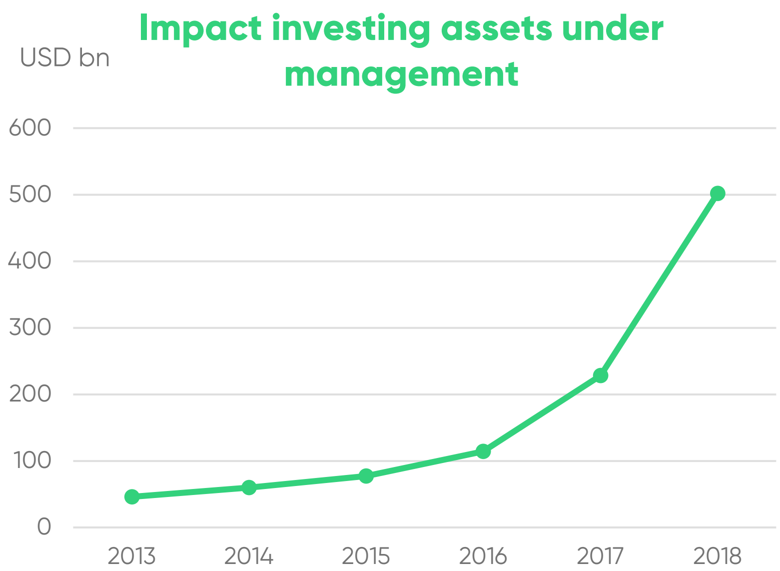
IMPACT INVESTING IN PRIVATE EQUITY

Impact investing is growing at a remarkable pace

Impact investing is currently one of the fastest growing investment strategies in the private equity industry. The growth is being sparked by an increasing worry for climate change, the planet's limited resources, social inequality and many other negative environmental and societal phenomena. Investors ranging from wealthy individuals to large pension funds are increasingly interested in allocating funds to investment targets that, in addition to generating profits, create positive impacts on the environment and the entire society.

Especially the younger generations – millennials – are extremely worried about the challenges facing the environment and the society and therefore they require more responsibility from their investments as well[1]. So, as they inherit the estimated 30 billion dollars of investment wealth, the demand for responsible investment opportunities is expected to skyrocket[2]. This demand and pressure to act responsibly will be reflected directly to the asset managers as well. The growth trend of impact investing AUM, which surpassed 500 billion dollars in 2018[3], is a concrete example of this effect.



Moreover, the value of portfolio companies is more driven by their level of responsibility and their impact than ever before. The younger generations regard companies and corporations to have a central role in solving the global environmental and societal challenges and sustainability is also a key driver in their consumer behavior[1]. Thus, it is evident that only companies that act sustainably and responsibly can succeed in the long run. Furthermore, an even more important observation is that those companies that aim to not only minimize their negative impact on the society but instead try to solve these global challenges have a tremendous business potential at hand.

[1] Deloitte. 2018. *2018 Deloitte Millenial Survey.*
[2] EY. 2017. *Sustainable Investing:*
[3] GIIN. *Annual Impact Investors Surveys 2013-2019.*

SITRA Pääomasijoittajat Finnish Venture Capital Association

New study sheds light on impact investing principles and best practices

Finnish Venture Capital Association's (FVCA) new study examined the principles and best practices of impact investing among European private equity investors[4]. 22 PE firms managing a total of 415 portfolio companies participated in the study. The study focused on clarifying the definition of impact investing, mapping the existing impact modelling and measuring methods, comparing different compensation structures and finally analyzing the effect of the above-mentioned aspects on the investments' financial performance and impact.

The findings of the study indicate clearly that the majority of impact investors are in many ways just like traditional private equity investors in Europe: they aim for market rate returns or even higher and they invest primarily in European companies. All investors who took part in the study believe that the LPs' interest towards impact investing will continue to grow in the future.

What does impact investing mean?

Impact investing is generally defined as investment activity that intentionally aims to achieve both financial profits and positive social or environmental impacts. Striving for positive impact does not mean compromising on profits, since impact investors specifically aim to find target companies in which the positive impacts form a core part of the company's business model and the revenue generation logic.

The results of the statistical analysis of the portfolio companies give indications of the effectiveness of the methods and practices deployed by the investors. Firstly, modelling the impacts before investing, especially using customized methods, seems to improve the financial performance of investments. Secondly, some impact measuring methods that are used in tracking the portfolio companies impacts, appear to increase the achieved impacts whereas some might decrease the investments' financial performance. However, the measuring methods are constantly evolving, so defining best practices is still too early at this stage. Finally, the results also indicate that focusing only on social impacts and linking the GP's compensation to impact might decrease the financial performance of investments.

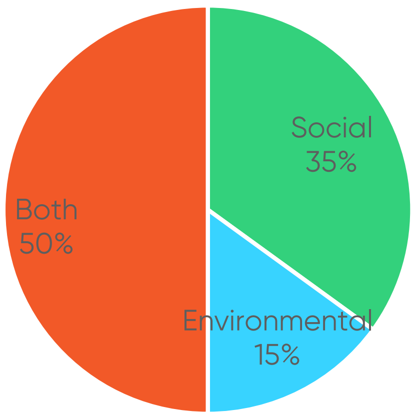
All in all, the study has many practical implications for both GPs and LPs. For GPs who are interested in maximizing their impact the study offers a useful package of information of the approaches and methods used by their European colleagues. Moreover, comparing the different methods enables benchmarking and implementing best practices. For the LPs the core message is clear: there is an increasing number of impact focused PE funds available and LPs hold a crucial role in setting industry standards and defining the acceptable levels for profits and impacts.

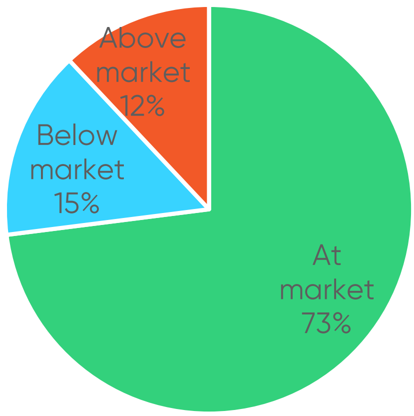
[4] Kirppu. 2019. *Impact Investing in Private Equity.*

Findings from the study: Views and practices of European impact investors

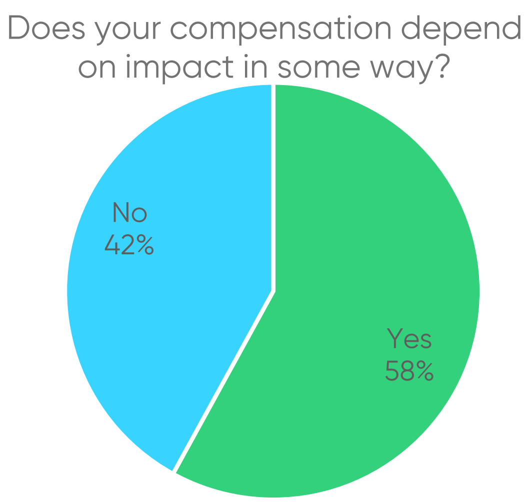
Based on the responses of the impact investors who took part in the study, it can easily be concluded that the majority of them regard impact investing as a regular investment activity in which market rate returns are pursued. Investors don't need to compromise on profits in order to achieve positive impacts but rather they are targeted simultaneously.

Impact investments are also directed broadly to many different domains, not just social projects. Half of the respondents focus on achieving both social and environmental impacts whilst 15 % opt for only targeting environmental impact.

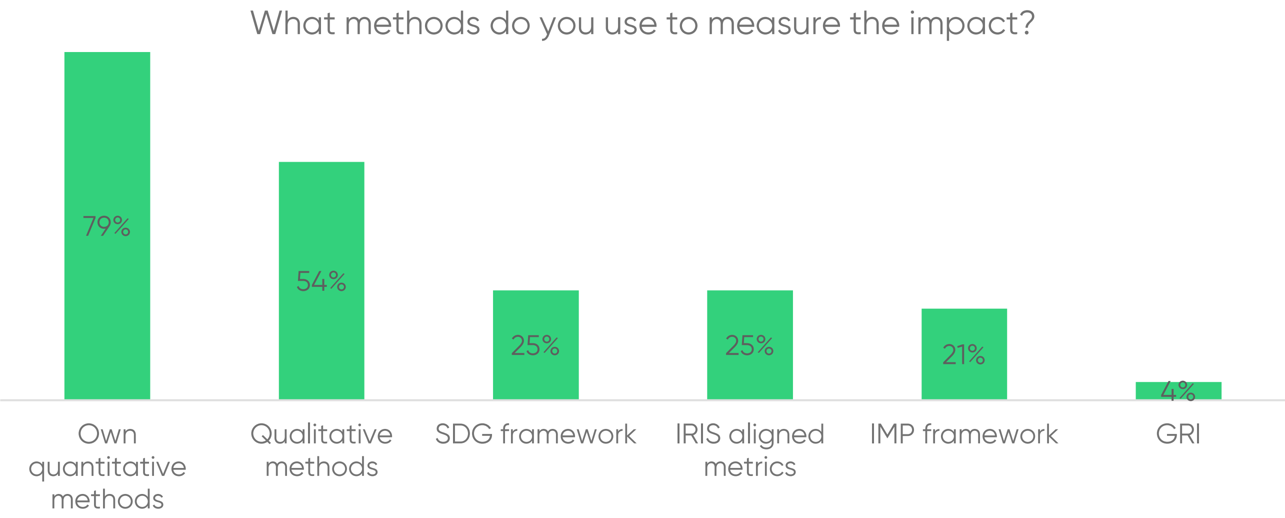




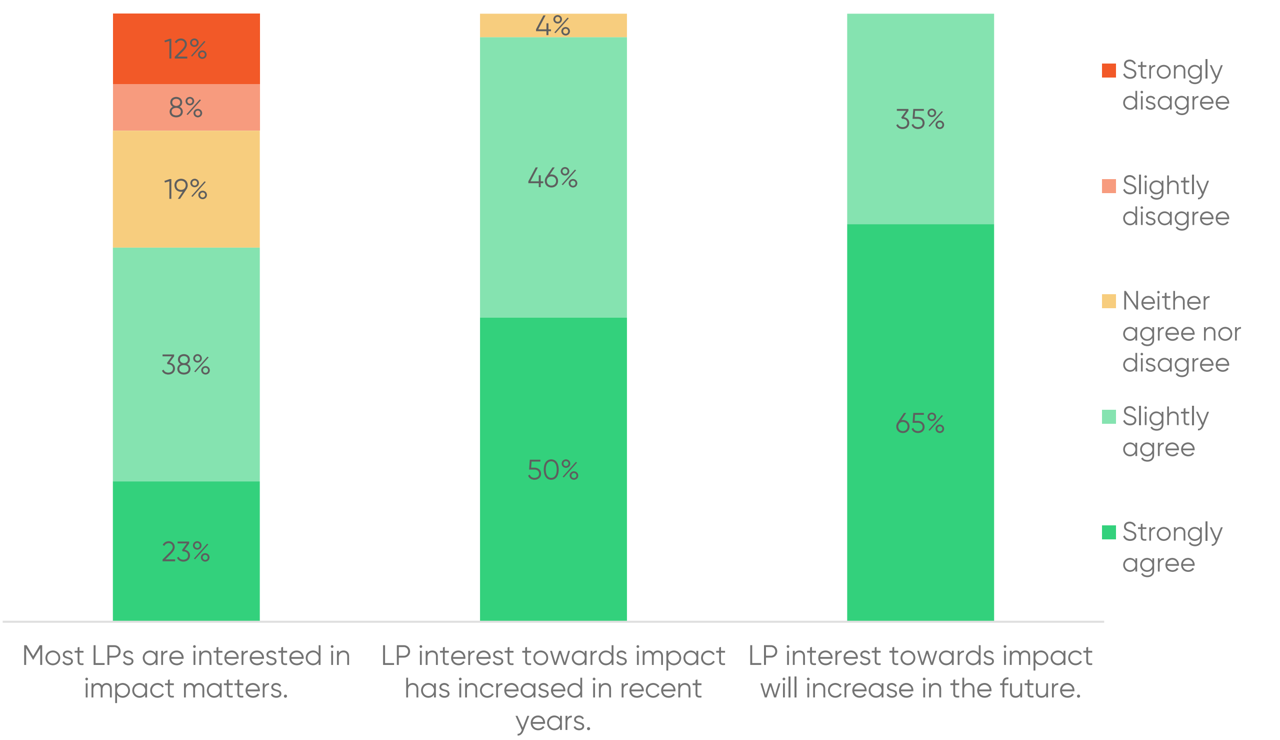
Using the achieved impacts as a criterion in how the GP's compensation is formed divides the respondents' opinions: 58 percent of the respondents have linked their compensation to the achieved impacts in some way whereas 42 percent receive their compensation based on their financial performance alone. Thus, linking compensation to impact is clearly not required in impact investing but rather practices vary.



Regarding impact measuring methods there is also a wide distribution in the responses. Own quantitative methods are the preferred method: almost 80 % of the respondents report to using self-developed measuring methods. Over half of the respondents' also use qualitative methods in describing the impacts that have been achieved. Out of the generally available methods the SDG framework, the IRIS metrics and the IMP framework are the most popular ones (more information of the measurement methods at the end).



However, there is one thing that brings the respondents together: LPs are interested in impact matters. According to the respondents' views LP interest towards impact has increased in recent years and most importantly it will only increase in the future.



Impact investing principles

What aspects should be considered when starting impact investing?

1. Impact targets

First of all, it must be decided what kind of impacts the investor wants to target and achieve. The focus can be on a specific phenomenon such as reducing the use of fossil fuels or the objective can be formed around a wider theme such as preventing climate change. The objectives can also be limited to a specific geographical area or they can be global; they can focus on improving the lives of a certain group of people or they can have an impact on everyone.

2. Modelling

Once the impact targets have been set, the next step is to figure out how and through what elements they could be achieved. For example, if the goal is to reduce the use of fossil fuels the number of alternative sources of energy that are available is one element of the phenomenon. However, if the alternative sources of energy are not put to use due to lack of funds or other obstacles, the use of fossil fuels will not decrease regardless of the number of alternative options available. So, in order to achieve positive changes that enable long-term impact to take place, the phenomenon and the causal connections related to it must be completely understood.

3. Measuring

When the whole phenomenon and its causal connections is well understood it is also easy to measure the right things. In the fossil fuel example mentioned above tracking the number of alternative fuels available or the number of power plants using alternative energy sources are not sufficient metrics even though they might seem like it, but rather the number of fossil fuels replaced by renewable energy sources should be measured.

4. Reporting

After setting targets, modelling and measuring, the achieved impact should also be reported and tracked. Investors want to know what has been achieved with their funds and whether the goals have been achieved. By tracking the situation an active owner can also guide and help the portfolio companies to move in the right direction.

More information

FVCA, Sitra, Deloitte. 2017. *Vaikuttavuussijoittamisen mahdollisuudet pääomasijoittamisessa.* Available at: https://media.sitra.fi/2017/06/05133212/FVCA-raportti-web-FINAL.pdf

GIIN. *What you need to know about impact investing.* Available at: https://thegiin.org/impact-investing/need-to-know/

Kirppu, 2019. *Impact Investing in Private Equity.*

Männistö, H. 2016. *Vaikuttavuusinvestoimisen opas sijoittajille.* Sitra. Available at: https://paaomasijoittajat.fi/wp-content/uploads/2019/09/2017061.pdf

IRIS is a set of metrics that includes over 500 different metrics related to profits or impact. The investor can choose the most relevant metrics for themselves.

GIIRS is a rating system based on the IRIS metrics that can be used for example to rate and compare funds.

The SDGs consist of 17 objectives that the UN has declared as the largest challenges globally that it aims to impact by 2030.

IMP is a project that aims to cretae a unified imoact measuring logic among impact investors. It is supported by the most relevant players in the industry.

Upright Project is a Finnish startup that uses machine learning methods to measure the net impact of companies.