Hamilton Lane Research

# IMPACT INVESTING IN THE PRIVATE MARKETS: CONSIDERATIONS FROM AN LP PERSPECTIVE

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For the private markets, 2018 was marked by some record highs in terms of fundraising and deal flow, some worrisome trends in the way of compressed outperformance versus the public markets, as well as some welcome developments – such as LPs increasingly investing in their own infrastructure. (High fives all around on that front!) Generally, the markets performed well once again, and investors remain positive on the industry overall, with most planning to maintain or increase their allocations as shown in our 2018/2019 Private Markets Survey.

A logical question, then, becomes where specifically do LPs plan to direct their increased allocations – to new strategies, managers, geographies? While there's no one single answer to that question, we are seeing pockets of interest that we believe are worth discussion and examination – and one such area is impact investing. It is a rare conversation with an LP today that does not touch on impact investing at some level, ranging from "What is impact?" to "What impact strategies are best positioned for success?" Undeniably, impact as a strategy has gained a significant amount of traction over the past several years as preferences and priorities have evolved, and investors increasingly are seeking to identify investments capable of delivering social benefits in addition to expected financial returns.

## The Draw

Over the last few years, the notion of "making an impact" has grown in favor not just in the investment world, but also among consumers. According to a recent CONE Communications study[1], 87% of Americans would purchase a brand/product because that company advocates for social or environmental issues. Another study from Morgan Stanley[2] found that 86 percent of millennials (who comprise a large and increasingly influential demographic of consumers and business decision makers) indicated an interest in socially responsible investing. And in turn, changing consumer preferences have sparked the establishment of ranking systems such as "Just Companies[3]" that allow consumers and investors to make decisions based on corporate behavior and governance. The unique value proposition of using capital to make a positive difference in the world has sparked interest from all corners.

In private markets investing, the value proposition of impact is particularly well positioned given the control nature of the investment coupled with the longer time horizon, which can allow managers to drive and influence change in their portfolio company investments. We've observed that the level of interest in impact investing varies from LP to LP – some already have a well-developed impact or ESG portfolio and are looking to add to their exposure, while others are new to the space and are seeking guidance on how best to build a program. In either case, these LPs are taking action – a 2018 Global Impact Investing Network survey[4] reported there is now $228.1 billion in impact assets under management, up from $114 billion the year before. A report last year from The Forum for Sustainable and Responsible Investment[5] found that investors in the U.S. had nearly $12 trillion in sustainable, responsible and impact investments. That figure grew at a 38% compound annualized rate between 2016 and 2018, which is more than twice the rate of U.S. investments overall. And the opportunities for deploying impact capital are vast and numerous, with the aim of addressing some of the world's largest societal and environmental challenges.

## Metrics and Measurement

For many investors, broad-based guidelines are setting the framework (and a bit of a standard for the industry) for their portfolio development. The most significant, and oft-quoted of these guidelines is the United Nations Sustainable Development Goals ("UN SDGs" or "Global Goals"), the 17 interconnected goals set as part of the UN SDG's 2030 Agenda[6] for a better, more sustainable world. Beyond these, many other sets of guidelines exist that may appeal to investors with specific religious, ethical or moral agendas. Some examples are the Bishop's Socially Responsible Investment Guidelines[7], which some faith-based organizations have adopted, an organization called the Principles for Responsible Investment[8] (of which Hamilton Lane is a long-time member) and The Forum for Sustainable and Responsible Investment[9] (US SIF).

These sets of guidelines often share common goals that help define the target "impact":

- Protecting the environment;
- Supporting clean energy and water;
- Fostering economic justice; and
- Providing education and healthcare in order to promote human dignity.

Additionally, there are, of course, core missions and objectives that drive individual organizations' impact strategies. It is not uncommon to see a company focus specifically on areas such as healthcare, education or financial inclusion. This is evidenced by the rise of "Place-Based" investment strategies wherein organizations combine both their highest-priority sustainability goals with investment into targeted geographies.

Much like the SDGs, which provide the framework for investors, the Sustainability Accounting Standards Board ("SASB") developed a "Materiality Map[10]" to guide investors' assessment of the financial impacts of sustainability as a way to add further structure for investment decision-making.

## Expanding Options; Increasing Complexity

As the interest and sophistication in impact has grown, so too has the opportunity set available to investors, which continues to become more diverse and expansive. In turn, the bar for measuring outputs and outcomes has been raised, and the sector is growing more complex.

For LPs, that means making choices between specialists versus generalists, where within the investment cycle to focus their exposure, as well as how to diversify across geographies and regions.

Regardless of the strategy, sector or geography, a resounding theme we hear from investors is the need for greater transparency. And while that theme is by no means new to the private markets generally, in the realm of impact investing, transparency can mean quite specific deliverables. LPs want to understand the process that GPs are undertaking to underwrite both the investment thesis, as well as the impact thesis. Further, they want to be assured of the ongoing monitoring and reporting of the impact thesis with identifiable metrics and regular measurement.

Yet, measurability is still very much a work in progress. In fact, we hear from LPs that this is one of the most challenging aspects of impact investing, because the impact being generated isn't always clear or quantifiable depending upon the types of investments being made and into what businesses and industries. As the market continues to mature, we expect that managers will improve upon transparency and be able to deliver more quantifiable metrics and results. The important strides being made in this area will add greatly to the overall approachability and, ultimately, adoption of impact investing more broadly. We continue to believe that data – and the use of technology to analyze, understand and utilize that data – will transform the private markets broadly, and impact investing specifically.

## Opportunity and Momentum

Within the private markets, the dollars being dedicated to impact represent a meaningful amount of capital invested into a significant number of companies: over $35B into 11,000 companies in 2017 alone.

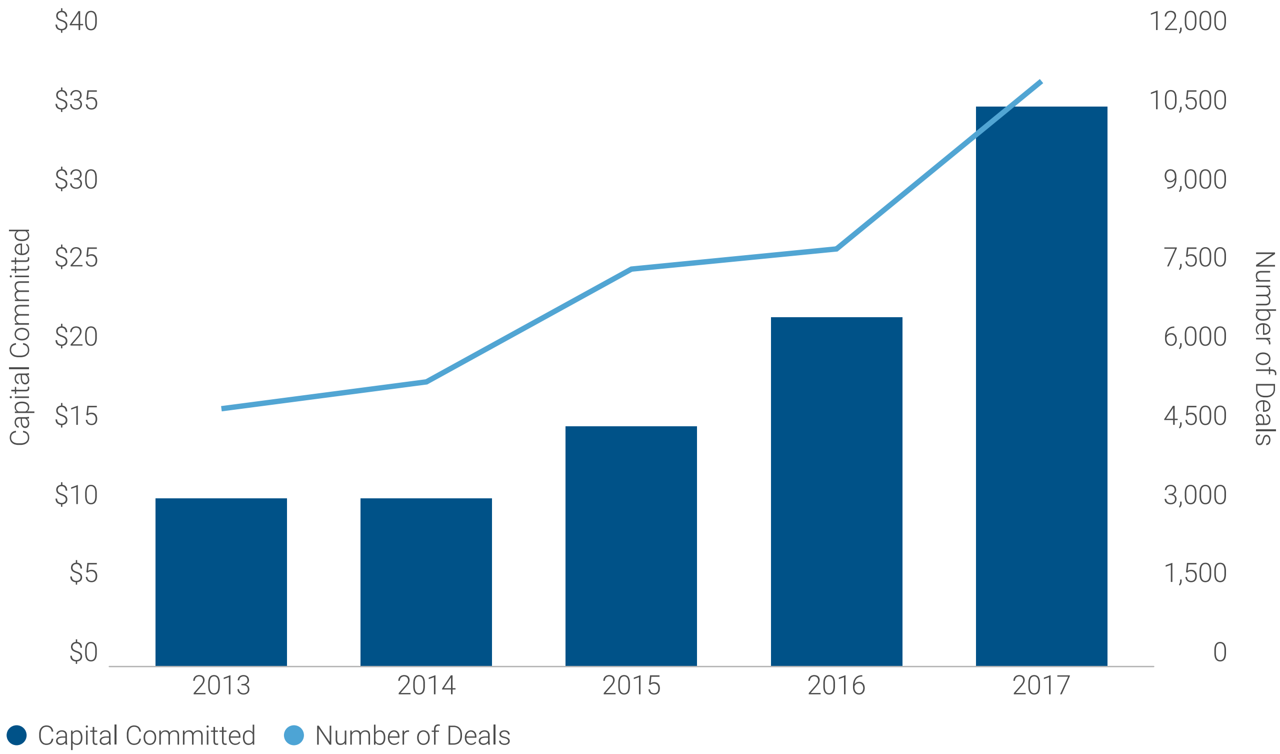
We're often asked for specific examples of what qualifies as an impact investment. While the range of investment types and strategies is quite broad, here are a few examples we've seen:

An irrigation company that brings much-needed water to arid land that creates an increased crop yield to feed a growing population and does so through the efficient use of water;

A mobile healthcare practice that brings quality healthcare to previously underserved populations;

## Capital Invested and Number of Deals in the Private Markets is Growing

USD in Billions




Source: GIIN Annual Investor Survey, 2014-2018

A geothermal electricity producer that provides an important alternative to high emission fossil fuels. Through its geothermal resources and energy-generation technologies, in addition to generating millions of MWh of electricity, this company has prevented the emission of millions of tons of carbon dioxide.

These are just a sampling, but of course there are many, many others. Our review of direct investments and fund managers suggests that there is no lack of attractive impact investment opportunities to match with institutional missions and values going forward.

As the universe of opportunities grows, we predict that the spectrum of how we look at and define impact will also increase in sophistication. In the (not too distant) future, we can envision LPs' questions shifting from "What is impact?" to "How much of my portfolio should I allocate to impact strategies?" or "What types of impact strategies are best for my organization?" And, as the outcomes of these strategies become more measureable, private markets capital will stand to represent an even larger piece of the impact investment pie.

## Endnotes

[1] Source: http://www.conecomm.com/research-blog/2017-csr-study

[2] Source: https://www.morganstanley.com/ideas/sustainable-socially-responsible-investing-millennials-drive-growth

[3] Source: https://www.forbes.com/just-companies/#3c0f9c5d2bf0

[4] Source: https://thegiin.org/research/publication/annualsurvey2018

[5] Source: https://www.ussif.org/trends

[6] Source: https://sustainabledevelopment.un.org/post2015/transformingourworld

[7] Source: https://www.catholicinvestments.com/catholic-investing/usccb-socially-responsible-guidelines/

[8] Source: https://www.unpri.org/

[9] Source: https://www.ussif.org/

[10] Source: https://www.sasb.org/standards-overview/materiality-map/

## Disclosures



**As of February 4, 2019**