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PERSPECTIVES

IMPACT PRIVATE EQUITY: SEPARATING THE WHEAT FROM THE CHAFF

Every new trend attracts its fair share of supporters, even more so when it brings with it the promise of a better world. Such has been the story of private equity's conversion to impact investing, supported by asset managers' quest for differentiating products and fueled by booming investor demand.

The lack of a common taxonomy has allowed investment strategies of all stripes to jump on the bandwagon, usually anchoring their impact credentials to the UN's Sustainable Development Goals (SDGs), which have de facto become the reference framework for impact investing. But below this catchy varnish, impact managers display deep discrepancies in the way they approach, promote and measure impact.

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The impact private equity kaleidoscope

Impact private equity strategies generally fall under one of three categories:

- **Emerging market private equity**: financing entrepreneurs and companies in developing economies complies, by nature, with impact objectives for most investors. Emerging market PE strategies were thus among the first to claim impact credentials, giving a new name to a form of investing they had been pioneering for years.
- **Thematic private equity**: some of the most prominent investment themes - clean energy, health and education, agri-food or infrastructure – go hand in glove with the SDGs. It therefore comes as no surprise that many thematic private equity funds have leveraged their natural proximity to impact to throw their hat into the ring.
- **Generalist impact**: while the first two categories draw their impact philosophy from the nature of their underlying investments, these funds attempt to generate impact without restricting their investment pipeline to companies whose products and services directly contribute to the achievement of specific SDGs. These strategies take impact to the micro level, focusing on fostering change within individual companies, with the implied belief that any investment can have an impact.

Faced with such a breadth of practices and players, how can asset owners separate the wheat from the chaff and how can private equity managers make sure they do not end up in the wrong pile? We have identified three dimensions as essential competitive edges for private equity firms entering impact.

Professing clear intentionality

Impact investing is a mindset, a way of allocating capital and engaging with companies with the intent of generating positive and measurable outcomes. This dimension is where many impact-labeled funds fall short. An impact fund must clearly state its intended objective rather than picking out impact KPIs mechanically linked to the financial performance of its holdings (job creation, reduced emissions...)

Impact-savvy LPs seek concrete, demonstrable, and relative impact. Bringing them inside the thought-process and collaboratively defining objectives and KPIs is one way for GPs to ensure the credibility of their approach and move away from a purely track-record-oriented discussion.

Showcasing robust methodologies

As the private equity landscape becomes flooded with purported impact strategies, bulletproof methodologies are bound to become the touchstone by which the legitimacy of any given strategy will be judged, used to draw the line between impact washing and 'true' impact. This is especially true for generalist strategies, where impact does not come from the nature of a portfolio but must transpire in other ways.

Optimal impact frameworks address each part of the investment value chain to ensure impact permeates every step of the investment process:

- Sustainability due diligences are a standard component of impact investors' vetting process, alongside traditional (commercial, legal, financial) reviews;
- Strategic planning and monitoring: impact frameworks transcend the barrier between ESG and corporate strategy and provide clear roadmaps for companies to generate measurable impact, in line with the fund's objectives;
- Reporting: innovative reporting tools and methodologies enable impact managers to tailor impact reporting to LPs' expectations and showcase their efforts to their own stakeholders.

Aligning private equity models

To many onlookers, the tension between impact investing and the private equity business model is insoluble. What kind of impact can truly be achieved over a 5-year investment horizon? How can impact ever become a central focus in an industry driven by carried interest?

Effective impact generation can only come about when the mechanics of private equity are in line to achieve it. For instance, private equity managers may need to cohere their portfolio company holding period with their impact objectives, to ensure that long-term projects do not get sidelined to the profit of short-term value maximization. They could also consider aligning remuneration structures with impact objectives, a move which would undoubtedly secure credibility in the eyes of LPs. Such mechanisms may well provide the most modern version of ESG's primary adage: 'doing well by doing good'.

Impact follows hot on the heels of Europe's private equity ESG revolution. Impact strategies and the ability to demonstrate them may be the key to answering client's appetite for a renewed raison d'être to private equity, whose business model is increasingly being challenged in the eyes of market stakeholders (LPs, academics, governments). GPs would do well not to underestimate this welcome opportunity for renewal.

INDEFI is a strategy advisory partnership for the investment management business.

Our positioning at the crossroads of assets managers and investors across Europe gives us a unique vantage point on private equity's conversion to impact investing.

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