Lending for impact

The case for impact investing in private debt

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- Impact investing continues to play a pivotal role in channelling private capital towards projects and companies that can help to address key social and environmental challenges.
- We believe private debt is particularly well-suited to impact investing, and could offer investors access to a diverse array of assets with the potential to generate intentional and measurable impact alongside a financial return.
- There could be huge opportunities to target real-world impact as calls to action on climate and sustainability intensify.

The impetus for impact

The conversation around environmental, social and governance (ESG) and sustainable investment practices has shifted dramatically over recent years. Part of this is due to increased attention from the wider investment community, led by institutional investors and large asset owners, given the growing desire of investors to align their investments with their long-term goals and values. Investors are also more engaged and looking for avenues to put their money to work in investable solutions that offer tangible, real world impact.

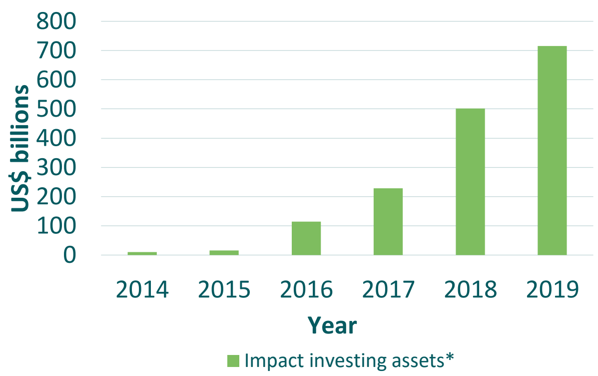
There are also strong policy and regulatory forces at play, especially in Europe, as officials attempt to both propel sustainable business, investment and capital markets forward, and provide structure with new rules, standards and frameworks designed to prevent 'greenwashing'.

While not itself impact investing, policy that facilitates the practices of ESG, responsible, and sustainable investing can also create pathways to impact investing. There is an urgent need to address key social and environmental challenges that the world is facing from climate change, pollution and biodiversity loss, to poverty, inequality and poor health outcomes – not least given the renewed emphasis in response to the pandemic. We believe impact investing has been, and will continue to be, pivotal in channelling private capital towards projects and companies that can help to address these key challenges.

Sizing the impact investment market

The Global Impact Investing Network (GIIN), a non-profit industry organisation, estimates that the global impact investment market was worth US$715 billion at the end of 2019.[1]

Figure 1: Estimated size of the global impact investment market



Source: GIIN, "2020 Annual Impact Investor Survey", June 2020. *Impact investing assets shown in the chart are estimates taken from previous GIIN Annual Impact Investor Surveys.

There has been incredible growth in the market in recent years, and what was once deemed a niche investment strategy, has developed into a complex and diverse universe offering myriad, differently-shaped and sized opportunities to a wider set of investors than seen previously.

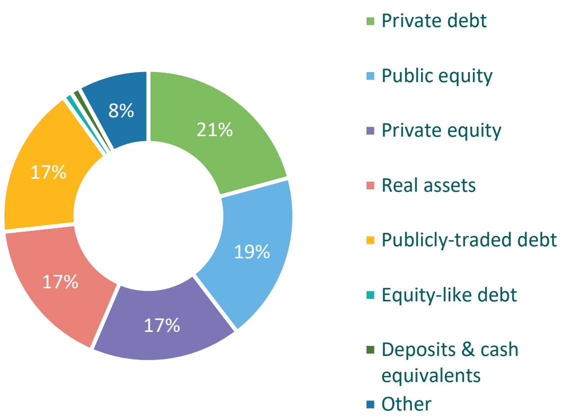
Impact investment is an investment practice traditionally rooted in private markets and most commonly utilised via private equity and private debt. Although these 'traditional' impact investment strategies may not be suitable for all categories of investors. Those investing in private equity or debt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

[1] GIIN, "2020 Annual Impact Investor Survey", June 2020. Survey respondents, an important sub-set of the market, collectively managed US$404 billion in impact investing assets at the end of 2019.

Lending for impact – A private debt approach

The case for using private debt to build impact investment portfolios has gained ground over recent years. Private debt is actually the largest contributing asset class, accounting for over a third of total impact AUM (including outliers) according to the GIIN Survey. Excluding outliers[2], private debt accounts for over a fifth of respondent impact AUM, followed by public equity:

Figure 2: Asset allocations by asset class (% of AUM)



Source: GIIN, "2020 Annual Impact Investor Survey", June 2020. Notes: % of AUM excl. outliers; n = 289; AUM = US$221 billion. 'Other' includes guarantees, mezzanine financing, and social outcomes contracts.

Historically, that capital has been targeted at microfinance funds – which operate by investing in intermediaries that make small loans to individuals, usually in developing countries, often to start businesses – and have been around since the early 1990s. However, there has been an emergence of multi-focus strategies offering more attractive risk-adjusted return levels while maintaining the positive impact in recent years, attracting the attention of mainstream institutional investors.

These multi-sector private debt impact strategies tend to target a broad range of opportunities by providing direct private loans to companies, projects and organisations operating in a number of diverse sectors, so are able to offer investors potentially attractive financial returns and diversification, while also generating a positive environmental or social impact.

Private loans can take many forms, including project or development finance to fund the construction of a new offshore wind farm that generates clean, renewable electricity to help to reduce harmful carbon dioxide (CO_2) emissions, loans to housing associations and registered social landlords to help them build new affordable housing developments that seek to provide a better quality of life and increased opportunities for low-income families, or debt issued to finance the construction of new mental healthcare facilities offering specialist inpatient care to people in underserved communities.

Private debt impact opportunity set

By drawing on the broad private debt universe in areas, such as renewable energy generation, energy-efficiency and green buildings or financial inclusion, health and social services, and affordable or social housing, it's possible to build a diversified impact investment portfolio that targets a range of positive outcomes and yet remain selective about which assets make it into a portfolio.

The UN Sustainable Development Goals (SDGs) have become a shared lexicon for impact investors to articulate how the impact of investments could deliver against the Global Goals. When mapping impact opportunities to the SDGs, we focus on making clear, tangible links.

Figure 3: Broad range of impact opportunities in private debt that could deliver against the Global Goals

Source: M&G Investments.

Why private debt for impact investing?

We believe private debt is well-suited to impact investing in many ways. The core focus tends to be on privately-negotiating transactions, analysing and managing risk through close relationships with borrowers to protect the value of investments for underlying investors, as well as an ability to offer bespoke lending structures to fit the nature and stage of the investment opportunity.

[2] GIIN refers to 'outliers' as those respondents to its Annual Survey that manage comparatively large impact investing portfolios.

We have outlined some other key reasons why we believe the asset class is a particularly good fit for an impact investment approach:

- **'Pure play' investments:** Private debt includes a wide range of assets that offer sustainable outcomes, and many more 'pure play' impact opportunities compared to public bond markets. This is because the finance is often dedicated to discrete projects, rather than broad corporate loans where there is typically no specified 'use of proceeds', for example this could be finance to construct new social or affordable homes, hospitals, university facilities, green 'environmentally-sustainable buildings, or wind farms. 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 we believe also contributes to the greater number of pure-play impact investment opportunities in private markets.

- **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. Private debt transactions are often bilateral or involve a small number of lenders, which means there is usually a close relationship between borrower and lender. This closer nexus enables private lenders to source the most relevant and useful impact metrics and data from borrowers and issuers through the life of the investment. Also, since private debt often finances discrete projects or smaller companies, it is normally more straightforward to identify and measure the positive impact from an investment, compared to investments in large public companies.

- **Management of impact and financial outcomes:** 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:

    - *Bespoke structuring* – Directly negotiate financial covenants and agree other investor protections upfront when structuring an investment to buffer in sufficient downside protection and help mitigate against the risk of capital loss.
    - *Engagement potential* – Foster close dialogue with borrowers to ensure that the expected impact is achieved over the life of the investment.

- **Access to a wide opportunity set:** Private debt markets can provide access to a broad and diverse opportunity set spanning multiple impact themes, sectors, asset types, maturities, risk/return profiles and debt instruments and structures.

Building private debt impact portfolios

There are several factors specific to impact investment in private and illiquid debt that we believe investors should take into consideration:

Asset sourcing and origination: The time and resources required to build a portfolio of private and illiquid impact assets should not be underestimated. It can take several months of analysis, structuring and negotiation, to complete a single transaction, so fully building a diversified portfolio of such assets will take some time. It can also require significant resource and expertise in a range of fields, to take advantage of the full breadth of opportunities across the private debt spectrum.

Illiquidity: Although private debt impact assets tend to be largely uncorrelated to public markets, there is typically no active secondary market so it may not be easy to trade in and out of investments. Private debt impact assets could pay a premium over similar-rated public assets to compensate for their lack of secondary trading opportunities, with this extra return or yield typically referred to as an 'illiquidity premium'.

Since bespoke private assets are often held to maturity, they require careful analysis, structuring/documentation and monitoring to ensure both high credit quality and expected positive impact generation are sustained throughout the life of the investment. For instance, this could be done by structuring the investment to offer credit enhancement to senior lenders in a transaction where there are significant equity contributions in the capital structure. Also, embedding certain impact considerations and performance requirements within loan documentation – as a minimum. Ongoing monitoring of investments can also help to ensure that investments remain on track to deliver their expected impact and financial returns.

Relative value: Value creation is an integral part of impact investing, therefore we believe it is important to not overpay for positive impact and ensure that the investment delivers a good level of financial return for the risk taken.

Impact measurement and management

The onus is on the lender to perform the due diligence needed to ensure the most impactful projects or companies receive the necessary and most appropriate financing to support their activities and growth.

Assessing and quantifying the impact of a project or company and identifying the key impact metrics is integral to our analysis and due diligence prior to making an investment. We assess an impact investment as we would any other asset in the private debt universe, with rigorous and detailed credit analysis and making investment decisions on a relative value basis. The only difference is that we carry out an impact assessment at the same time, using criteria we have developed in conjunction with a leading sustainability advisor.

Identifying broader impact

There also may be some investments that deliver multiple positive benefits to society where the borrower is engaged in activities that have various environmental and social benefits, such as improving the energy and resource efficiency of buildings and providing employment in an area of need.

We believe it is important to look at other factors when making impact investments in certain sectors, such as social housing. While in most cases, financing is specifically earmarked for the development, improvement or maintenance of social homes, we also consider how investments could support community development and foster social cohesion beyond the provision of housing. This could be the ability of registered social landlords or housing associations to find employment for residents through training, apprenticeship and employment programmes, or providing extra care schemes for older people and those with disabilities as well as healthcare services and financial planning assistance.

Lending that promotes sustainable, resilient and inclusive societies

It seems now, more than ever, impact investment is urgently needed to address the world's most pressing social and environmental needs and challenges. What's more, we believe impact investing offers a huge and scalable investment opportunity for institutional investors looking to generate real-world impact from their investments – that is both intentional and measurable – in addition to potentially receiving a competitive financial return.

Private debt is an asset class that is well-suited to an impact investment allocation for a variety of reasons in our view, and offers investors access to a broad and diverse array of impact assets that aim to achieve attractive levels of income and have a positive social and/or environmental impact.

A pivotal moment?

Here, we highlight some of the biggest themes that are helping to build momentum around ESG, sustainable and impact investing, and have the potential to galvanise the impact investment industry in the years to come:

Decade of Action and Build Back Better

With less than 10 years to go, the clock is ticking on delivering on the UN's 2030 Agenda and meeting the 17 SDGs, which codify the world's most pressing sustainability issues. As it stands, the Global Goals are far from being met.

The UN Commission on Trade and Development (UNCTAD) has estimated that to achieve the UN SDGs by 2030 will require US$6 trillion of investment each year[3]. Taking into account the SDG financial flows coming from public and private sources each year, this leaves an estimated median annual funding gap of US$2.5 trillion, on average, to fill. In turn, the SDGs are expected to create significant investment opportunities. It's been estimated that achieving the SDGs in just four areas – food and agriculture, cities, energy and materials, and health and wellbeing – could create US$12 trillion of new market opportunities by 2030[4].

The impact of the Covid-19 pandemic on progress made towards achieving the 2030 Agenda cannot be overstated, and it is increasingly clear that the pandemic has emphasised and exacerbated long-standing disparities throughout society. The UN has called on governments to seize the opportunity to create a shared vision and "build back better" during this Decade of Action as nations look to rebuild their economies and generate jobs.

As the world continues to grapple with the effects of the pandemic, stimulus packages and budgets announced so far in 2021 show early promise that many governments are heeding to this universal call to action. But what about the private sector? With the resources of governments, policymakers, international agencies and the third sector constrained, it has become imperative for the private sector to step up. We believe impact investing can play a central role in supporting a green, sustainable and fair recovery for current and future generations.

[3] UNEP FI, "Rethinking Impact to Finance the SDGs", November 2018.

[4] UNDP, "More than philanthropy: SDGs are a $12 trillion opportunity for the private sector", 25 Aug 2017.

The climate challenge – make or break?

The key long-term challenge for many economies nevertheless remains the evolving threat of climate change. With the EU and many others stepping up their action plans and agreeing to updated emissions-reduction targets as outlined in the Paris Agreement on climate change, and with a host of companies detailing their transition plans, there is no shortage of ambitious climate commitments on the table.

Beyond the rhetoric, confronting the climate challenge demands determined and meaningful action, and significant investment from a range of public and private actors to support the global decarbonisation effort. According to a recent report from Climate Action 100+, an investor initiative set up to ensure the world's largest corporate GHG emitters act on climate change, "only a handful of the 159 companies responsible for more than 80% of global industrial emissions have set adequate targets", as cited in an article by the Financial Times[5].

Much like the practices of ESG, responsible and sustainable investing, climate has also become a key theme in impact investing as impact investors increasingly recognise that substantial capital flows are needed to address the climate crisis.

> "Over two-thirds of respondents (68%) state they address climate change through their impact investments."
>
> **GIIN 2020 Annual Impact Investor Survey**

Transitioning to a low carbon 'green' economy creates significant investment opportunities, but presents an enormous challenge given the massive reallocation of capital required to align with global net-zero targets. As the IEA's 2020 Energy Technology Perspectives report remarks, "The clean energy technologies we will need tomorrow hinge on innovation today."[6] What's also needed to make a real difference is scale.

The very nature of impact investment, given its role in mobilising capital towards investments that target positive impact, can help to tackle climate change along with other key environmental challenges including pollution, waste management and biodiversity loss. Investing in renewable energy generation or energy efficiency, for instance is a good way to have impact – given the vast majority of global CO_2 emissions come from the energy sector – but the range of potentially investable impact solutions that can address climate change (mitigation, adaptation, resilience) is varied and evolving, spanning multiple sectors and industries.

As calls to turn rhetoric into action intensify, the need for innovative and robust investment solutions that deliver tangible impact will only grow, in our view.

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[5] Financial Times, "Powerful investor group finds net zero pledges distant and hollow", 22 March 2021.

[6] IEA, "Energy Technology Perspectives 2020, Flagship report — September 2020".

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