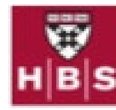

The Measurement of Impact Investors in an Age of Skepticism

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Summary: The past decade has seen a surge of activity in impact investing funds, as both fundraising and investments by dedicated groups and offshoots of large asset managers have grown sharply. The year 2023, however, presents a more challenging reality. Not only has the downturn triggered a "flight to safety" that has made fundraising more challenging for many groups, but impact investing has attracted critics from both the right and left ends of the political spectrum. This Webinar workshop explored these important issues and discussed a recent academic paper that examines whether impact investors are doing deals differently, in particular funding companies that would otherwise not have been. The panelists included Lisa Hall (Impact Chairperson, Private Equity at Apollo*),* David Kirkpatrick (Managing Director and Co-founder, SJF Ventures), Andrew Lee (Global Head of Sustainable and Impact Investing, UBS Global Wealth Management), and Ben Roth (Assistant Professor, Harvard Business School). Brian Trelstad (Senior Lecturer, Harvard Business School and Partner, Bridges Fund Management) was the moderator.

According to *The Economist* magazine, more than $35 trillion of assets globally are selected using some sort of sustainability lens, an increase of 55% since 2016.[1] Private capital is no exception: The size of impact funds (as sustainability-oriented venture, growth, and buyout funds are known) and the sheer number of players in the space have grown sharply. While there has been a considerable increase in dedicated impact investors, like SJF or DBL Partners, large asset managers such as Apollo, TPG and Bain Capital have also entered the space with large, dedicated impact funds.

The recent economic downturn, however, has created a few setbacks in impact investing. As in earlier periods of uncertainty and poor performance, investors have increasingly turned to established groups and strategies. Moreover, funds with a "do good" mandate are receiving increasing regulatory scrutiny. Some critics argue that the ESG ("Environmental, Social, Governance") investing missions have had negligible (or impossible to measure) effects on climate and social issues[2] especially given some evidence

[1] "The Fundamental Contradiction of ESG is Being Laid Bare," *The Economist*, September 29, 2022., https://www.economist.com/leaders/2022/09/29/the-fundamental-contradiction-of-esg-is-being-laid-bare?utm_medium=cpc.adword.pd&utm_source=google&ppccampaignID=17210591673&ppcadID=&utm_campaign=a.22brand_pmax&utm_content=conversion.direct-response.anonymous&gclid=Cj0KCQjw7PCjBhDwARIsANo7Cgm-YeiHzWj-cc73f1qGMP9iYgMkn7Psx865PGIQ81Aa50DrEQLWUq8aAkKbEALw_wcB&gclsrc=aw.ds.
[2] Tariq Fancy, "Tariq Fancy on the Failure of Green Investing and the Need for State Action," *The Economist,* November 4, 2021, https://www.economist.com/by-invitation/2021/11/04/tariq-fancy-on-the-failure-of-green-investing-and-the-need-for-state-action.

of underperformance by these funds.[3] Other critics have characterized investments in impact funds as efforts by elite institutions and individuals to impose their "woke" beliefs on pensioners and governments. These latter claims have led, for instance, the states of Florida and Texas to ban their pension funds from dealing with ESG-mandated investment firms.[4]

Defining Impact Investing

Before beginning the discussion of market conditions, there is an important distinction to be drawn between ESG and impact investing. Both concepts sit under the broader term of sustainable investing. But the ESG criteria can be applied in all types of private equity funds and center around the best practices and policies on environmental, social, and governance in portfolio companies. In practice, ESG is part of the due diligence, monitoring, and tracking of investments over time and is an essential element of creating value.

Impact investing, on the other hand, is a focused approach to investments where there is intentionality around objectives on the part of the investor and specific impact outcomes are measured in addition to financial returns. Some impact investors seek a market rate return, others a lower, or concessionary, return. This return orientation depends on the source of capital. A traditional fund manager with market-return-seeking limited partners, like Apollo or SJF, is aiming for market-rate returns for their asset class (venture capital or private equity). A concessionary fund manager, like Acumen or the Chicago Community Loan fund, which raises a combination of grants and concessionary investments, may prioritize impact over financial returns. An impact investor can focus on many areas, seeking to address poverty, racial justice, climate change, environmental degradation, etc.

Thus, a defining element of impact investing is the desire for real-world change that comes through impact-oriented solutions. Over time, the solution side has gotten more nuanced. Impact preferences have gotten more specific in terms of what people are looking to achieve, sometimes paired with their philanthropic objectives. The rise of specificity from clients has also given rise to more targeted types of vehicles that are not multi-thematic and may focus within verticals like climate, health care, or education.

The process of growing an impact portfolio company varies greatly. For instance, scaling a solar company differs significantly from scaling a diabetes company. One issue that sometimes arises is a mismatch where an impact fund is too small for the opportunity. Thus, there is no ability to contribute the capital needed in a follow-on financing to scale the business and deliver growth. As a result, a portfolio business may be starved for capital at a critical time, or the impact investor's stake may be substantially diluted down. Thus, it is essential for impact funds to grow with their portfolio companies, or at least to have impact funds that address different stages of investment.

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[3] Barber, Brad M., Adair Morse, and Ayako Yasuda, "Impact investing," *Journal of Financial Economics*, 139, 2021, 162-185.

[4] State of Florida, "Governor Ron DeSantis Further Prohibits Woke ESG Considerations from State Investments," January 17, 2023, https://www.flgov.com/2023/01/17/governor-ron-desantis-further-prohibits-woke-esg-considerations-from-state-investments/; State of Texas, "Governor Abbott Denounces ESG Standards Harmful To U.S. Energy Sector," March 16, 2023, https://gov.texas.gov/news/post/governor-abbott-denounces-esg-standards-harmful-to-u.s-energy-sector.

A related question is about exits of these investments. It is crucial for the returns of impact funds that when early-stage impact companies eventually scale up, they have attractive exit opportunities. While there have been a few recent large IPOs of impact portfolio companies (the $638 million IPO of Dave's Nextracker and the $200 million IPO of Vital Farms), historically, impact portfolio companies do not generally exit in an IPO, due to their relatively modest sizes. Instead, they are acquired in a strategic acquisition or a buyout by another private equity fund. Ensuring exits that do not compromise the impact goals of the firm (e.g., by shutting down the impact company's facility in a disadvantaged neighborhood and moving work elsewhere) is an ongoing challenge.

State of the Market: Impact Investing Fundraising

The combination of events highlighted in the opening paragraph led to a plateauing in impact fundraising between 2020 and 2022. Mirroring the challenges facing private capital fundraising overall[5], a decline in impact funds raised is anticipated in the first half of 2023. The panelists believe that most of the recent downturn is just part of the cyclical nature of the industry and a reflection of the tougher economic environment. In addition, the negative backlash against ESG, in the U.S. in particular, has had some modest spillover effects on impact investing, although there was some debate as to whether impact investing might be too small a niche to attract political attention at this point.

Despite the skepticism, the panelists still saw a lot of interest in impact investing. They felt it likely that there will be an uptick in the years to come, especially for impact funds with a clear strategy for real-world change and a strong track record. Also, the panelists saw the downturn as a good opportunity to enter the market as multiples have dropped, and there is more leverage in negotiating deals.

One persistent challenge for many impact funds has been getting access to wealth management platforms, such as UBS, housed within global financial services firms and others. Some of the challenges for platforms in approving impact funds include their relative lack of track record, size, and other typically institutional requirements. But high net worth investors have historically been an important backer of impact funds. Thus, more work must be done to build on more recent progress to make impact funds available to investors, particularly on the non-institutional side, where a huge amount of capital potentially awaits.

Measuring Impact

An essential aspect of impact investing is documenting real-world impact targeted by these funds. Many different existing standards (e.g., the Impact Reporting and Investment Standards, or IRIS, the B Impact Assessment tool, and more specialized metrics such as CDP's global environmental disclosure system) provide frameworks for thinking about the type of impact achieved.

[5] Preqin database; Bain & Company, *Navigating a Shifting Tide, Global Private Equity Report 2023,* 2023.

However, there really is no near-universal measure like IRR ("internal rate of return") or MOIC ("multiple on invested capital") on the financial side. Thus, the biggest challenge is harmonizing metrics to be able to compare "apples to apples." There is some progress with the International Accounting Standards Board's International Financial Reporting Standards. In Europe, there has been progress in integrating impact into financial disclosures under the Sustainable Financial Disclosure Regulation (SFDR). These existing impact measurement standards allow new fund managers to enter the space without having to "reinvent the wheel."

But taken together, there is still a long way to go in terms of harmonizing and measuring impact. The particular goals of impact funds' portfolio companies often differ, making evaluation and comparability generally challenging. (However, the rise of more thematic funds is helping to create good comparisons to one another from an impact standpoint.)

Impact Investing Research

The discussion then turned to looking at a recent academic study. Using a novel dataset of over 6,000 impact portfolio companies, Ben Roth and his colleagues sought to answer some important questions about whether impact investors were materially different from traditional investors.[6] First, they explored to what extent the investments of impact investors differ from traditional venture capital and private equity firms. Second, they examined the notion of additionality, which is the extent impact investors facilitate deals that traditional investors would not have invested in.

- ***Where are Impact Investors Investing***? The research shows that impact investors in the U.S. invest in companies headquartered in poor counties, more rural areas, and areas with fewer high school graduates. Impact investors are more likely to invest in consumer staples, energy, financial services, and real estate than traditional investors. In addition, the research finds evidence that impact investors are early movers and are more likely to invest in new industries. Thus, these impact investors are investing in companies that are among the first in their industry to raise financing, demonstrating that impact investors are more tolerant of risk.

- ***Are Impact Investments Additional?*** There was a consensus amongst the panelists that impact investors should lead the way and invest where traditional investors would otherwise not, i.e., they should be "additional." Impact investors should look for opportunities, not just for financial value creation, but also impact value creation. They should look for overlooked opportunities and areas that traditional investors are not paying attention to. These opportunities are not necessarily of lesser quality, but in many cases have the potential to have lower returns (as the studies alluded to above document).

[6] Cole, Shawn, Leslie Jeng, Josh Lerner, Natalia Rigol, and Benjamin Roth, "What do Impact Investors do Differently?," SSRN working paper, 2023, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4233480.

The research of Roth and his colleagues explores whether impact investors are indeed additional. The study finds little evidence that impact investors facilitate new deals that traditional investors do not make. The researchers examine the co-investment patterns between traditional and impact investors to understand whether impact investors are simply investing in the same round alongside a traditional investor in a deal that would have otherwise attracted traditional investors. In this case, the impact investor is not creating space for new companies that would have had trouble attracting capital from traditional investors. Only 12% of impact investors in the research data either never or rarely co-invest in traditional investors. Thus, very few impact investors are actively seeking out deals that are unattractive to traditional investors. In that sense, they may not contribute to addressing the capital gaps that young impact-focused firms face.

- **What Happens After the Investment?** At the post investment stage, the research examines whether having an impact investor makes you a more attractive employer. Using data from Revelio, the researchers look to see if the ratings on metrics such as employee satisfaction and diversity and equity improve. They find no evidence that ratings improve and in fact, ratings go down, similar to when traditional VCPE investors invest. The research will study in the future how impact investments will affect consumer ratings of portfolio companies.

The panelists felt that the results around additionality were understandable. They explained that it is difficult to scale an impact fund if one does not co-invest with traditional investors and aim for at least market-rate returns as well as impact. Thus, many impact funds may start making concessionary investments initially, but later change their strategy to targeting market rate (or better) deals. Furthermore, even though impact investors may not be additional, they can bring deep-pocketed investors to the table, which will enhance their portfolio companies and accelerate their growth rate.

Conclusion

Despite the current ESG backlash, impact investing is an important and innovative endeavor, albeit a rapidly evolving one. Investors purporting to drive impact should ensure they focus on delivering real-world change and aim to focus – where possible – on underserved stakeholders including the planet. A crucial part of impact investing’s continued success will be its ability to credibly deliver measurable positive impact outcomes.