti, Vice President at Allianz Global Investors, focused on private debt impact investments, says: “Equity tends to be considered the most impactful type of capital, given shareholders’ ability to drive the strategic decisions of businesses and projects. But impact debt capital can be more scalable given the higher proportional utilisation of debt, especially in large infrastructure projects and in the sponsored space. They also have the

Figure 3.1 Global impact investing pool by asset class



Analyst note: Private credit occupies only 13% of the global impact investing asset pool

Source: Phenix Capital

KEY FINDINGS

Private credit holds a small piece of the global impact investing pie

Share of private credit in global impact investing

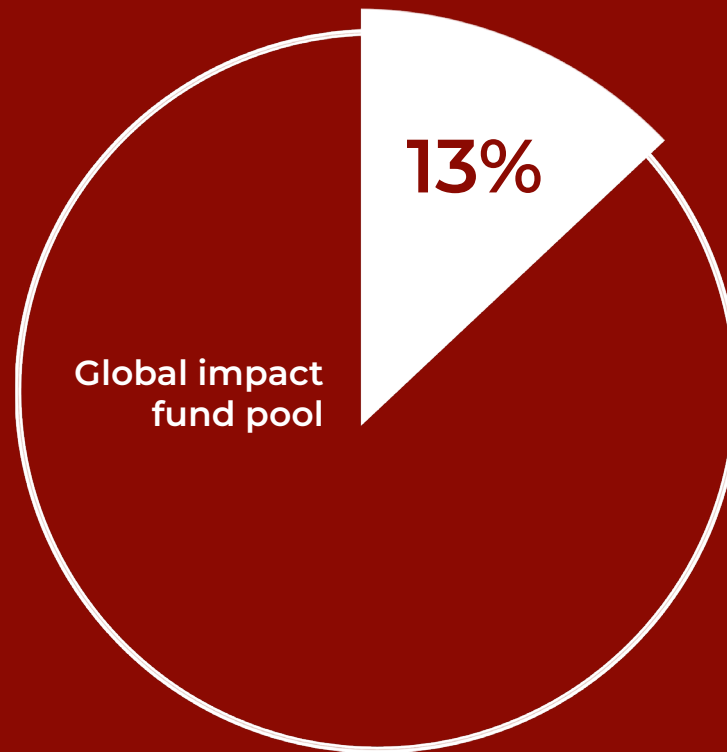
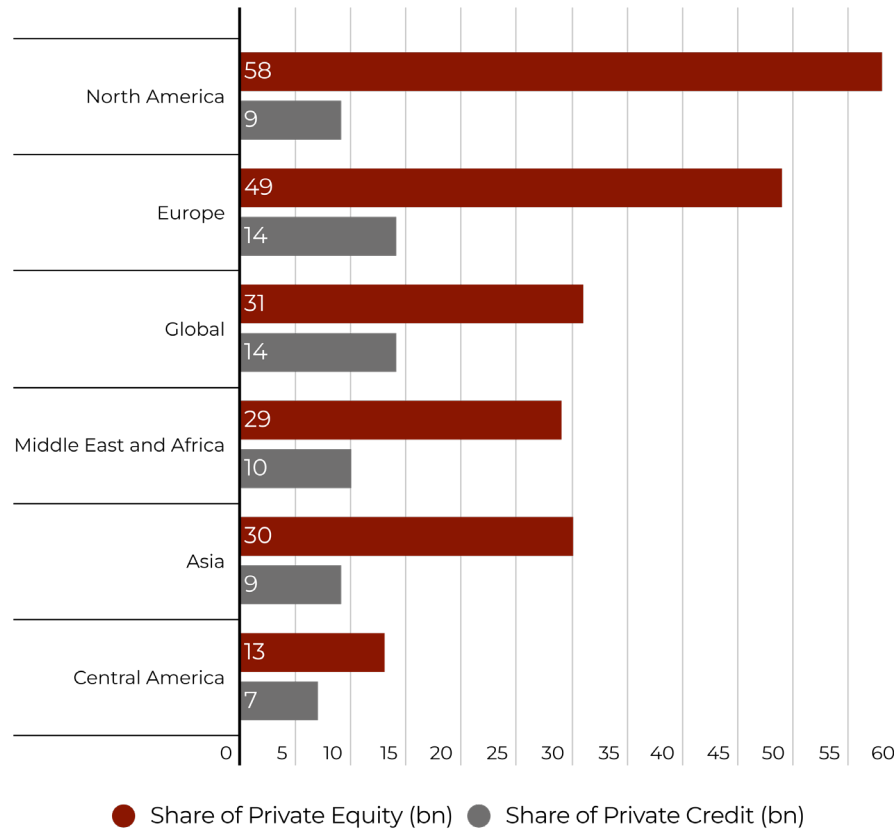


Figure 3.2 Private equity/private credit split in impact investing by region



Analyst note: Impact private credit lags behind impact private equity in every region

Source: Phenix Capital

ability to generate impact by funding growth or providing rescue capital.”

Wang adds: “Businesses in the impact space have historically had less access to traditional financing such as banks or equity funds. Stricter financing conditions with interest rate rises and uncertain equity valuations will steer many businesses looking for capital towards private credit to support their growth needs.”

BALANCED EXPECTATIONS

Measuring impact remains an evolving discipline – our survey revealed 73% of fund managers agree that the rise of more impact funds will put impact underwriting at a similar level of importance as financial underwriting (See Fig. 3.3). “Incorporating both levels of analysis allows an investor to better understand the business case and long-term value creation opportunity, as well as risk. It really is a win-win,” says Wang.

Still, our survey data shows a meagre 11% of fund managers report that they use the Global Impact Investing Network’s Impact Measurement and Management (IMM) return model to calculate the social and/or environmental return on every dollar (or equivalent) spent (See Fig. 3.4).

Undercooked measurement strategies may have fundraising implications. “It seems the perception of lower risk around impact funds hasn’t put real downward pressure on interest rates just yet, as KPIs around impact remain ambiguous,” says Bang-Löwgren.

Blended finance

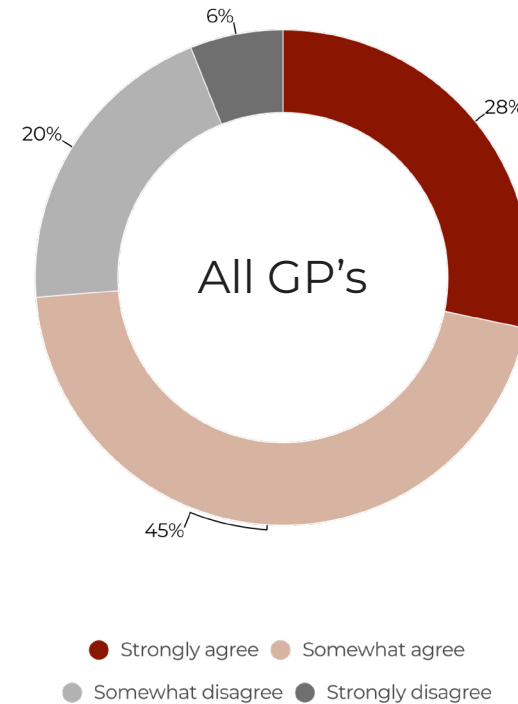
Blended finance – defined by the Global Impact Investment Network as “a strategy that combines capital with different levels of risk in order to catalyse risk-adjusted market-rate seeking financing into impact investments” – is an increasingly popular option for impact credit funds.

Usually a mix of public and private capital, blended finance is conducive to large-scale impacts – with public funds absorbing the ‘concessional’ return rates in order to protect the financial interest of private investors. Given that risk and return factors have played a key role in hindering the rise of impact credit funds, blended finance could be the way forward for many GPs that are nervous about their financial exposure – giving them more impact for their buck too.

“Blending has mostly been relevant in emerging and frontier markets, where the need for investments significantly exceeds the capital flowing. But it can also play an important role in developed economies, supporting institutional investors in increasing their appetite for newer clean technology investments that tend to generate material environmental impact,” says Nadia Nikolova, Lead Portfolio Manager, Development Finance at Allianz Global Investors.

“Importantly, blending techniques should not be used where there are capital providers who are willing to invest without de-risking – that is, blending should have strong additionality when used.”

Figure 3.3 The growing importance of impact underwriting



Analyst note: Respondents were asked, “To what extent do you agree that impact underwriting will become as important as financial underwriting as more impact funds are raised by private equity sponsors?”

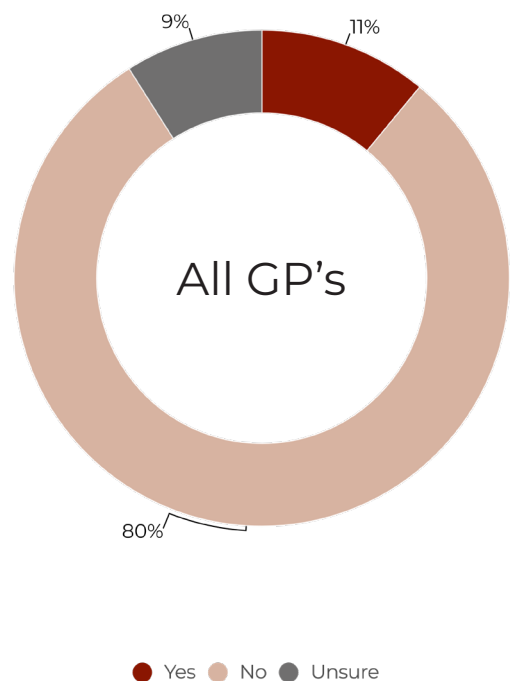
Source: Private Equity Wire Readers Survey

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Impact debt capital can be more scalable given the higher proportional utilisation of debt, especially in large infrastructure projects and in the sponsored space

Ricardo Cavilliotti,
Vice President, Allianz Global Investors

Figure 3.4 Adoption of the Impact Measurement and Management return model



Analyst note: Respondents were asked, 'Do you use the Impact Measurement and Management return model to calculate the social and/or environmental return on every dollar (or equivalent) spent?'

Source: Private Equity Wire Readers Survey

Fund managers use a range of measurement tools aligned with institutional covenants such as the UN's Sustainable Development Goals to set key performance indicators for their impact portfolios. An example is Allianz Global Investors's Impact Scoring System, which evaluates the 'impact thesis' of portfolio companies, adding other dimensions such as the additionality and differentiation of a company's offering, and risks that may reduce the likelihood of impact delivery.

Diane Mak, Director of Impact Measurement and Management at Allianz, notes that a range of comparative studies – between the impact products and other counterparts – as well as surveys among target populations can then be used to measure and test these KPIs. But there are complexities here too. "Output indicators, such as number of students educated, for instance, are easier to collect data for than outcome indicators, such as improvement in learning outcomes. Plus, different companies will be at varying stages of their impact measurement journey," says Mak.

"Fund managers can track and monitor reported impact at both the company and portfolio levels – they can compare ex-ante estimated impact to actual impact over the course of investment and benchmark impact performance across companies within the same sector, to better inform ongoing engagement with the underlying portfolio companies."

Mak also commented on the tension that might emerge between impact KPIs and financial

performance within the same portfolio. In many cases, she says the two sets of indicators will largely be aligned, but there are scenarios where they'll be at odds.

"For instance, it may be more profitable for an emerging markets-based financial services provider to serve middle-income households – generating impact at scale but with less depth – as opposed to a company serving lower-income, harder-to-reach households, which inverses the depth-to-reach ratio. To counter this, we take a multidimensional approach to assessing the impact of a company, and then construct our portfolio along impact/returns/risks considerations accordingly." ■

KEY TAKEAWAY

Impact measurement remains critical to unlocking credit's ESG potential – nearly three-quarters of managers agree that impact underwriting will become as important as financial underwriting as impact funds proliferate.

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Published by: Global Fund Media, Lion Court, 25 Procter St, London WC1V 6NY

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