The ability to earn high returns and do some good at the same time – that’s the promise of impact investing, a growing subset of private capital that seeks to generate a market rate financial return while simultaneously creating a measurable social impact.

**Impact goes mainstream**

While impact investing has been around for decades, to date, it has been largely the province of small and middle market private funds, NGOs or other quasi-public entities. Many of these institutions focused on projects with high social impacts, but that may have delivered below-market rate (concessionary) returns. However, that picture and focus is changing. Increasing awareness around social issues is precipitating a generational shift that is driving an increasing amount of assets toward investments that are serving as a social additive. Large, established managers have entered the space, backed largely by traditional private equity (PE) LPs, many of whom are making some of their first allocations to impact investments, suggesting that the asset class may finally be going mainstream. Perhaps most importantly, this new generation of investors are adamant that returns can be comparable to, or better than, other non-impact investments.

Among the most high-profile of these are the Bain Capital Double Impact Fund and the TPG Growth Rise Fund. In 2015, Bain Capital began fundraising for its Double Impact Fund, which closed with a reported US$400m. In late 2016, TPG launched its Rise Fund which raised over US$2b in commitments; the firm is currently raising its second fund with an even larger target.

They’ve since been joined by other large diversified alternative asset managers in allocating targeted pools of impact capital, including KKR, Blackstone, and Partners Group. What these funds are unlocking is an increasing propensity of institutional investors to invest in purpose-driven funds that promise sound financial returns and the fulfillment of a broader social mission. In total, according to the Global Impact Investor Network, impact investors put more than US$5b to work in PE investments last year, and deployed even more capital – roughly US$30b – via investments in private debt, real assets, and other asset classes.
A natural evolution – from “do no harm” to an active dual mandate

The increased interest in impact investing feels like a natural evolution; for decades, investors have sought to steer capital toward investments aligned with their beliefs – for example, the proliferation of mutual funds in the ’80s and ’90s that promised to avoid so-called “sin” industries such as alcohol and tobacco; or the push for university endowments in the early 2000s to divest from fossil fuels.

In the PE space, it’s manifested as a greater focus by PE firms on environmental social governance (ESG) – firms working to ensure that the companies in which they invest are environmentally sustainable, are diligently following labor regulations and are following best practices in diversity and inclusiveness, among others. Right now, there are many funds that do not consider themselves impact investment funds, but that have ESG measures to which they hold themselves accountable. Impact investing goes beyond this “do no harm” mentality, to an explicit active dual mandate that gives weight to both economic and social returns.

As impact investing has developed, these weightings haven’t always enjoyed equal priority. Indeed, until recently, impact investing has struggled with a reputation of “good people doing bad deals” as investors focused on social returns to the detriment of IRR. Many (but not all) of impact investing’s early adopters tended to be managers with extensive philanthropic backgrounds, but with limited experience underwriting PE-type investments.

However, this new wave of impact investors are seeking to reverse this image, employing the same rigor around commercial underwriting that they apply to any other non-impact investing deal. Increasingly, managers with the DNA of a PE investor are applying their skills to the impact investing space, driven by the mantra that ultimately, a business that fails within a few years of being funded will have minimal social impact.

“Businesses that fail have no social impact, because if they can’t sustain themselves financially, there is no product or service to deliver.”

— Elizabeth Burgess
Partner at Bridges Fund Management
The impact investing advantage

For investors with an impact mandate, sourcing presents additional complications and challenges above and beyond those faced by the typical PE fund; not only must deals meet financial underwriting criteria, but they must also pass muster as being a social additive. Indeed, the historical knock against socially conscious funds has always been that by imposing limits on a fund’s investible universe, returns are inclined to suffer.

However, many impact investors beg to differ – for them, their dual focus can be a source of significant competitive advantage. By viewing the landscape through the lens of social impact, funds are often able to identify opportunities that others might overlook. Moreover, impact funds can have an edge in negotiating PE deals that their non-impact counterparts lack. For entrepreneurs and business owners that have invested substantial parts of themselves in building a mission-based business, partnering with a fund that shares those values and is measured by the same mission-driven aspects is a natural next step. Impact funds can offer the ability to lock in a company’s mission for the long term, and to amplify its spread.

“When I sit across the table from a founder and tell them that I’m going to be held accountable for the social impact of the investment, a light goes on. That’s a real competitive advantage.”

— John Rogers
Partner at The Rise Fund

With growth comes challenges

At the same time, the increasing attention that impact investing is seeing is creating a number of challenges.

“Impact investing” can mean many things to different people. With more assets flowing into the space, some incumbents are raising fears of dilution and a potential loss of identity, while others worry about an influx of capital that’s chasing a finite universe of investible opportunities. For LPs, political considerations can be significant, with constituencies from one institution having very different ideas from another around what social objectives are worth pursuing. As the ecosystem continues to grow and evolve, the discussions will become more acute, and investors in the space will find themselves under increasing scrutiny as to their perspective on what defines an impact investment – and which “impacts” they support or want to back.

The importance of measurement and classification

One of the greatest challenges in the space is the measurement of the social impact. With its unique dual mandate, impact investing has a number of measurement and reporting considerations that traditional investments don’t. Beyond the economic returns, impact investors have to be able to consistently measure the positive externalities that were created by their involvement. How much carbon was eliminated from the atmosphere, or how much potable water was produced? How many people were connected to the internet, began using banking services or visited a hospital for the first time?

Currently, there are a number of competing and complementary tools and methodologies for measuring social impact. Many investors are using a blend of proprietary metrics, qualitative analysis and frameworks developed by third parties, like the Global Impact Investing Network IRIS metrics, the Global Impact Investing Rating System (GIIRS), the Social Return on Investment (SROI) and the Impact Management Project. As the industry continues to grow and evolve, uniformity in measurement will become increasingly important – large LPs don’t need 10 impact funds reporting 10 different ways. Standardization – through the promulgation and widespread acceptance of frameworks that allow LPs to compare impact investing results across funds and against a benchmark – will be a critical enabler for the further growth of the asset class. And as standardization in the way that social returns are measured increases, this will further enable classification taxonomies that allow investors to readily identify impact investment funds that more clearly match with their objectives and sense of purpose.

The benefits of mainstreaming

Many incumbent investors in the space consider this mainstreaming to be a positive development for the industry. Large funds can help push forward the professionalization of the asset class and help contribute to the conversation around standardization of metrics in a way that smaller funds are challenged to do.

And with large firms entering the space, impact investing’s credibility and profile among the pension funds, endowments, foundations and other entities that make up the universe of LPs is raised – and rising – dramatically. According to a recent survey by the Global Impact Investing Network, 18% of pension funds now represent the single largest source of capital for impact investors. Clearly, the desire by LPs to actually be doing something more “purposeful” and beyond simply generating returns is growing.
What's next? (Hint: you don't have to be a “true believer”)

Impact investors believe that commerce is a force that can enable dramatic social changes; that targeted, thoughtful investments in mission-based businesses and companies performing a social good, supported with the hands-on expertise in growing businesses that PE is known for, can make the world better. They believe they can help capture the purpose. Across the world, the levers of government are increasingly moving in the same direction – toward better health outcomes, toward increased educational opportunities, toward low-carbon sources of energy. Indeed, you don’t have to be a “true believer” to recognize that the opportunities are substantial, and that the direction of travel for the global economy runs parallel with the core tenets of impact investing. The potential is real, and the momentum is accelerating. Investing in purpose-led companies is gaining traction and delivering an impact.

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