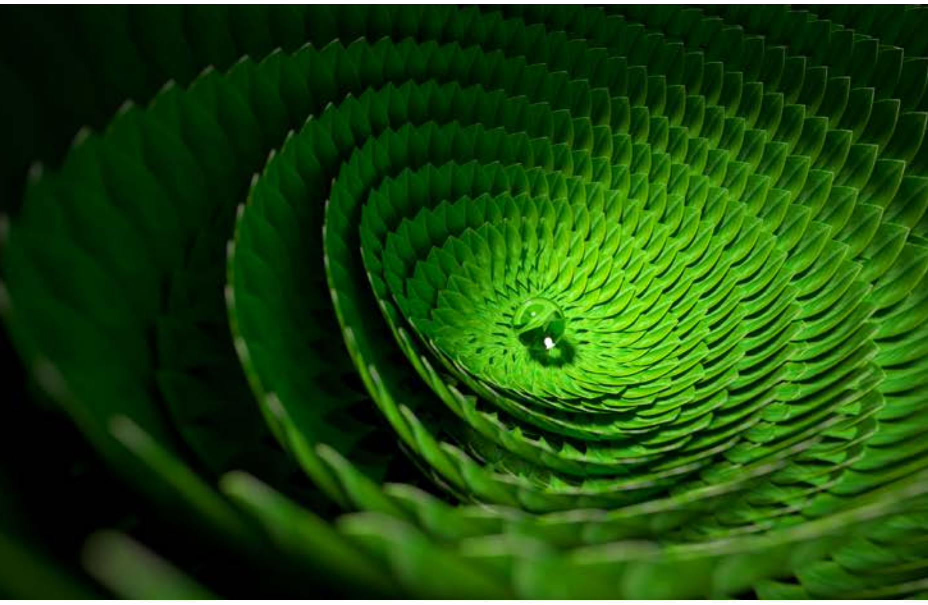
The reality of risk

Unearthed opportunity in growth equity impact

Growth equity impact supports enterprises poised to solve critical societal and environmental challenges. Concerned about an emerging funding gap, M&G Investments has partnered with Phenix Capital Group, a leading global impact investing consulting group, to explore the reasons this gap exists and the implications. Combining M&G research with the Phenix Impact Database, we present a data-based analysis of this critical issue.



Impact investing is a powerful force for both profit as well as environmental and societal progress. It is where capital is able to support innovation and technological development with the goal of solving some of our greatest global challenges. For investors we believe the commercialisation of these products and services offers compelling opportunities. Companies creating these solutions, likely the prime beneficiaries of powerful growth trends, offer investors the prospect of highly attractive long-term returns. It is this alignment of purpose with opportunity which makes impact investment such a powerful force.

Executive summary

Impact investing is an approach which has been embraced by investors in recent years. Now firmly established as a core investment strategy, the number of impact funds available has doubled over the last 10-years[1]. Specifically within the impact arena, private equity dominates with 50% of all impact funds sitting in this asset class. The importance of impact private equity is underlined by the growth in capital raised, a 370% increase over the last 10-years, to €188 billion today[2].

However, this has not been a story without its challenges. Not least the emergence of a funding gap – a growing differential between target versus actual impact private equity capital raised.

And this gap matters, serving as an impediment towards unlocking the potential of businesses positioned to make a lasting and impactful difference towards energy transition and indeed wider environmental and societal challenges. Further, it narrows the investment universe potentially excluding some of the most commercially compelling opportunities.

More specifically, this gap is disproportionately affecting Series B and C funding[3], a crucial point in corporate development where enterprises depend on capital injections in order to achieve scale and commercial success. In this paper we explore the likely reasons for this funding gap, seeking to separate valid investor concerns from those which are likely misconceptions.

The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The views expressed in this document should not be taken as a recommendation, advice or forecast, nor a recommendation to purchase or sell any particular security. While we support the UN SDGs, we are not associated with the UN and our funds are not endorsed by them.

[1,2] Phenix Capital Group – Impact Database, 2024.

[3] Series B funding: the funding stage for private companies at the point where they are typically looking to accelerate growth, expand market reach or scale their operations.
Series C funding: a later-stage funding round for established businesses with proven business models, revenue streams and typically seeking to accelerate growth or prepare for an Initial Public Offering (IPO).

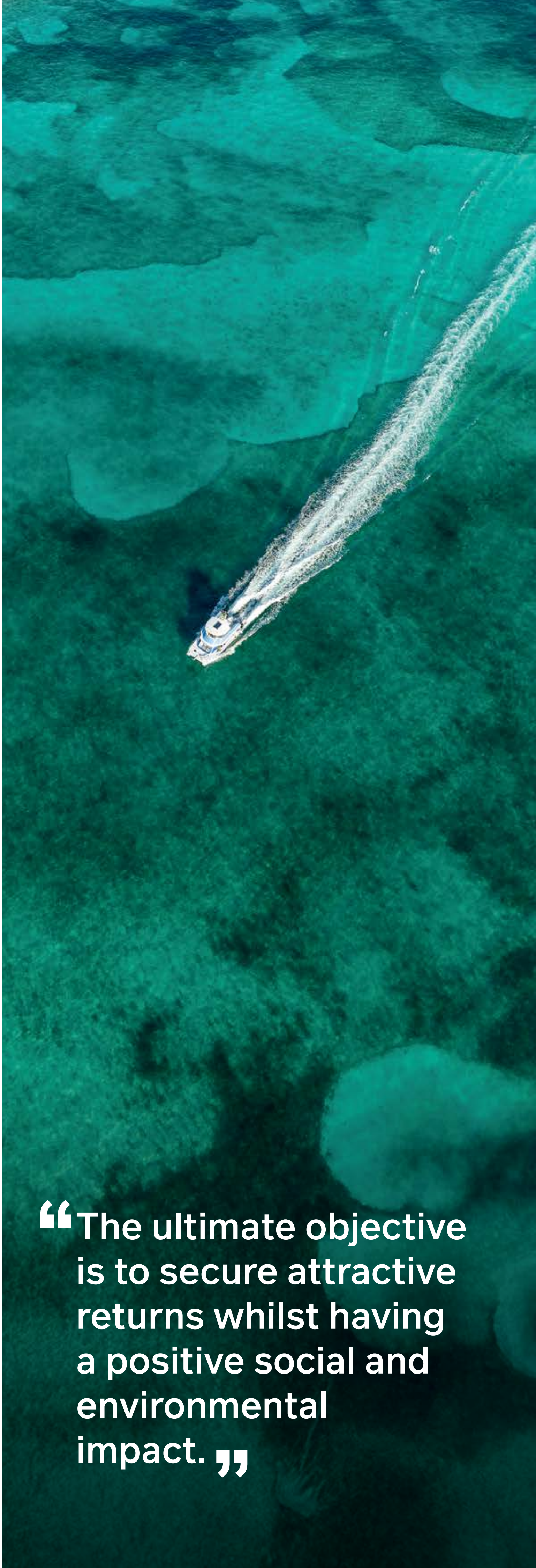
The funding gap

Across the wider growth equity impact sector, due to many funds failing to meet their fund raising targets, a clear overall funding gap for the sector has progressively developed, a trend which appears to have accelerated since 2022. Differences between targeted and actual capital raised are not unusual: historically the average growth equity impact fund only raises around 70% of their target[4]. However, the chart below indicates that in 2022 funds only raised 52% of their target and, whilst 2023 and 2024 vintages are likely still in fundraising and funds raised underreported, unquestionably this remains a challenging environment.

Early to late stage funding worst hit

Whilst the mismatch between capital raised and target size across the impact growth equity sector is worrying, of even greater concern is the impact this sharp fall in capital provision has for early to late stage growth company development. At this point it is helpful to define the precise part of the private equity spectrum we are referring to. These are growth enterprises, likely with a proven business model experiencing rapid customer and revenue growth.

At this stage in their development such businesses typically require further capital injections in order to expand their workforce, manufacturing and operational capabilities, R&D or geographic reach. Whilst the risk of failure is clearly not as great as at the venture capital stage, business and long-term funding remain potential risks. These are not start-ups but scale-ups, where in time, a sale to a strategic or private equity buyer or IPO would provide an exit to investors.

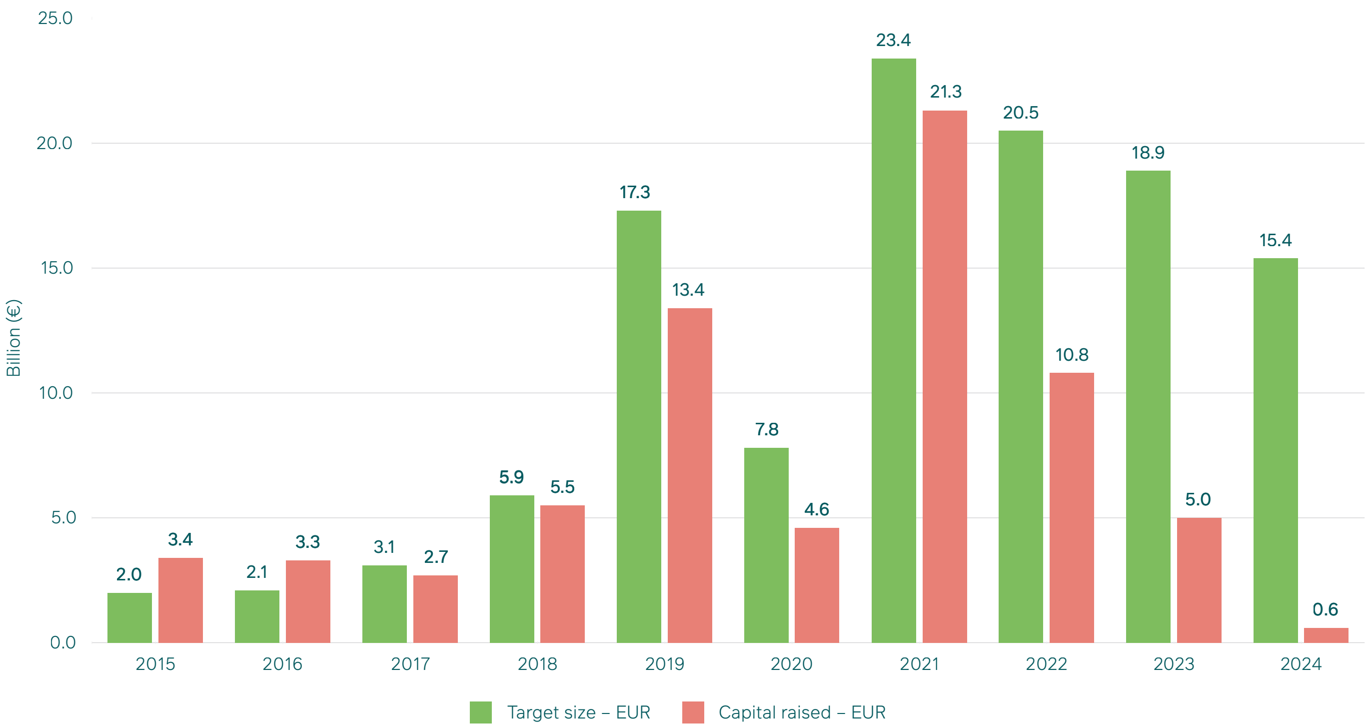


"The ultimate objective is to secure attractive returns whilst having a positive social and environmental impact."

[4]Phenix Capital Group – Impact Database, 2024.

An accelerating funding gap

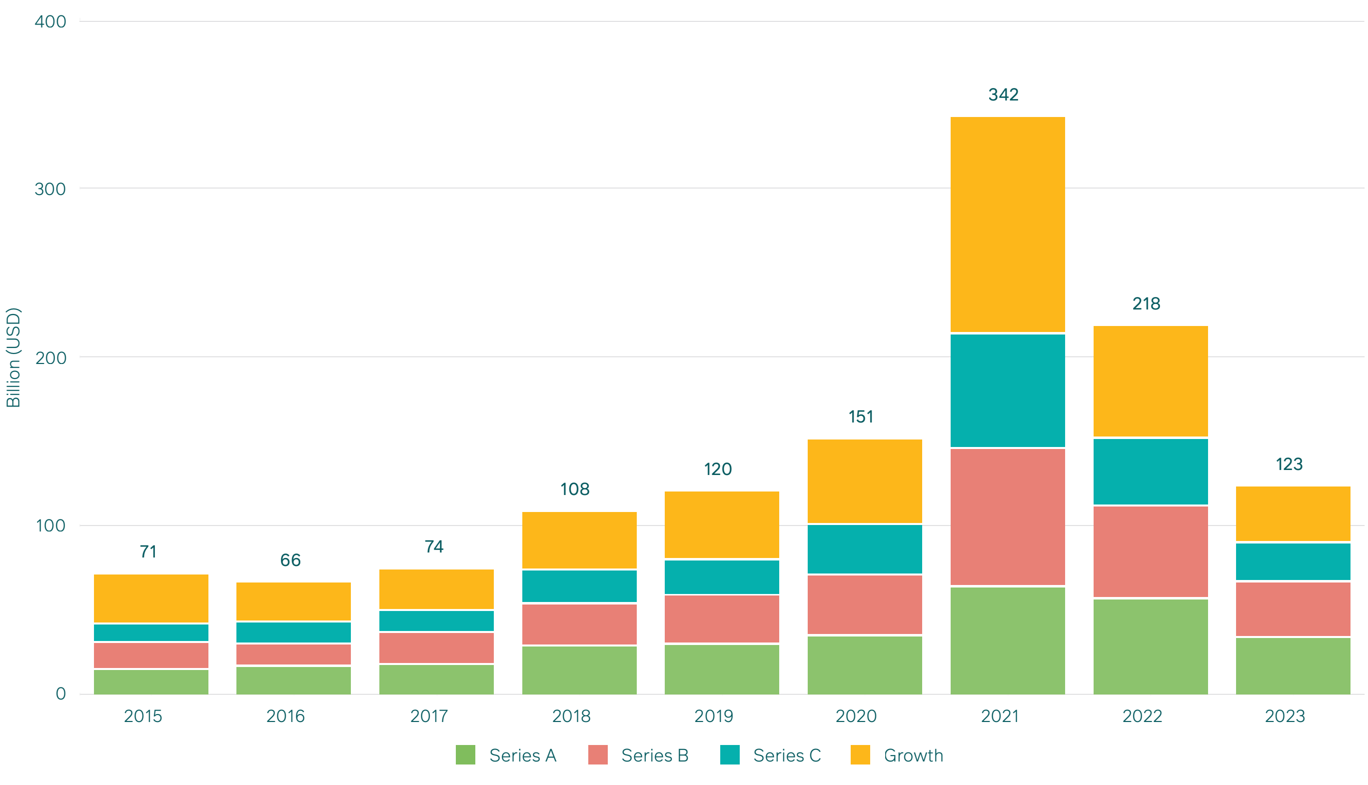
Target size and capital raised (Growth Impact Equity funds)



Source: Phenix Capital Group, Impact Database 2024

As the chart below illustrates, the funding gap which exists sits disproportionately within this late B to C funding stage.

Late-stage funding in decline



Source: M&G Investments, March 2024

Growth equity investors play a critical role by providing capital during this build and scale-up phase. Their role is not simply to invest capital but also work with management and shape the strategy of the business. As impact investors, the ultimate objective is to secure attractive returns whilst having a positive impact by scaling up purpose driven companies.

Why the under-allocation?

With a clear gap in capital provision at this vital funding stage, the obvious question is 'why'? At a top-level, one possible view could be that growth equity occupies an awkward space within private equity – the 'middle child' – neither venture capital or imminent buyout candidate. Perhaps there is simply a greater understanding among investors of the role of both venture capital (VC) and buyout relative to growth investing. If so, this would be unfortunate and potentially a missed opportunity. Arguably the growth stage offers a more compelling risk/return profile with lower failure rates than VC, but substantial remaining growth potential.

> "Growth equity impact has not gone global."

Regardless, there are likely more specific reasons why growth equity impact in particular is suffering from a relative funding drought with investors hesitant to increase allocations:

Scale-up risk – Early to late stage growth businesses viewed as being at a riskier point in their development. These businesses will continue to mature and likely require further capital support. As the failure rate remains high, some investors may be nervous increasing their capital commitment. In part, this risk can be mitigated by a sufficiently diversified portfolio.

Immature sector – Growth equity impact has a relatively short track record, both as an investment area but also in terms of manager performance. Compounding this is the lack of a universally agreed definition of precisely what 'growth equity' actually refers to.

Scepticism – 'Impact washing' is a suspicion that impact investing is more marketing than a credible investment strategy. There is a perception that impact cannot be reliably measured, therefore making it difficult to prove that it can enhance returns. This can be addressed via robust due diligence – authentic growth equity impact managers can evidence processes centred on impact screening, assessment, measurement, monitoring and reporting.

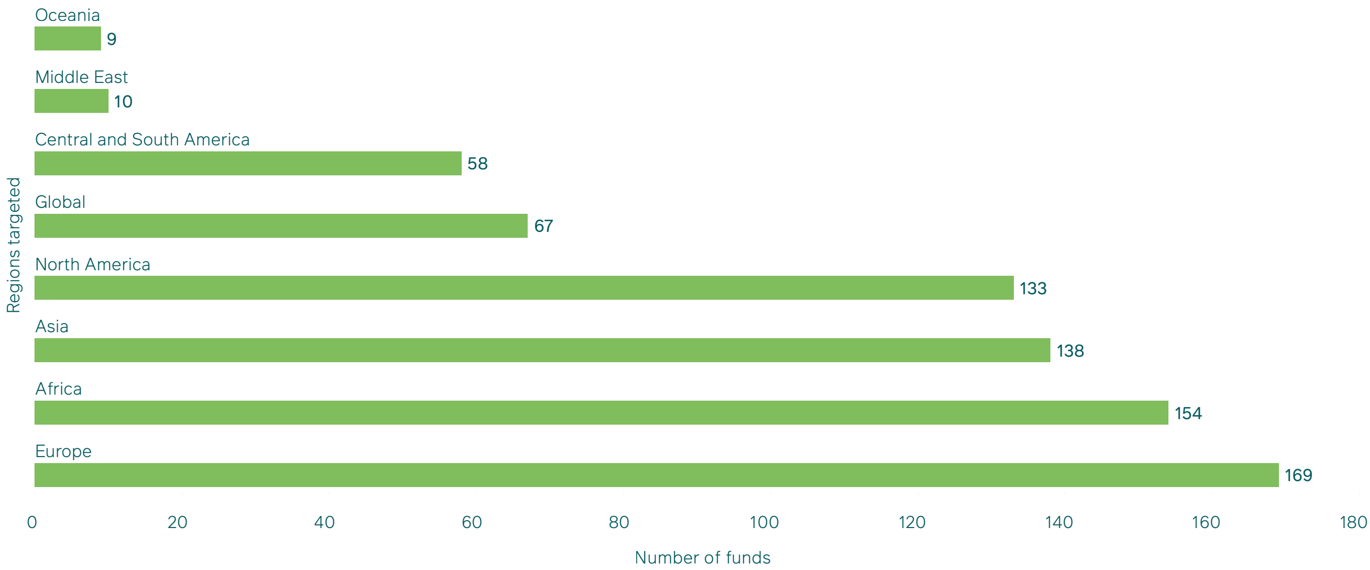
Valuation discipline – With fund raising targets for growth equity impact continuing to grow, concern that a larger number of investors chasing the same assets will lead to poor valuation discipline with subsequent value-add diminished. Here, being an established, well-respected manager will help as target companies will favour investors with a long-standing reputation, broad experience and demonstrably in a financial position to follow through and deliver the investment they promise, not just once, but on an ongoing basis.

Constrained opportunity set – Growth equity impact has not 'gone global'. According to research consultants, Phenix Capital Group[5], of almost 600 growth equity impact funds researched, almost all have a regional rather than global focus[6]. Indeed, only around 10% of available funds have a true global mandate. This predominantly regional rather than global focus may prove a deterrent for investors seeking to capture the widest opportunity set.

[5]Phenix Capital Group is a leading impact investing advisory firm established in 2012 with the mission to enable institutional investments towards the Sustainable Development Goals (SDGs), through its impact investing intelligence (digital databases, publications and thought leadership industry events) and tailored advisory services. For more information about Phenix Capital Group please visit phenixcapitalgroup.com and for more information about Phenix's impact funds database please visit: phenixcapitalgroup.com/impact-funds-database.
[6]Phenix Capital Group – Impact Database, 2024.

Growth equity impact predominantly regional in focus

Number of Impact Growth Private Equity funds per target region



Source: Phenix Capital Group, Impact Database 2024.

*Data includes double counting where funds target multiple regions

Taking a wider perspective, another possibility for this under-allocation to growth equity impact could be institutional investor exposure to an under-appreciated but potentially serious risk. Within traditional equity allocations, there likely will be a high exposure to legacy businesses and sectors. However, the pace of technological, climate and societal change is accelerating rapidly: in 2018 only 2% of new cars sold globally were electric vehicles (EVs), today that figure is 18%[7]. The risk that the industry leaders of today become irrelevant tomorrow has never been more real.

> **“Growth equity impact investment arguably has greater leverage to the most powerful growth dynamics.”**

A core attraction of growth equity impact is its natural bias towards companies and sectors which are more likely to sit within strong, long-term secular growth areas of the global economy. The mandate for most growth equity impact funds is to create positive environmental and social impact whilst also delivering attractive financial returns. Such a mandate will gravitate towards investment within sectors focussed on, for example, decarbonisation, energy transition, preventative healthcare, and financial democratisation – all multi-year growth opportunities.

Relative to traditional equity strategies, growth equity impact investment arguably has greater alignment to the most powerful growth dynamics evident across global economies. Potentially this enables growth equity impact to offer investors superior investment returns, over a longer time period, and align to the needs of many institutional and professional investors.

[7]IEA, Global EV Outlook, 2024.

Time to debunk the myths

Having discussed both the size and potential reasons for the funding gap which exists for early to late-stage growth investment, it is necessary to firmly address some of the persistent myths which surround growth equity impact. It is likely many of these concerns stem from dated beliefs or misconceptions. This is an opportunity to provide clarity and reiterate the potential strengths of the asset class.

'Won't I sacrifice returns?': The myth of subpar financial performance

The perception that impact investing leads to diminished returns began in the 1970s when early impact investing was synonymous with negative screening. This approach excluded industries such as alcohol, tobacco and weapons to align with the values of socially conscious investors. Investors prioritising environmental responsibility, for example, shunned auto makers but in the process forfeited substantial returns with vehicle demand booming.

> "Positive rather than negative screening is now more prevalent."

However, impact investing has since evolved and moved beyond a reliance on negative screening. Today, the strategy encompasses a variety of advanced methodologies designed to enhance both impact and return. Positive rather than negative screening is now more prevalent, proactively selecting companies that excel in sustainable practices and innovation. These investment approaches target sectors and companies poised for growth due to societal and environmental trends.

gradiant

As an illustrative example, Gradiant, an investment within the M&G Catalyst strategy, started as a spinout from the Massachusetts Institute of Technology (MIT). A technology-led business, it seeks to minimise the negative impact of industry, specifically addressing critical water challenges.

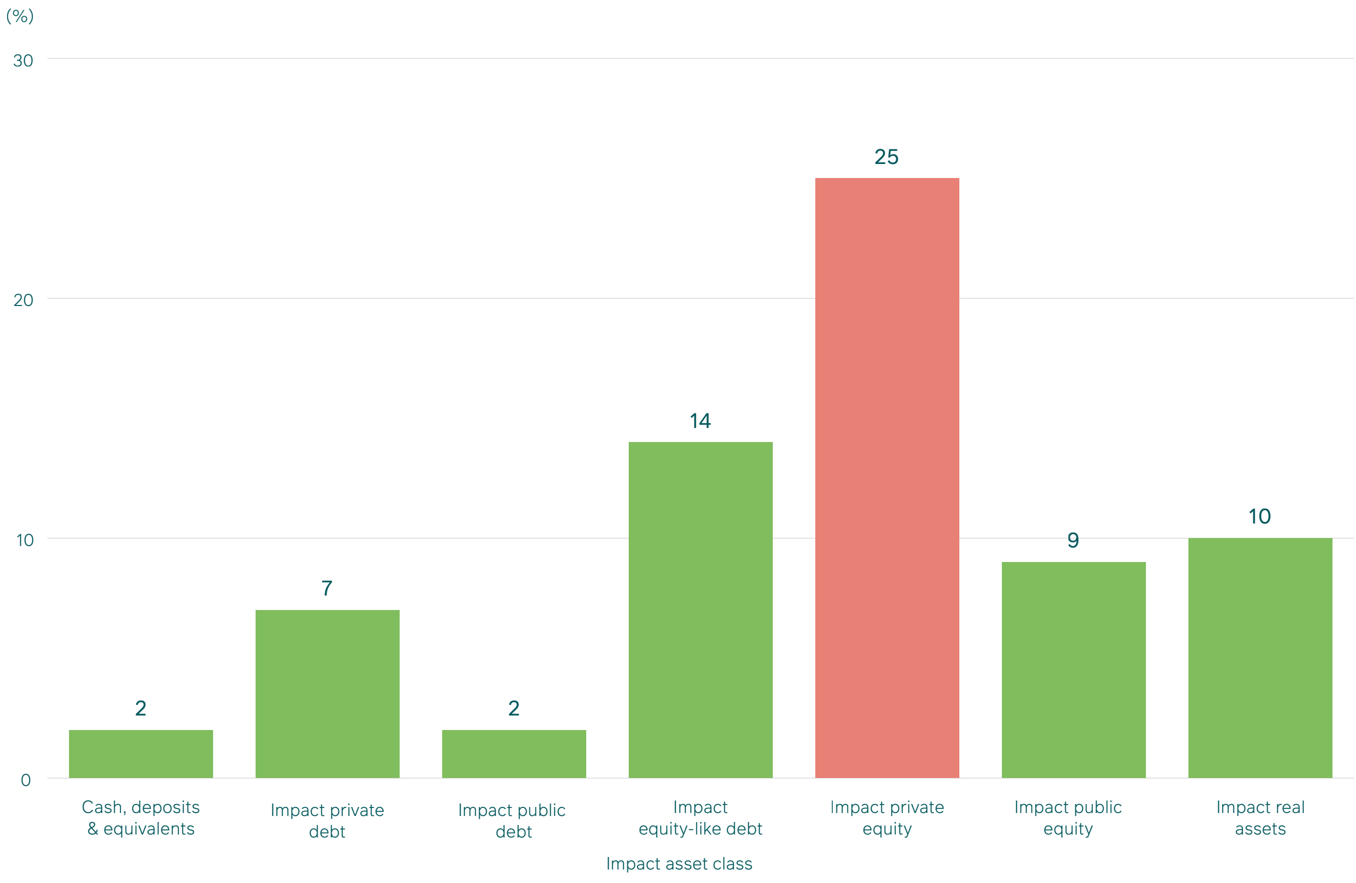
The company specialises in advanced water treatment and wastewater solutions providing essential infrastructure addressing challenges such as water scarcity and pollution. Their innovative technologies and dedication to sustainable resource management strategically position them to capitalise on secular growth trends.

Identifying Gradiant as a prospective investment was the result of a positive screening process. For investors seeking long-term resilience and impactful gains, Gradiant serves as an example of the type of investment which can offer a pathway to addressing urgent social needs while accessing significant opportunities for economic growth, driven be enduring market dynamics.

Providing consistent evidence of the relative performance of impact funds versus traditional funds is complicated by the fact that the term 'impact' has numerous definitions, making comparisons challenging. However, one of the most comprehensive studies undertaken was conducted by the World Bank in 2020[8]. This study compared a portfolio of impact investments relative to the S&P500 Index between 1956 and 2019. The impact portfolio outperformed the S&P Index by 15%.

Recent analysis by the Global Impact Investing Network (GIIN) further shows that impact private equity has substantially outperformed alternative impact strategies. This analysis is consistent with recent academic research which further indicates that impact funds tend to be more resilient during periods of pronounced market volatility. In one academic study, impact investments were seen to exhibit lower volatility but with equally compelling diversification compared to traditional venture capital investments[9].

Realised returns by impact asset class (gross) 2020-2023



Source: Global Impact Investing Network (GIIN), 2023.

Past performance is not a guide to future performance.

[8]World Bank Group, August 2020.
[9]Jeffers, Lyu and Posenau, 'The risk and return of impact investing funds', November 2024.

‘It’s all about climate, right?’: The myth of climate exclusivity

While climate-related investments represent a substantial segment of the impact investing domain, the belief that impact is only about climate mitigation overlooks the interdependent nature of impact themes and the considerable capital being directed into other areas. A stringent regulatory environment focusing on mechanisms for capital relief.

Extensive academic research leveraging the UN Sustainable Development Goals (SDGs) framework demonstrates that progress in one goal can instigate improvements in others, whereas deficiencies in one area may impede advancements elsewhere[10].

When looking at specific SDGs targeted by investors, there is a clear difference between the wider impact investment universe and growth equity impact specifically. With the former, a clear bias exists towards energy transition with almost 40% targeting Affordable and Clean Energy (SDG 7), whereas growth equity impact investors predominantly target themes contributing to reducing hunger and promoting responsible consumption.

BioFirst GROUP

Highlighting the interdependency of impact themes, M&G Catalyst investment, BioFirst, proves a compelling case study. BioFirst is a global leader in integrated pest management offering customised biostimulant and biopest control solutions.

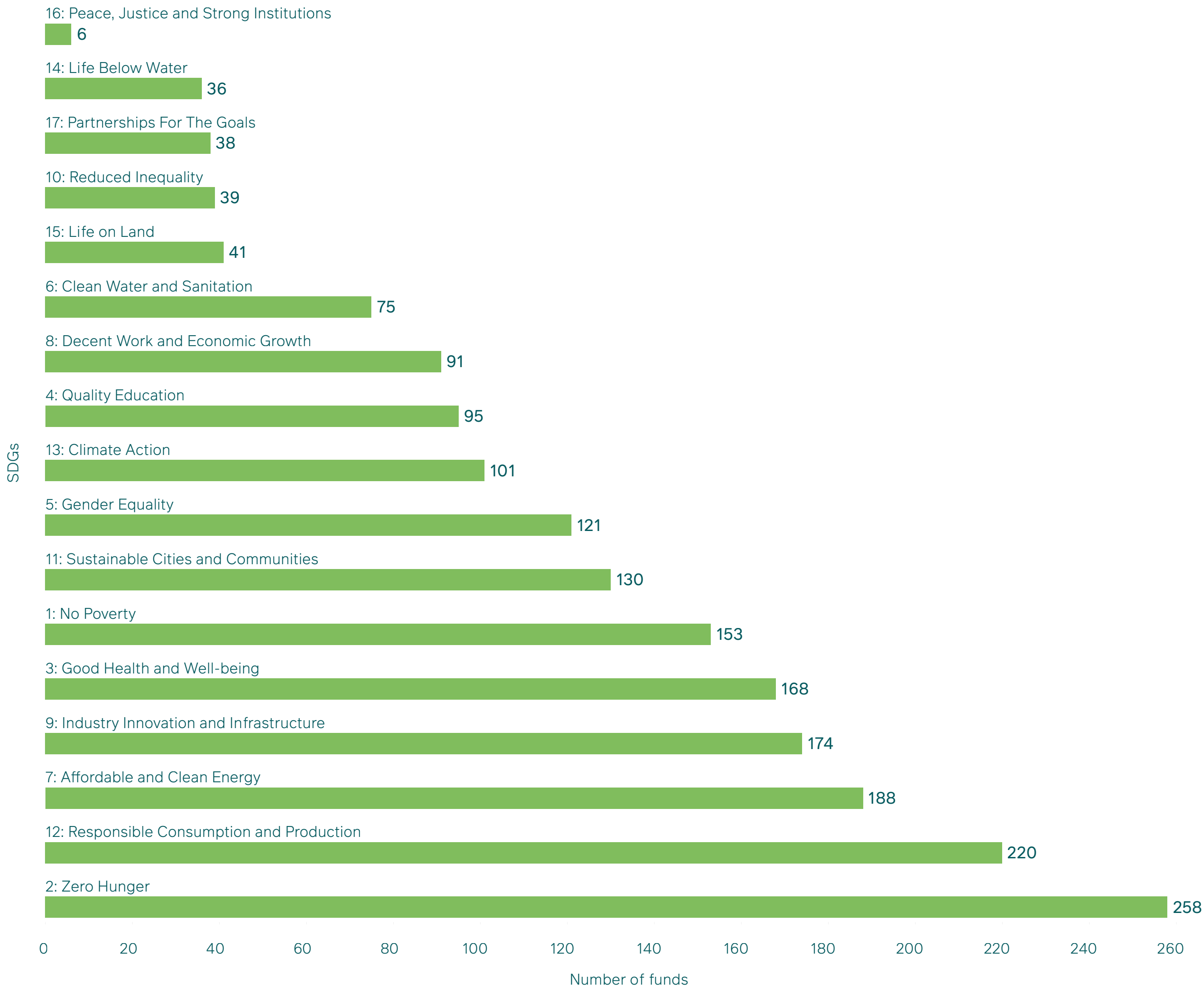
Due to its activities and products, it actively promotes several SDGs: SDG 12 (Responsible Consumption and Production) through sustainable agricultural practices, SDG 13 (Climate Action) and SDG 15 (Life on Land) by reducing CO2 emissions and preserving soil health.

The company advances SDG 4 (Quality Education) via farmer training, and supports SDG 8 (Decent Work and Economic Growth) with its commitment to fair pay. BioFirst bolsters SDG 2 (Zero Hunger) enabling food security and enhancing crop yields.

The breadth of SDGs a single company can align with is evidence of how interconnected many impact themes actually are.

[10] Laumann, von Kugelgen, Uehara, Barahona, Lancet, May 2022.

Number of Impact Growth Equity funds per SDG targeted



Source: Phenix Capital Group, Impact Database 2024.

A key takeaway however is that it is both unrealistic and undesirable for growth equity impact portfolios to target a narrow range of impact themes. In practice many impact themes are strongly correlated and inter-dependent. Mitigating concentration risk within a portfolio is also key and being liberated to invest both across geographies and impact categories can achieve this.

Thus, while energy remains a focal point, substantial investments in other sectors underscore the broader scope of growth equity impact investing. The myth of climate exclusivity is thoroughly debunked when considering the interdependency of impact themes. For discerning investors, this comprehensive insight opens up a vast array of high-impact opportunities that transcend climate-centric narratives.

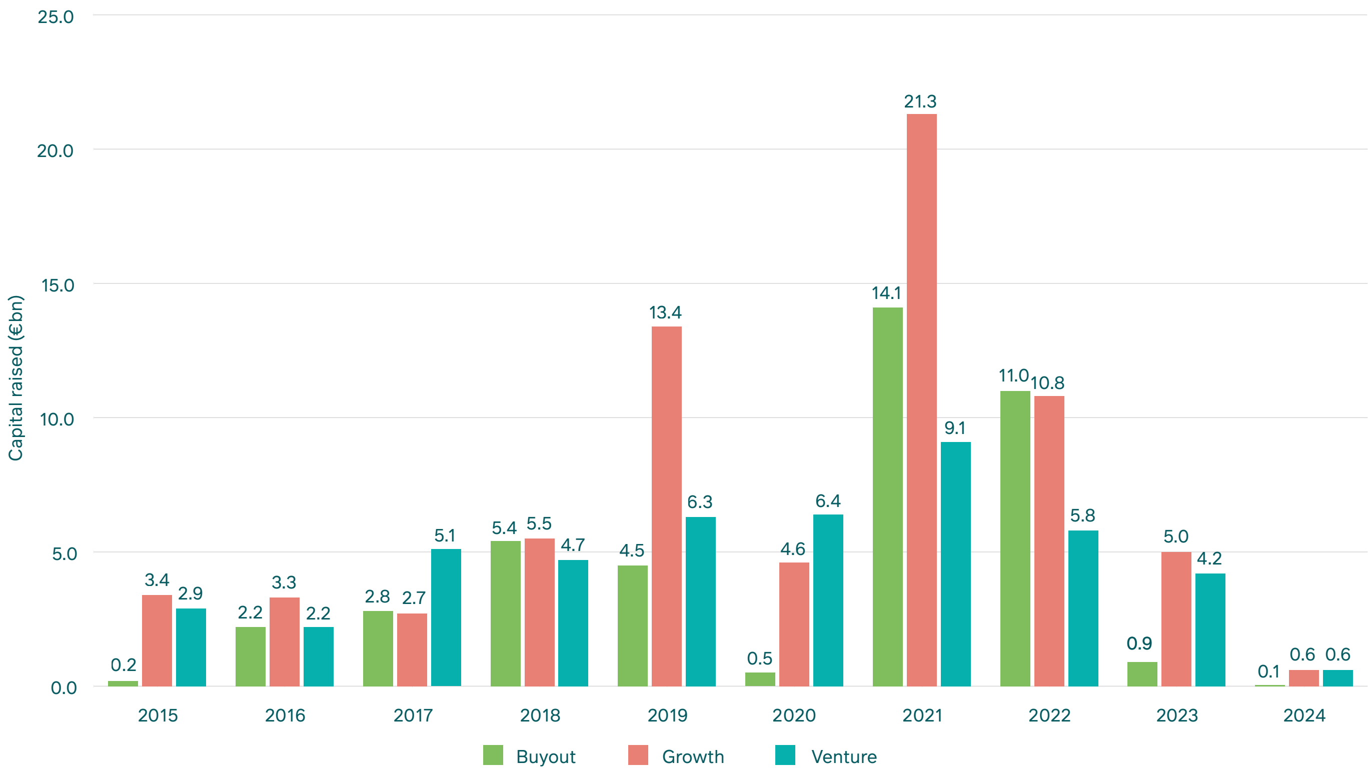
"The myth of climate exclusivity is thoroughly debunked when considering the interdependency of impact themes."

'Isn't it just another passing fad?': The myth of short-term enthusiasm

Until 2022, both the number of growth equity impact funds launched and capital raised had been steadily rising. However, mirroring the wider trend in private equity overall, since that point the number of new fund launches has retreated to an almost 10-year low, although in 2024 for the first time, new growth impact fund launches surpassed even venture capital[11]. As a disclaimer, it is probably prudent not to take a single year as evidence of a new norm.

The story is different however, when looking at total capital raised by these funds. In seven out of the last 10 years, growth equity impact as a strategy had raised more capital than either its buyout or VC counterparts reaching a peak of 62% of all private equity capital raised in 2023[12].

Total capital raised of funds per sub-asset class



Source: Phenix Capital Group, Impact Database (2024).

[11,12] Phenix Capital Group – Impact Database, 2024.

With growth equity impact fund launches steadily increasing up until 2022 (the point at which fund launches across all private equity sub asset classes fell) and the strategy claiming top spot for capital raised surpassing both buyout and VC, it seems extremely unlikely enthusiasm for growth equity impact is a transitory trend.

> "Outside of Europe and the US, few other regions appear to have any meaningful exposure."

Recent trends reveal that institutional investors, especially pension funds, are significantly boosting their allocations to impact investment more widely, positioning themselves as prominent leaders among asset owners within the impact investing space[13]. With private equity accounting for 50% of total impact investment, and growth equity impact taking a c.50% share of that, an overall market share of 25% hardly suggests this sub-asset class is in 'over-allocation' territory.

In fact, reviewing the profile of existing impact growth investors captured in the Phenix Capital Impact Database worldwide, there is significant scope to expand its reach. In terms of number of commitments within the growth equity sub-asset class, whilst development finance institutions and fiduciary managers represent the largest investor type, foundations/endowments, family offices/wealth managers and pensions funds have relatively low representation. Coupled to that, outside of Europe and the US, few other regions appear to have any meaningful exposure[14].

Embracing the opportunity

In order to address the early to late-stage funding gap that exists, perhaps it is worthwhile to restate the benefits growth equity impact can offer to a wide range of investors. As discussed in this paper, this is a growing sub-asset class within private equity, but one which offers strong long-term growth potential and possible superior returns. As a result, it should align well with the needs of many investors.

Meeting environmental and societal objectives

For those investors with economic, social and environmental mandates, growth equity impact strategies may be a compelling option offering the opportunity to make a positive impact by solving social or environmental challenges.

As a stark reminder, achieving net zero by 2050 requires an annual investment of $3.8 trillion[15] and meeting the UN SDGs by 2030 a further $2.5 trillion per annum[16]. Neither of these targets are on track to be met. Growth equity impact investing can contribute toward achieving these aims.

Role in Defined Benefits pension scheme end-game planning

With regard to the potential benefits of making an allocation to growth equity impact, the UK defined benefit (DB) pensions market serves as a powerful example of the attractions this strategy can offer. With over 75% of UK DB benefit pension funds now in surplus[17], renewed focus has fallen upon how trustees and sponsors of these pension schemes deliver benefits to members over the long-term ie the endgame strategy. The UK government in early 2025 announced new proposals allowing employers to unlock the current c.£150 billion surplus locked within DB pension schemes. The aim is to promote UK growth and potentially enhance member benefits through allowing investment in a greater range of assets.

[13] Hand, Ulanow, Pan, Xiao, 'Sizing the Impact Investing Market 2024', October 2024.
[14] Phenix Capital Group – Impact Database, 2024.
[15] Rockerfeller Foundation, November 2022.
[16] Stanford Social Innovation Review, October 2024.
[17] PensionsAge, March 2025.

Further momentum was provided by the recent Mansion House Accord with the UK government stating it wanted to promote 'access for savers to the higher potential net returns that can arise from investment in private markets'. Specifically, the government is seeking to accelerate investment in major UK infrastructure projects and clean energy development. Already 17 of the UK's largest defined contribution (DC) workplace pension providers have committed to invest at least 10% of their default funds into private markets by 2030. Together, these initiatives are likely positive drivers for even greater interest in private markets as an investment destination.

> **"Evidence suggests this strategy can potentially offer both superior absolute and risk-adjusted investment returns."**

With this backdrop, for schemes without short to medium term liquidity needs, we believe growth equity impact becomes an interesting investment option. As covered earlier, evidence suggests this strategy can potentially offer both superior absolute and risk-adjusted investment returns, in addition to increased resilience during periods of elevated market volatility. These characteristics may prove attractive as part of a pension scheme's wider endgame strategy.

Liability management

The long-term nature of private equity investment can align well with the long-term liability profile of many pension schemes. Added to this, as private equity investments are by definition not listed on public exchanges, there is less immediate mark-to-market risk. This lack of valuation volatility is beneficial to pension funds as they neither need to maintain high liquidity levels or risk becoming forced sellers in a falling market. The long-term nature of pension funds investment horizons further aligns with growth equity impact as it allows time and patience for compelling growth investments to mature and fully deliver their return potential.

Capturing the sweet spot

Arguably investment in early to late-stage growth enterprises is the most attractive point for investors seeking to maximise potential returns. It is at this stage that companies have already emerged from the riskiest part of their development journey. They are not speculative investments but credible businesses with proven business models and likely growing revenues. They are real businesses which simply require further capital support to scale up and exploit their market potential.

This may imply an asymmetrical trade-off between risk and likely return – the business has a lower risk of failure but retains the potential for exponential growth. Sitting within an impact universe, geared to strong secular growth drivers, this becomes an even more realistic scenario.

Investing for people, planet and profit

As an investor seeking to invest for people, planet and profit, the current funding gap for early to late-stage growth businesses is a clear concern. Without adequate funding many truly transformative and innovative businesses will simply not survive their development journey. New technologies capable of providing sustainable and environmentally clean energy will not come to market. Medical diagnostics capable of early detection of disease will not exist and people will needlessly suffer. Products and services capable of spreading the world's wealth to wider society will falter and unnecessary inequalities will persist and likely widen.

But it is not just people and planet that will be the losers, those seeking profit will also. It is precisely the enterprises innovating and leading transformational change within these sectors that likely offer the greatest prospective returns. The potential for companies sitting within these areas to develop and commercially innovate through revolutionary products and services is unbounded. With the pace of technological and societal change accelerating so rapidly, the opportunity to become a market leader within these areas has never been greater.

As with private equity in general, growth equity impact investment will not be for everyone: risk tolerance, accessibility and investment horizons are investor specific. However, the need for asset managers to provide investment solutions capable of addressing this most serious of funding deficits is indisputable. Success in meeting this challenge will ensure society, the environment and investors emerge as the greatest beneficiaries.

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