Impact Investing

WHITE PAPER

Kempen

Contents

If you have any questions or if you would like to discuss the subject of impact investing, please contact us, or go to www.kempen.nl

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Introduction

Sustainability and the necessity to leave the world in a good state for future generations is attracting increased global attention. Increasing numbers of private and institutional investors are also focusing their investment choices on financial as well as non-financial criteria. The role that impact investing can play in these choices has become an increasingly important part of the conversation. Besides the rising demand for investment opportunities in the area of impact investing, an increased number of asset managers are developing impact investment products. The purpose of this white paper is to provide a theoretical and practical background the subject of impact investing, describing what it is, how impact can be measured in practice, what the characteristics of this market are and what challenges impact investors are facing.

Global challenges

Our planet and society are confronted with a number of global sustainability challenges, including climate change, depletion of natural resources, loss of biodiversity, and inequality[1].
These trends and their adverse impact on society and the environment are strongly interlinked. Climate change, for instance, can lead to droughts and food shortages. Droughts, in turn, can lead to deforestation. Another example is clean drinking water. Poor infrastructure causes millions of early deaths every year due to diseases caused by polluted drinking water or poor hygiene. Clean drinking water and hygienic sanitary facilities will, therefore, have a positive impact on health and food safety.

There is a growing awareness that a radical transformation is required to address these global challenges. In order to mitigate the risks and consequences of climate change, the Paris Agreement was signed by 186 countries in 2015. With this agreement, the signatory countries agreed to keep the increase in global average temperature to well below 2 °C versus pre-industrial levels. In concrete practical terms, this means that in order to achieve this 2 °C goal, greenhouse gas emissions must be reduced by 60% by 2050 compared to the levels of 2010.

2015 was also the year in which the United Nations (UN) adopted the 2030 Agenda for Sustainable Development in the form of the Sustainable Development Goals (SDGs). The purpose of the SDGs is to end poverty, reduce inequality and combat climate change by 2030. The 2030 Agenda contains 17 SDGs comprising targets ranging from ending poverty, promoting health and education, increasing access to clean drinking water, increasing the use of renewable energy to tackling climate change. The SDGs are the successor of the Millennium Development Goals (MDGs), which expired at the end of 2015. According to the UN, the Sustainable Development Goals are more ambitious. They are far broader in scope, involving not just the development but also the sustainability of countries. Furthermore, the SDGs focus on all countries rather than just the developing countries. The SDGs

1 *http://www.un.org*

thus form a framework that enables corporations and governments to demonstrate how they contribute to promoting sustainable development by mitigating the negative impact and maximizing the positive impact on the planet and society as a whole.

SDGs and the necessary investments

Achieving the 17 sustainability goals will require significant investment. This investment will not only have to come from governments, but also from institutional and private allocators. The UN Conference on Trade and Development (UNCTAD) expects that achieving the SDGs will require between US$5 and $7 trillion of investment per year, with an investment deficit in developing countries of approximately US$2.5 trillion[2].

2 *http://undp.org*

Impact Investing

Impact investing will help to contribute to meeting the SDGs. Impact investors identify a problem in society and want to contribute to its solution. Impact investing is, therefore, investing with the specific intention to make a certain impact and solve a specific social or environmental problem.

Impact investing is defined as investing in companies or organizations that themselves operate with the express intention of achieving not only sound financial results, but also a positive impact on society and the environment; so-called *social enterprises*. The desired social impact may relate to environmental, climate-related or social areas, such as healthcare, education, food supply, and employment. Impact investing clearly involves a combination of financial returns and the earlier mentioned impact on society or the environment, as opposed to philanthropy where financial returns hardly play a role, if any.

Impact investing[3] is characterized by:

1. The intention to make a positive impact
2. The achievement of social as well as financial returns
3. Measuring the achieved impact

Intention: The Theory of Change

Intentionality is an important characteristic of impact investing. As a consequence, impact investing goes one step further than sustainable investing. Impact investors identify a problem in society and make a conscious choice to contribute to its solution, as opposed to sustainable investing which focuses on mitigating the adverse impact of the business operations and does not explicitly pursue the goal of achieving a positive social or environmental outcome.

It is not as simple as it seems to assess whether this intention is present in a company or investment fund. A company or a fund may profess to have an intention to benefit society, but we do not have a uniform test – yet – to assess whether this intention satisfies the above requirements. A method that is often used to assess the intention of an organization is to take a closer look at the *Theory of Change* of a company or fund.

The *Theory of Change* starts with the ultimate objective - the end goal - and works backwards from there to the actions that are needed to achieve this goal. A description is prepared of the social mission as well as the activities that are necessary to achieve the envisaged change in society, stating why these particular activities are necessary. For investors in impact enterprises or impact funds, it is important to define a number of aspects in advance, including the impact objectives of the company or fund, whether they match the impact objectives of the investor and how the progress towards achieving the impact objectives is measured.

3 *http://thegiin.org*

Achieving financial returns

The second characteristic of impact investing concerns the financial returns that people seek to achieve. The return on investment depends on the asset class in which one invests. Infrastructure investments, for example, offer different returns than private equity. Also the stage of development of the company concerned will have an effect on the risk-return ratio of the investment. In this respect, impact investments follow the rules of the financial world. This is referred to as 'market rate return'.

Social or environmental returns are often preconceived to be at the expense of financial returns. Over the years, significant research has gone into the question as to whether there is an interaction between financial returns and impact. The results of a survey by McKinsey[4] and a survey conducted by Cambridge Associates[5] show that achieving impact does not necessarily come at the expense of financial return.

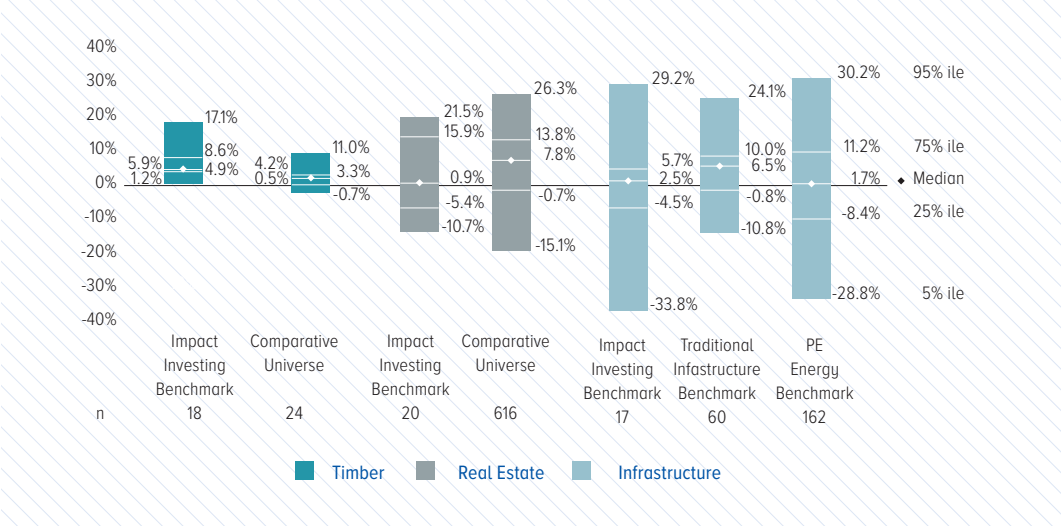
The article entitled 'A closer look at impact investing', and in particular 'The myth of lower returns' (Pandit, V. and Tamhane, T., 2018), describes a study in which McKinsey looked at 48 impact investments between 2010 and 2015. Figure 1 shows the internal rate of return (IRR) of the researched funds. The results of the survey show that these investments produced an average IRR of approximately 10%. One-third of the investments even yielded an average IRR of 34%, clearly indicating that it is possible to achieve profitable exits in social enterprises.

The Cambridge Associates study focused on impact investment funds. In collaboration with the Global Impact Investing Network (GIIN), Cambridge Associates published a report entitled '*Financial Performance of Real Assets Impact Investments*' (2017)[5] analysing the financial performance of impact funds as compared to conventional funds. 55 real assets impact investing funds of vintage years 1997 to 2014 were grouped into three sectors: timber, real estate, and infrastructure. Based on their analysis, two key conclusions were drawn. The first is that the distribution of impact investing fund returns mirrors the distribution of conventional real asset fund returns. The second is that fund selection is key to success in terms of financial returns, as the distribution of individual fund returns varies widely. This applies equally to impact investing funds and conventional funds. Some investment funds yield better returns than expected, and some perform less well.

4 *Pandit, V. and Tamhane, T., 'A closer look at impact investing', McKinsey Quarterly, February 2018*

5 *Cambridge Associates, The Financial Performance of Real Assets Impact Investments, May 2017, https://www.cambridgeassociates.com/*

FIGURE 1 Distribution of fund IRRs, net to LPs by quartile, as from June 2016



Source: GIIN & Cambridge Associates Financial Performance of Real Assets Impact Investments 2017.

Notes: The Timber Impact Investing Benchmark includes funds of vintages 1997-2014 and the comparative timber universe was constructed of traditional funds of the same vintages. The Real Estate Impact Investing Benchmark includes funds of vintages 2004-2014 and the comparative real estate universe was constructed of traditional funds of the same vintages. The Impact Investing Benchmark includes funds of vintages 2005-2014; the focus of funds in this benchmark is sufficiently differentiated that a comparative universe does not exist today. For reference purposes, we have included the returns of our traditional infrastructure benchmark and our PE Energy Benchmark, limited to funds raised over the 2005-2014 period.

> 'Not everything that counts can be counted, and not everything that can be counted counts.'
>
> **ALBERT EINSTEIN**

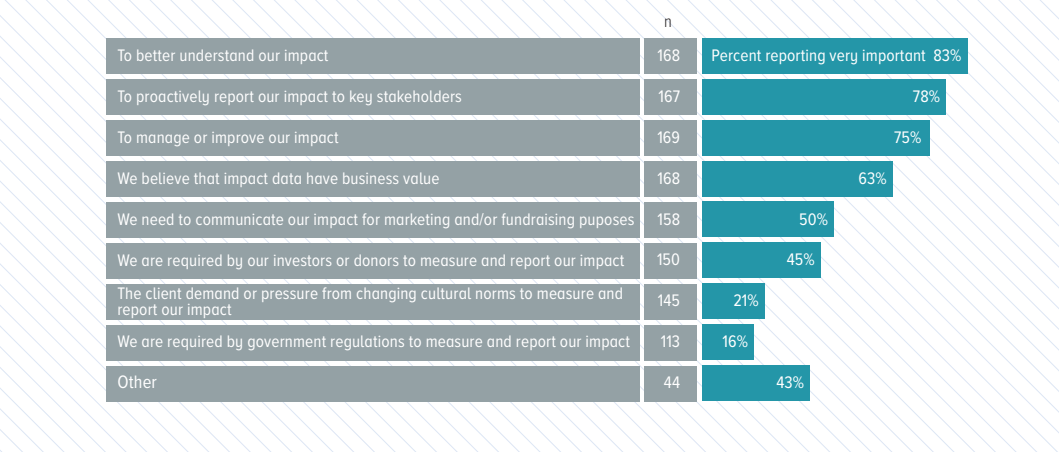
Measuring impact

A third characteristic of impact investing is measuring the impact targeted. Measuring the achieved impact is considered important for various reasons. A survey by the GIIN with support of The Rockefeller Foundation (2017)[6] shows the most common reasons are: i) to generate a better understanding of the impact of investments, ii) to be able to report on the impact to the various stakeholders, including the investors, iii) to manage the impact and improve the outcomes, and iv) based on the conviction that impact data are valuable for the company itself. One remarkable finding from this study was that the desire to measure the achieved impact is usually driven by intrinsic motivation. In other words, impact is not measured to comply with government regulations, but to improve the investments and to be able to better communicate about these improvements.

6 *Mudaliar, A., Peneiro, A., Bass, R. and Dithrich, H., 'The State of Impact Measurement and Management Practice', The GIIN and The Rockefeller Foundation, December 2017*

FIGURE 2 Reasons for measuring and managing impact

This figure shows the percentage of respondents who indicated that it was 'very important'. Respondents had several options to choose from.



Source: The State of Impact Measurement and Management Practice, The GIIN with the support of The Rockefeller Foundation, December 2017

Measuring impact in practice

While measuring and reporting financial returns is globally standardized, there is no standardized method to measure impact. In practice, there is yet no uniform, standardized method based on which the achieved impact can be charted. In practice, many impact enterprises and investors apply different methods and metrics, while various investors and organizations are trying to develop some form of standardization. An example of a commonly used method is the earlier mentioned *Theory of Change* and the measurement and management framework of the Impact Management Project[7], both methods are used by Kempen in our impact investing approach.

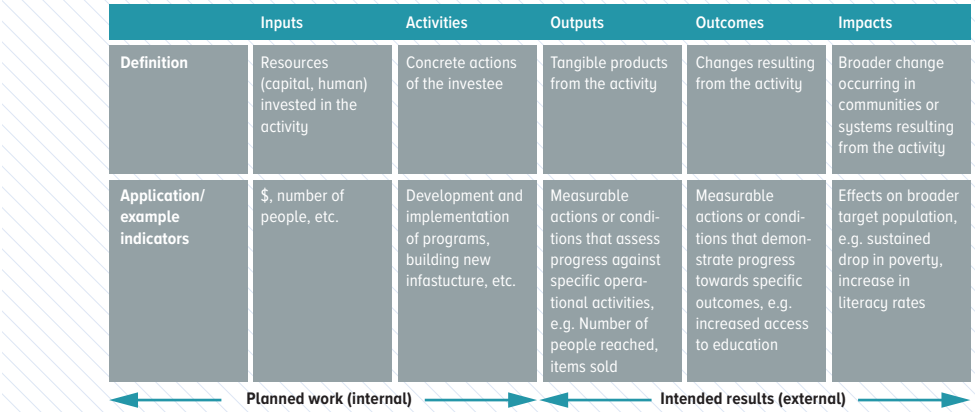
7 *https://impactmanagementproject.com/*

THEORY OF CHANGE

The *Theory of Change* starts with the ultimate objective - the end goal (impact) - and works backwards from there to the actions that are needed to achieve this goal. A *Theory of Change* provides a logical link between Input, Activities, Output, Outcome, and, eventually, Impact, as represented in figure 3. The model starts at the end goal, being the impact, and subsequently describes the outcomes and activities that are needed and can be measured in order to achieve this impact.

The schematic and visual way in which this model describes the process of change and the trajectory it follows towards the desired impact clearly shows the correlation between the available resources, the activities undertaken, and the change or desired results (the impact).

FIGURE 3 Theory of Change model



Source: Logic Model Development Guide

The Output is a direct result of Activities, such as the products and services sold by a social enterprise (e.g., the sale of solar panels). The Outcome is the short-term change induced as a result, or, in other words, the effects of the output on individuals or the environment (e.g., reduced CO2 emissions). The Impact is the long-term change that results from the Outcome (e.g., combating climate change). The result of a *Theory of Change* and the defined Outcomes and Output can subsequently be used to define the specific impact objectives (KPIs) that can be measured, monitored, and based on which progress can be reported. Impact KPIs can be defined for each individual organization or investment.

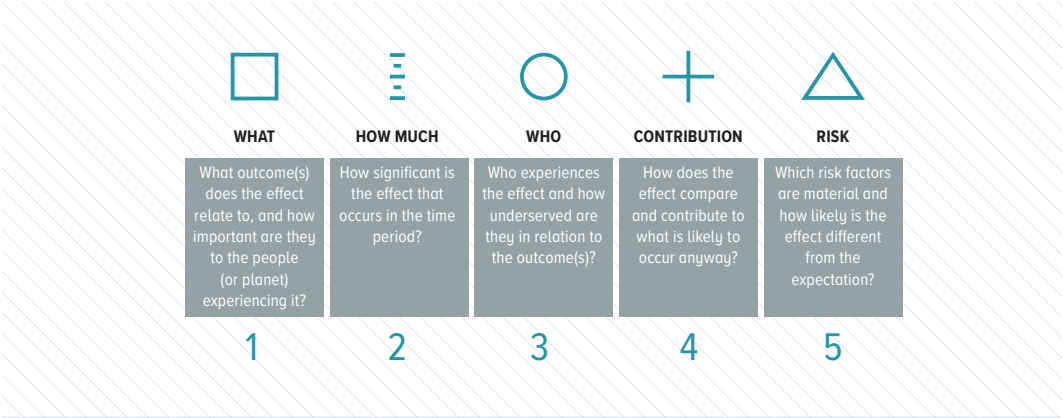
A *Theory of Change* can furthermore serve as a practical tool in selecting impact investments. The Logic Model[8] represented in Figure 3 offers impact investors a framework that can be used in discussions with social entrepreneurs or fund managers to understand what the plan is to achieve the targeted impact and which activities are required to achieve this target.

8 *W.K. Kellogg Foundation, Logic Model Development Guide, January 2004, https://www.bttop.org/*

THE IMPACT MANAGEMENT PROJECT

The Impact Management Project is an alliance of close to 2000 organizations for the purpose of creating a common language to communicate about impact investing and to chart the results. The method is broader than the steps described in the *Theory of Change*, in the sense that it lists the outcome by five dimensions: What, How Much , Who, Contribution, and Risk.

FIGURE 4 Impact Management Project model



Source: Impact Management Project

What is different about this method is that it lists the outcomes and their correlation to the targeted impact, while at the same time providing information about which groups in society (or the environment) experience the resulting effects. The Impact Management Project framework analyses both the negative and positive effects on people and the planet. It also defines different degrees of impact ('How much'), or its materiality. The 'Contribution' measures whether the intervention (and therefore the investor's investment) was of material importance or whether the impact would also have been achieved if the intervention had not taken place. This is also referred to as the 'additionality' of the investment. The 'Risk' dimension describes the chance that the impact pans out differently than expected.

Standardization in impact metrics

Every impact theme can be linked to various outcomes and output and subsequently to specific impact objectives (KPIs). In order to work towards more standardization in measuring impact, the impact metrics have been categorized by impact theme with the corresponding KPIs and made publicly available in public databases, such as the IRIS+ database, which is part of the GIIN. This is a catalogue that currently contains over 500 possible units to measure impact. IRIS+ is often used in combination with the 17 SDGs and their sub-goals to measure the progress towards the desired impact.

Characteristics of the impact market

Impact investing can take the form of providing equity or loans directly to companies. Besides direct investing, one can also elect to invest indirectly in an impact fund. Fund investments offer a valuable addition: fund managers have specific regional or sector-related expertise, and it is possible to diversify the assets across various types of companies, geographic regions, and impact themes. In addition, impact investors can typically allocate larger sums to funds rather than directly to impact enterprises.

Size

Global investments in impact investing solutions have increased strongly in recent years. The results of a survey conducted by the Global Impact Investing Network (GIIN) show that the global capital invested in impact solutions amounted to US$109 billion (Balandina Jaquier, 2016)[9] in 2014. According to statistics presented at the 2014 European Investment Forum, the size of impact investments by European institutional and private investors increased in 2013 to over €20 billion, which equates to a growth of 131.6% in the period between 2011 and 2013. The GIIN's most recent survey (2018) among 226 respondents shows that global investments in impact investing solutions have now reached $502 billion[10]. This can be seen as the lower limit of the impact investing market as the GIIN oversees only part of the market.

Impact themes

Given the investment solutions that are available in the market, we can distinguish several themes. The SDGs form a framework of impact themes to which investors can contribute by means of their investments. Based on a survey conducted by the GIIN (2019) among 252 respondents, impact investors appear to be focusing on several SDGs (please refer to Figure 5). The most common SDG allocated concerns 'decent work and economic growth' (SDG 8). This theme also addresses the problem that in many developing countries less than half of the population has access to financial services such as payments and loans to start up or run their own business. This perpetuates income inequality and hampers economic growth and well-being in rural areas. Over half of the investors focus on the themes of 'ending poverty' (SDG 1), 'gender equality' (SDG 5), 'good health and well-being' (SDG 3), and 'affordable and clean energy' (SDG 7).

9 *Balandina Jaquier, J. (2016), 'Catalyzing Wealth for Change: Guide to Impact Investing', Zürich, Switzerland: Libertas Pascal*

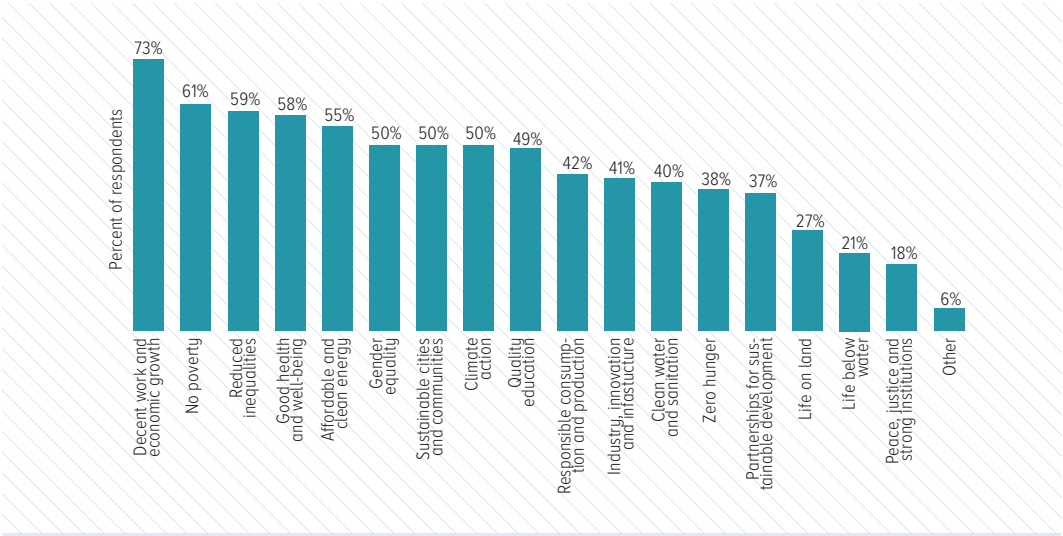
10 *Mudaliar, A., Bass, R., and Dithrich, H., Annual Impact Investor Survey, The GIIN, June 2019, http://thegiin.org/*

The focus on specific SDGs among respondents varies by subgroup. For example, if we compare investors in developed countries and investors in emerging countries, the latter focus more on 'ending poverty' (76% versus 42%), 'gender equality' (63% versus 32%), and 'decent work and economic growth' (80% versus 63%). On the other hand, investors in developed countries show a greater tendency to focus on SDGs such as 'sustainable cities and communities' (62% versus 36%) and 'climate action' (54% versus 38%).

At the same time, there is an overlap between investors who focus on 'decent work and economic growth' and investors who focus on 'ending poverty' and 'gender equality'. In addition, around half of the investors who focus on 'decent work and economic growth' invest in the SDGs of 'good health and well-being' (47 %), 'quality education' (44%), and 'gender equality' (44%).

FIGURE 5 SDG-aligned thematic focus of investors*

n = 252: optional question. Respondents could indicate multiple themes



Source: Annual Impact Investor Sur vey, The GIIN, 2019

* *Note: 'Other' themes include affordable and safe housing, sustainable technology, cybersecurity protection, strengthening of faith-based institutions, racial and ethnic equity and inclusion, circular economy, and SME development.*

In practice, however, impact funds typically do not target a single SDG. Instead, they target several goal themes ('*pure play*' versus '*multi-impact*' funds).

Asset classes

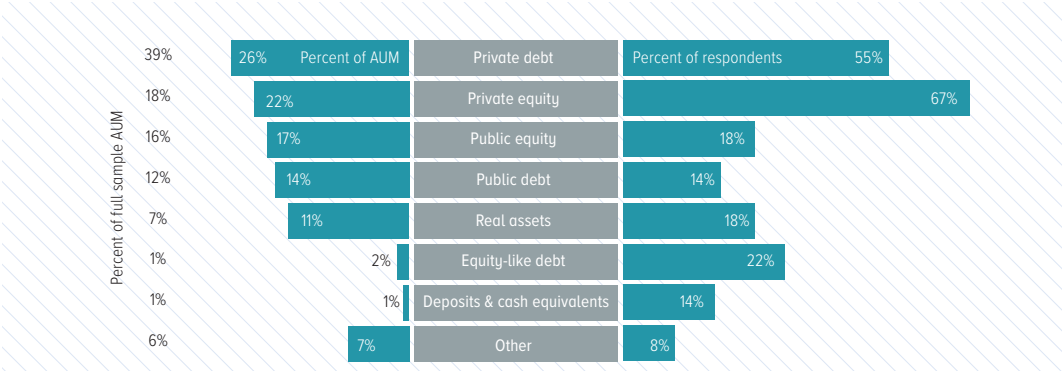
As impact investing focuses on investments with an explicit intention to achieve not only financial but also social and environmental returns, the selected manner of financing should enable the investor to achieve a certain impact in a targeted manner. Depending on the impact objective, the most suitable asset class is selected (e.g., private equity, bonds, private loans). The asset class is, therefore, subordinate to the impact objective rather than an objective in and of itself.

In practice unlisted (primary) asset classes qualify as impact investments, such as private equity, private debt, as well as real assets such as infrastructure, real estate and land because of their direct link and therefore influence on the business or project.
One example of a listed impact investment concerns green bonds, the proceeds of which are ring-fenced and have to be used to finance a specific 'green' project. Other financing examples include innovative investment structures such as Social Impact Bonds or guaranteed philanthropic funds (so-called 'Blended Finance')[11].

The impact investing market is typically characterized by illiquid asset classes. This means that these investments cannot be traded on a daily basis on trade platforms like the stock exchange. This is also reflected by the number of available impact funds. Figure 6 shows the average distribution of impact fund investments broken down by asset class. The largest percentage of investments are invested in private debt (26%) and private equity (22%). Funds investing in this asset class have a longer investment horizon and often have a minimum entry level. This makes it more complex for smaller investors to spread their assets across multiple investments.

Illiquid asset classes require a more extensive due diligence process, in view of the often limited available public information available on unlisted companies. The required research capacity will naturally increase when investors want to diversify their assets across multiple fund investments, making the procedure more time-consuming and expensive. Investing in a fund of funds prospectively achieves greater diversification, helps in addressing minmum investment fees, in addition to spreading the costs of research and monitoring across multiple investors

FIGURE 6 Instrument allocations by AUM and number of respondents*
Left side: percent of AUM excluding outliers: n 259; AUM = USD 131 billion
Right side: percent of respondents with any allocation to each instrument: n = 266; respondents may allocate to multiple instruments



Source: The GIIN, 2019 Annual Impact Investor Sur vey

* *Right side excludes three outliers. 'Other' includes guarantees and pay-for-success instruments.*

11 *Nicholls, A., Emerson, J., and Paton, R., (2015). Social Finance. Oxford University Press*

Challenges of the impact market

The impact investment market is still young but dynamic and rapidly gaining momentum. As a consequence, the impact market also faces a number of challenges. Examples include the earlier mentioned level of (under)development of measuring frameworks, the fragmentation of methods of impact measurement, and data collection. A further challenge impact investors face is the identification of attractive investment opportunities and the limited availability of impact funds with a long track record[12].

12 *Campden Wealth and UBS, The Global Family Office Report 2018, September 2018, http://campdenwealth.com/*

Risks

Depending on the selected asset class, impact investing entails several risks. In unlisted investments such as private equity, the early stage in which a company may find itself can present a risk, as can the liquidity risk corresponding to private investments. Furthermore in emerging markets investing, risks at play may include political risk, liquidity risk and foreign exchange rate risk. In this respect, impact investments are not that different from conventional investments. In addition, impact investments carry specific risks, including reputation risk and impact risk. Here we will address these specific impact-related risks.

Impact risk can be broken down into four types of risk: execution risk, efficiency risk, externality risk and additionality risk[13]. Execution risk is the risk that the targeted social returns are not achieved. In addition, there is the possibility that the intended impact can be achieved in an alternative, more efficient manner than with the business operations of the company in which one invests (efficiency risk). Execution and efficiency risk are interrelated. For example, it is more likely that the envisaged impact will not be achieved if the company has no efficient plan in place to pursue the goal. Externality risk concerns the possibility that the business activities by which social returns are pursued also have adverse side effects. In addition, there is a certain degree of probability that the targeted impact would have been achieved even without any intervention, which relates to the risk of lack of additionality on the impact.

A further risk that impact investors have to take into account is so-called 'impact washing'. This is when conventional investments are labelled as impact investments. To discourage mis-labelling, the GIIN published a set of principles for impact investing. These principles were published in 2019 and define the criteria that impact investments need to meet in order to qualify:

1. Intentionality
2. Use Evidence and Impact Data in Investment Design
3. Manage Impact Performance
4. Contribute to the Growth of the Industry.

One way to explore impact risk and mitigate it wherever possible involves conducting a thorough due diligence as well as measuring and managing the targeted impact objectives in accordance with a reliable framework, such as the earlier discussed *Theory of Change*.

13 *Bridges and Skopos, More than Measurement, 2017, http://bridgesfundmanagement.com/*

Conclusion

The increasing attention on sustainability and the necessity to leave the world in a better state for future generations encourages ever larger numbers of private and institutional investors to base their investment choices on both financial and non-financial criteria.

Besides an attractive financial return, impact strategies aim to have a demonstrable, identifiable positive effect in social and environmental terms. Impact investing is a way to achieve both these financial and social returns. The number of available investment solutions in the field of impact investing is increasing and so is the demand for these solutions among private and institutional investors. The SDGs offer a framework that enables both governments and investors to demonstrate their contributions to promoting sustainable development by reducing negative impact while maximizing positive impact on the planet and society as a whole.

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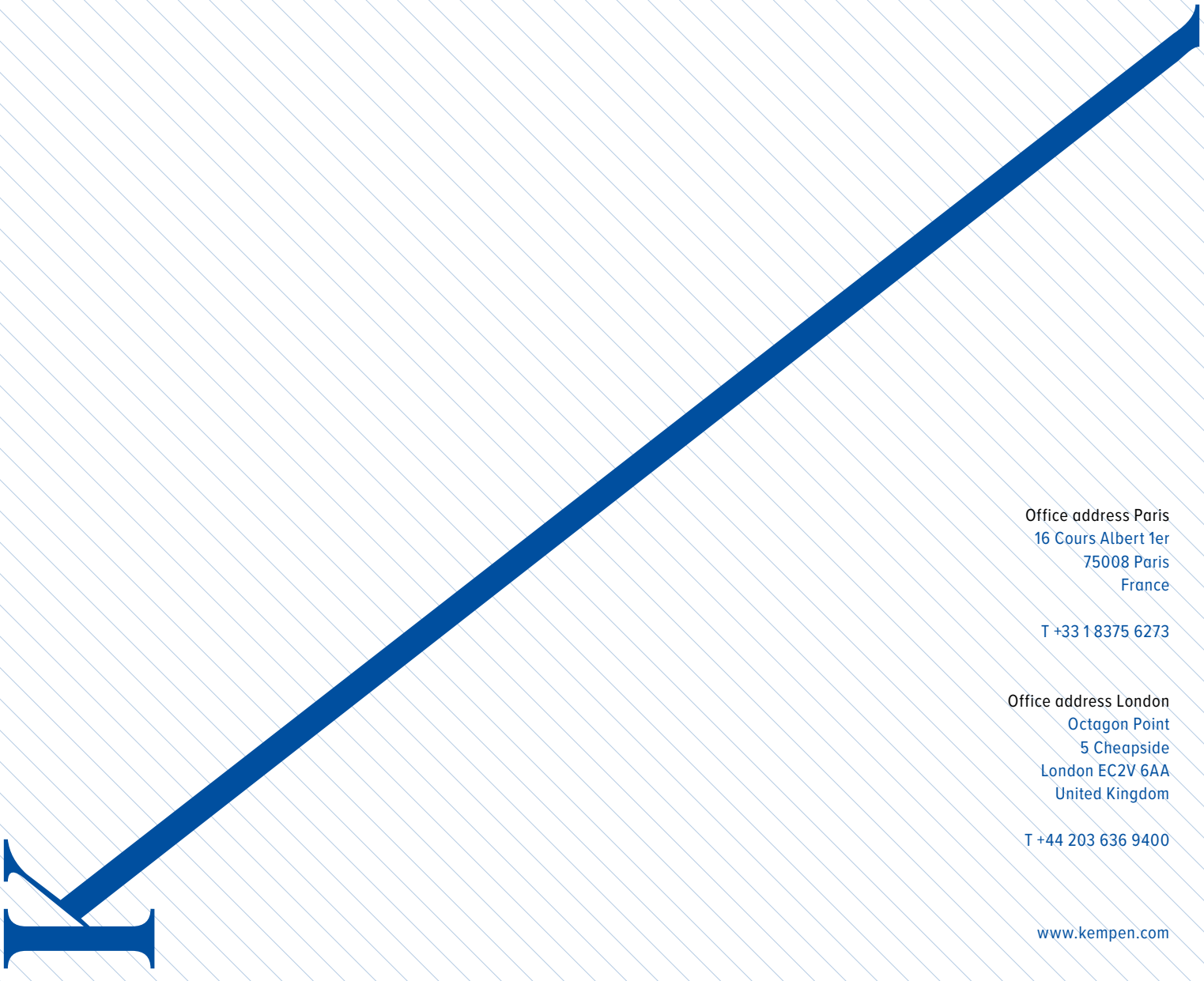

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