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Investment insight

Impact investing across the capital structure

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- Impact investment can help to tackle major global sustainability challenges and facilitate our low-carbon future
- Investors recognise how impact investment can help them meet their investment objectives over the long term
- Opportunities to achieve real-world impact and earn attractive returns now span various asset classes. asset types and impact themes

Harnessing private capital to advance social and environmental goals

There is a growing realisation that investment decisions made today and over the next decades will transform our world in the next century and beyond. This, together with the notion that many long-term issues can be addressed through market-based solutions, has helped to redefine the role of private capital in helping to achieve major global development and sustainability priorities.

The impetus for action and implementation from the private sector has been building since the dual ratification of the Paris Climate Agreement and the 2030 Agenda for Sustainable Development – which led to the formulation of the UN Sustainable Development Goals (SDGs) in 2015. With US$6 trillion of investment needed each year, and an estimated funding gap of $2.5 trillion on average[1], meeting the 17 goals and their 169 targets, and to limit global temperature rise to well below 2 degrees Celsius (and preferably as close to 1.5 degrees as possible), requires a massive reallocation of capital.

Investors are not only acutely aware of the global challenges we face, but are more engaged and looking for avenues to put their money to work in investable solutions that offer tangible, real world impact. Every investment should have an effect in the real world but some investments are created or structured with the express intention of generating a demonstrable social or environmental impact. In this sense, 'impact investing' aims to positively impact society beyond the risk mitigation or harm avoidance focus of many ESG strategies.

Impact investing has a dual objective in that it targets measurable positive environmental or social outcomes that are valued as highly as financial returns.

Charities and philanthropy will already be familiar with the philosophy behind impact investing but they are part of a sector where social returns rank above financial ones. Charities, for instance, may have similar aims to impact investors in terms of the societal benefit, but differ in that donors will give without expecting a financial return on their donation. As charitable organisations play an important role in helping to tackle the root causes of social problems and not just plug funding gaps, there will be some cases that remain dependent on charitable donations – even as market-based solutions evolve and become increasingly scalable and inclusive.

At a glance: The global impact investing market

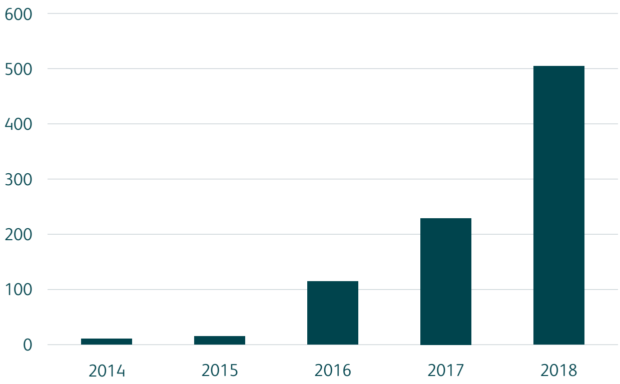
The impact investing industry has seen rapid growth in investor inflows and has been one of the fastest-growing areas of responsible investment in recent years. What was once deemed an 'emerging asset class' and niche investment strategy, impact investing has developed into a complex and diverse universe offering a myriad, differently-shaped and sized opportunities.

The Global Impact Investing Network (GIIN) Annual Impact Survey is the most comprehensive source of data on the state of the impacting investing market, although the GIIN caveats that there is subjectivity over what constitutes as an impact investment – some organisations include green or climate bonds as impact investments, others do not, for example.

[1] UNEP FI, "Rethinking impact to finance the SDGs", November 2018. Based on UNCTAD estimate.

Growth and state of the market:

Figure 1: Impact investment assets under management ($ billion)

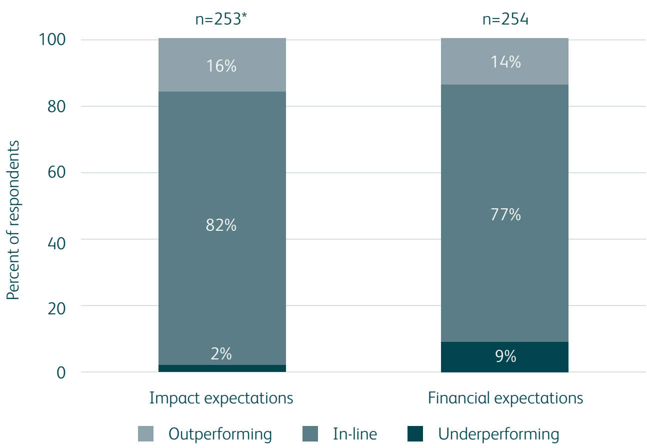


Source: GIIN, "Sizing the impact investing market", April 2019. Aside from 2018, the AUM figures in the chart are estimates taken from previous GIIN Annual Impact Surveys.

Respondents to the 2019 Annual Survey collectively manage $239 billion in impact investing assets, however the non-profit organisation has estimated the size of the full impact investment market at $502 billion as of end 2018. GIIN also found that impact investing AUM among the same survey respondents had increased by 17% (CAGR) over a four-year period between 2014 and 2018.

Investor demand also driven by return expectations:

Figure 2: Impact investment performance versus expectations

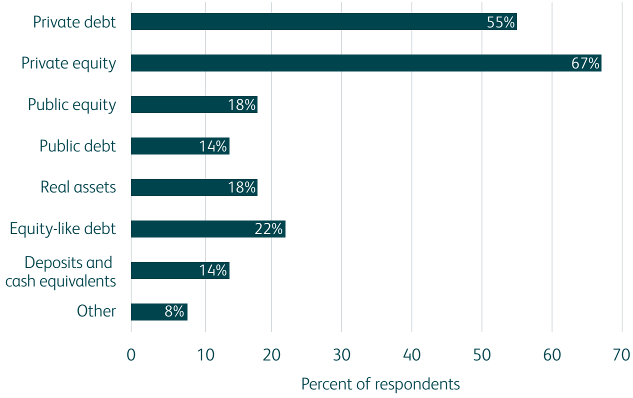


Source: GIIN, "2019 Annual Impact Investor Survey, June 2019. *Number of respondents shown above each bar; some respondents chose 'not sure' and are not included.

An overwhelming majority of survey respondents reported performance in line with or exceeding both their impact and financial expectations, with a growing number demonstrating financial and impact track records. It is worth noting that two-thirds of respondents target risk-adjusted market rate returns.

Expansion across asset classes:

Figure 3: Instrument allocations by share of respondents



Source: GIIN, "2019 Annual Impact Investor Survey, June 2019
Notes: Percent of respondents with any allocation to each instrument – excluding three outliers: n = 266; respondents may allocate to multiple instruments. 'Other' includes guarantees and pay-for-success instruments.

Impact investment is an investment practice traditionally rooted in private capital markets and most commonly practiced via private equity and private debt. These 'traditional' impact investment strategies may not be suitable for all categories of investors, however – those investing in private equity or debt funds need to make a significant size investment due to minimum investment thresholds associated with these funds – so these funds may only be accessible to those with the required capital to invest.

With the potential to generate positive net impact through the large-cap public markets, it is perhaps no surprise that impact investing has started to gain broad appeal among a wider set of investors than seen previously. Public equities now represent almost a fifth of the market, with investors allocating 17% of their capital through this asset class and 14% through public debt, according to the GIIN's 2019 Survey.

> "Impact investments can be made in several ways through a traditional model aligned with the theory of change, the concept of additionality and purpose-driven companies, to a more mainstream approach that focuses on medium and large businesses that deliver products or services to benefit society and the environment"

The Principles for Responsible Investment (PRI), "Impact investing marketing map", published 20 August 2018.

Figure 4: The impact ecosystem

		Impact investing		
			Growth	Maturity
	Philanthropy – Aid	Catalytic/patient capital	Private markets	Public markets
Example of instruments	Donations, grants	Private equity/debt	Private equity/debt	Listed equity/debt
Financial returns objectives*	No financial return	Below market returns	Market returns	Market returns
Impact orientation*	Primary focus	Primary focus	Dual focus: financial and impact	Dual focus: financial and impact
		Start-up		

Source: M&G, *generally applies but deviations can occur.

Accessing impact investment opportunities

The evolution of the impact investing industry to date has given rise to many more investment opportunities across asset classes, asset types, sectors, geographies and impact themes. There are several ways in which investors can access impact investment opportunities and generate positive social and environmental outcomes. Investors should consider the following aspects before deciding to pursue a particular impact investment approach.

Key considerations for investors:

- What are the investment priorities, impact goals and assets of the impact investment strategy (finance first; impact first), as well as the skill and experience of the asset manager?
- What does it define as impact and how do the investments achieve this?
- What comprises the universe of investable assets and does the investment approach offers sufficient scope to diversify portfolios?

We take a close look at impact investing through private debt and listed equity markets, respectively and explain why we believe these approaches are well-suited to impact investment.

Lending for impact – a private debt approach

Microfinance funds – which operate by investing in intermediaries that make small loans to individuals, usually in developing countries, often to start businesses – have been around since the early 1990s and make up the vast majority of existing private debt impact funds. These funds tend to be small and concentrated in emerging markets, and in many cases they focus primarily on the impact of the investments with financial returns a secondary consideration.

Impact initiatives in private debt, particularly the emergence of multi-sector strategies offering more attractive return levels while maintaining the positive impact, have attracted the attention of mainstream institutional investors. These strategies target a broad range of opportunities by providing direct private loans to companies, projects and organisations operating in a number of sectors, so are able to offer investors attractive returns and diversification.

Why private debt for impact investing?

- **'Pure play' investments:** Private debt includes a wide range of assets that offer sustainable outcomes, and many more 'pure play' impact opportunities than public bond markets. This is because finance is often dedicated to discrete projects rather than broad corporate loans. Private debt also involves lending to smaller companies that are more likely to be focused in a narrower range of business activities than companies that borrow in public markets, which also contributes to the greater number of pure-play impact investment opportunities in private markets
- **Wide opportunity set:** The investable universe spans a variety of asset types, maturities, risk/return profiles and debt instruments. Sourcing impact assets across a wide opportunity set and a range of impact themes can help to ensure the best possible value for underlying investors and allow for a high degree of diversification when constructing portfolios
- **A competitive financial return:** Private debt impact investments can generate attractive, stable financial returns and will often pay a premium over public bonds to compensate for their lack of secondary trading opportunities, with this extra return or yield typically referred to as an 'illiquidity premium'

- **Measurable impact:** A commitment by an investor to assess, quantify and report the social or environmental performance and progress of underlying investments is a core tenet of impact investing. The ability to get good (or at least better) metrics in private debt – due to the, often, close relationship between borrower and lender – to quantify the impact made for each individual asset is therefore an advantage
- **Management of impact and financial returns:** The direct contractual nature of a private loan creates more frequent contact between the lender and the borrower than is the case between bondholder and issuer. Lenders can take advantage of being private side in a transaction to:
  – Directly negotiate financial covenants and agree other investor protections upfront to buffer in sufficient downside protection if things were to go wrong
  – Foster close dialogue with borrowers to ensure that the expected impact is achieved over the life of the investment.

Private debt is well-suited to impact investing in many ways. Private debt markets offer access to a diverse range of investment opportunities that have a clear environmental or social outcome, including green buildings and transportation, renewables, energy efficiency, education, economic inclusion and social housing. This financing can be in the form of project finance to fund the construction of a new wind farm that generates clean electricity to help to reduce carbon dioxide (CO_2) emissions, or loans to housing associations to help them build new affordable housing developments that seek to provide a better quality of life and increased opportunities for low-income families, as well as create communities that promote social equality and cohesion among residents.

Investing in companies with strong sustainability credentials – a listed equities approach

Identifying truly impactful investments in public markets requires consideration of areas that extend beyond the financial investment case for a business. To separate impact investing from the wider universe of ESG investment approaches, there needs to be strong evidence of intentionality – ie an approach that invests in companies that have the explicit intention of addressing a range of societal and environmental issues the world is facing. In our view, companies that deliver positive impact can span a wide range of industries, end-markets and maturity of business models.

Impact financing in action:

Urbanest UK Vine Street Limited Partnership – constructing new buildings to high sustainability standards

The financing provided to Urbanest UK Vine Street Limited Partnership, the borrower, is to construct a new 'green' student accommodation building in London. The borrower's parent company, Urbanest, was established in 2008 and focuses on developing high quality student accommodation in central London. Urbanest has a property portfolio with circa 3,000 beds under management, and a 7% market share, making it the fourth-largest operator of purpose-built student accommodation in the capital.

Investment impact overview: The majority of the development's total floorspace has achieved design stage BREEAM Outstanding sustainability certification. On average, BREEAM Outstanding-rated buildings reduce energy usage and carbon emissions by an estimated 66% compared to average buildings[2].

Although we consider green buildings to be the primary impact theme for this investment, the development also delivers positive social impact through the provision of student accommodation in an area of high need.

This investment's primary impact theme of 'green buildings' is aligned with the following UN SDGs:

[2] Outstanding is the highest rating granted by BREEAM and less than 1% of new commercial buildings qualify for a BREEAM 'Outstanding' sustainability rating.

Why listed equities for impact investing?

- **Real impact, real return:** Investing in impactful companies and businesses in the real economy that create actual value for society can often lead to a virtuous circle of increasing, sustainable economic returns over the long term
- **Liquidity:** Publicly-traded markets tend to be more liquid, transparent and scalable. It is easier to trade in and out of underlying investments owing to high stock liquidity on exchanges. Investment usually takes place via structures that offer daily dealing and a high degree of liquidity risk management and oversight
- **Immediate investment:** There are no-ramp-up periods, so investors can be invested from day one. These impact strategies are available to a wider category of investors as there are no minimum investment requirements
- **Constructive engagement:** Engagement is traditionally associated with being a shareholder, since owning shares in a company typically grants voting rights. Investors also have the opportunity to have direct impact by engaging with companies to improve corporate practices that would drive positive impact and the potential of the company to achieve sustainable growth
- **Higher governance requirements:** There is typically higher expectations and regulatory oversight of governance standards for listed entities than unlisted entities.

Both sustainability and impact considerations are fundamental in determining the investment universe and assessing business models. As listed equity impact funds are generally dealing in secondary markets, and the directing or ringfencing of that funding is often not possible, the concept of additionality is considered in other ways, generally focused on understanding the additionality of the company.

What counts is the impact, right?

Impact investing through private debt and listed equities provides investors with exposure to a different set of impact opportunities each with their own risk, return and impact profile, given limited crossover between the assets and investments that comprise the investable universes. Both asset classes are well-suited to impact investing and can offer investors a number of benefits and advantages, as we have outlined. Some investors may ultimately favour investments that offer the potential to grow their capital to help them meet their particular investment goals, whereas others will be more concerned about regular income with capital preservation.

Impact investments that work towards achieving the same global goals

Whether impact investors prioritise financial return or impact, what they define as impact and how their investments achieve this varies greatly according to their impact investment strategy. The SDGs form a common framework for all investors to help tie together the different approaches to impact investing and understand how they work towards achieving the same global goals. We believe impact investing has a pivotal role to play in closing the SDG funding gap and helping to facilitate the transition to a low-carbon economy.

Equity impact in action:

SolarEdge – increasing solar energy usage

Established in 2006, SolarEdge is a global manufacturer of solar inverters, along with other solar energy solutions. As a global leader in smart energy technology, SolarEdge is driving more efficient energy consumption as inverters maximise power generation while lowering the cost of energy produced by the photovoltaic (PV) solar panel system. Improvements in energy efficiency play a significant role in taking strain off energy networks. Rapid deployment of PV systems could help solar become the largest source of low-carbon energy capacity by 2040, by which time the share of all renewables in total power generation is expected to reach 40%.

SolarEdge contributes most clearly to the following UN SDGs:

Figure 5: The global goals: A shared lexicon for impact investors

Source: UN.

Using the SDG framework to demonstrate real world impact

While the 17 SDGs and their respective targets have not been designed as a framework for investment in the first instance, impact investors have found that using the SDG framework to develop their own taxonomies (aimed at grouping investments according to relevant activities of a company or project) can help articulate and clarify how their impact investments work towards achieving global development and sustainability priorities. In this sense, the SDGs provides a shared lexicon for all impact investors when communicating the impact of their investments to clients.

Investors may map impact investments against the SDGs differently depending on how they outline and define their impact universe, for example by focusing on making clear, tangible links there may be several types of investments that map to one or more the SDG targets. It is also possible to create specific impact targets focused on key investible impact areas, which can also be mapped against the SDGs. Although clear alignment with the SDGs relies on having a robust framework and thorough selection process in place to measure and report the social or environmental outcomes of each investment, in addition to typical financial performance metrics.

Scaling up impact investing (and increasing its effectiveness)

Investors' appetite for impact investing has been estimated at $26 trillion according to the recent report, 'Creating Impact: The Promise of Impact Investing', from the International Finance Corporation (IFC). As the IFC notes in their report, "Turning this appetite into actual investments will depend on the creation of investment opportunities and investment vehicles that enable investors to pursue impact and financial returns in ways that are sustainable."

The current impact investment market offers a ready supply of diverse and viable opportunities to tackle the world's most pressing social and environmental issues. It is also a market that is evolving and becoming increasingly scalable and inclusive to a wider set of investors. As the industry scales up to reach the point of critical mass, advocates of impact investing have refocused their energies on maintaining credibility and integrity within the industry. To illustrate, the GIIN recently developed the 'Core characteristics of impact investing' to define what constitutes as credible impact investing and establish the baseline expectations for impact investing (please see overleaf):

GIIN: The core characteristics of impact investing

Intentionality – Impact investing is marked by an intentional desire to contribute to measurable social or environmental benefit. Impact investors aim to solve problems and address opportunities. This is at the heart of what differentiates impact investing from other investment approaches which may incorporate impact considerations.

Evidence-based investment design – Investments cannot be designed on hunches, and impact investing needs to use evidence and data where available to drive intelligent investment design that will be useful in contributing to social and environmental benefits.

Impact management – Impact investing comes with a specific intention and necessitates that investments be managed towards that intention. This includes having feedback loops in place and communicating performance information to support others in the investment chain to manage towards impact.

Contribution to industry growth – Investors with credible impact investing practices use shared industry terms, conventions, and indicators for describing their impact strategies, goals, and performance. They also share learnings where possible to enable others to learn from their experience as to what actually contributes to social and environmental benefit.

Source: GIIN.

GIIN GLOBAL IMPACT INVESTING NETWORK

M&G Investments is a member of the Global Impact Investing Network (GIIN). Our membership signifies a commitment to deepening our engagement in the impact investing industry.