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Impact Investing in Focus

By Kunal Shah and Tatiana Esipovich

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Impact investing has become a vibrant option for high-net-worth investors seeking to align their portfolios and their values.

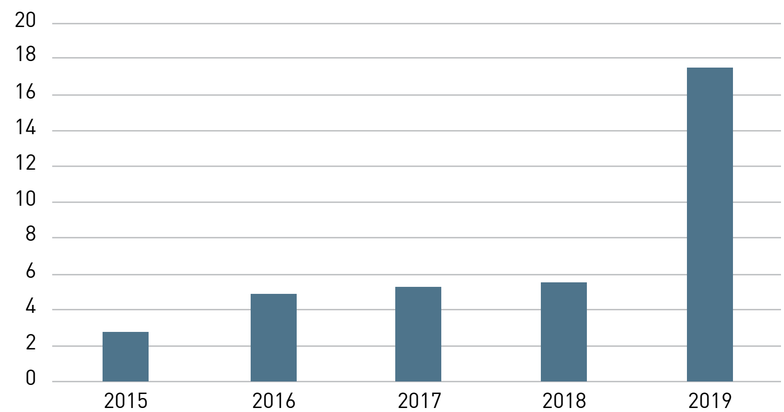
For example, Carbon Engineering is a Canadian clean energy company that, following a decade of development, launched commercial technology that extracts carbon dioxide from the atmosphere, much like photosynthesis but faster. The CO_2 is then compressed, stored, and later converted to a carbon-neutral fuel.

A growing number of small, private companies like Carbon Engineering are making social and environmental objectives an integral component of their businesses. As the economics of sustainability have improved—particularly in the renewable energy category—and the scope of impact has expanded beyond a narrow focus on the environment, these companies have become increasingly attractive to private equity investors.

The combination of this growing opportunity set and burgeoning investor interest in sustainability has set the stage for the rise of impact investing, a segment within the sustainable investing universe that seeks to generate a measurable social and environmental impact alongside a market-rate investment return.

Figure 1

FLOWS INTO SUSTAINABLE FUNDS



Note: Figure for 2019 is through the end of November. For illustrative purposes only.

Source: Morningstar and the Wall Street Journal*, as of November 2019.*

PRIVATE MARKETS ARE WELL SUITED FOR IMPACT

Compared with sustainable investment strategies offered in the public markets, we believe the private markets are better positioned to deliver positive impact while achieving market-rate financial returns. There are a few reasons for this. First, investors in public markets typically own a small percentage of shares and, as a result, have limited ability to influence the impact potential of these companies. Rather than actively drive impact, sustainable public market strategies often take a more passive approach by screening out undesirable industries (for example, fossil fuel or armaments) or investing in companies that perform well on environmental, social, and governance (ESG) measures.

One of the more common ESG-related approaches, known as ESG integration, often is marketed as "socially responsible," but a look under the hood of some of these funds reveals a larger focus on risk management related to corporate governance than on achieving positive environmental or social impact. Amid a dramatic rise in ESG assets under management, illustrated in figure 1, the U.S. Securities and Exchange Commission (SEC) is beginning to scrutinize funds' socially responsible claims to determine whether they are legitimate or amount to marketing spin, a phenomenon known as "greenwashing."[1]

Private equity (PE) firms, meanwhile, maintain significant influence over portfolio companies, enabling them to drive improved impact and financial outcomes. The PE model creates efficiencies by leveraging resources and expertise in management and technology across a portfolio of companies. As PE firms become more focused on impact, they are employing this model to deploy, manage, and measure the success of ESG programs and specific impact initiatives systematically across companies.

Another reason private markets can better foster impact is that the public markets tend to be less hospitable to smaller companies developing untested approaches or that have longer time horizons. Many impact-focused companies are innovative and technology-oriented, and they need time to prove their ideas. The vast majority of these companies are located in the private markets. The long-term nature of private equity better enables these companies to thrive: Unencumbered by quarterly reporting requirements, impact-focused private companies and their investors can be flexible and patient in building and following through with longer-term solutions to intractable social and environmental challenges. Public companies seeking to make an impact, meanwhile, must weigh the benefits of such long-term projects against critical near-term financial targets.

DEMAND FOR SUSTAINABLE INVESTMENT STRATEGIES IS RISING

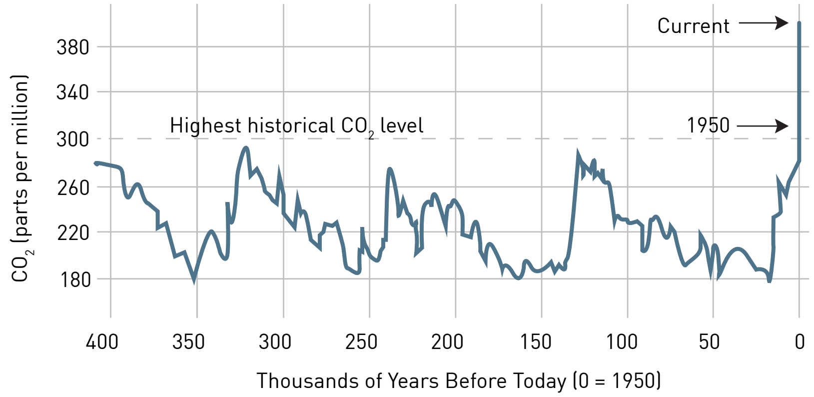
As issues related to global sustainability have gained prominence in recent years, investors have become increasingly interested in the sustainability of their portfolios. According to research from Bain & Company, 80 percent of global investors say they are more focused on sustainability today than five years ago.[2] Among individual investors, interest is particularly high among younger generations, who tend to be more socially and environmentally conscious than their parents. Millennials, who overtook baby boomers as the largest adult generation in the United States in 2019,[3] are twice as likely as the overall population to buy products from sustainable companies,[4] and 95 percent of millennials say they are interested in sustainable investment approaches.[5] With baby boomers expected to transfer an estimated $30 trillion in financial and nonfinancial assets to their heirs in the coming decades, this focus on sustainability bodes well for the growth of the impact category.

SUPPLY OF IMPACT-FOCUSED COMPANIES AND FUNDS HAS MATURED

Early impact PE funds were part of a nascent market that we refer to as "Impact 1.0." Often, companies in these v.1.0 funds were backed by government

Figure 2

CO_2 LEVELS HAVE RISEN



Data source: Reconstruction from ice core. Credit NOAA. For illustrative purposes only.

PRIVATE SECTOR IS INCREASINGLY INVOLVED IN SUSTAINABLE DEVELOPMENT

Shifting demographics are stressing the world's finite resources and contributing to social and environmental challenges. The global population is on track to grow to nearly 10 billion by 2050—an increase of 2 billion people in the next 30 years who will require water, energy, agriculture, and housing.* The development required to meet the needs of a growing population has driven global greenhouse gas emissions 48 percent higher since 1990, heating the Earth's atmosphere to devastating effect (see figure 2). Demographic changes also are having a significant societal impact in areas such as poverty, social inclusion, and health care.

Public institutions have taken the lead historically in addressing issues arising from demographic trends. As a country's population grows, for example, its government typically builds schools, power plants, and other essential infrastructure, such as roads and ports, to meet its evolving needs. Today, however, a growing funding gap exists between what public institutions can provide and what is required to serve their populations sustainably.

The United Nations laid out a blueprint that endeavors to end global poverty and protect the planet by 2030 in its 17 Sustainable Development Goals (see figure 3), but progress will come at a high financial cost. The UN Commission on Trade and Development estimated that $5 trillion to $7 trillion in annual investment would be required to achieve the SDGs, with 50 percent to 80 percent coming from governments and the rest from private capital.** This has opened the door for the private sector to supplement the development work of public institutions.

* *United Nations, "World Population Prospects 2019: Highlights" (June 2019), https://population.un.org/wpp/Publications/Files/WPP2019_10KeyFindings.pdf.*

** *Mara Niculescu, "Impact Investment to Close the SDG Funding Gap," United Nations Development Programme (July 13, 2017), https://www.undp.org/content/undp/en/home/blog/2017/7/13/What-kind-of-blender-do-we-need-to-finance-the-SDGs-.html.*

Figure 3

UNITED NATIONS SUSTAINABLE DEVELOPMENT GOALS

Source: United Nations. For illustrative purposes only.

subsidies (in the case of renewables) or forward-thinking pioneer investors, such as the World Bank. Meanwhile, the funds themselves were small and managed by first-time managers. Early impact funds were typically in the higher-risk venture space, focused on environmental concerns, and often delivered underwhelming performance.

Today, the cost of renewable energy has declined significantly, enabling these companies to achieve commercial viability.

These early impact companies and funds paved the way for Impact 2.0, a more mature, institutionalized sphere that has achieved scale and offers investors opportunities to participate at lower risk levels, with better return potential. Several factors have helped drive this evolution:

Reduced costs. Innovative, tech-focused companies in the impact space initially faced challenges achieving wide adoption of their products because of their costs. Early renewable energy companies, for example, spent considerable time and resources to develop alternatives to fossil fuel that, in the beginning, were significantly more expensive than traditional energy sources. Today, the cost of renewable energy has declined significantly, enabling these companies to achieve commercial viability.

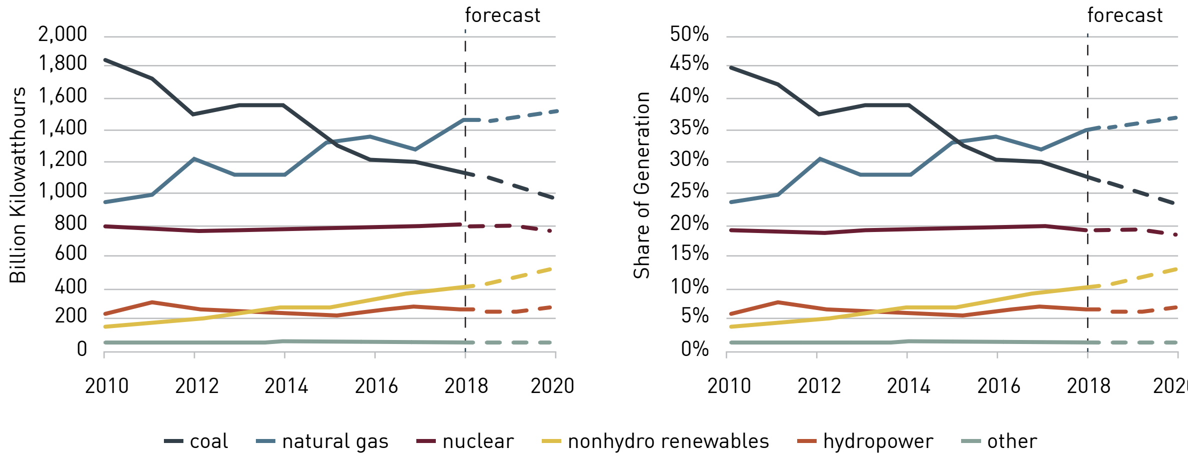
Increasing number of impact companies. As the pioneering companies of the early impact days have achieved commercial viability, many others have cropped up, seeing opportunity in developing solutions to environmental and social challenges. Existing companies also are leveraging technology to improve their impact potential. These companies are attracting investors seeking to capitalize on long-term sustainability trends. One example is Techem, a 67-year-old European company that provides water and heat sub-metering services. In recent years, the company has developed technology solutions to help consumers reduce their energy use, saving 6.9 million tons of CO_2 emissions annually, making it a viable impact investment.[6]

Broader penetration of sectors and investment categories. Compared to Impact 1.0, which focused largely on green technology, Impact 2.0 boasts a much wider variety of impact-oriented investment opportunities across sectors, including health care, education, financial services, and others. This enables investors to achieve a greater degree of diversification. Additionally, issues addressed by v.2.0 impact funds have broadened beyond environmental solutions to include social and governance concerns, and fund managers are introducing private credit, growth equity, and buyout models. We've even seen the introduction of a secondary impact strategy, which offers an indication of the degree to which the impact investing space has matured.

Participation by larger, established managers. Finally, a wider variety of PE managers are entering the category and raising capital at scale. Many of these managers are larger and more experienced than the typical v.1.0 manager. We are finding that these managers are more focused on developing impact measurement frameworks and reporting capabilities, which we

Figure 4

U.S. ELECTRICITY GENERATION



Note: Confidence interval derived from NYMEX options market information. For illustrative purposes only.

Source: U.S. Energy Information Administration. Short-Term Energy Outlook (January 2019).

believe is critical to the wider adoption of the category by investors. The entrance of these managers demonstrates the growth of the impact space.

ATTRACTIVE IMPACT CATEGORIES AND GEOGRAPHIES

In our research, we classify opportunities into six impact categories: energy and environment, social inclusion, conservation, consumer products, health care, and community development. Some are still nascent, but the following categories are farther along the path to achieving v.2.0 status:

Energy and environment. Within the energy and environment category, renewables have transcended the need for government subsidies and matured to reach successful scale. New wind and solar energy is now cheaper than most existing fossil fuels in the United States, making it competitive with traditional energy sources.[7] In fact, non-hydro renewable energy generation (solar and wind) more than doubled between 2010 and 2018 to more than 10 percent of total energy production in the United States (see figure 4).[8]

Health care and social inclusion. Similarly, health care and social inclusion (including education and financial inclusion) are mature sectors of the economy that lend themselves to creating impact across society while also having attractive investment characteristics. For example, PE-backed healthcare companies are helping combat opioid addiction through treatment clinics and novel, non-opioid pain-relief therapies.

CONSIDERATIONS WHEN ADDING IMPACT TO A PORTFOLIO

As with any investment, particularly in the private markets, careful due diligence is critical. We believe it's important to focus on fund managers with a proven track record in achieving a "double bottom line" of both impact and financial returns. Quantifying a fund's impact goals and key performance indicators can help investors avoid greenwashing and is especially important as larger, more mainstream fund managers enter the space.

Consistent benchmarks would offer the most effective way to measure impact. Similar to PE benchmarking, however, there isn't a single agreed-upon standard. Technology is helping accelerate the availability of high-quality data and analysis, but it is unlikely that a single industry standard will arise in the near term.

Commonly used and widely accepted metrics for measuring impact include the United Nations (UN) Sustainable Development Goals (SDGs), the Global Impact Investing Network's IRIS+, GIIRS Ratings, and the CA Impact Investing Benchmark. Today, the UN SDGs seem to be the most widely used: Two years after the ratification of the SDGs by the UN, three out of four investors reported that they track their investment performance to the SDGs or plan to do so in the future.[9]

IMPACT FUNDS COMBINE ATTRACTIVE RETURNS AND POSITIVE CHANGE

Significant improvements in the past decade have revolutionized the impact investment space, making it an attractive investment option for a broader audience. With a larger number of potential investment opportunities in maturing sectors, seasoned fund managers entering the space, and improving frameworks for quantifying and monitoring impact, investors can achieve private market-like returns alongside a measurable impact. As more high-quality, impact-focused private market strategies become accessible at lower investment minimums, we expect to see higher adoption rates among individual investors.

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IMPACT INVESTING IN FOCUS

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ENDNOTES

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