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Climate

Investors turn up the heat

KEYNOTE INTERVIEW

Private equity embraces impact

Managers are increasingly raising funds designed to marry financial returns with positive societal outcomes, says Tania Carnegie, leader of the Impact Ventures practice at KPMG

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Q Impact investment seems to have ramped up over the past 12 months. How would you describe that escalation?

I would describe the growth we have seen in impact investment in three ways. First, it is very much in line with a broader movement, calling for the evolution of capitalism. The latest evidence of that is the Davos Manifesto, promoting a shift to stakeholder capitalism.

Second, I would describe it in the context of a general maturation. In 2019, in particular, we really started to see some common practices emerging. A number of initiatives, such as the Operating Principles for Impact Management, released by the IFC, are supporting that, bringing clarity around best practice, as well as additional understanding around what impact really means.

Finally, the impact universe is expanding. Impact has historically been associated with value-based investors such as high-net-worth individuals, or foundations. But in the last year, we have seen a number of fiduciaries coming into the conversation and really starting to think about how a focus on impact can support their financial objectives. It's been an exciting 12 months.

Q What are the challenges around balancing impact outcome and fiduciary responsibility?

A number of member firm clients are fiduciaries, with very clear and tightly defined investment mandates that focus on maximising financial returns. They have to be very careful not to be perceived as deviating from that mandate. But when you look at the way that these fiduciaries have been embracing and incorporating ESG as part of their investment approach, you can see the focus has been on how ESG can add value to investment processes and outcomes. These fiduciaries are now looking at how an impact lens can also give them an edge. The focus is on driving financial performance as opposed to taking them off course.

Q How has the private equity industry's impact journey compared with other asset classes?

We have observed a very considered approach. Firms preparing to launch impact funds have gone through extensive

internal processes – they have really done their homework – talking to other players in the space and seeing how an impact approach could align with their current activities. They are exploring both how an impact strategy could appeal to their LPs, as well as give them a different perspective on investment opportunities. We have really seen a lot of work going on behind the press release announcements. This isn't just about a fear of missing out. There is determination to invest in a different way.

Q What types of private equity firms are getting involved?

The great thing about impact investment is that it is such an equal opportunity investment approach. What I mean by that, is that it can be scaled and adapted to all different types of investors, across asset classes, sizes and geographies. What we are seeing now is a far greater breadth of investors getting involved, recognising that potential.

Q How much differentiation are you seeing between managers in terms of their impact investment approach?

We are seeing a great deal of consistency in terms of a recognition that financial returns matter and that transactions need to meet the specific financial criteria of that investor in order to move ahead. GPs understand that a lot of their LPs are fiduciaries and this is the approach they need to take.

Where we see some differentiation is in the areas of focus for investment – the geographies and sectors that are being pursued. Often this is aligned to the way in which the GP is already investing. Managers want to make sure they are playing off their existing strengths in order to build confidence in their impact approach.

Q How are LPs responding to these new, and unproven, strategies and what is their approach to due diligence?

Even if an LP has been investing with a GP for years, investing in that GP's impact fund is a very different proposition. The manager may have a superior financial track record, but they won't have an impact track record and that's an important consideration.

LPs are, therefore, undertaking deep due diligence. First and foremost, they want to get comfortable with the integrity and

Q To what extent do you expect to see private equity impact investment grow further? And what is required for that to happen?

I definitely see this as a growing opportunity for private equity, in particular. In order to help managers exploit those opportunities, we need to see the continued evolution of impact standards. This is already starting to happen, with the work that is being done to create an ISO standard for sustainable finance, for example, as well as the work being done in the EU to create a green taxonomy for sustainable activities. These initiatives clarify what is truly impactful, for investors, and enable them to assess performance and make comparisons.

But I also think we need to get a lot clearer around impact language. Impact continues to conjure up a lot of preconceived notions – in particular, the idea that the considerations of impact will diminish financial returns. In reality, what we are seeing is that impact investment can work in many different ways to suit different investor requirements and that many different types of capital are needed to make the impact movement really successful.

There is a need for concessionary capital, certainly. But there is also a need for early-stage capital, growth capital and institutional capital. Each of these different types of investor, providing these different types of capital, needs to be evaluating opportunities in the context of their own risk and return profile. There are still a lot of blanket statements being made about impact and that is a challenge, for sure.

authenticity of the strategy. They want to understand why the GP is entering the space and to make sure it is not just a fear of missing out. They want to understand the manager's view on how an impact approach will add value and that there is real rigour to that approach. Once deals have been completed, they will look to see how the approach is applied through the investment lifecycle.

Q How are these funds being resourced?

Typically, a GP will hire a dedicated impact team. They are thinking about the types of expertise required to support the success of the strategy and so we are seeing a lot of hiring activity. We are also seeing partnerships with outside advisors, in order to draw in some of the more specialist knowledge needed. Managers are working in a co-ordinated and integrated fashion.

Q And what types of opportunity are these private equity impact funds pursuing? Is it primarily focused on environmental considerations?

It's broader than that, partly because there is a growing understanding that the environment, and climate change, have a social impact as well. GPs are looking at investments that tackle the wide range of challenges that are going to make it difficult for life as we know it to continue, either helping change that path or supporting adaption. I expect the understanding of investment opportunities to continue to become more holistic going forward.

Q How is private equity performing when it comes to both impact and financial returns? Or is it too soon to say?

Early indications are positive, not least because a number of GPs are now out raising second funds. One could certainly infer from that their initial experience has been positive from a deployment perspective and that the limited partner appetite is there too.

Q Is there sufficient dealflow to cater for all the fundraising we are seeing?

My understanding, from talking to clients, is that yes, there is. That was certainly an initial concern for some of the new entrants that have come into the space, but these managers have quickly realised that there is a diverse array of opportunity and a real thirst for capital amongst the growing number of companies that are identifying with a broader purpose. That growth in dealflow is part of what is driving the momentum behind all the fundraising that we are seeing.

"Managers want to make sure they are playing off their existing strengths in order to build confidence in their impact approach"

Q Is there a danger that the changing attitude to the capitalist model that is underpinning the impact movement reflects a temporary wave of public and political sentiment, or do you believe it is truly sustainable?

There is a real momentum behind this call for a shift towards stakeholder capitalism versus shareholder primacy. I do not believe this to be a temporary phenomenon. And I think that it is going to require everyone that is part of the investment ecosystem to really think about how they can operate in a way that lives up to those expectations. The opportunity, then, is to translate that sentiment into tangible action and to demonstrate how that action is making you better, as an organisation.

Q So, it's about communicating net positive impact?

Absolutely. There needs to be a recognition that impact is inherent in all companies and those companies need to manage that impact to ensure it is net positive. All this is part of a broader understanding that companies are deeply interconnected with the fabric of society. Quite frankly, the more companies that think in this way, the greater the pipeline for private equity firms thinking about where to invest next, and that obviously creates more robust choices for LPs as well.

Q And what role does KPMG seek to play in supporting the growth of the impact movement, particularly as it pertains to private equity?

Our role is to support clients along their individual journeys. In particular, member firms advise our clients to develop an impact strategy and impact management approach that adds value throughout the investment process, and help them to earn the confidence of their investors and stakeholders through our impact assurance services. We also assist with deal sourcing and due diligence, and advise portfolio companies to maximise opportunities for value creation and impact.

We have always sought to play a critical role in supporting the growth and evolution of the broader industry. We have some exciting things planned for 2020 that we look forward to sharing in the coming months. ■